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HALLIBURTON'S PERFORMANCE UNDER THE RESTORE IRAQI OIL 2 CONTRACT

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EXECUTIVE SUMMARY

Halliburton is the largest private contractor in Iraq. The company has operated there under three mega-contracts: the "LOGCAP" contract to provide support to U.S. troops; the original "Restore Iraqi Oil" (RIO) contract, which Halliburton received in secret without competitive bidding in March 2003; and the RIO 2 contract, which was awarded to Halliburton in January 2004.

Previous reports by government auditors and congressional investigators have evaluated the LOGCAP and RIO contracts. This report, however, is the first to examine the RIO 2 contract. It reveals that government officials and investigators have harshly criticized Halliburton's performance under RIO 2, citing "profound systemic problems," "exorbitant indirect costs," "misleading" and "distorted" cost reports, a "lack of cost control," an "overwhelmingly negative" evaluation, and an "obstructive" corporate attitude toward oversight.

The RIO 2 contract is critically important to the successful reconstruction of Iraq. The mammoth $1.2 billion contract gave Halliburton the responsibility for restoring the oil fields in southern Iraq, which historically have been Iraq's largest and most productive. Three years ago, Bush Administration officials promised that Iraq would be able to fund its own reconstruction out of its oil revenues. The successful restoration of the southern oil fields, which the Administration entrusted to Halliburton under RIO 2, was supposed to pay for the rebuilding of much of the rest of Iraq's infrastructure. But these promises have not been fulfilled.

To evaluate Halliburton's performance under RIO 2, this report analyzes hundreds of pages of previously undisclosed correspondence, evaluations, and audits. The documents reviewed in preparation of the report include correspondence from the Project and Contracting Office (PCO), the Defense Department agency charged with overseeing RIO 2; evaluations by a private contractor, Foster-Wheeler, hired to help the PCO oversee the contract; documentation related to award-fee determinations; and audits by the Defense Contract Audit Agency (DCAA).

These documents show that between July 2004 and July 2005, Halliburton's performance under RIO 2 repeatedly received scathing critiques:

- **<u>Intentional Overcharging:</u>** The PCO board evaluating Halliburton's request for award fees found that Halliburton repeatedly overcharged the taxpayer, apparently intentionally. In one case, "[c]ost estimates had hidden rate factors to increase cost of project without informing the Government." In another instance, Halliburton "tried to inflate cost estimate by $26M." In yet a third example, Halliburton claimed costs for laying concrete pads and footings that the Iraqi Oil Ministry had "already put in place."

- **Exorbitant Costs:** The PCO reported that Halliburton was "accruing exorbitant indirect costs at a rapid rate" and that Halliburton's "lack of cost containment and funds management is the single biggest detriment to this program." The oversight contractor found a "lack of cost control … in Houston, Kuwait, and Iraq." In a partial review of the RIO 2 contract, DCAA auditors challenged $45 million in costs as unreasonable or unsupported.

- **Inadequate Cost Reporting:** The PCO found that Halliburton "universally failed to provide adequate cost information," had "profound systemic problems," provided "substandard" cost reports that did "not meet minimum standards," and submitted reports that had been "vetted of any information that would allow tracking of details." The oversight contractor complained about "unacceptable unchecked cost reports."

- **Schedule Delays:** Halliburton's work under RIO 2 was continually plagued by delays. According to the PCO, Halliburton had a "50% late completion" rate for RIO 2 projects. Evaluations by the award fee board noted "untimely work" and "schedule slippage."

- **Refusal to Cooperate:** PCO evaluations described Halliburton as "obstructive" with oversight officials. Despite the billions in taxpayer funds Halliburton has been paid, the company's "leadership demonstrated minimal cooperative attitude resolving problems."

The decision to award Halliburton the RIO 2 contract was controversial. Before the award of the contract, DCAA auditors warned the Defense Department not to enter into additional contracts with Halliburton because of "significant deficiencies" in the company's cost estimating system, but the Department ignored this advice. It now appears that problems that led to the unusual DCAA warning have been realized in RIO 2, with serious implications for the reconstruction effort in Iraq and federal taxpayers.

PURPOSE AND METHODOLOGY

Halliburton is the largest private contractor in Iraq. It has worked under three huge contracts: (1) the Logistics Civil Augmentation Program (LOGCAP) contract with the U.S. Army to provide logistical support to the troops; (2) the original Restore Iraqi Oil (RIO) contract to import fuel into Iraq and rebuild Iraq's oil infrastructure facilities; and (3) the follow-on Restore Iraqi Oil (RIO 2) contract to continue rebuilding Iraq's oil infrastructure in southern Iraq. To date, Halliburton has been paid $13.5 billion for providing troop support in Iraq under the LOGCAP contract, and it has received $2.4 billion under RIO.[1] The RIO 2 contract is worth up to $1.2 billion.

