DEFENSE CONTRACT AUDIT AGENCY

AUDIT REPORT NO. 3311-2005K21000024

February 25, 2005

PREPARED FOR: Contracting Officer
Us Army Corps of Engineers
Fort Worth District
Attn: CESWR-CT-C
819 Taylor Street, Room 2A19
Fort Worth, TX 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 Revised Proposal for Restore Iraqi Oil Delivery Order No. 5

REFERENCES: Prime Contract No. DACA63-03-D-0005
Relevant Dates: See Page 35

CONTRACTOR: Kellogg Brown & Root, Inc.
Halliburton Company
4100 Clinton Drive
Houston, TX 77020-6237

REPORT RELEASE RESTRICTIONS: See Page 36

CONTENTS:

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) January 21, 2005 Cost-Plus-Award-Fee (CPAF) revised proposal for Delivery Order (DO) No. 5 under Contract No. DACA63-03-D-0005, Restore Iraqi Oil (RIO), to determine if the proposed costs are acceptable as a basis to negotiate a fair and reasonable DO price. The $887,339,958 revised proposal is to definitize the KBR mission support requirements in response to the Notice to Proceed (NTP) issued on May 4, 2003 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 May 4, 2003 through December 24, 2003 for all fuels.

This proposal is a revision to KBR's November 23, 2004 CPAF proposal for DO No. 5 in the amount of $885,091,489. We audited the November 23, 2004 proposal and presented our results in DCAA Audit Report No. 3311-2005K21000016, dated January 11, 2005. This report replaces our previous report in its entirety. This second revised proposal represents a $2,061,282 increase in direct costs and includes the following increases/(decreases).

Cost Element	Increase/(Decrease)	
Labor	$	102,720
Other Labor Related Cost (OLRC)		(47,639)
Subcontract		2,747,329
Other Direct Cost (ODC)		242,098
ETC Costs		
Labor		(37,040)
Other Labor Related Cost (OLRC)		(12,983)
Other Direct Cost (ODC)		(933,203)
	$	2,061,282

The subcontract cost change was caused by migrated fuel costs from Turkey transferred in from DO No. 7. The reduction in estimate-to-complete (ETC) is for ODCs that were migrated to DO No. 10.

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 15 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.

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., 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 (235 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 fuel. We used the DESC negotiated prices as a benchmark to assess the reasonableness of the proposed KBR costs and questioned $62,116,326. We believe KBR should have actively pursued reducing its negotiated prices with Altanmia after the initial award in May of 2003. Refer to Note 4c (1) in the Exhibit 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 $20,517,368 of questioned costs. Refer to Note 4(c) in the Exhibit for further details.

3. Proposed incurred and estimate to complete direct costs exceed recorded costs by $328,057. Specifically, KBR proposed direct costs of $812,146,070 while $811,818,012 was charged to the DO 5 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 5 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.