615072
649010?
6?9010?

PD-AAS-457
ISN 42867

POOR CONTRACTING HAS RESULTED IN WINDFALL PROFITS TO LOUIS BERGER NTERNATIONAL INC. AND ITS TECHNICIANS

AUDIT REPORT NO. 3-623-83-12
MARCH 25, 1983

POOR CONTRACTING HAS RESULTED IN
WINDFALL PROFITS TO LOUIS BERGER
INTERNATIONAL INC. AND ITS TECHNICIANS

TABLE OF CONTENTS

EXECUTIVE SUMMARY

Introduction

During 1981, three host country contracts to implement AID projects in East Africa were awarded to Louis Berger International, Inc. (LBII). Each of these contracts was a time rate contract, and each contained provisions for fixed lump sum payments to LBII or its personnel. The projects associated with these three contracts were (a) the Arid and Semi-Arid Lands Development Project in Kenya, (b) the Central Rangelands Development Project in Somalia, and (c) the Comprehensive Groundwater Development Project in Somalia.

During a brief review of the LBII contracts in December 1981, RIG/A/Nairobi became concerned that the contracts were "time rate" and had varying terms and payment features. We were also concerned as to how the Agency assured itself that the contract prices were reasonable. These concerns were expressed to the Regional Legal Advisor, the Regional Contracting Officer and USAID/Kenya. As the answers to our queries were not fully satisfactory, and in some instances raised still more questions, the current audit was undertaken.

Purpose and Scope

The purpose of our review was to determine the effectiveness of procedures followed by Kenya and Somalia in selecting the contractor and contract teams; to determine the degree of support and assistance provided to the host governments by USAID/Kenya, USAID/Somalia and AID's Regional Economic Development Services Office for East Africa (REDSO/EA); to review lump sum reimbursements to the contractor and/or its employees to determine whether they were reasonable; and to review the reasonableness of contract provisions. We reviewed project records, held discussions with project officials, and visited project offices in Kenya, Somalia and the U.S. as deemed necessary to conduct the review.

Findings, Conclusions and Recommendations

AID paid more for the LBII services than it should have because of poor contract negotiations, the use of time rate contracts and questionable contract provisions. We estimate that AID will pay about $2.0 million more than it would have under cost-plus-fixed-fee contracts for the same services (Exhibit A).

Host Country Contracting Procedures Were Deficient

These LBII contracts show the problems host governments have in letting cost effective contracts with U.S. firms for technical assistance. The host governments lacked the technical capability to negotiate, and the knowledge to determine what would be reasonable time rates for the services required; they lacked financial incentive to negotiate the lowest cost possible because the funding was a gift from the U.S. government; they lacked foresight about the financial risks associated with time rate contracts; and they lacked effective AID support during the contracting process. As a result, the contracts provide the contractor and contract technicians with opportunities to make windfall profits at the expense of the U.S. government (pages 3 to 5).

Time Rate Contracts Are Wasting AID Funds

The three LBII contracts were time rate contracts. LBII has the potential to make additional profit (which we estimated to be $693,000) by paying lower salaries than those used in the time rate formula. Additional profit was also made in subcontract and consultant time rates (pages 5 to 9).

Price Competition Is Needed On Host Country Contracts

Price competition should become part of host country contracting because the host governments are unable to select the most technically qualified contractor or negotiate contracts that are least costly to AID. In addition, it is incongruous to expect the host government to negotiate hard when it usually is not their money they are spending (pages 9 to 12).

The LBII-GOK Contract May Be A Cost-Plus-Percentage-Of-Cost Contract

The LBII contract in Kenya has attributes of the proscribed cost-plus-percentage-of-cost contract. LBII can increase the amount of fee it collects by an increase in salary or by overrunning cost estimates, which is the reason cost-plus-percentage-of-cost contracts are prohibited (pages 12 and 13).

Contractor Selection Criteria Was Faulty

The procedures for analyzing and ranking contractor technical proposals on the Kenya ASAL and the Somalia Rangelands projects were poorly conceived and resulted in contractor selection based on false assumptions (pages 13 to 15).

Certain Contract Provisions And Billing Procedures Increased AID's Costs And Allowed Windfall Gains For The Contractor And/Or Contractor Employees

The LBII contracts contain clauses that are favorable to LBII, enhancing their profit potential and their cash position while making the contract more expensive to AID. The various clauses and provisions which favored the contractor and its technicians at the expense of AID were:

- Contract advances totalling approximately $1.2 million were unnecessary and cost the U.S. government almost $112,000 in interest (pages 16 and 17).

- Application of a 30 day basis of billing increased the cost of the contract by about $65,000 (pages 18 and 19).

- Annual leave was billed up front which cost the U.S. government about $30,000 in interest (page 19).

- Certain fees totalling $217,000 should have been absorbed in overhead (page 19).

- Technicians in Somalia will receive unwarranted cost of living allowances of about $275,000 (page 20).

- Fixed lump sum amounts are escalated annually even though actual costs do not increase (pages 20 and 21).

- Technicians can profit from allowances, e.g., housing, etc. (pages 21 and 22).

We believe AID can effect considerable savings by being more prudent in using time rate contracts, and by more effectively assisting host governments in negotiating and developing contract provisions. Seven recommendations were made to accomplish this end.

At the conclusion of our review, copies of our draft report were provided to USAID/Kenya, USAID/Somalia, REDSO/EA, GC/LE, and M/SER/CM for their comments. Comments were received from each of these AID entities, except GC/LE. We have revised our final report and included these comments where considered pertinent.

BACKGROUND

Introduction

During 1981, three host country contracts to implement AID projects in East Africa were awarded to Louis Berger International, Inc. (LBII). Each of these contracts was a time rate contract, and each contained provisions for fixed lump sum payments to LBII or LBII personnel. The projects associated with these three contracts were:

- Kenya -- Arid and Semi-Arid Lands Development
- Somalia -- Central Rangelands Development
- Somalia -- Comprehensive Groundwater Development

The Arid and Semi-Arid Lands (ASAL) Development Project (No. 615-0172) began in Kenya on August 30, 1979, with a Project Assistance Completion Date of December 31, 1984. Planned AID financing over the life of the grant project is $13 million. The Government of Kenya (GOK) agreed to provide the equivalent of $5.645 million for the project, representing a 30.3 percent project contribution -- which meets the 25 percent host country contribution required by Section 110(a) of the Foreign Assistance Act.

