

A G E N D A

Interim Committee to Study the State Procurement Process

Monday, August 8th
9:00 a.m. — 3:00 p.m.
Senate Committee Room 356
State Capitol

SUMMARY FOLLOWS AGENDA

Call to Order & Introductory Comments

- 9:30 - 9:45** Procurement Code Overview Memorandum
• Marc Carey, Legislative Council Staff
- 9:45 - 10:45** Department of Personnel and Administration — Overview of Current Practices and Procurement Operations
• Jeff Wells, Executive Director
• Richard Pennington, Director, Division of Finance and Procurement
- 10:45 - 12:00** Office of the State Auditor — Update on performance audits addressing management issues contract
• Joanne Hill, State Auditor
• Jeff Belden, Deloitte & Touche LLP
• Richard Pennington, Director, Division of Finance and Procurement
- 12:00 - 1:30** **Lunch**
- 1:30 - 2:30** Economic Impact of Privatizing, Outsourcing and Offshoring State Functions
• Elizabeth Drake, AFL-CIO
- 2:30 - 3:00** Public Testimony
- 3:00** **Adjourn**
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Final

STAFF SUMMARY OF MEETING

STATE PROCUREMENT PROCESS

Date: 08/08/2005

ATTENDANCE

Time: 09:00 AM to 02:19 PM

Adams X

Felice X

Place: SCR 356

Garcia X

Hanna X

This Meeting was called to order by

Senator Groff

Kerr X

Liston E*

Marshall X

This Report was prepared by

Amy Larsen

Nevitt X

Owen E

Takis X

Teck X

Terry X

Weissmann X

Groff X

X = Present, E = Excused, A = Absent, * = Present after roll call

Bills Addressed:

Action Taken:

1st Meeting of the Procurement Interim Committee

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9:00 AM - Call to Order

The meeting was called to order by the Chairman, Senator Groff. He welcomed the members and asked each of them to introduce themselves. Non-legislative members of the committee include: Mr. Mac Terry, Executive Director of the Contract Administration Fund of Colorado; Mr. Dennis Houlihan, a labor economist with the American Federation of State, County and Municipal Employees, AFL-CIO; Mr. Dave Felice, representing the Communication Workers of America, AFL-CIO; and Mr. Steve Adams, President of Colorado AFL-CIO.

Two Legislative Council Staff memoranda were distributed to the committee. One provides an overview of the Interim Committee to Study the State Procurement Process (Attachment A), and the other provides background information about the state procurement process (Attachment B).

9:16 AM - Staff Overview of the State Procurement Process

Marc Carey, Legislative Council Staff, discussed the memorandum that provides an overview of the state procurement process (Attachment B). He explained that the Colorado Procurement Code (Section 24-101-101, C.R.S.) gives the Department of Personnel and Administration (DPA) authority over the procurement process including rule-making authority. Colorado's procurement process is relatively decentralized compared to other states, and executive departments and institutions of higher education have delegated purchasing authority with varying levels of oversight by DPA. Elected officials are exempt from the procurement code.

Mr. Carey explained that the state uses the Bid Information and Distribution System (BIDS) as a clearing house for vendors, and agencies to share information. This computer system and website is cash funded through vendor registration fees.

Mr. Carey explained that there are three main categories of state procurement purchases: contract awards, price agreements and purchase orders. Contract awards use a bidding process for goods or services depending on the amount of the contract. For contracts greater than \$150,000, a formal competitive bid process is required. Purchases between \$10,000 (for commodities) or \$25,000 (for services) and \$150,000 require an informal competitive process known as a documented quote, and commodity purchases under \$10,000 and services under \$25,000 do not require competitive processes. Sole source contracts are purchases for which only one vendor can supply the service or good.

Price agreements occur when the state specifies a commodity or service that it wishes to purchase, and vendors submit bids on a per unit basis. Agencies then contract with vendors on an as needed basis. Cities and counties can also participate in the price agreements, thereby helping to increase the state's leveraging power.

Purchase orders are typically used by the state to acquire commodities and small purchases of services under \$50,000. Purchase orders are a form of unilateral contract where the vendor may accept the terms either in writing or through performance. Once the good is shipped or the service is performed, the vendor is entitled to be paid.

