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**Presenter:** Lawrence Di Rita, Acting ASD (Public Affairs)

Thursday, December 11, 2003 6:15 p.m. EST

### Media Availability on the Kellogg Brown & Root Contract

(Participating were Under Secretary of Defense (Comptroller) Dov Zakheim; Acting Assistant Secretary of Defense for Public Affairs Lawrence Di Rita; William H. Reed, director, Defense Contract Audit Agency; and Senior Defense Officials.)

Di Rita: We will try and be quick about this, and I know some of you have different deadlines than others, so we'll be doubly quick.

What I'd like to do is just say that for the purposes of this brief anything that I say will be on the record. Dr. Zakheim will make a statement that will be on the record, and then after that in the Q&A Dr. Zakheim and this gentleman, who for your own edification is Bill Reed who is the Director of the Defense Contract Auditing Agency, will be on background.

The subject here is the contract with Kellogg, Brown, Root known as the LOGCAP contract and also RIO contract that they're responsible for in Iraq.

With no further ado, I will ask Dr. Zakheim to make a statement.

Zakheim: Thanks.

During the buildup of the Iraq war, we recognized that one of the more challenging of the tasks of the reconstruction of Iraq would be the awarding and oversight of the contracts. We wanted to be in a position to provide immediate relief and to restore basic services to the Iraqi people. We always had a firm commitment to assist the Iraqi people become self sufficient as a means of transition --

Di Rita: Can I interrupt for a second? We will provide you copies of the statement. Sorry.

Q: How about the memo? How about the executive summary of that?

Di Rita: Go ahead.

Zakheim: Restoring oil revenues has been another critical priority to ensure that Iraq could generate the funds necessary to finish reconstruction efforts.

Usually after the completion of major combat operations, normal contracting measures such as competitive procurement of goods and services are often delayed and we use sole source providers. This was necessary in Iraq in order to quickly establish basic services to the people. The provisions of the acquisition regulations allow for these types of contracts and they fall under the rubric of "urgent and

compelling circumstances” and the guidelines that attach thereto.

We recognized early in the period after combat operations in Iraq that we had to transition to normal contracting procedures, specifically full and open competition wherever possible. This was the direction we gave to the CPA, the Coalition Provisional Authority.

In May 2003 Deputy Secretary Wolfowitz assigned executive procurement authority to the Army Acquisition Corps with the instruction to transition from sole source procurement actions to full and open competition. At the same time, that is in May, I asked the Defense Contract Audit Agency, DCAA, to audit major contracts and provide assistance and advice to the CPA. I felt this was necessary in a sole-source contracting environment. I believe I briefed you before on the fact that we had created a cell in Iraq, including DCAA.

DCAA audits have found some problems that the department is addressing. We’ll brief you today on one company, Halliburton, Kellogg, Brown and Root -- KBR -- which has been a long time and essential DoD supplier of logistical support. KBR services include housing, food, transportation, training, and administrative support. The level of contract support that we requested from KBR in Iraq beginning in April of 2003 was unprecedented.

Today, Mr. Bill Reed, Director of DCAA, who by the way has been Director of DCAA for 16 years, will brief you on the contracting environment that necessitated use of sole-source contracts. He’ll also discuss the audit evaluations and events that have led to this briefing. After he’s finished, he’ll take your questions.

But before I introduce Bill, I want to add that throughout the contract audit oversight process for KBR and all other Iraq support contractors. I underline that. DCAA officials have provided documentation and kept the General Accounting Office and our own DoD Inspector General’s office informed on emerging audit issues as soon as they were identified. The department has been involved in a system of oversight to preclude duplication of scarce resources, but more importantly to send a clear statement that contractor improprieties and/or contract mischarging on department contracts will neither be condoned nor allowed to continue.

My point is that virtually all significant contracting issues to date in Iraq have been surfaced by DCAA auditors either based in Iraq, Kuwait or in the case of KBR, Houston.

Bill, over to you.

