STATEMENT BY
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BEFORE THE

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UNITED STATES HOUSE OF REPRESENTATIVES

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Thank you, Chairman Davis. My name is Alfred V. Neffgen. I am Chief Operating Officer for Government Operations, Americas Region at KBR, the engineering and construction subsidiary of Halliburton. In this role, I oversee all work performed by KBR Government Operations, Americas Region, for the U.S. Government.

I appreciate the opportunity to share with the Committee the facts about our work in Iraq to deliver support to U.S. troops and to restore Iraq's oil infrastructure. KBR is proud of its achievements in Iraq. We have delivered support to our troops in a very difficult environment of unprecedented danger to our employees.

Ours is a mission defined by the Army, often in urgent terms. We are operating in a war zone where decisions are made in minutes, not months, because of the ever-changing conditions. Our mission affects the well-being, morale and even the lives of our troops. Working in this demanding environment, we put together a massive enterprise virtually overnight to do everything from feeding tens of thousands of troops to repairing oil infrastructure and delivering emergency fuels to Iraqi civilians.

Speaking for the thousands of KBR employees who are risking their lives in Iraq to support our troops, I am eager to present our views. The public without question has the right to expect that its tax dollars are spent wisely, and it is appropriate to carefully consider whether KBR has met that obligation.

In the end, all we ask is for a fair assessment of KBR's performance under the difficult and challenging circumstances of operating in a war zone. The contracting process under the Federal Acquisition Regulation (FAR) provides for regular and continuous scrutiny of the pricing of our services, and we are discussing these issues with the Department of Defense on a daily basis. In the end, while we have undoubtedly made some mistakes, we are confident that KBR has delivered and accomplished its mission at a fair and reasonable cost.

Mr. Chairman, my testimony today will first describe my company's history in working for the U.S. military and the U.S. troops. Following that, I will describe KBR's procurement, management and accounting systems, along with our company's Code of Business Conduct.

Later, I will talk in detail about two contracts.

The first is known as RIO, for Restore Iraqi Oil. Under RIO, KBR is helping repair and rehabilitate oil infrastructure at the request of the U.S. Army Corps of Engineers and the Iraqi Oil Ministry. KBR helped return Iraqi oil production to pre-war levels by December 2003, three months ahead of schedule. Under extraordinarily difficult circumstances and with only hours of advance planning time, KBR also developed a massive fuel importation program to prevent civil unrest and disorder after fuel stocks for the Iraqi people had dwindled dangerously low. This fuel program was a success. KBR followed Army guidance for sourcing fuel and worked to keep costs down – two topics I will address in detail.

The second contract is called LOGCAP, for the Logistics Civil Augmentation Program. Through LOGCAP, KBR serves the basic needs of America's troops in Iraq and Kuwait. KBR's priority is to make certain the troops have the food, shelter and tolerable living conditions they need while fighting in Iraq. KBR builds camps, delivers mail, services equipment, cooks meals, provides drinking water and fulfills many other missions. KBR's goal under LOGCAP is to accomplish its essential support mission, at the direction of the U.S. military, so that the warfighters can perform their mission. One of our important jobs under LOGCAP is to provide dining facilities, which has raised issues involving the billing for these facilities that I will also address in detail.

Sixty Years of Service to the U.S. Military

Dating back 60 years, our employees have a long and proud history of serving the needs of the U.S. military and U.S. soldiers during times of war and peace, in the harshest of climates, in the most remote locations, and under critical timeline and budget constraints. Working under both Democratic and Republican administrations, we pride ourselves on accomplishing our assigned tasks – whether at home, on humanitarian missions, on peacekeeping missions, in war-torn zones and, now, in the combat environment of Iraq.

In World War II, we built battleships and destroyers. When the war ended, Brown & Root was entrusted as the managing partner for the massive reconstruction of war-torn Guam. For the Korean War, we rebuilt 1,500 World War II tanks. In the 1960s, we helped build a massive air force base in Vietnam.

More recently, KBR has fulfilled urgent requirements in Somalia, Haiti, Bosnia, Saudi Arabia, Kuwait, Rwanda, Uganda, Marshall Islands, Turkey, the Balkans, the Philippines, and Afghanistan. We have also responded to hurricanes in Florida and South Carolina, and earthquakes in California.

For both the military and contractors alike, Iraq has posed a unique set of logistical and security challenges. In all of our contingency operations, we have not lost a single employee due to hostile actions. Iraq is different. Almost every day a report crosses my desk that catalogues new attacks on KBR personnel – everything from mortar attacks on a camp site to attacks on truck convoys. Over the last two months, the attacks ranged from 40 to 80 per week. For anybody who reads these reports, it is abundantly clear that Iraq remains a dangerous war zone with continuing sabotage and hostilities.

We are deeply aware that these are not just dry statistics. KBR's employees are on the front lines, putting themselves in harm's way to support U.S. soldiers in a war zone. As a company and as individuals, we mourn the fact that KBR employees have lost their lives in Iraq. As of July 19, forty-two (42) employees and top-tier subcontractor employees have died while working in Iraq. These colleagues included average Americans -- truck drivers, construction workers and food service personnel – who made the ultimate sacrifice to support American troops. As of July 19, another 93 employees and subcontractor employees have been wounded, and two are missing.

KBR has more than 34,000 direct and subcontractor employees working in Iraq and Kuwait and the surrounding region supporting our operations for the U.S. government. Of this figure, approximately 11,000 are KBR expatriate employees, including employees from every state and the District of Columbia. Another 14,000 are subcontractor employees. The remaining employees include a group of approximately 2,700 Iraqis. We manage subcontracts with more than 200 different companies.

<u>The Rapid Growth of Our Mission in Iraq.</u>

KBR has faced enormous challenges in meeting the Army's requirements. What has made Iraq challenging? It wasn't only because Iraq was a typically unpredictable war-time situation. It was also because the mission in Iraq mushroomed quickly and dramatically.

