Questionable Contract Language Related to Interest Payable Under Kiewit Contract C069-93228 Sounder Preventive Maintenance Track Replacement and Related Improvements, Seattle, WA And Kiewit Contract C069-06834 South End Track and Related Improvements, Seattle, WA

Audit Report No. 508-2009

December 2, 2010

Audit Report Issued By:

NATIONAL RAILROAD PASSENGER CORPORATION
OFFICE OF INSPECTOR GENERAL
10 G STREET, N.E.
WASHINGTON, DC 20002

Memo

Date December 2, 2010

From David R. Warren, Assistant Inspector General for Audit

To Donald A. Stadtler Jr., Chief Financial Officer

Department Office of Inspector General

Subject Questionable Retainage Language in Kiewit Contracts for Sounder Track Replacement and Improvements, and South End Track and Related Improvements, Seattle, WA

Final Audit Report 508-2009

cc Jeff Martin, Chief Logistics Officer

Jessica Scritchfield, Internal Controls Officer

Enclosed is our final report on issues that came to our attention while we were conducting the audits of Kiewit Contract C069-93228 Sounder Preventive Maintenance Track Replacement and Related Improvements in Seattle, WA and Kiewit Contract C069-06834 South End Track and Related Improvements in Seattle, WA. Our objective for the two audits was to determine the accuracy and acceptability of costs billed by Kiewit Pacific Co. The audit results related to questioned costs and unsupported costs are included in our final report 504-2009. This report contains information concerning questionable retainage contract language and the Contractor's Cost of Living Adjustment rates that [redacted] the Bureau of Labor Statistics Consumer Price Index rate.[1]

Management's response from the Amtrak Chief Financial Officer to our draft report is in the attached Appendix. Management agreed with our three draft recommendations and provided additional comments on our finding and recommendations. In this final report, we modified our recommendations to address Management comments.

Thank you for your cooperation during the course of this audit. If you have any questions, you can contact See See Young, Senior Director, at (213) 683-6939 or by email at youngse@amtrak.com, or me at (202) 906-4742 or by email at david.warren@amtrak.com.

David R. Warren
Assistant Inspector General for Audit

Attachment

[1] We redacted certain proprietary information from this report.

EXECUTIVE SUMMARY

WHY WE DID THESE AUDITS

During our audits of Contracts C 069-93228 and C069-06834 to determine the accuracy and acceptability of costs billed by Kiewit Pacific Co (Kiewit), we identified issues pertaining to questionable contract retainage language and an opportunity to improve contract negotiation practices.

Amtrak's Department of Procurement and Materials Management (Procurement) requested the Office of Inspector General (OIG) to perform post-award audits of Contracts C069-93228 and C069-06834 for work performed in Seattle, WA. Both contracts require Amtrak to pay Kiewit reimbursable costs plus fee up to the Guaranteed Maximum Price (GMP). The contracts allow Amtrak to withhold 10 percent of progress payments (generally referred to as retainage) made to Kiewit on a cost incurred basis. The retainage funds to be withheld until the work has been satisfactorily completed and the OIG audit findings, if any, have been resolved. Kiewit billed a total of $4,584,491 for Contract C069-93228 and $4,213,991 for Contract C069-06834. These amounts are within the contracts' specified GMPs. For Contract C069-93228, Amtrak has paid $4,126,042 and withheld retainage funds totaling $458,449.[2] For Contract C069-06834, Amtrak has paid $3,792,592 and withheld retainage funds totaling $421,399.[3]

Contracts contain questionable retainage language that may potentially result in unreasonable burden and unnecessary costs to Amtrak.

We identified questionable retainage language in both contracts. The language states in the event the retainage is not paid to the Contractor within 90 calendar days following proper invoicing by the Contractor and receipt by Amtrak, both parties "shall agree to seek a mutually acceptable means of compensating the Contractor for the 'time value of money' associated with extended and/or unwarranted withholding of retainage from the Contractor without suitable cause." One of the mutually acceptable means stated in the contracts allows the Contractor to be paid interest on retainage not later reduced by audit findings. The OIG was not advised by Procurement about the subject language, before its inclusion in the contracts.

