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ONE HUNDRED TENTH CONGRESS

Congress of the United States

House of Representatives

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
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MEMORANDUM

February 15, 2007

To: **Members of the Committee on Oversight and Government Reform**

Fr: **Majority Staff**

Re: **Supplemental Information on Iraq Reconstruction Contracts**

In preparation for the full Committee hearing on the status of Iraq reconstruction efforts, this memorandum provides new information on the total amount of contractor overcharges in Iraq.

Last fall, GAO reported to Congress that Pentagon auditors had identified approximately $3.5 billion in contractor charges as "questioned" or "unsupported" costs. The Pentagon auditors have recently informed the Committee of significantly higher estimates of wasteful spending in Iraq. According to the auditors, questioned and unsupported costs have now risen to more than $10 billion — nearly three times higher than previously reported. According to the Pentagon auditors, more than one in six dollars they have audited in Iraq is suspect.

According to the information the Committee has received, over $2.7 billion in questioned and unsupported costs have been identified in contracts held by Halliburton, the largest private contractor operating in Iraq. The auditors also informed the Committee that Pentagon officials have rejected the majority of their recommendations to disallow the unreasonable charges they have identified.

The estimate of $10 billion in wasteful or undocumented spending in Iraq is likely to underestimate the full magnitude of the problem. Although the Pentagon auditors have reviewed $57 billion in Iraq spending, this does not include the total universe of spending for contractors working in Iraq. Moreover, the Pentagon auditors focus primarily on the reasonableness of costs that contractors propose and incur rather than physical inspections to determine whether contractors have delivered everything required under the contract. While such inspections are sometimes performed by other entities, such as the Special Inspector General for Iraq Reconstruction, they have not been conducted comprehensively or uniformly to date.

I. $10 BILLION IN QUESTIONED AND UNSUPPORTED COSTS IN IRAQ

The Defense Contract Audit Agency (DCAA) is responsible for performing audits of contracts with the Department of Defense and the branches of the military. In a briefing to Committee staff on February 1, 2007, DCAA reported that it has now identified a total of more than $10 billion in questioned and unsupported costs submitted by contractors for work in Iraq through the end of Fiscal Year 2006.[1]

DCAA defines "questioned" costs as those that should be excluded because they are unreasonably high and "unsupported" costs as those for which contractors have failed to provide sufficient documentation. Of the $10 billion, DCAA identified approximately $4.9 billion as questioned costs and approximately $5.1 billion as unsupported costs.

DCAA's new $10 billion figure dwarfs previous reports of contractor overcharges in Iraq. On September 25, 2006, the U.S. Government Accountability Office issued a report reviewing DCAA Iraq reconstruction audits issued between February 2003 and February 2006.[2] This GAO report concluded that DCAA had identified approximately $3.5 billion in questioned and unsupported costs by contractors working in Iraq, including $2.1 billion in questioned costs and $1.4 billion in unsupported costs. DCAA's new $10 billion figure is nearly three times higher than the previously reported estimate.

DCAA also informed the Committee that in the audits conducted to date, more than one out of every six dollars spent for Iraq reconstruction and troop support contracts was suspect. Through September 2006, DCAA auditors had examined $57 billion for Iraq reconstruction and troop support. The $10 billion in questioned and unsupported costs identified by DCAA represents 18% of the total contract dollars examined by DCAA.

II. PENTAGON REJECTIONS OF AUDITOR RECOMMENDATIONS

The Defense Department has disagreed with a majority of DCAA's recommendations to disallow questioned costs. When DCAA identifies contractor charges as "questioned" costs, it recommends that the Defense Department not pay these charges to the contractor. According to DCAA, the Defense Department typically agrees with its recommendations and withholds 50% to 75% of costs.[3] DCAA calls this the "sustention rate." With respect to Iraq overcharges, however, the opposite has occurred. Instead of withholding up to 75% of the disputed charges, the Pentagon has been withholding between 25% and 37% of the amounts in dispute.

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[1] Briefing by William Reed, Director, Defense Contract Audit Agency, to Staff, House Committee on Oversight and Government Reform (Feb. 1, 2007).

[2] Government Accountability Office, *Iraq Contract Costs: DOD Consideration of Defense Contract Audit Agency's Findings* (Report No. GAO-06-1132) (Sept. 25, 2006).

[3] Briefing by William Reed, Director, Defense Contract Audit Agency, to Staff, House Committee on Government Reform (Mar. 3, 2006).