The ASAL Development Project is to establish the basis for launching an accelerated development program in Kenya's arid and semi-arid lands, and improve and preserve the agricultural production base in portions of the Kitui District of Kenya. The project consists of three principal components: (a) planning for ASAL development, (b) data collection and analysis, and (c) soil and water conservation.

In August 1981, the GOK entered into a $9.8 million host country contract with LBII to implement the ASAL Development Project.

LBII also entered into two host country contracts in Somalia during 1981: a $7 million contract with the Government of Somalia Democratic Republic (GSDR) for the implementation of the Central Rangelands Development Project, and a $6.5 million contract with the GSDR for the Comprehensive Groundwater Development Project.

The Central Rangelands Development Project (No. 649-0108) began in Somalia on August 18, 1979, with a Project Assistance Completion Date of September 30, 1986. Planned AID financing over the life of the grant project is $14.944 million. The GSDR agreed to provide the equivalent of $5 million for the project, representing a 25 percent project contribution.

The Central Rangelands Development Project consists of a multi-donor effort to assist Somalia in (a) improving range management, livestock water supplies and veterinary services, (b) establishing non-formal training for pastoralists, and (c) improving Somalia's ability to implement range development by training staff at all levels and by providing internationally recruited senior technical staff. The project is to implement a system of range management which balances animals and forage to optimize livestock production while preserving the range resources. Project activities should consolidate and improve rangeland and livestock production, increase income of the pastoralists through the introduction of a system of range utilization, and contribute to the gradual concentration of pastoral communities. In December 1981, the GSDR entered into a $7 million host country contract with LBII to implement this project.

The Comprehensive Groundwater Development Project (No. 649-0104) began in Somalia on September 30, 1979, with a Project Assistance Completion Date of September 30, 1984. Planned AID financing over the life of the grant project is $13 million. The GSDR agreed to provide the equivalent of $4.965 million for the project, representing a 27.6 percent project contribution.

The Comprehensive Groundwater Development Project consists of an overall water development program beginning with hydrological and geophysical studies, followed by a production drilling program, while continuing the data collection begun with the initial studies. In August 1981, the GSDR entered into a $6.5 million host country contract with LBII to implement this project.

Purpose and Scope

We conducted a limited scope review of the three LBII - host country contracts. The purpose of the examination was to:

- Determine the effectiveness of procedures followed by Kenya and Somalia in selecting the contractor and contract teams, and the degree of support and assistance provided to the host governments by USAID/Kenya, USAID/Somalia, and AID's Regional Economic Development Services Office for East Africa (REDSO/EA).

- Review the reasonableness of contract provisions.

- Review lump sum reimbursements to the contractor and/or its employees to determine whether the rates were reasonable and necessary.

- Identify and report on signficant implementation and other problem areas.

We reviewed records, reports, and correspondence at USAID/Kenya, USAID/Somalia, REDSO/EA, LBII/Kenya, LBII/Somalia, LBII headquarters office in the U.S., and both host governments; and held discussions with officials from those organizations. Separate reports were issued on problems pertaining only to implementation of the Kenya project and to the two Somalia projects (AR 3-615-83-10, and AR 3-649-83-9, respectively).

FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

From our review of the three LBII contracts, we concluded that AID will pay about $2.0 million more than it would have under a cost plus fixed fee contract for the same number of man months of service (see Exhibit A). This was primarily due to poor contract negotiation, the use of time rate contracts, and questionable contract provisions.

Our estimate will vary depending on (a) LBII's actual overhead rate vs the 118.8 percent used in the fixed rates, and (b) future salary adjustments. There are indications that the higher overhead rate (128.5 percent for the twelve months ending June 30, 1982) will be offset by a decrease in later years because of a large government contract with another U.S. government agency. We estimate the effect of the higher overhead rate on our total estimate to be about $31,000 for LBII's FY ending June 30, 1982.

Our overall $2.0 million estimate would be about $130,000 higher had not LBII agreed in March 1982 to reduce the fixed time rates included in the Kenya contract to an actual salary basis. (As noted in the following section, however, the rates were subsequently escalated and are no longer based on actual salaries paid.)

Host Country Contracting Procedures Were Deficient

The three LBII contracts show the problems host governments have in letting cost effective contracts with U.S. firms for technical assistance. The host governments of Kenya and Somalia lacked the technical capability to negotiate, and the knowledge to determine what would be reasonable time rates for the services of a U.S. contractor; they lacked financial incentive to negotiate the lowest cost possible because the funds were a gift from the U.S. government; they lacked foresight about the financial risks associated with time rate contracts; and they lacked effective AID support in negotiating a cost effective contract. As a result the contracts provide the contractor and contract technicians with opportunities to make windfall profits at the expense of the U.S. government.

The contractor is making windfall profits (in addition to a 12% fee included in the time rates) in the time rates for LBII technicians, subcontract technicians, and hired consultants -- because the time rates were not based on actual salaries and/or cost. Windfall profits were also made on housing allowances, time rates for local hires, interest from unnecessary mobilization advances, the 30 day billing procedure, the billing of annual leave in advance, and the fees for purchasing and subcontract management.

The subcontractors also have the same opportunities as LBII to profit from the fixed time rates.

Under the Kenya contract individual technicians can profit from the fixed rates for housing allowances and guard service. Under all three contracts the technicians can profit from storage and shipment of household effects, and car allowances.

The fixed rate reimbursements lock AID into paying the fixed amount regardless what the actual cost really was. We have found examples where the actual costs were significantly less than the fixed billing rate -- resulting in AID paying more than it would have under a cost-plus-fixed-fee contract.

The time rates also permit the contractor to make additional profit from time overruns. For each time overrun, LBII can convert contract contingency factors into additional fees and contributions to overhead. The fee and overhead amount to 133 percent of each labor dollar. This is in addition to hidden profits that exist within individual time rates because the time rates are not based on actual salaries.