It is a common construction contracting practice for the owner to withhold a certain percentage of compensation from the contractor in retainage as a means to motivate the contractor to complete the work in a timely and satisfactory manner. Both contracts contain retainage language that is consistent with this good business practice. However, Amtrak added a note to

[2] While processing this final report, we found that Amtrak had released nearly all of the retainage back to Kiewit except for the net audit adjustment credit amounts of $99,531 related to Contract 069-93228 and $2,147 related to Contract 069-06834.

[3] See Note 1.

both contracts that includes questionable contract retainage language that may offset the benefits of withholding retainage. The 90 calendar days' timeframe included in the contract places a burden on Amtrak that may result in hasty Amtrak decisions. Further, the retainage language may potentially result in unnecessary costs to Amtrak.

Completion of the audit, to a large extent, is dependent on the timeliness and responsiveness of the Contractor in submitting adequate and appropriate documents to support its costs billed to Amtrak. The inclusion of the subject language in only Kiewit contracts presents an appearance that Amtrak accorded preferential treatment to the Contractor. Procurement management indicated that the subject interest language was included in only the two Kiewit contracts to induce the Contractor to do business with Amtrak because the Seattle Facility Infrastructure Improvement project underwent a number of changes, including project scope reduction, as a result of Amtrak's funding constraints.

Further, the interest payment clause may potentially impose limits on the OIG's responsibilities. Amtrak's General Provisions for the contracts clearly state that nothing in the contract shall limit the Amtrak OIG's rights, obligations, authority, or responsibilities. Further, the Government Auditing Standards provide the example that "unreasonable restrictions on time allowed to complete an audit or issue the report" could impair the auditor's independence; thereby, adversely impacting the audit.

We recommend that Amtrak

1. As a standard practice, exclude any contract language that allows paying interest payable to a Contractor on retainage and, if such language is included, formally justify its inclusion that it is in Amtrak's best interest and does not impair auditor independence.

2. Review all existing contracts for similar retainage language and ensure that Amtrak does not agree to the payment of interest to the Contractor on retainage.

3. Avoid contract language that could impair the auditor's responsibilities.

Amtrak Chief Financial Officer (CFO) responded to our draft audit report and agreed with our three draft recommendations. The CFO also provided additional comments on our draft, which are reflected in this final report.

In response to our draft recommendation to exclude contract language that allows compensation of interest payable, the CFO stated that as standard practice Amtrak should not include contract language that allows compensation of interest payable to the Contractor on retainage. He also stated that Management believes that in very specific and limited circumstances, the use of contract language allowing compensation of interest payable may be in the best interest of Amtrak. We recognize there may be limited circumstances where allowing compensation of interest may be in the company's best interest. Therefore, our final recommendation states that Management should as a standard practice exclude any contract language that allows paying interest payable to a Contractor on retainage and, if such language is included, formally justify its inclusion that it is in Amtrak's best interest and does not impair auditor independence. In response to our draft recommendation to review all existing contracts for similar retainage language, the CFO stated that Management had reviewed all existing contracts and found no contracts under Procurement's purview to contain interest payable language. In response to our last draft recommendation, the CFO stated the Amtrak Chief Logistics Officer will issue guidance to Procurement personnel reminding them of the need to avoid contract language that could impair the independence and objectivity of OIG and other external auditors. The guidance was issued to all Procurement personnel on November 19, 2010. Considering this action, our final recommendations states that Amtrak should avoid contract language that could impair the auditor's responsibilities.

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BACKGROUND

On May 21, 2008, Amtrak entered into three separate contracts with Kiewit Pacific Co. (Kiewit or "Contractor") to move forward with the completion of the Seattle Facility Infrastructure Improvement Project in Seattle, Washington. The three contracts are listed below:

1. **Contract C076-66826** was for the Design/Build Improvements at Amtrak's Seattle Maintenance Facility for a Guaranteed Maximum Price (GMP) of $2,525,000.
2. **Contract C069-93228** was for the Sounder Preventative Maintenance Track Replacement and Related Improvements in Seattle, WA, for a GMP of $4,676,367.
3. **Contract C069-06834** was for the South End Track and Related Improvements in Seattle, WA, for a GMP of $6,500,000.

