DEPARTMENT OF HOMELAND SECURITY
Office of Inspector General
Denton Field Office – Audit Division
3900 Karina Street, Room 224
Denton, Texas 76208

April 28, 2003

MEMORANDUM

TO: Edward Buikema, Regional Director
FEMA Region V

Tonda L. Hadley

FROM: Tonda L. Hadley, Field Office Director

SUBJECT: Lake Country Electric Cooperative
Grand Rapids, Minnesota
FEMA Disaster Number 1283-DR-MN
Public Assistance Identification Number 000-UCVOQ-00
Audit Report Number DD-04-03

The Office of Inspector General (OIG) audited public assistance funds awarded to Lake Country Electric Cooperative (Lake Country) in Grand Rapids, Minnesota. The objective of the audit was to determine whether Lake Country accounted for and expended FEMA funds according to Federal regulations and FEMA guidelines.

Lake Country received an award of $2.10 million from the Minnesota Division of Emergency Management (MDEM), a FEMA grantee, for damages caused by severe thunderstorms in July 1999. The award provided 75 percent FEMA funding for five large projects.[1] We audited the costs of two large projects totaling $1.29 million (61 percent of the total award) and performed a limited review of costs for the remaining projects. The audit covered the period July 4, 1999, to March 15, 2000, during which Lake Country claimed $2.10 million and MDEM disbursed $1.61 million in FEMA funds for direct program costs (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 Lake Country's accounting records, a judgmental sample of expenditures, and other auditing procedures considered necessary to accomplish the audit objective.

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

RESULTS OF AUDIT

Lake Country did not account for and expend FEMA funds according to federal regulations and FEMA guidelines. Lake Country's claim contained $269,660 in questioned costs ($202,245 FEMA share), consisting of costs not consistent with established policies ($250,344), labor costs not related to the disaster ($8,585), duplicate costs ($6,568), and an unapplied credit ($4,163). Further, Lake Country did not follow federal procurement regulations and FEMA guidelines in contracting for $1,593,498 in debris removal and repair work. As a result, fair and open competition did not occur and FEMA had no assurance that contract costs were reasonable.

Finding A: Costs Not Consistent with Established Policies

Lake Country's claim included $250,344 of contract costs that were not consistent with established policies. OMB Circular A-122, Attachment A, paragraph A.2(c) and (d) states that to be allowable under an award, costs must be accorded consistent treatment and must be consistent with policies and procedures that apply uniformly to both federally financed and other activities of the organization. Lake Country, a nonprofit electric distribution cooperative, used two wholly owned for-profit subsidiaries to perform the majority of claimed contract work. The policy, established before the disaster, provided Lake Country discounts on billings from its two subsidiaries. These discounts, which would have reduced contract costs by $250,344, were explicitly excluded for disaster work.

Specifically, Lake Country normally received a 15 percent discount on hourly rates billed by its Lake States Tree Service (LSTS) subsidiary and a 20 percent discount on hourly rates billed by its Lake States Construction (LSC) subsidiary. If this established policy had been followed for disaster work, Lake Country would have received a $100,065 discount from LSC (20 percent of the $500,325 billed[1]) and a $150,279 discount from LSTS (15 percent of the $1,001,862 billed). Therefore, the OIG questioned $250,344 because these costs were not consistent with policies and procedures applied to activities other than disaster work.

Finding B: Labor Costs Not Related to the Disaster

Lake Country's claim included $8,585 in contract labor costs for work not related to the disaster. An invoice provided by Lake Country to support its claim showed these costs were for labor that occurred prior to the disaster. According to 44 CFR 206.223(a)(1), to be eligible for financial assistance, an item of work must be required as a result of the major disaster event. Therefore, the OIG questioned $8,585 for work not related to the disaster.

Finding C: Duplicate Costs

Lake Country's claim inadvertently included $6,568 in duplicate contract costs. This amount was claimed on invoice numbers 18407 and 18408 on Project 439 and again on Project 444. Therefore, the OIG questioned the $6,568 because Lake Country claimed the contract costs twice.

[1] This amount is net of the $19,316 in LSC billings questioned in Findings B and C.