We began our work in Kuwait in the pre-war period, operating originally under the terms of the Scope of Work we had agreed to when we had won the most recent LOGCAP competition in 2001. That Scope of Work called on KBR to be prepared to support 25,000 troops, with an absolute maximum of 50,000, in seven base camps with 3,000 troops each, and a rear support area housing another 4,000 troops. This Scope of Work was appropriate for our previous assignments, even ones like the Balkans, previously our largest mission.

In Iraq and Kuwait our assignment quickly grew considerably beyond the original Scope of Work. The speed and volume of task orders accelerated, as the scope of work from the Army dramatically increased, along with multiple revisions of task orders. The pace of new requirements and changes to on-going missions greatly exceeded the original plans of both the government and of KBR. As a result, we now provide support for nearly 200,000 U.S. and coalition forces, as well as 11,000 others, for a total of 211,000 in more than 60 camps.

The rapid mobilization in Iraq beyond our initial Statement of Work required us to perform numerous jobs simultaneously – that is, to provide logistical support for a growing number of soldiers while simultaneously augmenting our own business management, accounting and personnel systems.

Thus, in an unpredictable situation, KBR mounted an enormous logistical operation that was distinctive for three reasons. It was many times larger than our previous logistical assignments that occurred concurrently in the Balkans and four other countries. It occurred according to the compressed timelines of a military force at war. And it was far broader in scope than we anticipated. Because of our substantial and unique experience in providing logistical support for the military, we adapted, adjusted, and modified our systems to meet the challenge.

In the earlier and smaller logistics missions, KBR had performed virtually all the tasks itself. In Iraq, it was difficult to find subcontractors in the Middle East who were knowledgeable about, and could comply with, U.S. regulations. It took time and effort to bring them up to standards. Thus, there were a combination of factors in Iraq – the speedy ramp-up, the ever-changing conditions dictated by wartime and the large scope of the assignment – that required us for the first time to build an extensive network of subcontractors, and assemble the people and systems to supervise them.

Facing these realities, did KBR make mistakes? Without question, we encountered difficulties in mounting such a large enterprise in a hostile, dangerous environment. Initially, given the dramatic ramp-up of responsibilities and constant changing of the Scope of Work, our business and subcontract management systems were stretched. No one at KBR would presume to say that our operation was flawless under these circumstances.

But while the rapid growth of our assignments and the demands of war taxed our systems, we placed continuous pressure on ourselves to do better. We worked hard to identify and fix problems. We worked equally hard with oversight teams from the Army and other DoD offices to correct problems they identified. We refined systems and improved our processes and performance – and we continue to do so. All the while, we worked within Army rules and regulations, supplemented by our own checks and balances and our Code of Business Conduct, which requires employees to conduct business honestly and ethically. I am confident that all this hard work – and the help of our oversight agencies – has led to success.

Let me give you two examples of where we identified problems and quickly fixed them:

- By late 2003 we were concerned about the overload that some of our procurement systems were facing. We subsequently dispatched a team of seasoned procurement and contract specialists to the theater to conduct an across-the-board review of our procurement processes, organization, systems, tools and training programs. As this group delved into its work, some shortcomings in our systems came to light, such as the need to assemble documentation to expedite subcontractor payments. This group's work – it is often referred to as the "Tiger Team" – was quite successful. Its recommendations have resulted in multiple improvements to our business management systems, including six new manuals and a reorganization of roles and responsibilities. It also helped accelerate subcontractor payments.

- Another example occurred early this year when KBR identified a billing irregularity that suggested a subcontractor may have improperly paid a kickback to a former employee. Once it had identified the issue KBR immediately reported the matter to the Department of Defense Inspector General's office, the Department of Justice, and to the Army, turned it over to authorities and provided the government with a $6.3 million credit. The credit represented the amount of the money that KBR, in turn, billed to the government for the subcontracts in question – far in excess of the alleged kickback amount. When we detect a problem, we immediately investigate, self-report, and take corrective action.

Today, Mr. Chairman, the committee will hear from some former employees of KBR who were briefly employed in the theater and who are critical of the company.

Let me say that we take seriously the comments or criticisms of any of our current or former employees. We wish the criticisms had been raised in our hotline process to allow us to investigate directly and address them. Ultimately, we believe that their criticisms are off the mark and are not informed by the full facts.

Procurement Controls in Contingency Contracts

Both LOGCAP and RIO are "cost-plus" contracts. They often are referred to as contingency contracts, and with good reason. A contingency contract provides a flexible procurement tool for obtaining the necessary logistical support to deal with unknown contingencies – for military, peacekeeping or humanitarian missions around the world that might occur on very short notice – without requiring the military to carry the costs associated with full-time, long-term logistics support personnel capable of responding on a moment's notice. Because the military's needs for such services are as unpredictable as the course of world events, the form of contract must be flexible to account for unknown contingencies.

The Department of Defense made the proper determination that cost-plus contracts are the only realistic way to respond to the Government's urgent needs in time of war and conflict where uncertainty rules. The needs of the military must be met extraordinarily quickly and without the constraints required of traditional fixed priced contracts. Frequently, the size and duration of the required needs are totally unknown.

But this does not mean that there are no controls or accountability. In fact, because the use of cost-plus contracts is widespread in federal procurement – including by the National Aeronautics and Space Administration, the U.S. Agency for International

Development, the National Oceanic and Atmospheric Administration, the Social Security Administration and the Department of Energy – federal acquisition regulations provide detailed guidance and procedures for administering such contracts. These regulations guide the allowability of reimbursable costs, the methods of accounting for such costs, and procedures for setting ceilings on such costs. In KBR's case, its contracts are "cost-plus award-fee" contracts, in which the largest part of the fee is determined by assessing how well the contractor has performed its job, including the job of controlling costs.

