Report of the
Joint Legislative Audit and Review Commission
To the Governor and
The General Assembly of Virginia

Review of Department of General Services Internal Service Funds

In Brief

Review of Department of General Services Internal Service Funds

Internal service funds (ISFs) are a financial mechanism to recapture costs incurred by one agency when performing services or procuring goods on behalf of multiple agencies. Section 2.2-803 of the *Code of Virginia* grants the Joint Legislative Audit and Review Commission (JLARC) oversight responsibility for ISFs. At the December 2008 JLARC meeting, the JLARC director advised that staff would review the ISFs managed by the Department of General Services (DGS) during the spring of 2009.

DGS operated nine ISFs in 2009 which provide a range of goods and services to agencies. In general, agencies are satisfied with the goods and services provided by the DGS ISFs. However, JLARC staff did find areas where the financial management of the funds could be improved. For example, the Department of Planning and Budget should develop a proposed schedule for review and approval of changes to ISF rates and other charges that is better integrated with Virginia's biennial budget process. In addition, the Department of General Services should develop specific cash balance thresholds for each fund it operates.

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This report is available on the JLARC website at http://jlarc.virginia.gov

COMMONWEALTH of VIRGINIA

Joint Legislative Audit and Review Commission

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July 22, 2009

The Honorable M. Kirkland Cox
Chairman
Joint Legislative Audit and Review Commission
General Assembly Building
Richmond, VA 23219

Dear Delegate Cox:

Section 2.2-803 of the *Code of Virginia* grants the Joint Legislative Audit and Review Commission (JLARC) oversight responsibility for internal service funds. At the December 2008 JLARC meeting, I informed the members that staff would review the internal service funds managed by the Department of General Services in Spring 2009. Findings of the study were presented to the Commission on June 8, 2009.

On behalf of the Commission staff, I would like to thank the Department of General Services staff for their assistance during this study. I would also like to thank the agency employees who participated in interviews and surveys.

Sincerely,

Philip A. Leone
Director

PAL/jcb

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JLARC Report Summary:

Review of Department of General Services Internal Service Funds

Key Findings

- The Department of General Services (DGS) managed nine internal service funds (ISFs) in FY 2009, with fund revenue totaling approximately $92 million in FY 2008. (Chapter 1)
- The financial management of the DGS ISFs is not fully aligned with the State's biennial budget process. There are also no agreed-upon thresholds to assess whether the variations in yearly gains, losses, or cash balances are acceptable. (Chapter 2)
- The Virginia Distribution Center (VDC) provides State agencies with products that typically cost less than potential alternatives. VDC's State agency customers are generally satisfied with VDC products and service. (Chapter 3)
- The centralization of leasing activities through the Division of Real Estate Services (DRES) has resulted in cost savings and other benefits, though there is still progress to be made in creating a centralized inventory of the State's property holdings. (Chapter 4)
- The Division of Consolidated Laboratory Services (DCLS) conducts timely and accurate tests on behalf of its State agency customers. It appears, however, that DGS should evaluate the feasibility of including additional agencies in the ISF and charging agencies the cost of service. (Chapter 6)

Internal service funds (ISFs) are a financial mechanism to recapture costs incurred by one agency when performing services or procuring goods on behalf of multiple agencies. Section 2.2-803 of the *Code of Virginia* grants the Joint Legislative Audit and Review Commission (JLARC) oversight responsibility for ISFs. At the December 2008 JLARC meeting, the JLARC director informed the Commission that staff would review the ISFs managed by the Department of General Services (DGS) during the spring of 2009. This report conveys the results of that review.

ISF OPERATIONS AND JLARC'S OVERSIGHT ROLE

DGS operated nine internal service funds in FY 2009. These ISFs represent centralized services provided to State agencies and include the management of vehicles, disposition of surplus property, and leasing and maintenance of State-owned property (see table). In total, the DGS internal service fund operations employ 240 staff and in FY 2008 collected approximately $92 million in revenue. JLARC plays a role in the creation of new and closing of existing ISF accounts, and also has general oversight of ISF operations.

Table: Services or Products Provided, Staffing, and Funding for ISFs Managed by DGS

Fund	Primary Service / Product	2009 Staffing	Revenue (FY 2008)	Operating Expense (FY 2008)
Virginia Distribution Center	Sale of food and housekeeping products	26	$33,597,698	$33,077,440[a]
Bureau of Facilities Management	Lease and maintenance activities on State-owned property	104	33,339,767	32,970,258
Office of Fleet Management Services	Management of cars and trucks used by State agencies	16	16,529,790	15,161,954
Division of Real Estate Services	Administration of leases for agencies that rent office space	14	N/A[b]	N/A[b]
Bureau of Capital Outlay Management	Assistance planning and procuring construction services	25	2,916,547	2,903,429
State Surplus Property	Sale or donation of State surplus items to agencies, non-profits, and the public	13	2,331,461	1,862,693
Division of Consolidated Laboratory Services	Laboratory testing of environmental, agricultural, and other samples	35	2,269,605	2,779,868
Federal Surplus Property	Sale or donation of federal surplus items to agencies, non-profits, and certain small businesses	3	412,209	310,226
Office of Graphic Communications	Printing and graphics services	4[c]	334,319	343,648
	TOTALS	**240**	**$91,731,396**	**$89,409,516**

[a] Operating expense includes cost of products purchased to sell to customers, which was $29,677,215.
[b] The Division of Real Estate Services (DRES) did not begin operating as an internal service fund until FY 2009. DRES projects its FY 2009 revenue will be approximately $54.6 million, which includes $1.85 million collected from fees charged to agencies.
[c] In mid-2009, DGS reduced staff and other operational expenses for the Office of Graphic Communications to match reduced revenues.

