DEPARTMENT OF HOMELAND SECURITY

Office of Inspector General

Hurricane Katrina Multitier Contracts

OIG-08-81

July 2008

Office of Inspector General

U.S. Department of Homeland Security
Washington, DC 20528

Homeland Security

July 15, 2008

Preface

The Department of Homeland Security (DHS) Office of Inspector General was established by the *Homeland Security Act of 2002* (Public Law 107-296), by amendment to the *Inspector General Act of 1978*. This is one of a series of audit, inspection, and special reports prepared as part of our oversight responsibilities to promote economy, efficiency, and effectiveness within the department.

This report addresses multitier contracting issues in the aftermath of Hurricane Katrina and the potential effect of recent legislation enacted to control the excessive use of subcontractors that do not contribute substantially to the contracted work. It is based on interviews with employees and officials of relevant agencies and federal contractors, direct observations, and a review of applicable documents.

The analysis herein has been developed to the best knowledge available to our office, and has been discussed with those responsible for DHS contracting. It is our hope that this report will result in more effective, efficient, and economical operations. We express our appreciation to all of those who contributed to the preparation of this report.

Richard L. Skinner
Inspector General

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Abbreviations

DHS	Department of Homeland Security
FAR	Federal Acquisition Regulation
FEMA	Federal Emergency Management Agency
IA-TAC	Individual Assistance Technical Assistance Contract
NDAA	John Warner National Defense Authorization Act for Fiscal Year 2007
OFPP	Office of Federal Procurement Policy
OIG	Office of Inspector General
Post-Katrina Act	Post - Katrina Emergency Management Reform Act of 2006
USACE	United States Army Corps of Engineers

OIG

Department of Homeland Security
Office of Inspector General

Executive Summary

We initiated this audit in response to Congressional concerns that, in the wake of hurricanes Katrina and Rita, multitier subcontracting (1) increased costs to the government, (2) limited opportunities for small and local businesses to participate in response and recovery efforts, and (3) resulted in layers of subcontractors being paid profit and overhead while adding little or no value to the work performed under the contract. Our objectives were to determine the validity of these concerns, as well as to determine the potential effect Section 692 of the *Post-Katrina Emergency Management Reform Act of 2006* could have on future disaster contracting.

It does not appear that multitier subcontracting, as an isolated factor, caused significant increases in costs to the government, nor did it reduce subcontracting opportunities for small and local businesses. The prime contractors subcontracted a significant amount of the value of their contracts to small and local businesses.

Although FEMA relied on large national prime contractors, initially preventing small and local businesses from participating as prime contractors themselves, the national prime contractors generally did well hiring small and local subcontractors. However, because subcontractor invoices generally do not include specific information on lower tier subcontractors, we could not determine how many layers of subcontracting existed on contracts or whether any layers involved contractors charging profit without contributing substantially to the work being performed on the contract.

Although Section 692 of the *Post-Katrina Emergency Management Reform Act of 2006* would limit subcontracting to 65% of total contract costs, nothing in this legislation specifically restricts the number of tiers of subcontractors. Further, by limiting subcontracting, Section 692 could restrict funding available to small and local businesses while potentially impairing FEMA's ability to respond quickly to future catastrophic disasters. The Department of Defense has promulgated less restrictive rules to control multitiering that reduce the risks inherent in Section 692. Therefore, we recommend FEMA officials work with DHS officials, the Office of Federal Procurement Policy and Congress to promulgate less restrictive rules over multitier contracting.

Background

Hurricane Katrina, which struck the Gulf Coast on August 29, 2005, was the most destructive and costly natural disaster in United States history. It caused over $81 billion in estimated property damage and resulted in more than 1,500 deaths. Three weeks later, Hurricane Rita also struck the Gulf Coast, making landfall just west of where Katrina came ashore. In the wake of these two storms, the Federal Emergency Management Agency (FEMA) received 2.4 million applications for individual assistance. Faced with unprecedented needs for assistance, the federal government turned to contractors to play an essential role in its disaster response.

A massively destructive storm hitting a metropolitan area, coupled with insufficient predisaster acquisition planning and the need for an immediate and urgent response and recovery effort, compelled the federal government to primarily rely on large prime contractors rather than contract directly with small and local businesses. These large prime contractors had the financial strength and operational expertise to immediately manage billion-dollar projects and possessed the ability to plan, coordinate, and hire resources to respond quickly to the disaster. These contractors and their subcontractors removed over 99 million cubic yards of debris, temporarily repaired 109,000 roofs, and installed approximately 120,000 trailers–at times installing an average of 500 trailers per day.

