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JAN 26 2006

Mr. Jean-Pierre Halbwachs
Chairman
International Advisory and Monitoring Board

Dear Mr. Halbwachs,

Thank you for the opportunity to brief the IAMB at your Paris meeting on January 23, 2006, regarding the comprehensive negotiated settlement between the U.S. Army Corps of Engineers (USACE) and Kellogg, Brown & Root Services (KBRS) of the six Development Fund for Iraq (DFI)-funded task orders under the Task Force Restore Iraqi Oil (TF RIO) contract. The total payment by USACE to KBRS under this settlement is **\$1.498 billion** for the DFI-funded portion of Task Orders 5-10. As part of the settlement, KBRS relinquished all future claims on the contract, thereby limiting further liability to the DFI beyond this amount. The only remaining payment anticipated from the DFI is \$47 million to reimburse USACE for final payments to KBRS. There are adequate funds remaining in the DFI sub-account to cover this amount.

At the meeting you asked for a more formal accounting of the resolution of the questioned costs that the Defense Contract Audit Agency (DCAA) identified in its audits of the TF RIO contract.

DCAA Audits. DCAA is an integral part of Department of Defense management controls within the acquisition process. DCAA provides advice and audits to assist contracting officials in negotiating fair and reasonable prices and to ensure that contractors comply with regulatory and contractual requirements. Contracting officials responsible for the TF RIO contract fully utilized DCAA's services in this regard. These services helped reduce costs to the DFI and protect U.S. and Iraqi interests.

Since the TF RIO contract was a cost-plus award fee contract, DCAA audits of KBRS's work were needed to support negotiation of the contract price and ensure the integrity and transparency of KBRS's costs. DCAA conducted a series of audits of KBRS's price proposals for final settlement of each task order. DCAA's final audits of TF RIO Task Orders 5-10 questioned **\$208.5 million** (*\$193.4 million* of which are DFI funds) of the costs submitted by KBRS. The audits identified these as questioned costs, not unallowable costs. Questioned costs represent DCAA recommendations for the USACE contracting officer's consideration in the negotiations with KBRS about the settlement of each task order and should not be construed as overcharges.

DCAA conducts numerous price proposal audits of Department of Defense contracts and frequently recommends price reductions. In complex contracting situations, such as that encountered in the TF RIO contract, it is not uncommon that the contracting officer examines the business operating environment, seeks advice of other technical advisers, and obtains additional information from the contractor that results in acceptance of some or most of the questioned costs.

With the benefit of information provided by DCAA and other advisors, the USACE contracting officer responsible for administering the TF RIO contract requested and, in most cases, received additional information (which included information other than cost data) from KBRS on those costs that had been questioned. After receiving the supporting information that KBRS provided, the contracting officer was prepared to negotiate a final settlement of each task order with KBRS. The contracting officer resolved the questioned costs in accordance with normal Department of Defense business procedures, fully considering the audits and financial advice provided by DCAA and other technical advisors.

Settlement and Resolution of Questioned Costs. The settlement price for each task order includes two components: costs KBRS actually incurred (the “cost” part of “cost plus award fee”) and management and performance fees (the “plus” part). For the six task orders, the contracting officer determined that **\$3.8 million** of the questioned costs were in fact unacceptable as incurred costs. USACE did not pay KBRS for these costs.

DCAA, in general, did not question whether KBRS had incurred the costs claimed, but whether KBRS could have used better business approaches in managing the contract. As a result, the contracting officer reduced KBRS’s management and performance fees. The contracting officer excluded \$108 million of the questioned costs from the amount used to determine the basis on which management and performance fees are calculated (these fees are percentages of the basis). Applying the management fee and average award fee percentages to this reduced basis, **\$5.2 million** was deducted from fees that would otherwise have been paid to KBRS. This amounts to a 7% reduction in the management and performance fees that KBRS could have received.

In sum, the contracting officer, in resolving the \$208 million in questioned costs recommended by DCAA, withheld **\$9 million** in payments that KBRS could otherwise have received.

Furthermore, in addition to the direct impact of \$9 million, the questioned costs affected the overall rating of KBRS’s performance on the contract. This resulted in a performance award fee percentage less than the maximum allowed (5%), further reducing KBRS’s potential fees.

In total, the settlement price of \$1.498 billion included:

- \$1.432 billion to pay KBRS for acceptable incurred costs and allocable overhead and administrative costs
- \$66 million for management and performance fees

The Department intends to continue to be fully supportive of the important work of the IAMB, and to be as transparent as possible concerning DFI-funded contracts administered by U.S. agencies. Please do not hesitate to contact me with any further questions the IAMB may have.

Best regards,



Joseph A. Benkert
Deputy Director