



The Commonwealth of Massachusetts
Office of the Inspector General

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Ellen Bickelman
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Operational Services Division
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Dear Ms. Bickelman:

For more than a year, the Office of the Inspector General has monitored School Specialty, Inc.'s statewide contract (OFF13) for art and instructional school supplies. The Operational Services Division awarded this contract to School Specialty in 2002. The office conducted this review as a result of concerns raised by Senator Marc Pacheco and an anonymous complainant.

The division is responsible for monitoring statewide contracts and for creating contracts that are open, fair, and competitive. Contractual language in the division's statewide contracts prohibits vendors from negotiating lower prices than those offered on the statewide contract with public sector entities. The division found School Specialty in violation of the statewide contract for this reason during the period between April 1, 2003 and March 31, 2004.

When the division found School Specialty to have "breached material terms of the statewide contract" by negotiating lower prices than on the statewide contract, the division required School Specialty to issue credits to users of the statewide contract. Negotiations between the division and School Specialty resulted in a total credit of nearly \$260,000 (according to the corrective action plan signed by School Specialty on July 21, 2004). The division also found that School Specialty had not properly accounted for the items it sold to public users, mainly local school departments. As a result, the division stated it would impose stricter monitoring practices on School Specialty, so that the vendor would not offer prices lower than the prices School Specialty offers on the statewide contract.

This office has found that School Specialty continues to negotiate lower prices to public users than the statewide contract prices and that stricter monitoring practices that the division stated it would impose on School Specialty have not been followed.

It appears that as early as July 16, 2004, the same week that School Specialty signed the corrective action plan, it underbid the statewide contract in a solicitation from the town of Newburyport. A complainant forwarded this information to division staff. In early 2005, a complainant notified division staff of another instance of underbidding by School Specialty in a solicitation from the city of Fall River. Division staff responded by saying: "School Specialty would have to win the bid" for this "to violate the pricing agreement." Division staff has denied receiving complaints about School Specialty since June 2004.

According to division staff, the division's sole means of contract oversight is through the vendors themselves. The division expects vendors on the statewide contract and their competitors to self-police to ensure compliance with statewide contract prices. However, it appears that the division did not take action when examples of underbidding the statewide contract were brought to its attention as referenced above.

Recently, staff from this office met with you and reported that School Specialty continues to violate the statewide contract and its corrective action agreement with the commonwealth. This office has also supplied the division with information supporting our identification of School Specialty's underbids. In response to this meeting, division staff met with staff from School Specialty and the division determined that School Specialty "appears to have, in fact, violated the pricing contract terms of their contract with the Commonwealth on several occasions."

As a result, the division has recently issued a request for documents to all art and school supply vendors on the statewide contract. This office acknowledges the division's actions in regard to this contract. However, the office believes that the contract violations would have continued to occur, had not the office alerted the division.

This office identified School Specialty's continued violation by selecting a sample of municipal school supply bids/solicitations. This office compared School Specialty's bid prices from these sample bids/solicitations to the statewide contract prices. This office found that School Specialty continues to underbid its statewide contract prices to municipalities conducting independent solicitations for art and school supplies. Additionally, this office found that the division is not monitoring or enforcing the School Specialty contract and the corrective action plan. This office has identified the following issues.

Issue 1: School Specialty continues to violate the statewide contract.

School Specialty continues to underbid prices on the statewide contract which is a violation of its contract with the commonwealth. This office is aware of six recent cases of municipalities receiving lower bids from School Specialty than the statewide contract prices; in five of the six cases, School Specialty won the bid.

A June 22, 2004 division letter to School Specialty states: "we are considering all possible responses to your material breach of this contract, including contract termination, suspension and involvement of the Attorney General's Office." The division settled on a credit by School Specialty to public entities. Since June 2004, the division has not identified additional contract violations even though they continue to occur.

Recommendation: The division should identify and respond to any continued contract violations by School Specialty and consult with the Attorney General's office regarding termination of the School Specialty contract and debarment of this vendor.

Issue 2: The division inadequately publicized the available credits and relied on the errant vendor to inform public entities.

The division and School Specialty inadequately publicized the available credits. For example, the division did not post the availability of credits on Comm-PASS, the commonwealth's web-based solicitation posting and maintenance site. The division and School Specialty did not follow-up on the use of the credits until after this office made inquiries. Only due to inquiries by the office did School Specialty prepare an additional mailing. However, at this time, this office is unaware if the letter has been sent to public entities that purchased off the statewide contract informing them of the credits. For example, School Specialty informed this office that as of August 2005, the city of Springfield had \$13,025 and the city of Lowell had \$14,636 in outstanding credits due them. After sending out an initial letter announcing the credit, the division relied on School Specialty to notify the eligible public entities of the credit.

