DEFENSE CONTRACT AUDIT AGENCY

AUDIT REPORT NO. 3311–2004K21000007

September 17, 2004

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SUBJECT: Report on Audit of Proposal for Restore Iraqi Oil Task Order No. 7

REFERENCES: Prime Contract No. DACA63-03-D-0005, Task Order No. 7
Relevant Dates: See Page 31

CONTRACTOR: Kellogg Brown & Root Services, Inc.
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REPORT RELEASE RESTRICTIONS: See Page 32

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SUBJECT OF AUDIT

As requested by the U.S. Army Corps of Engineers (COE), on March 3, 2004, we examined the Kellogg Brown & Root Services, Inc's. (KBR) Cost-Plus-Award-Fee task order (TO) 7 proposal, dated February 18, 2004, under the Restore Iraqi Oil (RIO) contract to determine if the proposed costs are acceptable as a basis to negotiate a fair and reasonable TO price. The $325,000,000 proposal was submitted in response to the Notice to Proceed issued on December 4, 2003, and is for the import and distribution of fuel products in order to meet the domestic need for fuels for commercial and private use within Iraq. The company proposed a period of performance (POP) of 46 days or until funds are expended, which ever occurs first.

KBR's proposed costs and the proposed Turkey and Jordan costs are subject to cost and pricing data. In contrast, the proposed costs for the Kuwait supplier, Altanmia, were subject of a cost and pricing data waiver granted by the Commanding General, COE, on December 19, 2003. As requested by Mr. Gordon Sumner, Director, Directorate of Contracting, COE, Southwestern Division on August 3, 2004, we evaluated the reasonableness of the refined fuels and related transportation from Kuwait which were subject to the waiver of the requirement to submit cost or pricing data. Refer to Note 5, page 15 for additional comments regarding the waiver.

The proposal and related cost or pricing data are the responsibility of the contractor. Our responsibility is to express an opinion on the proposal based on our examination.

EXECUTIVE SUMMARY

[redacted], in an effort to meet the needs of the contracting officer, we evaluated the proposal to the extent possible under the circumstances and gathered data to support a negotiation position. Our examination of the $325,000,000 proposal disclosed [redacted] of questioned costs. Our questioned costs are primarily based on reasonableness. [redacted]

SIGNIFICANT ISSUES:

1. The results of audit are qualified because we have not received the requested technical review of the proposed number and need for tanker trucks, Liquefied Petroleum Gas (LPG) barges, quantity of fuel, and a statement there was, or was not, a sufficient supply of fuel from Turkey and Jordan to justify the need for procuring fuel from Kuwait.

2. The primary reasons for questioned material and subcontract costs are discussed below:

[redacted] Proposed costs for the fuels procured from a Kuwait supplier (Altanmia) are based on May 2003 purchase orders negotiated in a very short time frame. [redacted] We recognize the challenges faced by KBR during the early stages of the war; [redacted] We only found two instances where KBR renegotiated some of the prices. In November 2003 and January 2004, KBR negotiated some reductions to the pricing for the Kuwait fuel transportation costs. [redacted]

[redacted] We found the Defense Energy Support Center (DESC) awarded purchase orders in March 2004 to Altanmia for transportation and to KPC for unleaded fuel. We used the DESC negotiated prices as a benchmark to assess reasonableness of the proposed KBR costs and questioned [redacted]. We believe KBR should have actively pursued reducing its negotiated prices with Altanmia after the initial award in May of 2003. Refer to Note 5c (1), page 10 for further details.

b. KBR failed to use the correct purchase order change orders for the Turkey purchase orders. We have incorporated the change orders signed before the estimated POP, and questioned costs of [redacted]. Refer to Note 5c (3), page 17 for further details.

c. We question [redacted] of the proposed [redacted] "subcontractor claims" and "demurrage costs". KBR did not provide a breakout of these costs between what was proposed as "subcontractor claims" and "demurrage" costs. Based on our review of the data presented by KBR, we determined all of the demurrage costs incurred by KBR were incurred under TOs 5 and 7. During concurrent audit activity conducted by our office, we determined $1,006,958 in demurrage costs should be accounted for under TO 7. Since KBR has not been able to identify or support proposed "subcontractor claims" costs, we question these costs as they represent contingencies which "should be excluded from cost estimates" in accordance with FAR 31.205-7 (c) (2). [redacted]

d. We question the entire costs proposed for LPG tanker trucks which totals [redacted]. The contract for the LPG brought in by truck was cancelled and no deliveries were made during the POP of this TO. Since the contract was cancelled and there was no use for these trucks, we believe these costs should be excluded from the proposal.

e. We question [redacted] of proposed subcontractor DBA insurance. Although DBA insurance is a requirement resulting from the Defense Base Insurance Act, we question these costs because (i) KBR did not provide any support for amounts proposed for subcontractors, and (ii) we would expect such costs would have already been included in subcontractor estimates.

Absent any support to the contrary, it appears the proposed costs duplicate costs already included in negotiated subcontracts. Refer to Note 6, page 20 for further details.

3. As of August 31, 2004, recorded direct costs on TO 7 are less than the proposed costs by [redacted]. Specifically, KBR proposed direct costs of [redacted] while [redacted] was charged to the RIO 7 Job Cost Ledger (JCL) as of August 31, 2004. KBR's proposal does not include any recorded costs. KBR is currently analyzing the validity of all RIO transactions and expects to make significant adjustments to all RIO TOs upon completion of its analysis. Any analysis and consideration of recorded costs during negotiations should include the impact of these adjustments to ensure accuracy of the cost information. Refer to pages 4 and 5 for further details.