In addition, it is important to note that the vast majority of our contracts and the vast majority of our subcontracts were competitively bid.

As part of complying with federal acquisition regulations, KBR maintains its own set of internal procurement policies and procedures. These policies and procedures are designed to ensure that KBR's procurement process operates with integrity, efficiency, effectiveness and accountability, and they include a number of checks and balances, accompanied by multiple layers of approval and oversight. One important part of KBR's checks and balances is that procurement compliance experts, whose sole purpose is to monitor the integrity of our procurement system, do not report to local project managers. Instead, to help maintain their objectivity, they report directly to a KBR corporate vice president of procurement.

Management oversight provides another layer of checks and balances. For example, procurement management regularly looks at process control, both on a transaction and trend basis. And periodic routine and random audits are conducted by four KBR divisions – Site Management, Internal Audit, Procurement Compliance and Government Compliance – as well as two federal agencies, the Defense Contract Audit Agency (DCAA) and the Defense Contract Management Agency (DCMA).

KBR maintains a comprehensive set of procurement instructions, procedures and policies. Our procurement policies are reviewed regularly by the government agency chartered with oversight responsibility, the DCMA. DCMA ensures that KBR complies with the FAR, and when DCMA identifies problems KBR makes corrections. Our procurement system is regularly reviewed and approved by the DCMA for compliance with federal law and regulation. Our most recent approval, which included a review of our in-theater procurement systems, was received in May 2003 and is valid for a period of three years. This validates that we operate in compliance with the guidelines set by the U.S. government for government contractors in the procurement area.

KBR trains its new employees in procurement processes, procedures, forms, ethics, company policies, compliance and site/project requirements. We also conduct a special Purchasing Supply Chain Academy to enhance the training and orientation for procurement new hires before they depart to the Middle East.

In addition, the Company for more than 20 years has had a policy prohibiting unlawful, unethical, and questionable conduct in its business affairs. Our Code of Business Conduct, which is distributed to each and every employee of the Company from the top down, specifically requires employees to conduct business honestly and ethically; in fact, as part of the hiring process each new employee is required to sign a statement certifying that they have read and will comply with the Code. We maintain an "open door" policy that encourages employees to report any issues to their supervisor, or anyone in management. It requires Company employees promptly to report any violations of the Code and provides employees with a confidential ethics hotline and an e-mail address for that purpose.

The hotline is staffed by an independent company and is available 24 hours a day in multiple languages. The Code prohibits retribution against any employee for making a good faith report. There is simply no reason for any employee with a good faith question or concern not to report it to the hotline or by e-mail so that it may be promptly addressed.

Just this month the Inspector General for the Coalition Provisional Authority issued a draft audit report that reviewed the adequacy and effectiveness of corporate self-governance programs of contractors in Iraq. Our company was one of five corporations reviewed in areas like Code of Business Conduct, internal controls, and compliance with government contracting policy and procedures. The draft report concluded: "Each contractor we reviewed demonstrated a viable corporate governance program by taking actions to identify and eliminate liability creating conduct. Of the contractors visited, each designed and implemented their corporate governance policies in a unique approach to best meet the needs of their company."

Restore Iraqi Oil (RIO)

The goal of RIO, which is simple to describe and challenging to accomplish, is to restore Iraq's oil production and maintain the flow of fuel to the Iraqi people. Through RIO, KBR helped restore oil wells, pipelines and refineries – all with the goal of getting the oil flowing for both domestic use and export to enable Iraq to develop hard currency income for the benefit of the Iraqi people and their nation.

Iraq is a large country with a land mass a little larger than California. Superimposed over a U.S. map, it would cover an area east to west from Washington D.C. to central Indiana. North to south, it would cover Lansing, Michigan to Raleigh, North Carolina. As reported to OPEC and other sources, Iraq has 5,520 miles of petroleum pipeline in diameters ranging from 6 to 56 inches, 10 refineries and four export facilities.

With all this oil infrastructure, the potential for disaster during and after Operation Iraqi Freedom was enormous.

Before Operation Iraqi Freedom began, the Army Field Support Command issued KBR a planning task under the competitively awarded LOGCAP contract. This plan identified potential scenarios under which we were tasked to develop a classified scenario-based contingency plan that involved short notice, disaster management, and experience in oil infrastructure. Our selection for this highly sensitive and urgent task was based in part on the fact that we had experienced personnel with the necessary security clearances and the experience in extinguishing oil well fires in the first Gulf War.

Later KBR was asked on a sole-source basis to help implement that plan to restore Iraq's oil infrastructure, an action that the General Accounting Office last month found was both legal and appropriate. As you know, federal law permits sole source contracts under specified conditions and they are widely used throughout the federal government. In its report the GAO said that "…the Army Corps of Engineers properly awarded a sole-source contract for rebuilding Iraq's oil infrastructure to the only contractor DOD had determined was in a position to provide the services within the required time frame given classified prewar planning requirements." [Page 4, GAO-04-605, "Iraq Reconstruction Contracting," June 2004]

The contingency plan was based on alternative scenarios. At the time the magnitude and nature of the conflict with Iraq was unknown, although it was a matter of history that Saddam Hussein's retreating forces had wrought significant damage to oil wells in Kuwait in 1991. Within the scenario's parameters, KBR was under contract to assess the condition of Iraq's oil infrastructure; extinguish and respond to oil fires and spills; restore oil infrastructure, including making necessary repairs to restart facilities damaged in war operations; and, finally, to support Iraqis with initial production and export operations.

KBR responded within a matter of hours. On March 21, 2003, the second day of the war, KBR engineers crossed into Iraq almost literally in the tracks of U.S. troops. On March 24, additional oil infrastructure experts left the United States, rolling into Iraq 48 hours after they landed at Kuwait International Airport.