Recommendation: The division should make every effort to ensure that the eligible entities are notified of a credit. Although a majority of the credits have been used by public entities, this had little to do with marketing efforts by School Specialty and outreach by the division. It appears to be mainly due to normal business activity. The division should consider adding a section on Comm-PASS to deal specifically with credits or other potential contract issues and changes. E-mails could also be sent to all users of a particular statewide contract to alert them of issues concerning a contract, in this case, the availability of a credit.

Issue 3: The division did not have a program to track the use of credits.

After the division negotiated the credit, the division relied upon School Specialty to apply the credits. The division did not have a mechanism to track the credits to ensure that each public entity got what they were entitled to. By not tracking these credits, the division did not ensure that School Specialty had actually accounted for its pricing discrepancies. If the division imposes a penalty for a contract violation it should ensure that it can effectively verify that the penalty is imposed.

Recommendation: The division should ensure that credits are distributed to any eligible entity and that penalties against this vendor are enforced.

Issue 4: The division failed to follow its corrective action plan with School Specialty.

The division issued a corrective action plan to resolve the pricing discrepancy by School Specialty on the statewide contract. In the plan, the division outlined several terms for School Specialty to follow including: the assignment of a dedicated pricing agent, pre-approval of all promotions by the division, handling of any additional pricing discrepancies in a similar manner, and several other terms that were outlined in a letter from School Specialty.

The plan also required School Specialty to conduct business reviews either quarterly or semi-annually. According to division staff, these business reviews have not been requested from School Specialty and have not been reviewed.

When the division imposes a penalty for a contract violation it should monitor all terms of the corrective action plan to ensure that all terms are upheld by the errant vendor and that further violations do not occur. If the division does not follow-up on the sanctions imposed on a vendor the division will have no means to ensure that contract performance has improved and that the conditions of the sanctions are met. Furthermore, vendors will not be held accountable for violations.

Recommendation: The division should use the corrective action plan as a tool to measure future compliance with the terms of the plan and the statewide contract to ensure that School Specialty does not continue to violate the contract.

Issue 5: The negotiated financial credits are really merchandise credits.

Although the division and School Specialty refer to financial credits, the dollar amounts applied to each entity's account are merchandise credits. This distinction is important because rather than the money being returned or credited in cash to each entity, the money was applied to the entity's School Specialty account. Therefore, this credit can only be applied against future purchases from School Specialty and only when the entity asks that the credit be applied.

This created the necessity for public entities to make additional purchases from School Specialty in order to receive the credits they are entitled to. Also, School Specialty negotiated with the division to have the credits applied over a two year period so the credits would not have an adverse "budgetary impact" on School Specialty. Therefore, public entities would have an incentive to make additional purchases to receive the credits due. In fiscal year 2004, School Specialty reported more than \$907 million in

corporate revenue and nearly \$375 million in gross profit. Bain Capital Partners recently purchased School Specialty for \$1.5 billion.

Recommendation: The division should make every effort to ensure that credits are made to users of statewide contracts without strings attached. These credits should be a reimbursement with no requirement for the public entity to continue doing business with a vendor who violated a statewide contract or whose actions otherwise caused an entity to receive a credit in the first place. A public entity should have the choice of whether to reward this vendor with new business under this credit program. School Specialty received no penalty for its contract violation.

Issue 6: The credits have diminished in value.

Around the same time that School Specialty issued its second round of credits, its statewide contract prices increased. School Specialty based the credits on older prices. Therefore, an entity may be applying a credit against a higher purchase price. This reduces the value of the credit and decreases the penalty imposed upon School Specialty. The division made no provision for this price increase when it allowed School Specialty to divide the application of credits over a two year period.

Recommendation: The division should have ensured that credits retain their full value. According to School Specialty, these credits will not expire. The division should ensure that School Specialty continues to honor the credits if and when its contract with the commonwealth ends.

Issue 7: The division did not enforce vendor reporting requirements.

The statewide contract outlines the reporting requirements required by School Specialty. The contract required School Specialty to semi-annually produce by entity, "an itemized list of items sold, including quantity, manufacturing and stock numbers, description, unit of measurement, and unit sold." The contract also requires data on the total amount spent and the total amount spent per item. The contract states, "[F]ailure to meet the reporting requirements established herein may result in contract termination."

However, when the division found School Specialty in contract violation for pricing discrepancies, School Specialty maintained that an itemized list could not be produced to determine the credit amount owed to each entity. In an April 2004 letter to the division, School Specialty stated, "After discussing this with our IT (information technology) department, we realized that, with the resources we had at our disposal, calculating this kind of a usage report for each customer would be a very difficult and time-consuming task." This reporting is required under the contract and School Specialty identified its ability to do so in its contract proposal. The reports would have been useful in the credit calculations.

Recommendation: The division should enforce its own contract requirements. The division should also examine its bid evaluation process since bidders are scored on their ability to meet contract reporting requirements. School Specialty claimed an ability to meet these requirements and was scored accordingly.

Additional Issues

This office's review identified the following issues that apply to division policies, as well as, the School Specialty contract.

Issue 8: The division's definition of a contract violation appears arbitrary.

