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OFFICE OF INSPECTOR GENERAL

**AUDIT OF USAID/PHILIPPINES'
INFRASTRUCTURE ACTIVITIES
UNDER ITS GROWTH WITH
EQUITY IN MINDANAO-2
PROGRAM**

AUDIT REPORT NO. 5-492-08-008-P
July 31, 2008

MANILA, PHILIPPINES



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Office of Inspector General

July 31, 2008

MEMORANDUM

TO: Acting USAID/Philippines Director, Elzadia Washington

FROM: Acting Regional Inspector General/Manila, William S. Murphy /s/

SUBJECT: Audit of USAID/Philippines' Infrastructure Activities under its Growth with Equity in Mindanao-2 Program (Report No. 5-492-08-008-P)

This memorandum transmits the Office of Inspector General's final report on the subject audit. In finalizing the report, we considered your comments to the draft report and included the comments (without attachments) in appendix II.

This report contains three recommendations to assist USAID/Philippines in improving its implementation and management of the subject program. Based on the information provided by the mission in response to the draft report, we consider that final actions have been taken on each of the three recommendations.

I want to thank you and your staff for the cooperation and courtesy extended to us during the audit.

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SUMMARY OF RESULTS

The southern Philippine island of Mindanao, including the Sulu Archipelago, is home to about 22 million people, representing close to a quarter of the total Philippine population of almost 89 million. About 20 percent of those on Mindanao are Muslims, concentrated in the southwestern area of the island. Known as the Autonomous Region in Muslim Mindanao, this area was created in 1989 by the Philippine Government. Despite the subsequent peace agreement signed in 1996 between the Government and the largest Muslim separatist group, which had fought for nearly 3 decades for independence or some form of autonomy, other groups have continued to cause unrest (see page 2).

USAID/Philippines has been implementing major assistance efforts in Mindanao for well over 10 years. In 1995, USAID expanded its assistance efforts to cover all of Mindanao and the Sulu Archipelago. After the signing of the peace agreement in 1996, USAID intensified aid in the conflict-affected areas of Mindanao (see page 2).

To implement its expanded assistance efforts, USAID/Philippines conceived the initial Growth with Equity in Mindanao (GEM-1) Program, which operated from 1996 to 2002. Considered to be the mission's "flagship" activity in Mindanao, this program was expanded and then continued for another 5 years as the GEM-2 Program. The GEM-2 contract eventually totaled \$83.6 million, most of which had been spent by December 31, 2007. The program covered a wide range of activities, of which the largest were infrastructure developments—the focus of the audit. Other activities were aimed at improving business and governmental practices as well as strengthening education (see pages 2--3).

In December 2007, USAID/Philippines awarded the contractor another 5-year contract, which had a total estimated cost of close to \$126 million, to continue similar activities under the GEM-3 Program (see page 3).

USAID/Philippines achieved completion of the planned infrastructure projects under the GEM-2 program. The infrastructure projects had a positive impact on the communities they were intended to benefit (see page 4).

However, USAID/Philippines could have improved the implementation and management of the program in three areas: (1) completed infrastructure projects needed more inspections and maintenance; (2) surety bond beneficiaries posed legal uncertainty; and (3) new agreements should be signed with Philippine Government counterparts. This audit provided recommendations to address these three areas (see pages 6–11). The audit also noted two problem areas dealing with work plans and progress reports for which no recommendations were made because the GEM-3 contract contains language addressing the problems noted (see pages 11–13).

In its response to the draft report, USAID/Philippines agreed with the findings and recommendations. Based on the audit's review of the mission's comments, detailed actions, and supporting documents received, the audit determined that final actions have been taken on the three recommendations in this report. USAID/Philippines' written comments on the draft report are included in their entirety as appendix II to this report.

BACKGROUND

The southern Philippine island of Mindanao, including the Sulu Archipelago, is home to about 22 million people, representing close to a quarter of the total Philippine population of almost 89 million. About 20 percent of those on Mindanao are Muslims, concentrated in the southwestern area of the island. Known as the Autonomous Region in Muslim Mindanao, this area was created in 1989 by the Philippine Government. Despite the subsequent peace agreement signed in 1996 between the Government and the largest Muslim separatist group, which had fought for nearly 3 decades for independence or some form of autonomy, other groups have continued to cause unrest. Violence and fears of violence are hindering economic growth and the emergence of economic opportunity. The absence of economic opportunity, in turn, helps maintain a situation where many individuals are ready to turn to violence and rebellion in the hope of improving their economic prospects.

USAID/Philippines has been implementing major assistance efforts in Mindanao for well over 10 years. In 1995, USAID expanded its assistance efforts to cover all of Mindanao and the Sulu Archipelago. After the signing of the peace agreement in 1996, USAID intensified aid in the conflict-affected areas of Mindanao.

