OFFICE OF INSPECTOR GENERAL

For the Millennium Challenge Corporation

AUDIT OF THE MILLENNIUM CHALLENGE CORPORATION'S REGIONAL INFRASTRUCTURE REHABILITATION PROJECT IN GEORGIA

AUDIT REPORT NO. M-000-09-007-P
September 30, 2009

WASHINGTON, DC

Office of Inspector General
Millennium Challenge Corporation

September 30, 2009

Mr. Darius Mans
Acting Chief Executive Officer
Millennium Challenge Corporation
875 Fifteenth Street, N.W.
Washington, DC 20005

Dear Mr. Mans:

This letter transmits the Office of the Inspector General's final report on the Audit of the Millennium Challenge Corporation's Regional Infrastructure Rehabilitation Project in Georgia. In finalizing the report we considered your written comments to our draft report and included those comments in their entirety in Appendix II of this report.

The report contained three audit recommendations for corrective action. As a result of MCC's response to the draft report, we have withdrawn the issue related to recommendation number 2 and renumbered the recommendations. Further, we revised recommendation number 3. We have determined that management decisions have not been reached on recommendations 1, 2 and 3. Please provide my office written notice within 30 days of any additional information related to the actions planned or taken to implement recommendations 1, 2 and 3.

I appreciate the cooperation and courtesy extended to my staff during this audit.

Sincerely,

Alvin A. Brown /s/
Assistant Inspector General
Millennium Challenge Corporation

Millennium Challenge Corporation
1401 H. Street N.W. Suite 770
Washington, DC 20005
www.usaid.gov/oig

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SUMMARY OF RESULTS

In September 2005, the Millennium Challenge Corporation (MCC) signed a 5-year, $295.3 million compact[1] with the Government of Georgia to improve the two main barriers to economic growth -- a lack of reliable infrastructure and the slow development of businesses, particularly agribusiness. The MCC compact in Georgia entered into force in April 2006, formally initiating the 5-year timeline for project implementation and will end in April 2011. In November 2008, MCC and the Georgian Government signed a compact amendment making up to $100 million of additional funds available to the Millennium Challenge Georgia Fund (MCG), thereby increasing the overall value of the compact to $395.3 million. These funds will be used to complete works in the Samtskhe-Javakheti Roads Rehabilitation, Regional Infrastructure Development, and Energy Infrastructure Development Projects contemplated by the original compact. As of August 2009, compact funds disbursed to date were $114.5 million (29 percent).

Based on an analysis of the three different projects (Samtskhe-Javakheti Roads Rehabilitation, Regional Infrastructure Development, and Energy Infrastructure) under the Regional Infrastructure Rehabilitation Project, the audit team elected to review only the roads and regional infrastructure development projects. This audit was conducted to determine whether the MCC's Regional Infrastructure Rehabilitation Project in Georgia was achieving its intended results. The MCC's Regional Infrastructure Rehabilitation Project in Georgia is partially achieving its intended results.

The Regional Infrastructure Development (RID) Project was aimed at improving municipal service delivery. The Project provides grants to eligible government entities (local self-government, municipal enterprise, and central government) for infrastructure. As of June 30, 2009, $9.2 million of a total budget of $64.5 million had been disbursed. The RID Project planned to rehabilitate water supply systems in the cities of Poti, Kobuleti, Kutaisi, Bakuriani, and Borjomi. The audit found that it's too early to determine whether the RID project will achieve its intended results in Kobuleti, Bakuriani, and Borjomi since rehabilitation works is ongoing, and is not scheduled to be completed until the fourth quarter of 2010. However, the RID project is achieving its intended results of rehabilitating water supply systems in Poti, and Kutaisi[2]. For example, the mayor of Poti noted the city once received water every 2 days or 5 to 6 hours a day (such as in the high-rise apartments) but now the city has water 24 hours a day. The mayor of Kutaisi noted that before MCC assistance, the city did not have a proper water supply. During a site visit, the audit team noted that pipes were being laid and connected to individual homes. As of August, 2009, the most recent status report noted that the city water supply network rehabilitation works are ongoing according to the schedule.

The Samtskhe-Javakheti Road Rehabilitation Project (the Road Project) aimed at restoring the road and transport network in the region. With a total budget of $183.6 million, the project plans to rehabilitate the 223.9-kilometer (km) road in Kvemo

[1] A compact is a multiyear agreement between MCC and an eligible country to fund specific programs targeted at reducing poverty and stimulating economic growth.
[2] The municipal water projects in Poti, Kutaisi, and Borjomi are being co-funded through other groups such as the European Bank for Reconstruction and Development (ERBD) and the Swedish International Development Cooperation Agency (SIDA).

Kartli and Samtskhe-Javakheti regions. Rehabilitation of roads in these regions will facilitate the trade and business development. Through May 31, 2009, MCC had disbursed $23.7 million (12.9 percent) of the compact funds for the Road Project. However, the Road Project may not achieve its intended results of fostering economic development in the Samtskhe-Javakheti area as a result of the poor performance of a major contractor responsible for 50 percent of the Road Project. The contractor had only completed 13.8 percent of road construction within a 12-month period and had about 13 months to complete almost 86 percent of the road projects. According to MCC, on July 2009, MCG, with MCC's "no objection," took action to remove from the contractor's contract one section of road and award it to another contractor in an attempt to have the Road Project completed within the compact because the original contractor was behind schedule to complete one of its three road sections (page 8). Also, the major contractor had received an advance payment of $6.5 million for mobilization; however supporting documentation on the use of these funds was not available in order to determine whether the funds were not used for other purposes. The contractor still had not fully mobilized a year after signing a contract with MCG (page 12).

The report includes three recommendations to MCC's vice president of Compact Implementation: (1) to develop and document a MCC/MCG action plan, which details construction milestones and related activities that need to take place, to ensure the Road Project is completed within the time period of the compact; (2) to have MCC request that the Millennium Challenge Georgia Fund obtain from the initial advance the amount of $2.3 million from the contractor, which would now be considered an overpayment; and (3) that MCC have an audit conducted to determine how the advance payment was used to cover the cost of mobilization.

Appendix II contains the management comments in their entirety. In its response, MCC partially agreed with one of the four Recommendations in the draft report (Recommendation No. 1), and disagreed with Recommendations 2, 3, and 4. The OIG believes that Recommendation No's 1 and 4 are still valid: MCC needs to develop and document a MCC/MCG action plan, which details construction milestones and related activities that need to take place, to ensure the Road Project is completed within the time period of the compact. However, based on MCC's response to Recommendation No. 2, we have agreed to remove the issue of whether the major contractor met the financial qualifications, renumbered the recommendations, and revised new Recommendation No. 3 to state that an audit should be conducted to determine how the advance payment was used to cover the cost of mobilization (pages 20-21).

BACKGROUND

Established in January 2004 by the Millennium Challenge Act of 2003, the Millennium Challenge Corporation (MCC) is a U.S. Government corporation designed to work with some of the poorest countries in the world. Based on its performance against MCC's 17 policy indicators, a country may become eligible to receive a compact, which is a 5-year agreement between MCC and the country to fund specific programs and targeted at reducing poverty and stimulating economic growth.

In September 2005, MCC signed a 5-year, $295.3 million compact with the Government of Georgia to improve the two main barriers to economic growth: a lack of reliable infrastructure and the slow development of businesses, particularly agribusiness (see appendix III, *Projects as a Result of Additional Funding*). These two investments focus on rehabilitating regional infrastructure and enterprise development to improve the lives of the poor through improved access to jobs and markets, more reliable access to basic services, and capital and technical assistance for enterprise development. The MCC compact in Georgia entered into force[3] in April 2006, formally initiating the 5-year timeline for project implementation.

