

July 2007

DEFENSE
CONTRACT
MANAGEMENT

DOD's Lack of
Adherence to Key
Contracting Principles
on Iraq Oil Contract
Put Government
Interests at Risk





Highlights of [GAO-07-839](#), a report to congressional requesters

Why GAO Did This Study

The Department of Defense's (DOD) U.S. Army Corps of Engineers (Corps) awarded the \$2.5 billion Restore Iraqi Oil (RIO I) contract to Kellogg Brown & Root in March 2003 in an effort to reestablish Iraq's oil infrastructure. The contract was also used to ensure adequate fuel supplies inside Iraq. RIO I was a cost-plus-award-fee type contract that provided for payment of the contractor's costs, a fixed fee determined at inception of the contract, and a potential award fee. The Defense Contract Audit Agency (DCAA) reviewed the 10 RIO I task orders and questioned \$221 million in contractor costs. We were asked to determine (1) how DOD addressed DCAA's RIO I audit findings and what factors contributed to DOD's decision and (2) the extent to which DOD paid award fees for RIO I and followed the planned process for making that decision. To accomplish this, we reviewed DOD and DCAA documents related to RIO I and interviewed Corps, DCAA, and other officials.

What GAO Recommends

GAO recommends the Secretary of the Army, in contingency situations, ensure that an analysis of the feasibility of following a rigorous award fee process is conducted when using cost-plus-award-fee contracts. In written comments, DOD agreed with the recommendation.

www.gao.gov/cgi-bin/getrpt?GAO-07-839.

To view the full product, including the scope and methodology, click on the link above. For more information, contact John Hutton at (202) 512-4841 or huttonj@gao.gov.

DEFENSE CONTRACT MANAGEMENT

DOD's Lack of Adherence to Key Contracting Principles on Iraq Oil Contract Put Government Interests at Risk

What GAO Found

DOD considered DCAA's audit findings on the RIO I contract and performed additional analysis before deciding to pay the contractor nearly all of the \$221 million in costs that DCAA questioned. DOD did, however, remove about \$112 million of the questioned costs from the amount used to establish the contractor's fee pool, which resulted in an effective lowering of the fee received by the contractor by approximately \$5.8 million. Lack of timely negotiations contributed significantly to DOD's decision on how to address the questioned costs—all 10 task orders were negotiated more than 180 days after the work commenced. As a result, the contractor had incurred almost all its costs at the time of negotiations, which influenced DOD's decision to pay nearly all of the questioned costs. The negotiation delays were in part caused by changing requirements, funding challenges, and inadequate contractor proposals. In our previous work, we have found that negotiation delays can increase risk to the government. Overall, DCAA considers \$26 million of the costs questioned on the RIO I contract to be sustained, which DCAA defines as cost reductions attributable to its audit findings. We compared the sustention rates on DCAA's 11 RIO I contract audits to the sustention rates for 100 DCAA audits of other Iraq contract actions, and found that the sustention rates varied widely for both groups.

DOD's Army Corps of Engineers paid \$57 million in award fees on the RIO I contract, or 52 percent of the maximum possible, and on individual task orders the fee awarded ranged from 4 to 72 percent of the fee available. While the award fee plan required regular award fee boards during the life of the contract, DOD did not conduct a formal board until nearly all work on the contract was complete. As a result, DOD was not able to provide the contractor with formal award fee feedback while work was ongoing, which federal regulations state should be done in order to motivate a contractor to either improve poor performance or continue good performance. DOD officials told us the workload of RIO staff members and logistical difficulties stemming from the challenging conditions in Iraq hindered efforts to hold evaluation boards during the period of performance. DOD also was unable to give us enough documentation for a full assessment of its compliance with other parts of its plan—it did not, for example, provide the scores the award fee board assigned to the contractor on the individual award fee criteria, so we could not see if the award fee board had followed contract criteria and weighting in evaluating performance. We compared the percentage of award fees earned on the RIO I contract to the fees earned on a group of other selected Iraq reconstruction contracts and found that the percentage of award fees earned on RIO I fell within the lower range of fees earned on the other contracts.

Contents

Letter

Results in Brief	1
Background	3
Delayed Negotiations Shaped DOD's Decision to Pay the Contractor for Nearly All of the Costs Questioned on the RIO I Contract	5
DOD Paid About Half of the Maximum Possible Award Fee for the RIO I Contract, but Did Not Fully Adhere to Key Steps in Its Award Fee Plan for Providing Performance Feedback to the Contractor	9
Conclusion	23
Recommendation for Executive Action	29
Agency Comments and Our Evaluation	30

Appendix I

Objectives, Scope, and Methodology	32
---	-----------

Appendix II

Comments from the Department of Defense	34
--	-----------

Tables

Table 1: GAO's Analysis of the Resolution of DCAA's Questioned Costs	12
Table 2: DCAA's Questioned Costs Sustained on the RIO I Contract Audits	21
Table 3: Award Fee Paid for RIO I Task Orders	24

Figures

Figure 1: Reasons for DCAA Questioned Costs	8
Figure 2: Elapsed Days from Notice to Proceed to Definitization	15
Figure 3: Comparison of Sustention Rates	22
Figure 4: Percentage of Award Fee Earned on the RIO I Contract and on 11 Other Selected Iraq Reconstruction Contracts from January 2004 to June 2006	29

Abbreviations

DCAA	Defense Contract Audit Agency
DESC	Defense Energy Support Center
DFARS	Defense Federal Acquisition Regulation Supplement
DOD	Department of Defense
DFI	Development Fund for Iraq
FAR	Federal Acquisition Regulation
RIO	Restore Iraqi Oil

This is a work of the U.S. government and is not subject to copyright protection in the United States. It may be reproduced and distributed in its entirety without further permission from GAO. However, because this work may contain copyrighted images or other material, permission from the copyright holder may be necessary if you wish to reproduce this material separately.



United States Government Accountability Office
Washington, DC 20548

July 31, 2007

The Honorable Henry A. Waxman
Chairman
The Honorable Tom Davis
Ranking Member
Committee on Oversight and Government Reform
House of Representatives

The Honorable Daniel K. Akaka
Chair
Subcommittee on Oversight of Government Management, the Federal
Workforce, and the District of Columbia
Committee on Homeland Security and Governmental Affairs
United States Senate

The United States, along with its coalition partners and various international organizations and donors, has embarked on a significant effort to rebuild Iraq. As of October 2006, the United States had obligated about \$29 billion for reconstruction and stabilization efforts in Iraq. The United States has relied heavily on private sector contractors to provide the goods and services needed to support reconstruction efforts in Iraq. For example, to help reestablish Iraq's oil infrastructure, in March 2003 the U.S. Army Corps of Engineers (Corps) awarded the Restore Iraqi Oil (RIO I) contract to Kellogg Brown & Root.¹ The contract was also used to import fuels from neighboring countries to avoid domestic fuel shortages in Iraq. Under this contract, the Corps issued 10 task orders worth approximately \$2.5 billion. The RIO I contract, like many other reconstruction and support contracts, was a cost-plus-award-fee type contract. In general, these contracts provide for payment of the contractor's allowable, allocable, and reasonable costs; a fixed base fee amount determined at inception of the contract; and a potential award fee sufficient to provide motivation for excellence in contract performance. A cost-plus-award-fee contract, like other cost reimbursement type contracts, increases the risk to the government of incurring higher than expected costs, as compared to some other contract types. To mitigate this risk, these types of contracts require sufficient oversight.

¹ Kellogg Brown & Root is now known as KBR.

The Defense Contract Audit Agency (DCAA) provides services that can help the Department of Defense (DOD) ensure accountability for its acquisitions. DCAA performs audits and provides financial advisory services in connection with the negotiation, administration, and settlement of contracts and subcontracts. For example, DCAA has audited many Iraq contract proposals and contracts and has identified costs it considers to be questioned. DCAA defines questioned costs as those costs that are not acceptable for negotiating a fair and reasonable contract price. Ultimately, the contracting officer has the final decision about whether questioned costs should be paid, taking into account DCAA's advice and other information. On the RIO I contract, DCAA identified \$221 million in questioned costs in its final audits of the task order proposals under the contract.

Because of your interest in understanding the final agreement reached between DOD and the contractor on the RIO I contract, we examined (1) how DOD addressed DCAA's audit findings on the contract and what factors contributed to DOD's decision of how to address these findings and (2) the extent to which DOD paid award fees for the contract and followed the planned process for making that decision.

To determine how DOD addressed DCAA's audit findings on the RIO I contract and the factors that contributed to DOD's decision of how to address those findings, we reviewed negotiation memorandums and DCAA audit reports for each of the 10 RIO I task orders and other documents related to the negotiation process and resolution of DCAA's findings. We also interviewed Corps, DCAA, and other government officials as well as contractor representatives. Additionally, to put DOD's decisions into context, we compared the resolution of DCAA's questioned cost findings on 100 audits of Iraq-related contract actions that were resolved as of the end of fiscal year 2006 to the resolution of the questioned cost findings on the RIO I task order audits. Because a contracting officer has the discretion to determine whether or not to pay questioned costs when reaching agreement with a contractor, our review does not include a determination of whether the DOD contracting officer should have approved payment for the questioned costs.

To determine the extent to which DOD paid award fees for the RIO I contract and followed its planned process for making that decision, we collected and reviewed key documents related to the award fee process, including the award fee determining official's decision and the award fee plan. We also interviewed Corps officials to develop an understanding of the process and outcome for the award fees and contractor

representatives to obtain their perspective on award fees. Additionally, to put the award fee for the RIO I contract into context, we examined available award fee documentation for 11 large contracts that DOD awarded in 2004 to carry out reconstruction activities in Iraq. During the period we looked at, January 2004 through June 2006, a total of 37 award fee evaluation periods were conducted for the 11 contracts. Because an award fee determination is a unilateral decision made solely at the discretion of the government based upon judgmental evaluations of individual contractor performance, our review does not include a determination of whether DOD reached the appropriate award fee decision for the RIO I contract. Appendix I provides details on our scope and methodology. We conducted our work from October 2006 through July 2007 in accordance with generally accepted government auditing standards.