9:28 AM -- Presentation by the Department of Personnel and Administration

Jeff Wells, Executive Director of the Department of Personnel and Administration (DPA) and Richard Pennington, Director of the Division of Finance and Procurement, DPA distributed copies of their PowerPoint presentation titled "State Procurement and Contracting" to the committee (Attachment C). Mr. Wells clarified that Department of Transportation bridge and highway construction projects, grants, and contracts by elected officials are exempt from the procurement code. In addition to the procurement code, the State Controller and the Attorney General review certain contracts.

Mr. Wells provided more information on Colorado's decentralized model for procurement. He explained that agencies must follow common procurement rules, but that they have internal procurement personnel and monitoring processes. Larger, fully-delegated agencies have their own specialized staff, while smaller agencies rely on DPA.

Mr. Wells explained that the state has moved away from lowest bid always winning the contract. Other factors, including ability to perform, are used to determine which bid is most advantageous to the state. When asked if vendor performance information is shared amongst departments, Mr. Wells explained that an agency can see if another agency had a contract with a specific vendor, but the agencies may or may not discuss vendor performance.

9:42 AM

Mr. Wells provided more detail on purchasing methods. For discretionary purchases (goods less than \$10,000 and services less than \$25,000), pricing is governed by the Controller's statutory requirement for "fair and reasonable" prices. For purchases over \$150,000, a request for proposal (RFP) can be published in BIDS for 30 days. The award is based on a formal process, including the option for vendors to appeal the award decision. Also available for purchases over \$150,000 is an invitation for bids (IFB) which is published in

BIDS for 14 days, and is awarded based on the low bid. For purchases between \$10,000 to \$150,000, a request for Documented Quotes (DQ) can be made. This process is informal, electronic, fast, and requires limited review. Awards are based on the most advantageous to the state.

Mr. Wells explained that the dollar thresholds discussed above are for annual purchases; thus, agencies are not allowed to divide up contracts to avoid the requirements of a higher threshold purchase. In those cases where an annual amount is unknown, price agreements are utilized. Price agreements ask for bids for ongoing orders when a total quantity is unknown, an example would be rental cars. Price agreements reduce duplication of effort. Oversight of price agreements is achieved through DPA monitoring activities and audits. Protests by other vendors also help identify problems. Beyond these activities, the annual budget process controls operating expenditures, but the possibility exists for inappropriate state spending.

Mr. Wells explained that contracts for architectural and engineering work basically follow the IFB process; however, awards are based on experience, qualifications, and ability to perform, before price. Competition is ensured since the state retains the ability to reject a bid, and restart the process.

10:05 AM

When asked if DPA oversees the process of determining if projects can be performed in-house before being contracted out, Mr. Wells replied that individual departments make the decision to contract. However, procurement rules provided by DPA must be followed.

When asked if state personnel have the qualifications and ability to evaluate vendors on large IT projects, Mr. Wells explained that those types of contracts go through the IFB or RFP process, and many times outside experts are hired to advise during the process. Problems have been related more to the ultimate contract provisions. DPA is developing rules to advise departments on when to involve outside experts.

10:13 AM

Mr. Wells provided some more information on BIDS, the state's on-line solicitation distribution system. Vendors pay a \$30 fee to register each year enabling them to bid on DQs, IFBs, and RFPs. While small business registration is 56 percent, and minority and women-owned business registration is 30 percent, the state does not give preference to these firms. When asked about the state's ability to hold a reverse auction, Mr. Wells stated that while it is an option, it is not widely utilized.

Mr. Wells presented statistics on the various competitive methods on BIDS. Documented quotes (DQs) are used significantly more often than IFBs or RFPs, but DQs have a lower overall dollar value.

10:24 AM

Mr. Wells provided the following definitions of privatization, outsourcing and off-shoring within the context of government contracts:

- **Privatization** is when a government takes a function, such as trash collection, and moves it to the private sector;

- **Outsourcing** is when a function is performed by an outside group, but the government keeps some control over the function; and
- **Off-shoring** occurs when an outsourced function is performed either overseas or outside of Colorado.

Mr. Wells added that the state's procurement software tracks for legal compliance, but it is not designed for full contract management. The tracking does not look at exactly who is performing the work, or where the work is performed, since tracking this information would be time and resource consuming.

Senator Groff asked if companies with an established record with the state can be given preference in awarding contracts. Mr. Wells responded that if there is a "tie" between two vendors, preference is given to a Colorado firm. However, if federal funds are involved, the state cannot impose preferences.