Source: JLARC staff analysis of DGS data.

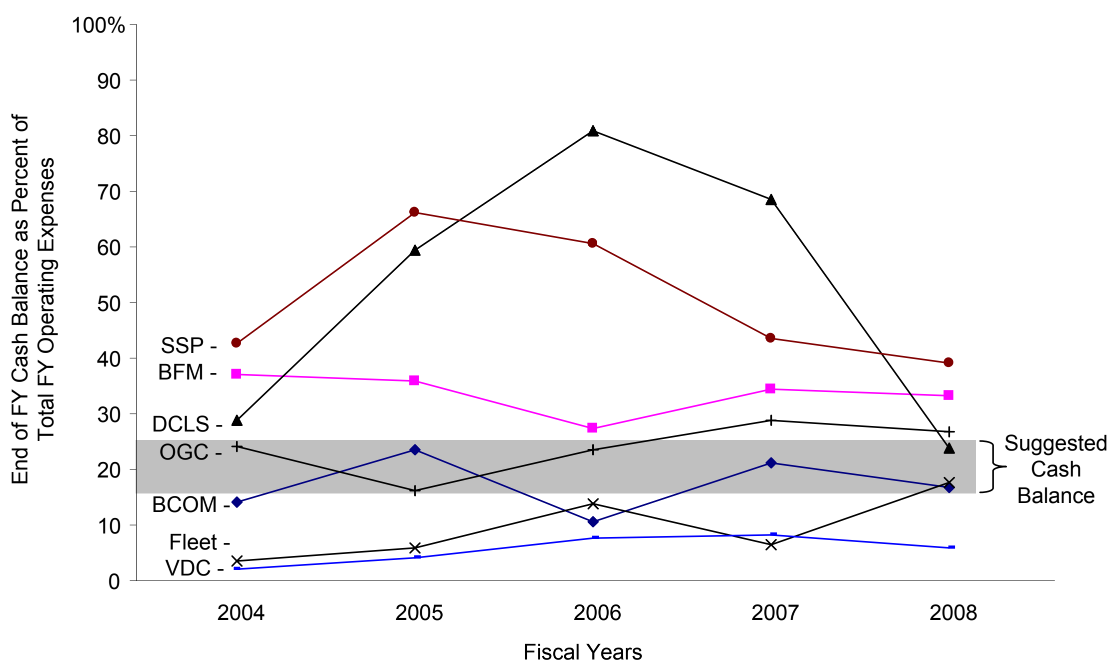
JLARC's oversight role typically takes two forms. The first is approving rates that ISFs charge customer agencies. The second is periodically conducting detailed reviews of ISF operations and funding. These detailed reviews, such as this report, seek to answer key questions about the efficiency and effectiveness of ISFs. This review covers the period from FY 2004 to FY 2008 and addresses six of the funds operated by DGS. It does not address the Office of Fleet Management Services or the Bureau of Capital Outlay Management (BCOM) because they have recently been reviewed by the Auditor of Public Accounts. It also does not address the Office of Graphic Communications (OGC) because DGS has reduced staff and other expenses to match reduced revenues.

OPPORTUNITIES TO IMPROVE ISF FINANCIAL MANAGEMENT

Within the last five years, it appears that DGS has applied sound financial management principles to its ISFs. However, this review has identified several opportunities for improvement. Recent DGS rate requests and subsequent JLARC rate approvals have occurred after the budget development and appropriations process. This lack of alignment with Virginia's biennial budget process is one factor that contributes to differences between what is appropriated to agencies for ISF products and services and what ISFs eventually collect from agencies in revenue. JLARC staff recommend that a schedule for submitting and approving ISF rates be proposed that is more closely aligned with the biennial budget process.

In addition, the funds have operated with varying annual gains, losses, and cash balances. JLARC policy and federal guidance suggest a working capital balance or cash reserve of between 60 and 90 days' worth of operating expenses (which translates into 16 to 25 percent of annual operating expenses). However, the end-of-year cash balances as a percentage of annual operating expenses have varied significantly over the last five years (see figure). Of the seven funds shown in the figure below, none had end-of-fiscal-year cash balances within the suggested range for all of the previous

Figure: Historical Cash Balances as Percentages of Annual Operating Expenses Have Varied Significantly



Note: Federal Surplus Property is not shown because federal allowances for cash balance are 200 percent of annual operating expenses. Division of Real Estate Services is not shown because FY 2009 will be its first full year of operation as an internal service fund collecting agency revenue. The Virginia Distribution Center is shown using its cash balance as a percentage of annual operating expenses plus the cost of goods sold.

Source: JLARC staff analysis of ISF profit and loss statements, FY 2004 – FY 2008.

five years. Four funds had cash balances within the range for between one and three of the previous five years. The other three funds had balances either below or above the range for the entire five-year period.

A variety of factors complicates an analysis of cash balances compared to the 60- to 90-day threshold, including whether some of these cash balances were already obligated, what to include in the calculation of a fund's operating expenses, and whether the fund is purposefully accumulating an above-threshold balance to pay for capital expenditures. In addition, there are currently no agreed-upon thresholds to determine whether the magnitudes of the gains, losses, and cash balances are acceptable. JLARC staff recommend that DGS develop specific thresholds to facilitate oversight of these key indicators of the financial condition of an ISF.

SIX INTERNAL SERVICE FUNDS PROVIDE A RANGE OF PRODUCTS AND SERVICES TO CUSTOMERS

This review examined six of the nine DGS funds, which provide products and services ranging from food to laboratory testing. The review addresses both operational and financial aspects of these funds. This includes answering key questions such as whether the funds provide competitively priced products or services, whether their agency customers are satisfied, and if revenue collected over time is sufficient to cover fund operating expenses.