Reed: From the very early beginning of the reconstruction effort, DCAA was in contact with all the contracting organizations so we could build a universe of contract awards -- who was getting what contracts, how were they being awarded, and what were the terms of the contracts specifically as regards to contract audit.

As we built that universe we also began to ramp up our resources in country, as soon as we could, transitioned people over there. We opened an Iraq branch office and began to do as much on-site work as we could possibly do. So the work involved both on-site as well as the accounting records being maintained by the companies in their home office locations in the United States.

The largest contracts by far, two of the larger contracts, are held by KBR to date. One being the LOGCAP III contract, which is the largest contract right now of the Iraqi reconstruction effort.

Zakheim: LOGCAP, if you don’t know, is Logistical Civilian Augmentation. That’s what it stands for.

Reed: And the RIO contract.

Zakheim: Restore Iraqi Oil.

Reed: Restore Iraqi Oil. Excuse me.

Those two contracts are referred to as IDIQ contracts --

Zakheim: Indefinite Duration, Indefinite Quantity.

Reed: Thank you.

Zakheim: I'm here to translate.

Reed: I appreciate that because I do talk in jargon. (Laughter.)

Which means that they are essentially ordering agreements. Then as a requirement is identified, a task order is issued for a specific requirement. And those task orders also become auditable in the sense that they may be a cost-type order. They may require a proposal and so forth.

So we have been doing our normal contract auditing activity based on materiality of the contracts and what we consider to be the risk, since the early period of the effort there.

We have identified a number of issues on the KBR contracts, I just mentioned which we are in the process of reporting or have reported to the contracting officials responsible for those contracts, as well as to KBR. We've engaged in the process of contract resolution with KBR. Some of those actions are still ongoing. We have found some issues of serious concern that are worthy of immediate attention and we're making sure that that kind of aggressive action is taken so that we resolve these issues as expediently as possible and hopefully without interfering with the mission that's so critical.

Di Rita: With that --

Q: How much money are you talking about?

Di Rita: Let me reiterate the ground rules. Those statements were on the record. Now we'll go on background.

Q: On background is what?

Di Rita: Senior Defense Official. Anything I say can be on the record.

Senior Defense Official: There is \$15.6 billion on these two contracts. \$8.6 is the LOGCAP portion and \$7 billion is the Reconstruct Iraqi Oil.

Q: Does that mean that much has already been spent on --

Q: That's the not to exceed, though?

Senior Defense Official: That is the not to exceed.

Q: That would be put on contract --

Senior Defense Official: Right. There is approximately \$5 billion on contract.

Q: Does that mean expenses or committed?

Senior Defense Official: Committed to orders.

Q: On all contracts.

Senior Defense Official: Yes.

Q: A total of \$5 billion has been committed.

Q: What is the potential overcharge? What do they add up to?

Senior Defense Official: There are two very significant issues that are the focus of our immediate attention. One is the \$61 million issue involved in the pricing of fuel on the Reconstruct Iraqi Oil contract. We believe that KBR has not demonstrated to us that they did an adequate subcontract pricing evaluation prior to award of that particular order and as a result of that potential overpricing could be as high as \$61 million through September 30<sup>th</sup>.

We have issued a draft report to KBR, which they are in the process of responding to. When we get their response, we'll take it to the next step in the contracting process.

Q: I'm sorry, that oil is, or that gas is being sold to Iraq, being provided to the U.S. military or to contractors over there?

Senior Defense Official: This is being provided for the Iraqi people being sold by Kuwait. A company in Kuwait.

Q: At what point (Inaudible.)?

Senior Defense Official: Potentially \$61 million.

Senior Defense Official: That's the key. You've got to remember this. What they've done is identified a potential issue. They then go to the contractor. This is standard operating procedure. They then go to the contractor and say look, this is what it appears to us. Now what --

Di Rita: Why don't we get to the other big discrepancies. People may want to peel off. Then we can drill into each of them.

Senior Defense Official: But the process applies in all cases.

Senior Defense Official: Most of these task orders were initiated under letter agreement and not to exceed prices. As a step in that process they proceed with contract execution but they have a requirement, a proposal, to definitize that price within certain timeframes.