Figure 1. Map of Mindanao, Southern Philippines



To implement its expanded assistance efforts, USAID/Philippines conceived the initial Growth with Equity in Mindanao (GEM-1) Program, which operated from 1996 to 2002. Considered to be the mission's "flagship" activity in Mindanao, this program was expanded and then continued for another 5 years. Known as the GEM-2 Program, it had two related objectives: (1) to help bring about and consolidate peace in Mindanao and (2) to accelerate economic growth in Mindanao and help ensure that as many

people as possible, including members of cultural minorities, benefit from the economic growth.

Like GEM-1, which had a total contract cost of \$37.6 million, the GEM-2 Program was implemented by the Louis Berger Group, Inc. (contractor). The original GEM-2 contract was for the period from August 15, 2002, to August 14, 2007, and totaled \$54.8 million. After several modifications, the contract amount was increased to \$83.6 million and the period extended to December 31, 2007.

The GEM-2 program was USAID/Philippines' single largest activity. It covered a wide range of activities that were aimed at accelerating economic growth throughout Mindanao, especially in conflict-affected areas. The largest of the GEM-2 program activities were infrastructure developments involving ports, road and bridge improvements, and hundreds of small construction projects such as water systems, warehouses, solar crop dryers, boat landings, footbridges, and community centers.

Initially, the GEM-2 program's other activities were aimed at supporting the creation and/or strengthening of business support organizations; assisting in the wide-scale production, marketing, and export of potentially lucrative nontraditional crops and commodities; and adopting and implementing improved governmental practices. Subsequently, significant activities, such as introducing computer and Internet education and working in joint efforts with parent-teacher-community associations to establish school libraries and science laboratories, were added to the program.

This audit focused on the largest component of the GEM-2 program, infrastructure development, which had a contract budget of \$41.6 million, representing about half of the total program contract budget of \$83.6 million. As of December 31, 2007, the contractor had spent \$82.1 million. As of the same date, USAID/Philippines had disbursed \$80.3 million for the GEM-2 program, which was managed by the Office of Economic and Democratic Governance.

In December 2007, USAID/Philippines awarded the contractor another 5-year contract, which had a total estimated cost of close to \$126 million, to continue similar activities under the GEM-3 Program.

AUDIT OBJECTIVE

The Regional Inspector General/Manila conducted this audit as part of its fiscal year 2008 annual audit plan to answer the following question:

- Did USAID/Philippines' infrastructure activities under its Growth with Equity in Mindanao-2 Program, implemented by Louis Berger Group, Inc., achieve planned results, and what was the impact?

Appendix I contains a discussion of the audit's scope and methodology.

AUDIT FINDINGS

USAID/Philippines achieved completion of the planned infrastructure projects under the Growth with Equity in Mindanao-2 (GEM-2) program. The infrastructure projects that were implemented had a positive impact on the communities they were intended to benefit.

The GEM-2 program completed the 40 planned Regional Infrastructure Projects (RIPs)¹ and all 830 of the planned Barangay Infrastructure Projects (BIPs).² RIPs are relatively larger and higher-impact projects (see table 1), whereas BIPs are smaller, community-based projects (see table 2). According to the mission’s GEM-2 contract, the cost range of a RIP was between \$500,000 and \$1 million, whereas that of a BIP was between \$5,000 and \$25,000.

Based on the diversity of infrastructure projects implemented, the number of reported beneficiaries, and the overall satisfaction of the communities involved, the infrastructure projects for the GEM-2 program had a significant impact on the affected areas in Mindanao. The mission has contracted with Management Systems International to conduct an extensive evaluation of the overall impact and effectiveness of all USAID assistance on peace, development, and conflict reduction in Mindanao.

Tables 1 and 2 provide an informative summary of the project types and locations. Western Mindanao includes the Zamboanga peninsular area in the far west of the island and the Sulu Archipelago. Central/Northern Mindanao includes the provinces along the central and north portions of the island around Cotabato City.

Table 1. Regional Infrastructure Projects (RIPs)

Project Type	Location		Total
	Western Mindanao	Central/Northern Mindanao	
Bridges	5	9	14
Roads	6	7	13
Ports	11	0	11
Commercial Center Building	0	1	1
Water Supply	1	0	1
Total	23	17	40

¹ Although GEM-2 reported completion of all 40 planned RIPs, 7 of these RIPs were originally BIPs that exceeded the BIP cost range beginning in 2006. As a result, the mission and contractor lowered the RIP cost threshold to \$55,000 and reclassified them as RIPs. There was no formal approval or contract modification for this change.

² Although reported as completed, one of the BIPs—a water supply project—was completed after the contract had expired. In addition, three BIPs had final costs that ranged between \$58,000 and \$100,000 but were still reported as completed BIPs, regardless of the informal change discussed in footnote 1.