In the aftermath of Hurricane Katrina, Congress enacted the *Post-Katrina Emergency Management Reform Act of 2006*, which was adopted as *Title VI of the Department of Homeland Security Appropriations Act of 2007* (P.L. 109-295, Title VI – National Emergency Management) (hereinafter referred to as the Post-Katrina Act). Section 692 of the Post-Katrina Act, "Limitations on Tiering of Subcontractors," is intended to address what many in Congress and the small business community, particularly in the hurricane-affected areas, felt was excessive tiering of subcontracts. The tiering was due to layers of subcontractors between the prime contractor and the subcontractor that actually performs the work, which result in additional costs without serving a legitimate purpose or adding value to the work under the contract.[1]

Section 692 of the Post-Katrina Act requires the Secretary of Homeland Security to promulgate regulations to minimize the excessive use by contractors of subcontractors, or tiers of subcontractors, to perform the

[1] Congress also included a provision in the *John Warner National Defense Authorization Act for Fiscal Year 2007 (NDAA)* (P.L. 109-364) that requires the Department of Defense to issue regulations addressing "excessive pass-through charges" on subcontracts under certain prime contracts (See Appendix C).

principal work of the contract. The law specifies that the regulations must require, at a minimum, that a contractor may not use subcontracts for more than 65% of the cost of the contract or the cost of any individual task or delivery order not including overhead and profit, unless the Secretary determines that such requirement is not feasible or practicable (Appendix B).

Although Section 692 of the Post-Katrina Act limits subcontracting to 65% of total contract costs, nothing in the Post-Katrina Act specifically restricts the number of tiers of subcontractors. Further, by limiting subcontracting, the Post-Katrina Act could restrict funding available to small and local businesses while potentially impairing FEMA's ability to respond quickly to future catastrophic disasters. (See page 9 for further discussion.)

While the large prime contractors had the financial and operational assets to step in and manage large projects, they did not necessarily have the personnel and material to perform all of the work themselves. They did have the ability to plan, coordinate, and hire resources more quickly than the federal government. As a result, these companies made extensive use of subcontractors. However, during Congressional testimony, local business representatives expressed concern that they were excluded from participating in disaster contracting. Small business representatives also suggested that prime contractors allowed multiple layers of unnecessary and costly subcontracts—a practice referred to as multitiering.[2]

While this report focuses on FEMA contracts, it should be noted that the U.S. Army Corps of Engineers (USACE) was engaged by FEMA for two major initiatives that also involved extensive subcontracting—debris removal and Operation Blue Roof. Under the Operation Blue Roof program, contractors and their subcontractors covered damaged roofs with blue plastic tarps to help prevent further property damage until more permanent repairs could be made.[3] Figure 1 shows an example of this program.

[2] Multitiering as used in this report is defined as more than one vertical layer of subcontractors under a prime contractor.
[3] A review of Operation Blue Roof is available at http://www.dodig.osd.mil/Audit/reports/FY07/07-038.pdf.

Figure 1: FEMA Trailer and House with "Operation Blue Roof" Tarp

Source: FEMA

Results of Review

Although we could not readily determine the extent of multitier contracting in the contracts we reviewed, we do not believe multitier contracting, as an isolated factor, caused higher costs or resulted in less opportunity for small and local businesses to participate in disaster response and recovery efforts.

We believe Section 692 of the Post-Katrina Act may adversely affect future disaster response and recovery contracting by reducing the funds available to small and local businesses while potentially impairing FEMA's ability to respond quickly to catastrophic disasters. Although Section 692 was designed, in part, to minimize the excessive use of tiers of subcontractors, it does not specifically restrict the number of tiers of subcontractors allowed on a contract.

Extent of Multiple Subcontracting Tiers

We could not readily determine the extent of subcontracting tiers because subcontractor invoices typically do not include information on lower-tier subcontractors. The Federal Acquisition Regulation (FAR) 52.209 instructs the contracting officer to insert into cost-reimbursement contracts the clause at FAR Part 52.215-2, Audit and Records. This clause provides that the government shall have the right to audit contractor records. Fixed priced contracts do not include this clause, and other than investigations regarding

fraud or other improprieties, no audit privilege exists. No federal or state laws, regulations, or contract terms required the prime contractors or subcontractors to submit cost information for lower-tier, fixed-unit-rate subcontracts. Furthermore, it is not a common business practice for a subcontractor to disclose the identity of, or amounts paid to, lower-tier subcontractors. We reviewed $236 million (12%) of $2.04 billion in Individual Assistance Technical Assistance Contract (IA-TAC) subcontractor invoices (See Appendix A). Few of these invoices included cost or other information on lower-tier subcontractors. Generally, the IA-TAC subcontractor invoices we reviewed described the type and location of the work performed and the amount charged, but provided no further details.