In one of the recent proposals that they submitted, they had a clear, obvious, miscommunication error where they had awarded the subcontract that was involved in their proposal prior to submitting the proposal to DCAA for audit. However, they failed to adjust the subcontract price that they submitted to us, was some \$67 million higher than the subcontract value they had already awarded.

Q: What was the service?

Senior Defense Official: This service was dining halls.

Q: So that's the potential overcharge?

Q: What?

Di Rita: Dining hall. Cafeteria services.

Senior Defense Official: But that's an issue we caught in the proposal process, which means we didn't pay that.

Q: You didn't pay that.

Senior Defense Official: We didn't pay that. We challenged that proposal, in fact we rejected that proposal as inadequate on the basis of having an egregious error like that. Then returned it to them for repricing.

Q: -- you see as a potential overcharge. \$61 million.

Senior Defense Official: That's correct.

Q: I worked with the Wall Street Journal for 17 years. I'm used to handling numbers. But that second one, you've got to walk me through it again, because I don't follow the second case here.

Senior Defense Official: I'm going to use a hypothetical number, sir.

Multiple Voices: -- TV people saying we've got enough, yeah. (Laughter.)

Senior Defense Official: They included a price in their proposal to the government to definitize the task order, they included a subcontract price of roughly \$220 million.

Q: To operate mess halls and --

Senior Defense Official: I thought it was a little lower than that.

Senior Defense Official: It's around the range of two-plus something.

We subsequently found out they had already awarded that subcontract at a price \$67 million less. Which means they made a commitment to pay \$67 million less than the price they were asking us to pay them.

Q: Who was the subcontractor?

Senior Defense Official: I don't know. I don't have that detail.

Q: An American company?

Senior Defense Official: I don't have that information.

Q: Is there any (Inaudible.) on that (Inaudible.) million --

Senior Defense Official: Let's --

Q: Let's stay on this one for a second first. As I follow this, that sounds like more than a miscommunication. That sounds like egregious price gouging. What's going on? Were they consciously asking the U.S. government to pay \$67 million more than their cost?

Senior Defense Official: KBR is suffering from having an organization that is essentially split. They've opened offices obviously in country to handle the contracting, the issuance of purchase orders and so forth. However, they're relying on their Houston office to prepare proposals and billing. I view this as a serious disconnect between their in-country people who awarded the subcontract and failed to tell the home office so they could update their proposal submission before they gave it to DCAA.

Q: (Inaudible.) the bill.

Senior Defense Official: I don't have any evidence to the contrary. But in the resolution of these findings, that's the kind of thing that we'll be looking for, or that the contracting officer will be looking for.

Q: (Inaudible.)

Senior Defense Official: That's the funded --

Q: The larger figure, \$220 million, is that itemized? Is that broken down by this much (Inaudible.), this much (Inaudible.)? Is there some basis for that figure?

Senior Defense Official: I don't have those details.

Di Rita: And your belief in the miscommunication, that's your speculation based on what you've been able to learn through the audits, is that correct?

Senior Defense Official: That's correct. We have seen a few other errors, not of the magnitude we're talking about here, but we have seen instances of miscommunication between the field people, so to speak, and the home office people.

So right now the burden is on the company to come back and provide evidence as to how that happened in their updated proposal.

We've issued what we call an estimating system report, which is criticizing their estimating procedures for not having that integration between the people issuing the purchase order and the contracts and the home office people who are preparing the proposals.

Q: My earlier question about how you got to the point where you acknowledge that perhaps \$61 million was an overprice, that number. When did you realize that and how did that realization come to you?

Senior Defense Official: The fuel obviously was a critical priority. It was a major cost item, so we were watching that from the very beginning in terms of the subcontracts that were being made. We were asked by the contracting officer to work with them monitoring this action. So it was just a normal fall-out of the kind of audit processes that we apply.

Q: Have you determined if that is overpricing (Inaudible.) normal consequence to (Inaudible.) award (Inaudible.)?