In November 2008, MCC and the Georgian Government signed a compact amendment making up to $100 million of additional funds available to the Millennium Challenge Georgia Fund (MCG). These funds, which increased the compact to $395.3 million, will be used to complete works in the Samtskhe-Javakheti Roads Rehabilitation, Regional Infrastructure Development, and Energy Infrastructure Projects contemplated by the original compact.

The Regional Infrastructure Rehabilitation Project of the compact totals $310.6 million and includes the following three activities:

- Samtskhe-Javakheti Road Rehabilitation. The $183.6 million activity will fund rehabilitation and construction of approximately 224 kilometers (Km) of main road traversing the Samtskhe Javakheti region. (See appendix IV, *Map of Road Project.*)
- Energy Infrastructure. The $62.5 million activity will be used to rehabilitate the North-South Gas Pipeline that fuels electric power generation and provides heat to homes and businesses, and to further develop and implement the Georgian government's energy sector strategy.
- Regional Infrastructure Development. The $64.5 million activity will fund regional and municipal physical infrastructure for water supply, sanitation, irrigation, municipal gasification, roads, and solid waste in regions outside of Tbilisi.

In Georgia, 54 percent of the population living outside of its capital city, Tbilisi, lives in poverty. By focusing on rehabilitating regional infrastructure and promoting private sector development, the compact will directly benefit approximately a half-million Georgians. In addition, over one quarter of the population of the country will receive

[3] According to MCC officials, entry into force is the point at which a binding commitment is recognized and compact funds are obligated.

indirect benefits from the compact; for example, the reliable transmission of gas will reduce environmental, health, and safety risks.

The Regional Infrastructure Rehabilitation Project enables agricultural and other suppliers to more easily connect with consumers. The project will improve the lives of the Georgian poor by helping them to integrate economically through improved access to jobs and markets, and by providing more reliable access to basic services such as heat and electricity.

AUDIT OBJECTIVE

The Office of the Assistant Inspector General for the MCC conducted this audit as a part of its fiscal year 2008 audit plan. The objective of this audit was to answer the following question:

- Is the Millennium Challenge Corporation's Regional Infrastructure Rehabilitation Project in Georgia achieving its intended results?

Appendix I contains a discussion of the audit's scope and methodology.

AUDIT FINDINGS

Is the Millennium Challenge Corporation's Regional Infrastructure Rehabilitation Project in Georgia achieving its intended results?

The Millennium Challenge Corporation's (MCC) Regional Infrastructure Rehabilitation Project in Georgia is partially achieving its intended results. For example, the Regional Infrastructure Development (RID) Project, whose aim is to improve municipal water service delivery, is achieving its intended results of rehabilitating water supply systems in two (Poti, and Kutaisi) of five cities. It is still too early to determine whether the RID project will achieve its intended results in Kobuleti, Bakuriani, and Borjomi since rehabilitation works are still ongoing and are not scheduled to be completed until the fourth quarter of 2010. However, the Samtskhe-Javakheti Road Rehabilitation Project (the Road Project) may not meet its intended results because the Road Project is currently behind schedule due to several issues noted below. For example, one contractor who is responsible for completing more than 50 percent of the total road project has only completed about 13.8 percent of road construction within a 12-month period (April 2008 to April 2009). Because the construction season lasts only 7 months (April to October) of the year, this contractor has about 13 months to complete almost 86 percent of its road projects. As a result, economic development in the Samtskhe-Javakheti area may not be realized.

<u>Water Supply Rehabilitation</u>

The audit found that the RID project was achieving its intended results of rehabilitating municipal water supply systems in the cities noted above. The rehabilitation work consisted mostly of constructing water pipelines and new chlorination plants, rehabilitating reservoirs and pumping stations, establishing distribution networks, and supplying and the installating water meters in households.

Photograph of new chlorination plant in Poti, Georgia, taken by OIG Auditor on June 1, 2009.

In Poti, the construction of the new water system at Grouli Spring Source has been completed as well as the new chlorination plant. Households have received new water meters and citizens are now receiving water 24 hours per day.

Photograph of Old Soviet Pumping Station in Kutaisi, Georgia, taken by OIG Auditor on June 2, 2009.

In Kutaisi, the city water supply network rehabilitation works are ongoing, with pipes being laid and hooked up to households.

The audit team met with the mayors of Poti and Kutaisi. The mayor of Poti thanked MCC for the water project and hoped MCC has more funds for other projects like the sewer system and investments, and also stated that citizens are feeling the impact of the new water system. They once received water every 2 days or 5 to 6 hours a day but now they have water 24 hours a day. The mayor of Kutaisi thanked the United States for assisting Georgia in improving the vital water supply infrastructure. According to the mayor, under Soviet control, the Soviets could not create a proper water supply. Without U.S. assistance, it would have remained a problem for many years.

Photograph of new pipe being laid in Kutaisi, Georgia, taken by OIG Auditor on June 2, 2009.

Road Rehabilitation

The Samtskhe-Javakheti Road Rehabilitation Project (the Road Project) may not meet its intended results because the Road Project is currently behind schedule due to several issues. The audit found that the initial road design was flawed because it was not physically validated before being finalized. The consulting firm responsible for the road design was unable to actually visit the road during the winter months. This resulted in the design not always corresponding with the existing cross sections and road alignments. Also, the supervising engineer stated in May 2009 that the road design did not show a former military facility near the Turkish border where the road was being realigned to bypass protected trees.

Photograph of old Soviet tank buried in hillside near Turkish Border and town of Kartsakhi, Georgia, which would be in the path of the planned road. Photograph taken by OIG Auditor on May 28, 2009.

The supervising engineer believed that the road design could not be used 70 percent of the time because of design problems. MCC did not agree with the supervising engineer's percentage rate, and thought the rate to be much lower.

Road Project procurements were delayed because the first set of bids were rejected for being too high, and rebidding delayed the commencement of three sections of the road projects by about 8 months. A contractor was finally awarded a contract for three road sections on March 20, 2008, with a commencement date of April 2, 2008. According to MCC, in July 2009, MCG, with MCC's "no objection," took action to remove from the contractor's contract one section of road and award it to another contractor in an attempt to have the Road Project completed within the compact.

Initial weak oversight by the former project management consultant and supervisory engineer team leaders resulted in actions not being taken to ensure that the Road Project was on schedule for completion. MCG's evaluations of the project management consultant and supervisory engineer for the period March through December 2008 stated that improvement was needed on monitoring and supervising the project.

Finally, the contractor responsible for three sections of the Road Project received an advance payment of $6.5 million that may not have been used entirely for mobilization. As of April 2009, a year after the contractor been awarded the contract, the contractor still had not fully mobilized. A lack of documentation to support the advance payment may increase the risk that the advance payment could have been used for purposes other than mobilization.

MCC and MCG have taken actions to resolve the issues. However, these actions may not be enough to ensure the Road Project will be completed on schedule.

These issues will be further discussed below.

Road Construction Activities Are Behind Schedule Which Could Result in Not Achieving Intended Results

Summary: Road construction activities are behind schedule because a major contractor responsible for 50 percent of the Road Project completed only about 13.8 percent of road construction within a 12-month period. With a road construction season of only 7 months, this contractor has about 13 months remaining to complete almost 86 percent of its road projects. The Conditions of Contract for Works of Civil Engineering Construction prepared by the Fédération Internationale des Ingénieurs Conseils (FIDIC), subclause 43.1, *Time for Completion*, states that the contractor shall complete section 1 in 24 months and sections 2 and 3 in 30 months from the commencement date. Subclause 46.1, *Rate of Progress*, states that if for any reason the rate of progress of work is too slow to comply with the *Time for Completion* sub-clause, the engineer shall notify the contractor who shall take the necessary steps to expedite progress to comply with the *Time for Completion*. Further, the initial road design was flawed because it was not physically validated before being finalized. In addition, road projects procurements were delayed because the first set of bids were rejected for being too high, and rebidding delayed the commencement of three

sections of the road projects by about 8 months. Also, weak oversight by team leaders resulted in actions not being taken to ensure that the Road Project was on schedule for completion. Finally, poor performance by the contractor led to road construction being behind by as much as 4 months as of April 2009. As a result, if the Road Project is not completed, its intended results of fostering economic development in Georgia may not be achieved.