Representative Marshall asked if the state can consider a vendor's ability to protect the privacy of the citizens of Colorado. Mr. Wells responded that the state does address these issues with vendors during the bidding process, and specific provisions are added to contracts when personal information is involved

Mr. Houlihan asked where analysts get guidance on cost comparisons, including indirect costs, when evaluating whether or not to outsource a state function. Mr Wells indicated that the Procurement Manual is the best source of guidance from DPA. In addition, the Division of Human Resources within the DPA can be contacted for technical help in determining if specific indirect costs should be included when determining if a function can be outsourced.

Senator Hanna asked about protections to ensure the security of personal information, when work is performed outside the United States. Mr. Wells replied that while there is no way to completely avoid security breaches, the state's biggest "club" is the contract itself. Criminal prosecution is also an option. Senator Groff asked about the privatization of child support enforcement. Mr. Wells did not have any information on that program, but agreed to provide the committee information at a later date.

10:49 AM

Continuing his discussion of procurement policies in Colorado, Mr. Wells explained that Colorado is a reciprocal preference state. Colorado bidders are only given preference over bidders from other states if those states give resident bidders preference. Most states do not give preference to resident bidders.

Mr. Wells stated that price agreements are a great benefit to local governments because the state uses its bidding system and expertise to establish a maximum price with a vendor for a specific product. Colorado has about 340 price agreements in place.

Mr. Wells added that a system of protests and appeals is available to vendors if they feel an error has been made. Protests are made to the procuring agency first. If the vendor is not satisfied, an appeal can be filed with DPA. In FY 2004-05, there were 35 protests and 12 appeals.

Commenting on another way departments can purchase goods, Mr. Wells discussed procurement cards. Procurement cards can be used for discretionary commodity purchases under \$10,000 and services under \$25,000. The state receives 0.95% back on such purchases. He stated that agency use of the cards is increasing in terms of both the number of transactions and amount spent.

Mr. Wells stressed the decentralized nature of procurement in Colorado. The Procurement Code allows for all higher education and large departments to have fully delegated procurement, and the State Controller can delegate contract approval authority too. Approximately 75 percent of contract transactions were fully delegated in FY 2004-05.

Mr. Wells explained that Colorado does not have a central contract management function. However, fiscal rules require sufficient documentation before payment is made. In response to the Legislative Audit Committee report, the Colorado Contract Procedures and Management Manual is being updated to include recommended contract management practices.

10:58 AM

Mr. Wells offered to discuss procurement issues for specific agencies. For example, at Health Care Policy and Financing, 90 percent of contracts are price agreements for purchased services. Purchased services are services purchased for a client, like home nursing care.

Senator Groff reiterated that the committee would like individual departments to provide the committee information on their procurement processes. Mr. Wells replied that he can give the committee information on the purchasing processes for all agencies; however, individual departments would need to reply to programmatic questions.

When asked for more information about DPA audits, Mr. Wells replied that DPA randomly monitors contracts verifying compliance with procurement rules. If DPA finds that an agency is not complying with the rules, it has the power to withdraw delegated authority. However, once a contract is signed, DPA does not have authority to change it, but Controller and Attorney General reviews can deny a contract if it does not meet their legal standards.

11:08 AM -- Presentation by the Office of the State Auditor

Joanne Hill, State Auditor, introduced herself and her colleagues including Cindi Stetson, Deputy State Auditor, Michelle Colin, Legislative Audit Manager, and Jeff Belden, with Deloitte and Touche LLP.

Sen Takis asked what percentage of state audits are done by contract. Ms. Hill replied that most audits are contracted out -- about \$2 million on financial audits and additional contracting in specialized areas.

Cindi Stetson, Deputy State Auditor, described the performance audit process as the review and evaluation of a particular program as authorized by the General Assembly. The Office of the State Auditor (OSA) considers the contract management evaluation function a significant area of risk for the state due to the delegation to agencies. The OSA is often asked why it is not involved while a contract is in process. Ms. Stetson stated that the OSA must maintain its independence to effectively perform its duties. The OSA cannot audit its own work.

Ms. Stetson explained that audit findings can be found on the OSA website (<http://www.leg.state.co.us/OSA/coauditor1.nsf/Home?openform>). Most audits include some information on contract monitoring, including recent audits on private prisons and highway design and construction projects. Members of the General Assembly can request an audit by sending a letter to the chair of the Legislative Audit Committee, currently Representative Val Vigil.

Senator Groff asked what the level of contract monitoring in each department is. While Ms. Stetson did not have a specific answer for each department, she indicated that the OSA views weak contract monitoring as a significant risk for the state.