All three contracts are cost reimbursable plus fee contracts up to the GMP. In addition, each of the contracts includes the possibility of a downward revision provision to the amount billed based on Amtrak Office of Inspector General (OIG) audit findings. Also, the contracts allow Amtrak and Kiewit to seek a "mutually negotiated resolution" to the Amtrak OIG audit findings.

Amtrak's Department of Procurement and Materials Management (Procurement) requested the OIG to perform post award audits of the three contracts. This report contains the OIG's finding related to questionable contract language and the Contractor's Cost of Living Adjustment (COLA) rates. The audit findings on questioned costs and unsupported costs for contracts related to Sounder Preventive Maintenance Track Replacement and Related Improvements and the South End Track and Related Improvements are covered in a separate Audit Report 504-2009.

Kiewit billed Amtrak $4,584,491 for services performed during the period from January 2, 2008 through February 15 2009 for Contract C069-93228 and $4,213,991 for services performed during the period from May 5, 2008 through July 19, 2009 for Contract C069-06834.

Contract Number	Contract GMP	Kiewit Billed Total	Amtrak Paid Total	Retainage Total Withheld
C069-93228	$ 4,676,367	$ 4,584,491	$ 4,126,042	$ 458,449
C069-06834	$ 6,500,000	4,213,991	3,792,592	421,399
		$ 8,798,482	$ 7,918,634	$ 879,848

As shown in the table above,[4] Kiewit's billing totals for the two contracts are within the contracts' GMPs.

[4] While processing this final report, we found that Amtrak had released nearly all of the retainage back to Kiewit except for the net audit adjustment credit amounts of $99,531 related to Contract 069-93228 and $2,147 related to Contract 069-06834.

RESULTS OF AUDIT

Finding: Contract language may unnecessarily increase costs and impair auditor's independence.

In our review of Contracts C069-93228 and C069-06834, we identified questionable retainage language in both contracts that may potentially result in unreasonable burden and unnecessary costs to Amtrak and impair the auditor's independence.

It is a common construction contracting practice for the owner to withhold a certain percentage of compensation (generally referred to as retainage) from the contractor as a means to motivate the contractor to complete the work in a timely and satisfactory manner. The 2nd paragraphs of the Compensation Sections of both contracts contain a retainage clause. The clause allows Amtrak to withhold 10 percent of the progress payments to ensure satisfactory completion of the work and disposition of any audit findings. Amtrak also added a Note 2 to the compensation sections of both contracts. Note 2 states that in the event the retainage is not paid to the Contractor within 90 calendar days following proper invoicing by the Contractor and receipt by Amtrak, both parties "shall agree to seek a mutually acceptable means of compensating the Contractor for the 'time value of money' associated with extended and/or unwarranted withholding of retainage from the Contractor without suitable cause." One of the listed "mutually acceptable means" is paying interest to the Contractor on retainage not eventually applied to resolve audit findings. This was to be paid at a rate of six percent or at the Wall Street Journal Published Prime Rate, whichever is lower. The OIG was not advised by Procurement about the subject language, before its inclusion in the contracts.

The inclusion of the notes the contracts may offset the benefits of withholding retainage until satisfactory completion of all work and disposition of OIG audit findings. The 90 calendar days' timeframe included in the contract note places a burden on Amtrak that may result in hasty Amtrak decisions. Further, the subject retainage language may potentially result in unnecessary costs to Amtrak and impair auditor's independence.