The compact with Georgia may not meet its intended results because the Road Project is currently behind schedule due to:

- Poor Performance by a Major Contractor
- Initial Road Design Flawed
- Delayed Road Projects Procurements
- Weak Oversight by Team Leaders

Poor Performance by a Major Contractor

The supervisory engineer stated in its April 2009 report that due to the lack of proper management ability, a major contractor cannot complete the work on one of its sections by April 1, 2010, as per contract requirements. The project management consultant's April 2009 quarterly report also noted that the financial progress over the last three months indicated an increasing delay, against the original forecast, of about 4 months. According to the supervising engineer's April 2009 quarterly report, the contractor had completed only 13.8 percent of road construction (30.9 km out of 224 km) within 12 months (April 2008 to April 2009). The supervising engineer further noted that "Actual progress of the works is substantially behind on [one section]. There is a lot of work to be executed within 7 to 8 months in order to complete on time." This contractor is responsible for three sections (more than 50 percent) of the Road Project, and must complete one section by April 1, 2010, and two sections by October 1, 2010. Due to a construction season of only 7 months (April to October), this contractor has about 13 months to complete about 86 percent of its road sections.

According to the project management consultant's quarterly report, this contractor's management of the project continues to be of concern. During the winter construction break, activities should have concentrated on finalization of working drawings, including identification and resolution of any problem areas. Additionally, planning for production of construction materials, particularly crushed stone, had not taken place and the primary crushing facility had not been established. Similarly, obtaining necessary permits, the contractor's responsibility, had not progressed. Further, the project management consultant stated in its April 2009 quarterly report that "without effective management and resourcing, it is unlikely that substantial completion of [one of the sections] can be achieved by November 2009." (Construction stops from November to March due to severe winter conditions.)

FIDIC, subclause 43.1, *Time for Completion*, states that the contractor shall complete section 1 in 24 months and sections 2 and 3 in 30 months from the commencement date. Subclause 46.1, *Rate of Progress*, states that if for any reason the rate of progress of work is, in the opinion of the engineer, too slow to comply with the *Time for Completion*, the engineer shall notify the contractor who shall take the necessary steps, subject to the engineer's consent, to expedite progress so as to comply with the *Time for Completion*. The contractor received letters in May and June 2009 from MCG, referred to as Clause 46 Notices under the Conditions of the Contract, which questioned the contractor's ability to complete the road projects within the stated time period. A Clause 46 Notice could lead to the termination of the contract.

MCG was aware that the contractor was behind schedule as early as October 2008 when the project management consultant stated in a monthly report that the contractor was about 3 months behind schedule. The first of three key team leaders was replaced in February 2009, and the last team leader was replaced in June 2009 (as discussed below in *Weak Oversight by Team Leaders*). In addition, MCG was aware that the contractor was not fully mobilized as late as March 2009, which could be an indication that the contractor was not prepared to meet the contract requirements. Despite the contractor's poor performance, the supervising engineer continued to certify and MCG continued to pay the contractor for services rendered, totaling about $9.3 million as of May 8, 2009. According to MCC, in July 2009, MCG, with MCC's "no objection," took action to remove from the contractor's contract one section of road and award it to another contractor in an attempt to have the Road Project completed within the compact.

Initial Road Design Flawed

The supervising engineer's quarterly report for January through March 2009 stated that "there are plenty of road sections in which the original design was not always corresponding with the actual condition situation." For example, the original design did not always correspond with the existing cross sections and road alignments. Also, the supervising engineer stated in May 2009 that the road design did not show the military facilities near the Turkish border where the road was being realigned to bypass protected trees. The supervising engineer believed that the road design could not be used 70 percent of the time because of problems with the design. However, an MCC official indicated that the percentage was overstated. In addition, a MCC official stated that MCG had hired consultants who provided faulty locations of utilities to the firm that developed the road design. These faulty locations further created additional road design flaws. As a result, new utility locations had to be identified before construction could continue.

According to a MCC official, the design firm responsible for the Feasibility Study, the Environmental Assessment Plan, the Resettlement Action Plan, and the evaluation of bids could not start fieldwork for the road design because of the winter months. The MCC official further stated that once the design firm started its fieldwork, it came under pressure from MCG to meet deadlines and therefore did not have time to validate the road design in the field. A consultant retained by MCC, the prior project management consultant, and the prior supervising engineer all reviewed the road design and made comments but their reviews were paper-based only. The MCC official acknowledged that the firm should have physically validated the road design in the spring of 2007, which would have eliminated some of the problems.

Delayed Road Projects Procurements

MCG posted its first bids for six road sections of the Road Project on April 23, 2007. However, MCG rejected those bids for being too high and rebid on October 24, 2007. A contractor was awarded a contract for three road sections on March 20, 2008, with a commencement date of April 2, 2008. This rebidding delayed the commencement of three sections of the road projects by about 8 months, based on a successful first bid in April 2007 and a contractor's commencement date of August 2007.

A contract was signed for two sections of the road project on May 14, 2008, with a May 28, 2008, commencement date. Completion dates of the two road sections were 30 months after the commencement date. However, due to the difficulties with the contractor's original joint venture partner, another joint venture partner was assigned, which resulted in no permanent works being performed during 2008. Contracts were awarded for two sections on April 27, 2009, with completion dates of 18 months because the sections were of shorter length than in the original tender. The remaining contract was awarded for the last section on June 12, 2009, also with a completion date of 18 months because the road section was also a shorter length than in the original tender.

Weak Oversight by Team Leaders

The team leaders for the project management consultant, the supervising engineer, and the contractor provided weak oversight of the Road Project. As a result of this weak oversight, team leaders did not take actions to ensure that the Road Project was on schedule. In an attempt to improve oversight, all of these team leaders were replaced.

The team leader for the project management consultant was hired in June 2007, 13 months after the compact's entry into force. MCG's evaluation of the project management consultant for the period April through December 2008 stated that the consultant needed improvement on monitoring the project in a timely manner. The consultant also needed to improve supervising the work of the supervising engineer and monitoring the work on construction contractors, including undertaking site visits. The project management consultant's team leader was replaced in May 2009, about 2 years after being assigned to that position.

The team leader for the supervising engineer was hired in April 2008, at the onset of the major contractor's road contract. MCG's evaluation of the supervising engineer for the period March through December 2008 stated that the team leader was not an effective manager and required "a much firmer attitude" toward construction contractors. The team leader was also consistently reluctant to make any engineering design decisions. The project management consultant stated in its October 2008 quarterly report that it had written a letter to MCG on September 12, 2008, regarding the performance of the supervising engineer. The project management consultant noted in the letter that the engineer's office in Tsalka was in pristine condition and gave no indication of use. This office was expected to be the field staff's central base. The supervising engineer's team leader was replaced in February 2009, about 10 months after being assigned to that position.