Results in Brief

DOD considered DCAA's audit findings on the RIO I contract and performed additional analysis before deciding to pay the contractor nearly all of the \$221 million in costs that DCAA questioned, a decision influenced by the fact that negotiations of the task orders' terms and conditions did not begin until most of the work was complete. DOD also removed about \$112 million of the questioned costs from the amount used to establish the contractor's fee pool, which resulted in an effective lowering of the fee received by the contractor by approximately \$5.8 million. Lack of timely negotiations was a major contributing factor to DOD's decision on how to address the questioned costs. Although the Defense Federal Acquisition Regulation Supplement (DFARS) generally requires that contract actions be definitized within 180 days after issuance of the action, all 10 task orders were negotiated more than 180 days after the work commenced. As a result, the contractor had incurred nearly all costs at the time of negotiations, and this fact influenced the DOD contracting officer's decision to pay most of the questioned costs. According to various DOD officials and contractor representatives, changing requirements, funding challenges, and inadequate contractor proposals contributed to the negotiation delays. These findings are consistent with our previous work, where we found that factors such as changing requirements and difficulties with funding were linked to delays in definitization, and that these delays can increase risk to the government. Overall, DCAA considers \$26 million of the costs questioned on the RIO I contract to be sustained, which DCAA defines as cost reductions directly attributable to its audit findings. We compared the sustention rates on DCAA's 11 RIO I contract audits to the sustention rates for 100 DCAA

audits of other Iraq contract actions, and found that the sustention rates varied widely for both groups.

DOD's Army Corps of Engineers paid about \$57 million in award fees, or 52 percent of the maximum possible award fees, on the RIO I contract, but it did not adhere to some key steps in its planned award fee process related to providing performance feedback to the contractor. The award fee paid varied by task order, ranging from 4 percent to 72 percent of the possible award fee. DOD developed an award fee plan that laid out the steps for making its award fee decision, but it did not fully adhere to that plan. For example, the plan required award fee evaluations on a regular basis during the period of performance, but DOD did not conduct a formal evaluation until July 2004, subsequent to the completion of nearly all work on the contract. DOD officials told us the workload of RIO staff members and logistical difficulties stemming from the challenging conditions in Iraq hindered efforts to hold evaluation boards during the period of performance. By not conducting such evaluations during the period of performance, DOD was not able to provide the contractor with formal award fee feedback while work was ongoing, which federal regulations state should be done in order to motivate a contractor to either improve poor performance or continue good performance.² Additionally, DOD was not able to provide us with sufficient documentation to enable us to fully assess its adherence to other steps of its plan. For example, DOD did not have the scores the award fee board assigned to the contractor on the individual award fee criteria in coming to its award fee recommendation. Without these scores, we were unable to determine whether the award fee board had followed the criteria and weighting laid out in the contract in reaching its recommendation. We compared the percentage of award fees earned on the RIO I contract to fees earned on a group of other selected Iraq reconstruction contracts and found that the percentage of award fee earned on the RIO I contract fell within the lower range of fees earned on other contracts.

To ensure that cost-plus-award-fee contracts provide the intended benefits, we are recommending to the Secretary of the Army that the department conduct an analysis of the administrative feasibility of following a rigorous award fee process before awarding a cost-plus-award-fee contract in contingency situations. In written comments, DOD agreed with the recommendation. DOD's comments are included in appendix II.

² Federal Acquisition Regulation (FAR) 16.405-2(b)(3).

Background

The United States, along with its coalition partners and various international organizations and donors, has embarked on a significant effort to rebuild Iraq. As of October 2006, the United States had obligated about \$29 billion for reconstruction and stabilization efforts in Iraq. The United States has relied heavily on private sector contractors to provide the goods and services needed to support the reconstruction efforts in Iraq.

Congress has appropriated substantial amounts to support rebuilding efforts such as restoring Iraq's oil and electric infrastructures, assisting in developing a market-based economy, and improving the country's health, education, and medical services. With regard to Iraq's oil sector, U.S. support has included efforts to (1) restore Iraq's oil infrastructure to sustainable prewar crude oil production and export capacity, and (2) deliver and distribute refined fuels for domestic consumption. Specific U.S. activities and projects for the restoration of Iraq's oil production and export capacity include repairing the Al-Fathah oil pipeline crossing, restoring several gas and/or oil separation plants near Kirkuk and Basrah, and repairing natural gas and liquefied petroleum gas plant facilities in southern Iraq. U.S. activities also include the restoration of wells, pump stations, compressor stations, export terminals, and refineries, and providing electrical power to many of these oil facilities. In addition to infrastructure restoration activities, from late May 2003 through August 2004, the United States facilitated and oversaw the purchase, delivery, and distribution of refined fuels throughout Iraq, primarily funded using the Development Fund for Iraq (DFI).³ These imports—used for cooking, heating, personal transportation, and private power generation—were required to supplement domestic production due to increased demand and Iraq's limited refining capacity.

In early 2003, DOD assigned the Corps the responsibility of the oil restoration activities known as Restore Iraqi Oil. In March 2003 the Corps awarded a cost-plus-award-fee contract, referred to as the RIO I contract, to support the oil restoration mission. Under this contract, the Corps awarded 10 task orders to the contractor worth a total of \$2.5 billion. Two task orders related to oil restoration planning and extinguishing oil fires;

³ On May 22, 2003, United Nations Security Council Resolution 1483 noted the establishment of the Development Fund for Iraq, a special account held on the books of the Central Bank of Iraq. The DFI includes frozen assets of the former Iraqi regime and Iraq oil proceeds. The DFI was to be used for the economic reconstruction and repair of Iraq's infrastructure, among other purposes.

two task orders were for the construction and repair of the oil infrastructure; one was for life support activities, such as lodging and dining services; and five task orders were for the importation, delivery, and distribution of refined fuels throughout Iraq.

At the request of the Corps, DCAA audited the contractor's proposals for the RIO I contract.⁴ DCAA performs many types of audits for DOD, including audits of contractor proposals, audits of estimating and accounting systems, and incurred cost audits. Generally, the results of DCAA audits of contractor proposals are intended to assist contracting officials in negotiating reasonable contract prices. Typically, DCAA audits contractors' proposals and provides contracting officials advice on the reasonableness of contractor costs prior to negotiations. DCAA also conducts audits of cost-type contracts after they are negotiated to ensure costs incurred on these contracts are acceptable. Relying on cost information provided by the contractor and assessing whether the costs comply with government regulations, DCAA may identify certain costs as questioned. DCAA defines questioned costs as costs considered to be not acceptable for negotiating a fair and reasonable contract price. DCAA reports its findings to contracting officers for consideration in negotiating fair and reasonable contract prices.

DCAA audit reports represent one way DCAA can assist contracting officials as they negotiate government contracts. Also, contracting officials may invite DCAA to participate in contract negotiations to explain audit findings and recommendations. DCAA's role is advisory, and the contracting officer is responsible for ensuring that the contractor's proposed price is fair and reasonable.⁵ While DCAA audit recommendations are nonbinding, federal regulations specify that when significant audit recommendations are not adopted, the contracting officer should provide rationale that supports the negotiation result in the price negotiation documentation.⁶

In its final 11 audits of the 10 task orders, DCAA identified \$221 million in questioned costs on the RIO I contract. In total, DCAA issued 22 proposal

⁴ These proposals were intended to definitize the contractual actions and were generally submitted after the contractor had incurred some of its costs.

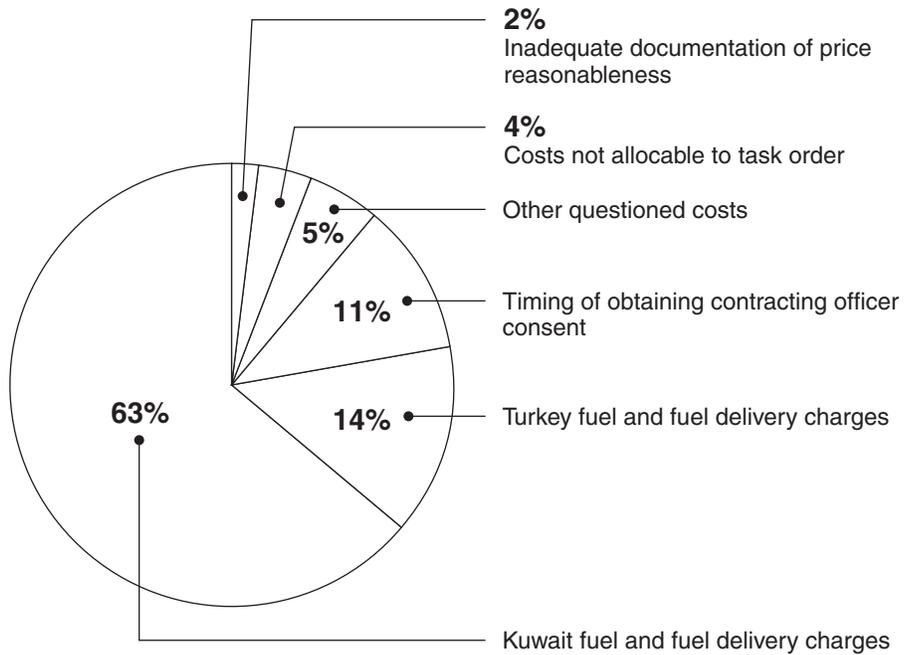
⁵ Federal Acquisition Regulation 1.602-2(c), 15.402(a).

