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INDEPENDENT NEWS FROM RUSSIA

Questions Raised Over Murky Deal to Supply Russian-Made Rockets to U.S.

By The Moscow Times

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An Atlas V rocket by United Launch Alliance launches with a Global Positioning Satellite (GPS) onboard at Cape Canaveral Air Force Station, Florida on Oct. 29, 2014.

ATLANTA/MOSCOW — For months, a powerful U.S. senator has been pushing for details of a murky deal under which a Russian manufacturer supplies the rocket engines used to launch America's spy satellites into space.

At issue: how much the U.S. Air Force pays for the engines, how much the Russians receive, and whether members of the elite in President Vladimir Putin's Russia are secretly profiting by inflating the price.

Now, documents uncovered by Reuters provide some answers. A tiny Florida-based company, acting as a middleman in the deal, is marking up the price by millions of dollars per engine.

That five-person company, RD Amross, is a joint venture of Russian engine maker NPO

Energomash and a U.S. partner, aerospace giant United Technologies. According to internal company documents that lay out the contract, Amross stands to collect $93 million in cost mark-ups under its current multi-year deal to supply the RD-180 rocket engine.

Those charges are being added to the program despite a 2011 Pentagon audit that contested a similar, earlier contract with Amross. That deal would have allowed Amross to receive about $80 million in "profit" mark-ups and overhead expenses on RD-180 engines, government documents show.

The confidential report of the 2011 audit described the mark-ups and additional charges as improper under U.S. contracting law. Amross, the auditors concluded, was a middleman that did "no or negligible" work. The audit characterized the $80 million in added costs as "unallowable excessive pass-through charges."

A spokesman for RD Amross said the company resolved the dispute by reducing its charges under the first contract. Neither Amross nor the Pentagon would disclose the dollar amount of the price cut.

But the documents indicate that Amross later managed to make up for the concessions. In the current deal, Amross is charging the same average total price per engine — $23.4 million — that was proposed in the initial contract rejected by the Pentagon auditors.

The disclosure of the middleman's profits and the 2011 contract dispute is likely to increase scrutiny of the deal — and the Russians behind it.

McCain Letter

Senator John McCain is seeking to end funding for future purchases of the Russian engines in the coming year's Defense Department budget. In June, he wrote to the Pentagon's chief of procurement seeking details about the price of the engines and the role of Florida-based Amross as a middleman. In his letter, McCain said he suspected that the Air Force was being overcharged. The Pentagon has not divulged the information he sought.

Told of the Reuters findings, McCain said he has been expressing deep concern to the Obama administration that U.S. taxpayers "are paying millions of dollars to companies that may have done no work but merely served as a 'pass-through' to enrich corrupt Russian businessmen connected with Vladimir Putin." The administration's response, he said in a written statement, signals "it is either ignorant of these allegations or unwilling to investigate them. This is unacceptable."

The Russian engine is a critical component in Atlas rockets, the workhorse of the U.S. military's satellite program. The latest Atlas model is made by United Launch Alliance, a joint venture of Boeing and Lockheed Martin. ULA has a long-term contract with the Air Force to put America's military and reconnaissance satellites into space. Many of the country's most sensitive missions could be grounded if the supply of RD-180s were cut off.

At a projected cost of $70 billion through 2030, the launch program is one of the biggest acquisition deals in Pentagon history. And because the program leaves Washington dependent on engines made in Russia, it is a potential flashpoint at a time of renewed Cold War tensions.

"It is outrageous that the United States today remains dependent on Putin's Russia, particularly for a national security space launch program," McCain said.

Allies of Putin

The Russian government owns 86 percent of Energomash, maker of the RD-180 engine. The company falls under the supervision of Dmitry Rogozin, the deputy prime minister responsible for the defense and space industries. Rogozin was among a number of Russians sanctioned by the Obama administration in March in retaliation for what the West says are Moscow's efforts to destabilize Ukraine.