Virginia Distribution Center Appears to Be Operating Well

The Virginia Distribution Center (VDC) offers more than 950 different products to its State and local customers. Products are non-perishable and generally fall into the categories of food/food-related items, such as frozen meats or canned goods, and housekeeping products, such as floor care products and paper towels. From 2003 to 2008, VDC estimates its customers realized cost avoidances of between $9.3 and $15.7 million annually. Throughout this time, these cost avoidances for agency customers have been substantially higher than VDC's operating expenses, which are covered through its mark-up rate.

Based on several measures, it appears that VDC's customers are receiving their products when needed and are satisfied with VDC's products and service. For example, over 88 percent of customers agreed or strongly agreed that they were generally satisfied with VDC's services.

VDC had a cumulative operating gain between FY 2004 and FY 2008 of about $2.3 million. This represents about 1.6 percent of VDC's total operating expenses during the time period. VDC's unique structure presents several possible methods to assess its cash balance. Depending on the method used, VDC's cash balance has been above, within, or below various thresholds.

Real Property Management ISFs Report Cost Avoidances, but Complete Data on All Properties Needed

The Bureau of Facilities Management (BFM) operates and maintains office space used by State agencies. BFM reports that its rental rate for State-owned office space is lower than the average charged by private landlords. BFM also indicates it is difficult to maintain a cash balance that is sufficient to address periodic needs for large cash expenditures, such as when capital equipment fails and needs to be replaced. JLARC staff recommend creation of a mechanism, consistent with agreed-upon cash balance thresholds, to facilitate better planning and funding for repairs not included in agency maintenance reserves.

Through the Division of Real Estate Services (DRES), the State is currently centralizing agency leases with private landlords. During the centralization, DRES is reporting cost avoidance through strategies such as renegotiating leases, relocating agencies in new space, or using leased space occupied by agencies more efficiently. These cost avoidances of approximately $8 million annually are substantially greater than the fees agencies will be paying DRES each year.

The existing centralized database at DRES does not include information about all the State's real property holdings and leases, in particular for those holdings not managed by DRES. According to DRES, the State cannot have confidence that it is effectively utilizing its real property assets without a centralized repository that includes square footage, cost, and staffing associated with the property. Particularly given the current budgetary climate, JLARC staff recommend that DGS and DPB identify the specific actions and milestones necessary to collect and maintain key data about the State's owned and leased property.

Office of Surplus Property Management Funds Are Operating Well, but Revenue Base May Need to Be Broadened

There are two surplus property ISFs, one for State surplus property and one for federal surplus property. Both of these funds have historically had an operating gain, and most customers indicated they are generally satisfied with the services provided. Despite the funds' past operating gains, DGS is concerned that certain changes in State agency operations will reduce the funds' future revenue streams and sustainability. The Office of Surplus Property Management (OSPM) is currently exploring opportunities to broaden the funds' revenue bases by providing surplus services to localities, and increasing the use of contract auctions and Internet sales.

Division of Consolidated Laboratory Services Provides Good Service, but Operation as ISF in Current Form Needs Evaluation

The Division of Consolidated Laboratory Services (DCLS) tests food products, animal feeds, water, soil, air, motor fuels, and human and animal tissue specimens. DCLS is unique among DGS's internal service funds because only some of its customer agencies are included in the fund. The fund's two main customers are the Virginia Department of Agriculture and Consumer Services (VDACS) and the Department of Environmental Quality (DEQ). Total revenue for the fund in FY 2008 was $2.3 million, which was approximately nine percent of DCLS's total budget in FY 2008. The remaining 91 percent of DCLS funds comes from general, federal, and enterprise funding.

DCLS testing is accurate, is provided in a timely manner, and VDACS and DEQ are generally satisfied with DCLS services. For example, over a five-year period, DCLS's accuracy ranged from 95.4 percent (in 2006) to 99.1 percent (in 2007). Both DEQ and VDACS indicated that DCLS generally provides high-quality services at a reasonable price, and that the turnaround times, with minor exceptions, are adequate.

Over the last five years, DCLS has shown a cumulative operating gain, but experienced a loss in FY 2008. The FY 2008 loss was largely caused by an increase in operating expenses. Much of the increase occurred because DCLS reallocated the salaries of some staff to the internal service fund from other general funds. DCLS anticipates reducing those allocations to address the shortfall in future years, which suggests that DCLS is not charging DEQ and VDACS rates sufficient to cover the actual costs of testing. JLARC staff recommend that DCLS evaluate the feasibility of including additional State agencies in the ISF and charging customer agencies the actual cost of testing.

Chapter 1 Introduction

In Summary

The Department of General Services (DGS) operated nine internal service funds (ISFs) in FY 2009. These ISFs represent centralized services provided to State agencies and include the management of vehicles, disposition of surplus property, and leasing and maintenance of State-owned property. In total, the DGS ISFs employed 240 staff and in FY 2008 collected approximately $92 million in revenue. JLARC plays a role in the creation of new and closing of existing ISF accounts, and also has general oversight of ISF operations. JLARC's oversight role involves two approaches: approval of rates that ISFs charge customer agencies, and periodic reviews of ISF operations and funding. These detailed reviews, such as this report, seek to answer key questions about the efficiency and effectiveness of ISFs.