⁶ Federal Acquisition Regulation 15.405(a).

audits of the RIO I contract because DCAA audited multiple proposals for some of the task orders. The final 11 audits included one audit of each task order and an audit of a contractor claim on the life support task order.⁷ Nearly 80 percent of the questioned costs related to the costs paid for fuel and fuel delivery. For example, DCAA questioned \$139 million of the costs the contractor paid for fuel and fuel transportation in Kuwait based on a comparison of the price paid by the contractor and the price paid by the Defense Energy Support Center (DESC) when it took over the mission for the contractor in April 2004. Figure 1 outlines the reasons for DCAA's questioned costs on the RIO I contract.

⁷ More than 99 percent of DCAA's questioned costs were on task orders 3, 5-10, and the contractor claim for task order 4, all of which were negotiated by one DOD contracting officer. Another DOD contracting officer negotiated the other three task orders. Report references to the DOD contracting officer refer to the contracting officer who decided how to address nearly all of the questioned costs.

Figure 1: Reasons for DCAA Questioned Costs



Source: GAO analysis of DOD data.

Note: Numbers do not add to 100 percent due to rounding.

The RIO I contract provided for payment of a fixed fee of 2 percent of the negotiated estimated contract cost plus an award fee amount of up to 5 percent, based on the government’s evaluation of the contractor’s performance. Award fee contracts allow an agency to adjust the amount of fee paid based on contractor performance.⁸ The award fee is intended to motivate excellence in contractor performance, and can also serve as a tool to control program risk and cost. However, the monitoring and evaluation of contractor performance necessary under an award fee contract requires additional administrative effort and cost, and federal regulations provide that the use of such a contract is suitable when the expected benefits of an award fee contract are sufficient to warrant this additional effort and cost.⁹

⁸ GAO recently reviewed DOD’s use of award and incentive fees. See GAO, *Defense Acquisitions: DOD Has Paid Billions in Award and Incentive Fees Regardless of Acquisition Outcomes*, [GAO-06-66](#) (Washington, D.C.: Dec. 19, 2005).

⁹ Federal Acquisition Regulation 16.405-2(b)(iii).

In general, for award fee contracts, DOD personnel (usually members of an award fee evaluation board) conduct periodic evaluations of the contractor's performance against specified criteria in an award fee plan and recommend the amount of fee to be paid. These evaluations are informed by input provided by government personnel who directly observe the contractor's performance. Typically, award fee contracts emphasize multiple aspects of contractor performance, such as quality, timeliness, technical ingenuity, and cost-effective management. Because award fees are intended to motivate contractor performance in areas that are susceptible to judgmental and qualitative measurement and evaluation, these criteria and evaluations tend to be subjective. After receiving the recommendation of the award fee evaluation board, a fee-determining official makes the final decision on the amount of fee the contractor will receive. In certain cases the fee-determining official may also decide to move unearned award fee from one evaluation period to a subsequent evaluation period or periods, thus providing the contractor an additional opportunity to earn previously unearned fee—a practice called rollover.¹⁰

Delayed Negotiations Shaped DOD's Decision to Pay the Contractor for Nearly All of the Costs Questioned on the RIO I Contract

DOD considered DCAA's audit findings and conducted additional analysis before deciding to pay the RIO I contractor nearly all of the \$221 million in costs that DCAA questioned, and to remove \$112 million from the amount used to establish the contractor's fixed and award fees. The reduction in the amount used to establish the fee pool resulted in an effective reduction of the contractor's fee by about \$5.8 million. DOD's decision to pay most questioned costs was shaped by the fact that negotiations did not begin until most of the work was complete and the costs had already been incurred. The delay in negotiations was influenced by factors such as changing requirements, funding challenges, and problems with the contractor's business systems. DCAA considers \$26 million of the costs questioned on the RIO I contract to be sustained, which DCAA defines as cost reductions directly attributable to its questioned cost findings. We compared the sustention rates on DCAA's 11 RIO I contract audits to the sustention rates for 100 DCAA audits of other Iraq contract actions, and found that the sustention rates varied widely for both groups.

¹⁰ In a March 2006 policy memo, DOD established limitations on the use of award fee rollover provisions, including that the use of rollover provisions should be the exception rather than the rule and is a business decision that should be addressed in the acquisition strategy. According to the memo, if the fee-determining official approves the use of rollover, the contract file must be documented accordingly.

DOD Decided to Pay the Contractor for Nearly All of the \$221 Million in DCAA Questioned Costs, but Removed \$112 Million from the Amount Used to Establish the Contractor's Fee on the RIO I Contract

To address the \$221 million in costs questioned by DCAA, DOD collected additional information and conducted additional analysis. For example, after DCAA issued its final audits, DOD collected additional information related to the difference in costs paid by the contractor and those paid by DESC for fuel and fuel delivery from Kuwait, as well as price adjustments the contractor paid to the subcontractor for fuel from Turkey, the two largest reasons for questioned costs. The DOD contracting officer also convened a meeting with contractor representatives, DCAA officials, and other Corps officials to discuss the additional information. As a result of the additional information and analysis presented in the meeting, the DOD contracting officer asked DCAA to conduct financial analyses to quantify options—referred to as financial positions—that he could use in developing the government's objectives for negotiations with the contractor. The financial positions differed from DCAA's final audit reports in some areas, for example, reflecting a narrower gap between the costs paid by the contractor and the costs paid by DESC for the fuel and fuel delivery from Kuwait.¹¹

DOD decided to address the \$221 million in questioned costs in the following ways:

- **Pay both the costs and fees.** The DOD contracting officer decided to pay the contractor costs and associated fees for nearly half of the costs questioned by DCAA. In general, these costs reflected the financial positions prepared for negotiations by DCAA after DOD collected additional information about some of the questioned costs. For example, although DCAA's final audits questioned the costs paid for fuel from Turkey, the financial positions did not include reductions for these costs. The contracting officer used the financial positions as a basis for deciding to pay the contractor for the costs for fuel from Turkey.
- **Not pay the contractor costs or fees.** For less than \$10 million of the questioned costs, DOD decided not to pay the contractor for its costs and the associated fees. For example, the Corps decided not to reimburse approximately \$4 million the contractor spent on leasing diesel trucks that were not used.

¹¹ DCAA officials told us the memos that outlined the financial positions do not supercede DCAA's final audit reports, but were provided to the contracting officer to assist with negotiations.

-
- **Pay the costs but not the fees.** For almost half of the questioned costs, DOD decided to pay the contractor but removed those costs from the amount used to calculate the contractor's fee. These costs were composed primarily of the difference that remained between the prices paid by the contractor and by DESC for fuel and fuel delivery from Kuwait after the contracting officer took into account the financial positions.

When asked about the reason for paying for questioned costs but removing those same costs from the amount used to establish the contractor's fee, the DOD contracting officer told us that this outcome was a result of negotiations. He stated that while the contractor probably did not do everything it could have to lower prices, it took reasonable actions to do so. For example, Corps officials stated that the contractor attempted to obtain lower prices for the fuel and fuel delivery from Kuwait through competition on several occasions. Also, the officials told us that DOD decided to pay for these questioned costs because it felt that it would have been unlikely to prevail in an attempt not to pay costs that had already been incurred by the contractor. Specifically, Corps officials told us they believed that in the event of litigation, they would have been ordered to pay the contractor for incurred costs because, for example, the Corps continually directed the contractor to perform work under the contract.¹² However, these officials told us they believed there was adequate justification to negotiate the exclusion of some questioned costs from fee eligibility.

The DOD contracting officer also believed there were several limitations to the primary reason for DCAA's questioned costs—the comparison of the price paid by the contractor for fuel and fuel delivery from Kuwait to the price paid by DESC, which took over the fuel importation mission in 2004. Specifically, the contracting officer attributed the contractor's higher price to factors such as the Kuwaiti subcontractor's perception of the risk of working in Iraq, short-term subcontracts for the fuel and fuel delivery because of the incremental funding provided, and differences in overhead costs. DESC officials also told us there were several factors that limited the usefulness of the comparison between the prices paid by DESC and the prices paid by the contractor for fuel and fuel delivery from Kuwait, such as the fact that DESC could commit to longer contracts with the

¹² The decision to pay the questioned costs rather than assume the litigative risk and attendant costs associated with defending a claim for disallowance of incurred costs is essentially a matter of the contracting officer's business judgment. See FAR 1.602-2.

Kuwaiti subcontractor and the fact that by contracting with the same subcontractor, DESC could use the fuel transportation infrastructure established under the prior contract (i.e., the start-up costs faced by DESC were lower).

In total, \$112 million of the questioned costs were removed from the amount used to establish the contractor's fee pool. The contractor's fixed and award fees were calculated as a percentage of the costs included in the fee pool. Consequently, removing \$112 million from the amount used to establish the fee pool resulted in an effective lowering of the fees the contractor received by about \$5.8 million (see table 1 for details).¹³

Table 1: GAO's Analysis of the Resolution of DCAA's Questioned Costs

Dollars in thousands

Task order	Purpose	Primary reason for questioned costs	DCAA questioned costs	Changes resulting from DCAA's questioned costs	
				Adjustments to the amount used to establish the fee pool ^a	Effective fee adjustments resulting from changes to the amount used to establish the fee pool ^b
1	Pre-positioning and training	Differences between proposed and actual costs	\$904	-\$904	-\$38
2	Quick fix design	Differences between proposed and actual costs	200	-197	-11
3	Infrastructure repair and restoration	Costs not allocable to task order	11,698	-4,830	-184
4	Life support	Indirect costs due to rate and base differences	86	1,745 ^c	66 ^c
4	Equitable adjustment claim - life support	Indirect costs due to rate and base differences	39	-39	N/A ^d
5	Fuel import and distribution	Kuwait and Turkey fuel and fuel delivery charges	84,446	-45,129	-2,437
6	Infrastructure repair and restoration	Timing of obtaining contracting officer consent	32,078	-5,289	-116

¹³ We calculated the \$5.8 million in the following manner: For each task order, we multiplied the award and fixed fee percentages received by the contractor by the adjustment to the amount used to establish the fee pool (this amount totaled -\$112 million across the task orders). We then summed this total for each task order.