There have been multiple reviews of the LOGCAP and RIO contracts. The Special Investigations Division has examined these contracts for Rep. Henry A. Waxman in several reports.[2] In addition, the contracts have been examined by the Defense Contract Audit Agency (DCAA), the Army Audit Agency, the Government Accountability Office, and the Special Inspector General for Iraq Reconstruction.[3] These reviews and audits have identified multiple problems with Halliburton's performance under the contracts, including unreasonable and unsupported costs of over $1.4 billion.[4]

There have been, however, no public assessments of Halliburton's performance under the RIO 2 contract.

At the request of Rep. Waxman, this report is the first detailed analysis of Halliburton's efforts under RIO 2. The report is based on four sets of previously undisclosed documents: (1) months of correspondence involving Halliburton and officials in the Project and Contracting Office, the Defense Department agency set up to oversee RIO 2 and other Iraq reconstruction contracts; (2) evaluations of RIO 2 conducted by Foster-Wheeler, a contractor hired to assist the PCO in

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[1] U.S. Army Field Support Command, *Media Obligation Spreadsheet, 27 Jan 06* (Jan. 27, 2006); U.S. Army Corps of Engineers, *Frequently Asked Questions: Engineer Support to Operation Iraqi Freedom* (Jan. 26, 2006) (available online at http://www.hq.usace.army.mil/CEPA/Iraq/March03-table.htm).

[2] *See, e.g.*, Minority Staff, House Committee on Government Reform, *Halliburton's Questioned and Unsupported Costs in Iraq Exceed $1.4 Billion* (June 27, 2005); Minority Staff, House Committee on Government Reform, *Halliburton's Gasoline Overcharges* (July 21, 2004).

[3] *See*, *e.g.*, Army Audit Agency, *Logistics Civil Augmentation Program in Kuwait: U.S. Army Field Support Command* (Audit Report A-2005-0043-ALE) (Nov. 24, 2004); Government Accountability Office, *DOD's Extensive Use of Logistics Support Contracts Requires Strengthened Oversight* (GAO-04-854) (July 21, 2004); Special Inspector General for Iraq Reconstruction, *Pipeline River Crossing: Al Fatah, Iraq* (Jan. 27, 2006).

[4] *Halliburton's Questioned and Unsupported Costs in Iraq Exceed $1.4 Billion*, *supra* note 2.

oversight of the RIO 2 contract; (3) documentation related to the government's RIO 2 award fee determinations; and (4) DCAA audits of Halliburton's RIO 2 cost proposals. The documents cover the period from January 2004 to July 2005.

BACKGROUND

The Bush Administration started planning for the take-over of Iraq's oil fields nearly a year before the invasion of Iraq. During the summer of 2002, a special team within the Pentagon called the Energy Infrastructure Planning Group was established and charged with developing a plan to restore and operate Iraq's oil infrastructure in the event that the United States became an occupying power.[5]

According to Administration officials, the revitalization of Iraq's oil fields would play a pivotal role in the reconstruction of Iraq. In March 2003, for example, then-Deputy Secretary of Defense Paul Wolfowitz assured members of Congress that Iraq's oil sector would be rehabilitated quickly, enabling Iraq's oil revenues to fund the reconstruction effort. In congressional testimony, Mr. Wolfowitz stated: "We're dealing with a country that can really finance its own reconstruction, and relatively soon."[6] Echoing these views, the head of the U.S. Agency for International Development, Andrew S. Natsios, stated a month later that "the American part" of the cost of rebuilding Iraq "will be just $1.7 billion."[7]

Halliburton's Contingency Planning Contract

From nearly the beginning, Halliburton had a major role in the Administration's oilfield planning. In the fall of 2002, Michael Mobbs, a Defense Department political appointee and the head of the Energy Infrastructure Planning Group, decided to award the oil infrastructure planning work to Halliburton. This decision was made in secret without competition from any other companies.[8]

As a result, Halliburton received a $1.9 million task order under the LOGCAP contract in November 2002 to draw up contingency plans for U.S. occupation of the Iraqi oil fields. At the time this no-bid contract was awarded, Mr. Mobbs

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5 Briefing by Michael Mobbs, Special Assistant to the Under Secretary of Defense for Policy Douglas Feith, for Staff, House Government Reform Committee (June 8, 2003).

6 House Committee on Appropriations, Subcommittee on Defense, *Hearing on FY2004 Appropriations*, 108th Cong. (Mar. 23, 2003).

7 *Nightline*, ABC News (Apr. 23, 2003).