Table 2: Barangay Infrastructure Projects (BIPs)

Project Type	Location		Total
	Western Mindanao	Central/Northern Mindanao	
Grains Solar Dryers	9	105	114
Box/Pipe Culverts and Spillways	15	81	96
Drainage Canal	26	66	92
Boat Landings	50	15	65
Passenger Waiting Sheds	17	44	61
Seaweed Solar Dryers	52	5	57
Grains Warehouses and Solar Dryers	6	49	55
Community Centers	19	35	54
Road Upgrades	12	40	52
Trading Centers	16	32	48
Footbridges	25	17	42
Potable Water Systems	13	27	40
Others (covered walkways, solar panels, etc.)	22	15	37
Seaweed Warehouses and Solar Dryers	9	1	10
Irrigation Canals/Facilities	0	7	7
Total	291	539	830

The GEM-2 program's key Philippine Government counterpart was the Mindanao Economic Development Council (Council). USAID/Philippines and the Council entered into a memorandum of agreement to help establish roles and responsibilities for the GEM-2 program. Both USAID and the Council provided monitoring and oversight of the program and a GEM-2 Steering Committee was established, chaired by the chairman of the Council.

Along with reviewing the GEM-2 files of the mission and the contractor, USAID auditors visited 7 of the 40 RIPs and 7 of the 830 BIPs reported as completed by the contractor. In general, the auditors found that the infrastructure projects visited were completed, appeared to be well constructed, and were being used by the intended beneficiaries. However, as shown in the discussion below, the auditors identified a number of areas in some of the infrastructure projects and matters related to the GEM-2 program that could be improved.



Photograph of a concrete two-lane bridge, a regional infrastructure project, on the Sulu Archipelago island of Basilan. On the right is the old one-lane bridge that was replaced. (Office of Inspector General, February 2008)

Completed Infrastructure Projects Need More Inspections and Maintenance

Summary: Under the GEM-2 contract, as part of a memorandum of agreement, local municipal governments agreed to maintain the facilities provided to them. Moreover, in accepting the project as documented by the project turnover/acceptance certificate, the local governments signified their commitment to operate and maintain the completed project in accordance with the memorandum of agreement. However, some of the completed infrastructure projects were not properly maintained or used. The local governments were slow both in recognizing the need for maintenance and in providing it once the need became clear. As a result of maintenance problems with some infrastructure projects, the intended beneficiaries will not be able to fully benefit from the facilities, and the sustainability of the facilities could be in peril.

According to the GEM-2 contract, Louis Berger Group, Inc. (contractor) was to carry out an infrastructure program for the completion of regional and barangay projects that were intended to improve the quality of life and economic well-being of intended beneficiaries.

Under that contract, a memorandum of agreement was signed with each municipal local government in which the contractor required the local government to receive training in operations and maintenance. Moreover, in accepting the project as documented by the project turnover/acceptance certificate, the local government signified its commitment to operate and maintain the completed project in accordance with the memorandum of agreement.



Photograph of the Cotabato City Square, a regional infrastructure project, on the west central coast of Mindanao. (Office of Inspector General, February 2008)

During visits to completed infrastructure projects, the audit team noted that some of the projects were not properly maintained or used by the local governments. For example, a number of problems were found with some of the completed regional projects, as described below.

- The Bobo Bridge had a girder at the bottom of the bridge that was so loose it had to be removed because villagers feared someone might steal it. Other girders also were loose but were left in place to await the needed repairs. The bridge was completed on September 15, 2007.
- The Cotabato City Square, the most expensive infrastructure project, had not been placed in operation because the mayor and city council could not reach an agreement as to who should operate the facility and how. This commercial center was completed on September 20, 2007.
- The Maluso Port has sectional areas, within and along the perimeter fence of the port, that have started to settle. The settling has caused depressions in some sections of the port, and significant cracks have started to appear along the perimeter fence. These structural problems are likely to affect the operation of the port, and repair costs are expected to be substantial. The port was completed on September 12, 2007.
- Sections of the gravel Tuburan Road had started to deteriorate prematurely. The road was reported as completed on February 28, 2007.

In addition, problems were uncovered in some of the smaller barangay projects, as shown below.

- Drains that had been improved as part of an improved water drainage system had not been cleaned.
- A water faucet that was installed as a part of a water supply system had significant leaks that had gone without repair.
- A box culvert,³ erected as part of a road project had mud that had accumulated several inches deep on the culvert, which made it difficult for vehicles approaching and exiting the box culvert to pass by.

After the audit team brought these issues to the attention of the contractor, the contractor proceeded to initiate actions to correct some of the problems.

In terms of periodic monitoring, the contractor performed “beneficial use monitoring,” which involved visits to recently completed barangay projects, specifically to determine issues relating to the operations and maintenance of completed facilities. Although there were many monitoring visits over the course of the program, precarious security conditions and inclement weather made it difficult to closely monitor so many projects. In addition, the final monitoring visits were directed only to the barangay projects. Thus, the contractor was not aware that some significant problems had developed with some of the completed regional projects.