Once our engineers began work, they found that many oil facilities were in complete disrepair due to decades of neglect, as well as recent looting and sabotage. Many pipelines in the south were damaged during battles. Wellheads were rigged with explosives, some of which were triggered, causing greater damage and again creating significant risk for our employees. These wells were assessed and extinguished in priority order.

We found that the Iraqi oil equipment was old, neglected and often desperately in need of repair. We found compressor stations where pump couplings were not available, and we found one site where technicians had improvised a coupling from pieces of leather. At fuel depots in and around Baghdad, brand new but poorly manufactured foreign-made pumps frequently broke down or simply performed poorly, putting our mission in jeopardy.

Before Operation Iraqi Freedom, there was little warning of the level of destruction that would be caused by continuing vandalism and sabotage. Almost immediately, our teams encountered bands of Iraqi men roaming the oilfields. Often they were armed, and often they stripped facilities of anything of value. They removed power generation equipment, tools, air conditioners, pumps, vehicles, valves – even furniture. Outside the facility, they would use tractors or even donkeys to pull down power lines so they could scavenge and sell the inner copper core.

In July 2003, the Army Corps of Engineers, the Coalition Provisional Authority and the Iraq Ministry of Oil decided to pursue a study to determine the ideal end-state of the country's oil infrastructure. These three entities developed a "final work plan," with 226 projects spread over three phases. All of KBR's RIO work is at the direction of its client, formerly the Army Corps of Engineers and now the Project and Contracting Office.

KBR was one of several contractors that received taskings from the Army Corps of Engineers; specifically, we were given the job of overseeing seven key projects. KBR was directed to procure materials and equipment – some of which were readily available, some of which had to be manufactured and delivered months later by boat – for the maintenance staff of Iraq oil operating companies so they could make repairs. The Army was responsible for providing security for the Iraqi oil facilities infrastructure.

For example, at the Al Bakr Oil Terminal, we helped repair two of the four sets of marine loading arms. For the Ministry of Oil, we helped design, engineer, acquire and install a communications network. And, because reliable electric power is absolutely necessary for refineries to operate, we developed a plan to stabilize the power available to the refineries in Southern Iraq by procuring more than 300 mega-watts of power generation, enough to light most small cities in the United States.

In all, our team has made substantial progress in meeting or exceeding the milestones set by the Army Corps of Engineers. In earlier testimony to this committee, Major Gen. Carl Strock, director of Civil Works, the U.S. Army Corps of Engineers, said the Corps estimated before the war that it would take 12 weeks to reopen the oil fields. He added, "Due in large part to the hard work of Task Force RIO, its contractors, and especially the Iraqi experts in oil production, however, it took only about three weeks to get the oil flowing again."

KBR's work has directly affected the ability of Iraq to resume producing and exporting oil:

- After assessing about 600 oil infrastructure facilities, KBR identified 167 facilities that were critical to what we called "First Oil," the resumption of production. The first oil flowed from the southern oilfields on April 28, 2003.

- As production levels grew, exporting oil from the Al Bakr Oil Terminal became a reality on June 28, 2003, a day ahead of schedule.

- And on December 30, Iraq produced 2.4 million barrels a day – the pre-war production level – three months ahead of schedule.

Since exports restarted in June 2003, Iraq produced some $12 billion in revenue from oil sales in a year's time – oil revenues that the Iraqi people need to lay claim to their nation's future, not only to finance modernization of its oil equipment but also to build new schools and libraries. Iraq continues to export more than two million barrels a day, although exports fluctuate due to sabotage and attacks on the infrastructure.

As you know, the Army Corps of Engineers earlier this year competitively selected two companies to assume the responsibilities for RIO project management and execution for northern and southern Iraq. The Parsons Worley Joint Venture assumed projects north of Baghdad. KBR now oversees projects for the southern Iraq section.

Finally, let me address the issue of the costs for oil field fire fighting equipment under the RIO contract. As early as November 2002, KBR participated in meetings with the Army to discuss plans to address oil well fires that were anticipated upon the launch of the Iraq war. Boots & Coots had already begun work with DoD planners prior to KBR's involvement and the Army expressed its preference that Boots & Coots perform this work.

On Feb. 12, 2003, the Army issued a classified task order under the LOGCAP contract (Task Order No. 42), directing KBR to purchase the fire fighting equipment. While typical lead time is 6 to 20 weeks to manufacture and obtain this specialized equipment, we were given just a couple of weeks to deliver equipment to Iraq. Boots & Coots was in a position to supply the required fire fighting equipment on an accelerated basis and so they were sent an RFP. Generally, this type of equipment is leased, not purchased, but given the potential long-term need for the equipment, KBR, with the Army's support, determined it was far more cost-effective to purchase rather than lease the equipment.

Boots & Coots agreed to a reduction from the commercial price list. Moreover, selling their customized equipment was something most companies would not agree to do. The government will also have the equipment for future use.

In addition, Boots & Coots substantially discounted its fire-fighting costs. Rather than charge its "list" prices of up to $15,000 per day per man, Boots & Coots agreed to substantially reduce its costs to $5,000 per day per man in Iraq and $3,500 per day per man in Kuwait.

These prices were fair and reasonable, particularly given the immediate, compelling and urgent nature of the government's classified task order. KBR received the Task Order on Feb. 12, and two weeks later, delivered by positioning the equipment by February 25.

<u>Fuel Assignment</u>

For much of what KBR is accomplishing in Iraq, it is vitally important to see our efforts in the context of the times when the Army has urgent needs. No better example exists than the mission to deliver fuel to Iraq so that Iraqi civilians could cook, heat their homes and drive their cars.

On May 3, 2003, the Army Corps of Engineers contacted KBR in Kuwait, stating that a civilian fuel shortage threatened to lead to civil unrest, posing a serious and imminent danger to U.S. troops. In less than 100 hours, KBR had arranged the logistics so that the first trucks of gasoline and liquid natural gas were rumbling northward from Kuwait into Iraq.

