DEFENSE CONTRACT AUDIT AGENCY

AUDIT REPORT NO. 3311–2005K21000025

February 25, 2005

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

REFERENCES: Prime Contract No. DACA63-03-D-0005
Relevant Dates: See Page 32

CONTRACTOR: Kellogg Brown & Root Services, Inc.
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REPORT RELEASE RESTRICTIONS: See Page 33

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SUBJECT OF AUDIT

As requested by the U.S. Army Corps of Engineers (COE), on January 25, 2005, we examined the Kellogg Brown & Root Services, Inc's. (KBR) Cost-Plus-Award-Fee revised Delivery Order (DO) 7 proposal, dated January 21, 2005, under the Restore Iraqi Oil (RIO) contract to determine if the proposed costs are acceptable as a basis to negotiate a fair and reasonable DO price. KBR proposed a period of performance (POP) from December 24, 2003 through February 6, 2004, for all fuels except for the Turkey fuels which had a POP of December 25, 2003 through February 7, 2004.

This report incorporates the second revised proposal submitted by KBR and replaces the first revised Audit Report No. 3311-2005K21000017, dated January 12, 2005, in its entirety. In KBR's revised proposal, the proposed costs can be reconciled to source documents and KBR removed proposed costs related to potential claims by its subcontractors. The $324,943,044 proposal was submitted in response to the Notice to Proceed issued on December 3, 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 updated the proposal to reflect cost incurred through the performance period for this DO. The proposal represents a $1,361,823 increase in direct costs and includes the following increases/(decreases). The increased subcontract cost represents cost transfers made to correct errors in the prior proposal. These corrections were made at the direction of the COE.

Cost Element	Increase/Decrease
Labor	$ 6,833
Other Labor Related Cost (OLRC)	(19,126)
Material	(19,728)
Subcontract	1,395,002
Other Direct Cost (ODC)	(1,158)
	$ 1,361,823

KBR's proposed costs, including Turkey costs, require submission of 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, under the initial audit of this DO, 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 14 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 proposal as submitted is not acceptable for negotiation of a fair and reasonable price. However, 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.

SIGNIFICANT ISSUES:

1. 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 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. initial purchase order issued May 2003 and Notice to Proceed on DO 7 issued December 3, 2003). 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 Kuwaiti Petroleum Company (KPC) for fuel. We used the DESC negotiated prices as a benchmark to assess reasonableness of the proposed KBR costs and questioned $25,937,257. We believe KBR should have actively pursued reducing its negotiated prices with Altanmia after the initial award of the base contract in May of 2003. Refer to Note 4c (1), page 12 for further details.

2. 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 $7,670,004 of questioned costs. Refer to Note 4c (4), page 18 for further details.

3. Proposed incurred and estimate to complete direct costs exceed recorded costs by $72,368. Specifically, KBR proposed direct costs of $298,028,401 while $297,956,033 was charged to the DO 7 Job Cost Ledger as of January 29, 2005. KBR is currently analyzing the validity of all RIO transactions and expects to make significant adjustments to all RIO DOs 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.

4. 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. We requested a technical review of the above costs under the audit of the initial DO 7 proposal and did not receive the review. Therefore, we did not request a new technical review for this revised proposal; however, we consider the technical analysis to be essential for our results of audit.