Dollars in thousands

Task order	Purpose	Primary reason for questioned costs	Changes resulting from DCAA's questioned costs		
			DCAA questioned costs	Adjustments to the amount used to establish the fee pool ^a	Effective fee adjustments resulting from changes to the amount used to establish the fee pool ^b
7	Fuel import and distribution	Kuwait and Turkey fuel and fuel delivery charges	35,681	-16,598	-896
8	Fuel import and distribution	Kuwait and Turkey fuel and fuel delivery charges	22,781	-14,562	-786
9	Fuel import and distribution	Kuwait and Turkey fuel and fuel delivery charges	19,903	-15,578	-841
10	Fuel import and distribution	Kuwait and Turkey fuel and fuel delivery charges	13,603	-10,782	-582
Total			\$221,418	-\$112,163	-\$5,826

Source: GAO analysis of DOD data.

^aNumbers in this column reflect our analysis of cost adjustments made to the amount used to establish the fee pool as result of DCAA's questioned costs. At negotiations, DOD also adjusted other contract costs not resulting from DCAA's questioned costs, which are not reflected in this table.

^bNumbers in this column reflect our analysis of what would have happened if DOD had applied the fixed and award fee percentages earned for each of the task orders to the adjustments to the amount used to establish the fee pool resulting from DCAA's questioned costs.

^cCertain costs were questioned by DCAA based on the task order to which they were allocated. The increase to the amount used to establish the fee pool for task order 4 reflects allocation adjustments made based on DCAA's findings associated with task order 3.

^dBecause the equitable adjustment claim exceeded the not-to-exceed amount for task order 4, the contracting officer decided that no fixed or award fees would be paid on the claim.

DCAA officials said they believed the DOD contracting officer followed the standard process for addressing questioned costs. For example, the Director of DCAA testified before Congress that the process worked as it is defined, and that in making its decision of how to address the costs, the Corps "rightly considered other evidence other than the audit reports and considered extenuating circumstances that might have affected the contractor's actions."¹⁴ When asked if he was satisfied with the resolution of the questioned costs, a DCAA official involved in the process told us he

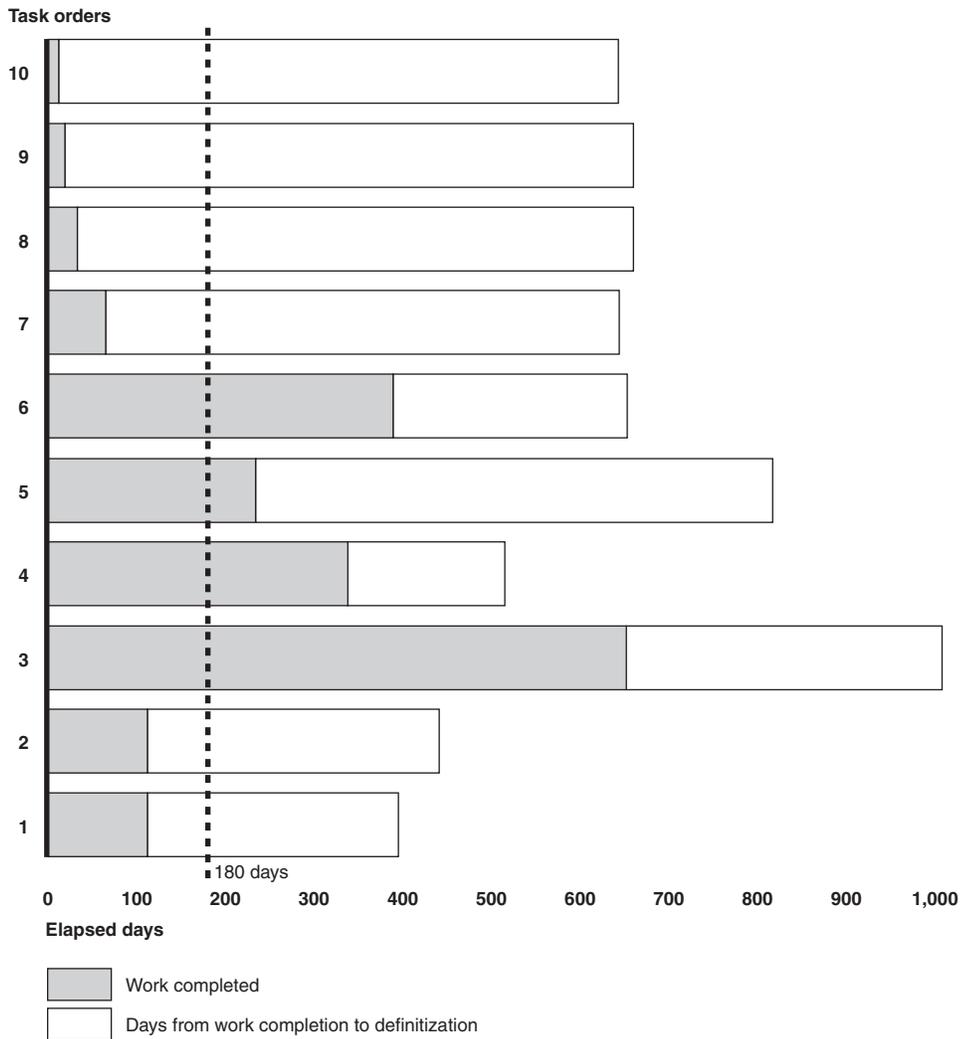
¹⁴ *Iraq Reconstruction: Hearing before the House Comm. on Oversight and Government Reform*, 110th Cong. (2007).

thought the DOD contracting officer did the best job he could, given the circumstances.

Delays in Negotiations Influenced the Contracting Officer's Decision to Pay Questioned Costs

All 10 RIO I task orders were negotiated more than 180 days after the work commenced, and all were negotiated after the work had been completed. The RIO I task orders were considered undefinitized contracting actions because DOD and the contractor had not reached agreement on the terms, specifications, and price of the task orders before performance began. Undefinitized contract actions are used when government interests demand that the contractor be given a binding commitment so that work can begin immediately, and negotiating a definitive contract is not possible in time to meet the requirement. DOD requires that contract actions be definitized within 180 days after issuance of the action or when the amount of funds obligated under the action is over 50 percent of the not-to-exceed price, whichever occurs first. The head of an agency may waive these limitations in certain circumstances that likely would have applied for this contract, including for a contingency operation, but Corps officials told us that waivers were not requested for these task orders. Figure 2 shows the time it took for DOD and the contractor to reach agreement on the terms and conditions for the task orders. Because of the delays in negotiations, virtually all of the costs had been incurred by the contractor at the time of negotiations.

Figure 2: Elapsed Days from Notice to Proceed to Definitization



Source: GAO analysis of DOD data.

The contracting officer determined that the questioned costs he decided to pay were reasonable and in accordance with the FAR, and his decision to pay nearly all of the questioned costs was influenced by (1) the fact that nearly all of the costs had been incurred at the time of negotiations and (2) his belief that payment of incurred costs was required, absent unusual

circumstances.¹⁵ The contracting officer stated in final negotiation documentation that unusual circumstances did not exist for most of the questioned costs. For example, the DOD contracting officer indicated that because DCAA chose not to suspend or disallow the funds, which DCAA can do by issuing a Form 1, unusual circumstances did not exist.¹⁶

Changing Requirements, Funding Challenges, and Inadequate Contractor Proposals Contribute to Negotiation Delays and Increase Risk to the Government

Several factors contributed to the delay in negotiations, including DOD's changing requirements, DOD's funding challenges, and inadequacies in several of the contractor's business systems. Based on contract documentation as well as interviews with DOD officials and contractor representatives, these factors made it difficult for the contractor to submit proposals in a timely fashion. Without a qualifying contractor proposal, the government and the contractor are not able to reach agreement on the terms and conditions of a task order.¹⁷ For many of the task orders, the contractor did not submit qualifying proposals until late in the period of performance or after the work had been completed. For example, for 6 of the 10 task orders, the contractor did not submit a qualifying proposal that was audited by DCAA until after the period of performance was complete.

¹⁵ Under the FAR, there is no presumption of reasonableness when costs are incurred by the contractor. If the contracting officer challenges a specific cost, the contractor has the burden of proof to establish that such cost is reasonable. A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business. What is reasonable depends upon a variety of considerations and circumstances, including whether it is the type of cost generally recognized as ordinary and necessary for the conduct of the contractor's business or the contract performance. FAR 31.201-3. The contracting officer is allowed wide latitude to exercise business judgment and could still decide to pay the costs after consideration of the audit findings based on a judgment of what the best business decision would be, including the desire to avoid the cost of litigation.

¹⁶ Pursuant to the authority of DOD Directive 5105.36, DCAA can issue a Form 1. A Form 1 constitutes notice of costs suspended and/or disapproved incident to the audit of contractor costs incurred under a contract. Suspended costs are costs that have been determined to be inadequately supported or otherwise questionable, and not appropriate for reimbursement under contract terms at that time. Such costs may be determined reimbursable after the contractor provides the auditor additional documentation or explanation. Disapproved costs are costs that have been determined to be unallowable, that is, not reimbursable under the contract terms.

¹⁷ The Defense Federal Acquisition Regulation Supplement defines a qualifying proposal as a proposal containing sufficient information for DOD to do complete and meaningful analyses and audits of the (1) information in the proposal and (2) any other information the contracting officer has determined DOD needs to review in connection with the contract. DFARS 217.7401(c).