8 Briefing by Michael Mobbs, Special Assistant to the Under Secretary of Defense for Policy Douglas Feith, for Staff, House Government Reform Committee (June 8, 2003). *See also* Letter from Rep. Henry A. Waxman to Vice President Richard B. Cheney (June 13, 2004) (online at www.democrats.reform.house.gov/Documents/20040623114026-70050.pdf) (describing June 8, 2004, briefing).

knew that the company that received the contingency contract would also be awarded the much larger RIO contract.[9]

The Government Accountability Office later investigated the award of the contingency contract and concluded that it was not "in accordance with legal requirements" because "preparation of the contingency support plan for this mission was beyond the scope of the contract."[10] GAO added that the work "should have been awarded using competitive procedures."[11]

The Original RIO Contract

On March 8, 2003, the U.S. Army Corps of Engineers awarded Halliburton subsidiary KBR a no-bid monopoly contract to restore and operate Iraq's oil infrastructure. The Restore Iraqi Oil contract was awarded in secret, and other qualified companies, like Bechtel, which did most of the oilfield work after the first Gulf War, were precluded from bidding.[12] The Defense Department justified awarding the lucrative no-bid contract to Halliburton on that basis that Halliburton had done the pre-war planning for operation and restoration of Iraq's oilfields under the contingency contract.[13]

Halliburton charged approximately $2.4 billion under the RIO contract, which had a potential value of $7 billion.[14] Halliburton's work was split generally between oil infrastructure projects and fuel importation tasks. Work has concluded on all ten RIO task orders.

Reps. Henry A. Waxman and John Dingell began to raise questions about Halliburton's RIO contract soon after the contract was awarded.[15] In a series of letters, they provided evidence that Halliburton's prices to import gasoline from Kuwait were too high. They reported that Halliburton appeared to be charging

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9 U.S. General Accounting Office, *Rebuilding Iraq: Fiscal Year 2003 Contract AwardProcedures and Management Challenges* (GAO-04-605) (June 2004) (concluding that "DOD recognized as early as November 2002 that the contractor, given its role in preparing a contingency support plan, would be in the best position to execute the plan").

10 U.S. General Accounting Office, *Rebuilding Iraq: Fiscal Year 2003 Contract Award Procedures and Management Challenges* (GAO-04-605) (June 2004).

11 *Id.*

12 Minority Staff, Special Investigations Division, House Committee on Government Reform, *Halliburton's Gasoline Overcharges* (July 21, 2004).

13 U.S. Army Corps of Engineers, *Justification for Other Than Full and Open Competition for Execution of the Contingency Support Plan* (Feb. 27, 2003).

14 U.S. Army Corps of Engineers, *Frequently Asked Questions: Engineer Support to Operation Iraqi Freedom* (Jan. 26, 2006).

15 Letter from Rep. Henry A. Waxman to Lt. Gen. Robert Flowers, U.S. Army Corps of Engineers (Mar. 26, 2003).

twice as much as it should have for fuel imports.[16] Independent experts characterized Halliburton's charges as "highway robbery" and "outrageously high."[17]

These concerns about Halliburton's inflated costs were validated by Pentagon auditors. In its audits of the ten task orders under the RIO contract, DCAA identified $219 million in "questioned" costs and $60 million in "unsupported" costs.[18] The DCAA auditors criticized virtually every aspect of Halliburton's work, including its excessive charges to import fuel into Iraq from Kuwait and its unnecessary retroactive payments to its Turkish fuel subcontractors.[19] Revised audits lowered the total amount of questioned and unsupported costs to $263 million.[20]

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16 Letter from Reps. Henry A. Waxman and John D. Dingell to Lt. Gen. Robert Flowers, U.S. Army Corps of Engineers (Oct. 21, 2003).

17 Letter from Reps. Henry A. Waxman and John D. Dingell to Joshua Bolten, Director, Office of Management and Budget (Oct. 15, 2003).

18 DCAA, *Report on Audit of Proposal for Restore Iraqi Oil, Task Order No. 1* (Audit Report No. 3311-2004K17900011) (Mar. 19, 2004); DCAA, *Report on Audit of Proposal for Restore Iraqi Oil, Task Order No. 2* (Audit Report No. 3311-2004K17900009) (Apr. 9, 2004); DCAA, *Report on Audit of Proposal for Restore Iraqi Oil, Task Order No. 3* (Audit Report No. 3311-2004K17900056) (Oct. 2, 2004); DCAA, *Report on Audit of the Additional Funding Proposal for RIO I Task Order No. 04* (Audit Report No. 3311-2004K17900086) (Sept. 3, 2004); DCAA, *Report on Audit of Revised Proposal for Restore Iraqi Oil Delivery Order No. 5* (Audit Report No. 3311-2005K21000024) (Feb. 25, 2005); DCAA, *Report on Audit of Proposal for Restore Iraqi Oil Task Order No. 6* (Audit Report No. 3311-2004K21000028) (Sept. 16, 2004); DCAA, *Report on Audit of Revised Proposal for Restore Iraqi Oil Delivery Order No. 7* (Audit Report No. 3311-2005K21000025) (Feb. 25, 2005); DCAA, *Report on Audit of Revised Proposal for Restore Iraqi Oil Delivery Order No. 8* (Audit Report No. 3311-2005K21000026)(Feb. 25, 2005); DCAA, *Report on Audit of Revised Proposal for Restore Iraqi Oil Delivery Order No. 9* (Audit Report No. 3311-2005K21000019) (Feb. 3, 2005); DCAA, *Report on Audit of Revised Proposal for Restore Iraqi Oil Delivery Order No. 10* (Audit Report No. 3311-2005K21000020) (Feb. 3, 2005).