Another important aspect of monitoring was that the local governments should assume responsibility for operating and maintaining the projects after completion. However, the local governments were sometimes slow in recognizing the need for maintenance and in providing it once the need became clear.

If problems with completed infrastructure projects are not promptly detected, USAID/Philippines could lose its opportunity to have the problems addressed during the warranty period of 1 year (see separate finding on page 9). In addition, if problems are not immediately addressed, the completed projects will not fully deliver their intended benefits, the projects may not be sustainable, and beneficiaries and other interested parties may form a negative image of USAID-funded projects. This audit report therefore makes the following recommendation.

Recommendation No. 1: We recommend that USAID/Philippines conduct postcompletion inspections on a sample of projects to ensure that they are being used as intended and maintained by local governments before awarding those same local governments any future projects.

³ A box culvert is a box-shaped sewer or drain passing under a road or embankment.

Surety Bond Beneficiaries Pose Legal Uncertainty

Summary: To help ensure that completed infrastructure projects were sustainable, the contractor required subcontractors to obtain surety bonds to guarantee the repair of defects for the completed projects. The subcontractors obtained the required surety bonds with either Louis Berger Group, Inc., or the GEM-2 program as the named beneficiary. The providers of the surety bonds could potentially question the eligibility of USAID to exercise any rights bestowed by the surety bonds on the named beneficiary. Neither the contractor nor the mission had recognized the potential problem with only the contractor or the GEM-2 program as the named beneficiary in the surety bonds. As a result, USAID/Philippines may not be able to claim and collect on the surety bonds.

The construction of GEM-2 infrastructure projects was subcontracted by the contractor to local construction firms that were required to provide surety bonds for the completed projects. These bonds provided a 365-day warranty to repair any defects discovered after project completion.

The audit determined that the subcontractors obtained the required surety bonds. However, the beneficiary of the surety bonds was identified as either the contractor or the GEM-2 program. Neither the contractor nor the mission had recognized the potential problem with only the contractor or the GEM-2 program, as opposed to USAID, being named as the beneficiary in the surety bonds issued.

If the contract with the contractor ends or is prematurely cancelled, USAID may not be able to claim and collect on surety bonds issued on behalf of subcontractors who completed projects under the GEM-2 program and provided warranties for the work completed. Since the surety bonds named the contractor and/or the GEM-2 program, the providers of the surety bonds could potentially question the eligibility of USAID to exercise any rights bestowed by the surety bonds on the named beneficiary. Therefore, collection could be in doubt or not obtainable at all. As a result, this audit report makes the following recommendation.

Recommendation No. 2: We recommend that USAID/Philippines obtain a legal counsel determination on USAID's legal rights regarding the surety bonds under the Growth with Equity in Mindanao-2 program.

New Agreements Should Be Signed With Philippine Government Counterparts

Summary: USAID's policy recognizes its critical coordinating role with respect to partners and host country governments, encouraging strategic operating teams to establish periodic meetings with broader partner groups in order to share information and elicit feedback. However, considerable delays were experienced before USAID/Philippines and its Philippine Government counterparts signed the GEM-2 implementation agreements. Also, as of April 2, 2008, no agreements between the mission and its Philippine counterparts had been signed for the new GEM-3 program. According to mission officials, as in the GEM-2 program, the mission and its Philippine Government counterparts focused on program implementation rather than expediting the signing of new agreements. The absence of formal implementation agreements that explicitly define the roles, responsibilities, and authorities of each party could result in less-than-optimal project implementation because of differing expectations and impaired coordination.

USAID's policy, Automated Directives System (ADS) 202.3.5.3, recognizes USAID's critical coordinating role with respect to partners and host country governments. It notes that strategic objective team leaders and activity managers are considered official U.S. Government representatives and, as such, can open lines of communication. Further, USAID's policy states that USAID encourages strategic operating teams to establish periodic meetings with broader partner groups to share information and elicit feedback.

As part of the GEM-2 implementation process, USAID/Philippines signed agreements with its Philippine Government counterparts: the National Economic Development Authority (Authority) and the Mindanao Economic Development Council (Council). The GEM-2 implementation agreements were intended to define the roles and responsibilities of the parties during implementation of the GEM-2 program.

However, considerable delays were experienced before the mission and its Philippine Government counterparts signed these implementation agreements. For example, the memorandum of understanding with the Authority was signed by the USAID/Philippines mission director on August 12, 2004, but was not signed by the Authority until 9 months later on May 18, 2005. There was an even longer delay in signing a memorandum of agreement (MOA) between USAID/Philippines and the Council. The MOA was not signed by both the principal parties until February 10, 2006, almost 4 years into the GEM-2 program.

The GEM-2 program has ended and the new GEM-3 program has started, but as of April 2, 2008, the mission and its Philippine Government counterparts have not yet signed agreements for the new GEM-3 program. USAID signed the contract with the contractor for implementation of the GEM-3 program on December 19, 2007.

