



A. JOSEPH De NUCCI
AUDITOR

AUDITOR OF THE COMMONWEALTH

ONE ASHBURTON PLACE, ROOM 1819
BOSTON, MASSACHUSETTS 02108

TEL (617) 727-6200

NO. 97-2510-9

STATE AUDITOR'S DETERMINATION
OF THE
MASSACHUSETTS HIGHWAY DEPARTMENT'S
PROPOSAL TO PRIVATIZE
THE MAINTENANCE OF STATE ROADS
IN WORCESTER COUNTY

OFFICIAL AUDIT REPORT
DEC 12 1996

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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 (a) the agency complied with all provisions of Chapter 7, Section 54, of the General Laws and all other applicable laws; (b) the quality of the services to be provided by the designated bidder is likely to equal or exceed the quality of services that could be provided by regular employees; (c) the total cost to perform the service by contract will be less than the estimated in-house cost; (d) the designated bidder has no adjudicated record of substantial or repeated noncompliance with relevant federal and state statutes; and (e) the proposed privatization contract is in the public interest in that it meets applicable quality and fiscal standards. 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 service, 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.

The Massachusetts Highway Department (MHD), under Chapter 6A, Section 19, of the Massachusetts General Laws, is an agency within the Executive Office of Transportation and Construction that is under the supervision and control of a five-member Board of Commissioners appointed by the Governor, who also designates one board member to be Commissioner of Highways. The Commissioner acts as the executive and administrative head of MHD, which, according to statute,

has four divisions: Administrative Services, Highway Engineering, Highway Construction, and Highway Maintenance. The Highway Maintenance Division is responsible for maintaining the state highways in good repair and condition.

For highway maintenance purposes, MHD has divided the state into 14 contract areas. At the present time the highway maintenance for four of these areas is being performed through contracts, and the highway maintenance for the remaining 10 areas is being performed by agency employees. On November 12, 1996, MHD notified the State Auditor of its intent to award two privatization contracts for the maintenance of state highways in contract areas 3B and 3C of District 3 in Worcester County. As required by law, the notification was accompanied by a certification signed by the Commissioner of MHD and the Secretary of Administration and Finance, and by documentation subject to review and determination by the State Auditor in accordance with state laws and applicable guidelines issued by the State Auditor.

Scope, Objectives, and Methodology

The objectives of this review were to determine whether MHD has complied with Chapter 296 of the Acts of 1993, the privatization law, including the quality and compliance requirements of the law, and whether the cost of performing the highway maintenance services by contract would be less than the estimated cost for performing these services with agency employees.

To meet these objectives, we examined the written statement of services for the highway maintenance services, the management study of the present in-house operations, the Request for Proposals, the summary of bids received, the successful proposal, and the proposed privatization contracts. We also examined the cost forms and supporting documentation submitted by MHD and compared the estimated cost of contract performance with the estimated cost to perform the services in-house with MHD employees. We traced and verified all of the cost elements listed in the cost forms to the supporting documentation. We also interviewed MHD management officials.

DETERMINATION

Based on our review, we have concluded that the Massachusetts Highway Department (MHD) has complied with Chapter 296 of the Acts of 1993 in reaching its decision to award two privatization contracts for the maintenance of state highways in contract areas 3B and 3C of District 3 in Worcester County. This service had previously been performed by MHD employees.

MHD certified that the quality of services to be provided by the contractor is at least equal to or greater than that which had been provided by MHD employees, that the designated contractor has no adjudicated record of noncompliance with relevant statutes, and that the cost of having the work performed under contracts would be less than the estimated cost of having the work performed with MHD employees. We therefore approve MHD's certification in each of these required areas.

Based on our review and as summarized in Exhibit A, the cost of performance for the two-year period of the contract is estimated to be \$6,926,653, or \$1,660,385 less than the estimated cost of \$8,587,038 to perform the work with MHD employees. In our opinion the cost data set forth in Exhibits A, B and C, as adjusted, present fairly the estimated cost of having the highway maintenance performed under contracts and having the work performed with MHD employees.

We do note, however, that potential costs savings would be realized should MHD adheres to its plan of using a work force of 27 highway maintenance employees and seven engineers to perform its portion of the work in the two contract areas. Should the number of MHD employees increase during the two-year contract period, there would be a corresponding decrease in the potential cost savings. The MHD Deputy Commissioner stated that this has not happened in other contract areas where the work is being done by contract or where the work is being done by union (MHD) employees, and that it is not expected to happen in this instance either.