Section 30.6 (Right to Audit) of the Amtrak General Provisions for Design/Build Contracts, revised May 21, 2008 of both Kiewit Contracts states:

> *Nothing in this Contract shall be construed to limit the rights, obligations, authority, or responsibilities of Amtrak's Office of the Inspector General pursuant to the Inspector General Act of 1978, as amended, including the right to seek information by subpoena.*

The OIG is required to conduct audits in accordance with professional standards. Section 3.10 of the Government Auditing Standards specifically states that "audit organizations must be free from external impairments to independence." The section gives the example that "unreasonable restrictions on time allowed to complete an audit or issue the report" could impair the auditor's independence; thereby, adversely impacting the audit.

The contract interest language related to retainage could have placed time restrictions on our audit, since it included a 90-calendar-day timeframe for completing our audit once the bills were received by Amtrak. Such a requirement could potentially limit our auditor's ability to maintain independence and objectivity. However, the subject retainage language in the case of these contracts did not affect our audits. Also, the timeliness of the audit completion, to a large extent, is dependent on the timeliness and responsiveness of the Contractor in submitting adequate and appropriate data and records to support its billed costs. Further, by only including the interest retainage language in the Kiewit contracts may present an appearance that Amtrak accorded preferential treatment to the Contractor.

Procurement officials indicated that the interest paid to Kiewit related to retainage was not a standard practice. They further stated that it was included in the two Kiewit contracts to induce the Contractor to do business with Amtrak. They felt this inducement was because the Seattle Facility Infrastructure Improvement project underwent a number of changes, including significant project scope reduction, due to Amtrak's funding constraints.

RECOMMENDATIONS

We recommend that Amtrak Management take the following actions:

1. As a standard practice, exclude any contract language that allows paying interest payable to a Contractor on retainage and, if such language is included, formally justify its inclusion that it is in Amtrak's best interest and does not impair auditor independence.

2. Review all existing contracts for similar retainage language and ensure that Amtrak does not agree to the payment of interest to the Contractor on retainage.

3. Avoid contract language that could impair the auditor's responsibilities.

MANAGEMENT'S COMMENTS AND OIG RESPONSE

Amtrak Chief Financial Officer (CFO) responded to our draft audit report and agreed with our three draft recommendations. The CFO also provided additional comments on our draft, which are reflected in this final report.

In response to our draft recommendation to exclude contract language that allows compensation of interest payable, the CFO stated that as standard practice Amtrak should not include contract language that allows compensation of interest payable to the Contractor on retainage. He also stated that Management believes that in very specific and limited circumstances, the use of contract language allowing compensation of interest payable may be in the best interest of Amtrak. We recognize there may be limited circumstances where allowing compensation of interest may be in the company's best interest. Therefore, our final recommendation states that Management should as a standard practice exclude any contract language that allows paying interest payable to a Contractor on retainage and, if such language is included, formally justify its inclusion that it is in Amtrak's best interest and does not impair auditor independence. In response to our draft recommendation to review all existing contracts for similar retainage language, the CFO stated that Management had reviewed all existing contracts and found no contracts under Procurement's purview to contain interest payable language. In response to our last draft recommendation, the CFO stated the Amtrak Chief Logistics Officer will issue guidance to Procurement personnel reminding them of the need to avoid contract language that could impair the independence and objectivity of OIG and other external auditors. The guidance was issued to all Procurement personnel on November 19, 2010. Considering this action, our final recommendations states that Amtrak should avoid contract language that could impair the auditor's responsibilities.

OBSERVATION

Observation: Kiewit's cost of living adjustment rates [redacted] the BLS CPI rate.

We determined that for Contract C069-93228, Kiewit paid certain employees cost of living adjustment (COLA) payments at effective rates of [redacted] and [redacted] in 2008. For Contract C069-06834, Kiewit paid a staff supervision employee COLA payments at an effective rate of [redacted] in 2008. The COLA payments for both contracts were applied to Kiewit's labor costs charged under the contracts.

