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AUDIT OF USAID/ECUADOR'S
EMERGENCY REHABILITATION PROJECT
(NO. 518-0046)

Audit Report No. 1-518-87-24
April 21, 1987

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AGENCY FOR INTERNATIONAL DEVELOPMENT

OFFICE OF THE REGIONAL INSPECTOR GENERAL
AMERICAN EMBASSY
TEGUCIGALPA — HONDURAS

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April 21, 1987

MEMORANDUM FOR: Director, USAID/Ecuador, Frank Almaguer

FROM: RIG/A/T, Coinage N. Gothard

Coinage N. Gothard

SUBJECT: Audit of USAID/Ecuador's Emergency Rehabilitation Project (No. 518-0046)

This report presents the results of audit of USAID/Ecuador's Emergency Rehabilitation Project. The first report recommendation is closed on the date of this report. Please advise this office within 30 days of the actions planned or taken to implement the second recommendation. We appreciate the courtesy extended to our staff during the audit.

Background

El Niño is a warm ocean current which normally appears off the coast of Ecuador and Peru near Christmastime. In 1982, abnormal variations in the current caused the worst flooding Ecuador had experienced in at least 90 years. USAID/Ecuador estimated that the damage, concentrated in coastal areas, exceeded $250 million.

USAID/Ecuador responded to the El Niño disaster primarily through the Emergency Rehabilitation Project (No. 518-0046). The project began on September 27, 1983, and was expected to be completed by September 30, 1987, nine months after the original project assistance date. The project agreements provided $22 million in AID funds ($6 million in grant funds and $16 million in loan funds), and required counterpart contributions of $10.2 million. USAID/Ecuador was also authorized to obligate $1 million in grant funds outside the project agreements for technical assistance, training, and logistical support for the project. Thus, a total of $33.2 million was available to accomplish project objectives.

The major project activities planned consisted of:

-- repairing irrigation canals, ditches, and levees;

-- building flood control works;

-- repairing and improving roads in the Guasmo, a low-income area of Guayaquil, the country's largest city;

-- repairing potable water and sewerage systems;

-- reconstructing and repairing homes and schools;

-- repairing electrical generators and transmission lines; and

-- studying alternatives for preventing landslides on a mountain overlooking Quito.

The Ecuadorian Development Bank coordinated the efforts of the eleven Government of Ecuador agencies which implemented the project.

Audit Objectives and Scope

The Office of the Regional Inspector General for Audit/Tegucigalpa performed a program results audit of USAID/Ecuador's Emergency Rehabilitation Project. The audit objectives were to evaluate the project's effectiveness in achieving its goals, and to assess compliance with applicable laws and regulations. The audit covered activities from the project's inception on September 27, 1983 through December 19, 1986. About $21 million in AID disbursements and advances was covered by the audit.

AID and host government project officials in Quito and Guayaquil were interviewed. Project records such as the project paper, project agreement, reports, correspondence, and accounting records were reviewed. The review of internal controls and compliance was limited to the findings in this report. The audit began in August 1986 and ended in December 1986, and was made in accordance with generally accepted government auditing standards.

Results of Audit

The project was generally making satisfactory progress toward achieving its goals. Management's system for measuring project effectiveness was generally adequate, except that reports on activities funded under the original grant and loan did not present accomplishments in a manner compatible with the goals established in the project paper.

Compliance with applicable laws and regulations was adequate except for non-compliance with AID's procurement policy (discussed below) and several financial management problems discussed in the "other pertinent matters" section of this report. Other than these conditions, tested items were in compliance with applicable laws and regulations. The audit disclosed three internal control exceptions. First, the agency in charge of infrastructure work in Guayaquil lacked contracting procedures which would ensure effective competition. Second, no guidance existed to prevent the use of disaster assistance funds for non-disaster-related infrastructure works. Third, the normal methods used by AID Missions to control the expenditure of AID funds were not used effectively on this project.

However, USAID/Ecuador's management deserves praise for the manner in which it exercised control over the $2.7 million in counterpart contributions budgeted for the water and sanitation component of the project. The implementing agency periodically submitted statements for all expenditures under this component, whether from AID or counterpart funds. An AID-funded advisor examined the supporting documentation for these expenditures, and the Mission disbursed an amount equal to 43 percent of the expenditures it found properly supported. In this way, the Mission could be sure that the Government of Ecuador fulfilled its commitment to fund 57 percent of the cost of this component. In our opinion, other AID Missions would be well advised to follow USAID/Ecuador's lead and adopt similar procedures to ensure compliance with counterpart contribution requirements.