Finding D: Unapplied Credit

Lake Country's claim did not reflect a $4,163 credit adjustment to an invoice for disaster work. OMB Circular A-122, Attachment A, paragraph A.1 states that the total cost of an award is the sum of the allowable direct and allocable indirect costs less any applicable credits. Therefore, the OIG questioned $4,163 because Lake Country did not reduce its claim by the amount of the credit.

Finding E: Unallowable Contracting Procedures

Lake Country did not follow federal regulations or FEMA guidelines in awarding contracts totaling $1,593,498. As a result, fair and open competition did not occur and FEMA has no assurance that contract costs were reasonable. Federal regulations at 44 CFR 13.36:

- State that all procurement transactions will be conducted in a manner providing full and open competition.
- Require that sub-grantees 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.
- Prohibit the use of time and material type contracts unless a determination is made that no other contract is suitable and provided that the contract include a ceiling price that the contractor exceeds at its own risk.

In addition, FEMA's Public Assistance Guide (FEMA Publication 322, October 1999) states:

- Noncompetitive proposals may be used when there is an emergency requirement that will not permit a delay.
- FEMA provides reimbursement for three types of contracts: lump sum, unit price, and cost plus fixed fee.
- Time and materials 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.
- Applicants must carefully monitor and document contractor expenses, and a cost ceiling or "not to exceed" provision must be included in the contract.

Lake Country paid its two wholly owned subsidiaries $1,522,623 for performing disaster work and paid independent vendors an additional $70,875. Lake Country did not compete the work, use written contracts, analyze proposed rates, or maintain records to justify its procurement actions. All work was billed on an hourly basis without cost ceilings. Further, Lake Country could not provide evidence of contract monitoring. Lake Country officials stated that line supervisors performed monitoring, but they were unable to provide evidence to support their statements. Without adequate monitoring, there was no assurance that contractors performed as required and in an efficient manner.

The OIG concluded that Lake Country could have obtained better prices by following proper contracting procedures. In fact, prices granted to Lake Country by its LSC subsidiary were higher than prices offered to the subsidiary's third-party customers. A report[3] posted on Lake Country's web site stated:

> Our review shows that LSC bills LCP differently than it bills unaffiliated third parties. In addition, LCP receives a 20% discount on current billings from LSC. Because of the billing differences, it was difficult to draw exact comparisons, but even after the "20% discount," it appears as though LCP may be charged 19% to 36% more than third parties.

At a minimum, Lake Country should have solicited competitive bids for contract work within days after the thunderstorms and carefully monitored all contract work billed on an hourly basis. Further, after power was restored on July 14, 1999. Lake Country should have competitively procured the remaining work using fixed price contracts because a clear scope of work could have been developed.

RECOMMENDATIONS

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

1. Disallow $269,660 of questionable costs.

2. Develop and implement procedures for future disasters to ensure that subgrantees are knowledgeable of and follow federal regulations and FEMA guidelines related to contracting.

DISCUSSION WITH MANAGEMENT AND AUDIT FOLLOW-UP

The OIG discussed the results of the audit with Lake Country on March 24, 2003, with FEMA on April 7, 2003, and with MDEM on April 21, 2003. Lake Country and MDEM officials agreed with all findings and recommendations.

Pursuant to FEMA Instruction 1270.1, please advise the Denton Field Office, Audit Division, by June 27, 2003, of the actions taken or planned to implement the audit recommendations. Should you have any questions concerning this report, please contact me at (940) 891-8900. The major contributor to this report was Stuart Weibel.

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[3] The web site is http://www.lakecountrypower.com/news/releases/special/AGReport.pdf. The report was titled "Final Study" and was written because of a rate increase made by Lake Country for the December 31, 2000, operating period. The author of the report is unknown.

EXHIBIT

Schedule of Projects
Lake Country Electric Cooperative, Inc.
FEMA Disaster Number DR-1283-MN

Project Number	Category	Amount Awarded/ Claimed	Amount Questioned	Finding Reference
439	A	$ 840,621	$143,056	A, B, D
441	F	445,968	0	
442	A	581,150	87,004	A
443	F	48,882	6,500	A
444	F	183,046	33,100	A, C
Total		$2,099,667	$269,660	