SCOPE OF AUDIT

Except for the qualification described below, we conducted our examination in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the examination to obtain reasonable assurance that the proposal is free of material misstatement. An examination includes:

- evaluating the contractor's internal controls, assessing control risk, and determining the extent of audit testing needed based on the control risk assessment;
- examining, on a test basis, evidence supporting the amounts and disclosures in the proposal;
- assessing the accounting principles used and significant estimates made by the contractor;
- evaluating the overall proposal presentation; and
- determining the need for technical specialist assistance.

We evaluated the proposed costs using the applicable requirements contained in the:

- Federal Acquisition Regulation (FAR);
- Defense FAR Supplement (DFARS); and
- Cost Accounting Standards (CAS).

[redacted]

[redacted]

[redacted]

The scope of our examination reflects our assessment of control risk and includes audit tests designed to provide a reasonable basis for our opinion

QUALIFICATION

On March 22, 2004, we requested a technical evaluation from the COE to determine the reasonableness of the number and need for tanker trucks and LPG barges, the quantity of fuel, and a statement if there was or was not a sufficient supply of fuel from Turkey and Jordan to justify the need for procuring fuel from Kuwait. On April 14, 2004, Mr. Vernon D. Vann, Contract Specialist, informed us a technical evaluation would not be provided to us. We consider the technical analysis to be essential for our results of audit. Accordingly, the audit results are qualified to the extent additional costs could have been questioned based on a technical evaluation.

RESULTS OF AUDIT

In our opinion, except for the qualification discussed above, the cost or pricing data submitted by the offeror are inadequate in part (see comments on Exhibit A, Notes 2, 5, and 6 respectively for labor, fuel costs related to Jordan and Turkey, and other direct costs, respectively). However, the inadequacies described are considered to have limited impact on the subject proposal. The other than cost or pricing data submitted by the offeror are not adequate (see comments on Exhibit A, Notes 5 related to Kuwaiti fuel and transportation costs). [redacted] in an effort to meet the needs of the contracting officer, we evaluated the proposal to the extent possible under the circumstances and gathered data to support a negotiation position. However, the technical evaluation described above is significant enough to materially impact the results of audit. Therefore, as discussed with Mr. Vann by Stephanie Casey, Auditor, on March 22, 2004, we recommended that contract price negotiations not be concluded until the results of the technical evaluation are considered by the contracting officer.

<u>Recorded Costs</u>

As of August 31, 2004, recorded direct costs on TO 7 are less than the proposed costs by [redacted]. Specifically, KBR proposed direct costs of [redacted] while [redacted] was charged to the RIO 7 JCL as of August 31, 2004. KBR's proposal does not include any recorded costs. KBR is currently analyzing the validity of all RIO transactions and expects to make significant adjustments to all RIO TOs upon completion of its analysis. Any analysis and consideration of recorded costs during negotiations should include the impact of these adjustments to ensure accuracy of the cost information.

As part of our accounting system review, KBR disclosed it was in the process of performing a detailed analysis of RIO transactions, particularly fuel related transactions. [redacted] Since KBR has not reflected all adjustments in its official books and records, we are unable to perform our review of the correcting entries. KBR plans to complete its analysis and processing the adjusting journal vouchers in the near future. Our office plans to review adjusting entries when KBR's adjustments are completed.

Proposed Costs

Our examination of the $325,000,000 proposal disclosed [redacted] in questioned costs, as summarized below.

EXHIBIT A

	Contractor's Proposal & Results of Audit Review			
Cost Element	**Proposed**	**Questioned Costs**	**Difference (Note 1)**	**Note**
Direct Costs				
Labor	[redacted]	[redacted]	[redacted]	2
Other Labor Related Cost (OLRC)	[redacted]	[redacted]	[redacted]	3
Equipment	[redacted]		[redacted]	4
Material	[redacted]	[redacted]	[redacted]	5
Subcontract	[redacted]	[redacted]	[redacted]	5
Other Direct Cost (ODC)	[redacted]	[redacted]	[redacted]	6
Subtotal of Direct Costs	[redacted]	[redacted]	[redacted]	
Indirect Costs				
Overhead	[redacted]	[redacted]	[redacted]	7
Subtotal	[redacted]	[redacted]	[redacted]	
G&A	[redacted]	[redacted]	[redacted]	8
Facilities Capital Cost of Money	[redacted]		[redacted]	9
Total Costs	[redacted]	[redacted]	[redacted]	
Base Fee	[redacted]			
Award Fee	[redacted]			
Rounding	[redacted]			
Total Costs & Fee	$ 325,000,000			

Explanatory Notes

1. The amounts in this column are presented solely for the convenience of the procurement activity in developing its negotiation objective. They represent only the arithmetic difference between the amounts proposed and questioned costs. You should not consider the amounts to be audit approved or recommended amounts. DCAA does not approve or recommend prospective costs because the amounts depend partly on factors outside the realm of accounting expertise, such as opinions on technical and production matters.

2. Labor

a. Summary of Conclusions:

We questioned [redacted] of labor costs primarily due to KBR proposing area differential and danger pay in excess of Department of State Standardized Regulations (DSSR), as of January 2004. Questioned costs are summarized as follows:

	Questioned Costs
Base Pay Changes	[redacted]
Area Differential & Danger Pay	[redacted]
Computational Error	[redacted]
Total	[redacted]

b. Basis of Contractor's Cost:

Labor hour calculations for the proposed employees are based on management estimates. [redacted] In addition to basic pay, employees receive premiums such as foreign service bonus, area differential, and danger pay based on their locations. KBR proposed area differential and danger pay rates of [redacted] percent for Kuwait and between [redacted] and [redacted] percent for Jordan and Turkey. [redacted]. Labor rates used in this proposal are the actual labor rates currently being paid by KBR; [redacted]. The Home Office Support and Closeout Administrator rates are based on an average of employee rates performing jobs under these job classifications. KBR stated the rates are within the company's established salary grade range for the positions and are in line with pay rates of other employees performing like functions in support of this contract.