Of the $10 billion in questioned and unsupported costs, DCAA has identified $4.9 billion in questioned costs through FY 2006. Of that amount, Defense Department officials have come to a resolution on $2.6 billion in questioned costs. Of this $2.6 billion, Defense Department officials have agreed with DCAA recommendations to withhold $632 million. This represents only 25% of the total costs questioned by the DCAA.

Of the $2.6 billion in questioned costs that have been resolved, approximately $876 million were associated with work not ultimately contracted for by the Defense Department, such as costs questioned in "pre-award" audits of competitive bids that did not result in winning contract awards. Even factoring in these amounts, DCAA's sustention rate remains at approximately 37%, in contrast to the historical rate of between 50% and 75%.

III. AUDITOR FINDINGS ON SPECIFIC IRAQ CONTRACTS

In addition to providing new information on the totality of questioned and unsupported costs, DCAA has provided the Committee with updated data on charges relating to several specific contracts.

A. Halliburton Contracts

The largest private contractor operating in Iraq is Halliburton. Through its KBR subsidiary, Halliburton has held three large contracts in Iraq: the Logistics Civil Augmentation Program (LOGCAP) contract to provide support services to the troops; the Restore Iraqi Oil (RIO) contract to rebuild oil fields throughout Iraq; and the Restore Iraqi Oil 2 (RIO 2) contract to rebuild oil fields in southern Iraq. The total value of these three contracts is approximately $25.7 billion.[4] According to the information received by the Committee, it appears that DCAA has audited $19.8 billion of the costs incurred under the Halliburton contracts and identified over $2.7 billion in questioned and unsupported billings.

The LOGCAP Contract. Under the LOGCAP contract for logistical and life support for U.S. troops, DCAA has identified nearly $2.4 billion in questioned and unsupported costs, including $1.9 billion in questioned costs and $450 million in unsupported costs. This $2.4 billion figure represents 15% of the $16.2 billion in LOGCAP costs audited by DCAA. The $1.9 billion in questioned costs is significantly higher than the $1.3 billion in questioned costs reported by DCAA in March 2006.[5]

Among the costs questioned by DCAA under the LOGCAP contract are $212 million worth of meals that exceeded the value of actual meals served, $100 million in costs associated with sites that have been closed down, and $42 million in duplicated subcontractor costs.

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[4] According to DCAA, the total current value for the ongoing LOGCAP contract is $22.1 billion, the total amount expended under the RIO contract was $2.4 billion, and the total contract value for the RIO2 contract was $1.2 billion, for a total value of $25.7 billion for all three contracts.

[5] Briefing by William Reed, Director, Defense Contract Audit Agency, to Staff, House Committee on Government Reform (Mar. 3, 2006).

Of the $1.07 billion in questioned costs under the LOGCAP contract that have been resolved, the Defense Department has sustained the DCAA auditors on $465 million, 43% of the disputed costs.

The RIO Contract. The first RIO contract was awarded to Halliburton without competition in March 2003 to restore and operate Iraq's oil fields. Under this contract, DCAA has identified over $281 million in questioned and unsupported costs, including $221 million in questioned costs and $60 million in unsupported costs. This total represents 12% of the $2.4 billion in RIO costs billed by Halliburton. The vast majority of questioned costs related to unreasonable costs charged by Halliburton to import millions of gallons of gasoline into Iraq from Kuwait and Turkey. According to a report released by Chairman Waxman's staff, these fuel charges were inflated by surcharges of up to $1.86 per gallon for transportation, overhead, and profits, resulting in fuels prices twice as high as reasonable.[6]

The Defense Department has now resolved all of these questioned costs. It sustained DCAA's recommendations for only $26 million, just 12% of the total amount in dispute. GAO is currently examining the propriety of the Department's payments to Halliburton under this contract.

The RIO 2 Contract. The RIO 2 contract for oil field restoration in southern Iraq was awarded to Halliburton in January 2004 as a follow-on contract to RIO. Under this contract, DCAA has identified approximately $52 million in questioned and unsupported costs, including $47.7 million in questioned costs and $4 million in unsupported costs.

The RIO2 contract was awarded to Halliburton despite warnings from auditors not to enter into further contracts with Halliburton.[7] Since then, it has been plagued with problems, such as billing for excessive employees and failing to complete projects on time. On one task order, DCAA concluded that 69% of the costs were questioned or unsupported. Halliburton's deficiencies led to the issuance of a cure notice in which the Project and Contracting Office stated that Halliburton's "lack of cost containment and funds management is the single biggest detriment to this program."[8]

DCAA has not provided data on the sustention rate of questioned costs under the RIO2 contract.