The team leader for a major contractor provided weak oversight. MCG's evaluation of the contractor for the period March through December 2008 stated that the team leader had some problems in management and with subcontractors. As early as July 2008, the project management consultant discussed with MCG its concerns about the experience of the contractor's project management team, particularly the contractor's failure to appreciate the contract requirements. Further, the supervising engineer commented in its April 2009 quarterly report on the contractor's lack of proper management ability. The supervising engineer requested in June 2009 that the contractor's team leader be replaced, about 14 months after the commencement date of the contract.

If the Road Project is not completed, its intended results of fostering economic development through (1) increasing exports of agricultural products from the region; (2) increasing social, political and economic integration of the local population with the rest of Georgia; (3) expanding international trade; (4) developing the tourism potential of Vardzia, a World Heritage site; and (5) complementing other road development projects may not be achieved.

To move the Road Project toward completion, this recommendation addresses the road construction being behind schedule rather than each individual cause.

> *Recommendation No. 1: We recommend that the Millennium Challenge Corporation's vice president for Compact Implementation develop and document a Millennium Challenge Corporation/Millennium Challenge Georgia Fund action plan, which lays out construction milestones and related activities that need to take place, to ensure the Samtskhe-Javakheti Road Rehabilitation Project is completed within the time period of the compact.*

Lack of Documentation to Support Advance Payment of $6.5 million Used for Mobilization

Summary: The contractor responsible for three sections of the Road Project received an advance payment of $6.5 million that may not have been used for mobilization. The Bidding Document Volume II, for the Road Project, issued on October 24, 2007, for the Road Project states that MCG shall make an advance payment to the contractor. The supervising engineer certifies that the contractor has received an unconditional bank guarantee in written form and by a bank acceptable to MCG in an amount equal to the advance payment. The bank guarantee indicates the bank will pay in the event that the contractor used the advance payment for purposes other than the costs of mobilization. Documentation could not be provided to support the amount of funds used for mobilization. As of April 2009, a year after the contractor had signed a contract with MCG, the contractor still had not fully mobilized. As a result, the lack of documentation to support the advance payment increases the risk that the advance payment could be used for purposes other than mobilization.

The contractor received an advance payment of $6.5 million (10 percent of the contract price) on April 23, 2008, about 1 month after it signed a contract with MCG to rehabilitate three sections for the Road Project. On May 1, 2008, the contractor submitted an invoice, with supporting documentation (bank guarantee), requesting the advance. This advance payment was to be used for mobilization, which consists of the preparation for works and operations and can include the movement of personnel, equipment, and supplies to the project site. To receive the advance payment, the contractor must submit an unconditional bank guarantee in writing.

The contractor submitted the required bank guarantee, dated April 16, 2008. According to the guarantee, the bank stated "At the request of the contractor, we … hereby irrevocably undertake to pay you any sum or sums not exceeding in total an amount of USD$6,546,753 upon receipt by us or your first demand stating that the contractor is in breach of its obligation under the contract because the contractor used the advance payment for purposes other than the costs of mobilization in respect of the works."

The contractor may not have used the advance payment for mobilization. The supervising engineer's quarterly report for January through March 2009, dated April 2009, stated that the contractor's mobilization was not complete. For example, the facilitation of the laboratory in Tsalka was still under progress by the end of March 2009, and bigger crushing plants and concrete plants were not operational. This was about 1 year after receiving the advance payment. Although the contractor had increased the number of engineers and other employees at the site, the supervising engineer noted that the nonpresence of senior management personnel reduced the contractor's capacity to produce plans and drawings for approval. Additionally, a software project spreadsheet provided by the supervising engineer, during the audit, on the status of the contractor's projects indicated that for all three sections, the contractor had only completed about 13 percent of its portion of the road project.

The project management consultant, the supervising engineer, and MCG were not able to provide documentation establishing what had been spent by the contractor on mobilization. A lack of documentation was also noted during a review of the contractor's invoices. For example, several e-mails between the prior project management consultant's team leader and the prior supervising engineer's team leader related to a lack of supporting information for some earthwork items lacking volume calculations. According to one e-mail, "Earthworks represents 65% of the total contract price and it is clearly essential to provide full supporting documentation as early as possible." In addition, an audit conducted by a major accounting firm for the period July 1 through December 31, 2008, identified the lack of supporting documentation as a material weakness. The e-mail from the project management consultant's team leader, dated December 11, 2008, indicated that the team leader had expressed concern to the supervising engineer's team leader on many occasions concerning supporting documentation for the contractor's invoices.

The audit team spoke with an official with the Maryland State Highway Administration that we contacted made the following statement when questioned about a contractor spending over a year to mobilize: "*I would anticipate that actions would have been taken by the administrating office to alert the contractor of non performance and/or stop payment and/or notify the bonding company."*

Under Bidding Document Volume I, issued on October 24, 2007, for the Samtskhe-Javakheti Roads Rehabilitation Project, Contract No. Four - Lots 1-6, Section IV, Part II: Conditions of Particular Application (COPA), sub-clause 60.7, *Advance Payment*, states that MCG shall make an advance payment to the contractor. The advance payment will be made after the supervising engineer certifies that the contractor has received an unconditional bank guarantee in written form and by a bank acceptable to MCG in an amount equal to the advance payment. MCC will retain the right to approve the form and substance of the bank guarantee. Further, according to the bidding document, Item 101, *Contractor's Mobilization and Site Installation*, "This item shall consist of preparatory works and operations, including but not limited to, those necessary for the movement of personnel, equipment, supplies and incidentals to the Project site; for the establishment of all contractor's offices and buildings or other facilities necessary for work on the project, including removal after completion of the works."

There was an apparent lack of internal control processes and policies related to supporting documentation regarding the expenses involving advance payments; specifically, when the contractor fails to use advance payments in a timely manner. Without a clear understanding of what has been spent on mobilization, MCC and MCG would be unable to provide supporting documentation to the bank reflecting that the contractor was in breach of its obligation under the contract because the contractor used the advance payment for purposes other than the costs of mobilization in respect to construction works.

MCC stated the following:

> "Advance payments are provided to enable a contractor to cover cash flow requirements (i.e., the lag between incurring costs and getting paid for them) during mobilization and the early phases of a project. These costs are much higher and extend beyond the items covered in Bill Item 101: Contractor's Mobilization and Site Installation.
>
> Advance payments are secured against a bank payment guarantee and do not normally require backup as to what they are being expended for. In addition, the contract provides for amortization of the advance payment against future invoices for works completed. Calling an advance payment guarantee would be justified if, for example, a contractor were to fail to mobilize and start work on a project, which is not the case with [this contractor].
>
> The issue of documentation of interim payments raised by [the accounting firm] has been addressed by MCG in a separate document. Regarding [the contractor's] poor performance, today, MCG as Employer and [the supervising engineer] under the construction contract are taking measures to rectify the situation. Following the issuance of a series of formal contractual notices (the Clause 46 Notices referred to on page 10), MCG is in the process of removing [one section from the contractor's] contract, and warning the firm that additional measures would be taken if its performance on [two other sections] does not improve within a month."

Since the advance payment was based on 10 percent of the contractor's contract price (about $6.5 million) for three sections, then MCG should recover about $2.3 million from the contractor, the advance payment received for that section. Also, because the contractor has a record of poor performance and has not fully mobilized in more than a year, MCC should recover the amount of funds initially provided for mobilization.