Internal service funds (ISFs) are a financial mechanism to recapture costs incurred by one agency when performing services or procuring goods on behalf of multiple agencies. Section 2.2-803 of the *Code of Virginia* grants the Joint Legislative Audit and Review Commission (JLARC) oversight responsibility for ISFs. At the December 2008 JLARC meeting, the JLARC director informed the Commission that staff would review the ISFs managed by the Department of General Services (DGS) during the spring of 2009 (Appendix A). In conducting this review, JLARC staff analyzed data from the ISFs and conducted interviews of ISF managers. In addition, JLARC staff surveyed customer agencies about their use of and satisfaction with the DGS ISF services (Appendix B).

INTERNAL SERVICE FUNDS ACCOUNT FOR CENTRALIZED SERVICES

According to the Governmental Accounting Standards Board, internal service funds account for the financing of goods or services provided by one department or agency to other departments or agencies on a cost-reimbursement basis. Typically, ISFs are operated by a program or office that serves as a centralized point to provide goods and/or services to other agencies. Depending on the ISF's products or services, agencies' relationships with the ISF is either through transactions as needed or on a regularly occurring basis. For example, agencies use the fleet management ISF on a periodic basis depending on their needs for vehicles. On the other hand, agencies occupy office space that is managed by an ISF on a continual basis.

After receiving the goods or service, the customer agency is billed by the ISF and submits payment. The ISF bills the agency for an amount at a rate sufficient to cover a unitized portion of the ISF operating expenditures, as well as the cost of the product or service the customer received. For certain ISFs, general funds in the form of working capital advances from the State treasury are provided in the early years of their operations. State agency customers are ultimately appropriated funds, which they in turn use to pay for the ISF goods or services.

DGS operates nine ISFs that provide a range of products and services to agencies (Table 1). These include the management of cars and trucks, disposition of surplus property, and leasing and maintenance of State-owned property. The DGS ISFs collectively employed 240 people at the beginning of 2009. The Bureau of Facilities Management (BFM) employed the most staff at 104.

Table 1: Services or Products Provided, Staffing, and Funding for ISFs Managed by DGS

Fund	Primary Service / Product	2009 Staffing	Revenue (FY 2008)	Operating Expense (FY 2008)
Virginia Distribution Center	Sale of food and housekeeping products	26	$33,597,698	$33,077,440[a]
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[a] Operating expense includes cost of products purchased to sell to customers, which was $29,677,215.
[b] The Division of Real Estate Services (DRES) did not begin operating as an internal service fund until FY 2009. DRES projects its FY 2009 revenue will be approximately $54.6 million, which includes $1.85 million collected from fees charged to agencies.
[c] In mid-2009, DGS reduced staff and other operational expenses for the Office of Graphic Communications to match reduced revenues.

Source: JLARC staff analysis of DGS data.

The DGS ISFs collected approximately $92 million in revenue in FY 2008. The Virginia Distribution Center (VDC) collected the most revenue at approximately $33.6 million. The revenue collected by the funds is primarily used to cover the fund's operating expenses, which in certain cases can include large amounts of funds that are passed through to the private sector to pay for goods or services.

The ISFs had operating expenses ranging from approximately $33 million for BFM and VDC to $343,648 for the Office of Graphic Communications (OGC). As noted above, each ISF charges its customers a rate or fee for the products or services it provides. These rates are intended to cover the ISF's operating expenses over time. These rates and the methodology used to calculate them will be discussed in more detail for selected ISFs in Chapters 3 through 6.

JLARC'S OVERSIGHT ROLE FOR INTERNAL SERVICE FUNDS

JLARC's role in regard to ISFs is derived from several sections of the *Code of Virginia*, as well as the legislature's desire to still have oversight of the funding of activities that receive "sum sufficient" appropriations in the budget. Section 2.2-803 of the *Code* requires ISFs for specific types of activities:

> As to the operation of merchandising activities, or other centralized support services provided by one state agency to other state agencies for which charges are made, the system of accounting shall be designed to reflect all charges properly allocable so that the net profit or loss therefrom shall be reflected.

The same section also grants JLARC its oversight responsibility:

> In the furtherance of this objective, the Joint Legislative Audit and Review Commission may direct the Comptroller to establish under such terms and conditions as they may determine internal service fund accounts on his books and record therein the receipts and expenditures of these several functions. The Comptroller shall provide the agencies responsible for the operations of these functions with working capital advances with which to finance the operations pursuant to appropriations made by law. The Joint Legislative Audit and Review Commission may direct the Comptroller to transfer excess fund balances to the general fund or to remove from his books internal service fund accounts that are no longer considered appropriate and record the necessary transfer of funds.

Section 2.2-1101 of the *Code* created the ISF accounts, stating that "upon written request of the Director of (DGS), the Joint Legislative Audit and Review Commission may direct the Comptroller to establish internal service fund accounts …".

The responsibility for appropriating funds rests solely with the legislature. However, because ISFs typically receive no direct general fund appropriations, the budget bill indicates they are funded at a level that is "sum sufficient." Part of the rationale for JLARC's oversight of ISFs was to allow for legislative insight into ISF operations despite the sum sufficient level of funding. JLARC articulated its intended oversight role in 1983 when it established policy for the ISFs. The policy requires DGS to keep JLARC informed of the financial condition of the funds and any proposed changes in services, customers, or pricing. The policy requires DGS to provide financial statements and annually submit a schedule of proposed charges and rates for the next fiscal year. Additionally, the policy identifies three basic objectives for ISFs:

Other State Legislature Involvement

State legislatures have different degrees of involvement with internal service funds. For example, West Virginia's legislature is not directly involved in authorizing what functions are service funds, approving agency participation, or overseeing the rates charged. However, Georgia's legislature is directly involved in all three aspects of fund operations.

1. Ensuring activities are managed in a businesslike manner;

2. Promoting efficiency by making agencies pay the full costs of providing agency services; and

3. Allocating the costs of central administrative services across all fund types, so that non-general funds share in the costs of general government support.