Corps officials told us that changing requirements made it difficult for the contractor to submit a proposal. In particular, the requirements for the fuel mission were not well defined and changed over time, particularly in terms of the quantity of fuel needed and the period of performance for the work. According to Corps officials, the fuel mission was initially envisioned as a 21-day requirement, but ultimately extended into many months. The extension of the requirements is reflected in modifications to task order 5, the initial fuel mission task order, where the period of performance was extended. Additionally, numerous correspondences between DOD officials demonstrate the uncertainty as to how much fuel was required and the time frame during which fuel importation would be needed. For example, one correspondence indicates that as of April 21, 2003, there was no immediate need for the importation of fuel products because Iraq was able to provide sufficient refined products to satisfy the domestic need, and one DOD official considered it unlikely that the need would arise.¹⁸ Less than 2 weeks later, on May 2, 2003, DOD correspondence indicates that fuel shortages were anticipated, and DOD officials began preparations to execute the fuel importation mission. At that time, officials anticipated the need for 10- to 30-day supplies of fuel, not a mission that would expand into many months. In addition, the statements of work for the fuel mission did not outline the quantities needed to fulfill the mission. The quantities of fuel required changed numerous times. For example, between July 16, 2003, and August 3, 2003, the Corps issued four separate letters to the contractor, each one increasing the quantities of fuel required to fulfill the mission. Overall, through numerous modifications, the Corps increased the funding on task order 5 from \$24 million to \$871 million, a value more than 36 times greater than the initial allocation.

The Corps also experienced challenges in establishing and maintaining a consistent, reliable, and sufficient source of funding for the RIO I contract, which exacerbated the problem of fully defining the requirements. The RIO I task orders were funded using several sources, including the Army's Operation and Maintenance Appropriation, Iraqi vested assets, and the

¹⁸ However, DOD did recognize the need to have a contingency plan available in case the need arose.

Development Fund for Iraq.¹⁹ For the fuel mission, a high-level Corps official involved in the funding aspect of the contract told us that the Corps had a difficult time finding enough funding to support the mission, a fact that contributed to short-term requirements. For example, this official told us that the Corps received funding on a short-term basis rather than the longer-term funding it requested, which affected the quantity of fuel the Corps could direct the contractor to purchase. Additionally, to support the fuel mission when funding was tight, the Corps began using funds from the infrastructure repair and restoration task orders to fund the fuel mission task orders, resulting in the delay of work the Corps believed was critical to the repair of the oil infrastructure.

DOD officials and contractor representatives also told us that the contractor's business systems were not fully prepared to handle the growth in work the company experienced as a result of the war in Iraq, and this contributed to the delays in proposal submission. From 2002 to 2004, the contractor's revenues grew from \$5.7 billion to \$11.9 billion. Subsequent to the issuance of the RIO I contract, and after the war in Iraq began, DCAA identified deficiencies in several of the contractor's business systems. For example, DCAA considered the contractor's estimating system—a system important for proposal development—adequate prior to the issuance of the RIO I contract. However, subsequent to the issuance of the RIO I contract, DCAA issued an audit that found the contractor's estimating system to be inadequate for providing verifiable, supportable, and documented cost estimates that are acceptable for negotiating a fair and reasonable price.²⁰

¹⁹ "Vested assets" refers to former Iraqi regime assets held in U.S. financial institutions that the President confiscated in March 2003 and vested in the U.S. Treasury. The United States froze these assets shortly before the first Gulf War. The USA PATRIOT ACT of 2001 amended the International Emergency Economic Powers Act to empower the President to confiscate certain property of designated entities, including these assets, and vest ownership in an agency or individual. The President has the authority to use the assets in the interests of the United States. In this case, the President vested the assets in March 2003, and these funds were made available for the reconstruction of Iraq in May 2003.

²⁰ In its most recent audit of the contractor's estimating system, issued in September 2005, DCAA found that the contractor had taken corrective action and made improvements to the system. However, DCAA continued to cite some deficiencies in the system. As of December 2004, the DOD systems administrative contracting officer who is responsible for determining the acceptability of the contractor's estimating system determined the system to be acceptable with corrective action. This determination was in effect as of the issuance of this report.

We have shown through our previous work the link between delays in definitization and challenges with requirements, funding, and proposal submission. For example, in a review of 77 undefinitized contract actions issued by various DOD agencies, we found that contracting officers cited timeliness of a qualifying proposal, changing or complex requirements, and changes in funding availability as three of the top four reasons for delays in definitization.²¹ In a previous review of Iraq reconstruction contracts, agency officials told us that delays in reaching agreement on the terms and conditions of a contract resulted from the growth in requirements and from concerns over the adequacy of contractor proposals.²²

Delays in definitization can increase the risk to the government because when contracts remain undefinitized, the government bears most of the risk. For example, in a prior review of how DOD addressed DCAA's audit findings on 18 audits of Iraq contract actions, we found that DOD contracting officials were less likely to remove questioned costs from a contract proposal if the contractor had incurred these costs before reaching agreement on the work's scope and price.²³ In a previous review of Iraq reconstruction contracts, as well as a review of DOD's logistics support contracts, we found that delays in definitizing contract actions can increase the risk to the government by reducing cost control incentives, particularly for cost reimbursement type contracts like the RIO I contract.²⁴

DCAA Attributes \$26 Million in Cost Reductions on the RIO I Contract to Its Audit Findings

In total, DCAA considers \$26 million of the costs questioned on the RIO I contract to be sustained. DCAA defines questioned costs sustained as the negotiated cost reductions directly attributable to questioned cost findings reported by the DCAA auditor. DCAA's calculation of questioned costs sustained includes costs DOD decided not to pay to the contractor and other types of cost reductions. Specifically, the \$26 million of questioned

²¹ GAO, *Defense Contracting: Use of Undefinitized Contract Actions Understated and Definitization Time Frames Often Not Met*, [GAO-07-559](#) (Washington D.C.: June 2007).

²² GAO, *Rebuilding Iraq: Fiscal Year 2003 Contract Award Procedures and Management Challenges*, [GAO-04-605](#) (Washington D.C.: June 2004).

²³ GAO, *Iraq Contract Costs: DOD Consideration of Defense Contract Audit Agency's Findings*, [GAO-06-1132](#) (Washington D.C.: September 2006).

²⁴ [GAO-04-605](#) and GAO, *Military Operations: DOD's Extensive Use of Logistics Support Contracts Requires Strengthened Oversight*, [GAO-04-854](#) (Washington D.C.: July 2004).

costs sustained includes (1) \$9 million composed primarily of costs DOD decided not to pay to the contractor and including some costs DOD decided to pay but moved from one task order to another because of improper allocation²⁵ and (2) \$17 million in costs removed from the contractor's final proposals but questioned by DCAA in prior audits of previous contractor proposals. For example, in an early version of a proposal for one of the fuel mission task orders, the contractor proposed demobilization costs that DCAA questioned. The contractor removed these costs in a subsequent proposal, and DCAA considered the removal of these costs attributable to its audit findings, and therefore counted that amount as sustained. For purposes of calculating a sustention rate, which is a calculation of questioned costs sustained divided by questioned costs, in its internal management system DCAA increased its questioned costs on the final audits from \$221 million to \$237 million to reflect the \$17 million sustained from prior audits.²⁶

Table 2 shows the questioned costs sustained and the sustention rate for each of the audits of the RIO I contract. The sustention rates ranged from 0 to 20 percent for the fuel mission task orders, which represented a large portion of the questioned costs. As discussed earlier in the report, the DOD contracting officer collected additional information and conducted additional analysis to address some of these questioned costs. Additionally, he identified limitations to the comparison between the prices paid by the contractor and DESC used by DCAA to question some of the fuel costs, such as differences in the length of contract terms for purchase of fuel and fuel delivery from Kuwait, and referred to these limitations in his rationale for his decision on these costs.

²⁵ For example, in one audit, DCAA questioned whether some costs were properly allocated to the task order, and suggested the costs should be allocated to another task order under the contract. The DOD contracting officer agreed the costs were improperly allocated, and moved the costs to the appropriate task order. Because DCAA calculates questioned costs sustained for each audit, DCAA considered these questioned costs sustained.

²⁶ Numbers do not add due to rounding. DCAA officials told us that, in general, DCAA calculates a sustention rate across all audits for each fiscal year. They use the sustention rates for internal management purposes—for example, they compare the sustention rate from fiscal year to fiscal year to see if there is variation. When there is variation, they try to identify reasons for that variation. The officials told us they do not have a specific goal for an overall sustention rate, and that it is not unusual for an individual audit to have a sustention rate of 0 percent or of 100 percent.