According to the DCAA Contract Audit Manual, "questioned costs" are costs "on which audit action has been completed" and "which are not considered acceptable." Questioned costs may be determined unacceptable for several reasons: they may be "unallowable" under the contract terms; they may not be "allocable" because they are not "incurred specifically for the contract;" or they may be "unreasonable in amount." Costs are considered unreasonable in amount when they "exceed that which would be incurred by a prudent person in the conduct of a competitive business." DCAA classifies charges as "unsupported" when "the contractor does not furnish sufficient documentation to enable a definitive conclusion" about the acceptability of the charges.

19 *See, e.g.*, DCAA, *Report on Audit of Revised Proposal for Restore Iraqi Oil Delivery Order No. 5*, *supra* note 18, at 2; DCAA, *Report on Audit of Revised Proposal for Restore Iraqi Oil Delivery Order No. 7, supra* note 18, at 2.

20 *Army to Pay Halliburton Unit Most Costs Disputed by Audit*, New York Times (Feb. 27, 2006).

The RIO 2 Contract

In response to widespread criticism of Halliburton's no-bid RIO contract, the Corps of Engineers promised to hold a competition for the oil sector work. On April 8, 2003, just one month after the award of the RIO contract, Lt. Gen. Robert Flowers, the Commander of the Corps of Engineers, assured Rep. Waxman that "[t]here will be ample opportunity for competition of the overall requirements to support the restoration of Iraq's oil infrastructure."[21] Gen. Flowers promised that "the requirements will be competed at the earliest opportunity consistent with mission needs."[22] In May 2003, Gen. Flowers stated, "The best estimate for award of the contract … is approximately the end of August."[23] However, the award of the follow-on RIO 2 contract was repeatedly delayed until January 2004.

According to participants, the competition was not only slow but seriously flawed. Sheryl Tappan, who led Bechtel's proposal team in the competition before Bechtel withdrew, characterized the competition as a "sham" and "farce."[24] In her testimony before the Senate, Ms. Tappan stated, "In my 12 years doing government proposals, I had never seen anything as arrogant, as egregious as the ways in which Pentagon officials … treated the bidders, how they ignored our federal laws and regulations and the procedures that I still believe normally ensure fair play."[25] Ms. Tappan accused the Corps of Engineers of misleading bidders about the nature of the contract and structuring the competition to heavily favor the incumbent contractor, Halliburton.

In January 2004, the Corps of Engineers finally awarded a pair of RIO 2 contracts. Parsons Corporation received an $800 million contract to restore oil infrastructure in northern Iraq, while Halliburton received a $1.2 billion contract to restore oil infrastructure in southern Iraq.[26] Historically, the southern oil fields have been Iraq's largest and most productive.

Both of the RIO 2 contracts are "cost-plus," meaning that the contractor is reimbursed for costs it incurs under the contract and then receives its profit, or

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[21] Letter from Lt. Gen. Robert B. Flowers, U.S. Army Corps of Engineers, to Rep. Henry A. Waxman (Apr. 8, 2003).

[22] *Id.*

[23] Letter from Lt. Gen. Robert B. Flowers, U.S. Army Corps of Engineers, to Rep. Henry A. Waxman (May 2, 2003).

[24] Senate Democratic Policy Committee, *An Oversight Hearing on Iraq Contracting Abuses* (Sept. 10, 2004).

[25] *Id.*

[26] U.S. Army Corps of Engineers, *Press Release: U.S. Army Corps of Engineers Awards Contracts for Repair of Iraq's Oil Infrastructure* (Jan. 16, 2004).

fee, as a percentage of those costs. Under its RIO 2 contract, Halliburton can receive up to 3% of its costs as an award fee.[27]

The award of the RIO 2 contract to Halliburton was controversial because DCAA had warned the Corps of Engineers not to enter into future negotiations with the company without consulting with the auditors. On December 31, 2004, DCAA issued a "Flash Report," alerting various Defense Department agencies about "significant deficiencies" in Halliburton's cost estimating system that "could adversely affect the organization's ability to propose subcontract costs in a manner consistent with applicable government contract laws and regulations."[28] Based on that Flash Report, the auditors sent out a second memo on January 13, 2004, warning that Halliburton could not adequately estimate its costs for work in Iraq.[29] The memo emphasized that Halliburton's systemic deficiencies "bring into question [Halliburton's] ability to consistently produce well-supported proposals that are acceptable as a basis for negotiation of fair and reasonable prices."[30] It also stated:

> We recommend that you contact us to ascertain the status of [Halliburton's] estimating system prior to entering into future negotiations.[31]

On January 16, 2004, just three days after this memo was sent, the Army Corps of Engineers awarded Halliburton the new $1.2 billion contract.[32] The Corps of Engineers confirmed that it had received the DCAA memo before making the decision, but according to DCAA, the Corps did not consult with the auditors as advised.[33] In response to questions about why the Corps disregarded the auditor

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27 Projecting and Contracting Office, *Amendment of Solicitation/Modification of Contract* (Dec. 16, 2004). There is no automatic base fee under the RIO 2 contract.