JLARC's oversight of ISFs attempts to strike the appropriate balance between legislative oversight and executive branch responsibility to operate efficiently and effectively. This requires allowing the executive branch—in particular ISF fund managers, the DGS Director, Secretary of Administration, the Department of Planning and Budget, and the Governor—sufficient flexibility to make decisions about how best to manage fund operations during a given year. The balance also requires, however, providing the legislature a reasonable level of confidence that ISFs are operating efficiently, effectively, and in a manner consistent with the JLARC objectives for ISFs identified above.

To provide some level of confidence about ISF operations, JLARC has two primary approaches to its oversight of ISFs. The first approach addresses the rates that ISFs charge customer agencies. As needed, DGS develops proposed rates based on the projected cost and volume of services provided to agencies. These rates are, in most cases, the additional fee that an ISF needs to charge agencies to recover the cost of the services the fund provides. The proposed rates are typically submitted to the JLARC internal service fund subcommittee for review. JLARC staff then evaluate the proposed rate based on the assumptions used and adequacy of rates to recover the full cost of services. The subcommittee may then recommend approval, modification, or denial of the proposed rates to the full Commission at one of its meetings.

Previous Detailed JLARC Reviews of DGS ISFs

JLARC periodically conducts detailed reviews of DGS ISFs. These include reviews of the State's vehicle fleet in 2004 and the Virginia Distribution Center in 2001.

The second approach that JLARC uses for oversight of ISFs is periodic, detailed reviews. These reviews typically assess a range of issues related to ISF operations and funding. For this review, JLARC staff identified key oversight questions intended to address both operational and financial aspects of an ISF (Exhibit 1).

Exhibit 1: Key Questions for Detailed Reviews of ISFs

1. Are products or services provided at a competitive and/or reasonable price compared to potential alternatives?
2. Is centralization through the ISF creating cost avoidances or savings for the State?
3. Are services or products of sufficient quality?
4. Are services or products provided in a timely manner?
5. Are customers satisfied with their services or products?
6. Is revenue collected through the ISF rate approximately equal to, over time, ISF operating expenses?
7. Are costs shared by all users of services, regardless of fund type?

Source: JLARC staff.

DGS regularly collects information to answer some of these key questions. In other cases, JLARC staff collect additional information to support answering key questions. In general, affirmative answers to the questions provide confidence to DGS, ISF customer agencies, JLARC, and other interested parties that the ISF is operating in an effective and efficient manner. Negative answers to certain questions may indicate that some aspect of ISF operations needs to be changed, including the products or services offered, customer base, rate charged to customer agencies, or internal staffing or processes and resultant operating expenses. For example, the answer to question #6 in Exhibit 1 for OGC as of 2009 was "no." Due to an executive branch moratorium on agency printing and reduced agency use of OGC in general, the revenue collected by OGC was no longer sufficient to cover its operating expenses. With no change in this situation for the foreseeable future, DGS reduced staffing and other operational expenses for OGC to match the reduced revenue level.

The remaining chapters of this report provide more information about the overall financial management of the DGS ISFs and provide insight into the key oversight questions, when applicable. Chapter 2 addresses overall financial management, while Chapters 3 through 6 address the VDC, BFM, Division of Real Estate Services, Surplus Property Management Office, and Division of Consolidated Laboratory Services. This report does not further address the Office of Fleet Management Services and the Bureau of Capital Outlay Management because these ISFs were reviewed by the Auditor of Public Accounts in 2007 and 2008, respectively. Finally, OGC is not further addressed because of the recent reductions discussed above.

Chapter 2 General Financial Management

In Summary

Within the last five years, it appears DGS has applied sound financial management principles to its ISFs. There are, however, several opportunities for improvement. Recent DGS rate requests and subsequent approvals by JLARC have occurred after the budget development and appropriations process. This lack of alignment with the biennial budget process is one factor that contributes to differences between what is appropriated to agencies for ISF products and services and what ISFs eventually collect from agencies in revenue. The rate approval process would be improved if DGS submitted ISF rates for approval in a timeframe that is more closely aligned with the biennial budget process. In addition, the DGS ISFs have operated with varying annual gains, losses, and cash balances. There are currently no agreed-upon thresholds to determine whether the magnitudes of the gains, losses, and cash balances are acceptable. DGS should develop specific thresholds to facilitate oversight of these key indicators of the financial condition of an ISF.

As noted in Chapter 1, this detailed ISF review addresses both operational and financial issues. Within the last five years, it appears that DGS has applied sound financial management principles to its ISFs. However, addressing several aspects of the financial management of the funds would improve alignment with the biennial budget process. It would also provide for better management of the gains, losses, and cash balances of the funds.