Table 2: DCAA’s Questioned Costs Sustained on the RIO I Contract Audits

Dollars in thousands

Task order	Purpose	Primary questioned costs reason	Questioned costs based on DCAA’s internal management system ^a	Questioned costs sustained	Sustention rate by audit report
1	Pre-positioning and training	Differences between proposed and actual costs	\$904	\$904	100%
2	Quick fix design	Differences between proposed and actual costs	200	197	99%
3	Infrastructure repair and restoration	Costs not allocable to task order	20,290	12,555	62%
4	Life support	Indirect costs due to rate and base differences	86	0	0%
4	Equitable adjustment claim - life support	Indirect costs due to rate and base differences	39	39	100%
5	Fuel import and distribution	Kuwait and Turkey fuel and fuel delivery charges	84,446	0	0%
6	Infrastructure repair and restoration	Timing of obtaining contracting officer consent	32,194	0	0%
7	Fuel import and distribution	Kuwait and Turkey fuel and fuel delivery charges	35,681	0	0%
8	Fuel import and distribution	Kuwait and Turkey fuel and fuel delivery charges	27,423	5,509	20%
9	Fuel import and distribution	Kuwait and Turkey fuel and fuel delivery charges	22,552	4,618	20%
10	Fuel import and distribution	Kuwait and Turkey fuel and fuel delivery charges	13,603	2,336	17%
Contract total			\$237,418	\$26,158	11%

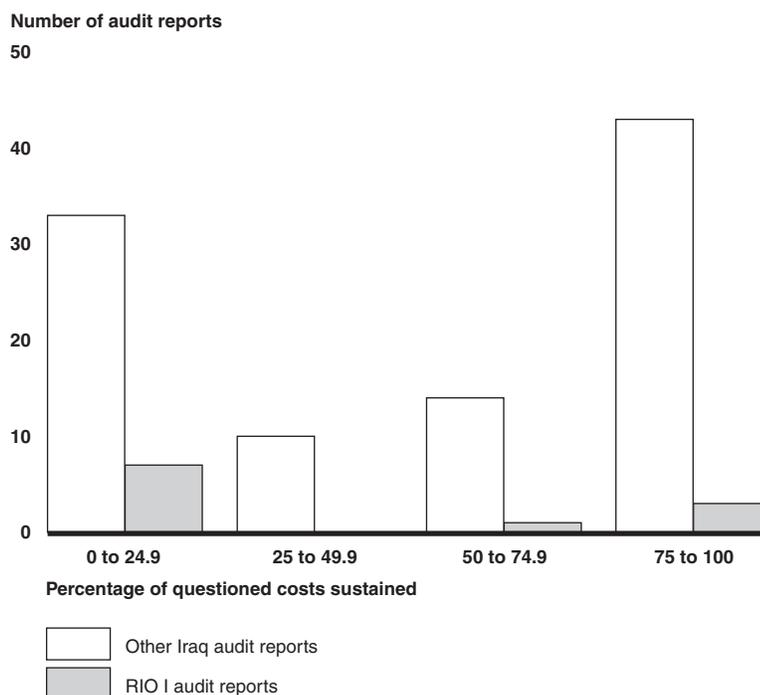
Source: GAO analysis of DOD data.

^aData in this column include costs questioned in the final audits and costs questioned in prior audits that DCAA considers sustained.

The Sustention Rates on the DCAA Audits of the RIO I Contract and the Sustention Rates on DCAA Audits of Other Iraq Contract Actions Both Varied Widely

We compared the sustention rates for the 11 RIO I audit reports to the sustention rates for 100 DCAA audits of other Iraq contract actions, and found a similar pattern in the distribution and range of sustention rates for both groups.²⁷ Specifically, as shown in figure 3, the sustention rates for both groups of audit reports varied widely. DCAA officials told us that it is not unusual to have a sustention rate of 0 percent or of 100 percent on an individual audit, and these were common values in the two groups we looked at.

Figure 3: Comparison of Sustention Rates



Source: GAO analysis of DOD data.

Note: While this analysis provides a basis for context, the circumstances surrounding each of the contracts or task orders audited are unique. Consequently, sustention rates between individual audit reports may not be directly comparable.

²⁷ For comparison purposes, we used the audit report as our unit of analysis. By using the audit report as the unit of analysis, each sustention rate generally reflects a contracting officer's decision on how to address DCAA's findings for that particular audit. As a management tool used by DCAA, sustention rates do not represent an analysis of the validity of underlying costs or how the contracting officer made a decision on the reasonableness of specific costs.

DCAA officials told us that they do not expect every questioned cost to be sustained, because reasonable people can disagree about how some of these costs should be resolved. Additionally, as discussed earlier, contracting officers may consider other information provided subsequent to DCAA's issued audit as part of the process of resolving DCAA audit findings.

DOD Paid About Half of the Maximum Possible Award Fee for the RIO I Contract, but Did Not Fully Adhere to Key Steps in Its Award Fee Plan for Providing Performance Feedback to the Contractor

DOD paid approximately \$57 million in award fees, or 52 percent of the maximum possible award fee, for the RIO I contract. However, DOD missed potential opportunities to motivate contractor performance by not following steps outlined in its award fee plan to provide performance feedback to the contractor. Further, DOD was unable to provide sufficient documentation to enable us to fully evaluate its adherence to its award fee plan. In comparing the RIO I award fee to award fees earned on other selected Iraq reconstruction contracts, we found that the percentage of award fee earned on the RIO I contract fell within the lower range of fees earned on these other contracts.

DOD Paid Approximately \$57 Million in Award Fees for the RIO I Contract

The overall award fee paid to the contractor on the RIO I contract totaled about \$57 million, just over half of the maximum possible award fee. The contract provided for a fixed fee of 2 percent of the negotiated estimated contract cost and an award fee of up to an additional 5 percent that could be earned based on the government's evaluation of the contractor's performance in areas including technical and cost performance and business management. The possible 5 percent award fee was based on a negotiated estimated contract cost of about \$2.2 billion, translating into a maximum award fee of about \$109 million.²⁸ The award fee decision states that, overall, while the quality of the contractor's work was generally rated highly, the contractor did not do as well in the areas of adherence to schedule and business management. As shown in table 3, the award fee

²⁸ The total value of the RIO I contract was about \$2.5 billion, including the negotiated costs to be paid and the fixed and potential award fees that could be earned by the contractor.

varied by task order, ranging from 4 percent to 72 percent of the possible award fee.

Table 3: Award Fee Paid for RIO I Task Orders

Dollars in thousands

Task order	Purpose	Award fee possible	Award fee paid	Percentage of possible award fee paid
1	Pre-positioning and training	\$399	\$175	44
2	Quick fix design	54	39	72
3	Infrastructure repair and restoration	32,333	11,640	36
4	Life support	2,207	794	36
5	Fuel import and distribution	39,208	26,662	68
6	Infrastructure repair and restoration	9,700	388	4
7	Fuel import and distribution	14,354	9,761	68
8	Fuel import and distribution	7,679	5,222	68
9	Fuel import and distribution	1,896	1,289	68
10	Fuel import and distribution	802	546	68
Contract total		\$108,631	\$56,515	52%

Source: GAO analysis of DOD data.

Note: A separate request for equitable adjustment was also negotiated for task order 4. However, because the equitable adjustment claim exceeded the not-to-exceed amount for task order 4, the contracting officer decided that no fixed or award fees would be paid on the claim.

DOD Missed Opportunities to Motivate Contractor Performance by Not Following Key Steps Outlined in Its Award Fee Plan

DOD's award fee plan for the RIO I contract included several steps related to providing the contractor with ongoing performance feedback. For example, the plan called for award fee evaluations to be conducted on a regular basis during the period of performance.²⁹ These evaluations were to include a meeting of the award fee board to determine a recommended award fee for the contractor and a final decision by the award fee determining official. After each award fee evaluation, the contractor was to be notified of the percentage and amount of award fee earned. In addition to these formal award fee evaluations, the plan also called for monthly interim evaluations to be conducted in which award fee board members would consider performance evaluation reports submitted by

²⁹ Specifically, the plan noted that end-of-period evaluations were to be conducted semiannually for the first evaluation period and quarterly for all remaining performance periods thereafter.

DOD staff designated as performance monitors, reach an interim evaluation decision, and then notify the contractor of the strengths and weaknesses for the evaluation period.

However, despite its plans to conduct formal award fee evaluations during the period of performance, DOD did not convene an award fee board for the RIO I contract until contract performance was almost entirely completed. DOD officials told us that they were unable to hold boards due to the heavy workload of RIO staff and logistical challenges such as difficulties with communications, travel, and security conditions. DOD officials and contractor representatives also indicated that holding an award fee board was not a high priority because their focus was on making sure that the work under the contract was accomplished. Ultimately only one award fee board was held, in July 2004, after fieldwork on all but one task order had been completed. The contractor was notified of its award fee scores in January 2005, after completion of all work on the contract.³⁰ This process was in contrast to the rationale for award fee evaluations explained in federal regulations: Evaluation at stated intervals during performance, accompanied by partial payment of the fee generally corresponding to the evaluation periods, can induce the contractor to improve poor performance or to continue good performance.

In addition to not holding formal evaluations as planned during the period of performance, DOD did not meet the rigor called for in the award fee plan when providing interim performance feedback to the contractor. DOD did provide some interim feedback to the contractor on its performance during the period of performance. For example, DOD officials and contractor representatives told us that DOD contracting staff and contractor staff had daily informal discussions about contractor performance. In addition, RIO administrative contracting officers sent the contractor letters on a semiannual basis that provided feedback on the contractor's performance. However, as discussed previously, the award fee plan states that the award fee board should hold monthly interim evaluations of the contractor's performance and provide the contractor

³⁰ After receiving DOD's initial award fee decision in January 2005, the contractor requested the opportunity to have its award fee scores reconsidered. The award fee determining official granted this request. After the contractor presented additional information, the award fee determining official made some upward adjustments to the award fee in his final decision when he determined that new information provided by the contractor was sufficiently significant to do so. In this report, all award fee amounts and percentages refer to the award fee determining official's final decision.

with feedback from the evaluations. DOD officials were only able to provide us with information about one interim evaluation board, and the contractor was not provided with results from this evaluation. Contracting staff and others providing feedback to the contractor expressed to us views ranging from very negative to very positive on the contractor's performance during the same time period. Thus, without feedback reflecting consensus judgment, the contractor may not have been fully aware of the government's views on the strengths and weaknesses of its performance. Given that the award fee is intended to motivate excellence in contractor performance, providing the contractor with this type of feedback is an important step in achieving this aim.