R&R is based on [redacted] employment agreements which states, "Employees are eligible for 14 days paid leave and travel after working 12 weeks at site."

c. Audit Evaluation:

[redacted]

We questioned [redacted] of area differential and danger pay which is in excess of the January 2004 Department of State Standardized Regulations (DSSR) for area differential and danger pay. KBR proposed [redacted] percent for area differential and danger pay for Kuwait and between [redacted] and [redacted] percent for Jordan and Turkey. According to the DSSR, as of January 2004, area differential and danger pay for Kuwait is 15 percent of employees' base pay and area differential for Turkey and Jordan is 10 percent (there is no danger pay for Turkey and Jordan). In addition, we questioned [redacted] of labor costs because the actual Closeout Administrator rate is higher, and the Home Office Support rate is lower, than the proposed rates.

In addition, we questioned [redacted] due to a computational error found on WBS 23L. KBR removed a Logistic Supervisor position it originally proposed for Jordan. However, when it removed this position, KBR only changed the proposed hours per week to zero and failed to remove the proposed employee from the columns "Head Count" and "Days". Since KBR failed to remove the proposed employee from the "Head Count" and "Days" columns, uplifts, burdens, and DBA insurance were still calculated for this employee. Since this employee never worked on the TO, we questioned the related uplifts, burdens, and DBA insurance costs.

d. Contractor's Reaction:

KBR representatives do not concur with the questioned area differential and danger pay. KBR set uplift percentages based on what it felt was needed to recruit and maintain employees for its work overseas. Also, KBR stated it should be paid the higher proposed rates instead of the DSSR rates because employees did not strictly stay in the countries where they performed most of their work as they often traveled into more dangerous countries to perform various tasks. Currently, KBR pays area differential and danger pay based on where an employee wakes up each day. In addition, KBR stated it will make the appropriate changes to the labor rates to update the proposal to the actual rates paid to employees. KBR also concurred in the questioned costs due to the computational error.

e. Auditor's Response:

DCAA maintains it position above, KBR should pay area differential and danger pay based on DSSR rates. We also concur with KBR if employees travel to more dangerous countries to work; those employees should be paid higher uplifts. However, KBR does not record on its timesheets where an employee is working. As a result, we do not have a method for determining where employees work except for where they are assigned. Therefore, we believe area differential and danger pay rates should be based on where employees are assigned to work using DSSR rates which is a valid benchmark for determining reasonableness.

3. OLRC

a. Summary of Conclusions

Since we questioned costs related to area differential and danger pay, base salary labor costs, and a computational error as shown in Note 2 above, we questioned [redacted] of associated burdens and benefits. In addition, the questioned costs reflect an upward adjustment for the use of the correct DBA insurance rate of [redacted] percent as compared to the proposed [redacted] percent. Computations will be provided upon request.

We are currently auditing burden and benefits rates and recommend, prior to finalization of negotiations, the use of the audit results or the negotiated rates, if available. In addition, as described in Note 2 [redacted] labor may need to be reclassified to [redacted] which would also require a reclassification of associated OLRC to [redacted].

b. Basis of Contractor's Cost

Other labor related costs, sometimes called burdens and benefits, consist of, payroll burdens, insurance and retirement benefits, and defense base act (DBA) insurance. Burdens and benefits are paid at rates depending on one of three companies assigned. [redacted] Personnel directly supporting the TO while based in Houston are identified as Brown & Root Services or Procurement Service Center employees. KBR proposed [redacted] percent for DBA.

c. Audit Evaluation

We compared the proposed burden and benefit rates to the FPRR dated [redacted] and took no exception. We applied the proposed rates to questioned labor costs. We also compared the proposed DBA rate of [redacted] percent to the rate its insurance company is charging of [redacted] percent and computed an upward adjustment.

d. Contractor's Reaction:

See KBR's comments provided on page 7, Note 3d above.

4. Equipment

Due to the insignificance of the individual equipment costs we did not review the proposed costs.

5. Material and Subcontract Costs
and

a. Summary of Conclusions:

We questioned [redacted] of material and subcontract costs primarily due to: [redacted]

Proposed and questioned costs are summarized as follows:

	Proposed	Questioned
Material	[redacted]	[redacted]
Subcontracts	[redacted]	[redacted]
Total	[redacted]	[redacted]

b. Basis of Contractor's Cost:

The Kuwaiti proposed fuel and transportation costs are based on seven purchase orders dated between August 2003 and November 2003. These purchase orders include the same pricing as the initial May 2003 purchase orders which were negotiated in a very short time frame. The Kuwaiti transportation costs are based on a monthly rental fee, independent of the number of trips and fuel costs are based on a unit price per liter. The proposed LPG truck transportation costs are for a contract which was not used during the POP of this TO. The Turkey proposed fuel costs are based on twelve purchase orders dated between May and December 2003. KBR issued change orders to cover this TO. The proposed Jordan subcontract costs are based on the contractual agreement between KBR and [redacted] issued October 19, 2003. KBR did not provide the basis for estimates, including calculations, for the proposed costs for subcontractor claims and demurrage.

c. Audit Evaluation:

The following is a schedule of the material and subcontract costs:

Material Costs	**Proposed**	**Questioned**	**Note**
Kuwait - Unleaded Gasoline	[redacted]		(1)
Kuwait - Kerosene	[redacted]		(1)
Kuwait - LPG	[redacted]		(1)
Other	[redacted]		(2)
Total Material Costs	[redacted]		
Subcontract Costs			
Kuwait Transportation - Unleaded Gasoline	[redacted]		(1)
Kuwait Transportation - Kerosene	[redacted]		(1)
Kuwait Transportation - LPG Truck	[redacted]	[redacted]	(1)
Kuwait Transportation - LPG Barge	[redacted]		(1)
Total Kuwait Subcontract Costs	[redacted]		
Total Kuwait Material & Subcontract Costs		[redacted]	(1)
Turkey - Unleaded Gasoline	[redacted]		(3)
Turkey - Diesel	[redacted]		(3)
Turkey - Kerosene	[redacted]		(3)
Turkey - LPG	[redacted]		(3)
Total Turkey Subcontract Costs	[redacted]	[redacted]	
Jordan - Diesel	[redacted]		(4)
Jordan - Kerosene	[redacted]		(4)
Total Jordan Subcontract Costs	[redacted]		
Subcontractor Claims & Demurrage	[redacted]	[redacted]	(5)
Other	[redacted]		(2)
Total Subcontract Costs	[redacted]		
Total for Material & Subcontract Costs	[redacted]	[redacted]	

** The break-out of the total questioned costs of [redacted] is [redacted] for material costs and [redacted] for subcontract costs. Details of these calculations will be provided during negotiations.

(1) <u>Kuwaiti Material & Subcontract Costs</u>

Proposed costs for the fuels procured from a Kuwait supplier (Altanmia) are based on May 2003 purchase orders which were negotiated in a very short time frame [redacted] We recognize the challenges faced by KBR during the early stages of the war; however, [redacted] We only found two instances where KBR renegotiated some of the prices. In November 2003 and January 2004, KBR negotiated some reductions to the pricing for the Kuwait fuel transportation costs. [redacted]

[redacted] As an alternative, to determine the reasonableness of the prices, we evaluated the consent packages KBR provided to its ACO. These consent packages included a Request for Consent from KBR and a letter from the ACO granting KBR approval to enter into or extend the contract with the subcontractor. The Request for Consent included the type of subcontract, a list of previous change orders, and the process KBR used to select the subcontracto[redacted]

[redacted] we explored alternative methods to evaluate the reasonableness of the Kuwait fuel prices. We found the DESC awarded purchase orders in March 2004 to Altanmia for transportation and to KPC for unleaded gasoline. We used the DESC negotiated prices as a benchmark to assess reasonableness of the proposed KBR costs and questioned [redacted].

The following is a schedule, showing the calculations, of the questioned costs for Kuwaiti fuel and transportation:

Contract No.	Proposed Number of Units	Proposed Unit Price (Liter)	Audit Recommended Unit Price*	Difference in Unit Price	Questioned Costs
Unleaded Fuel					
IO-JIK-PO-3129	80,459,598	[redacted]			
IO-JIK-PO-S0164 (Transportation)					
Subtotal		[redacted]	$ 0.417	[redacted]	[redacted]
Kerosene					
IO-JIK-PO-2893	65,709,038	[redacted]	$ 0.262		
IO-JIK-S0138 (Transportation)			0.111		
Subtotal		[redacted]	$ 0.373	[redacted]	[redacted]
Total Unleaded Gasoline & Kerosene Costs					[redacted]
LPG Tanker Trucks					
Total Questioned Costs					[redacted]

Audit recommended price includes fuel and transportation costs.

We questioned $[redacted] of fuel and transportation costs based on the information KBR provided and information obtained from outside sources to determine the reasonableness of the proposed prices per liter. Using DESC negotiated fuel prices as a benchmark for reasonableness as discussed below, we computed audit recommended prices per liter and questioned the difference between the proposed and our recommended prices.

[redacted] we have, as an alternative evaluation technique, compared the proposed prices to recently negotiated prices used by DESC. DESC believes its negotiated prices are reasonable and can be used beginning January 2004. However only 11 days, were proposed prior to January 2004. Since most of the POP occurred during 2004 and there is no other information available to determine reasonableness of fuel and transportation costs, we used DESC's prices as a benchmark for reasonableness for unleaded fuel and transportation costs for kerosene for the complete POP of 46 days. We took no exception to proposed kerosene fuel price per liter.

DESC has three contracts consisting of the purchase of fuel from KPC (Contract No. SP0600-04-0491), transportation services from Altanmia (Contract No. SP0600-04-D-0492), and management and oversight of the fuel operation from the Public Warehousing Company (Contract No. SP0600-04-C-5418). Below is a table summarizing the audit recommended liter prices of the fuel using prices negotiated by DESC adjusted by the Platt Pricing Index:

	Unleaded (Liter)	Reference
Weighted-Average Market Price	[redacted]	(a)
Transportation		(b)
Management & Oversight		
Total		

(a) Weighted-Average Market Price

DESC negotiated a price per liter with KPC and Altanmia in the February/March 2004 timeframe. The negotiated base fuel price varies with market prices as indexed with the Platts Pricing Index. For every half month period the pricing is based on the previous half month period. For example, the average Platts price for December 1 through 15, 2003 was $0.299 per liter for unleaded gasoline. For fuel delivered during the time period of December 21 through 31, 2003, KPC would invoice DESC $0.299 per liter. KBR stated TO 7 started December 21, 2003, in its proposal KBR proposed a POP of 46 days; therefore, we estimated a POP from December 21, 2003, through February 4, 2004, or 46 days, and used a weighted-average price per liter developed from DESC prices in accordance with the Platts Pricing Index for the POP. Using unleaded fuel as an example, we computed the weighted-average market price using the estimated POP as shown below:

Unleaded Gasoline

Period of Performance	Platts Pricing Period	No. of Days	No. of Liters Delivered	Platts	Cost
Dec. 21 - Dec. 31	Dec. 1 - Dec. 15	11	19,240,339	$ 0.299	$ 5,752,861
Jan. 1 - Jan. 15	Dec. 16 - Dec. 31	16	27,985,947	$ 0.315	8,815,573
Jan. 16 - Jan. 31	Jan. 1 - Jan. 15	15	26,236,825	$ 0.291	7,634,916
Feb. 1 - Feb. 4	Jan. 16 - Jan. 31	4	6,996,487	$ 0.319	2,231,879
Total		46	80,459,598		$ 24,435,229
	Weighted-Average Price Per Liter				**$ 0.304**

To compute the weighted-average price per liter we divided the audit recommended total cost by the total number of liters delivered.