All these gains to LBII and the technicians are a result of poor negotiating and lack of incentive to control costs, use of the time rate contract, and poor contract provisions that favor the contractor at the expense of AID. LBII is merely billing what the contract provides and what AID and the host governments permitted. Although the profits made are made within the contract provisions, the contracts themselves are a "criminal" waste of AID funds (approximately $2.0 million) in the name of administrative simplicity.

The REDSO/EA Regional Legal Advisor indicated that AID may have a basis for claiming restitution on a legal theory of "unjust enrichment" under the Suppliers Certificates submitted by LBII. He stated, however, that he does not have the library or materials to adequately research the issue but supports our requesting General Counsel (GC) in Washington to follow up.

Conclusion and Recommendation

The LBII contracts show how ineffective host governments are in negotiating contracts, and how ineffective AID is in providing guidance to the host governments. As a result, we estimate that AID will pay about $ 2.0 million more under these three LBII contracts than it would have paid under a comparable cost-plus-fixed-fee contract. Although it would be impractical at this time to eliminate all of the fixed rates in the contract, LBII representatives indicated they might be willing to bill salaries based on cost-plus-fixed-fee.

Recommendation No. 1

USAID/Kenya and USAID/Somalia, in conjunction with the host government agencies, determine whether LBII is willing to retroactively amend the contracts to change the time rates to actual cost plus a fixed fee. If not, the USAIDs should request GC/LE to determine whether AID has a possible case for "unjust enrichment" under the contractor's Suppliers Certificate.

The following sections of the report detail contract letting deficiencies and describe the contract provisions which increase AID's cost.

Time Rate Contracts Are Wasting AID Funds

The three LBII contracts are time rate contracts. These time rates include salary, fringe benefits, overhead, fee, post differential in certain instances, and (in Somalia) cost of living allowances.

Our prime objection to these time rate contracts is that the rates are not based on actual salaries paid. LBII is making additional profit by paying lower salaries than those used in the rate. Fixed rates would be more palatable if the negotiating team had the salary histories of the actual technicians to be supplied as a basis for negotiation; however, this was not the case. The result was the contractor had a decided advantage in negotiation because he was the technician supplier and could control the salaries he paid. AID and the host government on the other hand had no basis for determining whether the salaries were reasonable other than that they were in the "ball park".

During a brief review of the LBII contracts in December 1981, RIG/A/N became concerned that the three contracts were "time rate" and had varying terms and payment features. We were also concerned as to how the Agency assured itself that the contract prices were reasonable. In Kenya we questioned whether LBII was actually paying their employees the base salary included in the time rate. We found that the use of actual salaries had become a disputed issue between the GOK - USAID/Kenya and LBII. The GOK's and USAID/Kenya's position was that the contract as negotiated was based on actual salaries. LBII, however, disagreed and stated that the rates were fixed; therefore, they billed the fixed rates. Our opinion is that the contract in Kenya was clearly fixed time rate for the first two years, and neither the GOK nor USAID had a firm basis for expecting LBII to bill actual salaries.

In Kenya, the contractor, during the first five months of the contract, would have made $9,000 extra because the salaries in the rates exceeded actual salaries. However, LBII subsequently agreed to retroactively adjust the salaries included in the fixed rates to actual salaries, and a letter agreement was signed to that effect. At LBII's home office, we found, however, that LBII was not billing actual salaries. They were billing about $2,000 per month more than actual because the salary figure in the formula had been escalated in accordance with the contract; however, the technician's salaries were not adjusted to reflect the escalation.

The inflated salaries also inflate overhead and the fee which is based on the ficticious salary. The estimated savings to AID based on the post facto letter agreement dated March 5, 1982, was about $130,000. However, current billing rates will still net LBII about $73,000 more than what should have been billed if in fact actual salaries were used.

In the Somalia Groundwater contract we found that all of the fixed rates were based on salaries that were more than the actual salary, except for the Coordinator. We estimate that over the life of the contract LBII will collect about $521,000 more than it would if actual salaries were used. In the Somalia Rangelands project we found some fixed rates contained higher and some contained lower salaries than actual. We estimate that over the life of the contract LBII will collect about $99,000 more than it would if the rates were based on actual salaries.

The subcontractors under the LBII contracts also have potential for making profit from their time rates. We estimated the amount the four subcontractors can collect in excess of rates based on actual salary cost to be about $346,000.

On two of the subcontracts, the rates billed by LBII exceeded the billing rates by the subcontractors. On the Groundwater contract LBII will collect $90,000 more from AID than it will pay, and on the Rangelands contract LBII will collect an additional $42,000. These estimates do not include the effect of rate escalation or salary adjustments in future periods.

LBII was also making large profits when they hired consultants to fill contract positions. For example, one consultant was being paid $3,850 per month, whereas AID was being billed the $8,085 time rate included in the contract. We estimate profits on consultant subcontracts to be about $126,000. The consultants are subcontracted and should be billed at actual cost.

In total we estimate that LBII can bill about $1.2 million more under the fixed rates than it would bill under a cost reimburseable contract.

AID Handbook 11, Chapter 1. Section 3.1.3 states:

> "Time-rate contracts are useful when services are tied to schedules whose duration is uncertain, but the type of skill(s) is known. They usually combine aspects of both fixed price and cost-reimbursement contracts. Salaries, overhead, and profit are combined into a fixed rate per time unit (day, week, or month). Other direct costs, such as travel and allowances, are usually paid on a cost-reimbursement basis although they may also be included in the fixed rate. The contractor is paid the fixed rate for the days actually worked, plus the related cost-reimbursement items, up to the maximum contract amount.
>
> The major advantage in using time-rate contracts is the relative ease of administering them compared to cost-reimbursement contracts. The major disadvantages are that contingencies are included in the fixed rate and that the amount of the fee increases as more time is spent in performing the contract.
>
> The determination that contract costs are reasonable is more difficult for time-rate contracts than for any other form. This is so because the fixed rates usually include an amount for contingencies that may or may not be reasonable under the circumstances and which may not be readily identifiable. An analysis is not difficult in short-term contracts under known conditions. When the contract is for a longer term, and the problems facing the contractor are less forseeable, a cost-reimbursement contract is usually less costly and, therefore, preferable."