According to mission officials, as in the GEM-2 program, the mission and its Philippine Government counterparts focused on program implementation rather than expediting the signing of a new agreement for the GEM-3 program.

The absence of formal agreements that define the implementation arrangements between the mission and its Philippine Government counterparts could result in less-than-optimal project implementation because of differing expectations and impaired coordination as roles, responsibilities, and authorities of each party are not formally defined and agreed upon. As a result, this audit report makes the following recommendation.

Recommendation No. 3: We recommend that USAID/Philippines sign agreements with its Philippine Government counterparts as soon as possible to clearly establish the roles, responsibilities, and authorities regarding the new Growth with Equity in Mindanao program.

Annual Work Plans Were Incomplete and Not Approved As Required

Summary: USAID's policy states that intended results need to be explicit in order to achieve results effectively, and that outputs—critical to achieving results—should be specifically described. In addition, USAID/Philippines' contract with the contractor and agreement with its Philippine Government counterpart agency required the approval of the work plans. However, the contractor's work plans lacked necessary information to be fully useful for monitoring and evaluating planned activities for the GEM-2 program and were not approved. The work plans lacked necessary information and were not approved because the GEM-2 contract lacked specificity on what the work plans should contain and a mission official indicated that an approved work plan was not an issue. Without a mutually agreed-upon annual work plan to accurately define interim milestones for the expected results, the mission lacked an effective tool to assess progress in achieving results to hold the contractor accountable for achieving targets in the timeframe planned.

USAID ADS 200.3.2.1 states that intended results need to be explicit in order to achieve results effectively. Additionally, according to ADS 202.3.6, outputs are critical to achieving results and are specifically described within the contract statement of work.

The GEM-2 contract stipulated that the GEM-2 Steering Committee should review and approve the annual work plans and other key documents prepared by Louis Berger Group, Inc. (contractor). The Steering Committee was to be composed of representatives from USAID, the contractor, and the Mindanao Economic Development Council (Council) as the principal Philippine Government counterpart. The MOA between the Council and USAID/Philippines, signed on February 10, 2006, likewise provided that the Steering Committee should approve the work plans.

However, with regard to describing specific outputs, the contractor's annual work plans did not describe and establish specific planned infrastructure activities and the corresponding time frames for the coming year. For example:

- The Year 4 Work Plan for October 1, 2005, to September 30, 2006, did not provide specific, detailed descriptions on the activity that was to be completed, and there was ambiguity as to when an activity would start or finish.

- The Year 5 Work Plan for October 1, 2006, to August 14, 2007, did not provide specific, detailed descriptions on the activity that was to be completed or the planned dates when an activity would be completed.

Although USAID policy requires specific outputs, the GEM-2 contract did not prescribe the level of detail that an annual work plan should contain to achieve the objectives of the program. Furthermore, the work plans were not approved by the Steering Committee. A Council official indicated that the Council was neither reviewing nor approving the GEM-2 work plans. This official added that the Council was not aware that it was a requirement for them to do so. The Council further confirmed that no work plans were presented to the Steering Committee for approval.

A mission official indicated that an approved work plan was not an issue since the mission had a Performance Management Plan used for tracking progress against performance indicators, which were then reported in the annual report and semiannual portfolio reviews. However, the audit's review of the fiscal year (FY) 2006 annual report disclosed that the mission did not include the performance indicator for regional infrastructure projects, which represented the single largest activity for GEM-2.

A contractor official also stated that he was not aware of a formal document that indicated USAID approval of the work plans. The GEM-2 contract with the contractor did not include a requirement for USAID's cognizant technical officer to approve the annual work plans.

Without properly prepared and approved work plans, the mission impaired its ability to effectively monitor and evaluate the GEM-2 program and to hold the contractor accountable for the timely achievement of specifically planned activities.

The audit does not make a recommendation on this issue because the new GEM-3 contract contains language that describes what the work plans should include, such as the specific tasks/activities to be implemented to achieve annual performance targets or expected results and the target dates for completion of those tasks/activities. The new GEM-3 contract also specifically requires the cognizant technical officer to review and approve the contractor's work plans.

Progress Reports Lacked Essential Information

Summary: USAID policy provides performance management techniques that missions are expected to follow to help ensure that projects deliver their planned outputs and meet their overall objectives. Although the quarterly progress reports submitted by the contractor highlighted actual accomplishments, the reports did not provide sufficient information on whether or not the contractor had met planned targets for each program activity. The GEM-2 contract did not include any specific language that described clearly what the required progress reports should address. As a result, the mission's ability to identify potential implementation problems, initiate corrective actions early on, and make informed decisions on a timely basis for the GEM-2 program was reduced.

To help ensure that projects deliver their planned outputs and meet their overall objectives, missions are expected to follow the performance management techniques outlined in ADS 200.6. These techniques include (1) monitoring the results of activities, (2) collecting and analyzing performance information to track progress toward planned results, (3) using performance information to influence program decision-making and resource allocation, and (4) communicating results achieved, or not achieved, to advance organizational learning and tell USAID's story.