28 Defense Contract Audit Agency, *Flash Report on Estimating System Deficiency Found in the Proposal for Contract No. DAAA09-02-D-0007, Task Order No. 59* (Audit Report No. 3311-2004K24020001) (Dec. 31, 2003).

29 Defense Contract Audit Agency, *Status of Brown & Root Services (BRS) Estimating System Internal Controls* (Jan. 13, 2004).

30 *Id.*

31 *Id.*

32 U. S. Army Corps of Engineers, *News Release: U. S. Army Corps of Engineers Awards Contracts for Repair of Iraq's Oil Infrastructure* (Jan. 16, 2004) (including, but not limited to, "extinguishing oil well fires; environmental assessments and cleanup at oil sites; oil infrastructure condition assessments; engineering design and construction necessary to restore the infrastructure to a safe operating condition; oilfield, pipeline and refinery maintenance; procurement and importation of fuel products; distribution of fuel products within Iraq; technical assistance in marketing and sale/export; and technical assistance and consulting services to the Iraqi oil companies").

33 House Committee on Government Reform, *The Complex Task of Coordinating Contracts Amid Chaos: The Challenges of Rebuilding a Broken Iraq* (Mar. 11, 2004).

warnings, an Army spokesman stated: "We have our own internal audit process [and we] haven't turned up any serious wrongdoing or major problems."[34]

Under the RIO 2 contract, Halliburton has been tasked with a range of oil infrastructure restoration and fuel importation projects. The contract currently is worth over $365 million out of a maximum value of $1.2 billion.[35] The contract is overseen by the Project and Contracting Office, which is operated by the Defense Department. A private contractor, Foster-Wheeler, assists the PCO in overseeing both RIO 2 contracts.

FINDINGS

The previously undisclosed correspondence, evaluations, and award fee documentation reviewed in preparation of this report reveal multiple serious problems with Halliburton's performance under the contract. These problems include apparently intentional overcharging, exorbitant costs, poor cost reporting, slipping schedules, and refusal to cooperate with the government. Over the course of a year, from July 2004 to July 2005, these problems emerged, worsened, and persisted. By January 29, 2005, the problems were so severe that the PCO took the extreme step of issuing a "cure notice" to Halliburton, which is a notification that the contract may be terminated for cause. When Pentagon auditors reviewed $365 million in Halliburton costs, they challenged $45 million as questioned or unsupported.

Correspondence and Evaluations Reveal Persistent Problems

A review of hundred pages of correspondence between Halliburton and the PCO and multiple evaluations prepared by the oversight contractor, Foster-Wheeler, reveal a persistent pattern of deficient performance and inadequate cost reporting.

The story of Halliburton's RIO 2 problems begins on May 29, 2004, when the PCO provided Halliburton with a detailed description of the cost reporting it expected from the company.[36] Within two months, problems started to surface. In July 2004, Halliburton was informed by the PCO that its "reporting needed to show changes which have been made in the last six months to visibly demonstrate we are not repeating past mistakes of the RIO contract."[37] The company was also

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34 *Halliburton Contract Questions Dog White House,* Chicago Tribune (Feb. 1, 2004).

35 Briefing by Defense Contract Audit Agency for Committee on Government Reform staff (Mar. 3, 2006).

36 Letter from Coalition Provisional Authority, Program Management Office to KBR Contracts Manager (May 29, 2004).

37 KBR, *Minutes of Meeting* (July 15, 2004).

directed to commit to reducing its support staff in Kuwait to just ten individuals within 90 days.[38]

On August 28, 2004, the PCO sent Halliburton a sharply worded "letter of concern."[39] The letter began by stating, "you have universally failed to provide adequate cost information as required."[40] According to the PCO, its "own failed attempts to get [Halliburton] to provide adequate cost information under this contract" and adverse audit findings "reflect profound systemic problems."[41] The PCO also explained that Halliburton was "accruing exorbitant indirect costs at a rapid pace."[42]

In an attachment to the letter, the PCO noted that Halliburton "has not shown any attempt to comply" with the cost reporting requirements established in the original May, 29, 2004 letter.[43] The PCO explained that Halliburton "has done the minimum and has not shown initiative in providing the information required despite repeated requests and several meetings."[44] The PCO then expressed the concern that the reports that had been provided were "vetted of any information that would allow tracking of details."[45] The PCO also complained that Halliburton had denied the government access to its electronic cost reporting system.