11:17 AM

Mr. Belden, with Deloitte and Touche LLP, stated that he conducted the audit of statewide contract management practices completed earlier this year, and summarized the recommendations and findings for the committee. Recommendations and findings include:

- evaluating the possible implementation of a centralized contract monitoring system;
- reviewing the policy to increase delegation to agencies;
- finding noncompliance by departments with procurement rules, for example failure to list the maximum price, work beginning prior to final approval of contract, and incorrect signatures;
- considering the possible expansion of personal services contract criteria;
- developing performance measures for each contract since agencies are not consistently using performance measures (6 of 31 contracts reviewed had performance measures);
- developing a centralized monitoring system for contract disputes;
- finding the contract monitoring process to be weak, including incomplete file documentation, and a lack of standards across departments;
- improving and updating contract management guidance; and
- evaluating contract monitoring and administration in employee performance evaluations.

11:31 AM

Senator Takis asked if Mr. Belden found any contracts that were nullified due to internet bidding. Mr. Belden said that they did not find nullified contracts, but noted the audit was limited. When asked about the potential usefulness of additional definitions in statute, he stated that definitions of outsourcing, privatization, and off-shoring would provide guidance for monitoring contracts. Ms. Hill noted that definitions are a great reference for her office and the departments.

Mr. Houlihan asked if state contracting procedures in the contract manual should be more than advisory. Ms. Hill replied that the contract manual is advisory in part, but there is a statutory framework and significant case law regarding state contracting.

11:38 AM

Ms. Hill summarized four (simplified) contract stages for large IT contracts:

1. Business Process re-engineering: Colorado Trails, a \$62 million automated system for foster care and adoption processes, was found in a November 2002 audit to be plagued by numerous problems, delays, and substantial costs. There were not sufficient procedures in place related to change management. Business procedures under the old system differed significantly from the procedures required under the new system. These problems required county workers to perform "work-arounds" to complete routine tasks. Repetition of these problems was found with CBMS. Ms. Hill stated that the state must rethink how it implements new business processes, and encouraged the committee to look for ways to institutionalize best practices for business process re-engineering.

2. Contract development: Agencies spend a lot of time on the legal and contractual scope of contracts, but spend less time on the business processes. The state does not do a good job of defining and requiring deliverables in IT contracts.

3. Contract Management: First, the state needs to improve the assignment of accountability. The state tends to identify a matrix of responsibility instead of individuals. Second, questions of who is in charge of monitoring the project and what resources are required must be addressed. A third key to contract management is determining what penalties take place for poor performance.

4. Training Staff: The state must anticipate and plan for this time consuming stage to make the service work.

Ms. Hill concluded by asking the committee to use the OSA as a resource.

11:51 AM

The committee commented that problems seem to center around the decentralized process with no check on deliverables. Ms. Hill noted that decentralization is the trend in large government agencies, but perhaps a different approach to training and deliverables could provide uniformity and discipline in state contracts. Mr. Belden noted that contract phasing is commonly used to evaluate the progression of projects, and that there may be some statewide performance measures that should be built into every contract, but other measures must be specific to the contract.

11:58 AM -- Recess

1:32 PM -- Economic Impact of Privatizing, Outsourcing, and Off-shoring State Functions

Elizabeth Drake stated that she is in the public policy department of the AFL-CIO, and works on issues related to international trade, outsourcing, privatization, and off-shoring. Specifically, she analyzes the net impacts of these policies for governments spending tax dollars. Ms. Drake stated that the AFL-CIO feels that outsourcing should only be used when it provides a net benefit to the state. Outsourcing opens the door for poor service quality, corruption, and cost overrun which would not exist if performed in the public sector. Ms. Drake explained that where work is performed is an important question. There are usually claims of net savings to taxpayers when contracts are off-shored. The problem is that the state has no way of knowing that savings is actually passed on to taxpayers, unless there is full disclosure.

Ms. Drake identified negative impacts of off-shoring including higher unemployment, higher dependence on state welfare programs, increased default on mortgages, and lower tax revenue. In addition, overseas worker salaries do not have the multiplier effect on the state's economy. She stated that she does not know how many jobs are lost overseas, but the number appears to be increasing. The broad view shows that Colorado has lost a total of 30,000 jobs since 2002. Workers who lose jobs to free-trade are often unable to find new jobs, and if they do, salaries are typically 23 percent less with their new employers.