Senior Defense Official: We know there have been other fuel contracts awarded at lesser prices to a different country, and we also know that there have been comments made which we have not verified yet, that the market price of fuel is much less than what they are charging.

Q: Can you tell us what the prices were per gallon?

Senior Defense Official: The delivered price -- We're talking about unleaded fuel. Gasoline. The delivered price was \$2.27 a gallon including transportation. We're comparing it to another contract where the delivered price was \$1.18 per gallon including transportation.

Q: Coming from Kuwait also? Or is that --

Senior Defense Official: This is from Turkey.

Q: Can you tell us what, an overarching issue, do your sole-source contracts like this have a greater incidence of problems because they don't have to go through all the tests that contracts have to when they are competed in the front?

Senior Defense Official: No, I don't think I could generalize that way. I've seen issue both ways.

Q: -- might say (Inaudible.) contractor in Kuwait (Inaudible.).

Senior Defense Official: That's why we've given them the draft report. This is part of the due process. We give them what is concerning us, what appears to be a problem. We're asking them to show us the facts. Why did you do this? Why did you pay this much? How did you evaluate the price as fair and reasonable?

If they give us factual information to pursue, we will audit that information and we will adjust our final report accordingly.

Q: (Inaudible.)? Obviously you heard about it --

Senior Defense Official: No.

Di Rita: Remember, just to emphasize. On the basis of the nature of this contract, the size, all the things that Dr. Zakheim pointed out, this is something that we instituted as a regular order of business.

Senior Defense Official: Here's essentially --

Q: -- the market price. I'm wondering --

Senior Defense Official: There is correspondence in some of the files that we looked at.

Senior Defense Official: Let me just point one thing out. DCAA, this is their business. So for all contracts they have the prerogative to look in, to review, to audit. That's the kinds of questions they're asking here. The surface issues, what has surfaced here.

When we went into Iraq my feeling was that we needed to get, as soon as possible, these people out there to perform the same kinds of tasks they were performing elsewhere. And in fact DCAA operates not just in the United States but around the world.

Q: Can you explain how you handle this in the end? When you have a situation like this, normally the contractor would pay back the U.S. government. But in this case the injured party is the Iraqis who are buying fuel. How do you make restitution for that?

Senior Defense Official: KBR has the responsibility for justifying the price they're charging. If they can't justify the price they're charging, we are going to recommend to the contracting officer that he disallow this excess cost.

Di Rita: And let me really get back. It's very important, Pam, all of your terms were conclusive type terms. This is all the first step in the process.

Q: I got that, but --

Q: How much has been billed? Of the \$5 billion, give us the universe of how much has been billed that you're auditing so we get some context to whether this is episodes or problems or there's a systemic problem with millions of dollars, they've billed to date that DCAA has looked at.

Senior Defense Official: I don't have that specific number.

Q: Do you have any instance that this is more than episodes? Or is there a potential systemic problem with all the task orders they've billed to date?

Senior Defense Official: Certainly with all of the task order proposals, we are very concerned with problems in their estimating system. So we're going to look at every single one of those proposals very, very closely. So that part of it is systemic.

Q: The estimating system that all defense contractors are supposed to have in place to ensure the government that what he's proposed to you is based on solid figures?

Senior Defense Official: Correct.

Q: They don't have that in this case.

Senior Defense Official: We have identified deficiencies in their process.

Q: Does the \$61 million that they've overcharged, ultimately that money didn't go to KBR, it went to Kuwait, who is buying this at a (Inaudible.) price.

Senior Defense Official: That's correct.

Q: So who ultimately got the money that the government was overcharged for was the Kuwaiti subcontractor.

Senior Defense Official: That's right.

Q: What was the price differential between the subcontractor and the delivered price? Was that a couple of pennies? What is --

Senior Defense Official: There was no differential. KBR charged us the price their subcontractor charged them plus their normal overhead.

Di Rita: The important point, it's not money that went to the company. The taxpayer was out that much money possibly.

Q: If they were deficient in some way it was in not shopping around or negotiating a good market price for that delivered product, not in the fact that they inflated the price in order to enrich themselves.