The audit showed that contracting procedures used by the Ecuadorian Housing Bank gave the Bank virtually unlimited discretion in selecting contractors. The report recommends that USAID/Ecuador require the Bank to follow formal competitive procedures in awarding future AID-funded contracts. The audit also disclosed the need for additional counterpart contributions and accordingly the report recommends that the Mission obtain an additional $600,000 in counterpart financing. Two other pertinent matters are also discussed in this report.

Better Contracting Procedures Were Needed - AID's procurement policy, which encourages formal competition, is based on the principle of obtaining the best price through competition, using sound judgment and fair procedures. USAID/Ecuador waived formal competition for infrastructure works in the Guasmo section of Guayaquil, requiring instead informal competition among at least three firms. In practice, the contracting procedures used by the Ecuadorian Housing Bank gave the Bank virtually unlimited discretion in awarding contracts. This created the potential for favoritism, and resulted in prices which were higher than necessary. Mission staff in Guayaquil were concerned about this situation, but were reportedly told not to become involved. USAID/Ecuador needed to require the Bank to implement improved contracting procedures.

Discussion - AID policy, as stated in Handbook 1, Supplement B, Section 12C, is that host country contracts for the procurement of AID-financed goods and services should be awarded using formal competitive procedures. This policy is based on the principles that "[t]he best price for goods and services is obtained through competition," and that "[p]rudent management of public funds requires use of sound judgment and fair procedures." To compensate for delays in beginning infrastructure rehabilitation work in Guayaquil, USAID/Ecuador waived the requirement for formal competition and required instead that informal competition take place among at least three firms. Given the principles which underlie AID's procurement policy, it would be reasonable to expect that even informal competition procedures would result in reasonable prices and a defensible basis for selecting one contractor over another.

In fact, the procedures USAID/Ecuador permitted the Ecuadorian Housing Bank to employ gave the Bank virtually absolute discretion in awarding contracts. AID staff were concerned about this situation and had offered to closely monitor the Bank's actions, but were reportedly told by the former Mission Director not to become involved.

For example, potential surveying and supervision contractors were not required to submit proposals. Instead, they were selected by the head of the Housing Bank's implementing unit from lists provided by the College of Civil Engineers of Guayas. This individual stated that he chose those engineers known to him who he felt were most qualified to do the work. This may have been the case, but the documentation pertaining to the award of these contracts did not demonstrate that the most qualified engineers were chosen. Also, it would be difficult to conclude that informal competition among at least three parties occurred simply because the names of several different engineers appeared on a list of possible candidates.

The procedures used to award road construction contracts were also unsatisfactory. Potential contractors were invited to submit cost and technical proposals. The proposed prices played no part in the selection because the Bank decided to pay each contractor the same unit prices paid by the Ministry of Public Works. Instead, the selection was ostensibly made based on technical factors such as the contractors' experience, the equipment they had available, and when they could begin work. However, the majority of the proposals provided us by the Bank included only proposed prices (which were not used), and did not include any technical information which could serve as a basis for such an evaluation. At least two of the eighteen road sector contracts were awarded to firms who had provided no technical information. None of the documentation concerning the award of any of the road sector contracts demonstrated that the most qualified contractors were selected.

Drainage contracts were awarded by inviting five offerors to submit cost and technical proposals. The documentation supporting the award of at least one of three drainage contracts did present a defensible case that the best contractor was chosen, price and other factors considered. However, the comparative prices discussed below indicate that even in this case effective price competition may not have taken place.

The poor procedures used by the Housing Bank created the potential for favoritism, and resulted in prices which were higher than necessary. The comparative prices presented in Exhibit 1 show that the Housing Bank often paid three to four times what the Ecuadorian Hydraulic Resources Institute (the implementing agency for another project component) paid for the same type of work in more remote locations. For example, the Housing Bank paid four and one-half times as much for laying down and compacting road sub-base material, and three and one-half times as much for installing drainage pipe. This difference was particularly important in view of the fact that the Government of Ecuador planned to request reprogramming about $900,000 remaining under the project to the Guasmo infrastructure component. Adopting better contracting procedures would likely permit three to four times as much work to be done with these funds.

Recommendation No. 1

We recommend that USAID/Ecuador notify the Ecuadorian Housing Bank that formal competitive procedures will be required for any future work in the Guasmo section of Guayaquil.

USAID/Ecuador concurred with this finding and recommendation. However, due to the oligopolistic price setting practices prevalent in the construction industry in Guayaquil, it did not believe that formal competition would have any appreciable impact on cost.