Effect of Subcontracts on Costs

Unnecessary tiers of subcontractors may have existed in the aftermath of Hurricane Katrina. Business representatives and media sources provided anecdotal accounts of multiple subcontracting tiers, at times five and six levels deep, in some cases generating "excessive pass-through charges."[4] However, in the invoices we reviewed, multitier subcontracting as an isolated factor was not a significant cause of higher costs. This was because all four IA-TAC prime contractors paid subcontractors based on fixed unit rates for the majority of their work (84% of the $236 million reviewed). Fixed-unit-rate contracts do not allow subcontractors to pass overhead and other operating costs above the agreed-upon fixed rate to prime contractors.

Once the federal government and the prime contractor agree on a price for a particular service, and the prime contractor issues a fixed-price subcontract, the number of tiers of subcontractors has no effect on the cost to the government. What might be a legitimate concern is whether the agreed-upon contract price between the government and the prime contractor is too high or whether the contractor subcontract rates were excessive.

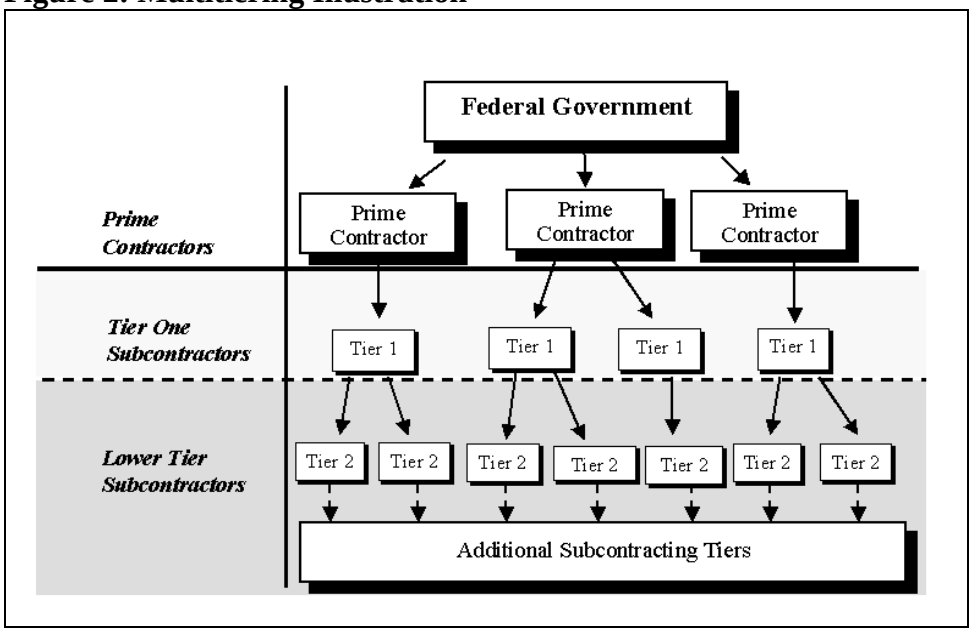
Another potential concern is when the subcontractor that actually performs the work is paid an amount significantly lower than that paid by the government to the prime contractor. There also may be a perception of unfairness when it is believed that some tiers simply charge overhead and profit without

[4] As defined in NDAA, "the term 'excessive pass-through charge', with respect to a contractor or subcontractor that adds no, or negligible, value to a contract or subcontract, means a charge to the Government by the contractor or subcontractor that is for overhead or profit on work performed by a lower-tier contractor or subcontractor (other than charges for the direct costs of managing lower-tier contracts and subcontracts and overhead and profit based on such direct costs)." See also GAO, *Defense Contracting: Contract Risk a Key Factor in Assessing Excessive Pass-Through Charges*, GAO-08-269, January 2008.

performing any real work. However, under current practice, the government is not a party to the subcontractor agreement or pricing structure and it is generally not privy to the tiers of subcontractors below the first tier.

A brief illustration of a cost-reimbursable[5] federal contract is provided in Figure 2. In this illustration, the prime contractors hold cost-reimbursable contracts with the federal government and then subcontract for some of the goods or services necessary to fulfill the requirements of their contracts. In this illustration, the subcontractors hold firm-fixed-price[6] contracts with the prime contractors or their subcontractors.

Figure 2: Multitiering Illustration



To understand the effect of multiple tiers of subcontracts on the cost to the government, using the illustration, we will assume that each prime contractor awards subcontracts to the Tier 1 subcontractors for a firm-fixed-price of $1,000 for a particular service. That means the direct cost of that service that the prime contractor can pass on to the government is $1,000. Whether the

[5] "Cost-reimbursement types of contracts provide for payment of allowable incurred costs, to the extent prescribed in the contract. These contracts establish an estimate of total cost for the purpose of obligating funds and establishing a ceiling that the contractor may not exceed (except at its own risk) without the approval of the contracting officer." FAR Part 16.301-1.