Although Federal Procurement Regulations (FPRs) do not apply to host country contracts, they point out several unfavorable characteristics of time rate contracts. The FPRs indicate that care must be exercised in the use of this type of contract because by its nature it does not encourage effective management control. It does not afford the contractor with any incentive to manage the labor force effectively. The subject contracts encourage LBII to increase labor costs because the contingency factors can be turned into profit by increasing labor costs. For example a large cost overrun (estimated to be $189,000) in the ASAL Water Study will increase LBII's profit.

The FPRs further indicate that it is essential that this type of contract be used only when provision is made for adequate controls, including appropriate surveillance by government personnel during performance, to give reasonable assurance that inefficient or wasteful methods are not being used. Neither the USAIDs nor the host governments had the personnel required to closely monitor or control the LBII contracts. In fact, the lack of GOK support has caused wasteful use of technicians' time contributing to the cost overrun in Kenya (see AR 3-615-83-10).

The FPRs also state "Because this type of contract does not encourage effective cost control and requires almost constant Government surveillance, it may be used only after a determination that no other type of contract will suitably serve." Since the FPRs do not apply to host country contracts, such a determination was not required and was not made. However, the AID officials who approved the contracts should have been aware of the pitfalls of time rate contracts and advised the host governments that cost reimbursable contracts were a more cost effective method of contracting.

<u>Conclusion, M/SER/CM Response, RIG/A/N Comments, and Recommendation</u>

Time rate contracts are being used for host country contracts in East Africa. We believe this is a poor contracting method because the necessary close control is lacking, because it is a more difficult type contract to negotiate, because the technicians do not get the host country support they need to work effectively, and because it has the potential of providing contractors with windfall profits. Contractors like and encourage the use of this type of contract because it is easier for them to administer, and they can profit from it. We conclude that this type of contract should be used only in exceptional cases when the cost-plus-fixed-fee type of contract is not practical.

Our draft report recommended that M/SER/CM issue a directive that prohibits the use of time rate contracts unless adequately justified and approved by the AA/M. In response to that draft report, M/SER/CM stated:

"All such authority is vested in the Regional Assistant Administrators under A.I.D. Delegation of Authority 5 and 38, and may be redelegated to the missions. If you feel that a separate approval of time rate contracts is needed (in addition to A.I.D. approval of the contract itself), it should be at either the Mission Director or Regional AA level, not AA/M."

Based on the fact that the three time rate contracts under review were approved by Mission Directors, we do not believe the method suggested by M/SER/CM would be effective. We believe that time rate contracts should be prohibited unless specifically justified and approved at a higher level of Agency management. We are therefore recommending that the use of time rate contracts be reviewed by AID's Procurement Policy Advisory Panel, and an Agency policy be developed.

Recommendation No. 2

AA/M request the Procurement Policy Advisory Panel to study the issues surrounding time rate contracts, and develop an Agency policy on their use and approval authority.

Price Competition Is Needed On Host Country Contracts

Currently, AID regulations discourage the use of price competition for selection of host country technical assistance contractors.

AID Handbook 11, Chapter 1, Section 2.3 states:

"Contracts for professional and technical services are awarded on the basis of negotiation rather than on a formal bid basis. The selection of a prospective contractor with whom to negotiate is based exclusively on professional qualifications for the project. Price is not included in the technical proposals which are evaluated qualitatively based on the needs of the specific project. A price proposal is requested from the offeror submitting the highest ranked technical proposal and negotiations are conducted concerning both technical and cost proposals. If a satisfactory contract cannot be concluded, the Contracting Agency terminates negotiations with that contractor and initiates negotiations with the next ranked offeror.

Exceptions to this rule may be authorized only by the Regional Assistant Administrator or his delegate. The request for the exception must fully explain the procedure to be used in evaluating both the technical and price elements of the proposal."

The Project Officers' Guidebook on Host Country Contracting states "the basis for the competition is not price but the professional qualifications of the competitors for the contract."

We believe price competition should be used for all host country contracts, particularly when use of a time rate contract is justified and approved. Price competition is used for selecting technical services contractors by many state governments and by AID in some countries. This procedure requires two separate proposals -- a technical proposal and a price proposal. Under this concept the technical proposals are reviewed and the firms are ranked. The price envelopes for the highest ranked firms are opened and price is then considered.

In view of the lack of host government capability to select a contractor based on a technical proposal (see pages 3 to 5 of report) and negotiate a reasonable price for contracts, technical proposals combined with price competition appears to be a reasonable alternative. Host governments do not have the capability or background in many instances to determine who is most technically qualified and what is a reasonable price with a U.S. firm. The U.S. firm has a distinct advantage during negotiation and generally comes away with a contract (as LBII has) that is not in the best interest of AID.

We solicited comments from the prior REDSO/EA/RLA on how AID can assure reasonableness of contract prices in host country contracts -- particularly time rate contracts covered by this review. The RLA's comments included the following:

> "... it is apparent to the REDSO/EA RLAs and the REDSO/EA RCO that lack of price competition in the selection of host country contractors financed by AID is a drain on the U.S. Treasury. It is doubtful that the contractor selected for the procurements involved in this memo could compete successfully in terms of price with other U.S. contractors, based on previous direct contract bids (where price competition is required by statute) in other REDSO countries. If the resulting contract price for some or all of these contracts is higher than might be paid had there been price competition and more AID control in the contracting process, it is AID's worldwide policies in favor of host country contracting and its rule (exceptions authorized only by the Regional Assistant Administrator) not to consider price in the selection of host country contractors which are more at fault than the approving actions of the USAID officials involved."

In the Kenya LBII contractor selection, price competition was brought up by the GOK; however, price was not considered in the invitation for bid. In a letter to the GOK, the current Mission Director stated:

> "Thus, if I could obtain permission to revise the procedures that the bidders have already followed, at no small cost, there would be considerably additional delay before Government could proceed to evaluate new proposals. As you are aware, the total elapsed time between your Government's approval of the original Request for Proposal and your completion of selection procedures by the inter-Ministerial Committee was nine months....
>
> For future projects, with your assistance in setting forth a justification, we might consider requesting separate submission of financial proposals at the time of submission of technical proposals on a case-by-case basis. On the three projects for which proposers have already drafted their bids, however, I hope we can proceed as before and that your Government will confirm the selection of Louis Berger for the Kitui ASAL project."