The lack of adherence to the award fee plan also made it difficult to ensure that all aspects of the contractor's performance were considered in the final award fee decision. Although performance monitors were supposed to complete reports monthly and at the end of each evaluation period in order to provide the award fee board with information about the contractor's performance, which would mean that hundreds of reports should have been completed during the course of the contract, a DOD official told us that fewer than 10 performance monitor reports were ever provided to the award fee board. The board received so few reports because (1) written reports were not prepared on a regular basis, as required by the award fee plan, and (2) reports that were prepared were not submitted to the award fee board. Specifically, DOD officials and correspondence indicated that performance monitor reports did not begin to be completed until several months into the contract period of performance and even then were not completed on a monthly basis. In addition, DOD officials provided us with more than 25 reports that they told us had been completed but not provided to the award fee board members. DOD officials told us that board members were not provided with these documents because the Corps had received a large number of documents related to the RIO I contract from Iraq that had not been sorted through by the time the award fee board was held in July 2004. Because the DOD officials had not sorted through all of the documents, the award fee board was also not provided with full information about an interim evaluation board held in May 2003. Specifically, award fee board members were provided with only one task order score from the interim evaluation board, despite the fact that documentation of consensus scores and contractor strengths and weaknesses was prepared for four task orders. DOD officials responsible for selecting the award fee board members told us that they selected board members to ensure that they included individuals who had directly observed the contractor in different time periods and locations. However, because the award fee board meeting was

near the end of fieldwork on the contract and because RIO staff rotated during the period of performance, written observations of contractor performance would have been important in ensuring that the board had full knowledge of all aspects of the contractor's performance.

We have previously reported on problems with DOD adhering to its award fee process in contingency situations. In our review of DOD's use of logistics support contracts, for one large contract we found that the Army was not holding award fee boards according to the terms of the contract. We also found that Army officials were not evaluating and documenting the contractor's performance on that contract.³¹

DOD Could Not Provide Sufficient Documentation to Enable Us to Fully Evaluate Its Adherence to Its Award Fee Plan

To evaluate the extent to which DOD followed its planned process for making the RIO I award fee decision, we attempted to review DOD's adherence to the process outlined in its award fee plan, but were not able to fully do so because DOD could not provide us with documentation of some elements of the process. For example, according to DOD officials and the award fee board minutes, the board determined its recommended score for each task order by first reaching a consensus on individual criteria outlined in the contract, and then computing the overall score based on the weighting included in the contract for those criteria. However, according to DOD officials, they could not provide us with the consensus scores on the individual criteria because records of those scores were destroyed after the final award fee decision was reached.³² Without these scores, we could not determine whether the award fee board adhered to the weighting of the criteria outlined in the contract in reaching its recommendation. We also had limited insight into any additional factors the award fee determining official considered in making his initial decision, which included upward adjustments to the award fee board's recommendation, because DOD officials could not provide us with documentation of the reasons for the difference and told us they did not believe such documentation had ever been developed. This apparent lack of documentation was not in accordance with the award fee plan, which

³¹ [GAO-04-854](#).

³² The Defense Federal Acquisition Regulation Supplement provided that the basis for all award fee determinations was required to be documented in the contract file. DFARS § 216.405-2(a)(ii) (Currently, this provision is in DFARS Procedures, Guidance, and Information § 216.405-2(2)). However, there is no specific requirement that records of the award fee board's consensus scores on individual criteria be kept.

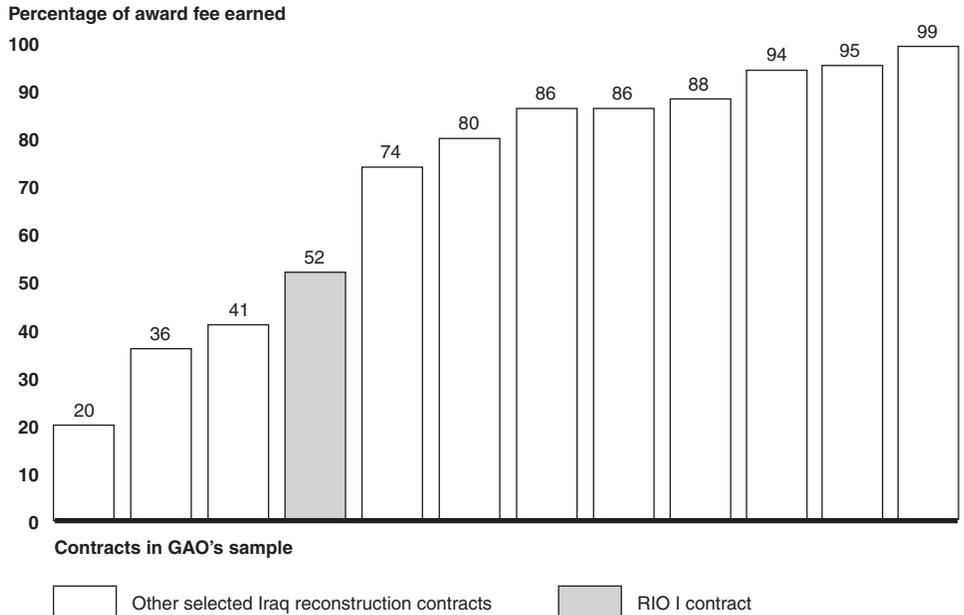
states that reasons for any differences between the award fee determining official's decision and the award fee board's recommendation must be fully documented.

DOD officials also could not provide us with complete information regarding the monitoring of the contractor's performance during the period of performance. For example, we could not obtain full documentation of interim boards referred to in the award fee board minutes, including documentation of the number of boards held, the dates of the boards, or the results from the boards. Without such information, we could not determine how results from interim evaluations were figured into the award fee board's recommendation, as the award fee plan indicates they should be.

The Percentage of Award Fee Earned on the RIO I Contract Fell within the Range of Award Fees Earned on a Sample of Other Iraq Reconstruction Contracts

To put the RIO I award fee into context, we also analyzed the award fees earned on other selected Iraq reconstruction contracts and found that the percentage of award fee earned on the RIO I contract was within the range of award fees earned on these other contracts. More specifically, we reviewed 11 contracts that DOD awarded in 2004 to conduct reconstruction activities in Iraq, which, like the RIO I contract, were large-scale cost-plus-award-fee contracts. During the period we looked at, January 2004 through June 2006, a total of 37 award fee evaluation periods were conducted for the 11 contracts. As illustrated in figure 4, the percentage of award fee earned during the period varied by contract, ranging from 20 percent to nearly 100 percent.

Figure 4: Percentage of Award Fee Earned on the RIO I Contract and on 11 Other Selected Iraq Reconstruction Contracts from January 2004 to June 2006



Source: GAO analysis of DOD data.

Notes: Because some of these contracts were still active as of June 2006, the ultimate amount and percentage of award fees earned may have changed depending on contractor performance over the remainder of the contract. In 11 of the 37 award fee evaluation periods we analyzed, the award fee determining official chose to roll over the unearned award fee from one evaluation period to a subsequent evaluation period or periods. In these cases we excluded rolled-over fees from the available fee pool. While this analysis provides a basis for context, the circumstances surrounding each contract are unique. Consequently, the percentage of award fee earned may not be directly comparable between contracts.

Conclusion

To meet the urgent operational needs of reestablishing Iraq’s oil infrastructure and importing fuel, the Corps authorized the contractor to begin work before task orders had been definitized. Factors such as changing requirements, funding challenges, and problems with contractor proposals delayed negotiations until well past the timing required by DOD for definitization. For all 10 RIO I task orders, the work was completed before negotiations were finalized. Delays in definitizing contract actions can increase the risk to the government by reducing cost control incentives, particularly for cost reimbursement type contracts. In addition, our findings on the agreement reached between DOD and the contractor on the RIO I contract build on other significant evidence in our prior work that the value of DCAA’s audits of contractor proposals is limited when negotiations take place too long after work has begun.

Award fees can serve as a valuable tool to help control program risk and encourage excellence in contract performance. To reap the advantages that cost-plus-award-fee contracts offer, the government must implement an effective award fee process, which requires additional administrative effort and cost to monitor and evaluate performance. The FAR requires that the expected benefits of using a cost-plus-award-fee contract are sufficient to warrant this additional effort and cost, but in the case of the RIO I contract, even if this condition had been met, DOD's Army Corps of Engineers did not carry out its planned award fee process. According to DOD officials, efforts to hold award fee boards during the period of performance were stymied in part by the logistical conditions in Iraq. We have previously identified problems with DOD's award fee process in contingency environments. Given that the award fee is intended to motivate excellence in contractor performance, providing the contractor with regular feedback that reflects the consensus of the government about its strengths and weaknesses is important to enable the contractor to put forth its best effort to excel in the areas deemed important to the government. While contingency situations may pose additional challenges for adhering to an award fee process, without an effective process, the government risks incurring the additional cost and administrative effort of an award fee contract without receiving the expected benefits.

Recommendation for Executive Action

To ensure that cost-plus-award-fee contracts provide the intended benefits, we recommend that the Secretary of the Army take the following action:

- In contingency situations, as a part of weighing the costs and benefits of using a cost-plus-award-fee contract, ensure that an analysis of the administrative feasibility of following a rigorous award fee process is conducted before the contract is awarded.

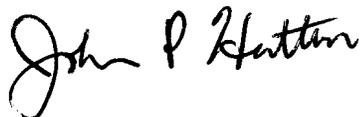
Agency Comments and Our Evaluation

We provided a draft of this report to DOD for comment. In written comments, DOD concurred with our recommendation. The department's comments are reproduced in appendix II. In concurring with the recommendation, DOD noted a number of factors that exist in this contingency operation that it believed demonstrated the difficulty of conducting an analysis of the administrative feasibility of using an award fee contract in future contingency situations. These factors included urgent contracting time frames, uncertain requirements, and difficulties in identifying appropriate oversight personnel. As specified in federal regulations, the use of an award fee contract is suitable when the expected

benefits of such a contract are sufficient to warrant the additional effort and cost required to monitor and evaluate contractor performance. It is precisely factors such as those outlined by DOD that we believe are important for consideration when determining the administrative feasibility of a cost-plus-award fee contract in a contingency environment.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to the Secretary of Defense and other interested parties. We will make copies of this report available on request. In addition, this report will be available at no charge on GAO's Web site at <http://www.gao.gov>.