[6] "A firm-fixed-price contract provides for a price that is not subject to any adjustment on the basis of the contractor's cost experience in performing the contract. This contract type places upon the contractor maximum risk and full responsibility for all costs and resulting profit or loss. It provides maximum incentive for the contractor to control costs and perform effectively, and imposes a minimum administrative burden on the contracting parties." FAR Part 16.202-1.

Tier 1 subcontractor performs the service itself or subcontracts to a Tier 2 subcontractor, or whether the tiers of subcontracts are 4 or 5 layers deep, the Tier 1 subcontractor can charge the prime contractor only $1,000 for the service. This, in turn, limits what the prime contractor can charge the government. Further, under the firm-fixed-price subcontract, whether the actual cost to the Tier 1 subcontractor is $900, $500, or $300, the Tier 1 subcontractor is entitled to charge only $1,000 to the prime contractor. Therefore, multiple tiers of contractors, as an isolated factor, do not increase costs to the government.

It is important to note that, in most cases, the government has only a legal relationship, or privity of contract, with the prime contractors. This limits the amount of information on subcontracts to which the government is entitled. Typically, the government has some visibility into the first tier of subcontractors through their invoices to the prime contractors, but often the government has little to no visibility into the levels of subcontractors below the Tier 1 subcontractors. This means that the government usually does not have any right to know how many layers of subcontracts exist on a contract or what those subcontractors are charging to the contractor or subcontractor above them.

Prime Contractors Use of Small and Local Businesses

In Congressional hearings, small business representatives expressed concern that small and local firms were not provided an adequate opportunity to participate in response and recovery contracts. FEMA's reliance on large national prime contractors initially prevented small and local businesses from participating as prime contractors. However, the IA-TAC prime contractors subcontracted a significant portion of their work to small and local businesses.

Based on the subcontracting reports provided by the IA-TAC prime contractors, they exceeded FEMA's goal for subcontracting to small businesses (see Table 1).[7] Although FEMA did not set specific goals for hiring local businesses, FEMA instructed its IA-TAC contractors to use local businesses to the maximum extent practicable. FEMA set the small business subcontracting goal at 40%. Overall, the IA-TAC contractors reported that, of

[7] The U.S. Small Business Administration relies on small businesses to self-designate and accurately report their small business status. We did not confirm the small business results provided by the prime contractors other than to compare a sample of claims of small business status to the federal government's Central Contractor Registration Internet site.

the $2.04 billion paid to subcontractors, $1.45 billion (71%) went to small businesses and $1.26 billion (62%) went to local businesses.[8]

Table 1: IA-TAC Subcontracting Results

IA-TAC Subcontracting Results (dollars in millions)	**Fluor**	**Shaw**	**Bechtel**	**CH2M Hill**	**Percent**
Total Contract Value[9]	$1,350	$950	$517	$434	
Amount Subcontracted	**$712**	**$646**	**$323**	**$355**	**63%**
- to Small Businesses	$475	$441	$265	$270	71%
- to Local Businesses	$378	$494	$227	$160	62%

Source: FEMA

The term "small business," as defined by the U.S. Small Business Administration for purposes of federal small business programs, might not be considered "small" by a layman unfamiliar with federal small business programs. The U.S. Small Business Administration uses "size standards" to numerically define a small business. In most retail and service industries, a company qualifies as a "small business" when its annual revenue is less than $6.5 million. For most general and heavy construction industries, the size standard is $31 million.[10]

While FEMA uses the U.S. Small Business Administration standards to determine whether a business is "small," prior to Hurricane Katrina, FEMA had not developed clear definitions for how to determine whether a business qualified as "local" for contracting purposes. In mid-2006, post-Katrina, the General Services Administration issued new guidance to contracting officers to use in determining whether a business is local to the disaster-affected area. This guidance is available for use in future disasters.

[8] Many subcontractors were both small and local, and were therefore counted in both categories. Similarly, some businesses could have been large, while still local to the disaster. For example, one large prime contractor was headquartered in Louisiana. Also, subcontracting results only reflect the status of first-tier subcontractors. The status of lower tiered subcontractors is not included.

[9] Katrina Small Business Subcontracting Report for February 2007. Source: FEMA

[10] 13 Code of Federal Regulations Part 121.201.

