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**STATE AUDITOR'S REPORT ON THE
DEPARTMENT OF REVENUE'S PRIVATIZATION
OF MAIL OPENING SERVICES**

**OFFICIAL AUDIT
REPORT
MARCH 22, 1995**

TABLE OF CONTENTS

	<u>Page</u>
INTRODUCTION	1
Background	1
Scope, Objectives and Methodology	2
REVIEW RESULTS	3
Review of the Department of Revenue's Decision to Privatize Mail Opening Services	
COST FORMS	
Form 1 – Cost Comparison	5
Form 2 – In-House Cost Estimate	6
Form 3 – Contract Performance Costs	7

INTRODUCTION

Background

Chapter 296 of the Acts of 1993, the Commonwealth's privatization law, outlines the process that must be followed by agencies and applicable Authorities seeking to contract for a service that is presently performed by state or Authority employees. The law, which became effective December 15, 1993, applies to contracts that have an aggregate value of \$100,000 or more. Pursuant to this law, a specific process must be followed to demonstrate and certify to the State Auditor that the total cost to perform the service by contract will be less than (and at least of equal quality to) the in-house cost. The State Auditor has 30 days to approve or reject the agency's certification.

The process that the agency must follow includes preparing a detailed written statement of services, estimating the most cost-efficient method of providing those services with agency employees, selecting a contractor through a competitive bidding process, and comparing the in-house cost and the cost of contract performance. The agency must also ensure that the private bids and private contract, if ultimately awarded, contain certain provisions regarding wages, health insurance, the hiring of qualified agency employees, nondiscrimination, and affirmative action.

In April 1994, the Office of the State Auditor (OSA) initiated a review of the Department of Revenue's (DOR) contract for lockbox services with a private vendor to determine whether a negotiated amendment to the contract to include mail opening services had been executed in accordance with Chapter 296 of the Acts of 1993. Our review concluded that DOR had not adhered to the requirements of Chapter 296. The Office of the Attorney General also reviewed the matter and notified DOR that Chapter 296 appeared to be applicable to the amended contract.

Thereafter, DOR, while disagreeing with this position, consented to submit to the OSA for its review a cost analysis that conformed with the requirements of Chapter 296 and the State Auditor's Guidelines for Implementing the Commonwealth's Privatization Law, published in March 1994. On

January 18, 1995 DOR submitted to the OSA a cost analysis comparing the in-house cost of providing the services using DOR personnel with the cost of contractor performance.

Scope, Objectives and Methodology

This report summarizes the result of our review of the cost analysis pursuant to the above agreement. Because the cost analysis was not submitted to the OSA until after the contract had been awarded (and completed), the procedures followed by this office in evaluating this contract differ from the procedures mandated by Chapter 296.

Our procedures were limited to a fiscal review of the cost analysis that DOR submitted pursuant to the above agreement and did not include other major requirements of Chapter 296. Our objective was to determine whether the cost of having certain services performed by contract was greater or less than the cost of performing these services with DOR employees. The Chapter 296 requirements that were not part of our review because of the circumstances stated previously include the following:

1. The Commissioner of DOR and the Executive Office for Administration and Finance did not certify in writing that Chapter 296 of the Acts of 1993 and other applicable laws had been complied with and that the cost to perform the services by contract would be less than the in-house costs (with no reduction in the quality of services).
2. The cost analysis did not compare the cost of contract performance with the most cost-efficient method of providing the mail opening services with DOR employees. The comparison was made with the method that had previously been used by DOR. Chapter 296 calls for using the most cost-efficient method, and the OSA Guidelines call for a management study to determine whether changes in the existing method of operation could feasibly be made that would result in a more efficient operation.
3. DOR did not solicit competitive sealed bids for the mail delivery services and publicly designate the bidder to which it proposed to award the contract.
4. The cost analysis was submitted after the privatization contract was awarded.

REVIEW RESULTS

Review of the Department of Revenue's Decision to Privatize Mail Opening Services

Each year, the Department of Revenue (DOR) is inundated with tax returns for the week-and-a-half period centered around the April 15 filing deadline. DOR generally receives approximately 900,000 pieces of mail during this period, about 500,000 of which are tax returns with payments enclosed. In order to process the volume of incoming mail in a short period of time, and because the process is extremely labor intensive, a large number of employees are utilized.

In the past, DOR had employees from each of its divisions suspend their regular job activities to open and process mail. Because DOR believed that the process was disruptive to regular DOR operations and not cost-efficient, it sought a different means of accomplishing this task. Accordingly, for the 1993 filing season DOR engaged its existing lockbox payment processing contractor, Shawmut Bank, to extract, arrange, screen, and sort tax payments and other mail received around the filing deadline. The agreed-upon price was \$.27 per unit handled, with a minimum payment of \$110,000. The lockbox contract with Shawmut bank was amended on April 6, 1994 to incorporate these services.