Conclusion, Recent Agency Action, and RIG/A/N Comments

We conclude that price competition should become part of host country contracting because the host governments are unable to select the most technically qualified contractor or negotiate contracts that are least costly to AID. In addition, it is incongruous to expect the host government to negotiate hard when it usually is not their money they are spending (grant funds). We conclude that price competition in conjunction with technical qualifications should become the preferred method of contract award.

Recent Agency Action and RIG/A/N Comment -- A memorandum dated January 4, 1983 to the Administrator indicates that the Procurement Policy Advisory Panel decided not to pursue adding cost competition as an optional procedure to Handbook 11. This effort was discontinued because of opposition by the architect-engineering societies (AES), BIFAD and within AID itself. We would expect AES and BIFAD to oppose the proposition because it would pressure them into tighter budget constraints. Contractors are experts at negotiation, host governments are not; therefore, the contractors have a distinct advantage and want to keep it that way.

We are puzzled why bureaus within AID would oppose this proposition. It will add no work and may make AID's job a little easier, less costly, and probably would result in more cost effective contracts.

We believe a policy which requires justification for an exception effectively discourages the use of that procedure. For example, the policy that required AA approval not to use host country contracting effectively reduced the use of AID direct contracts even in instances when it was known host country contracting was not prudent.

Since the issue of price competition was recently addressed at a high level, we have deleted our recommendation to make price competition an accepted method. However, we believe the Administrator should allow host governments and missions to decide when price competition should be used because we believe it is in the best interest of the Agency to do so.

The LBII-GOK Contract May Be A Cost-Plus-Percentage-Of-Cost Contract

The LBII contract in Kenya has attributes of the proscribed cost-plus-percentage-of-cost (CPPC) contract. AID Handbook 11 identifies a CPPC contract as one in which the profit or fee (however described) increases without limitation as the cost of the contract increases.

In the Kenya LBII contract the fee is based on a percentage of cost. The monthly time rates for one LBII technician are calculated as follows:

Basic Salary	\$3,284
Post differential at 15%	493
Fringe benefits and overhead at 118.8% of salary	3,901
	\$7,678
Fee computed at 12%	921
Monthly time rate	\$8,599

The contract contains an escalation clause which annually adjusts the salaries included in the rate a maximum of 10 percent, based on cost of living factors. This adjustment, made in May 1982, was 6.47 percent of salary; therefore, the new salary in the example was \$3,496. The escalation adjustment does not necessarily mean the technician's salary was increased, merely that LBII may increase the time rate for each employee. The new monthly time rate for the aforementioned LBII technician would be calculated as follows:

Basic Salary	\$3,496
Post differential at 15%	524
Fringe benefits and overhead at 118.8% of salary	4,153
	8,173
Fee computed at 12%	981
New monthly time rate	\$ 9,154

The fee increased by $60 a month for this one position. The total increase in fee for the contract for a year would be about $4,300, because the salary was escalated.

LBII can increase the amount of fee it collects by an increase in salary or by overrunning cost estimates. This is why a cost-plus-percentage-of-cost contract is prohibited.

An example of the effect of a cost overrun is a water study in Kenya. As of September 30, 1982, the cost of the water study had exceeded its budget by $12,500. USAID/Kenya expects that the total cost to complete the study will be $189,000 more than budgeted. We estimate this cost overrun will result in about a $14,000 increase in fees for LBII. This increase in fee will come out of the contingency amount included in the contract. This overrun is partly caused by lack of vehicle availability and other GOK support.

Another factor which has the attributes of a CPPC contract is that the fixed time rates negotiated and included in the Kenya contract are no longer fixed. LBII agreed to change their rates to an actual salaries basis rather than a fixed rate. Therefore salaries can now be adjusted by LBII and passed on to AID in higher rates -- so long as the total of all the actual monthly rates based on actual salaries do not exceed the total budgeted fixed monthly rates included in the contract. It appears to us that this agreed to change, by itself, makes the contract a CPPC contract. Increases in salaries of technicians will increase profit. In other words there will be pressure to increase salaries so the fee will increase.

Conclusion and Recommendation

LBII can increase its profit on the Kenya contract by increasing its labor costs, which indicates this contract is a proscribed CPPC contract.

Recommendation No. 3

GC/LE determine whether the Kenya LBII contract is a cost-plus-percentage-of-cost contract, and if so, take appropriate action.

Contractor Selection Criteria Was Faulty

The procedures for analyzing and ranking contract proposals on the Kenya ASAL and the Somalia Rangelands projects were poorly conceived and resulted in contractor selection based on false assumptions.

The weighting procedure for contractor selection on the Kenya project awarded more than 60 percent of the overall weight to the quality of personnel <u>proposed</u> for the project. Factors such as lesser developed country (LDC) experience, total experience, Kenya experience and demerits for age were considered. LBII received 600 points for personnel out of a total of 950 points.

The fallacy with this part of the selection procedure was that LBII has provided only one of the ten proposed personnel for which it received 600 points. This in effect makes the selection process meaningless because the basis for selection was not valid.

On the Rangelands contract in Somalia a weight of 70 percent was given to personnel. On this project none of the proposed personnel ended up on the project. (Personnel was not a factor included in the Groundwater contract selection criteria.)

The inability of the contractor to provide the specific personnel included in the proposal is not unusual because of the long time lag between developing and submitting a proposal and providing the technicians to do the work. It is not unusual for this process to take up to a year. In fact it is unreasonable to expect the proposed technicians to be available a year later. We conclude that giving personnel much weight in selecting a contractor is a weak basis for selection.

More important factors, in our opinion, are experience of the contractor in providing capable personnel, the technical proposal itself, and prior evaluations of the contractor's performance by AID. In this selection process we did not see where any weight was given to the contractor's prior performance.

Conclusion, REDSO/EA Comments and Recommendation

The method of selecting the most qualified contractor for technical assistance needs to be reviewed and guidelines established. We conclude that personnel is not a factor which should be given much weight -- because of the long time lag between the proposal and implementation it is unlikely that persons named in the proposal will actually work under the contract. LBII contracts in Kenya and Somalia are classic examples of contractor selection based on invalid selection criteria.