Facing immense security and logistical challenges, KBR developed the fuel program from scratch under brutally difficult circumstances – responding to the Army Corps' requests to continually expand shipments to meet the mounting demand. The program eventually mushroomed from what was initially envisioned as a limited 21-day emergency program to a massive 11-month undertaking.

With your permission, I would like to set the record straight on three important issues related to the fuel assignment: the cost of fuel, the sourcing of fuel, and the security environment surrounding fuel delivery.

First, the price of fuel.

KBR did everything in its power to ensure that the Army's requirements were met at the lowest cost possible. One day after receiving the initial task order from the Army, we contacted more than a dozen firms to supply fuel and logistics support, including tankers and drivers. We received several written bids and chose the low bidder, a Kuwaiti company called Altanmia.

At the same time KBR, on its own initiative, sought alternative sources of fuel in Turkey to meet the Corps' urgent demand. The fuel market in Turkey was more competitive and the security risks associated with delivering fuel from the north were much lower. As a result, sourcing fuel from Turkey was much more cost efficient than sourcing fuel from Kuwait. By May 11, 2003, eight days after the Corps' initial request, KBR began delivering fuel from Turkey as well.

I want to emphasize an important point here about the so-called "overcharging" for fuel deliveries by Altanmia from Kuwait. DCAA, which examined the fuel pricing, took KBR's cost of delivering fuel from Kuwait, compared it to KBR's cost of delivering fuel from Turkey, calculated the difference between the two, and called it potential "overpricing." But that simple calculation fails to take into account a fundamental fact: It was impossible to get fuel to the entire country of Iraq from Turkey alone. Only the northern part of Iraq could be supplied through Turkey. Turkish delivery drivers refused to drive through the Sunni Triangle because of the danger of attack there. And the Army directed KBR to purchase particular quantities of fuel from Kuwait and Turkey. Certainly it was more expensive to obtain fuel through Kuwait than Turkey, but that is understandable given the greater dangers, the longer distances and other logistical difficulties involved in supplying through Kuwait. Everyone knew of these differences from the beginning.

Between May and October – when we rebid the fuel subcontracts – the Army Corps of Engineers provided funding for the fuel mission through a series of short-term incremental extensions without any assurance that longer-term funding would be available. In addition, KBR was often provided little notice of the Army's requirements for future periods – in many cases, only a day or two. These constraints effectively prevented KBR from contracting with our existing supplier, Altanmia, for a longer period (and perhaps obtaining lower prices) or conducting an additional competitive procurement process.

In mid-October 2003, the Corps notified KBR that funding for the mission would continue through at least January 31, 2004. As a result, KBR sought competitive bids for a 90-day contract. KBR attempted to award the contract to the low bidder, the Kuwait Establishment Company. But this company could not prove that the state-owned Kuwaiti Petroleum Company (KPC) would provide it with fuel. Without proof, KBR had no other viable option than to award to the next qualified bidder, Altanmia. In fact, over the course of the contract, Altanmia has been the *only* company able to prove that it could obtain fuel from KPC. At this stage of the process, KBR sought – with success – to negotiate discounts from Altanmia, again with the goal of saving costs. In fact, at the end of the day, we were able to cut close to 20 percent off the price of delivery of the fuel.

The principal reason for the high fuel costs in Kuwait was the high cost of logistics, primarily because of the difficult security environment. When we structured the subcontracts, we anticipated that each tanker would make four round-trips per month from Kuwait to Iraq. Security-related conditions and other logistical challenges prevented that schedule. Tankers instead were only able to make fewer than two trips per month on average. Since tanker charges were a fixed price per month, this caused the price of delivered fuel to increase.

Had tankers been able to make four round-trips a month, the transport price per gallon from Kuwait would have been approximately $.82 rather than the $1.28 KBR paid. Thus four round-trips a month would have meant $.46 savings in the transport cost per gallon, or slightly less than a 20 percent savings on the total costs of fuel and delivery.

Second, I would like to discuss the sourcing of fuel from Kuwait and Turkey.

Initially, in the absence of directions from the Corps, KBR on its own initiative sourced fuel from both Kuwait and Turkey. After May 21, the Corps directed specific levels of fuel purchases from Kuwait and Turkey. As would be expected, KBR complied with these directions.

By the end of our involvement in the program, KBR had delivered a total of 463 million gallons of gasoline. Nearly three out of every four gallons came from Turkey. In all, 333 million gallons (72 percent of the total fuel delivered) was delivered from Turkey while 130 million gallons (28 percent of the total fuel delivered) came from Kuwait.

Third, I think it is important that the Committee understand the extraordinary, hazardous conditions we faced in delivering fuel.

Transporting the fuel was a dangerous and complicated mission. We and our subcontractors recruited and/or sourced hundreds of drivers, some 1,800 tankers, and supplied more than a hundred different download points across Iraq. It was nothing like transporting fuel in the United States. We leased every available tanker in Kuwait; when we exhausted that supply, we leased tankers from elsewhere in the region. We were totally dependent on military escorts to provide security, and faced constant and real threats: our subcontractor lost approximately 200 trucks and five drivers in hostile and non-hostile incidents.

There were many logistical challenges along the way, such as delays in military escorts, mortar attacks, sabotage, closed supply routes, and last-minute changes in supply destinations. As I mentioned above, our convoys depended on military security escorts. Once convoys got going, stopping or slowing them created enormous risk to both military and contractor personnel. As a result, in some cases – including cases where a tanker broke down or even had a flat tire – a truck would be abandoned or destroyed to avoid life threatening risks from hostile attacks or the loss of military cargo to the enemy. But let me be clear: these decisions were made by the U.S. Army for security reasons, not by KBR. The Army told us what to deliver, when to travel, and what route to take, and provided convoys to ensure security. When a truck broke down, the decision about whether to repair the truck on the spot, abandon the truck and allow recovery personnel to come and pick it up, or to destroy it, was made by the Army. For good reason, these decisions were made by military personnel – only military personnel were in a position to calculate the security risk.