Meetings were held in October 2004 to further discuss these problems. At these meetings, the PCO expressed concern that the size of Halliburton's support staffs in Houston and Kuwait was excessive. According to the PCO, the Kuwait office had already spent 78% of its budget "in four months of a nineteen month schedule."[46]

A report from Foster-Wheeler in late October found that "unacceptable unchecked cost reports [were] being issued" by Halliburton.[47] The oversight contractor also pointed out that Halliburton was prioritizing RIO 2 projects "without PCO approval" and that there was a "lack of cost control … in Houston, Kuwait, and

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38 *Id.*

39 Letter from Project and Contracting Office to KBR (Aug. 28, 2004).

40 *Id.*

41 *Id.*

42 *Id.*

43 Project and Contracting Office, *PCO Comments on the KBR July Monthly Reports* (undated).

44 *Id.*

45 *Id.*

46 Project and Contracting Office, *Review of KBR Cost Reports: Summary of Points Raised 26 Oct 04 – KBR Offices, Basra* (undated).

47 Foster-Wheeler, *Cost Review Meetings at KBR Offices, Basra — 25-29 Oct 04* (Oct. 29, 2004).

Iraq" under one task order.[48] Foster-Wheeler concluded that the company's "top, very top management" should be informed of the PCO's "serious concerns."[49]

Halliburton's deficient performance continued into November 2004. In a November 11 letter to Halliburton, the PCO stated that Halliburton's recent monthly cost report "does not meet minimum standards."[50] After noting Halliburton's "on-going cost reporting deficiencies," the PCO explained that Halliburton "failed to provide an adequate cost report in the nine months since contract award."[51] The PCO warned that continued "substandard" cost reports could result in a cure notice.[52]

Halliburton's October, November, and December cost reports were similarly criticized. Foster-Wheeler found Halliburton's description of the progress made on an oil field project to be "misleading" and "distorted."[53] The oversight contractor also stated that "there are still too many people booking man hours in Houston."[54] Although Halliburton acknowledged cost overruns and schedule slippage in its December report, Foster-Wheeler found that Halliburton "does not address … how they intend to reduce costs and get schedules back on target."[55]

The PCO took the extreme step of issuing a "cure notice" on January 29, 2005. This letter notified Halliburton that its RIO 2 contract could be terminated if the ongoing problems were not cured. The contracting officer stated that Halliburton's "failure to deliver a useable, accurate cost report" was "endangering performance of the contract."[56] He explained:

> The Government has made numerous attempts to work with KBR to bring their cost reporting procedures into minimal acceptable standards.… To date, KBR has yet to produce a cost report that would meet minimal acceptable standards to report accurate costs incurred to date.[57]

The cure notice also stated that Halliburton's "lack of cost containment and funds management is the single biggest detriment to this program."[58]

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48 *Id.*

49 *Id.*

50 Memorandum from Project and Contracting Office to KBR (Nov. 11, 2004)

51 *Id.*

52 *Id.*

53 Foster-Wheeler, *Follow-Up Cost Review — Qarmat Ali Water Injection* (Nov 22, 2004).

54 Foster-Wheeler, *Critique of KBR November 2004 Monthly Cost Report*

55 Foster-Wheeler, *PCO — Delinquencies with KBR Dec 2004 Monthly Report* (undated).

56 Letter from Project and Contracting Office to KBR (Jan. 29, 2005).

57 *Id.*

58 *Id.*

On February 20, 2005, Halliburton presented its "Corrective Action Plan" for addressing cost reporting deficiencies identified in the cure notice.[59] The company committed to making the necessary changes in its February cost report, but these changes were not made. Foster-Wheeler's analysis of the February cost report disclosed ongoing problems. According to the oversight contractor, "Baseline schedules are continually changing from one month to the next, making it impossible to evaluate the slippage against the original plan."[60] Foster-Wheeler found that under just one task order, Halliburton was billing for 30 excessive employees in Houston.

On March 7, 2005, the PCO formally responded to Halliburton's proposed corrective actions. According to the PCO contracting officer, Halliburton's characterization of a February meeting between the parties was "not a factual statement."[61] The contracting officer explained that "[t]he purpose of the meeting was for the Government representatives to gain an understanding of the system to help us understand how the cost reports have gotten so out of control."[62] He stated, "Inaccurate data is primarily what has made the cost report ineffective to date."[63] The contracting officer also expressed "sheer frustration with the consistent lack of accurate data" despite "repeated failed attempts by the Government."[64] Moreover, he was concerned that "it appears as though KBR is billing the Government on estimated hours versus actual costs incurred."[65] He concluded that "cost containment and control has become the number one issue for this program."[66]

Problems persisted in March and April. Foster-Wheeler highlighted schedule delays in engineering and procurement.[67] Under one task order, Halliburton reported savings of $285,000 when, in fact, there was a cost overrun of more than $1 million.[68]

By late May 2005, the contracting officer detected improvements in cost control and reporting.[69] However, the cure notice remained in effect for a full six months

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59 Kellogg Brown & Root, *Monthly Cost Report Corrective Action Plan* (Feb. 20, 2005).