In response to our finding REDSO/EA stated:

> "The reference memorandum contains a recommendation that REDSO/EA should develop a valid criteria for evaluating contractor proposals. From the text, it is apparent that this recommendation flows from the fact that on a number of contracts, a high weight was given to personnel, and yet the persons contained in the proposal did not actually end up working on the project.

We believe this to be a valid observation and one that should be taken into consideration in establishing any evaluation criteria, and in making an award.

At the same time, we don't believe it is feasible to develop a set of criteria that would hold for all projects. The criteria will inevitably vary depending on the nature of the project and, in fact, should not be established in advance of the project in the abstract.

We should all be cognizant, however, of the issue raised in your memorandum, and be realistic in determining a weighting for personnel in light of past AID experience.

At any rate, each mission has the responsibility to review its contractual requirements and to determine appropriate criteria by which to select the best qualified offeror. This is not a REDSO/EA responsibility except when requested to participate by the mission."

We believe REDSO/EA comments are valid; however, most missions in East Africa have little contract expertise other than the assistance they get from REDSO/EA. Therefore, it would be appropriate for REDSO/EA to issue guidance to the missions.

Recommendation No. 4

REDSO/EA develop and issue guidelines to USAIDs in their geographical area to help them develop sound and valid criteria with the host governments for evaluating contractor technical proposals.

Certain Contract Provisions And Billing Procedures Increased AID's Costs And Allowed Windfall Gains For The Contractor And/Or Contractor Employees

The LBII contracts contain clauses that are favorable to LBII, enhancing their profit potential and their cash position while making the contract more expensive to AID. The fixed allowances of the contracts are also extremely lucrative to the contract technicians, who can make additional income in addition to their tax free salary, differential, and free housing.

In our opinion these contracts were poorly negotiated and demonstrate the problems of negotiating fixed rates by the Agency and host governments. In the following sections we discuss the various clauses and provisions which favor the contractor and its technicians at the expense of AID. We have not made recommendations to recoup amounts which are provided by the contracts. Where Agency policy should be reviewed regarding the issues raised, we have made recommendations.

Contract Advance Provisions Were Unnecessary

The advances provided LBII were unnecessary and tied up Agency funds for long periods of time. These advances were called a mobilization payment in the Kenya contract and advance payments in the Somalia contracts.

In Kenya, the contractor was provided a dollar advance of $300,000 and a local currency advance equivalent to $264,000. The advances were repayable six months after payment in six equal monthly installments. The local currency advance has not been repaid as stipulated because local currency costs were not large enough to offset the advance repayments. No repayment of the difference was required. The Kenya contract also provides for advanced estimated billings each month.

In Somalia, the contractor was provided dollar advances totalling $620,000 and local currency advances equivalent to $89,678 for the Rangelands and Groundwater contracts. The repayment terms on these range from 30 equal payments beginning the fifth month on Rangelands, to 18 equal payments beginning the seventh month on Groundwater.

The Kenya contract also provided advance payments to the contractor for the estimated cost of purchases of equipment and supplies. The contract stipulates the advance checks must be held by LBII until LBII makes payment. This is an unnecessary exercise resulting in provision of funds before they are actually needed.

The contractor had few mobilization costs (except for small advances provided to subcontractors -- $40,000 on Rangelands, and $41,000 on ASAL) because the contracts were basically to only provide people. All costs under this type of contract are reimbursable on a monthly basis; therefore, there is little cost to mobilize people. These advances cost the U.S. government an estimated $112,000 in interest while probably earning LBII about the same amount.

AID regulations permit mobilization advances to U.S. and Code 941 host country contractors. The regulations indicate that AID normally prefers to provide mobilization advances in single, lump sum payments as opposed to incremental payments because, among other things, contractors need an inducement to compensate for the risks of entering into agreements with the governments of less developed countries.

The U.S. Treasury Department has agreed that although incremental advances are desirable for purposes of cash management, lump sum mobilization advances may be provided as long as (a) there is true competition in the bidding process, and (b) the U.S. government (AID) obtains the advantage of reduced contract costs as a consequence of providing the advance.

It is quite apparent that the U.S. government did not obtain the advantage of reduced contract costs as a consequence of providing advances to LBII. In fact the opposite happened -- LBII and/or its contract employees are making windfall profits from the lump sum payments, allowances and interest on the advances. Advances should only be made if the contractor is required to invest his funds for a period of time without being reimbursed. Furthermore, an advance should not be used as an inducement to compensate for the risks of entering into agreements with governments of less developed countries when AID pays the bills because there is little risk.

Conclusion, Recommendation and M/SER/CM Response

The advances paid to LBII were unnecessary, benefited the contractor at AID's expense and were not justified.

Recommendation No. 5

M/FM, in coordination with M/SER/CM, initiate action to revise AID regulations to ensure that advances are paid to host country contractors only when the contractor is required to invest his funds without prompt reimbursement through the monthly billing cycle.

In response to our draft report, M/SER/CM stated:

"The question of advances to host country contractors is also undergoing active review in AID/W. The controller's office prepared coverage for Handbook 1, supplement B, Chapter 15 concerning payments to country contractors. GC and M/SER raised a number of legal and policy questions and FM is preparing another revision. We appreciate the need for increased guidance in this area, however, we suggest that the action assignment for this recommendation be quote M/FM, in coordination with M/SER/CM."

We have revised our recommendation accordingly.

Application Of The Thirty Day Basis Of Billing Increased The Cost Of The Contract

The contracts included a provision that lump sum daily billing rates, when necessary (when a technician does not work the full month), can be applied at 1/30th of the monthly rate. This method of billing benefits the contractor and costs AID additional funds.

For example, one monthly rate is $8,704 (about average), and the 1/30 rate is $290 per day. Using the normal work day rate, the rate per day would be $396 (based on 22 work days per month). If a technician does not work five days, LBII bills 25 days worked under the 1/30 rate. Using the normal work day rate, the contract would be billed for 17 days. In the example AID would pay $518 more under the 1/30 rate than it would under the normal work day rate.