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[6] Minority Staff, Special Investigations Division, House Committee on Government Reform, *Halliburton's Gasoline Overcharges* (June 21, 2004) (online at www.oversight.house.gov/Documents/20040817115902-43717.pdf).

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

[8] Letter from Project and Contracting Office to KBR (Jan. 29, 2005). *See* Minority Staff, Special Investigations Division, House Committee on Government Reform, *Halliburton's Performance Under the Restore Iraqi Oil 2 Contract* (Mar. 28, 2006) (online at www.oversight.house.gov/Documents/20061024163434-45471.pdf).

B. The Parsons Contracts

Parsons is another large contractor operating in Iraq, with contracts worth over $2.2 billion for the reconstruction of Iraq's infrastructure, including contracts to build and renovate public buildings such as government offices, hospitals and housing and a contract to repair and operate the oil infrastructure in the northern part of Iraq. Under these Parsons contracts, DCAA has identified over $90 million in questioned and unsupported costs, including $15.7 million in questioned costs and $74.4 million in unsupported costs.

The Special Inspector General for Iraq Reconstruction has also identified problems involving Parsons's contracts. Parsons was awarded a contract in March 2004 to restore and build 150 primary health clinics in Iraq. Although Parsons charged the government $186 million under the contract, the IG has reported that the company completed only six health clinics.[9] On a contract to renovate the Baghdad Police College, the IG reported that Parsons's work resulted in feces and urine leaking through the ceilings.[10] According to the Special Inspector General for Iraq Reconstruction, 13 of the 14 major Parsons projects his office has visited have failed to meet acceptable standards.[11]

DCAA has not provided data on the sustention rate of questioned costs under Parsons Iraq reconstruction contracts.

IV. UNDERESTIMATION

The $10 billion in questioned and unsupported costs identified by DCAA is likely to underestimate the full magnitude of wasteful spending in Iraq. Through the end of FY 2006, DCAA had audited only $57 billion in Iraq contracts. According to DCAA, it does not know the total amount spent on contracts in Iraq. The total amount, however, is likely to far exceed $57 billion. To date, the war in Iraq has cost the taxpayer $351 billion.[12]

In some cases, the Committee is aware of contracts that have not been audited by DCAA — and hence are not included in DCAA's $10 billion estimate of questioned and unsupported costs — but that have resulted in significant overcharges. For example, DynCorp has a contract with the State Department to help train and equip Iraqi police. Although DCAA did not audit

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[9] House Committee on Government Reform, Testimony of Stuart W. Bowen, Special Inspector General for Iraq Reconstruction, *Hearing on the Reconstruction Contracting in Iraq* (Sept. 28, 2006).

[10] Special Inspector General for Iraq Reconstruction, *Baghdad Police College* (SIGIR PA-06-078.2 & 079.2) (Jan. 29, 2007).

[11] House Committee on Government Reform, Testimony of Stuart W. Bowen, Special Inspector General for Iraq Reconstruction, *Hearing on the Reconstruction Contracting in Iraq* (Sept. 28, 2006).

[12] Letter from Peter R. Orszag, Director, Congressional Budget Office, to Senator Kent Conrad, Chairman, Senate Budget Committee (Table 1) (Feb. 7, 2007).

this contract, the Special Inspector General for Iraq Reconstruction did conduct an audit and found millions of dollars in questionable contractor charges.[13]

Moreover, DCAA audits may not reveal the full scope of overcharging or abuse. DCAA conducts audits related primarily to the costs that contractors propose and incur. DCAA examines contractor documentation to ensure that costs such as labor and overhead are reasonable and consistent with rates charged under other contracts. DCAA also ensures that costs actually incurred by contractors are reasonable, allowable under the contract terms, and allocable to specific contract tasks. DCAA does not have engineers or other inspectors with the responsibility of verifying that the final product or service delivered by the contractor meets all contract terms.

Other audit entities, such as the Special Inspector General for Iraq Reconstruction, have conducted some physical inspections after contract work was completed and found significant performance problems. Wasteful spending attributable to poor performance is not typically included in DCAA cost audits.

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[13] Special Inspector General for Iraq Reconstruction, *Review of DynCorp International, LLC, Contract Number S-LMAQM-04-C-0030, Task Order 0338, for the Iraqi Police Training Program Support* (SIGIR-06-029) (Jan. 30, 2007).