The contractor submitted the required quarterly progress reports to the mission, but the progress reports provided limited information on the progress being made toward achieving GEM-2 planned results. For example, while the quarterly progress reports highlighted actual accomplishments, they did not provide sufficient information on whether or not the contractor had timely met planned targets for each program activity.

The audit determined that the GEM-2 contract did not include any specific language that clearly describes what the required progress reports should address. In response, a mission official indicated that the mission's Performance Management Plan designated certain performance indicators against which progress was tracked and reported in the annual report and semiannual portfolio reviews. However, the audit team's review of the FY 2006 annual report disclosed that the mission did not include the performance indicator for the GEM-2 regional infrastructure projects, even though this component was the single largest cost activity in the GEM-2 program.

With the contractor's progress reporting limited to actual accomplishments, the mission and the Philippine Government did not have all the information to effectively monitor and assess whether the contractor was timely achieving planned results under the GEM-2 program. As a result, their ability to identify potential implementation problems, initiate corrective actions early on, and make informed decisions on a timely basis for the GEM-2 program was reduced.

The audit does not make a recommendation because the GEM-3 contract specifically prescribes that the quarterly progress reports should include the expected outputs for the quarter, report the major accomplishments for the same quarter, and discuss the outstanding issues and implementation problems as well as the options for resolving these issues and problems.

EVALUATION OF MANAGEMENT COMMENTS

In its response to the draft report, USAID/Philippines agreed with the findings and recommendations. Based on the audit's review of the mission's comments, detailed actions, and supporting documents received, the audit determined that final actions have been taken on the three recommendations in this report.

USAID/Philippines' written comments on the draft report are included in their entirety (without attachments) as appendix II to this report.

SCOPE AND METHODOLOGY

Scope

The Regional Inspector General/Manila (RIG/Manila) conducted this performance audit in accordance with generally accepted Government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. The objective of this audit was to determine whether USAID/Philippines' infrastructure activities under its Growth with Equity in Mindanao-2 (GEM-2) program, implemented by Louis Berger Group, Inc. (contractor), achieved planned results, and what was the impact.

The contractor was carrying out these activities under a 5-year, \$83.6 million contract that began on August 15, 2002. At December 31, 2007, the contractor had spent \$82.1 million on GEM-2. As of the same date, USAID/Philippines had disbursed \$80.3 million to the contractor.

We focused our audit on the largest component of the GEM-2 program, infrastructure development, which had a contract budget of \$41.6 million, representing about half of the total program contract budget of \$83.6 million.

The audit was performed from January 29 through April 2, 2008. It covered infrastructure construction activities implemented in Mindanao by the contractor from August 15, 2002, through December 31, 2007.

Audit fieldwork was conducted at USAID/Philippines and the contractor offices in Manila and Davao City. We also interviewed key officers of Philippine Government counterpart agencies in Manila and Davao City. We made site visits to project sites in Mindanao, specifically those on the island of Basilan and several provinces in Central Mindanao, where the contractor implemented the infrastructure construction activities. Because of security restrictions, we were not able to pursue our planned visit to project sites on the island of Jolo.

As part of the audit, we assessed the significant internal controls used by USAID/Philippines to manage its infrastructure construction activities. The assessment included controls related to whether the mission (1) conducted and documented site visits to evaluate progress and monitor quality, (2) required and approved contractor work plans, (3) reviewed contractor progress reports, and (4) compared the contractor's reported progress to planned progress and the mission's own evaluations of progress.

We also assessed significant internal controls used by the contractor to monitor subcontractors' activities. Specifically, we reviewed how the contractor ensured compliance by its subcontractors with project design and specifications and construction schedules.

We also reviewed the mission's annual self-assessment of internal controls in accordance with the Federal Managers Financial Integrity Act. Finally, we reviewed relevant prior audit reports.

Methodology

To answer the audit objective, we interviewed officials and staff from USAID/Philippines, the contractor, and the Philippine Government counterpart agencies (the National Economic Development Authority and the Mindanao Economic Development Council). We also reviewed and analyzed relevant documents at both the mission and the contractor. This documentation included annual work plans, the contract and its modifications, site visit and other monitoring reports, progress reports, and financial reports and records.

The contractor uses Excel spreadsheets to track progress on each of the Barangay Infrastructure Projects (BIPs) and Regional Infrastructure Projects (RIPs). To verify the accuracy and reliability of the reported performance data, we traced the 830 BIPs and 40 RIPs reported as completed by the contractor in the final progress report to the performance data in these spreadsheets.