The cost analysis submitted by DOR on January 18, 1995 indicated that the total cost of contract performance for the 1993 filing season was \$.28 per unit (see Form 3), whereas the in-house cost was estimated to be \$2.64 per unit, a difference of \$2.36, or about \$1,180,000 for the 500,00 returns with payments enclosed that were estimated to have been processed in 1993 (see Form 1).

Our review of DOR's cost analysis disclosed that the in-house cost estimate was overstated by \$1.95 per unit, or a total of \$975,000, primarily because certain lost revenue costs were not applicable as in-house costs (see Form 2). However, applying the actual in-house cost of \$.69 per unit, which is still \$.41 higher than the \$.28 per-unit cost of contracting performance, would result in a total savings of \$205,000 (see Form 1).

Conclusion: Our review of DOR's cost analysis revealed that the privatization of the mail opening services has resulted in a cost savings to DOR. However, in the future, DOR should comply with

all requirements of Chapter 296 of the Acts of 1993 when seeking to contract for services being performed by DOR employees, when the criteria outlined in Chapter 296 is applicable.

FORM 1

Department of RevenueCost Comparison of the Privatization
of Certain Mail Processing Services

	<u>Cost Per Unit</u>		
	<u>Department Of Revenue</u>	<u>Office of the State Auditor</u>	<u>Difference</u>
In-House Cost Estimate	\$2.64	\$.69	\$1.95
Less:			
Contract Performance Costs	<u>.28</u>	<u>.28</u>	<u>-</u>
Cost Savings Per Unit	<u>\$2.36</u>	<u>\$.41</u>	<u>\$1.95</u>
 Multiplied by Number of Units	 <u>500,000</u>	 <u>500,000</u>	 <u>500,000</u>
 Total Cost Savings	 <u>\$1,180,000</u>	 <u>\$205,000</u>	 <u>\$975,000</u>

FORM 2

Department of RevenueIn-House Cost Estimate for Certain Mail Processing Services

		<u>DOR</u> <u>1993 Costs</u>	<u>OSA</u>	<u>Notes</u>
1.	Personnel Cost			
	a. Average DOE Salary Per Year	\$ 38,188	\$ 38,188	
	b. Benefits (32%)	<u>12,220</u>	<u>12,220</u>	
	c. Total	<u>\$ 50,408</u>	<u>\$ 50,408</u>	(1)
	d. Average Number of Days Worked Per Year	<u>240</u>	<u>240</u>	
	e. Average Personnel Cost Per Day (c divided by d)	\$ 210	\$ 210	
	f. Total Person Days to Complete The 1993 Mail Opening	1,593	1,635	(2)
	g. Total Personnel Costs (e multiplied by f)	<u>\$334,530</u>	<u>\$343,350</u>	
2.	Lost Revenue Costs			
	Auditors \$249,900			
	Collectors <u>736,610</u>			
	Total Lost Revenue	<u>986,510</u>	<u>-</u>	(3)
		<u>\$1,321,040</u>	<u>\$343,350</u>	
3.	Number of Units	<u>500,000</u>	<u>500,000</u>	(4)
4.	Unit Cost	<u>\$2.64</u>	<u>\$.69</u>	

- (1) DOR used the costs for 1993 because these were the latest available costs at the time the privatization contract was issued in early 1994. The personnel costs in 1994 averaged \$51,472 (average salary of \$38,585 plus benefits of \$12,887 (33.4%)). Use of the 1994 cost data would have increased the total personnel costs by \$5,372 to \$340,902, or about \$.01 per unit.
- (2) This adjustment is for a mathematical error in the cost analysis.
- (3) DOR estimated that, when mail was opened by DOR personnel, about \$986,510 in revenue was lost because auditors and collectors spent 196 and 238 days, respectively, opening the mail instead of performing their regular duties. During this period they were not producing revenue (generally about \$1,275 a day on average when they perform audits and \$3,095 a day when they perform collections). However, DOR could not demonstrate that any revenue was lost because no audits were cancelled and no money owed to the Commonwealth was written off as uncollectable. At most, audits and collections were postponed or delayed, resulting in some lost interest earnings.
- (4) DOR estimated that its personnel opened about 500,000 returns during the last several weeks of the 1993 filing season (April 1994) and used this amount to compute the in-house unit cost. In 1994 the contractor actually opened 544,707 tax returns, about 9% more than the 1993 estimate. We accepted the 500,000 as a reasonable estimate. However, if the actual 1994 count of 544,707 were used, the in-house unit cost would be about \$.06 lower (from \$.69 to \$.63).

FORM 3

Department of RevenueContract Performance Costs for
Certain Mail Processing Services

	<u>Amount</u>
1. Contract Price with Shawmut	\$147,070
2. Contract Administration	
Processing Division	\$4,443
Internal Audit	2,067
Shipping	<u>1,352</u>
	<u>7,862</u>
3. Total Contract Costs	<u>\$154,932</u>
4. Number of Units	<u>544,707</u>
5. Cost Per Unit	<u>\$.2844</u>