



We could write several thousand words about the importance of effective subcontractor management, because we consider it to be the number one most important factor that determines whether or not a program executes on time, on schedule, and within the contractual quality envelope. Indeed, we have *already* written thousands of words on this topic, having previously posted several articles bearing on it. (If you are interested in those articles, the site has a keyword search feature.)

We have also written several thousand words about the importance of documenting why the prices paid to subcontractors were reasonable in amount. We dedicated a series of [four articles](#) to the obstacles facing Kellogg Brown & Root Services (KBR) as it attempted to prove the price it had paid one of its largest LOGCAP subcontractors, Tamimi, for dining support services at Camp Anaconda, Iraq, was reasonable in amount—and thus reimbursable under its cost-type prime contract with the U.S. Army. It cost KBR about \$30 million (by our reckoning) for its failure to prove the prices it had negotiated with Tamimi were reasonable. We discussed some [lessons learned](#) from Judge Miller's decision. Among those lessons learned we asserted that—

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KBR had the ability to determine the best subcontract type, to conduct (and document) negotiations and, thus, to be prepared to demonstrate why Tamimi's prices were fair and

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Written by Nick Sanders

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reasonable. Ultimately, KBR was not able convince Judge Miller that it had done a good job in those areas.

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... acquisition personnel need to own subcontractor source selection and award decisions. In this case, KBR's Operations personnel ran roughshod over KBR's Purchasing System policies and procedures in the name of expediency and troop support. ... KBR personnel obviously did not work as a coherent team, and let organizational silos get in the way....

We mention the foregoing because KBR recently lost [another case](#) at the Court of Federal Claims, for similar reasons.

We are not going to spend a lot of time discussing the facts that led to the dispute over subcontractor pricing. As was the case with Tamimi, KBR was supporting the Army in Southwest Asia by providing dining services. In the words of Judge Miller, resolving the dispute between KBR and the Army "calls for reconciliation of the prime contractor's burden to provide reasonable justification—years after the fact—for claimed costs that were passed through to the prime contractor under fixed-price contracts with the reality that the costs were incurred during the exigencies of war."

One subcontract (called the "SK 465 subcontract") was awarded pursuant to competition. That is to say, a Request for Proposals was issued, multiple proposals were received from potential subcontractors, the proposals were evaluated, and a winner was selected. Normally—and when properly documented—those circumstances are considered sufficient to demonstrate that the price paid to the winner is fair and reasonable. ABC International Group ("ABC") was the winner of the SK 465 subcontract.

Unfortunately for KBR, although its evaluation of the bidders showed that ABC was the low bidder (which is why it was selected), there was an error in the evaluation spreadsheet prepared by the KBR Subcontract Administration team. Instead of being \$100,000 lower than the next lower competitor (Eurest), the reality was that ABC's proposed price was *\$1 million*

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higher than Eures's bid. The error was not discovered during the "green sheet" management review and, indeed, was not discovered until after the subcontract had been awarded to ABC. In addition, the KBR Pre-Negotiation Memorandum (PNM) was acknowledged (by both parties to the litigation) to be "inadequate" and poorly documented/supported.

Oops!

Because the Army kept changing its projected personnel counts, the SK 465 subcontract was based on bands of headcounts ("headbands"), with a fixed price per head based on what headband the headcount fell in. Indeed, the Army changed its personnel count, the type of dining facility to be constructed, and the location of the dining facility itself. The Army's changes in its direction to KBR led KBR to change its direction to ABC, resulting in change orders to the SK 465 subcontract. ABC's change order prices formed a significant basis for the Army's assertion that the subcontract pricing was unreasonable.

One of the problems was that ABC's change order pricing was determined by KBR to be reasonable, based on a comparison to ABC's original pricing (which had been determined to be fair and reasonable based on the competition). This would normally be an acceptable practice—assuming that the original proposal price analysis had been done well. But in this case, since the original proposal evaluation had been flawed, the comparison to it in order to determine the reasonableness of the proposed change order pricing was invalid.

In addition, the KBR Subcontract Administration team's change order analysis suffered from other problems. As Judge Miller wrote, "Essentially, Mr. Nasery's methodology justified a quadrupling of the total price because he doubled not only the number of troops to be served, multiplied by the rate per person, but also the per-person rate."

Oops!

In November, 2007, DCAA issued a "Form 1" suspending payment of "certain costs that KBR paid to ABC pursuant to [Change Order 1] such as costs for dining equipment, the facility lease, reefers, generators, labor, and consumables"—for a total of \$11.3 million. A year later (December, 2008), DCAA supplemented its original Form 1 and increased the amount of the

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suspended costs to \$12.5 million. The revised Form 1 was received by KBR in July 2009. (No reason was provided for the seven month delay.)

The DCAA told KBR that its subcontractor payments were considered unreasonable—

... because KBR[] performed an inadequate analysis related to (i) the prices for higher headcount bands, and (ii) the costs of building a new DFAC facility. In addition, KBR[] billed costs using a headband that was significantly higher than the actual headcount served.

In January, 2008, DCAA issued another Form 1, suspending “\$783,342 of KBR’s direct costs, indirect costs, and fee.” KBR remitted this amount to the U.S. Treasury. However, in May, 2010, DCAA revised its Form 1, lowering the amount of suspended costs to \$698,779. The U.S. Government did not refund to KBR the difference (*i.e.*, the excess amount of suspended costs).

(As an aside, this is a good example of why giving DCAA the authority to suspend contractor costs at its discretion often leads to an abuse of that authority, since DCAA auditors are not held accountable for injuries to the contractor from their errors.)

In deciding the appeal, Judge Miller wrote the following regarding cost reasonableness—

While the court considers the violence in Iraq as a circumstance bearing on the reasonableness of the agreed-upon prices, the court emphasizes that the determination is not what the court considers to be reasonable; rather, *the court will examine whether plaintiff’s evidence supports the claimed amounts as reasonable.*

[Emphasis added.]

Using that standard, Judge Miller found that KBR did not meet its burden, writing—

KBR has not shown that it employed sound business practices and acted as a reasonably prudent business in accepting ABC’s proposed prices for CO 1. The court accepts KBR’s decision not to hold a competition [for the changed work] as reasonable, given the sense of urgency conveyed by Major Hunter and the Army. *That urgency, however, is insufficient to*

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justify the acceptance of unreasonable prices.

Moreover, while it does appear that KBR—whether pursuant to its request or not—received additional information from ABC supporting the prices in the latter’s proposal, this, too, is insufficient to establish reasonableness. This information did not illuminate the costs of the components that ABC would provide; rather, the documents that Mr. Al-Awadi submitted to Mr. Nasery in July 2004 merely identified the numbers of each component that would be provided, the number of laborers for each job title that would be necessary, the layout of the new DFAC, and a schedule of materials to be used.

[Emphasis added.]

However, KBR did win on some items. It was awarded \$4.2 million for erroneously suspended costs that were never refunded (as well as for some undisputed cost items), and it was awarded the disputed dining facility costs (because Judge Miller found KBR’s price justification to be persuasive for that element). It also prevailed on the second Form 1 issue, which turned on an interpretation of subcontract payment terms. That said, by our reckoning ineffective subcontractor management cost KBR more than \$8 million.