FEMA, under its *Stafford Act* authority, assigned the task of debris removal and disposal to the USACE. The USACE then awarded four $500 million contracts to large companies. In 2006 Congressional testimony, business representatives expressed concern that the USACE excluded small and local businesses from fully participating in the debris removal program. However, the USACE prime contractors also reported success subcontracting with small and local businesses. The U.S. Army Audit Agency reported that the four prime debris removal contractors paid a majority of the $889 million in subcontracting to local small businesses. As of May 10, 2006, the prime contractors reported they paid $762 million (86%) to small businesses and $582 million (65%) to local small businesses.

Effect of Post-Katrina Act on Future Disaster Contracting

Section 692 of the Post-Katrina Act may adversely affect future disaster response and recovery efforts, including goals to use small and local businesses, by limiting the amount of funds available for subcontracting. It would limit first-tier subcontracting on certain contracts and task or delivery orders but would not directly limit the number of tiers allowable; thus, it does not specifically prevent multitiering.

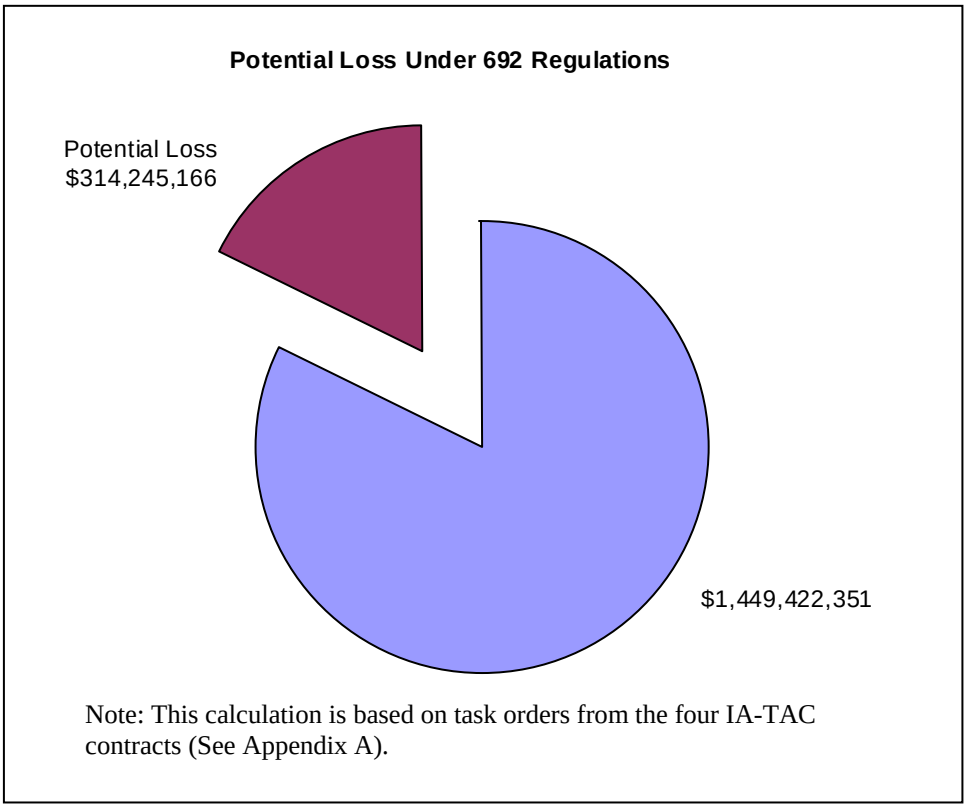
Section 692 of the Post-Katrina Act would limit the use of subcontractors to perform the principal work of a disaster response and recovery contract. It requires that disaster-related, cost-reimbursable contracts and task or delivery orders involve subcontracting of no more than "65 percent of the cost of the contract or the cost of any individual task or delivery order (not including overhead and profit)." It allows the DHS Secretary, however, to waive this requirement when it is determined that it is not feasible or practicable to restrict subcontracting to 65% of the prime contract amount. DHS is in the process of amending its Homeland Security Acquisition Regulations to implement this new contracting requirement.

Had the Post-Katrina Act been in effect immediately following Hurricane Katrina and been applied to the four large IA-TAC contracts and their related task orders, it could have had the effect of requiring some of the work that was subcontracted to be done in-house by the prime contractors. This could have decreased the amount of dollars available to subcontractors, and possibly could have affected the ability of the prime contractors to fulfill their disaster response assignments in an effective and timely manner.

To demonstrate the possible future effect Section 692 of the Post-Katrina Act could have on small and local businesses, we applied the subcontracting

limitations, as they would likely be implemented, to the Hurricane Katrina IA-TAC prime contractor billings. We calculated that, had the requirement been in effect following Hurricane Katrina, approximately $300 million worth of subcontracting would not have been allowed (see Figure 3).