The Mission implemented this recommendation by issuing Project Implementation Letter No. 50 on February 23, 1987. Therefore, this recommendation is closed on the date of this report.

Additional Counterpart Contributions Were Required - The loan agreement amendment required the Government of Ecuador to contribute the equivalent of $3.33 million to support project activities. However, the Government had only programmed local currency equivalent to $2.73 million (using the exchange rate in effect when the agreement was signed) for specific project purposes. The loan agreement amendment did not specify how the remaining $600,000 was to be used. As a result, fewer resources than required by the agreement were available to implement rehabilitation activities.

At the time of the audit, the Mission and the Government of Ecuador were preparing to reprogram about $900,000 in unused AID funds. USAID/Ecuador should require the Government to program the equivalent of an additional $600,000 in local currency before disbursing these unused AID funds.

Recommendation No. 2

We recommend that USAID/Ecuador require the Government to program the equivalent of an additional $600,000 in counterpart contributions before disbursing reporgrammed AID funds.

USAID/Ecuador agreed with this finding and recommendation.

Other Pertinent Matters - Two other matters warrant Mission attention.

Selection of Project Activities - Some of the activities funded under the Emergency Rehabilitation Project were not related to the El Niño disaster. For example, about $113,000 was used to provide street lighting in the Guasmo section of Guayaquil. The project paper recognized that the inclusion of this activity could be debated, but concluded that street lighting was justified since it would help reduce crime in the Guasmo. We disagree, since the problem of crime in the Guasmo was not related to the El Niño disaster. In our opinion, these disaster assistance funds would more appropriately have been used to fund some of the millions of dollars worth of disaster-related repair and rehabilitation works for which no funding source had yet been identified.

As another example, the $4.8 million potable water and sanitation component was justified in the Project Paper exclusively in terms of repairing and rehabilitating infrastructure damaged by flooding in 1982 and 1983. In fact, only a small portion of the work was directed toward repair and rehabilitation. The majority of the resources was used to install new potable water systems where none existed before, or to expand existing systems. While these works may have been badly needed, a disaster assistance project is not an appropriate vehicle for funding new potable water systems. Among other reasons, this activity experienced serious problems due to a lack of technical and administrative capabilities in the implementing agency. A development assistance project with explicit institutional development objectives would have been an effective way to address these weaknesses.

These examples demonstrate the need for Agency guidance on what types of activities should and should not be included in disaster assistance projects. We plan to recommend, in a separate report to the Bureau for Program and Policy Coordination, that such guidance be developed.

Financial Management - The Mission's financial management of AID dollar funding under this project was extremely weak. Most seriously, the audit disclosed obligations of funds in excess of an allotment, obligations of funds after the appropriation had expired, and payments to contractors whose contracts had expired. These apparent violations of the Anti-Deficiency Act and AID's fund control regulation will be the subject of a separate report to the Bureau of Management. Other financial management problems included advance ledgers which showed negative balances outstanding and earmarked amounts which were denominated in local currency with no U.S. dollar equivalent. The nature of these financial management problems suggests that other projects in the Mission's portfolio may have similar problems. We are not making a recommendation because USAID/Ecuador had already taken steps to improve the training and supervision of Controller's Office staff.

AUDIT OF USAID/ECUADOR'S
EMERGENCY REHABILITATION PROJECT
(NO. 518-0046)

EXHIBITS AND APPENDICES

Comparison of Unit Prices Paid by the Ecuadorian Housing Bank and the Ecuadorian Hydraulic Resources Institute

Work Units	Hydraulic Resources Institute Prices and Dates Paid		Housing Bank Prices and Dates Paid		Ratio of Housing Bank Prices to Hydraulic Resources Institute Prices
Laying down and compacting road base (cubic meter)	S/. 146	6/85	S/. 360	7/85	2.5
Laying down and compacting sub-base (cubic meter)	241	6/85	1,100	7/85	4.6
Transporting base and sub-base materials (cubic meter, per kilometer)	17	6/85	19	7/85	1.1
Installing 20" drainage pipe (lineal meter)	481	6/85	1,864	1/86	3.9
Installing 24" drainage pipe (lineal meter)	664	6/85	2,252	1/86	3.4
Surveying - establishing reference points (kilometer)	5,640	1/85-6/86	21,086	7/85	3.7
Surveying - taking elevations and cross sections (kilometer)	1,890	1/85-6/86	8,760	7/85	4.6

Note: At the time of our review, the exchange rate was 142 Ecuadorian sucres to 1 dollar.

Source: Housing Bank prices were taken from the implementing unit's records. Comparative prices were provided by the Ecuadorian Hydraulic Resources Institute through the project technical coordinator.