In addition, AID pays more than they should because the 1/30 rate assigns a value to non-work time (weekends) because a month never contains 30 workdays. If a technician does not work a full period, LBII deducts only days not worked. Proper application of the 1/30 rate would deduct a proportionate share of the non-work days when an employee does not work a full period. For example, if an employee did not work for five days during a month with eight weekend days, the correct monthly cost (using the employee's rate from our prior example) at the 1/30 rate would be $6,864.1/ The correct number of days to bill would be 30 less 5 days not worked less 1.33 for the weekend share of days not worked -- or 23.67 days, not the 25 days billed.

Under the 1/30 monthly rate method, AID would be charged $7,250 instead of $6,864.

We estimate that AID can pay $65,000 more than it should for the three LBII contracts because the 1/30 rate does not take weekends into consideration for time off.

A similar situation exists regarding annual leave. LBII bills 12 months in eleven and does not charge when leave is taken. For example, if over the period of a year an employee takes 22 days of leave in small increments (5 days or less), LBII will deduct for only 22 days off but will be paid for 30 days. Thus, LBII can make a profit on leave. AID Handbook 11 states that for time rate contracts the contractor should be paid the fixed rate for days actually worked. The contracts stipulate a 40 hour work week. The 30 day rate does not bill for days worked or for a 40 hour work week.

1/ $\frac{\$8,704}{30} \times \left[25 - \frac{(5 \times 8)}{30} \right] = \$6,864$

The method of billing authorized by the contract favors the contractor, and permits collecting more from AID for time not worked and for leave taken.

Annual Leave Was Billed Up Front

The monthly billing rates are based on an actual work month basis which is eleven months per year. The 12th month, which is considered annual leave, is included in fringe benefits. In effect, the contractor is billing for 12 months of technician's time in eleven months. If a technician works 22 months without leave, LBII will collect 24 months of salary in advance of the technician being paid for the two months leave.

The LBII personnel policies state that full time employees will earn three weeks of leave, and that normally leave will not be authorized until after serving a minimum of 18 months overseas. Fixed term employees are to take leave at the end of the project or after serving 24 months overseas.

The three LBII contracts have different leave payment provisions. The Kenya contract provides for 22 work days while the two Somalia contracts provide for one month leave. The actual cost of the leave is unknown because it is billed as part of overhead.

The eleven month billing procedure benefits the contractor and provides cash in advance of actual payment. Paying the leave in advance costs the U.S. government about $30,000 in interest over the life of the three contracts. Leave authorized by the contract should be billed and paid by AID when it is taken, not in advance.

Certain Fees Should Have Been Absorbed In Overhead

The contracts contain fees for purchasing and fees for managing subcontracts under the technical assistance portion of the contracts. The actual costs of LBII purchasing and managing the subcontracts is either charged directly to the contract or is charged to overhead. The cost of these items is not offset against the fee; therefore, on the three contracts AID is paying for these services twice.

The fees for procurement and management of the contracts should have been an overhead cost and should have been reimbursed through overhead. The total fees for procurement and management of subcontracts for the two Somalia contracts is $52,000, and $165,000 for the Kenya contract.

Technicians In Somalia Received Unwarranted Cost Of Living Allowances

In Somalia, the fixed rate provided each full time technician with a $400 Cost of Living Allowance (COLA) each month. In July 1982 the Department of State terminated this allowance for U.S. government employees in Somalia because the Somali shilling was devalued 150 percent. LBII contract employees, however, have continued to receive the COLA, as well as the financial gains associated with a devalued foreign currency. LBII also benefits because a 12 percent fee is charged on the COLA.

This windfall gain occurred because the contracts are inadequate; they should have contained provisions that tied the COLA to the prevailing AID rate.

Under the two LBII contracts with Somalia, contract employees have collected $25,600 in COLA since the Department of State terminated the allowance. An additional $250,000 is provided for COLA by the contracts for the remaining contract periods.

Annual Escalation Of Fixed Lump Sum Amounts Was Questionable

The contracts included lump sum payments to the technician or LBII for such items as storage and transport of personal property, office operations, housing, guard services, and reports and printing costs. The allowances are paid regardless of how much the technician (or LBII) pays. Some allowances are adjusted upward annually based on the consumer price index in the U.S. or host country index as applicable.

For example, in June 1982, under the Kenya LBII contract the housing and guard allowances were increased 10 percent and the storage allowance was increased 6 percent. These increases were not based on the technician or LBII having to pay more. A maximum allowance is warranted, but actual costs should be reimbursed if actual is less than the maximum. Technicians should not make money from allowances.

One subcontract technician in Kenya was paying approximately $810 monthly for rent and utilities, and was receiving a monthly housing allowance of $1,320. He was therefore making an additional $510 a month -- approximately $12,000 over a two year contract. Free housing is a normal benefit for overseas living, but to make such a sizeable gain is unconscionable. This gain can increase with the escalation clause if actual cost of rent and utilities does not increase.

We found that in Kenya, LBII was not paying its technicians the full housing allowance (as far as we could determine the subcontract technicians received the full allowance). Before the escalation

LBII was collecting $1,200 and paying the technicians $1,100. After the 10 percent escalation LBII was collecting $1,320, and paying $1,200. LBII will make approximately $32,000 from the fixed rate housing allowance.

Fixed Allowances For Technicians Were Questionable

A $3,000 allowance is provided a technician for vehicle expense. This allowance is said to cover the cost of shipping a vehicle to the host country; if no vehicle is shipped, it is to cover the additional cost of purchasing a vehicle; and if neither of the above, it is to cover taxi fares or rental vehicles while in the host country.

We agree that if the technician ships a vehicle the cost should be reimbursed; however, the allowance may be too high. Our review of selected shipments of small vehicles showed that it typically costs about $2,000 to ship a car from the U.S. east coast and clear it through customs in Mombasa, Kenya. By shipping a small car the technician can make about $1,000 from the allowance. If the contractor buys the car in Europe, or buys a car locally, the employee can clear up to $3,000.

In Kenya, we found an example where a technician owned a vehicle already in country from a prior assignment, yet he collected the $3,000 allowance.