Logistics Civil Augmentation Program (LOGCAP)

Our largest contract with the U.S. government is LOGCAP, the Logistics Civil Augmentation Program. It is the modern-day equivalent of the U.S. military's reliance on civilian contractors to provide supplies and services – a reliance that began with the Revolutionary War.

LOGCAP is the U.S. Army contract first awarded to KBR in 1992 after a competitive bidding process. We frequently refer to that contract as "LOGCAP I." During this period, KBR provided support principally to contingency operations in Haiti, Somalia and the Balkans. KBR lost the contract to a competitor in the 1997 procurement competition ("LOGCAP II"), and won it again in 2001 ("LOGCAP III") as part of another open competitive procurement process. LOGCAP, our biggest contract, is not a "sole-source" contract at all, although it is frequently and erroneously referred to as such.

Under the LOGCAP contract, we are on call to provide a wide range of services to the U.S. military – all logistical in nature and designed to provide as much in the way of creature comforts to soldiers as possible. Many are familiar with our LOGCAP work today in Iraq and Kuwait. But through the LOGCAP contract, KBR today also supports contingency operations in Afghanistan, Djibouti, Republic of Georgia and Uzbekistan. We provide support whenever and wherever it is required.

In Iraq and Kuwait, we build camps, cook meals, deliver mail, supply drinking water, provide a supply transportation infrastructure, and provide ongoing operations and maintenance of facilities. By fulfilling our mission, we allow the troops to fulfill their mission. The work of our employees frees the Army from having to maintain a large number of logistics support personnel on a continuous basis. Contracting like this has been recommended over the years, including in 2001 by the U.S. Commission on National Security, known as the Hart-Rudman Commission, which encouraged the Secretary of Defense to establish a 10-year goal of reducing infrastructure costs by 20 to 25 percent "through outsourcing and privatizing as many DOD support agencies and activities as possible."

Iraq is not the first place we have provided these services – but it is the first one to occur in such a hostile environment with such difficult logistics challenges. We are extremely proud of our work there, which we have accomplished under incredible stress and in an extremely hostile and dangerous environment.

The challenges are immense, but our employees are delivering. Here is one description of our work, in a New York Times article by Dan Baum, "Nation Builders for Hire," June 22, 2003:

> *"KBR essentially took an entire Army base out of containers and made it rise in the middle of the Kuwaiti desert two days ahead of schedule: air-conditioned tents complete with 110-volt outlets for the soldiers' boom boxes, male and female shower blocks, kitchens, a laundry, Pepsi machines, a Nautilus-equipped health club with an aerobics room ("Latin Dance Thurs & Sat!"), a rec center with video games and a stack of Monopoly sets, a Baskin-Robbins and a Subway sandwich shop. . . .To conjure Camp Arifjan in a twinkling amid one of the most hostile environments on the planet was by any measure a stunning logistical achievement."*

As many officers and enlisted personnel have told us, LOGCAP has changed the way they live in the theater. Instead of lying on the ground they have shelter, and sleep on cots. Instead of eating MREs – meals, ready to eat – they eat hot meals. Instead of using a bucket of water to wash up, they have showers. Instead of using a bucket of water to wash their uniforms, they have laundry service.

The scale of providing these services to our soldiers would be challenging enough in even the most hospitable of environments. But we were called upon to do so without delay in areas that often lacked even the most rudimentary services, such as electricity, communications and potable water.

Every day in Kuwait and Iraq, often in hostile conditions, KBR:

- Serves more than 475,000 meals,
- Washes almost 16,000 bundles of laundry,
- Provides 2.3 million gallons of potable water,
- Hosts 40,000 patrons at Morale, Welfare and Recreation facilities,
- Collects nearly 10,000 cubic meters of trash, and
- Has as many as 700 trucks on the road at any time providing transport support to the military.

Let me repeat, Mr. Chairman and members of the Committee – that is what our people do for our troops *every day*.

We have faced a good deal of criticism for our LOGCAP contract. Even our critics agree that we have delivered the goods and services that the Army needed, and that the level of service we have provided has been excellent. The criticisms go to cost issues – KBR is criticized for supposedly being insensitive and inattentive to how much the LOGCAP and other contracts are costing the American taxpayer. We have faced a good deal of audit scrutiny, and that process has led us to make some changes in our systems and procedures. Their criticisms are just wrong. At the end of the day, the government will satisfy itself about the reasonableness of all our costs.

It is frequently said that, because most of the task orders under LOGCAP are "cost-plus," KBR lacks concern about running up costs to the Government because – so the criticism goes – the more the cost, the greater our fee. That is not the way it works. Under LOGCAP, the biggest part of our fee is the so-called "award fee," which is a maximum of two percent of the costs that have been defined and agreed upon, a step called "definitization" that involves final agreement on the scope and price of the work. The award fee is just what it sounds like – an "award" that the Army makes if it concludes that we have done a good job at controlling costs, meeting all our milestones and deliverables, and meeting and exceeding performance expectations. The potential award fee for RIO is five percent, and it is two percent for LOGCAP. If we do not control costs well, our award fee can be lowered.

Moreover, the Government has been operating with cost-reimbursement contracts for a very long time, and has developed a highly sophisticated body of regulations to make sure it is not overcharged.