Senior Defense Official: I think that's a fair characterization of it.

Q: Who in Kuwait is responsible for this? Whether it's a company (Inaudible.).

Senior Defense Official: All fuel is controlled by a state-owned corporation, called the Kuwaiti Petroleum Corporation. Only they are allowed to resell fuel. They authorized one company to bid on the fuel associated with the RIO contract.

Q: Public company or private? It's state-owned?

Senior Defense Official: This is not a state-owned company. They received the government's permission to be the reseller.

Q: And are you (Inaudible.)?

Senior Defense Official: Yes.

Q: And you (Inaudible.)?

Di Rita: Does the subcontractor necessarily know this yet? This is KBR, but in other words --

Senior Defense Official: We don't deal with subcontractors.

Di Rita: We don't think we can --



Senior Defense Official: I don't think it's a good idea, because if they don't know we shouldn't be --

Senior Defense Official: I think that's fair, because the due process is working. KBR has to go to this vendor.

Senior Defense Official: They have to go to the subcontractor.

Senior Defense Official: We're dealing with KBR. They are the ones who are responsible to us.

Q: What's the volume of the gasoline that's involved? Either for the total contract or for delivery?

Senior Defense Official: 56.6 million gallons.

Q: Has been delivered between the end of the war and...?

Senior Defense Official: Through September 30<sup>th</sup>. Beginning through September 30<sup>th</sup> for the reconstruction effort. This is not the military fuel.

Di Rita: And let me just, in the context. I think this is accurate and correct me if I'm wrong. The Kuwaiti government provided to the United States, to the coalition, fuel at no cost for the purposes of the campaign, the military campaign. So it's important to have that sort of backdrop as you try and drill into the elements --

Q: Do you know how much fuel they provided free?

Senior Defense Official: We can get that.

Di Rita: We can get that.

Senior Defense Official: The other thing is that at Madrid the Kuwaiti government made a huge pledge, if I recall about \$500 million, to the reconstruction of Iraq. The Kuwaiti government, as a government has pitched in, in a huge way

Di Rita: -- a significant contributor to this coalition in-kind and financial ways that are large figures. I only mention that to you as context, as you look at it. There may have been a contracting dispute with an element of it, which we will take seriously, and we should.

Q: I got here late, I apologize. You're alleging that there was a \$61 million overcharge on the 56.6 million gallons of fuel that's been --

Senior Defense Official: Potentially.

Di Rita: It's an audit finding that bears further scrutiny and that scrutiny process is in process.

Q: To be clear, KBR in neither of these instances actually pocketed the money.

Senior Defense Official: That's correct.

Q: Either the \$67 million that's in the subcontract, or the \$61 --

Di Rita: The \$67 is a billing dispute. They've not been paid. The \$61 appeared to have flowed to a subcontractor, but that's part of the process of understanding the details.

Q: If the \$61 million would be disallowed at some future point, who would eat that cost?

Senior Defense Official: KBR.

Q: And then they would --

Di Rita: They would have a suit against their subcontractor.

(Multiple voices.)

Senior Defense Official: -- their subcontractor.

Q: One of their overall numbers, Reuters says \$2 billion has been expended on the gasoline contract.

Q: The RIO contract in general, the gasoline contract, the subcontract --

Senior Defense Official: I don't have the exact numbers but that sounds --

Di Rita: Remember, \$5 billion between the LOGCAP and the RIO.

Q: I'm trying to break out the RIO.

Senior Defense Official: -- actually expended --

Q: What's the best number to use on the RIO alone?

Q: \$1.7?

Di Rita: Do you know it?

Senior Defense Official: I've got --

Senior Defense Official: I think you have --

Senior Defense Official: We have a funded number, a committed number. Hang on.

Senior Defense Official: The RIO number is \$1.567 billion.

Q: Funded?

Senior Defense Official: That's funded.

Q: That's not the maximum.

Senior Defense Official: The maximum is \$7 billion.

Q: By funded you mean expended or -- Okay.