The sanctions against Rogozin nearly derailed the engine program. A U.S. rival to ULA, Space Exploration Technologies, won a federal court order freezing the Energomash deal in April on the grounds that the Pentagon should not deal with a company overseen by a sanctioned foreign official.

The Obama administration, faced with losing the only ready supplier of the engine, opposed the move. The administration argued that it wasn't required to cut off business with Energomash because it had made no determination that Rogozin controlled the company. In response, the judge lifted the freeze.

But Rogozin isn't the only associate of Putin involved in Energomash. A closer intimate of the president has played an important role in the company, corporate ownership documents show.

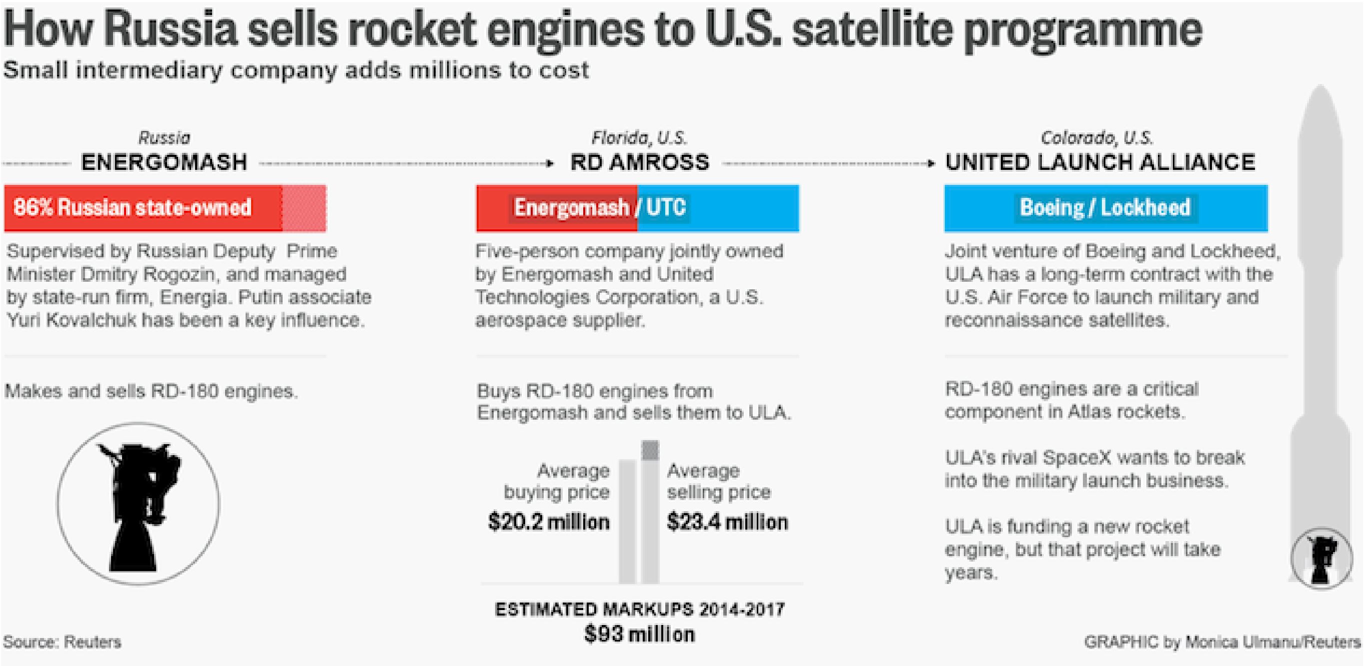
That man, billionaire businessman Yuri Kovalchuk, is one of Putin's oldest friends. In March, he too was sanctioned over Ukraine. The U.S. Treasury cited his close ties to Putin, describing Kovalchuk as the Russian president's "personal banker."

In October 2010, Kovalchuk took partial control over Energomash when Putin ordered that the business be placed under the oversight of another state-owned space company, RSC Energiya. Through an asset management firm that he controlled until this spring, Kovalchuk had control of a minority stake in Energiya.