Kiewit submitted company issued memoranda to support its COLA rates. However, in comparing Kiewit's effective rate to the Bureau of Labor Statistics (BLS) Consumer Price Index (CPI) rate for the Seattle-Tacoma-Bremerton, WA area (which covers the Amtrak jobsite), Kiewit's rate [redacted] the average BLS CPI rate of [redacted] for 2008. Based on Kiewit's invoices submitted to Amtrak for both contracts, the inclusion of COLA payments were not evident as the Contractor's summary labor documents that were included with the invoices did not detail the labor charges.

We recognize that the Contractor has the right to provide cost of living adjustments to its employees as an established compensation policy. However, we suggest that for future cost reimbursable contracts, Amtrak obtain an adequate understanding of the Contractor's COLA policy and practices and factor the information obtained in its contract negotiation decisions. This will assist Amtrak in controlling contract costs.

Audit Staff:

Trig Alonso
Anil Gunaratne
See See Young

EXHIBIT
Scope and Methodology

We conducted this performance audit in accordance with the generally accepted government auditing standards (GAGAS). These 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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. We conducted the reviews of Contract C069-93228 between November 2008 and July 2009 and Contract C069-06834 between May 2009 and December 2009. We used the following scope and methodology in conducting these reviews.

Scope

The audit scope encompassed actual, estimated, and other financial cost information provided by Kiewit to support the billed costs for nine invoices covering the period from January 2, 2008 through February 15, 2009 for Contact C069-93228 and 13 invoices covering the period from May 5, 2008 through July 19, 2009 for Contract C069-06834. We reviewed Kiewit's labor, equipment, material, subcontractor, profit, and overhead costs. From these major cost categories, we judgmentally selected samples for detailed cost review and verification. We also obtained the technical opinion from Amtrak Engineering on the reasonableness of Kiewit owned equipment, labor, rental equipment, and subcontract costs. For Amtrak payments made to Kiewit, we obtained and used the payment data provided by Amtrak Finance. As we did not perform any testing on the payment data, we do not attest to the reliability, consistency, and currency of such data.

Methodology

Our methodology included: the review of contracts, Kiewit's job cost records and other documents submitted in support of the costs billed; the performance of attribute testing and data analysis using Audit Command Language and Microsoft Excel; and the discussions of relevant matters with Amtrak project personnel and Kiewit representatives. We also performed other work as deemed necessary to complete the audit.

APPENDIX
Management's Response

NATIONAL RAILROAD PASSENGER CORPORATION
30th Street Station, 5th Floor Southeast, Philadelphia, PA 19104

Memo

AMTRAK

Date	September 30, 2010	From	DJ Stadtler Chief Financial Officer
To	Dominic Pinto, Acting AIG, Audits	Department	Finance
		Subject	Inappropriate Retainage Language in Kiewit Contracts for Sounder Track Replacement and Improvements, and South End Track and Related Improvements, Seattle, WA Report 508-2009
		cc	John Martin, Chief Logistics Officer Gary Eckenrode, Sr. Director - Procurement and Materials Management

This letter is in response to Office of Inspector General ("OIG") audit 508-2009 "Incurred Cost Audit- Inappropriate Contract Language Related to Interest Payable Kiewit Contract C069-93228 Sounder Preventive Maintenance Track Replacement and Related Improvements, Seattle WA and Kiewit Contract C069-06834 South End Track and Related Improvements, Seattle Washington", dated August 18, 2010.

<u>Background</u>

At the time that the Kiewit contracts were awarded, Amtrak had been experiencing a shortage in available funding. The lack of available funding resulted in the need to contract for this service via the issuance of numerous Letters of Agreement and individual contracts. The Contractor was very cognizant of the funding challenges facing not only this project, but also for Amtrak overall, which had been well publicized in the media. There

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were extensive negotiations between Amtrak and the Contractor resulting in three separate agreements. In addition, due to the restrictive availability of cash flow during this time, there were multiple changes in the scope of work and fluctuations related to the project budget.

Due to the unique nature of Amtrak's financial constraints and the nature of the work required, management within Procurement made the business decision to select Kiewit via a sole-source agreement due to their solid performance record and the belief that they could effectively work within the limitations and constraints that existed in the environment at the time. It is also noted that because Amtrak had audited the contractor on prior projects, they had prior experience understanding the requirements of the IG audit process.