In addition, with respect to other provisions of the privatization law, we noted the following:

- o Section 54(2) contains certain requirements related to the wages to be paid and health insurance to be provided by the contractor to individuals who will be employed under the contract. This Section, however, does not apply if it is inconsistent with Sections 26 to 27F of Chapter 149 of the Massachusetts General Laws, which govern the labor rates paid to employees on projects funded by MHD.

- Section 54(3) requires the contractor to offer available positions to qualified MHD employees who are being terminated as a result of the privatization. The privatization contracts contain a clause whereby the contractor agrees to make best efforts to hire those qualified former MHD regular maintenance employees whose jobs were eliminated through privatization. It is noted, however, that MHD does not plan to lay off and highway maintenance employees as a result of this privatization initiative. The employees whose jobs will be terminated are to be transferred to other area of MHD where there are shortages of personnel.

EXHIBIT A

Massachusetts Highway Department
Privatization of Highway Maintenance – Areas 3B and 3C
Cost Comparison
Two-Year Period

In-House Cost Estimate as Adjusted (Exhibit B)	\$8,587,038
Contract Performance Costs as Adjusted (Exhibit C)	<u>6,926,653</u>
Estimated Cost Savings over Two Years	<u>\$1,660,385</u>
Estimated Annual Savings	<u>\$ 830,193</u>

EXHIBIT B

Privatization of Highway Maintenance – Areas 3B and 3C
In-House Cost Estimate
Two-Year Period

	<u>Per MHD</u>	<u>Audit Adjustment</u>	<u>Adjusted In-House Cost Estimate</u>	<u>Notes</u>
Personnel Costs:				
Highway Maintenance	\$4,503,019	\$ (405,272)	\$4,097,747	1
Engineers	<u>1,058,970</u>	<u>(607,866)</u>	<u>451,104</u>	2
	\$5,561,989	\$(1,013,138)	\$4,548,851	-
Fringe Benefits:	1,835,457	(334,336)	1,501,121	3
Overtime	<u>278,344</u>	<u>(25,051)</u>	<u>253,293</u>	4
Total Personnel Costs	<u>\$7,675,790</u>	<u>\$(1,372,525)</u>	<u>\$6,303,265</u>	-
Other Direct Costs:				
Materials	\$ 130,918	\$ (11,783)	\$ 119,135	4
Vehicle Maintenance	77,010	(6,931)	70,079	4
Fuel	190,060	(17,105)	172,955	4
Police	121,676	(44,240)	77,436	5
Contracts	207,000	-	207,000	-
Equipment Usage	<u>\$ 1,734,060</u>	<u>\$ (96,892)</u>	<u>\$1,637,168</u>	6
Total Other Direct Costs	<u>\$ 2,460,724</u>	<u>\$ (176,951)</u>	<u>\$2,283,773</u>	-
Total In-House Cost Estimate	<u>\$10,136,514</u>	<u>\$(1,549,476)</u>	<u>\$8,587,038</u>	-

EXHIBIT B-1

Privatization of Highway Maintenance – Areas 3B and 3C
In-House Cost Estimate
Two-Year Period

Notes

1. This represents a reduction from 77 full-time equivalent (FTE) employees on the payroll as of July 8, 1995 to the 70 FTE employees who are presently doing the highway maintenance work (68 employed plus two vacancies) in the two areas. The reduction is for the salaries of seven FTE employees and reflects the more cost-efficient in-house operation that is being achieved.
2. This represents a reduction from 19 FTE engineers who are presently employed in the two areas, and would still be used if the work were to be done by agency employees, to seven FTE engineers who will be needed if the work is privatized. The privatization law requires MHD to submit the cost estimate of agency employees providing the service in the most cost-efficient manner. There was no demonstrated reason why the engineering services could not be performed with seven engineers, whether the work is done in-house or is privatized. Although it agreed that the number of FTE engineers could be reduced, MHD was doubtful that it could go as low as seven if the work was done by MHD employees because of the manner in which the work is structured and other factors. The adjustment amount is \$451,104, which is the same amount used in Exhibit C for engineer salaries.
3. Represents 33% (fringe benefit rate) of the above salaries.
4. The cost estimates for overtime, materials, vehicle maintenance, fuel, and police were based on the ratio of the budget for these items in those contract areas where agency employees are doing the work to the number of employees in these contract areas. Because of the above reduction of FTEs from 77 to 70 (9%) there would be a corresponding 9% reduction in the cost of these items.
5. In addition to the adjustment indicated in Note 4, there is an additional adjustment caused by the use of a higher amount for police than was budgeted.