With the support of the Russian space agency, Kovalchuk thus became a key player in both Energiya and Energomash, according to a senior manager at Energiya. The billionaire's brother served as chairman of Energiya from 2011 to 2013. Kovalchuk's role at Energomash hasn't been previously reported.

A person close to Kovalchuk declined to address questions about the corporate registration documents tying him to Energomash. This person said: "Assumptions regarding management functions and any control of Y.V. Kovalchuk in the companies RKK Energiya and NPO Energomash are false." Kovalchuk's brother, Mikhail, declined to comment.

In March, shortly before the U.S. announced sanctions against Kovalchuk and others, Kovalchuk's interests in Energiya and Energomash were transferred to another member of Putin's circle.



Missing Millions

Much remains unclear about the RD-180 program, including the price the Air Force ultimately pays for the engines and what becomes of all the profit earned by Amross.

Washington is not the only capital where the deal has raised questions. Russian government auditors informed the Kremlin in 2010 that Energomash was making large losses on the RD-180 deal, in part because proceeds were being captured by unnamed offshore intermediary companies.

According to unpublished records of Russia's federal audit board, Energomash made a $50 million loss from the engine sales to the U.S. from 2008 through 2010. The shortfalls were the result of mismanagement by unnamed former executives who sold the engines to Amross for less than their production cost, the auditors estimated.

"In reality, money was made, but it didn't come to the country," Vitaly Davidov, then deputy director of the Russian Federal Space Agency, told a 2011 meeting of the audit board, according to minutes of the gathering.

U.S. reliance on the RD-180 is a byproduct of post-Cold War warming.

In the 1950s and 1960s, Soviet engineers developed rocket engines that used liquid oxygen and kerosene to generate great thrust, putting heavier rockets and payloads into space. The U.S. had its own engines, but by the 1990s it had stopped making ones powerful enough for the biggest jobs. With the Cold War over, Washington turned to Russia, and in 1996 the RD-180 was selected to power Atlas rockets.

But Energomash has never sold the engines directly to the rocket program. Instead, it has sold them to a joint venture it set up with a unit of United Technologies. The engines are then resold to the Pentagon's main contractor, which since 2006 has been ULA.

The joint venture — the middleman in the engine deal — is Florida-based RD Amross. The firm's role is an uncommon one. The Pentagon has rules limiting the use of middlemen in contracts, a safeguard against fraud and wasteful spending. But in this case, the arrangement was seen as temporary.

The partners originally planned to co-produce the engine in America for U.S. government space missions, according to a review in May by the Defense Department. That hasn't happened. The engines proved to be cheaper to make in Russia, and Energomash had a ready supply of them.

The Pentagon finds itself highly dependent on the Russian engines as a result, according to the Defense Department review. Through 2020, the U.S. government will rely on RD-180-powered Atlas V rockets for more than 56 percent of its space launches, the report said.

Amross and its five full-time employees occupy a small suite in a beige stucco building just off the white sands of Cocoa Beach, Florida. The building is home to doctors, a dentist and a hearing aid seller.

Since 2011, the company has been run by U.S. space industry veteran William Parsons. A former Marine, Parsons worked at NASA for years, serving as director of the John F. Kennedy Space Center in nearby Cape Canaveral. Before joining RD Amross, he was vice president of strategic space initiatives at Lockheed Martin, co-owner of United Launch Alliance. Parsons declined to comment.

Tough Questions

Amross' engine sales have been questioned over the years in Washington. Most recently, in a June 20 letter to Defense Department acquisitions chief Frank Kendall, McCain wrote that he had unspecified information indicating that "ULA — and ultimately the Air Force — buys the RD-180 for a price significantly above what RD Amross pays NPO Energomash." As a result, "the U.S. taxpayer [is] essentially giving a Russian company a profit by perhaps more than 200 percent. Is this allegation accurate?"