Q: Can you go over one more time on the \$67 million why you at this point are confident that --

Di Rita: Make this the last one.

Q: -- problem being (Inaudible.) in Iraq rather than (Inaudible.) the bill?

Senior Defense Official: First of all we have seen some communication difficulties between the KBR field elements in country and their home office and we've got auditors looking at both ends and these auditors talk to each other and we see the disconnects. In different forms of communication.

This one also, I think, we should look at it from a standpoint -- You'd have to be pretty stupid to put an error like this in a proposal on purpose. It is such an obvious comparison that the auditors make. I

just would not -- My first assumption would be until it's proven otherwise this appears to be just an egregious error.

Q: We can't use it on the record. This shows that this is avarice more than stupidity.

Di Rita: No. He's saying that it wasn't --

Q: No, no. But can we use this on the record? This was a stupid mistake?

Di Rita: But we don't know that. It just appears that way. Let's just stay the way we are.

Q: Can you read any of the findings to us? We can't quote you by name, but the results -

Di Rita: -- the record.

Senior Defense Official: The rest of the draft --

Q: The company --

Senior Defense Official: It's in process, and part of the due process is the company gets to give us a rebuttal before we confirm a final conclusion.

Senior Defense Official: They could give us information, which changes this significantly.

Di Rita: That's the point.

Q: But you did say there were other things that were --

Senior Defense Official: There were other things?

Q: DCAA audits have found some problems, which the department has addressed. This isn't the only one with Halliburton. What are the other problems?

Senior Defense Official: Well you mentioned the second one --

Di Rita: You mean in other contracts? There were two that he mentioned with KBR.

Q: -- other contractors?

Senior Defense Official: This was meant to deal strictly with KBR.

Senior Defense Official: There are others, of course. They audit lots of contractors.

Q: I know you audit a bunch, but here you've said you've found problems in others too. Is that correct?

Q: Are there other problems?

Senior Defense Official: At KBR or --

Q: No. In the other reconstruction contracts.

Senior Defense Official: We have not found any major, significant cost issues in the other contracts. We have found business system issues like you need to have better support for your payroll preparation, but we couldn't find an impact. Doing, especially going out in the field and finding people, perhaps their supervision wasn't as close as it should be to verify the work was being performed. Procedural

things like that. We found a lot of that, as you might expect given the conditions. But none of those have we identified any significant cost impact.

Senior Defense Official: The problem isn't in all-encompassing terms.

Di Rita: We're going to have to wrap it up here.

Q: So of the billion-five they have in the RIO one, and the \$2 billion on the other, you basically at this point, there's \$67 billion in the subcontract --

Di Rita: Million.

Senior Defense Official: Million, million.

Q: Million. And then \$61 million in overages -- potential overages. That's basically what you've found so far against that universe of dollars.

Senior Defense Official: That is correct.

Q: Is that in your view a systemic problem with overcharging? Or is that -- This is the subcontractor.

Senior Defense Official: No, I do not think it's a systemic problem of overcharging. I think it's an example that they've got estimating deficiencies, which we are calling to their attention so that if it is a communication difficulty I spoke of, they develop better procedures to avoid that in the future. But I would not call -- Certainly the \$61 million is not systemic. It's a very unique item.

Di Rita: Thank you.

Voices: Thank you.

(Continuation of questions.)

(Multiple voices.)

Di Rita: You know how we are. Get it fast, get it right --

Senior Defense Official: -- That's on the record. Bill Reed made an oral statement, that was on the record.

Q: Can we get the Kuwait number in terms of the in-kind contribution?

Senior Defense Official: How much Kuwait actually contributed?

(Multiple voices.)

Q: -- on the record.

Q: You don't have a copy of that opening statement, do you? I apologize --

Q: can you explain more about the \$67 million? I understand --

Di Rita: -- made an oral statement on the record --

Q: I want to get his opening statement.

Di Rita: He didn't write it.

Senior Defense Official: As part of KBR's proposal they estimated to us what their subcontract costs would be. Their estimates were much higher as it turns out than the price which had already been established for that subcontract.



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