DEFENSE CONTRACT AUDIT AGENCY

AUDIT REPORT NO. 3311-2004K17900055

October 8, 2004

PREPARED FOR: Procuring Contracting Officer
U.S. Army Corps of Engineers
Fort Worth District
ATTN: Contract Specialist (Vernon Vann)
819 Taylor Street, Room 2A19
Fort Worth, Texas 76102

PREPARED BY: DCAA Arlington Branch Office
Kellogg Brown & Root Suboffice
4100 Clinton Drive, Building 1, Room B53
Houston, Texas 77020-6237

Telephone No.	(713) 753-2167
FAX No.	(713) 753-2919
E-mail Address	dcaa-fao3318@dcaa.mil

SUBJECT: Report on Audit of Proposal for Restore Iraqi Oil Task Order No. 5

REFERENCES: Prime Contract No. DACA63-03-D-0005, Task Order No. 5
Relevant Dates: See Page 3

CONTRACTOR: Kellogg Brown & Root Services, Inc.
A Division of Kellogg Brown & Root, Inc.
4100 Clinton Drive
Houston, Texas 77020-6237

REPORT RELEASE RESTRICTIONS: See Page 3

CONTENTS:

SUBJECT OF AUDIT

As requested by the U.S. Army Corps of Engineers (COE), on May 14, 2004, we examined the Kellogg Brown & Root Services, Inc's. (KBR) Cost-Plus-Award-Fee task order (TO) 5 proposal, dated May 5, 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 $875,255,894 proposal was submitted in response to the Notice to Proceed issued on May 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. KBR proposed a period of performance (POP) of 229 days or until funds are expended, whichever occurs first. KBR represented the proposed costs were based on actual costs for fuel purchased from Turkey, Jordan and Kuwait.

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 to 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 also evaluated the reasonableness of the proposed costs for 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 Page 3 for additional comments regarding the waiver.

The proposal and related cost or pricing data and information other than 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

The cost or pricing data and the information other than cost or pricing data submitted by the offeror are not adequate. Our examination of the $875,255,894 proposal disclosed $108,409,622 in questioned costs and $1,255,333 in unresolved costs. We recommend contract price negotiations not be concluded until KBR provides the schedule of actual costs for the Turkey and Jordan fuel which reconciles to KBR's accounting records, and the results of the technical evaluation are considered by the contracting officer.

SIGNIFICANT ISSUES:

1. KBR represented the proposal is based on actual costs. The data provided did not reconcile to KBR's accounting records, and KBR was unable to demonstrate the proposal was based on actual costs. As discussed on page 5, in the Recorded Costs paragraph, KBR proposed direct costs of $800,765,540 while $817,899,175 was charged to the RIO 5 Job Cost Ledger (JCL) as of August 31, 2004. We requested a schedule of the actual costs for the procurement of the Turkey and Jordan fuel. In response, KBR provided a schedule of cost data, but the cost data did not reconcile to KBR's accounting records. We requested a revised schedule. To date, KBR has not provided the revised

data; see Restriction paragraph 1, page 3, for further details. With $502,932,525 proposed for Turkey fuel and $10,601,096 for Jordan fuel, we believe it is essential this requested information be provided for government review before negotiations are concluded. In addition, KBR has proposed a credit for material costs of $4,358,895 for kerosene purchased from Turkey vendors. It is illogical to have negative proposed costs for kerosene and KBR needs to explain the proposed credit. Refer to Note 5c (3), page 3 for further details.

KBR proposed $252,808,547 for unleaded gasoline and kerosene, and related transportation purchased from Kuwait vendors; however, when we requested supporting documentation for the proposed costs KBR provided spreadsheets which did not support the proposed amount. The supporting schedule reflected costs of $225,599,379, a difference of $27,209,168. Refer to Note 5c (1), page 11 for further details.

2. 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. Our audit found purchase orders and procurement files related to the Kuwait supplier did not contain data to support the reasonableness of the negotiated purchase orders. We recognize the challenges faced by KBR during the early stages of the war; however, KBR did not periodically update its purchase order files to document the reasonableness of the negotiated prices and the circumstances surrounding the purchase order awards within a reasonable period of time (e.g., 30 to 90 days after "urgent and compelling" circumstances subsided). It is not reasonable to use prices negotiated in only a few days, under extremely difficult circumstances, for the entire period of performance which extends for almost a year (229 days). Effective subcontract administration of purchase order files requires ongoing (e.g., monthly) documented reviews of the continued reasonableness of the Kuwait fuel prices and efforts to renegotiate these prices if such reviews indicated unreasonable prices. KBR's purchase order files submitted to us do not include adequate documentation to demonstrate the reasonableness of the Kuwait fuel prices over the life of the purchase orders. 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. However, KBR's purchase order files do not include documentation to demonstrate these updated transportation prices were fair and reasonable.

In the absence of adequate supporting data, we explored alternative methods to evaluate the reasonableness of the Kuwait fuel prices. We found the Defense Energy Support Center (DESC) awarded purchase orders in March 2004 to Altanmia for transportation and to Kuwait Petroleum Company (KPC) for unleaded fuel. We used the DESC negotiated prices as a benchmark to assess the reasonableness of the proposed KBR costs and questioned $62,046,284. 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) Kuwaiti Material & Subcontract Costs, page 3 for further details.

3. KBR negotiated fixed-unit-rate and firm-fixed-price subcontracts with various Turkey vendors to deliver fuel into Iraq. During the performance of the subcontracts, the market price of the fuel increased. The Turkey subcontractors asked KBR to increase the unit price of the fuel to compensate

for losses due to market increases. KBR agreed to pay the higher prices retroactively instead of the negotiated subcontract unit prices and issued change orders reflecting the higher unit prices. We do not believe it was appropriate to retroactively adjust the fuel unit prices of KBR's fixed-unit-rate and firm-fixed-price subcontracts when there are no provisions in the subcontracts to do so. We therefore questioned the retroactive application resulting in $16,826,584 of questioned cost as further described on page 3 (Turkey Unleaded and Kerosene Fuel).

4. KBR proposed Liquefied Petroleum Gas (LPG) purchased from Kuwait at $82,100 for material (fuel) costs and $27,514,833 in LPG subcontract (transportation) costs. It is illogical that it would cost $27,514,833 to deliver $82,100 in LPG fuel. Refer to note 5c (2), page 3 for further details.

5. We unresolved the proposed demurrage costs totaling $1,255,333. Concurrent audit activity is being conducted by our office to determine the validity of the proposed demurrage charges. Therefore, the results of audit are limited to the extent that completion of the audit may result in additional questioned costs. Refer to Kuwaiti LPG Fuel and Transportation Costs on page 3.

6. The results of audit are restricted because we have not received the requested technical review of the proposed number and need for tanker trucks, number of LPG barges, quantity of fuel, and a determination if there was, or was not, a sufficient supply of fuel from Turkey and Jordan to justify the need for procuring fuel from Kuwait, a higher priced source. On July 20, 2004, we requested a status on the technical report; however, the COE has not provided us a response on our request. During our evaluation of proposals for RIO TOs 7 through 10, we were told a technical report would not be provided.