Figure 3: IA-TAC Subcontracting Dollars and Small and Local Business Dollars Potentially Lost



Note: This calculation is based on task orders from the four IA-TAC contracts (See Appendix A).

Federal laws require FEMA to promote small and local business participation in disaster response and recovery contracts. However, it is not always practical for FEMA to have prime contracts with small and local businesses in place prior to a disaster, or to contract directly with numerous small and local businesses immediately after a disaster. Further, the response and recovery tasks that follow catastrophic disasters like Hurricane Katrina are generally too large for small businesses to perform effectively. However, to increase small and local business participation once it became feasible, FEMA awarded contracts for trailer maintenance and other services primarily to small and local businesses.[11]

[11] DHS OIG, *FEMA's Award of 36 Trailer Maintenance and Deactivation Contracts*, OIG-07-36, March 30, 2007.

The 65% subcontracting limitation also could have a negative effect on FEMA's ability to respond quickly to future catastrophic disasters. This is because subcontracting is the principal means available to prime contractors to obtain the surge capacity needed to respond quickly.

Without a waiver from the Secretary of DHS, Section 692 of the Post-Katrina Act could limit small and local business participation and reduce FEMA's ability to respond quickly. Further, while the Post-Katrina Act imposes limits on the dollar amount of subcontracting, it would not actually restrict the number of subcontracting tiers.

Legislative Update

Congress is concerned about excessive tiering and related pass-through costs, and has not settled on a single remedy. Since multitiering came to the forefront of congressional interest in the wake of hurricanes Katrina and Rita, as well as military actions in Iraq and Afghanistan, language has been included in several bills to set limits on what is perceived as excessive multitiering.

The language included in the Post-Katrina Act, enacted October 4, 2006, is the most restrictive, specifying that the Secretary shall promulgate regulations that require prime contractors to subcontract no more than 65% of the value of the contract (see Appendix B). Also, the NDAA, enacted October 17, 2006, requires the Secretary of Defense to:

> "prescribe regulations to ensure that pass-through charges on contracts or subcontracts (or task or delivery orders) … are not excessive in relation to the cost of work performed by the relevant contractor or subcontractor." (see Appendix C).

In response to P.L. 109-364, the Department of Defense issued an interim rule on April 26, 2007,[12] that requires contractors to identify the percentage of work that will be subcontracted and, when subcontract costs will exceed 70% of the total cost of work to be performed, to provide information on indirect costs, profit, and value added with regard to the subcontract work.[13] It is important to note that the Department of Defense rule does not *limit*

[12] Federal Register, Vol. 72, No. 80, April 26, 2007, p. 20758.

[13] The interim rule amends the Defense Federal Acquisition Regulation Supplement at 48 Code of Federal Regulations Parts 215, 231, and 252, effective April 26, 2007, DFARS Case 2006-D057.

subcontracting, it requires additional reporting only when subcontracting exceeds 70% of the total cost of the work to be performed.

On November 7, 2007, the Senate passed S. 680, the *Accountability in Government Contracting Act of 2007*. As introduced, the bill included a clause nearly identical to the tiering language in the Post-Katrina Act. This clause required the Administrator of the Office of Federal Procurement Policy (OFPP) to promulgate regulations to limit subcontracting to no more than 65% of the value of the work to be performed under the contract.[14] The language was essentially identical to that in the Post-Katrina Act. S. 680 requires the Administrator of OFPP to promulgate regulations to be applied government-wide. Rather than specifying a specific limit on tiering, the Act requires the OFPP Administrator to:

> "promulgate regulations…to minimize the excessive use by contractors of subcontractors or tiers of subcontractors in cases where a subcontractor does not perform work in proportion to any overhead or profit that the subcontractor receives under the contract."[15]

In the report accompanying S. 680, the Committee wrote that it

> "does not intend to impose an absolute limit on tiering, but does intend that non-value added tiering be eliminated."[16]

DHS is bound by the more restrictive language of the Post-Katrina Act. However, the Department of Defense is in the process of finalizing regulations, and the Administrator of OFPP may in the future promulgate regulations for civilian agencies that use less restrictive language. DHS is currently developing regulations according to the restrictions of the Post-Katrina Act. However, should S. 680 be enacted in its present form, the department should consider adopting the government-wide multitiering regulations to be set by OFPP.