Recommendation 1: Amtrak should exclude any contract language that allows compensation of interest payable to the Contractor on retainage in all future contracts.

Management concurs that as standard practice, Amtrak should not include any contract language that allows compensation of interest payable to the Contractor on retainage.

The inclusion of interest payable language in this case represented an isolated incident due to the unique circumstances related to Amtrak's' financial constraints at the time of contract award. The interest insertion represented an agreement between Amtrak and the Contractor to allay the Contractor's concerns in this area about Amtrak's overall ability to pay its obligations in the future and to be reasonable, fair and equitable under the circumstances. Any interest on monies due the Contractor, applied only to mutually agreed-upon, unwarranted delays in the payment of bona fide amounts due the Contractor. In addition, it is noted that the interest rate used was obtained from a third party reputable source, *The Wall Street Journal*, was capped at 6 percent and subject to downward revision only. It is further noted that the prime rate of interest at the time of contract award was significantly lower. Management contends that the rate and method by which the interest rate was determined was both fair and equitable to Amtrak and the Contractor. It is further noted that no interest was paid to the contractor on retainage owed.

At a minimum without this interest note included, the Contractor would likely have added this risk of delayed payment into its pricing to Amtrak. Furthermore, in being practical about this situation amounts due including retainage is money earned by the Contractor and a liability to Amtrak. A Contractor who is unreasonably delayed in the payment of their retainage or any other monies due without just cause could seek to litigate the matter and would likely seek additional damages (interest, punitive or otherwise) as determined

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by the Court. Therefore, under the circumstances that existed at the time, the inclusion of the interest note in these Contracts gave the Contractor at least some sense of assurance that the retainage or other monies due them would not be delayed due to any further deterioration in Amtrak's financial condition.

Management believes that in very specific and limited circumstances, the use of contract language allowing compensation of interest payable may be in the best interest of the company.

Recommendation 2: Review all existing contracts for similar retainage language and ensure that Amtrak does not agree to the payment of interest to the Contractor on retainage.

Management concurs, and has reviewed existing contracts. At this time, no contracts under Procurement's purview contain interest payable language.

Recommendation 3: Consult with the OIG before inclusion of any contract language that could have a potential impact on the OIG's responsibilities.

Management concurs. While management has the authority to incorporate business decisions that it deems appropriate in regard to contract awards without a prior consultation with the OIG, as courtesy any language that may specifically affect the OIG should be vetted through the OIG before inclusion in contracts. The Chief Logistics Officer will issue guidance by

October 31, 2010 to Procurement personnel reminding them of the need to avoid contract language that could impair the independence and objectivity of external auditors such as the OIG. Management does not believe that the inclusion of the retainage language in this case had such an effect. The 90-day interest payable note represented an acceptable agreement between the contractor and Amtrak under the circumstances that existed at the time. The interest note did not provide the Contractor any additional benefits beyond what any other Contractor would be entitled to in the event Amtrak arbitrarily withheld payment from the Contractor. It is also noted that no interest was paid to the Contractor.

<u>Other Observations</u>

Observation: Kiewit cost of living adjustment rates [redacted] the BLS CPI rate.

The pay increases to certain Contractor management employees assigned to these Amtrak projects were found to be consistent with the Contractor's overall payroll, including OIG increases to employees that were not assigned to Amtrak projects. In addition, the pay increases granted were not limited to the Amtrak contracts alone and were not unreasonable or excessive in nature.

While the increases were not fully in line with COLA for the area, the OIG did not opine on whether the pay increases involved catch-up, talent retention or any other factors that may have accounted for the higher COLA rates.

Procurement further asserts that had contractor personnel assigned to Amtrak projects been limited to the area COLA, that it would not have been beneficial to Amtrak. In fact, this could actually deter higher caliber Contractor staff from Amtrak projects, as those working *non*-Amtrak projects for the same Contractor would be paid more than staff assigned to comparable Amtrak projects with COLA limitations.