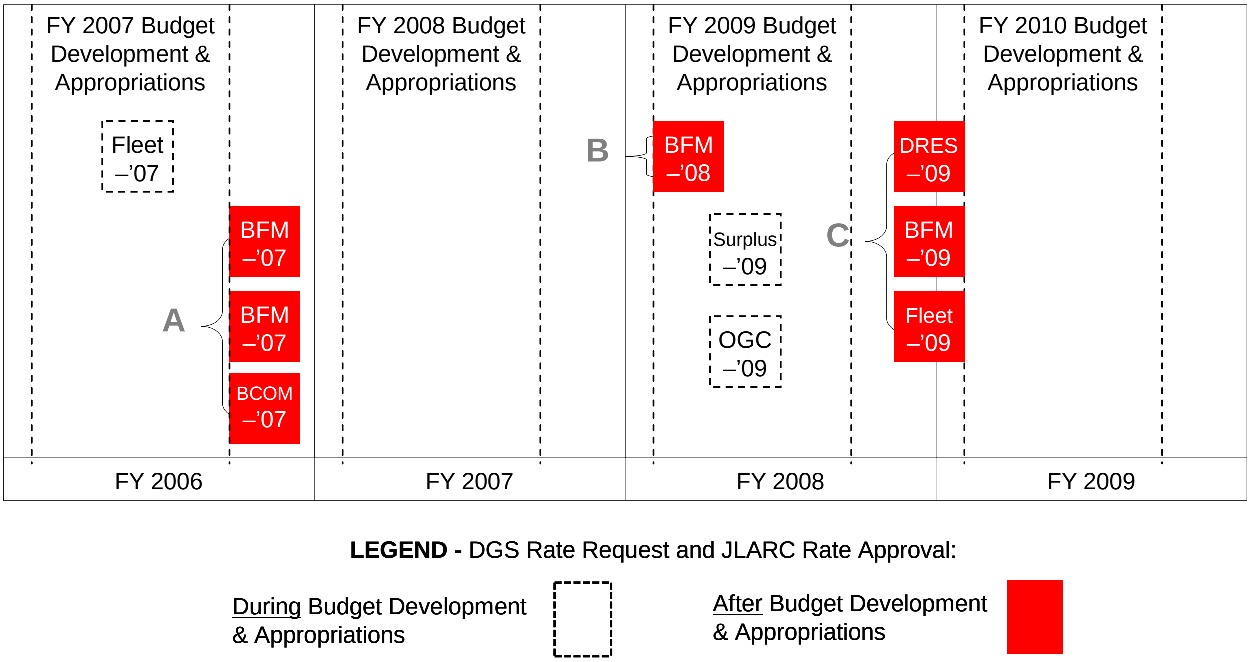
INTERNAL SERVICE FUNDS AND THE BIENNIAL BUDGET

The programs or offices within DGS that manage the ISFs operate within the State's biennial budget process. Key stages of developing the State's biennial budget include the executive branch budget development process and legislative appropriations processes. DGS also submits rates to JLARC for approval.

ISF Rate Request and Approval Could Be Better Aligned With Biennial Budget Process

JLARC policy requires DGS to annually submit proposed charges and rates for the next fiscal year. An ideal alignment of the submission and approval of rates with the budget process would consist of rates for a given fiscal year being developed, requested, and approved during the budget development process for that same fiscal year. However, as shown in Figure 1, DGS rate requests and

Figure 1: ISF Rate Requests and Approvals Tend to Occur After the Budget Development and Appropriations Process



Source: JLARC staff analysis of budget process and previous DGS rate requests and JLARC rate approvals.

subsequent JLARC rate approvals have in recent years tended to occur after the completion of the budget development and appropriation process. Three examples in Figure 1 are described below:

A. The rate requests for the Bureau of Facilities Management (BFM) and the Bureau of Capital Outlay Management (BCOM) for FY 2007 were submitted in May 2006 and approved by JLARC in June—several months after the budget development and appropriations process had concluded for FY 2007.

B. The rate request for BFM for FY 2008 occurred in August 2007 and was approved by JLARC in September—well after the budget development and appropriations process and two months into FY 2008.

C. The rate requests for the Division of Real Estate Services (DRES), BFM, and the Office of Fleet Management Services for FY 2009 were submitted in June 2008 and were approved by JLARC in July—several weeks into FY 2009.

There is no statutory requirement or JLARC policy regarding when DGS should submit rate requests. Within the executive branch, the Department of Planning and Budget (DPB) asks DGS to submit a form during the budget development process that notifies DPB of possible rate changes and the justification for the change. However, in an interview with JLARC staff, DPB staff expressed concern about the tendency for rate requests and approvals to lag the budget development and appropriation process. The concern was primarily because the lack of alignment made it difficult to ensure customer agencies were given sufficient funds in the budget to pay for the goods or services if the rate applied to them was increasing. DPB noted that more detailed and advance projections of rate changes would be beneficial.

Lack of Alignment With Budget Process May Contribute to Differences Between Appropriations and Revenue Collected

This tendency for rate requests and approvals to occur after the budget development and appropriations process in part contributes to the variation between what is appropriated to agencies for ISF spending, and what agencies actually send to the ISF—which in turn is ISF revenue. DPB noted that this variation tends to be most problematic if rates are substantially changed after the start of a fiscal year. ISFs are budgeted as a "sum sufficient" in the Appropriation Act, as the actual funding is appropriated to customer agencies. Costs for each ISF are estimated in budget language, such as in this example for the Office of Fleet Management Services in the FY 2007-08 budget:

> *Included in statewide vehicle management services is an internal service fund derived from charges to agencies for those services. The estimated cost for this internal service fund is $13,829,191 the first year and $13,829,191 the second year.*

During the last five fiscal years, there were 36 such clauses in budget language that estimated costs for various DGS ISFs (Table 2). Two-thirds of these clauses varied by more than 10 percent from what the ISF eventually collected in revenue. Total ISF revenue eventually collected ranged from $21 million less than appropriations in FY 2004 to $19 million more than appropriations in FY 2008. These variances indicate either

- <u>more</u> being appropriated than what agencies collectively spent—an opportunity cost that could have been used for other budgetary priorities during the fiscal year, or
- <u>less</u> being appropriated than what agencies spent—which at times requires DPB to make special transfers to agencies during the budget year to cover the shortfall.

