



DEPARTMENT OF HOMELAND SECURITY

Office of Inspector General
Dallas Field Office - Audit Division
3900 Karina Street, Room 224
Denton, Texas 76208

October 29, 2003

MEMORANDUM

TO: David I. Maurstad, Regional Director
FEMA Region VIII
Tonda L. Hadley

FROM: Tonda L. Hadley, Field Office Director

SUBJECT: Minnkota Power Cooperative, Inc.
Grand Forks, North Dakota
FEMA Disaster Number 1279-DR- ND
Public Assistance Identification Number 035-00061-00
Audit Report Number DD-01-04

The Office of Inspector General (OIG) audited public assistance funds awarded to Minnkota Power Cooperative, Inc., Grand Forks, North Dakota (MPC). The objective of the audit was to determine whether MPC expended and accounted for Federal Emergency Management Agency (FEMA) funds according to federal regulations and FEMA guidelines.

MPC received an award of \$6.76 million from the North Dakota Division of Emergency Management (NDDDEM), a FEMA grantee, for damages resulting from severe storms, flooding, snow and ice, ground saturation, landslides, mudslides, and tornadoes on March 1, 1999, and continuing. The award provided 90 percent FEMA funding for five large projects. The audit covered the period March 1, 1999, to December 7, 2000, during which MPC claimed \$6.76 million and NDDDEM disbursed \$6.43 million in direct program costs. The OIG examined the costs for two Category F (Utilities) large projects¹ totaling \$6.29 million, representing 93 percent of the total award (see Exhibit).

The OIG performed the audit under the authority of the Inspector General Act of 1978, as amended, and according to generally accepted government auditing standards. The audit included tests of MPC's accounting records, a judgmental sample of project expenditures, and other auditing procedures considered necessary under the circumstances.

¹ Federal regulations in effect at the time of the disaster defined a large project as a project costing \$47,800 or more and a small project as one costing less than \$47,800.

RESULTS OF AUDIT

MPC did not expend and account for FEMA funds according to federal regulations and FEMA guidelines. MPC's claim included questioned costs of \$643,030 (\$578,727 FEMA share), consisting of unsupported contract equipment costs (\$489,941), ineligible contract labor and equipment costs (\$104,910), unreasonable costs on "cost-plus" contracts (\$35,890), and unsupported contract labor costs (\$12,289).

Further, MPC did not follow federal procurement regulations to contract for \$4,015,277 in disaster work. As a result, fair and open competition did not occur and FEMA had no assurance that contract costs claimed were reasonable.

Finding A: Unsupported Contract Equipment Costs

MPC's claim included \$489,941 for contract equipment hours billed without supporting documentation, such as foremen's activity logs or equipment usage records that identified the operator who used the equipment. According to 44 CFR 13.20(b)(2), a subgrantee must maintain records that adequately identify the source and application of federal funds. Further, MPC failed to follow federal procurement regulations and FEMA guidelines in procuring these cost-plus time-and-materials (T&M) contracts (see Finding E). According to 44 CFR 13.43(a)(2), a material failure to comply with applicable statutes or regulations can result in the disallowance of all or part of the costs of the activity or action not in compliance.

In the absence of directly applicable guidance and in an effort to lessen the effects of these regulation violations on MPC's claim, the OIG applied FEMA's force account equipment directives to determine the eligibility of the unsupported equipment costs. FEMA's Public Assistance (PA) Guide (Pub. 322, p. 81) states that, in order to review the eligibility of equipment costs, the applicant must provide a summary of operator hours for any equipment being claimed (operator hours must match or exceed equipment hours). For the contractor that billed 60 percent of the unsupported equipment costs on project 1093, total equipment hours (15,352) exceeded total labor hours (10,294) by 5,058 hours, or 49 percent, and total "equipment operator" hours (2,287) by 13,065 hours, or 571 percent. Absent documentary evidence to the contrary, it was not reasonable to allow equipment hours for every employee (i.e., linemen and supervisors) when the main purpose of the project was to erect high voltage electrical lines. It was also not reasonable to allow equipment hours on the basis that designated operators were capable of operating 6.7 pieces of equipment simultaneously. Therefore, based on the discrepancy in labor hours versus equipment hours, some pieces of the equipment were idle at all times. Under 44 CFR 206.223(a)(1) an asset must be performing work directly related to the disaster for its cost to be eligible and idle equipment is not performing

work. Because MPC failed to provide the required documentation to substantiate \$489,941 in equipment usage, the OIG questioned this cost as unsupported.

Finding B: Ineligible Contract Labor and Equipment Costs

The MPC claim included \$104,910 in unallowable contractor labor and equipment costs, consisting of \$68,316 for equipment in standby status on T&M contracts, \$34,841 for a mechanic, and \$1,752 for vehicle fuel. FEMA's PA Policy Digest (Pub. 321, p. 42) states that equipment rates typically include operation and maintenance costs. In addition, the Policy Digest (p.41) states maintenance activities necessary due to the use of equipment to perform emergency or permanent work are not eligible. Further, equipment in standby status is not being used to perform work directly related to the disaster as required by 44 CFR 206.223(a)(1) for eligibility. Therefore, the OIG questioned \$104,910 in ineligible contractor labor and equipment costs.