EXHIBIT 1

UNITED STATES GOVERNMENT

memorandum

DATE: February 27, 1987

REPLY TO ATTN OF: Frank Almaguer, Director FA

O/CONT-87-140

SUBJECT: Mission Response to draft audit report on Project 518-0046, Emergency Rehabilitation Project

TO: Mr. Coinage Gothard, RIG/LAC

This Mission has reviewed the subject draft report and has the following comments:

1. We have taken action to clear the recommendation related to the procurement of construction services for repair and reconstruction activities. Implementation Letter No. 50 is attached to this memorandum to verify the action that has been taken.

2. Page nine of the draft audit report states that "the project agreements required the Government of Ecuador to contribute the equivalent of $3.33 million, or about 13 percent of the total cost of the project." The Mission believes this statement is misleading.

   Grant Agreement 518-0046 provides $6 million in AID funds for emergency works. Specific counterpart requirements contained in the Grant Agreement consisted of 830 person months of GOE professional services and S/.118.000.000 (=$1,352,436.00 at the time the Agreement was signed) of "national resources", presumably already assigned to a housing loan fund at the time of signing the Grant Agreement.

   Loan Agreement 518-F-043 required the use of all local currencies generated, equivalent to $5,500,000, to finance the second project component, Agricultural Credit Program. Total cost of the Project was, thus, $11,500,000, of which the GOE was required to finance $5,500,000, or 48% of total costs.

   Loan Agreement 518-F-043A provided for activities totalling $13,330,000, of which GOE funds would finance $3,330,000, or 25% of total costs.

   Taking the Project as a whole (all three Agreements), the total financial cost is $32,182,436, of which the GOE was required to provide $10,182,436 in financial resources (31.6% of total financial costs) plus approximately 830 person month of services on an in-kind basis.

OPTIONAL FORM NO. 10
(REV. 1-80)
GSA FPMR (41 CFR) 101-11.6
5010-114
☆ U.S. GPO 1986 491-218 40042

The Mission, therefore, suggests that the counterpart funds section be revised as follows:

"The three Project Agreements required the Government of Ecuador to contribute the equivalent of $10,182,436 in financial (i.e. not in-kind) resources, including local currency generated, about 32% of total project financing. Activities to be financed under the third agreement were to be funded with $10 million in AID loan funds and the equivalent of $3.33 million of GOE resources. However, it appears that only the local currency equivalent of $2.73 million was programmed for project purposes (using the exchange rate in effect when the agreement was signed). At the time of the audit, the Mission and the Government of Ecuador were preparing to reprogram about $900,000 in unused AID loan funds. We believe the Mission should require the GOE to provide the equivalent of an additional $600,000 in counterpart funding."

Att.: a/s

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UNITED STATES GOVERNMENT

memorandum

DATE: March 3, 1987

REPLY TO ATTN OF: Frank Almaguer, Ecuador Mission Director FA

SUBJECT: Draft Audit Report - Emergency Rehabilitation Project

TO: Coinage Gothard, RIG/A/T

Based on my recent visit to Guayaquil (Feb. 25-28) and discussions with USAID and GOE project personnel at the site, you may wish to consider the following observations in finalizing the reference audit report. This memo is supplementary to the Mission's draft audit response dated February 27, 1987.

1. The PIL requiring formal competition for Guasmo related activities has now been received by project authorities. I was assured by all key GOE players in Guayaquil that they would strictly abide by the new tighter procedures.

2. I have also been assured by the appropriate project counterpart authorities that upcoming reprogramming of remaining funds will not include street lights or any other activity not related to disaster rehabilitation or prevention.

3. Funds for repair of road work already completed but damaged by recent floods will be included in the reprogramming.

4. With regard to the draft audit's comment that failure to adopt better contracting procedures may have resulted in excessive charges, I reviewed the matter in some detail with a number of people in Guayaquil--ranging from the Governor of the Province to our local contract engineer. I got fairly uniform responses which may have some bearing on the audit observation:

   - transportation costs in Guayaquil are much higher than elsewhere because: 1) road building material has to be brought in from fairly long distances and 2) all truckers belong to a co-op that acts as a monopoly in setting prices.

   - there are only two firms that have asphalt surfacing equipment and the demand for their equipment is such that they do not compete.

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based on the monopolistic, price-setting practices that are prevalent in the construction industry in Guayaquil, no one believed that formal competition would have any appreciable impact on cost.

cc: Bob CLark, CONT
Cynthia Giusti, ODR

APPENDIX 2

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