People hear that the Army has proposed to withhold some 15 percent of our requests for reimbursement under the LOGCAP contract, and they assume that the Army must be accusing KBR of overcharging. That is simply not the case. The proposed withholding comes because KBR's Iraq task orders have taken a long time to "definitize," and the Army has applied a regulation that says the Government can only reimburse 85 percent until definitization has occurred. But, as GAO and DCAA have both recently noted, the big reason for slow definitization is the repeated scope changes to the LOGCAP task orders, and those scope changes reflect the fluid nature of the situation in Iraq. The Army has recognized that it would be unfair to hold back 15 percent under these circumstances, and has agreed to delay imposition of the withholding regulation while we work hard with DCAA and the Army to complete the definitization process.

We are experiencing a 15 percent withholding under the RIO contract. This means that approximately $50 million of our requests for reimbursement have been withheld. While we do not believe this withholding is appropriate, we are working with the DCAA and the Army to get the proposals definitized so we can be paid. Again, this withholding has nothing to do with any allegation of overcharging.

Some of our critics point to specific examples of allegedly wasteful procurement practices. Our contracts create incentives for cost savings, and we have a myriad of checks and balances and audit procedures. On top of this, the government closely scrutinizes every single cent we spend.

It is true that DCAA has made some criticisms of our billing and estimating systems. It has taken longer than normal to finalize cost proposals because of the unusual communication difficulties in Iraq, and constant customer changes in our Scope of Work.

While our systems have certainly been stretched by the enormous demands of the Iraqi operation, in the end, our systems work and we strongly believe that the Government has not been overcharged. We have made changes, including automation of our systems. Normally this process of give-and-take with DCAA occurs in a much less public environment, but we are continuing to work cooperatively to assure that our costs are properly documented.

Dining Facilities

One of our most important jobs is feeding the U.S. troops as well as other Coalition forces, government officials and contractor personnel. Through a rapidly changing series of task orders, we were directed to establish and operate more than 60 dining facilities in widely diverse geographical locations throughout Kuwait and Iraq, and serve three and in many cases four hot meals a day with no limitation on portions or take-out orders.

I am pleased to have the opportunity to set the record straight on the issue of KBR's supposed "overcharging" for dining facility services. It has frequently been alleged that KBR has improperly billed the government for meals that were never served. Again, these criticisms are mistaken. The Army directed us to build enormous dining halls and kitchens, to hire employees and procure food based upon an estimated number of personnel who would expect to be fed.

Our subcontractors got the job done, and asked us to pay them on the basis provided in the subcontracts, namely, those estimated numbers of troops to be fed provided by our customer at various intervals. This is a normal practice in the catering industry. DCAA has concluded that when the actual number of meals served fell short of the estimates, the actual number should be the basis for payment. But that is not what the agreements say, and we cannot, we believe, breach those agreements. The contractors deserve to be compensated for building a 4,000 person facility and hiring personnel to serve 4,000 people, even if only 3,500 show up at mealtime.

Because this issue has been so prominent, let me give you some history and a fuller explanation:

We were directed to set up the dining facilities as soon as possible after task orders were issued. We were told that time was of the essence and the failure to act quickly could affect the operational and personnel readiness of the U.S. troops. In the case of the V

Corps Task Order, the goal was to stand up and serve more than 120,000 troops in more than two dozen locations by July 4, 2003, a period of less than three weeks. Thus, the time frames were short and the conditions often harsh and dangerous. And in some cases, because this is war and troop deployments change, the U.S. Army Materiel Command issued revisions of our orders. For example, by June of 2003 the Army had formally modified the task order related to dining facilities at Camp Arifjan 15 times. This is not a complaint. Repeated revisions like this are just a fact of life in a war zone.

Most task orders specified a minimum number of people that each dining facility had to serve on a daily basis.

For example, a given task order might specify that the dining facilities should be ready to serve 4,000 people four meals a day (breakfast, lunch and dinner, as well as a late night meal/snack). At some dining facilities, the Army gave periodic and fluctuating projected headcounts – changing troop movements caused some of this fluctuation. The minimum and headcount projections were designed to ensure that no soldier goes hungry, and that KBR prepare enough food so that the last soldier in line had the same selection as the first soldier served. The emphasis is on ensuring that U.S. troops are fed hearty, high-quality meals.

The task orders did not seek to control or limit the ability of soldiers to take extra helpings, or leave with extra meals for themselves or another soldier who was unable to come to the facility. As a result a significantly greater number of meals were served each mealtime beyond the actual number of persons who entered the dining facilities.

KBR determined that the best way to meet the immense time pressures to get the dining facilities up and operating was to utilize qualified, reliable subcontractors who could mobilize quickly, and we entered into a series of agreements with six principal subcontractors. Operating under brutal conditions and in the hostile environment, the subcontractors had to purchase and transport the materials necessary to build a dining facility; construct it; purchase and transport the equipment needed to prepare and serve meals to meet the estimated number of diners; hire, transport and house sufficient staff to serve the food; and purchase, transport and store the necessary food.

Taking on such a subcontract required a substantial investment on the part of the subcontractor. Frequently, subcontractors had to procure supplies and hire employees from outside Iraq and Kuwait. Often, they could not find regional sources for the goods and services the contracts required. Even when the subcontractors could find regional sources, they had to pay premium prices due to the limited supply and extreme demand.

Most subcontractors based their pricing on the minimum number that an individual dining facility had to be ready to serve each day. The contracts were relatively short-term, so they needed to calculate their bid so as to recover their significant start up costs within the life of the contract. A subcontractor who is directed to serve, say, 4,000 people a day must incur all of the costs to purchase and transport building supplies to build the facility, buy and transport the equipment, hire and transport sufficient staff and purchase enough food to be ready to serve 4,000 people whether they all show up to be fed, or whether a lesser number arrive at the dining facilities on a given day.

The best analogy is catering a wedding. The first question that the caterer will ask is how many guests are expected. The caterer will then calculate a price to enable him to cover his costs and make a profit. The price the caterer will propose is based upon this estimate of attendees. If fewer guests show up, the caterer will still charge for the estimated amount. He still must prepare for the estimated number of people and be ready to cook for that number. He is unable to refreeze the food and use it for another day because of health standards. KBR and its subcontractors were in the same position as the wedding caterer – with the many significant additional challenges of operating in a war zone.