To test the validity of the computer-processed data in the spreadsheets, we traced the data to the documents maintained by the contractor for each of the 40 completed RIPs and 28 judgmentally selected BIPs. These document reviews included tracing the 40 RIPs and 28 BIPs reported as completed to completion certificates and project turnover/acceptance certificates. The completion certificates document the contractor acceptance of the projects as being completed satisfactorily by the subcontractor in accordance with authorized plans and specifications. The project turnover/acceptance certificates document the contractor turnover of a particular project to the intended beneficiaries.

We conducted site visits to seven RIPs and seven BIPs to test the reliability of reported performance data, examine the quality of outputs, and observe that the facilities are properly being operated and maintained by the beneficiaries. During the site visits, we also interviewed the project beneficiaries to assess their satisfaction with the quality of the completed facilities.

MANAGEMENT COMMENTS



July 25, 2008

TO: Catherine M. Trujillo, Regional Inspector General

(original signed by E. Washington)

FROM: Elzadia Washington, Acting Mission Director

SUBJECT: Audit of USAID/Philippines Infrastructure Activities under its GEM-2 Program

Thank you for providing the draft report providing information and recommendations coming out of the subject Audit. As requested, USAID is pleased herewith to provide comments regarding the three recommendations included in the draft report.

Recommendation No. 1: We recommend that USAID/Philippines conduct post-completion inspections on a sample of projects to ensure that they are being used as intended and maintained by local governments before awarding those same local governments any future projects.

USAID Response

USAID agrees that post-completion inspections of completed infrastructure projects, with appropriate follow-up following the inspections, are important tools in the effort to encourage LGU beneficiaries of infrastructure projects to comply with their responsibilities to assure proper use and appropriate maintenance of the facilities. USAID/Philippines has taken action to expand and intensify post-completion inspections of completed infrastructure projects.

The principal mechanism developed during GEM-2 which was aimed at helping assure proper use and maintenance of completed infrastructure facilities was the Beneficial Use Monitoring (BUM) Program. Under the BUM Program, all completed infrastructure projects were to be visited/inspected by a BUM Team within six months of their being completed, with a report being prepared by the BUM Team with respect to their findings. In the case of completed projects where the BUM Team identified problematic situations with respect to use or maintenance of a facility, follow-up "Get Well" letters were sent to the owner of the facility (usually a municipal government) pointing out the deficiency and requesting that action be taken to address the concern. Follow-up visits were then made by the nearest GEM Regional office to ascertain whether corrective actions were taken. If not, additional steps were taken - including enlisting MEDCo to

contact the relevant LGU officials to urge action; contacting the provincial governor to request that he/she approach the LGU to urge action; etc. Municipal and provincial leaders were advised that failure to assure proper use and maintenance of facilities would jeopardize prospects of their receiving additional projects in the future.

While the BUM system, which was also supplemented by occasional visits on completed projects by USAID engineers, did largely serve the purpose for which it was designed, it did not result in 100% compliance by all beneficiary LGUs with the requirements to assure optimal use and maintenance of the facilities provided. Reports from USAID and GEM staff traveling around Mindanao occasionally cited problems with some facilities. The RIG report also indicates that the BUM system had not been working perfectly.

Accordingly, USAID has directed GEM-3 leadership to modify some procedures associated with management of GEM-3 infrastructure activities. The revised procedures are aimed at increasing prospects that all beneficiaries will be more diligent in carrying out their responsibilities to assure proper use and maintenance of facilities. GEM-3 has taken the requested steps. These steps include:

- Assuring that the "Barangay Infrastructure Program (BIP) Fact-Sheet" (the broadly distributed brochure which describes the BIP program and is often the principal source of information LGUs have about the BIP Program) includes language making it clear that acceptable past performance in managing and maintaining infrastructure is a key factor used in determining eligibility for future infrastructure assistance. (A copy of the GEM-3 "BIP Fact-Sheet," which includes this language, is attached – Attachment 1).

- Modifying the standard MOU signed between GEM and the beneficiary LGUs laying out obligations and expectations of each party with respect to the infrastructure facility to be constructed to include specific language advising that failure of the LGUs to assure proper use and maintenance of the facility may result in the disqualification of the LGU from eligibility for any future GEM program support. (See Clauses V and XII of the attached standard MOU - Attachment 2).

- Modifying the BUM Program procedures so as to: 1. specify that there are two inspection trips to completed facilities in the year following completion of the facilities (e.g., at 4-5 months after completion, and then at 8-11 months after completion), and then at least one visit during each succeeding year; 2. include specific language in the "Get Well" letters sent to LGUs where concerns had been identified to alert the LGU that "failure to resolve these issues might jeopardize future collaboration between your municipality and the GEM Program," and advising the LGU that processing of any and all proposed GEM projects for the LGU is being put "on-hold" pending corrective action on concerns identified with previously completed projects. (Copies of the GEM-3 BUM Guidelines, and copies of two typical "Get Well" letters to municipalities are attached - Attachment 3).

USAID believes the steps taken, as discussed above, will result in improved LGU performance in managing and maintaining infrastructure facilities. These actions will be supplemented and reinforced by regular inspection visits by USAID engineers and other staff.