DGS noted that in certain cases this budget language does not correctly represent what is actually allocated within agency budgets. Furthermore, it is important to note that even with better align-

Table 2: Appropriations Vary From Revenue Eventually Collected

Fund	Variance Between Appropriations Language and Eventual Revenue Collected (Revenue – Appropriations)				
	FY '04	*FY '05*	*FY '06*	*FY '07*	*FY '08*
Bureau of Capital Outlay Management	21%	-2%	0%	25%	17%
Bureau of Facilities Management	-6	-1	4	29	36
Division of Consolidated Laboratories	-30	-1	5	-29	-27
Office of Fleet Management Services	3	-7	-2	14	20
Federal Surplus Property	-33	N/A	N/A	-37	-66
State Surplus Property	40	N/A	N/A	100	237
Office of Graphic Communications	23	-17	-5	8	-11
Virginia Distribution Center[a]	-43	-40	-34	21	29
Total % Annual Variance	*-23*	*-20*	*-14*	*20*	*27*
Total $ Variance (millions)	*-$21.0 m*	*-$17.8 m*	*-$12.7 m*	*$14.4 m*	*$19.4 m*

[a] Calculation for VDC also includes revenue from non-State government entities, such as local governments.

Source: JLARC analysis of appropriations and DGS ISF profit and loss statements.

ment of the ISF funding and biennial budget process, there will still be differences between appropriations language and revenue eventually collected by the ISFs. This is largely because ISF expenses and agency use of ISF products or services can be challenging to predict. While certain expenses for an ISF are typically stable over time, other expenses can vary substantially. For example, the utilities charges that BFM must pay on behalf of agencies during the year can change substantially as energy costs rise and fall. Another complicating factor is that agencies' use of ISF services or products can change during the year. Use of ISF services can change for a variety of reasons, such as agencies starting new programs or closing other programs and thus needing more or less office space.

Budget Transparency

The Auditor of Public Accounts (APA) has recently underscored the importance of budget transparency. A 2009 APA report found "significant budget transparency issues that affect the ability of citizens to understand the Commonwealth's budget and how resources are used." The report defined budget transparency as "clear, visible, and understandable" to an interested citizen.

Recommendation (1). The Department of Planning and Budget (DPB), with the assistance of the agencies that operate internal service funds (ISFs), should develop a proposed schedule for review and approval of changes to ISF rates and other charges that is better integrated with the biennial budget process. DPB should submit the proposed ISF rate approval schedule to the Joint Legislative Audit and Review Commission for its concurrence and implementation during the FY 2011–FY 2012 budget development and appropriations process.

In addition, the current method of sum sufficient appropriations and corresponding budget language limits the transparency about what the State is spending to administer the ISFs. This is because current appropriations language does not indicate what portion will eventually go towards ISF operating expenses. Operating expenses as a percentage of revenue can vary substantially. For example, 99 percent of BFM's revenue went towards its operating expenses in FY 2008. Other funds, such as the Virginia Distribution Center or DRES, collect revenue from agencies, but then spend large portions of that with the private sector for the purchase of goods and services to meet ISF customer demand.

ISF GAIN, LOSS, AND CASH BALANCES

From JLARC's oversight perspective, there are two indicators of the financial condition of an internal service fund. The first is the fund's gains or losses, which reflect the relationship between the revenue collected by the fund through the rate and the fund's operating expenses. The second indicator is whether the fund has sufficient working capital reserves in the form of cash balances with the State treasury to cover its daily operating expenses.

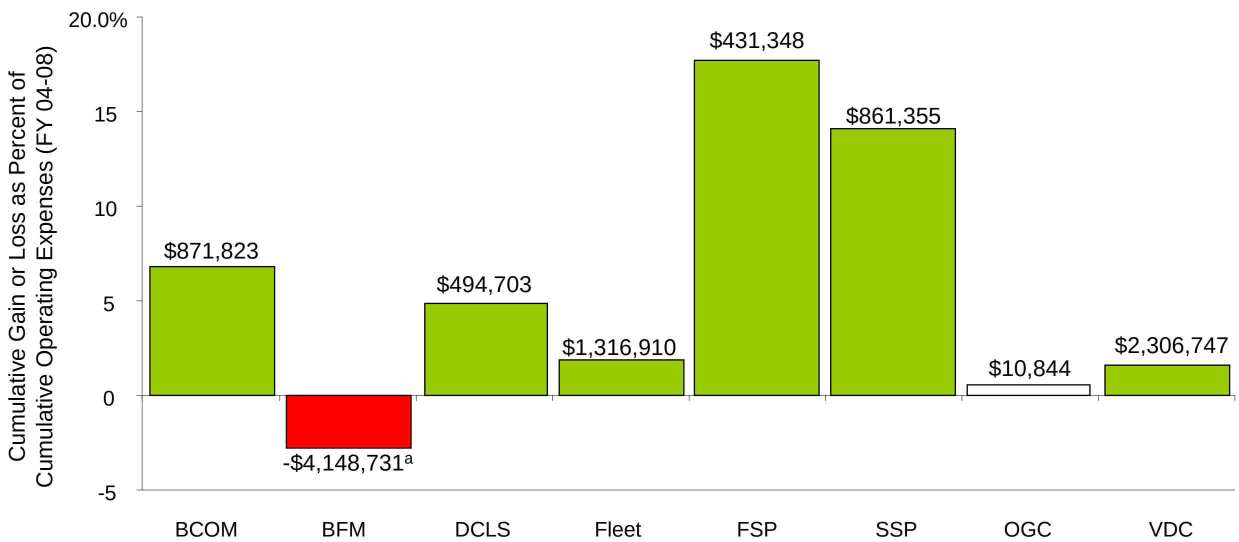
No Established Thresholds for ISF Gains or Losses

It is difficult to set ISF rates such that, within a given year, the revenue collected is equal to fund operating expenses. Consequently, fund gain or loss can vary significantly from year to year. From FY 2004 to FY 2008, individual fund gain or loss varied widely, ranging from a 22 percent loss for the Division of Consolidated Laboratory Services (DCLS) in FY 2008 to a 45 percent gain for Federal Surplus Property (FSP) in FY 2007.