In its response to the draft report, MCC stated, "At the time of the removal of one lot (out of a total of three) from the construction contract, MCG negotiated a settlement with the contractor. In exchange, the contractor agreed to vacate the removed section and to enter into a release where under it released MCG and others from any and all claims and actions related to the removed section. Reduction of the amount of the advance payment already paid was not part of the settlement." Further, MCC stated that "the contractor provided a reference letter from its bank that the contractor's parent could raise $15 million for the cash requirements of the roads project. The contractor could have accessed the funds referenced in the letter either directly or through its parent. If such is true, then an advance payment for cash flow support would not be needed". Since MCG negotiated a settlement with the contractor which would impact our Recommendation concerning the return of any additional funds provided for mobilization, and since the OIG still believes that an audit should be conducted, we are revising Recommendation No. 3 to determine how the advance payment was used to cover the cost of mobilization

> *Recommendation No. 2: We recommend that the Millennium Challenge Corporation's vice president for Compact Implementation request that the Millennium Challenge Georgia Fund obtain from the contractor from the initial advance, the amount of $2,316,824.27, which would now be considered an overpayment on the section.*

> *Recommendation No. 3: We also recommend that the Millennium Challenge Corporation's vice president of Compact Implementation have an audit conducted to determine how the advance payment was used to cover the cost of mobilization.*

Other Issues

The OIG noted one other issue during its fieldwork related to a report issued by a MCC contractor hired to review the environmental compliance of one of the contractors. Although the audit team did not verify the issues noted while on site, they did discuss these issues with MCC officials in headquarters to determine the actions taken by the MCC and the MCG to address the issues noted by the contractor. Further, this audit includes this issue because the contractor who failed to comply with environmental requirements was the same contractor responsible for a most of the Road Project.

Contractor Did Not Comply With Environmental Requirements

One of the three contractors working on the Road Project was not in compliance with the environmental requirements of its contract with MCG. A firm hired by MCC that specialized in environmental planning and assessment stated in its first field mission report, dated November 20, 2008, that the clearing contractor removed a number of protected species, *Taxus Baccata*, which were identified in both the Environmental Impact Assessment (EIA) study and the Environmental Management Plan (EMP). Further, the firm noted the following in its February 2009 report: (1) the contractor improperly handled and stored oil and lubricants at one of its camps, and no drip trays or secondary containments were available; (2) the volume of the secondary containment of the diesel tank at another camp was too small and did not comply with the Pollution Prevention Plan; and (3) water from the vehicle washing facility at another camp flowed untreated into the ditch and away from the camp site.

Subclause 5.3 of the contract states that the contractor and subcontractors shall comply with MCC's Environmental Guidelines. Sub-clause 19.1 of the contract *Safety, Security,* *and Protection of the Environment*, states the contractor must apply the recommendations of the project's EIA study and the EMP. Based on the firm's reports, as a result of the contractor not complying with the environmental requirements, there is an increased risk of even greater environmental issues.

According to MCC, MCG has made significant improvements, including:

- Replacing the team leaders of the project management consultant and the supervisory engineer;
- Requesting changes in the management at the contractor;
- Increasing staffing of the supervisory engineer and contractor;
- Requiring improvements in environmental oversight by the supervisory engineer and the project management consultant, which resulted in the issuance of citations and withholding of payment for environmental management and mitigation measures; and
- Requesting that the pre-construction survey be completed before significant actions are taken, and the survey is now underway.

In addition, MCG has been fully engaged and proactive it identifying and managing specific environmental compliance issues. For example, during the initial clearing of the contractor's section of the road, a total of four protected Yew trees were cut by the contractor's clearing subcontractor. The contractor was fined by the Ministry of the Environment (MOE). Additionally, in order to remedy the tree issue and avoid further adverse impacts, MCG established a group of specialists, including MCG, the designer, the construction contractor, the National Park Authority, MOE, geographical information system (GIS) specialists, and biologists. They took the following actions:

- Reviewed the legal situation;
- Studied the potentially affected area in detail by preparing accurate GIS maps of boundaries of the road and property and identification of protected species;
- Demarcated the southern border of the Algeti National Park in areas where the existing road is either close to or cuts into the park for several meters;
- Reviewed the road delineation and design in order to avoid any damage; and
- Revised the contractor's environmental management plan to identify critical areas and the necessary monitoring and mitigation requirements.

Based on the actions taken by MCG and MCC, this audit is not making a recommendation.

EVALUATION OF MANAGEMENT COMMENTS

The MCC provided written comments to our draft report that are included in their entirety in Appendix II. In its response, MCC, partially agreed with the first recommendation, but disagreed with the remaining three recommendations.

Recommendation No. 1 in the draft report we recommended that MCC develop and document an action plan, which lays out construction milestones and related activities that need to take place, to ensure the Samtskhe-Javakheti Road Rehabilitation Project is completed within the time period of the compact. MCC partially concurs with this recommendation. According to MCC, it and the Millennium Challenge Georgia Fund (MCG) have taken steps to remedy this poor performance including (i) threatening to terminate the underperforming contractor's contract, (ii) removing one of the lots from this contractor's contract, (iii) replacing the team leader of the project management consultant, and (iv) replacing key and support staff of the engineer. In addition, MCC stated that MCG and the engineer have increased their monitoring of construction activities with greater site visits and more frequent progress reports. At the end of this construction season, MCC stated that it and MCG will assess progress and determine what steps will be necessary to ensure completion within the term of the Compact. MCC stated that the delays on the Samtskhe-Javakheti Road Rehabilitation Project are not due to a lack of an action plan but rather poor performance. It is for this poor performance reason that we made the recommendation for MCC to develop and document a Millennium Challenge Corporation/Millennium Challenge Georgia Fund action plan, which lays out construction milestones and related activities that need to take place, to ensure the Samtskhe-Javakheti Road Rehabilitation Project is completed within the time period of the compact. We agree that both the MCC and MCG have taken steps to ensure completion of the project. It is the steps that MCC and MCG plan to take at the end of this construction season that we want MCC and MCG to develop and document in an action plan that will ensure completion of the road project within the term of the Compact. It would appear that is what MCC and MCG intend on doing. However, until an action plan is provided to us, a management decision has not been reached.

Recommendation No. 2 in the draft report we recommended that MCC develop and implement procedures for providing technical evaluation panels the guidance for determining financial or technical qualifications of a perspective contractor. MCC disagrees with this recommendation. MCC stated that this guidance is already provided by MCC in the Program Procurement Guidelines, which are periodically reviewed and revised accordingly. MCC stated that the OIG makes this recommendation based on its conclusion that Ashtrom International Ltd. ("Ashtrom International"), a bidder on roads works, was not a qualified bidder based on certain financial requirements. MCC believes that the process followed by MCG in assessing the financial qualification of Ashtrom International was correct and reasonable. In addition, MCC stated that it believes that Ashtrom International was a qualified bidder. However, most of the MCC discussion focused on the Contractor's potential ability to rely on its parent or subsidiary companies financials to meet the financial qualifications. The OIG is still concerned that without an agreement between the contractor and its parent related to the ability of the contractor to obtain funding as needed, the contractor may not have met the financial qualifications. However, the OIG does agree that the evaluation committee conducted an appropriate financial review. Since this was the only instance where it appeared a contractor may not have met the financial qualifications, and the evaluation committee did conduct an appropriate review, we have removed this issue from the body of the report.

Recommendation No. 3 in the draft report (Recommendation No. 2 in this final report) we recommended that MCC request that the Millennium Challenge Georgia Fund obtain from the contractor from the initial advance, the amount of $2,316,824.27, which would now be considered an overpayment on the section. MCC disagreed with the recommendation. MCC stated that OIG makes this recommendation based on their finding that the contractor responsible for three sections of the road project received an advance payment of $6.5 million that may not have been used for mobilization. According to MCC, the amount listed in the recommendation is the portion attributable to the lot removed from the contract. At the time of the removal of one lot (out of a total of three) from the construction contract, MCG negotiated a settlement with the contractor. MCG removed a lot from the contract, reduced the dollar value of the contract, revised certain rates in the bill of quantities, agreed the amount of the retention to be returned to the contractor at the time of taking over, and reduced the value of the performance security required. According to MCC, in exchange, the contractor agreed to vacate the removed section and to enter into a release where under it released MCG and others from any and all claims and actions related to the removed section. Reduction of the amount of the advance payment already paid was not part of the settlement. The OIG was not aware of any negotiated settlement until our exit conference with MCC. At such time the OIG requested a copy of the settlement, and based on our review of the settlement, the OIG would consider deleting this recommendation. However, MCC did not provide a copy of the settlement along with their response. As a result, the OIG is retaining the recommendation, and does not consider that a management decision has been reached on this recommendation. We will await a copy of the negotiated settlement in order to determine if a management decision has been reached.