(b) Transportation

Our recommended transportation price of $0.111 per liter is based on the current DESC subcontract with Altanmia for three round trips (turns) per month. DESC negotiated this liter price effective for contracts beginning in April 2004. We believe this basis can be used for the POP for TO 7 and KBR should have pursued lower fuel and transportation costs within a reasonable timeframe after the "urgent and compelling circumstances" it faced in May 2003. DESC believes its negotiated prices are reasonable and can be used beginning January 2004. However only 11 days, were proposed prior to January 2004. Since most of the POP occurred during 2004 and there is no other information available to determine reasonableness of transportation costs, we used DESC's prices as a benchmark for reasonableness.

[redacted]

Our review disclosed on May 4, 2003, KBR procured unleaded fuel including the subcontractor's additive factors and the fuel transportation. On May 8, 2003, the contractor rebid the transportation component for some unknown and undocumented reason(s). Thus, the Kuwaiti supplier was relieved of the transportation component. The same Kuwaiti supplier subsequently won the transportation component less than a week later. [redacted]

[redacted]

(c) Management & Oversight

DESC negotiated a contract for management and oversight to provide services to distribute the imported fuel to the Iraqi civilian populace. In computing an audit recommended price, we used the DESC contract rate as a benchmark for reasonableness.

Using the negotiated rates by DESC as a benchmark for reasonableness, we compared the proposed unleaded gasoline fuel and transportation costs to the current DESC contracts. We determined the proposed prices for unleaded gasoline and its transportation costs to be approximately [redacted] percent higher than the DESC negotiated amounts. We believe these differences in prices are unreasonable. As a result, using the DESC negotiated prices adjusted by the Platt Pricing Index as a benchmark for reasonableness; we questioned the difference between the proposed fuel prices and the DESC negotiated prices as discussed above.

Of the questioned $[redacted] fuel and transportation costs, we questioned $[redacted] of kerosene transportation costs in Kuwait. DESC has not issued a contract for kerosene fuel; therefore, we were unable to compare the reasonableness of the proposed kerosene fuel price to negotiated DESC prices. As a result, we compared the proposed kerosene fuel liter prices to other proposed fuel liter prices and took no exception. However, DESC did negotiate transportation costs at $.42 per gallon, or $0.111 per liter, for kerosene in its contract with Altanmia under Contract No. SP0600-04-D-0492. Using the DESC negotiated transportation liter price as a benchmark for reasonableness, shows the proposed kerosene prices are approximately [redacted] percent higher than the DESC negotiated amounts. We believe these differences in prices are unreasonable and have questioned transportation costs above the $0.111 liter price.

During our audit, we learned the COE waived KBR's requirement for submission of cost and pricing data on Contract No. DACA63-03-D-0005. The waiver from General Robert B. Flowers states,

> "I have hereby determined that it is in the best interest of the United States Government to waive the requirement for cost and pricing data from Kellogg Brown and Root Services regarding its award of a subcontract for gasoline to Altanmia. By the authority delegated to me as the Head of the Contracting Agency, in accordance with FAR 15.403-1(c)(4), and upon reviewing the foregoing facts, authorities and analysis, I concur with the recommendation of my Contracting Officer and grant this Request for Waiver to Kellogg Brown and Root Services to exempt KBR from providing any cost and pricing data pertaining to its subcontract with Altanmia for the purchase of fuels under Task Orders 0005, 0007, and subsequent task orders involving the purchase of fuel under DACA63-03-D-0005."

On July 29, 2004, we issued a letter to the COE Director of Contracting requesting clarification on the waiver. Specifically, we requested clarification on whether a contracting officer determination had been made the costs proposed and incurred by KBR for Altanmia refined fuels and transportation are fair and reasonable. On August 3, 2004, COE Director of Contracting responded a DCAA audit was needed to assist in determining if KBR's proposed prices for Altanmia are fair and reasonable.

Our reading of the waiver does not relieve KBR of its responsibility to conduct a price analysis of the proposed Altanmia subcontract prices to demonstrate the reasonableness of the proposed subcontract prices. FAR 15.404-1(a)(2) states, "Price analysis shall be used when cost or pricing data are not required." FAR 15.404-3(b), Subcontract Pricing Considerations, states, "The prime contractor or subcontractor shall...Conduct appropriate cost or price analysis to establish reasonableness of the proposed subcontract prices." Despite the waiver granted by the COE, KBR states the fuel and transportation procurement is competitively priced. [redacted] Our review of the documentation provided by KBR disclosed it had obtained vendor quotes on May 4, 2003, from three firms, with Altanmia being the lowest bidder. This information was communicated to the contracting officer who requested the Kuwait Oil Minister approve Altanmia as the subcontractor to provide fuel to Iraq. [redacted]

Additionally, in early May 2003, during a period of a few days, KBR obtained three supplier quotes and awarded a purchase order in the amount of [redacted] to Altanmia for unleaded fuel. [redacted]. Over the next several months, KBR made additional awards to Altanmia of over [redacted] for unleaded gasoline using the May 2003 price. [redacted] FAR 15.403-1(c) states,