<u>Reduction in FTE:</u>	<u>One Year</u>	<u>Both Years</u>
\$790.00 @ 77	\$60,830	\$121,660
\$790.00 @ 70	<u>55,300</u>	<u>110,600</u>
	\$ 5,530	\$ 11,060
 <u>Reduction in Budget:</u>		
\$237.00 @ 70	<u>16,590</u>	<u>33,180</u>
	<u>\$22,120</u>	<u>\$ 44,240</u>

6. MHD computed the equipment usage cost based on the new equipment that would have to be purchased if the work were done (a) by MHD employees and (b) through privatization. The purchase price and the useful life of the equipment was determined and was amortized for the two-year contract period for both scenarios. In making its amortization schedule, 7½% was used as the rate paid by the Commonwealth on its bond issues. We used 5½%, which is the rate presently being paid by the Commonwealth. The adjustment reduces the equipment costs by \$96,892 under the in-house estimate and by \$27,812 under the privatization estimate for the two-year contract period.

EXHIBIT C

Massachusetts Highway Department
Contract Performance Costs
Two-Year Period

	<u>Per MHD</u>	<u>Audit Adjustment</u>	<u>Adjusted Contract Performance Costs</u>	<u>Notes</u>
Contract Price				
District Area 3B	\$1,594,574	-	\$1,594,574	
District Area 3C	<u>1,695,292</u>	-	<u>1,695,292</u>	
Total	<u>\$3,289,866</u>	-	<u>\$3,289,866</u>	
Contract Administration				
Personnel Costs:				
Highway Maintenance Salaries	\$1,567,566	-	\$1,567,566	
Engineer Salaries	<u>425,256</u>	<u>25,848</u>	<u>451,104</u>	1
Total – Salaries	<u>\$1,992,822</u>	<u>\$ 25,848</u>	<u>\$2,018,670</u>	
Fringe Benefits	657,632	8,530	666,162	2
Overtime	<u>72,520</u>	<u>-</u>	<u>72,520</u>	
Total – Personnel Costs	<u>\$2,722,974</u>	<u>\$ 34,378</u>	<u>\$2,757,352</u>	
Other Costs:				
Materials	\$ 16,000	-	\$ 16,000	
Vehicle Maintenance	35,000	-	35,000	
Fuel	66,626	-	66,626	
Police	110,000	-	110,000	
Contingency	\$95,000	-	\$95,000	
Equipment	<u>\$617,520</u>	<u>\$(27,812)</u>	<u>\$589,708</u>	3
Total – Other Costs	<u>\$ 940,146</u>	<u>\$(27,812)</u>	<u>\$ 912,334</u>	
State Income Tax	<u>(164,494)</u>	<u>131,595</u>	<u>(32,899)</u>	4
Total Contract Costs	<u>\$6,788,492</u>	<u>\$138,161</u>	<u>\$6,926,653</u>	

EXHIBIT C-1

Privatization of Highway Maintenance
Notes for Contract Performance Costs
Two-Year Period

1. This represents a 3% increase in the salaries of the seven engineers in the first year of the contract period, the same as used in the in-house cost estimate for engineer salaries, and a 69% allocation of the salaries instead of the 67% used by MHD.
2. This represents 33% (fringe benefit rate) of the above salaries.
3. MHD computed the equipment usage cost based on the new equipment that would have to be purchased if the work were done (a) by agency employees and (b) through privatization. The purchase price and the useful life of the equipment was determined and was amortized for the two-year contract period for both scenarios. In making its amortization schedule, MHD used 7 ½% as the rate paid by the Commonwealth on its bond issues. We used 5 ½%, which is the rate presently being paid by the Commonwealth. The adjustment reduces the equipment costs by \$96,892 under the in-house estimate and by \$27,812 under the privatization estimate for the two-year contract period.
4. We estimated the state income taxes expected to be paid by the contractor at \$32,899, which is based as an estimated profit under the contracts of 10% and a corporate income tax rate of 10%, as shown below:

10% of Contract Price of \$3,289,866	<u>\$328,987</u>
Corporate tax rate 10%	(\$32,899)
Amount used by MHD (5% contract price)	<u>\$164,494</u>
Adjustment	<u>\$131,595</u>