Finding C: Unreasonable Costs on "Cost-Plus" Contracts

MPC's claim included \$35,890 in unreasonable contractor costs consisting of \$31,590 in unreasonable labor overhead and \$4,300 in markups on equipment rental costs exceeding those specified in the contract. The unreasonable labor overhead consisted of a 4 percent labor markup for hand tools and a compounding of labor overhead markups (i.e., markups on markups). The markup on equipment rental was 22 percent when the contract allowed for only 10 percent.

The Office of Management and Budget (OMB) Circular A-122, "Cost Principles for Non-Profit Organizations," Attachment A, states that a cost is reasonable if, in its nature or amount, it does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the costs. Further, the Circular states consideration should be given to such factors as generally accepted sound business practices, arms length bargaining, federal regulations, and terms and conditions of the award. These contracts were not competitively procured; therefore, they were not wholly the result of arms length bargaining. Additionally, paying rates greater than those established by the contract is not generally accepted sound business practices. Further, these contracts were not awarded in accordance with federal regulations. Therefore, the OIG questioned \$35,890 in unreasonable costs.

Finding D: Unsupported Contract Labor Costs

MPC's claim included \$12,289 of unsupported contract labor costs. According to 44 CFR 13.20(b)(2), a subgrantee must maintain accounting records that adequately identify the source and application of federal funds. Additionally, 44 CFR 13.20(b)(6) provides a specific list of source documentation, including cancelled checks, paid bills, payrolls,

time and attendance records, and contracts that are acceptable as supporting documents for the accounting records. The OIG questioned these costs because MPC did not provide acceptable source documentation, such as time and attendance records, as support.

Finding E: Unallowable Contract Procedures

MPC did not follow federal procurement regulations or FEMA guidelines in awarding contracts totaling \$4,015,277 for the repair of two high voltage power lines. As a result, fair and open competition did not occur and FEMA had no assurance that contract costs claimed were reasonable.

Under 44 CFR 13.36, procurements must provide for (1) competitive bids, unless an allowable exception is met; (2) reasonable costs; (3) a cost or price analysis; and (4) negotiation of profits as a separate element of the price for each contract in which there is no price competition. Further, these regulations prohibit the use of a cost-plus-a-percentage-of-cost contract, limit the use of T&M contracts to situations where no other contract is suitable, and mandate the inclusion of a ceiling price that the contractor exceeds at its own risk for T&M contracts. Also, subgrantees must maintain records sufficient to detail the significant history of the procurement, including the rationale for the method of procurement, the basis for contractor selection, and basis for the contract price.

In addition, FEMA's PA Guide states that T&M contracts should be avoided, but may be allowed for work that is necessary immediately after the disaster has occurred when a clear scope of work cannot be developed. If applicants use T&M contracts, they must carefully monitor and document contractor expenses, and a cost ceiling or "not to exceed" provision must be included in the contract.

The OIG examined procurement procedures for three contracts. None of the three procurements was supported by contracting documents. Even though federal regulations prohibit the cost-plus-percentage-of-cost contracts, two of the three contracts were clearly marked as having been negotiated on a "Cost-Plus Basis;" and the third was a T&M contract even though, with the exception of site conditions, the scope of work could be clearly defined. MPC failed to include a cost ceiling in this T&M contract, analyze proposed contract costs, monitor contract performance, or negotiate profit as a separate element. In summary, MPC failed to follow federal procurement regulations and FEMA guidelines in procuring all of these contracts.

Under 44 CFR 13.43(a)(2), failure to comply with applicable statutes or regulations can result in the disallowance of all or part of the costs of the activity or action not in compliance. Because MPC disregarded federal procurement regulations and FEMA guidelines, FEMA had the authority to disallow all of the \$4,015,277 claimed contract

costs. However, except for the \$643,030 questioned in Findings A through D, the OIG did not recommend disallowance of costs because MPC incurred the majority of costs for eligible work. Further, there was no way to quantify the impact of MPC's non-compliance with federal regulations and FEMA guidelines related to procurement.

RECOMMENDATIONS

The Office of Inspector General recommended that the Regional Director, in coordination with the North Dakota Division of Emergency Management:

1. Ensure that, for future disasters, subgrantees are provided guidance on federal regulations and Federal Emergency Management Agency guidelines related to procurement.
2. Disallow \$643,030 of questionable costs.

DISCUSSION WITH MANAGEMENT AND AUDIT FOLLOWUP

The OIG discussed the results of this audit with officials from MPC on September 11, 2003. MPC officials disagreed with the findings and recommendations, stating that they obtained the best value available under the circumstances. MPC contended that this statement was true because of its limited choices and long-term relationships with the selected contractors. The OIG contended that 44 CFR 13.36 allows adequate latitude for purchases made under exigent circumstances, but MPC failed to follow even these relaxed procurement requirements. The OIG discussed the results of this audit with officials from NDDEM and FEMA Region VIII on September 11, 2003.

Please advise this office by November 28, 2003, of the actions taken or planned to implement the recommendations, including target completion dates for any planned actions. If you have questions concerning this report, please contact me at (940) 891-8900. Major contributors to this report were Daniel Benbow, Doug Denson, and Patti Smith.

Schedule of Audited Projects
Minnkota Power Cooperative, Inc.
FEMA Disaster Number 1279-DR-ND

<u>Project Number</u>	<u>Amount Claimed</u>	<u>Questioned Costs</u>	<u>Finding Reference</u>
PW 1093	\$3,464,198	\$433,706	A,B,C,D,E
PW 1103	<u>\$2,821,588</u>	<u>\$209,324</u>	A,B,C,E
TOTALS	<u>\$6,285,786</u>	<u>\$643,030</u>	