> (1) *Adequate price competition.* A price is based on adequate price competition if-
> (i) Two or more responsible offerors, competing independently, submit priced offers that satisfy the Government's expressed requirement and if-
> (A) Award will be made to the offeror whose proposal represents the best value (see 2.101) where price is a substantial factor in source selection; and
> (B) There is no finding that the price of the otherwise successful offeror is unreasonable. Any finding that the price is unreasonable must be supported by a statement of the facts and approved at a level above the contracting officer;
> (ii) There was a reasonable expectation, based on market research or other assessment, that two or more responsible offerors, competing independently, would submit priced offers in response to the solicitation's expressed requirement, even though only one offer is received from a responsible offeror and if-
> (A) Based on the offer received, the contracting officer can reasonably conclude that the offer was submitted with the expectation of competition, *e.g.*, circumstances indicate that-
> (1) The offeror believed that at least one other offeror was capable of submitting a meaningful offer; and
> (2) The offeror had no reason to believe that other potential offerors did not intend to submit an offer; and
> (B) The determination that the proposed price is based on adequate price competition, is reasonable, and is approved at a level above the contracting officer; or
> (iii) Price analysis clearly demonstrates that the proposed price is reasonable in comparison with current or recent prices for the same or similar items, adjusted to reflect changes in market conditions, economic conditions, quantities, or terms and conditions under contracts that resulted from adequate price competition.

[redacted]

[redacted]

We take no exception to the Kuwaiti LPG fuel and barge costs. The LPG proposed prices are based on, at the time of the purchase order, the actual Saudi Aramco government stated price plus Altanmia's stated fee. KBR prepared an estimation based on historic LPG pricing for the last two years, Altanmia's proposed price was within the relevant range of the historical prices. In addition, KBR allowed for market fluctuation in the contract price.

Additionally, we questioned [redacted] in LPG truck costs. The contract for LPG to be delivered by truck from Kuwait was not being used during the POP of this TO. Since no deliveries were made, these transportation costs should not be included in this proposal. Also, since the LPG truck transportation contract did not expire until January 2004, these costs should be settled under a termination claim, if applicable, and not submitted in a proposal.

In summary, in our opinion, KBR should have actively pursued reducing the price for fuel and transportation within a reasonable timeframe after the "urgent and compelling circumstances" it faced in May 2003. As demonstrated by DESC, reasonable prices could be negotiated with Altanmia and KPC for transportation and fuel [redacted]

(2) Other Costs

We did not audit these costs due to immateriality.

(3) Turkey Subcontract Costs

Below is a summary of the questioned costs related to the Turkey fuel costs.

Contract No.	Proposed Liters/Metric Tons	Proposed Unit Price Liter/Metric Ton	Audit Recommended Unit Price Liter/Metric Ton	Difference in Unit Price	Questioned Costs
Unleaded Fuel					
GU64-TURIO-S0005	27,045,855	[redacted]	[redacted]	[redacted]	[redacted]
GU64-TURIO-S0006*	63,288,048	[redacted]	[redacted]	[redacted]	[redacted]
GU64-TURIO-S0007**	63,288,048	[redacted]	[redacted]	[redacted]	[redacted]
GU64-TURIO-S0031	17,260,119	[redacted]	[redacted]		
Subtotal					[redacted]
Diesel Fuel					
GU64-TURIO-S0006	65,169,703	[redacted]	[redacted]	[redacted]	[redacted]
GU64-TURIO-S0007	65,169,703	[redacted]	[redacted]	[redacted]	[redacted]
Subtotal					[redacted]
Kerosene					
GU64-TURIO-S0025	49,681,176	[redacted]	[redacted]		
GU64-TURIO-S0026	49,681,176	[redacted]	[redacted]	[redacted]	[redacted]
GU64-TURIO-S0027	49,681,176	[redacted]	[redacted]	[redacted]	[redacted]
GU64-TURIO-S0030	10,925,558	[redacted]	[redacted]	[redacted]	[redacted]
Subtotal					[redacted]
LPG					
GU64-TURIO-S0003	13,099	[redacted]	[redacted]		
GU64-TURIO-S0008	26,198	[redacted]	[redacted]		
GU64-TURIO-S0011	11,654	[redacted]	[redacted]		
GU64-TURIO-S0011	1,445	[redacted]	[redacted]	[redacted]	[redacted]
GU64-TURIO-S0016	3,035	[redacted]	[redacted]		
GU64-TURIO-S0016	10,064	[redacted]	[redacted]	[redacted]	[redacted]
Subtotal					[redacted]
Total Questioned Costs					[redacted]

*Contract delivered to various sites in Iraq; each site had a different delivery price ($0.327, $0.332, and $0.348) an average of $0.336.

**Contract delivered to various sites in Iraq; each site had a different delivery price ($0.314 and $0.340) an average of $0.327.

We questioned [redacted] of the Turkey fuel costs. KBR subcontracted with various Turkey vendors to deliver fuel into different parts of Iraq. It entered into Fixed-Unit-Rate and Firm-Fixed-Price contracts with these vendors. After the subcontract agreements were put into effect; the market price of the fuel increased. The Turkey subcontractors asked KBR to increase the unit price of the fuel to compensate for its losses due to the market increases. KBR agreed to pay the vendors unit prices higher than the subcontracted agreement and issued change orders to increase the subcontract unit price. KBR's proposal did not take into account all of the change orders; therefore, we adjusted its proposal to reflect these changes. KBR stated TO 7 started on December 21, 2003. In its proposal KBR proposed a POP of 46 days; therefore, we estimated a POP from December 21, 2003, through February 4, 2004, or 46 days, and only applied change orders signed before this date. We did not apply the change orders signed after the start of the estimated POP because KBR's subcontract agreements are fixed and we do not believe these prices should be retroactively changed after the POP started.

We reviewed the Turkey subcontract files and found KBR contracted with the lowest bidder for the procurement and delivery of fuels from Turkey to Iraq. We also reviewed the change orders issued which changed the unit prices of the fuel and applied the correct change orders to the proposal. Based on the estimated POP, KBR did not use the correct change orders in its proposal for the unleaded gasoline, diesel, kerosene, and LPG fuels. We did not apply the change orders signed after the start of the estimated POP because KBR's subcontract agreements are fixed and we do not believe these prices should be retroactively changed after the POP started.