Despite the extreme time pressures, the war zone environment and the extreme scope of the challenge, the facilities have reliably provided high quality food. Indeed, the government has complimented KBR and its subcontractors on their food services on many occasions.

Questions and Controversies

As a government contractor, KBR is subject to numerous areas of oversight. We welcome this oversight. As is expected in the give-and-take of major government contracts, the oversight has sometimes resulted in various areas of disagreement between KBR and some oversight agencies.

The auditing process on large, complex government contracts always identifies issues, which are normally worked out quietly and professionally with the auditors. DCAA has identified some issues with which we agree, and some with which we disagree. This is the normal process, and we are working with them and the Army to iron out differences. In the meantime, however, the taxpayers' interests are fully protected.

In the case of dining facilities, the DCAA, while carrying out its responsibility of making audit recommendations, has raised questions about the billing methods of our dining facilities subcontractors. As you know, DCAA makes audit recommendations and provides audit reports, usually to the contracting officer. It is up to the contracting agency to decide whether the DCAA report findings and recommendations are valid or not – and whether the recommendations should be followed in whole, in part, or not at all.

DCAA has questioned whether any subcontractor billing methodology other than "boots through the door" or "meals served" is appropriate. In other words, it questions whether the subcontractors who were told to expect a minimum number of troops to be fed each day, and who calculated their proposed prices and made their bids to build, equip and operate a dining facilities based on that number, should be allowed to still bill for that minimum number if fewer than that minimum number visit their facility. The contracts require that subcontractors be reimbursed for these reasonable costs on the basis provided in their subcontracts.

It is important to note that the current difference of opinion over billing methods stems from subcontractor bills submitted to KBR for payment. There is no contention that KBR has sought reimbursement for dining facilities expenses that have not actually been incurred by it or invoiced by its subcontractors.

Soon after the DCAA raised these questions, KBR dispatched a team of contract specialists to Iraq and Kuwait to review contracts, invoices and supporting documentation at more than 60 dining facilities. When our review was completed, we reported these findings:

- No systemic billing irregularities were discovered (minor discrepancies are adequately addressed in the normal course of subcontract review and payment)

- The amounts invoiced by the subcontractors were fair and reasonable and in keeping with the terms of the LOGCAP contract, the dining facilities task orders and the individual subcontracts

- Where the Army furnished minimum personnel numbers for specific dining facilities it was reasonable for subcontractors to bill on the basis of such minimums, because they based their (mostly fixed) cost of operations and consequently pricing upon those numbers, which they would not recover if they were required to bill on the actual number of dining patrons

- In fact, the Army has relied on the exact same billing methodology as KBR – and with the exact same food vendor as KBR. This occurred when the Army contracted directly with a dining facility contractor to provide meals in Kuwait and Iraq. After contracting directly with this contractor, the Army turned the contractor over to KBR. Later the Army took back the contract and is managing the contractor. In all three situations the payment method was based on minimum personnel numbers, not on actual boots through the door.

Until this matter is resolved, slightly less than 20 percent is being withheld from KBR's dining facility invoices. KBR continues to work cooperatively with the DCAA and the Army to try to resolve this issue.

We should not be held to ideal peacetime standards during wartime realities. Any auditing of KBR's efforts and our business systems should take into account the chaotic and challenging nature of wartime contingency logistics contracting.

This dilemma was perhaps best described on June 24, 2004 by Michael Wynne, Deputy Undersecretary for Acquisition and Technology of the Department of Defense, testifying before the Readiness Subcommittee of the House Armed Services Committee on Contractor Support in Department of Defense:

“The Army is reporting absolute appreciation for the LOGCAP contract that is recently being questioned by the DCAA; the oil is, in fact, flowing extraordinarily well – on behalf of all the folks at Halliburton.”

and

“There are two sides here. One is you must come up with a contract vehicle that, in fact, induces competition and induces people to actually want to perform on behalf of the American soldier in this condition, and on behalf of our national goals and objectives. That having been said, we are very hard to do business with. We have in our context, and contracts very stringent rules, regulations and follow up audit rights, that are rarely granted in any commercial activity. So when we have, in fact, induced commercial firms to help us, and many times these construction companies do not often do business with the Department of Defense under a cost-type schema. When they find out what the follow up is, usually, and in the case of even somebody as experienced as KBR, they find their accounting systems to be a little bit wanting, as it flows down to subcontractors.

“In the case of Iraq one of the most daunting features is cash payment. They have no banking system, so we don't write checks. As a result, a lot of contracts are, in fact, especially at the sub, sub level, are cash payments to get the job done. That having been said, it requires a certain accounting – our accountants love to – I mean, we're used to and our auditors are used to following up with some specific rationale for an expenditure of money across the board. And many times in the heat of the zone or trying to get a job done, you may not have exactly the kind of rationale that pleases a general auditor. And they get to look at it, if you will, under a little bit less trying circumstances than it may have been issued in the first place.”

Conclusion

Mr. Chairman, the work in Iraq has been demanding and dangerous. Yet, when our employees were called upon to assemble a massive enterprise, they did so. The facts show that this enterprise has delivered and continues to do so. When the hostilities became intense, we did not close up shop. We instead delivered our mission – and with great pride we continue to deliver today. No other company in the world could have acted with such resolve and dedication to accomplish so much in such a short order.

Our challenge is to continue to meet the expectations of our customer, the United States Army, in demanding wartime conditions where time is often of the essence.

This was not easy work in the first hours after the U.S. soldiers entered Iraq, it is not easy work today, and it will not be easy work in the weeks and months ahead. But we have made a commitment to stay the course – a commitment we will keep to the U.S. soldier, to the Iraqi people, and to the American people.

Thank you.

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