Recommendation No. 4 in the draft report (Recommendation No. 3 in this final report) recommended that MCC have an audit conducted to determine the amount of additional funds initially provided for mobilization, which should be returned. MCC disagrees with this recommendation. According to MCC advance payments are provided to contractors for two purposes -- to cover the cost of mobilization and for cash flow support. The second of the two purposes is to enable a contractor to cover cash flow requirements (i.e., the lag between incurring costs and getting paid for them) during the early phases of a project. Further, advance payments are secured against a bank payment guarantee. In addition, the advance payment is disbursed only after the contractor has provided a performance security as well. In addition, MCC stated that advance payments do not normally require backup as to what they are being expended for. In fact, the generally accepted international form of construction contract does not require an accounting of the proceeds of the advance payment made to contractors. MCC believes it should continue to follow generally accepted industry practice in this regard. In MCC's response to whether the contractor met the financial qualifications, MCC stated that the contractor provided a reference letter from its bank that the contractor's parent could raise $15 million for the cash requirements of the roads project. According to MCC, the contractor could have accessed the funds referenced in the letter either directly or through its parent. The OIG believes that if such is true, then an advance payment for cash flow support would not be needed. Further, the language in the bank guarantee letter states, *"that the contractor is in breach of its obligation under the contract because the contractor used the advance payment for purposes other than the costs of Mobilization in respect of the works."* Further, the OIG believes that there is an increased risk that funds provided to the contractor under the advance payment may have been used for purposes other than mobilization since mobilization was slow. Therefore, the OIG believes that an audit should be conducted to determine how the advance payment was used to cover the cost of mobilization. Because the OIG did not agree with MCC's response, a management decision was not reached.

SCOPE AND METHODOLOGY

Scope

The Office of Inspector General conducted this performance audit of the Millennium Challenge Corporation's (MCC) program in Georgia in accordance with generally accepted Government auditing standards. Those 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 objective(s). We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. The audit reviewed the projects from the April 7, 2006, the entry-into-force date, to August 19, 2009. Through August 2009, MCC had disbursed $114.5 million of the compact funds out of the total $395.3 million. From a total of $183.62 million for the Road Project, $23.7 million had been disbursed through May 31, 2009. From a total of $64.5 million for the Regional Infrastructure Development Project, $9.2 million has been disbursed through June 30, 2009.

We conducted the audit at MCC headquarters in Washington, DC, and at Millennium Challenge Georgia (MCG) in Tbilisi, during a site visit from May 18 through June 5, 2009. During the site visit, we interviewed various beneficiaries in Poti and Kutaisi who received the benefits from a new rehabilitated water supply system. We also met with the supervising engineer and project management consultant along with the contractors for the roads and bridges, and visited two of the three road project sites. Our audit work represented 62.7 percent of the total compact funding.

To reach our conclusions regarding MCG's Regional Infrastructure Development and Samtskhe-Javakheti Road Rehabilitation Projects, we relied on interviews with MCC staff, MCG staff, contractors, and implementing entities. We used these interviews to help assess the program's work plans, financial reports, quarterly progress reports, and the monitoring and evaluation plan. We also examined supporting documentation from the contractor's and implementing entities' reports and MCG quarterly progress reports.

We examined the internal control environment by identifying and assessing the relevant controls. We tested for various controls, including supporting documentation, verification procedures, and guidance. In addition, we reviewed prior audit reports and considered relevant findings.

We also depended on the work of a firm hired by MCC that specialized in environmental planning and assessment.

Methodology

To answer the audit objective, audit steps were established to determine the following:

- Whether MCG had established plans and milestones to monitor and implement the compact's projects, and

- Whether the program was on schedule according to the established plan and milestones.

- Based on an analysis of the three different projects (Samtskhe-Javakheti Roads Rehabilitation, Regional Infrastructure Development, and Energy Infrastructure) under the Regional Infrastructure Rehabilitation Project, the audit team elected to review only the roads and regional infrastructure development projects.

Specifically, we performed the following activities:

- Interviewed MCC personnel, MCG staff, and implementing partners to gain an understanding of the overall objectives of the program and its challenges.

- Conducted a detailed examination of supporting documentation for the two projects we reviewed to verify that intended results were being achieved. The examination consisted of reviewing relevant documentation, conducting interviews, and making site visits.

- Interviewed beneficiaries to determine how MCC-funded programs had affected their lives.

- Determined the potential impact of achieving or not achieving selected milestones and targets.

MANAGEMENT COMMENTS

MILLENNIUM
CHALLENGE CORPORATION
UNITED STATES OF AMERICA

DATE: September 24, 2009

TO: Alvin Brown
Assistant Inspector General for the Millennium Challenge Corporation

FROM: Michael Casella
Acting Vice President for Administration and Finance,
Millennium Challenge Corporation /s/

SUBJECT: MCC Management Response to the Draft Report of the Audit of the Millennium Challenge Corporation's Regional Infrastructure Rehabilitation Project in Georgia

The MCC appreciates the opportunity to respond to the draft report on the Audit of the Millennium Challenge Corporation's Regional Infrastructure Rehabilitation Project in Georgia.

Recommendation No. 1: ***We recommend that the Millennium Challenge Corporation's Vice President for Compact Implementation develop and document a Millennium Challenge Corporation/Millennium Challenge Georgia Fund action plan, which lays out construction milestones and related activities that need to take place, to ensure the Samtskhe-Javakheti Road Rehabilitation Project is completed within the time period of the Compact.***

MCC partially concurs with this recommendation. MCC recognizes the importance of an action plan to ensure timely completion, but the delays on the Samtskhe-Javakheti Road Rehabilitation Project (SJRRP) are not due to a lack of an action plan but rather poor performance. MCC and the Millennium Challenge Georgia Fund (MCG) have taken steps to remedy this poor performance including (i) threatening to terminate the underperforming contractor's contract, (ii) removing one of the lots from this contractor's contract, (iii) replacing the team leader of the project management consultant, and (iv) replacing key and support staff of the engineer. In addition, MCG and the engineer have increased their monitoring of construction activities with greater site visits and more frequent progress reports. At the end of this construction season, MCC and MCG will assess progress and determine what steps will be necessary to ensure completion within the term of the Compact.

<u>Recommendation No. 2:</u> We recommend that the Millennium Challenge Corporation's Vice President for Compact Development develop and implement procedures for providing technical evaluation panels the guidance for determining financial or technical qualifications of a perspective contractor.

MCC disagrees with this recommendation. This guidance is already provided by MCC in the Program Procurement Guidelines, which are periodically reviewed and revised accordingly. OIG makes this recommendation based on its conclusion that Ashtrom International Ltd. ("Ashtrom International"), a bidder on roads works, was not a qualified bidder based on certain financial requirements. MCC believes that the process followed by MCG in assessing the financial qualification of Ashtrom International was correct and reasonable. In addition, we believe that Ashtrom International was a qualified bidder.