60 Foster-Wheeler, *SPCOC Critique — KBR Feb 2005 Monthly Report* (Mar. 21, 2005).

61 Letter from Project and Contracting Office to KBR (Mar. 7, 2005).

62 *Id.*

63 *Id.*

64 *Id.*

65 *Id.*

66 *Id.*

67 Foster-Wheeler, *PCO Oil Program — South: KBR Monthly Detailed Progress Report Dated March 2005* (June 13, 2005).

68 Foster-Wheeler, *Monthly Report Review: KBR Monthly Report, April 2005* (May 25, 2005).

69 Letter from Project and Contracting Office to KBR (May 29, 2005).

until July 2005 because of outstanding problems. Over one year after the Defense Department began identifying serious problems under the RIO 2 contract and instructed Halliburton to correct them, the company's performance was still plagued by significant deficiencies.

Award Fee Determinations Confirm Halliburton's Poor Performance

Another indication of Halliburton's consistently poor performance is its dismal award fee evaluations. The first award fee determination covered the period from January 16, 2004, to January 29, 2005. The second covered the period from January 30, 2005, to July 27, 2005. Both are highly critical of Halliburton's performance.

First Award Fee Determination

In the first award fee determination, Halliburton was eligible for up to $7.9 million in award fees, but was granted $0.[70] As a result, Halliburton received no award fee for over a quarter of a billion dollars worth of work it had completed under 16 task orders in 2004. According to the evaluation forms, its overall score fell within the "poor-inadequate" range.[71]

The evaluations by the PCO upon which the award fee decision was made are revealing. The reviewers "learned of a 'Rate Factor' that KBR had unilaterally elected to include [in] all estimates … that was not revealed to the Government … Only after KBR was compelled to deliver [original files] did the Government understand that many elements of cost in the proposals were marked up with a contingency."[72] In other words, "Cost Estimates had hidden rate factors to increase cost of project without informing the Government."[73]

In one case, Halliburton claimed costs for laying concrete pads and footings that the Iraqi Ministry of Oil "had already put in place."[74] In another case, Halliburton "tried to inflate [a] cost estimate by $26M" by paying "Turkish suppliers above the actual costs incurred."[75] For yet another project, Halliburton "could never justify quotes. When the Government pressed the issue and an actual quote was produced, the quote was 50-75% lower."[76]

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70 Project and Contracting Office, *Award Fee Decision* (May 6, 2005); Email from Joint Contracting Command — Iraq (June 11, 2005).

71 Contractor Performance Evaluation Report (undated).

72 Project and Contracting Office, *KBR Award Fee Board (Up to 29 Jan 05)* (undated).

73 *Id.*

74 *Id.*

75 *Id.*

76 *Id.*

These were not isolated incidents. Under several task orders, the reviewers found that Halliburton could not justify or substantiate its costs. An entire task order "was terminated as the Government and KBR could not reach a fair and reasonable price."[77] Moreover, the reviewers found that Halliburton was still billing for too many support staff hours in Houston and "continued to overburden existing task orders with excess manpower."[78]

Other serious performance problems were noted, as well. The reviewers found that 50% of RIO 2 projects had not been completed on time. They also found that "[l]ittle effort has been shown to date to catch and correct schedule slippages."[79] According to the reviewers, "lapses in technical performance" forced the government to bear unnecessary costs.[80] Moreover, the reviewers found that Halliburton "has not shown the initiative to address systemic problems with the cost reporting system."[81]

The PCO evaluation also described Halliburton's "minimally cooperative attitude." The PCO reported, for example, that "it appeared that the Government request" to access Halliburton's Electronic Document Management System "had been ignored."[82]

<u>Second Award Fee Determination</u>

Halliburton's persistent performance problems are also reflected in a second award fee evaluation, covering the period from January 30, 2005, through July 27, 2005. In this instance, Halliburton received $876,713 in award fees, just 20% of the amount for which it was eligible.[83] The PCO's Oil Sector Contracting Chief characterized the evaluation upon which the decision was made as "overwhelmingly negative." [84] He also said that the evaluation "paints a picture much more dire than [Halliburton's score of] 75% might seem to represent."[85]

The PCO reviewers presented one Halliburton "weakness" after another.[86] The reviewers expressed concern about "not realistic" and "inaccurate cost

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77 *Id.*

78 *Id.*

79 *Id.*

80 *Id.*

81 *Id.*

82 *Id.*

83 Project and Contracting Office, *Award Fee Decision* (undated).

84 *Id.*; Email from Joint Contracting Command — Iraq to Project and Contracting Office (Aug. 18, 2005).