In Somalia, on the Groundwater Contract we found four instances where technicians had collected $3,000 each in automobile allowances even though the technicians did not have an automobile in-country; and on the Rangelands contract each of the 10 full time technicians will collect the $3,000 allowance in accordance with contract amendment No. 2 even though probably only five of them have or plan to bring personal vehicles in-country. Most of these technicians have access to project vehicles for personal use.

A contract technician should be reimbursed for shipping a car to the host country and for returning it to the U.S. if it can't be sold for a reasonable price. The technician should also be paid for storage and shipment of personal effects. The fixed allowances do not accomplish this purpose. Rather, they provide an opportunity for the technician to make money at AID expense. The payment of an allowance for this type of expense is inappropriate because it can be abused.

Fixed, lump sum allowances for an automobile and transport and storage of personal effects also vary among the contracts. A person who completes a two year contract for LBII would receive $5,400 for these items under the ASAL contract, $13,000 under the Rangelands contract, and $12,000 under the Groundwater contract. The technician can request and be paid the lump sum regardless what the technician pays.

In Kenya a technician can pay one shilling a month for guard service and collect KSh. 1,325 ($135). A technician can pay $1 a month for storage and collect $106. The only criteria to collect these amounts, according to LBII, is that the technician must incur and certify some expense to collect the fixed amount.

Contract provisions that can be abused should not be permitted in contracts. Fixed rates make the contractor's bookkeeping easier and less costly, but that is one of the reasons why AID pays overhead.

LBII Made A Profit On A Guest House And Local Salaries

LBII is making a profit from the guest house and lump sum local salary rates in Kenya.

LBII out-of-pocket expenses for the guest house in Nairobi are about $650 less per month than the guest house fixed rate, and almost $700 less per month for local Kenyan salaries. LBII will make about $85,000 in profit from these two categories. This profit will increase if LBII maintains the expense level because the fixed rates are escalated each year.

Conclusion, Recommendations, M/SER/CM Response, and RIG/A/N Comments

LBII and its technicians can make additional profit and income from the fixed rates and provisions included in the existing contracts. The use of fixed rates in contracts should be discouraged. The 1/30 day billing rate should be prohibited. Instead contractors should be paid based on days worked. Leave should be billed when taken. Transportation of vehicles should be reimbursed to an upper limit.

Contractors may be making windfall profits in other countries on time rate contracts. An effort should be made to weed them out; and where the contracts are resulting in windfall gains, efforts should be made to renegotiate them. (We recognize that it would be difficult, if not impossible, to renegotiate windfall gains to individual contractor employees on a retroactive basis.)

We conclude that host country contracts should be cost-plus-fixed-fee. The fixed rate provisions included in these three contracts should be closely reviewed and used as a basis for providing guidance to the field.

Recommendation No. 6

M/SER/CM provide information to the field on the need to exercise care in the use of certain contract provisions because of the risk of paying excessive amounts.

Recommendation No. 7

> M/SER/CM, in conjunction with GC/LE and the AID Missions that are financing time rate contracts, determine whether the Agency should on a case by case basis encourage the host governments to renegotiate contracts where there is evidence of windfall profits.

In response to our draft report, M/SER/CM stated:

> "Although we can (and do) write volumes of rules and guidance on various aspects of contracting, there is still a need for A.I.D. employees to think. The use (or lack) of judgment is best reflected in merit pay awards, not in hortatory guidance. Recommendation 6 should be dropped."

RIG/A/Nairobi agrees that there are probably enough rules and guidance, that AID employees should think, and that merit awards should and are being used to reward good judgement. However poor judgement, and judgement which costs the Agency money, goes on unabated with no apparent means of discouraging it. The use of time rate contracts and costly contract provisions is an example of management's desire to reduce administrative responsibility and burden without adequately considering the cost. This is understandable with the pressue of reduced staff. However, AID has examples of the cost of this trend and it should be discouraged. We believe these three contracts can be used as a lessons learned scenario to provide information on pitfalls to be avoided in contracting. We therefore believe an information bulletin or some other means should be used to provide overseas managers with information on contracting practices that should be avoided. We have revised our recommendation accordingly.

EXHIBIT A

LBII Contracts In Kenya and Somalia

Estimate of Windfall Profits

Potential Profits in LBII Time Rates:	
Kenya - ASAL	$ 73,000
Somalia - Rangelands	99,000
Somalia - Groundwater	521,000
Potential Profits in Subcontract Time Rate	346,000
Potential Profits on Consultants	126,000
Interest Cost of Unnecesary Mobilization Advances	112,000
Possible excess billing - 1/30 day billing rate	65,000
Interest on leave paid in advance	30,000
Purchasing and subcontract management fees	217,000
Cost of living allowance in Somalia	275,000
Fixed Rates for housing, shipping effects, storage, guard service	1/
Difference billed on housing rates	32,000
Vehicle allowances, no vehicle shipped	30,000
Guest house and local salaries	85,000
	$2,011,000

1/ Unable to estimate - estimated housing profit for one LBII technician was $12,000 for two year tour. Housing alone on the Kenya contract could exceed $200,000 over the four year contract if windfall profits for all technicians were equivalent to the one example.

VA

List of Report Recommendations

Recommendation No. 5 17

M/FM, in coordination with M/SER/CM, initiate action to revise AID regulations to ensure that advances are paid to host country contractors only when the contractor is required to invest his funds without prompt reimbursement through the monthly billing cycle.

Recommendation No. 6 22

M/SER/CM provide information to the field on the need to exercise care in the use of certain contract provisions because of the risk of paying excessive amounts.

Recommendation No. 7 23

M/SER/CM, in conjunction with GC/LE and the AID Missions that are financing time rate contracts, determine whether the Agency should on a case by case basis encourage the host governments to renegotiate contracts where there is evidence of windfall profits.

APPENDIX B

List of Report Recipients

	No. of Copies
Field Offices	
USAID/Kenya	5
USAID/Somalia	5
REDSO/EA	3
AID/Washington	
AA/M	2
AA/AFR	5
LEG	1
GC	1
OPA	1
IG	1
AFR/EA	2
GC/LE	3
M/SER/CM	3
M/FM	2
FM/ASD	2
PPC/E	1
S&T/DIU	4