MCG created a technical evaluation panel to review bids on sections of the Roads project. Although the panel was highly qualified in construction matters, it did not consider itself sufficiently qualified to assess the financial qualification of the prospective bidders. The panel, therefore, requested the expert opinion of MCG's fiscal agent on such qualifications. GFA Consulting Group GMBH acts as MCG's fiscal agent and is an internationally-recognized consultant in financial systems and administration. MCC believes that the evaluation panel acted reasonably and prudently in securing the expert opinion of a qualified consultant on the financial qualification of prospective bidders. In reviewing the findings of the evaluation panel, MCC found nothing that suggested Ashtrom International was not a qualified bidder.

OIG makes three arguments why Ashtrom International was not qualified: (1) that its financial statements omitted a statement of cash flows, (ii) that it was not financially sound as evidenced by its current assets/current liabilities quick ratio and (iii) that it did not have sufficient sources of financing available to meet cash flow demands of the construction contracts.

No qualification criteria require a statement of cash flows. One qualification criteria (Criteria 3.1) is that prospective bidders submit audited balance sheets for the last five years.[4] Bidders also fill out Form FIN–1, which asks for balance sheet and income statement information for all prospective bidders. To support such data, prospective bidders were requested to attach "copies of financial statements (balance sheets, including all related notes, and income statements) for the last five years." The qualification criteria make no mention of a statement of cash flows.[5] To qualify, Ashtrom

[4] See Section III, Qualification Criteria, Sub-Factor 3.1.

[5] As a matter of historic interest, Ashtrom International did not include the cash flow statements because they were not then required by Israeli accounting rules. Ashtrom is subject to the requirements of the Israel Accounting Standards Board ("IASB"), not US GAAP. The IASB did not adopt International Financial Reporting Standards (IFRS) until July 2006 – after the date of all financial statements submitted in support of Ashtrom International's bid. The statement in the auditors' reports that Ashtrom International's financial statements did not include a statement of cash flow as required by GAAP was simply a statement of fact, not an indication that the financial statements failed to satisfy the then-current requirements. The importance of recognizing the national financial reporting variations is reflected in Sub-Factor 3.1 which permitted prospective bidders to provide other financial statements if an audited balance sheet were "not

International simply had to provide audited balance sheets and statements of income, which it did.

The same qualification criteria goes on to require that the provided balance sheets must "demonstrate the current soundness of the bidder's financial position". OIG agrees with GFA Consulting that a quick ratio is a reasonable index of such soundness. OIG suggests that GFA incorrectly calculated the quick ratios for Ashtrom International because it used the consolidated statements rather than the statements of the company by itself. According to OIG, such an approach was an error because the consolidated statements included Ashtrom International's parent company. In fact, the consolidated statements do not include Ashtrom International's parent but instead include its subsidiaries. This is made clear in Note 2 to the financial statements: "The consolidated financial statements include the accounts of companies over which the Company exercises control." GFA Consulting correctly calculated the quick ratios and did not include the financial position of Ashtrom International's parent company.[6] Such ratios were well above 1.00, which OIG admits were "good".

The final qualification criteria at issue (Criteria 3.3) requires that the bidder "demonstrate access to, or availability of, financial resources" necessary to meet $15 million in cash flow requirements.[7] Ashtrom International provided a reference letter from Bank Hapoalim that Ashtrom Group could raise $15 million for the cash requirements of the roads project. OIG points to an ambiguity in the letter about whether Ashtrom Group was a subsidiary of Ashtrom International or vice versa and points to Form FIN-1, which requires financial statements to exclude parent companies. Form FIN-1, however, is used for Criteria 3.1 and has no bearing on Criteria 3.3. The correct form for Criteria 3.3 is Form FIN-3, which includes no language that excludes the resources of a parent company. The language is very broad, permitting a letter of credit or "other financial means". Ashtrom International could have accessed the funds referenced in the letter either directly or through its parent. GFA Consulting correctly concluded that Ashtrom International had adequate financial resources available to it for the project.[8]

<u>Recommendation No. 3:</u> We recommend that the Millennium Challenge Corporation's Vice President for Compact Implementation request that the Millennium Challenge Georgia Fund obtain from the contractor from the initial advance, the amount of $2,316,824.27.

MCC disagrees with this recommendation.

OIG makes this recommendation based on their finding that the contractor responsible for three sections of the road project received an advance payment of $6.5 million that

required by the law of the bidder's country".

[6] Note 9 of the 2006 Financial Statements describe many of Ashtrom International's subsidiaries. Confusion may stem from the use of the term "Group" in Note 2. "Group" refers to the consolidated group – Ashtrom International and the companies it controls. Ashtrom International's parent is named Ashtrom Group Ltd. However, as Note 1 to the financial statements makes clear, the defined term for Ashtrom Group Ltd. is "the parent company" and not "Group".

[7] See Section III, Qualification Criteria, Sub-Factor 3.3.

[8] Ashtrom International's financial statements for 2008 do include a statement of cash flows and show that Ashtrom International (independent of Ashtrom Group) had a cash balance of $18.6 million as of December 31, 2007 – indicating it could have satisfied Criteria 3.3 with its own cash resources.

may not have been used for mobilization. The amount listed in the recommendation is the portion attributable to the lot removed from the contract. At the time of the removal of one lot (out of a total of three) from the construction contract, MCG negotiated a settlement with the contractor. MCG removed a lot from the contract, reduced the dollar value of the contract, revised certain rates in the bill of quantities, agreed the amount of the retention to be returned to the contractor at the time of taking over, and reduced the value of the performance security required. In exchange, the contractor agreed to vacate the removed section and to enter into a release where under it released MCG and others from any and all claims and actions related to the removed section. Reduction of the amount of the advance payment already paid was not part of the settlement.

OIG does not consider the settlement as a whole. To focus on one element of the settlement and request return of the advance payment is a misunderstanding of the nature of the settlement and would not be in keeping with the agreement that has been executed.

Recommendation No. 4: ***We recommend that the Millennium Challenge Corporation's Vice President of Compact Implementation have an audit conducted to determine the amount of additional funds initially provided for mobilization, which should be returned.***