Conclusion and Recommendation

Regulations required by Section 692 of the Post-Katrina Act could result in reduced subcontracting opportunities for small and local businesses while potentially impairing FEMA's ability to respond quickly to catastrophic

[14] Accountability in Government Contracting Act of 2007, S.680, 110th Cong., 1st Sess. (2007), Subtitle C, Section 126.
[15] Accountability in Government Contracting Act of 2007, S.680, 110th Cong., 1st Sess. (2007), Title III, Section 305.
[16] S. Rep. No. 201, 110 Cong., 1st Session (2007).

disasters. The Department of Defense has taken a less restrictive approach to subcontract tiering that does not present the risks inherent in Section 692. Also, pending legislation may allow other federal agencies to take a less restrictive approach to controlling tiering of subcontractors. Should this pending legislation be adopted in its present form, the department should consider requesting that it be allowed to adopt the less restrictive approach.

We recommend that FEMA:

1. Work with DHS officials, the Office of Federal Procurement Policy and Congress to promulgate less restrictive regulations over multi-tier contracting.

Miscellaneous Issue

One prime contractor made two identical $625,225 invoice payments to a subcontractor for the installation of travel trailers in Louisiana. We discussed these duplicate charges with the IA-TAC contractor who said the second payment was a clerical error. The subcontractor immediately issued a $625,225 reimbursement check to the IA-TAC contractor who then reimbursed FEMA for the overcharges.

Management Comments and OIG Evaluation

FEMA provided written comments on the draft of this report and generally concurred with the recommendation. FEMA commented that even though Section 692 would negatively impact small businesses, DHS remains required by law to promulgate regulations precluding contractors from using subcontractors for more than 65% of the cost of the contract or delivery order. However, FEMA agreed to work with DHS and OFPP to promulgate less restrictive regulations, and to work with Congress should legislation be considered that might provide an opportunity to modify the law. (FEMA's written comments are contained in Appendix B.)

Our objectives were to identify the extent and effect of multitier contracting, and assess the potential effect Section 692 of the Post-Katrina Act could have on future disaster contracting. Our fieldwork consisted of interviews with FEMA and contractor personnel, document reviews, and analyses of financial data. We gathered and reviewed information relating to the multitiering of Hurricane Katrina contracts in order to gain an understanding of the issues involving increased costs and small and local business participation. We reviewed information from congressional testimony and prior OIG, Army Audit Agency, Defense Contract Audit Agency, and Government Accountability Office audit reports. We also reviewed relevant laws, regulations, and FEMA policies, procedures and procurement guidelines.

We reviewed FEMA's IA-TACs because they were among the largest disaster response and recovery contracts, and they included $2.04 billion in subcontracting. These contracts also constituted virtually all of DHS' Hurricane Katrina cost-reimbursable contracting. As of the end of calendar year 2006, the IA-TACs billed FEMA approximately $2.88 billion of the $6.42 billion (45%) for Hurricane Katrina related work. We focused on trailer installation task orders because they included the largest amount of subcontracting. In total, we reviewed $236 million of the $2.04 billion in subcontracting invoices (12%).

We conducted our fieldwork between February 2007 and July 2007. We visited the four IA-TAC contractors and interviewed key personnel at each location:

- Fluor (Greenville, South Carolina);
- Shaw (Findlay, Ohio);
- Bechtel (Oak Ridge, Tennessee); and
- CH2M Hill (Englewood, Colorado).

During our visits, we reviewed invoices, accounting records, and subcontract agreements. We also traced subcontractor invoices to prime contractor invoices submitted to FEMA.

To perform the calculations reported in Figure 3, we obtained task order cost information from all four IA-TACs and reduced the overall task order costs by their related overhead and profit. We then compared these figures, (i.e., the amount that would presumably be allowed under Section 692), to the amount that was actually subcontracted to identify the dollar value of subcontracting that would have exceeded the 65% limitation.

The Defense Contract Audit Agency assisted us by verifying the IA-TAC financial data provided by the contractors to the contractor's financial accounting system.

We conducted the audit under the authority of the *Inspector General Act* of 1978, as amended, and according to generally accepted *Government Auditing Standards.*

U.S. Department of Homeland Security
Washington, DC 20472

FEMA

MAY 23 2008

MEMORANDUM FOR: Richard Skinner
DHS Inspector General

FROM: Marko Bourne
Director
Office of Policy & Program Analysis

SUBJECT: FEMA's Response to OIG Draft Report, *Hurricane Katrina Multitier Contracts, dated April 2008*

Attached, you will find our response to the subject report.

Please contact our Chief Audit Liaison, Brad Shefka, 202-646-1308, concerning any questions you may have concerning our review.

Attachment:
FEMA Comments, OIG Draft Report, *Hurricane Katrina Multitier Contracts, dated April 2008*

Federal Emergency Management Agency (FEMA) Response to Department of Homeland Security (DHS) Office of Inspector General (OIG) DRAFT REPORT, ***Hurricane Katrina Multitier Contracts*****, dated April 2008**

Recommendation 1:

Work with DHS officials, the Office of Federal Procurement Policy (OFPP), and Congress to promulgate less restrictive regulations over multi-tier contracting.