Recommendation No. 2: We recommend that USAID/Philippines obtain a legal counsel determination on USAID's legal rights regarding the surety bonds under the GEM-2 Program.

USAID Response

USAID agrees with the recommendation and has taken action to remedy any potential problem emanating from the surety bond situation.

As pointed out by the Audit, the surety bonds the GEM-2 contractor (the Louis Berger Group - LBG) required be obtained by all sub-contractors undertaking construction work on GEM-2 infrastructure projects (to guarantee the repair of defects for the completed projects) specified that the beneficiary of the bonds would be the LBG. This prompted concern by the Auditors as to whether USAID would be able to collect payment against the bonds in the event that, during the one-year life of the surety bonds, the LBG Group disappeared from the scene (i.e, because they lost the overall GEM contract, or went out of business, or the like).

In looking into the matter, USAID determined that the Auditor's concerns were well founded. Communications sent to the six principal surety bond issuing companies used by the GEM-3 construction sub-contractors resulted in their advising that, as the policies were written, USAID would not automatically become the beneficiary of the bonds should LBG go out of business. They advised that in order to correct this situation, LBG should request that the parties that purchased the surety bonds (the various construction sub-contractors) approach the surety bond companies with written requests that the policies be amended to show USAID as the beneficiary in the event LBG goes out of business, or was no longer the prime contractor.

However, as the surety bonds on all of the remaining projects (8 of them) will expire within the next six weeks, and as it is not likely that LBG will disappear from the scene during the next six weeks, USAID believes it not worthwhile to have the still extant surety bonds amended at this time.

For GEM-3 projects, however, USAID requested that the surety bond issue be addressed so that the potential problem could be prevented. The following corrective actions were taken:

- LBG has modified the standard provisions attached to all its construction sub-contracts (e.g., its "Conditions of Subcontract"), to add the following language in the provision dealing with "Retention" (provision 43.2) - "This bank guarantee or surety bond shall guarantee the project against latent defects that may be discovered later due to faulty construction, and shall remain effective until the end of the Defects Liability Period. **The surety bond shall provide the Louis Berger Group, Inc, and/or the U.S. Agency for International Development, as assured.**" (A copy of the relevant pages of the Conditions of Subcontract is attached - Attachment 4).

- the standard draft Surety Bond which LBG provides to its sub-contractors (to guide them as they go about obtaining surety bonds from suitable providers) was also modified to add language showing USAID as well as LBG as the assured. (A copy of that document is attached – Attachment 5).

USAID believes the above steps will assure that USAID becomes the beneficiary of the Surety Bonds in the event LBG disappears from the scene.

Recommendation No. 3: We recommend that USAID/Philippines sign agreements with their Philippine Government counterparts as soon as possible to clearly establish the roles, responsibilities, and authorities regarding the new Growth with Equity in Mindanao Program.

USAID Response

USAID agrees with the recommendation regarding agreements, and has taken appropriate actions.

USAID's GEM-3 Program is the principal activity being carried out under the Mindanao Peace and Development (MPAD) Agreement, which was signed by USAID (on behalf of the USG) and the Mindanao Economic Development Council (MEDCo) (on behalf of the GRP) in September 2007 at Malacanang Palace. As such, the parameters of the GEM-3 Program, and the principal understandings between the USG (USAID) and the GRP (MEDCo) with respect to the GEM-3 Program - including its objectives, its component activities, roles and responsibilities of the USAID and MEDCo with respect to the Program, indicators to be used to measure attainment of objectives, etc. - are laid out in the MPAD Agreement.

These understandings were further elaborated in correspondence between the Executive Director of MEDCo and the USAID CTO regarding an "Aide Memoire on the Agreements made during the USAID-MEDCo meeting of 24 January 2008." The Aide Memoire was sent to USAID as an e-mail attachment on 7 March 2008, with USAID acknowledging the accuracy of the Aide Memoire in an email to MEDCo dated 10 March 2008. The Aide Memoire lays out mutual understandings between USAID and MEDCo with respect to: 1. MEDCo oversight of GEM-3 through a Steering Committee and a Management Committee; 2. Procedures to be followed with respect to identification/packaging/approving/contracting for/monitoring/etc. all GEM-3 infrastructure projects; and 3. Logistic and staff support required by MEDCo for proper oversight of MPAD/GEM-3 activities. (A copy of the Aide Memoire and accompanying e-mail messages is attached - Attachment 6).

USAID believes that between the overall MPAD Agreement, and the subsequent agreements as laid out in the Aide Memoire between USAID and MEDCo mentioned above, that both parties are fully aware of each others obligations and expectations.

Attachments:

- 1) BIP Fact-Sheet
- 2) MOU
- 3) GEM-3 BUM Guidelines
- 4) Conditions of Subcontract
- 5) Draft Surety Bond
- 6) Aide Memoire/E-Mail messages

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