(4) Jordan Subcontract Costs (Diesel & Kerosene)

We take no exception to the proposed diesel and kerosene costs for the proposed Jordan subcontracts. KBR obtained five bids and selected the lowest bidder. We reviewed the Jordan subcontract files and found KBR contracted with the lowest bidder for the procurement and delivery of fuels from Jordan to Iraq. The subcontract was a Firm-Fixed-Price contract and the price of the proposed fuel did not change in the subcontract.

(5) Subcontractor Claims & Demurrage Costs

We questioned [redacted] of the proposed [redacted] subcontractor claims and demurrage costs, KBR did not provide the basis of estimate, including calculations for these proposed costs. KBR also did not provide a breakout of these costs between what was proposed as subcontractor claims or demurrage costs. Based upon concurrent audit activity conducted by our office, we have determined all of the demurrage costs incurred by KBR were incurred under TOs 5 and 7. We received an e-mail from [redacted], KBR Government Compliance, on June 23, 2004, stating only TOs 5 and 7 received demurrage costs. He also stated of the demurrage invoices, two had not been identified with a TO. When we reviewed these invoices, we found the invoices were dated in 2003, indicating they could only be charged to TOs 5 or 7 since those were the only TOs worked on in 2003. During concurrent audit activity conducted by our office, we determined [redacted] in demurrage costs should be charged to TO 7. In addition, we believe subcontractor claim costs should not be included in a proposal. [redacted] we question these costs as they represent contingencies which "should be excluded from cost estimates" in accordance with FAR 31.205-7 (c)(2).

d. Contractor's Reaction:

KBR did not provide any comments concerning factual matters during the exit conference in regards to the Kuwaiti and Turkey fuel and transportation and the subcontractor claims and demurrage costs. However, based on discussions and correspondence received during the audit, KBR does not concur in our position for Kuwaiti fuel and transportation costs and stated it had a contract for a fixed rate and there was no reason to renegotiate fuel prices. For Turkey fuel purchases, based on prior discussions during the audit, KBR feels paying Turkish vendors for increases due to market fluctuations even when subcontract modifications were executed retroactively is acceptable because the subcontract fixed rates were lower than rates paid to the Kuwaiti subcontractor. In addition, KBR stated it is reviewing the LPG truck transportation costs to see if the costs were submitted in a claim from Altanmia or if the costs were actually incurred under TO 5. KBR finally stated it wanted to definitize the TO with all of the costs proposed in order to obtain fee for the costs it may incur in the future for subcontractor claims.

e. Auditor's Response:

We maintain our position as stated above that Kuwaiti fuel and transportation costs are unreasonable. [redacted]. For the Turkey fuel prices, the subcontracts were negotiated as fixed rate purchases without any provisions to adjust prices based on market fluctuations. In regards to proposed subcontractor claims, KBR is unable to determine their amount at this time. KBR stated the subcontractors have not supported the claim amounts and will not pay any claims which are not supported. Since KBR does not know the amounts of the claims, these costs represent a contingency and are unallowable per FAR 31.205-7 (2). Once the subcontractor submits supportable claims, KBR should submit prime contractor claims to the government to include the subcontractor claims.

6. <u>Other Direct Costs</u>

a. Summary of Conclusions:

We questioned [redacted] of ODCs due to KBR proposing subcontractor DBA insurance. KBR did not provide any support and we believe such costs would have been included in subcontractor estimates.

b. Basis of Contractor's Cost:

ODCs consist of costs for subcontractor DBA insurance, airfare and hotel costs associated with R&R, per diem costs for employees working in Kuwait, and cell phone charges.

For DBA insurance KBR stated the proposed rate of [redacted] percent is an error and the proposed rate should be [redacted] percent. KBR also proposed the same rate for its subcontractors.

c. Audit Evaluation:

We questioned [redacted] in subcontractor DBA insurance costs. Although DBA insurance is a requirement resulting from the Defense Base Insurance Act, we question these costs because (i) KBR did not provide any support for amounts proposed for subcontractors, and (ii) we would expect such costs would have already been included in subcontractor estimates. We requested support for the proposed subcontractor DBA insurance costs and KBR stated it did not have the subcontractors' insurance policies and did not provide any billings indicating the subcontractors separately billed this cost to KBR. Since the DBA insurance is a requirement of the contract and absent any support to the contrary, it appears the proposed costs duplicate costs already included in negotiated subcontracts; therefore, we removed these costs from the proposal.

d. Contractor's Reaction:

KBR concurs with our audit position.

7. <u>Overhead</u>

a. Summary of Conclusions:

We questioned overhead costs of [redacted]. Questioned costs result from rate and base differences.

b. Basis of Contractor's Cost:

The contractor's overhead is computed by applying a proposed December 5, 2003, FPRR rate [redacted] percent to total direct costs. KBR did not provide a break out of the proposed costs for 2003 and 2004.

c. Audit Evaluation:

[redacted]. We also applied the current 2004 FPRR rate to the questioned base costs to determine questioned costs due to questioned base costs. We only applied the 2004 rate to the questioned base costs due to KBR recording the bulk of the proposed costs in 2004.

Questioned costs are computed as follows:

CFY 2003	
Costs Questioned Due to Rate:	
Proposed Base	[redacted]
Questioned Overhead Rate [redacted]	[redacted]
Questioned Overhead due to Questioned Rate	[redacted]

CFY 2004	
Costs Questioned Due to Rate:	
Proposed Base	[redacted]
Questioned Overhead Rate [redacted]	[redacted]
Questioned Overhead due to Questioned Rate	[redacted]
Costs Questioned Due to Base:	
Questioned Base	[redacted]
Audit Position Overhead Rate	[redacted]
Questioned Overhead due to Questioned Base	[redacted]
Total Questioned Overhead	[redacted]

d. Contractor's Reaction:

KBR concurs the use of the December 5, 2003 FPRR should be updated to the latest agreed to position for overhead which is currently the July 29, 2004 FPRR.