Response:

It must be recognized that Section 692 of Public Law 109-295 is the law, and FEMA is bound to follow it. Pursuant to Section 692, DHS must promulgate regulations precluding a contractor from using subcontracts for more than 65 percent of the cost of the contract or cost of any task or delivery order (not including overhead and profit). To the extent that it can consistent with the law, FEMA looks forward to working with the appropriate officials at DHS and OFPP in order to promulgate less restrictive regulations over multi-tiered contracting. Furthermore, FEMA will work with Congress should they decide to take up legislation on this subject.

Section 692 of the *Post-Katrina Emergency Management Reform Act of 2006,* adopted as Title VI of the *Department of Homeland Security Appropriations Act of 2007* (P.L. 109-295), which was signed into law on October 4, 2006.

SEC. 692. LIMITATION ON TIERING OF SUBCONTRACTORS.

(a) REGULATIONS.—The Secretary shall promulgate regulations applicable to contracts described in subsection (c) to minimize the excessive use by contractors of subcontractors or tiers of subcontractors to perform the principal work of the contract.

(b) SPECIFIC REQUIREMENT.—At a minimum, the regulations promulgated under section (a) shall preclude a contractor from using subcontracts for more than 65 percent of the cost of the contract or cost of any individual task or delivery order (not including overhead and profit), unless the Secretary determines that such requirement is not feasible or practicable.

(c) COVERED CONTRACTS.—This section applies to any cost-reimbursable type contract or task or delivery order in an amount greater than the simplified acquisition threshold (as defined by section 4 of the Office of Federal Procurement Policy Act (41 U.S.C. 403) entered into by the Department to facilitate response to or recovery from a natural disaster or act of terrorism or other manmade disaster.

Section 852 of the *John Warner National Defense Authorization Act for Fiscal Year 2007* (P.L. 109-364), which was signed into law on October 17, 2006.

SEC. 852. REPORT AND REGULATIONS ON EXCESSIVE PASS-THROUGH CHARGES.

(a) Comptroller General Report on Excessive Pass-Through Charges-

(1) IN GENERAL- Not later than 180 days after the date of the enactment of this Act, the Comptroller General shall issue a report on pass-through charges on contracts or subcontracts (or task or delivery orders) that are entered into for or on behalf of the Department of Defense.

(2) MATTERS COVERED- The report issued under this subsection--

(A) shall assess the extent to which the Department of Defense has paid excessive pass-through charges to contractors who provided little or no value to the performance of the contract;

(B) shall assess the extent to which the Department has been particularly vulnerable to excessive pass-through charges on any specific category of contracts or by any specific category of contractors (including any category of small business); and

(C) shall determine the extent to which any prohibition on excessive pass-through charges would be inconsistent with existing commercial practices for any specific category of contracts or have an unjustified adverse effect on any specific category of contractors (including any category of small business).

(b) Regulations Required-

(1) IN GENERAL- Not later than May 1, 2007, the Secretary of Defense shall prescribe regulations to ensure that pass-through charges on contracts or subcontracts (or task or delivery orders) that are entered into for or on behalf of the Department of Defense are not excessive in relation to the cost of work performed by the relevant contractor or subcontractor.

(2) SCOPE OF REGULATIONS- The regulations prescribed under this subsection--

(A) shall not apply to any firm, fixed-price contract or subcontract (or task or delivery order) that is--

(i) awarded on the basis of adequate price competition; or

(ii) for the acquisition of a commercial item, as defined in section 4(12) of the Office of Federal Procurement Policy Act (41 U.S.C. 403(12)); and

(B) may include such additional exceptions as the Secretary determines to be necessary in the interest of the national defense.

(3) DEFINITION- In this section, the term ‘excessive pass-through charge’, with respect to a contractor or subcontractor that adds no, or negligible, value to a contract or subcontract, means a charge to the Government by the contractor or subcontractor that is for overhead or

profit on work performed by a lower-tier contractor or subcontractor (other than charges for the direct costs of managing lower-tier contracts and subcontracts and overhead and profit based on such direct costs).

(4) REPORT- Not later than one year after the date of the enactment of this Act, the Secretary of Defense shall submit to the congressional defense committees a report on the steps taken to implement the requirements of this subsection, including--

(A) any standards for determining when no, or negligible, value has been added to a contract by a contractor or subcontractor;

(B) any procedures established for preventing excessive pass-through charges; and

(C) any exceptions determined by the Secretary to be necessary in the interest of the national defense.

(5) EFFECTIVE DATE- The regulations prescribed under this subsection shall apply to contracts awarded for or on behalf of the Department of Defense on or after May 1, 2007.

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