Ms. Drake stated that there is not a lot of information available about off-shoring of public contracts. She cited a Washington State survey that indicated 36 of 41 agencies found that some work had been off-shored. Another study found that the amount of state contracts moved off-shore is about \$10 billion now and is expected to reach \$23 billion by 2008.

Ms. Drake noted that in addition to the cost to the community due to off-shoring, there are also issues of quality and accountability. Functions being off-shored involve personal health data, tax data, engineering, and highway data. When work is performed overseas, individuals may lose control and accountability of personal information.

1:41 PM

Ms. Drake explained that states can use several tools to deal with the accountability issue. Some states require vendors to disclose how much work

will be performed overseas. Protections can also be put in place for the security of personal information. Finally, the state could prohibit contracts from being sent offshore or give preferences to in-state contractors. She stated that more than 30 states have introduced this type of legislation.

Ms. Drake discussed international trade agreements. Some agreements prohibit states from giving preference to in state contractors, and create new rights for foreign bidders that do not exist for domestic bidders. Under these agreements, states are unable to evaluate bids on other criteria such as the use of recycled goods, supplier qualifications, or local job creation. As state legislatures realize that their authority to set procurement policy has been compromised, many are demanding increased involvement. Some governors and state legislatures are withdrawing their states from these agreements.

Sen Groff asked if Governor Owens has signed Colorado onto any international trade agreements. Ms. Drake explained that Colorado is signed onto the agreement on government procurement through the World Trade Organization. Colorado also has bilateral agreements with Australia, Chile, Morocco and Central America. Others agreements are in negotiations.

Senator Groff asked Ms. Drake to review what other states have done to give preferences to their companies. Ms. Drake replied that about five states have given preference to in-state suppliers and contractors. Those states allow purchasing officers to consider where work will be done in awarding contracts. New Jersey specifically prohibits awarding contracts to companies that intend to perform work overseas. Although little information exists on state-to-state impacts, there has not been a negative impact internationally. Colorado companies will have access to foreign markets, whether or not Colorado signs on to trade agreements

Representative Kerr commented that services are more intangible than goods, and asked how off-shoring services can be managed. Ms. Drake replied that contractors should be the ones managing this and stipulating that subcontracted work not be completed offshore. Representative Kerr asked if that was a form of protectionism. Ms. Drake noted that there was a difference between private companies' operations and the spending of public tax dollars. Public dollars represent only a small portion of the total amount of contracts off-shored. In addition, she stated that it is important to remember the multiplier effect which occurs when public dollars are invested in the local economy. As more services are able to be performed overseas due to advances in information technology, many state legislatures want to have a greater voice in the decision making process.

Mr. Felice asked if there is a penalty for withdrawal from trade agreements. Ms. Drake explained that the federal government is responsible for ensuring state compliance with trade agreements. International trade tribunals cannot force a state to change its laws. The federal government would likely urge state compliance, but it is not known what the penalties may be.

2:04 PM - Public Testimony

Mr. Morgan Smith, a board member of the World Trade Center Denver, explained that the United States is a major beneficiary of free trade and foreign investment, and that the cost of labor is not the only factor in determining investment. The United States is politically stable, has an educated work force, good infrastructure, and a good judicial system.

Mr. Smith explained that the impact of outsourcing is complicated. He gave the example of a Nepalese company that had formed a joint venture with a Boston company. The only way for the new company to succeed was to hire labor in both Nepal and Boston. The company started with six employees in both Nepal and Boston, and now has 75 employees in each location. Without the partnership, no jobs would have been created in either location.

Mr. Smith noted that Colorado has about 93,400 workers employed due to foreign investment and ownership, according to the Organization of International Investment. He stressed that it was important to keep a welcoming image for foreign companies doing business in Colorado. If Colorado is going to maintain economic leadership, it must have the ability to create investment opportunities.

Senator Hanna commented that this committee is focusing on state dollars and the ability of the state to contribute to the local business community. Mr. Smith stated that the state's image is just as important as the actual amount of money contracted. If legislation is passed, it may impact the state's image in a negative way.

Senator Groff asked if the state requires disclosure, instead of prohibiting outsourcing or off-shoring, would Colorado face the same kind of "chilling" effect of international relations. Mr. Smith replied that disclosure and data security are both important issues.

2:19 PM

The committee adjourned. The next meeting will be Tuesday, August 9, at 9:00 AM in HCR 0112.