McCain sought specifics. "For how much does NPO Energomash sell the RD-180 to RD Amross?" he wrote. "For how much does RD Amross subsequently sell the RD-180 to ULA? For how much does ULA sell the RD-180 to the Air Force?"

Despite the Pentagon's silence, the documents examined by Reuters answer his first two questions.

RD Amross buys the engines from Energomash for $20.2 million each on average, according to Amross' current contract with Energomash, dated June 5, 2014.

Amross adds $3.2 million to each engine, a 15 percent markup. It then sells them to ULA for $23.4 million, according to an amendment to Amross' contract with ULA, dated Oct. 2, 2014.

In all, Amross will reap $93 million in mark-ups over the course of the deal. The $680 million contract calls for 29 engines to be delivered from this year through 2017.

The current arrangement follows an earlier, $303 million contract proposal that called for Amross to deliver 12 engines to ULA from 2011 to 2013.

In an August 2011 report, the Pentagon's Defense Contract Audit Agency detailed the deal. It said that middleman Amross would pay $17.9 million per engine on average. Amross then planned to add on average $5.5 million in "profit" to the price of each engine — an extra 31 percent — before reselling them to ULA. The profit mark-ups totaled more than $66 million.

In a 67-page report, Pentagon auditors called the proposal "not acceptable for the negotiation of a fair and reasonable price." They contested the $66 million profit "in its entirety, as unallowable excessive pass-through charges" under federal contracting law. The services Amross cited to justify the profit "constituted 'no or negligible value,'" they concluded. The auditors also contested $14.4 million in overhead expenses.

The findings were extraordinarily blunt, said Charles Tiefer, a military contracting specialist and professor at the University of Baltimore School of Law, who reviewed the document.

"The bottom line is that the joint venture between the Russians and Americans is taking us to the cleaners," Tiefer said. He said he had reviewed Pentagon audits critical of Iraq War contracts, but those "didn't come anywhere near to how strongly negative" the Amross audit was.

ULA and RD Amross said they resolved the dispute to the Air Force's satisfaction. The price was reduced, they said, but they wouldn't put a dollar figure on the discount. The Air Force said the audit was taken into account in working out the contract. It wouldn't discuss the price it paid ULA for engines under that deal or the current arrangement.

"ULA and the government ultimately determined that the RD Amross contract price was fair and reasonable and there were no 'unallowable excessive pass-through charges,'" ULA spokeswoman Jessica Rye said in a written statement.

In a letter to McCain last month, Defense Department acquisitions chief Kendall said Amross' value in the deal included providing technical advice, logistics and "anomaly resolution."

Reuters described its findings about Kovalchuk's ties to Energomash to Amross, ULA and the Air Force. The Air Force did not address the Kovalchuk connection. ULA said it was "not aware" of any involvement at Energomash by the Russian billionaire.

Amross referred questions to the joint venture's American co-owner, the Pratt & Whitney Military Engines unit of United Technologies. A spokesman there, Matthew Bates, said Amross' lawyers had looked into the Kovalchuk connection.

"We disagree with your assertion that 'Kovalchuk has had a significant role in Energomash,'" Bates said in an e-mail. The indirect stake, Bates said by e-mail, was not a majority holding. What's more, "these alleged connections were severed prior to the imposition of U.S. sanctions against Yury Kovalchuk." He didn't address the role played by Kovalchuk's brother as chairman of Energiya, the company that runs Energomash.

Washington had warned it was considering sanctions on Russian officials. About two weeks before the sanctions were announced, Kovalchuk's investment appeared to diminish. But it stayed in friendly hands.

Control of his indirect holding in Energiya shifted to a pension fund run by a businessman named Yury Shamalov. He is the son of longtime Putin associate Nikolai Shamalov, a co-owner of a powerful bank run by Kovalchuk. The Shamalovs had no comment.

In June, Energomash and Amross finished up a new agreement to supply RD-180 engines to the Air Force program.ULA is paying $23.4 million per engine — the same price originally called for in the prior contract that caused all the wrangling.

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