The division has opined that vendors only violate statewide contracts when they underbid a statewide contract *and* win the bid. This office asked the division for this opinion in writing but it was not provided. According to division staff, the vendor does not violate a statewide contract by offering prices lower than the statewide contract. The violation comes only when the offer is accepted through a contract award. If no purchase is made under an awarded contract, this may or may not be a violation.

This office disagrees with the division's opinion. The terms and conditions section of the statewide contract with School Specialty states:

The Statewide Contractor(s) is/are prohibited from negotiating separate contracts, agreements, licenses, or other terms and conditions with any Eligible Entity that differ from or are in addition to the terms and conditions negotiated as part of the Statewide Contract unless agreed to, in writing, by the Contract Manager. Breach of this requirement will result in sanctions.

This language suggests that submitting or offering a lower price is violating this clause of the statewide contract.

Recommendation: The division should clarify contract language to ensure that the statewide contracts are open, fair, and competitive.

Issue 9: Contract promotions are inadequate for their intended use.

The division allows vendors on all statewide contracts to make promotional offers with prices lower than those on the statewide contract. These promotions or sales may come with quantity minimums, delivery limitations or other restrictions. According to industry representatives, these promotions are sometimes offered in order to accommodate one public entity who would like to receive a volume or other discount. For example, a large school district may wish to order 500 cases of notebook paper. A vendor may wish to offer a volume discount. To do this on the statewide contract, a

promotion must be offered and approved by the division. The promotion may be that for an order of 500 cases of notebook paper or more, a 15 percent discount applies. This promotion may run for days, weeks, or months. In other situations, vendors may wish to pass on incentives from manufacturers to customers or may simply want to offer discounts to clear inventory.

Contract promotions are to be used to resolve contract underbidding.

Since the issuance of the corrective action plan, division staff never identified an example of statewide contract underbidding by School Specialty. If division staff had identified underbidding, the division would have required School Specialty to offer a promotion that would be available to all users of the statewide contract. However, this remedy does not appear adequate to address chronic underbidding. Additionally, the current promotion system does not seem to be an adequate tool for any of its intended purposes because of poor marketing and management.

Contract promotions may be a lost opportunity for statewide contract users.

This office *does not* object to the idea of promotions on statewide contracts. However, this office *does* object to the lack of marketing of these promotions. The promotions are only passed on to the public entities by the vendor or listed on Comm-PASS as an update for a specific contract. There is no website link to promotions or other marketing by the division for promotions. Promotions are, in effect, sale prices being offered by vendors on the statewide contract. But, these sale prices are given a very low profile and must be sought out by customers as opposed to being readily identifiable on Comm-PASS.

These may be great deals for public entities but unless an entity is looking for promotions or happens to be ordering school supplies from the vendor offering the promotion when the promotion is being offered, the entity may never know about the promotion. If the division intends to use promotions to rectify instances of underbidding, some effort should be made to ensure that the users of the contract are aware of these promotions. Otherwise, having vendors offer promotions as a punitive measure will not have the intended effect. This could be a lost savings opportunity for many public entities.

Recommendation: The division should better market promotions to the users of statewide contracts and should make it easier for vendors to offer promotions under the statewide contract. Public entities should be able to take advantage of discounts and cost savings when allowable under procurement law and regulation.

Conclusion

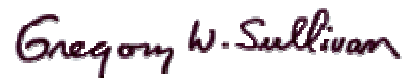
The lack of contract management and oversight by the division has allowed School Specialty to continue to violate the terms of the statewide contract by not conforming to

statewide contract requirements. The division should strive to ensure that all statewide contracts are granted with sufficient safeguards to protect the public interest and that the users of the contracts are receiving competitive, best value prices. Most importantly, the division needs to employ adequate oversight over every contract and, when necessary, impose meaningful and appropriate sanctions to ensure that users of the contract receive adequate compensation for any contract violations.

According to your December 9, 2005 letter that confirmed School Specialty's continued violation of its contract with the commonwealth, the division cannot "determine the severity of the sanctions" to be taken against School Specialty until additional research is conducted. When the division initially found School Specialty in violation of the statewide contract, this office wrote to the division recommending that the division contemplate terminating the School Specialty contract. In light of the continued underbidding by School Specialty and School Specialty's failure to comply with the corrective action agreement, this office recommends that the contract with School Specialty be terminated and that the division consult with the Attorney General's office to debar this vendor.

Additionally, the division needs to take steps to improve dramatically its oversight and monitoring of statewide contracts. This should include enforcing vendor agreements and monitoring bidding by statewide contract vendors. The monitoring and oversight of statewide contracts will assist the division to ensure that contracts are open, fair, and competitive.

Sincerely,



Gregory W. Sullivan
Inspector General

cc: The Honorable Marc Pacheco, Chairman, Senate Post Audit and Oversight
Thomas Trimarco, Secretary of Administration and Finance
William McAvoy, Operational Services Division, General Counsel