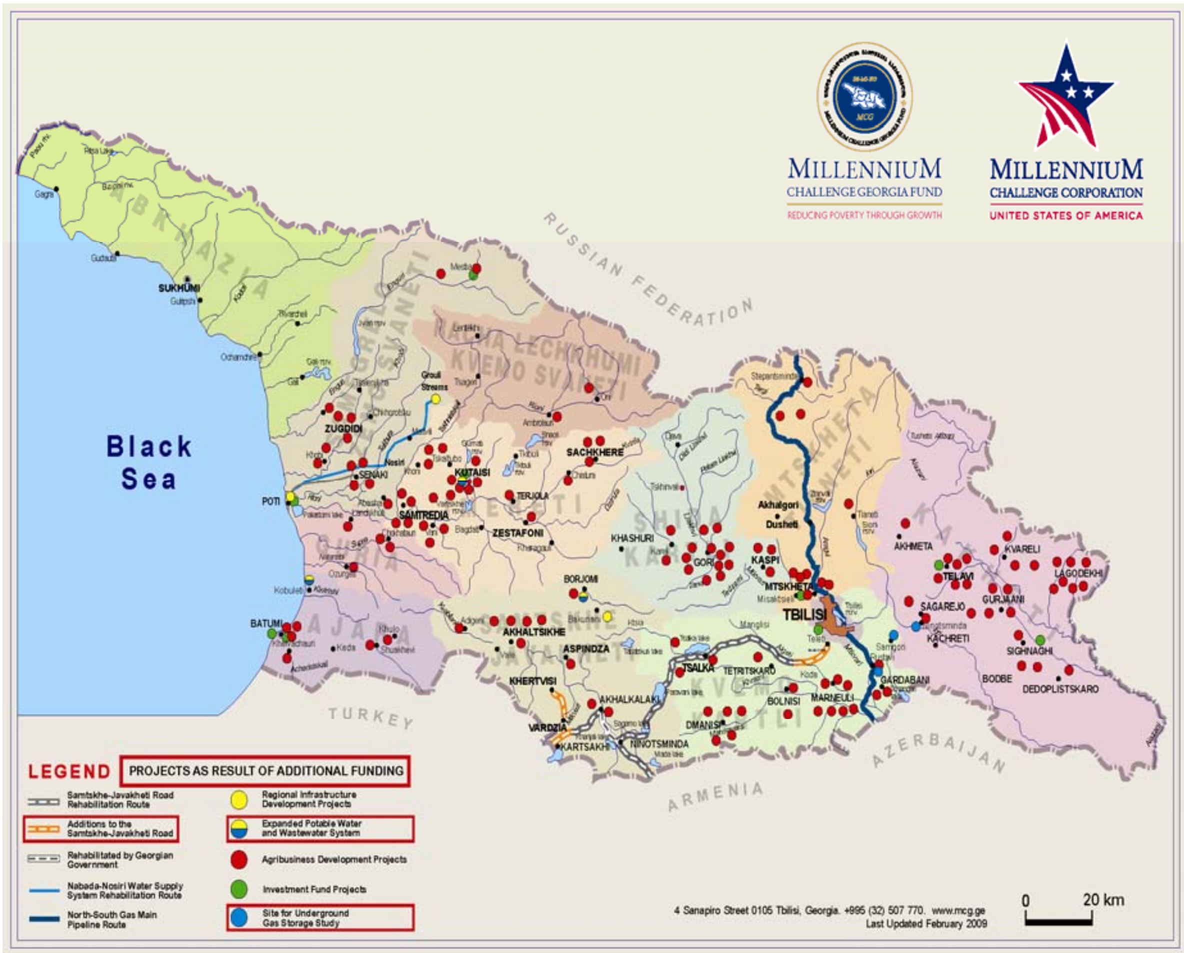
MCC disagrees with this recommendation.

Advance payments are provided to contractors for two purposes -- to cover the cost of mobilization and for cash flow support. The second of the two purposes is to enable a contractor to cover cash flow requirements (i.e., the lag between incurring costs and getting paid for them) during the early phases of a project. Costs incurred are much higher and extend beyond the items covered in Bill Item 101: Contractor's Mobilization and Site Installation in the Bill of Quantities. For example, the contractor is permitted to invoice for work completed and measured, as per the Bill of Quantities. There are many costly activities, such as extracting materials from quarries, crushing aggregates, and hauling and stockpiling materials, for which the contractor is not paid until the materials have actually been laid as base and sub base. The activity that triggers payment may occur several months after costs have been incurred.

Advance payments are an accepted aspect of international contracts. The advance payment reduces the cost of a contract by removing financing costs from the construction firm at nominal risk to the employer or owner. Advance payments are secured against a bank payment guarantee. In addition, the advance payment is disbursed only after the contractor has provided a performance security as well. Moreover, the contract provides for amortization of the advance payment against future invoices for works completed.

Advance payments do not normally require backup as to what they are being expended for. In fact, the generally accepted international form of construction contract does not require an accounting of the proceeds of the advance payment made to contractors. MCC believes it should continue to follow generally accepted industry practice in this regard.

Projects as a Result of the Additional Funding

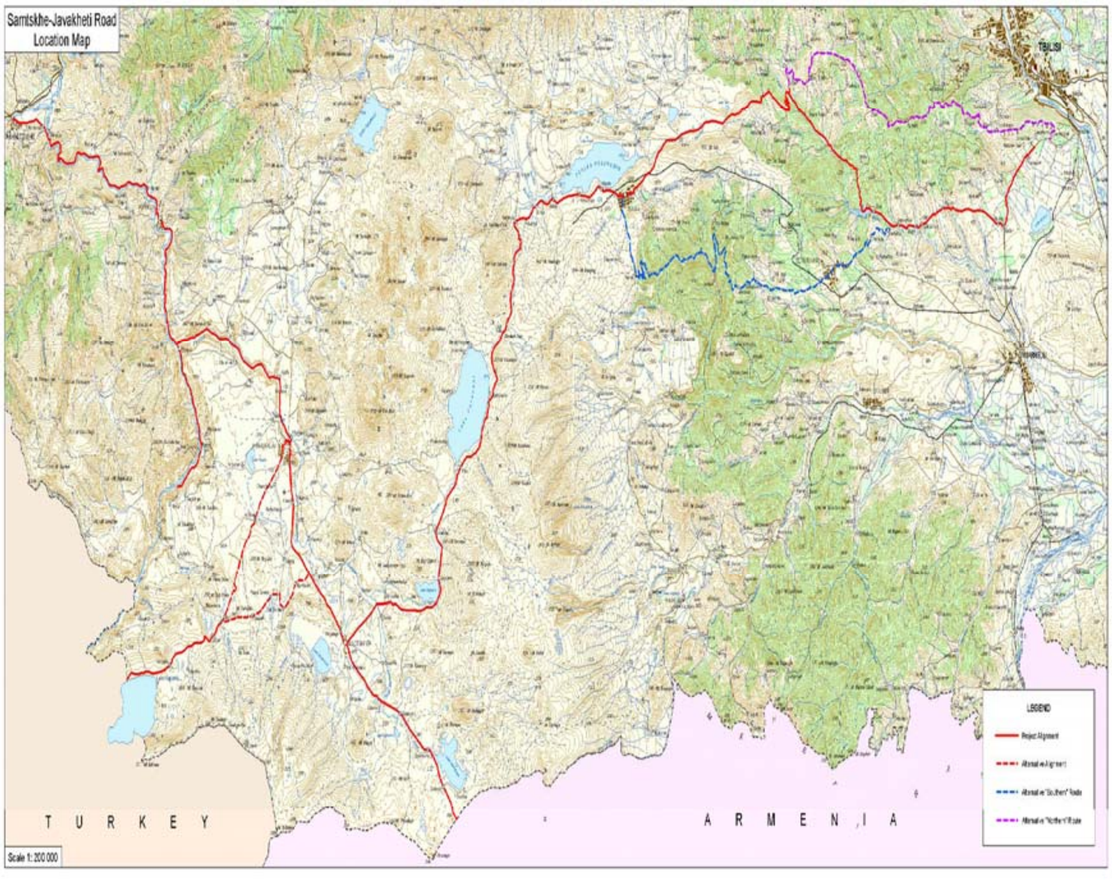


Map provided by Millennium Challenge Georgia Fund

This map shows the projects funded by the additional $100 million. The additional funds were used to complete works in the Samtskhe-Javakheti Road Rehabilitation Project, Regional Infrastructure Development (RID) Project, and Energy Infrastructure Development Projects, contemplated by the original compact.

Map of Road Project

Samtskhe-Javakheti Road Rehabilitation



The Samtskhe-Javakheti Road Rehabilitation Project aims at restoring the road and transport network in the region. With a total budget of $183.6 million, the project envisages rehabilitation of the 223.9km road in Kvemo Kartli and Samtskhe-Javakheti regions. Rehabilitation of roads in Samtskhe-Javakheti and Kvemo Kartli will facilitate the trade and business development in these regions. The map shows the locations of those roads, which will expand international trade by providing a direct transport link from Tbilisi to the Turkish and Armenian borders.

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U.S. Agency for International Development
Office of Inspector General
1300 Pennsylvania Ave, NW
Washington, DC 20523
Tel: (202) 712-1150
Fax: (202) 216-3047
www.usaid.gov/oig