85 *Id.*

86 Project and Contracting Office, *DB-KBR Six Months Evaluation for Period Ending 27 Jul 2005* (Aug. 19, 2005).

estimating," as well as Halliburton's failure to implement "cost avoidance measures."[87] They found that bloated staffing in Kuwait was still "eating away at limited resources."[88] The reviewers also found that Halliburton "did not adequately demonstrate initiative needed to effect the recovery of schedule slippage" despite its "untimely work."[89]

The review again noted Halliburton's resistance to oversight. According to the PCO, Halliburton's contracting department was "obstructive" and the company's "leadership demonstrated minimal cooperative attitude resolving problems."[90] The reviewers reported that the government's requests to access Halliburton's electronic document management system met "with little success."[91]

DCAA Audit Findings Challenge Costs

Audits from the Defense Contract Audit Agency shed additional light on Halliburton's failure to control costs under the RIO 2 contract, identifying questioned and unsupported costs totaling $45 million.

In response to a bipartisan document request, DCAA provided the Committee on Government Reform with four initial audits of Halliburton's RIO 2 contract.[92] The audits examine $111 million in Halliburton costs under three task orders. In these initial audits, the auditors detected significant questioned and unsupported costs. As Table A shows, out of $111 million in RIO 2 costs examined, DCAA challenged $57 million in costs as questioned or unsupported. This is more than half of Halliburton's costs for these projects. For one project, DCAA challenged 69% of Halliburton's proposed costs.

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87 *Id.*

88 *Id.*

89 *Id.*

90 *Id.*

91 *Id.*

92 DCAA, *Report on Audit of Recorded Direct Costs on Contract No. W9126G-04-D-0001, Task Orders 2 and 5* (Audit Report No. 3311-2004K17900090) (Feb 19, 2005); DCAA, *Report on Audit of Proposal for Kellogg Brown and Root Services, Inc. NGL/LPG Storage/Shipping Terminal at Umm Qasr (Project 5)* (Audit Report No. 2131-2005N21000005) (Feb. 5, 2005); DCAA, *Report on Audit of TO 11 Project 2 Proposal for the Khor Zubayr NGL Facility* (Audit Report No. 2131-2005N21000002) (Feb. 5, 2005); DCAA, *Report on Audit on Kellogg Brown & Root Services, Inc. Proposal for Repair and Continuity of Iraqi Oil Infrastructure — South (Project 1)* (Audit Report No. 2131-2005N21000001) (Feb. 5, 2005);

TABLE A: QUESTIONED AND UNSUPPORTED COSTS UNDER HALLIBURTON'S RIO 2 CONTRACT			
Task Order	**Proposal Value**	**Questioned or Unsupported Costs**	**Percentage of Costs Questioned/ Unsupported**
2	$6,330,504	$712,543	11%
5	$3,702,820	$674,052	18%
11 (Project 1)	$40,666,591	$28,088,218	69%
11 (Project 2)	$31,700,937	$14,675,617	46%
11 (Project 5)	$28,705,950	$12,845,449	45%
TOTALS	$111,106,802	$56,995,879	51%

In the audits, DCAA repeatedly found that Halliburton "was unable to provide adequate justification of price reasonableness for proposed equipment, material, subcontract and other direct costs."[93] DCCA concluded: "we do not believe the contractor's proposal is an acceptable basis to negotiate a fair and reasonable price due to the significant inadequacies in the cost and pricing data."[94]

According to DCAA, eight additional audits of RIO 2 have been completed and three are ongoing.[95] Some of these additional audits may supersede the four audits provided to the Committee. The complete set of 15 audits examines $365 million in Halliburton costs. DCAA identified $41 million in questioned costs and $4 million in unsupported costs. Thus, DCAA has challenged a total of $45 million in costs, or 12% of the total costs examined.

CONCLUSION

Two years ago, despite warnings from auditors not to enter into further contracts with Halliburton, the Defense Department awarded Halliburton a new oil infrastructure contract, RIO 2. Internal government documents show that Halliburton's performance under RIO 2 has been deeply flawed. Among the serious and persistent problems identified in the documents are repeated examples of apparently intentional overcharging, exorbitant costs, poor cost reporting,

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93 *See, e.g.*, DCAA, *Report on Audit of Proposal for Kellogg Brown and Root Services, Inc. NGL/LPG Storage/Shipping Terminal at Umm Qasr (Project 5)* (Audit Report No. 2131-2005N21000005)(Feb. 5, 2005).

94 *Id.*

95 Briefing by Defense Contract Audit Agency for Committee on Government Reform staff (Mar. 3, 2006).

slipping schedules, and a refusal to cooperate with the government. The impact on the reconstruction effort in Iraq and on taxpayers is significant, with Pentagon auditors challenging $45 million in RIO 2 costs.