If you have any questions concerning this report, please contact me at (202) 512-4841 or by e-mail at huttonj@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Other major contributors to this report were Marie Ahearn, Penny Berrier Augustine, Greg Campbell, Arthur James Jr., Eric Lesonsky, Stephen Lord, Anne McDonough-Hughes, Janet McKelvey, and Kenneth Patton.



John P. Hutton
Director
Acquisition and Sourcing Management

Appendix I: Objectives, Scope, and Methodology

To determine how the Department of Defense (DOD) addressed the Defense Contract Audit Agency's (DCAA) audit findings on the Restore Iraqi Oil (RIO I) contract and the factors that contributed to DOD's decision of how to address those findings, we reviewed negotiation memorandums and 22 DCAA audit reports, including 11 final audit reports, for the 10 RIO I task orders. Additionally, we reviewed other documents related to the negotiation process and resolution of DCAA's findings. We also interviewed Corps, DCAA, and other government officials as well as contractor representatives. Because a contracting officer has the discretion to determine whether or not to pay questioned costs when reaching agreement with a contractor, our review does not include a determination of whether the DOD contracting officer should have approved payment for the questioned costs. Additionally, to put DOD's decisions of how to address DCAA's RIO I contract audit findings into context, we compared the resolution of DCAA's questioned cost findings on 100 audits of other Iraq-related contract actions to the resolution of the questioned cost findings on the RIO I task order audits. We selected the 100 audits for comparison because they represented all audits of Iraq-related contract actions other than the RIO I contract for which DCAA had calculated the questioned costs sustained as of the end of fiscal year 2006, excluding those calculated automatically.¹ To ensure we used a consistent unit of measurement, we used the audit report as the unit of analysis for comparison. To develop an understanding and assess the reliability of the information included in the database that contained the results for these 100 audits, we held discussions with and obtained documentation from DCAA officials located at Fort Belvoir and we conducted electronic and manual testing for obvious inconsistencies and completeness. We determined the data used in our review to be sufficiently reliable for our purposes.

To determine the extent to which DOD paid award fees for the RIO I contract and followed its planned process for making that decision, we collected and reviewed key documents related to the award fee process, including the award fee provisions of the RIO I contract, the award fee

¹ According to DCAA guidance, for certain types of audit assignments with questioned costs lower than \$500,000, DCAA's internal management system automatically calculates questioned costs sustained based on the actual average sustention rate of proposals for an agency with questioned costs over \$500,000 for the prior 3 fiscal years. Because questioned costs sustained is calculated automatically for these assignments, the sustention rate does not reflect the contracting officer's decision on the specific audit, and therefore we excluded these cases from our analysis.

determining official's decision, the award fee plan, and minutes from the award fee board meeting. We also interviewed Corps officials, including the award fee determining official and members of the award fee board, to develop an understanding of the process and outcome for the award fees, and contractor representatives to obtain their perspective on award fees. Additionally, to put the award fee for the RIO I contract into context, we gathered and analyzed award fee documentation provided by the Joint Contracting Command-Iraq/Afghanistan for 11 contracts that DOD awarded in 2004 to conduct reconstruction activities in Iraq. We selected these contracts because, like the RIO I contract, they were large-scale, cost-plus-award-fee contracts. During the period we looked at, January 2004 through June 2006, a total of 37 award fee evaluation periods were conducted for the 11 contracts. In 11 of the 37 award fee evaluation periods we analyzed, the award fee determining official chose to roll over the unearned award fee from one evaluation period to a subsequent evaluation period or periods. In these cases we excluded rolled-over fees from the available fee pool. Because an award fee determination is a unilateral decision made solely at the discretion of the government based upon judgmental evaluations of contractor performance, our review does not include an assessment of whether DOD reached the appropriate award fee decision for the RIO I contract.

We conducted our work from October 2006 through July 2007 in accordance with generally accepted government auditing standards.

Appendix II: Comments from the Department of Defense



DEPARTMENT OF THE ARMY
U.S. ARMY CORPS OF ENGINEERS
441 G ST. NW
WASHINGTON, D.C. 20314-1000

July 30, 2007

Mr. John P. Hutton
Director, Acquisition and Sourcing Management
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

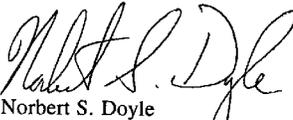
Dear Mr. Hutton:

This is the Department of Defense (DoD) response to the GAO draft report 07-839, 'DEFENSE CONTRACT MANAGEMENT: DOD's Lack of Adherence to Key Contracting Principles on Iraq Oil Contract Put Government Interests at Risk,' dated July 3, 2007, (GAO Code 120596).

I appreciate the opportunity to comment on the draft report. I concur with the GAO recommendation as discussed in the enclosure.

If you have any questions or require additional information, please contact Ms. Alicia Matias, 202-761-4375, alicia.s.matias@usace.army.mil.

Enclosure


Norbert S. Doyle
Colonel, Acquisition Corps
Acting Director of Contracting

GAO DRAFT REPORT DATED 3 JULY 2007, GAO-07-839 (GAO
CODE 120596)

DEFENSE CONTRACT MANAGEMENT: DOD'S LACK OF
ADHERENCE TO KEY CONTRACTING PRINCIPLES ON IRAQ OIL
CONTRACT PUT GOVERNMENT INTERESTS AT RISK

DEPARTMENT OF DEFENSE RESPONSE TO THE RECOMMENDATION

Recommendation 1: The GAO recommends that the Secretary of the Army: in contingency situations, as a part of weighing the costs and benefits of using a cost-plus-award-fee contract, ensure that an analysis of the administrative feasibility of following a rigorous award fee process is conducted before the contract is awarded.

DOD RESPONSE - Concur

a. The bottom line recommendation is that the Secretary of the Army conduct an analysis of the feasibility of conducting a rigorous award fee process before awarding a contract containing such fees. In the context of a contingency operation of the type involved in the RIO 1 contract, it is far from clear how such an analysis could be completed. Making such a determination would be particularly difficult in similar future contingency operations involving the following factors, which were present in RIO 1. It was urgent to get a contract in place. Formal responsibility for executing the RIO mission was assigned to the Army on 22 Jan 03 and to USACE on 13 Feb 03. USACE developed a Justification & Approval (J&A) supporting the award of a sole source contract to KBRS, which was approved on 28 Feb 03. On 17 Mar 03 hostilities began and USACE was directed to begin contract execution. Actions which had been completed before 17 Mar 03 included identifying the necessary work force, processing them through the CRC, and getting them and the required equipment into the approved personnel/cargo flow so they could be deployed to Kuwait. The requirements were not firm and even the mission itself was classified. There was no firm funding for the mission; no organization existed to administer the contract; the volunteers who ultimately made up the organization had to be identified; and there was no firm understanding of the type of security or communications which would be available. To take one concrete example, the contract specified that the work would be performed in "benign" conditions and it would be somewhat of a stretch to describe the resulting

Enclosure

GAO DRAFT REPORT DATED 3 JULY 2007, GAO-07-839 (GAO CODE 120596) –
“DEFENSE CONTRACT MANAGEMENT: DOD’S LACK OF ADHERENCE TO KEY
CONTRACTING PRINCIPLES ON IRAQ OIL CONTRACT PUT GOVERNMENT
INTERESTS AT RISK -- DEPARTMENT OF DEFENSE RESPONSE TO THE
RECOMMENDATION (Cont’d)

conditions in Iraq as “benign”. Obtaining the necessary approval for the J&A supporting the sole source contract at high levels within Army resulted in delays in getting contractor personnel and equipment deployed. Any additional administrative requirements of the type recommended by GAO would have to be carefully designed to avoid further delays in getting contractor personnel in place to respond to requirements from contingency operations.

b. Military personnel can be ordered to deploy. Civilian personnel cannot. USACE and other government organizations generally must rely on volunteers to conduct contingency operations. So long as we continue to do so, it will continue to be difficult to insure that we have the right personnel in the right places to execute all contingency contracting operations with the same degree of oversight used for other than contingency contracts. Changes could be made to the personnel system to help with this problem. Potential changes could include the designation of more emergency essential positions in which the incumbents agree to deploy up front as a condition of employment; designation of positions in which the incumbents also have to become members of the Individual Ready Reserve; or the use of NSPS authority to set higher pay for persons who agree in advance to deploy if needed.

GAO's Mission

The Government Accountability Office, the audit, evaluation and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's Web site (www.gao.gov). Each weekday, GAO posts newly released reports, testimony, and correspondence on its Web site. To have GAO e-mail you a list of newly posted products every afternoon, go to www.gao.gov and select "Subscribe to Updates."

Order by Mail or Phone

The first copy of each printed report is free. Additional copies are \$2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. Government Accountability Office
441 G Street NW, Room LM
Washington, D.C. 20548

To order by Phone: Voice: (202) 512-6000
TDD: (202) 512-2537
Fax: (202) 512-6061

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm

E-mail: fraudnet@gao.gov

Automated answering system: (800) 424-5454 or (202) 512-7470

Congressional Relations

Gloria Jarmon, Managing Director, JarmonG@gao.gov (202) 512-4400
U.S. Government Accountability Office, 441 G Street NW, Room 7125
Washington, D.C. 20548

Public Affairs

Paul Anderson, Managing Director, AndersonP1@gao.gov (202) 512-4800
U.S. Government Accountability Office, 441 G Street NW, Room 7149
Washington, D.C. 20548