8. G&A

a. Summary of Conclusions:

We questioned G&A costs of [redacted]. Questioned costs result from rate and base differences.

b. Basis of Contractor's Cost:

The contractor's G&A is computed by applying a proposed December 5, 2003, FPRR rate [redacted] percent to total direct and overhead costs. KBR did not provide a break out of the proposed costs for 2003 and 2004.

c. Audit Evaluation:

[redacted]

[redacted] We also applied the current 2004 FPRR rate to the questioned base costs to determine questioned costs due to questioned base costs. We only applied the 2004 rate to the questioned base costs due to KBR recording the bulk of the proposed costs in 2004.

Questioned costs are computed as follows:

CFY 2003	
Costs Questioned Due to Rate:	
Proposed Base	[redacted]
Questioned G&A Rate [redacted]	[redacted]
Questioned G&A due to Questioned Rate	[redacted]

CFY 2004	
Costs Questioned Due to Rate:	
Proposed Base	[redacted]
Questioned G&A Rate [redacted]	[redacted]
Questioned G&A due to Questioned Rate	[redacted]
Costs Questioned Due to Base:	
Questioned Base	[redacted]
Recommended G&A Rate	[redacted]
Questioned G&A due to Questioned Base	[redacted]
Total Questioned G&A	[redacted]

d. Contractor's Reaction:

KBR concurs the use of the December 5, 2003 FPRR should be updated to the latest agreed to position for G&A which is currently the July 29, 2004 FPRR.

9. Facilities Capital Cost of Money (FCCM)

We compared the proposed FCCM rate to the FPRR dated July 29, 2004 and took no exception. However, in questioning direct costs there are associated FCCM questioned costs; we have determined these costs to be insignificant.

Exit Conference:

We discussed factual matters concerning our findings with Brian Fee, Sr. Compliance Analyst; Mike Morrow, Contract Manager; and Susan Stoj, Government Compliance; in an exit conference held on September 16, 2004. The factual matters discussed are detailed below.

- Labor rates changed due to payroll information given to DCAA;
- [redacted]
- The contract for the LPG truck transportation was not used under this TO, therefore, these costs should not be proposed under this TO;
- Based on audit activity of this office, KBR proposed more demurrage costs than it incurred, in addition, it did not support for the proposed subcontract claims;
- KBR did not provide supporting documentation for the subcontractor DBA insurance costs;
- KBR did not use the current Turkey purchase order change orders as the basis of the proposed Turkey costs; and
- The proposal is not based on the current FPRR.

We did not provide the dollar impact of our findings. KBR concurred with labor rate changes, the labor computational error, DBA insurance, and agreed to use the latest agreed to rates. However, KBR did not agree with our questioned costs concerning area differential and danger pay and questioned fuel prices from Kuwait and Turkey. We expect the contractor to contest the area differential and danger pay costs, questioned fuel costs, and LPG truck transportation costs raised in our audit, we recommend you invite a DCAA representative to attend the negotiations conference.

CONTRACTOR ORGANIZATION AND SYSTEMS

1. Organization

[redacted] Based on the information we have, Halliburton's business is organized into two groups, the Engineering and Construction Group and the Energy Services Group (ESG). ESG includes four business segments – Drilling and Formation Evaluation, Fluids, Production Optimization, and Landmark and Other Energy Services. The Engineering and Construction Group (E&C) operates as KBR. This group provides engineering, procurement, construction, project management, facilities operation, and maintenance for oil and gas to industrial and Governmental customers.

In 2003, KBR transferred its U.S. Government contracts to Kellogg Brown & Root Services, Inc. (KBRSI), a division of KBR, and Halliburton provided a performance guarantee for the transferred contracts. KBRSI is responsible for performance of the Logistics Civil Augmentation Program (LOGCAP III), Restore Iraqi Oil (RIO) program, and Balkans support contracts. LOGCAP III, with a ceiling of [redacted] billion, provides contingency/wartime logistics support to military and civilian personnel for more than 80 locations worldwide. RIO consists of two contracts: one for the rebuilding of Iraqi oil infrastructure with a contract value of [redacted] billion and one for the restoration of southern Iraqi oil fields with a contract value of [redacted] million. The Balkans support contract provides full logistic services to U.S. troops in the Balkans region. Halliburton has provided a corporate guarantee fir the LOGCAP, RIO, and Balkans support contracts.

Halliburton revenues and personnel worldwide for prior fiscal years and projected revenues for FY 2004 are as follows:

	2004	2003	2002	2001
Total revenues (in millions)	[redacted]	$16,271	$12,572	$13,046
U.S. Government sales	[redacted]	26%	<10%	<10%
Personnel		101,000	83,000	85,000

2. Systems

a. Accounting System

[redacted]

FOR OFFICIAL USE ONLY

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

b. Estimating System

[redacted]

[redacted]

[redacted]

c. Subcontract Management System

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

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RELEVANT DATES

Request for Audit: PCO – dated and received March 3, 2004
Revised Due Date – September 17, 2004

AUDIT REPORT AUTHORIZED BY:

/s/ Gary R. Catt
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2. Under the provisions of Title 32, Code of Federal Regulations, Part 290.7(b), DCAA will refer any Freedom of Information Act requests for audit reports received to the cognizant contracting agency for determination as to releasability and a direct response to the requestor.

3. The Defense Contract Audit Agency has no objection to release of this report, at the discretion of the contracting agency, to authorized representatives of KBR.

4. Do not use the information contained in this audit report for purposes other than action on the subject of this audit without first discussing its applicability with the auditor.