Over the longer term, however, an ISF should operate at near zero gain or loss. The *Code* requires that "unit prices of services rendered by internal service funds shall be fixed so that all costs properly allocable to providing the service shall be fully recoverable." By extension, JLARC policy stipulates that ISFs should ensure that charges to customers are sufficient to recover the actual cost of providing services, but not at a level to accrue a surplus. However, cumulative gains or losses between FY 2004 and FY 2008 have varied widely, with all but one fund having a cumulative gain during the time period (Figure 2). For example, the FSP fund had a $431,384 cumulative gain during the time period. This was approximately 17 percent of the cumulative operating expenses during the same time. Conversely, BFM had a $4,148,731 cumulative loss, which was approximately three percent of its cumulative operating expenses.

There is currently no agreed-upon standard to determine whether these cumulative gains or losses are acceptable. The nuances of each ISF's operations suggest that there should be different gain or loss thresholds for different funds. For example, the FSP gains are largely attributable to money made donating (and charging a service charge for) federal property that is provided to the State—in which case a cumulative gain accrues to the State. On the other

Figure 2: All DGS ISFs Except BFM Operated With a Cumulative Gain Between FY 2004 and FY 2008



[a] BFM's cumulative loss is largely the result of the acquisition of property in FY 2006.

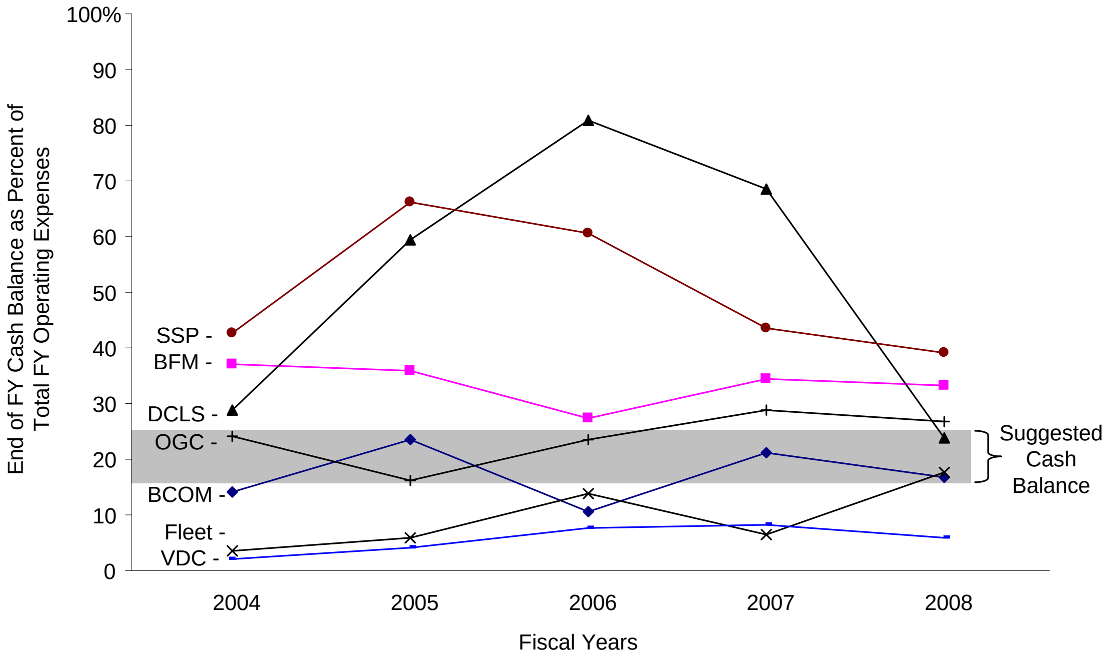
Source: JLARC staff analysis of ISF gain and loss statements, FY 2004 – FY 2008.

hand, a large gain in other funds would indicate that the ISF is charging its customers—many of whom are State agencies—more than is necessary to cover its annual operating expenses. Losses over time would indicate that the ISF is not charging its customers enough to cover its annual operating expenses, or that it needs to improve its efficiency so it can provide the same service at lower operating expenses. The lack of gain or loss thresholds unnecessarily complicates fund oversight and JLARC approval of rates based on whether more or less revenue is necessary for an ISF.

No Agreed-Upon Thresholds for Cash Balances as Percentage of Operating Expenses

The cash balance reserves of a given ISF are in the form of cash with the State treasury. JLARC policy and federal guidance suggest a working capital balance or cash reserve of between 60 and 90 days' worth of operating expenses. This equates to a cash balance with the State treasury of between 16 and 25 percent of annual operating expenses. As shown in Figure 3, the end-of-year cash balances as a percentage of annual operating expenses have varied significantly over the last five years. Of the seven funds shown, none had end-of-fiscal-year cash balances within the suggested range for all of the previous five years. Four funds had cash balances within the suggested range for between one and three of the previous five years. The other three funds had balances either below or above the range for all five years.

Figure 3: Historical Cash Balances as Percentages of Annual Operating Expenses Have Varied Significantly



Note: Federal Surplus Property is not shown because federal allowances for cash balance are 200 percent of annual operating expenses. Division of Real Estate Services is not shown because FY 2009 will be its first full year of operation as an internal service fund collecting agency revenue. The Virginia Distribution Center is shown using its cash balance as a percentage of annual operating expenses plus the cost of goods sold.

Source: JLARC staff analysis of ISF gain and loss statements, FY 2004 – FY 2008.

A cash balance shown in an end-of-year financial statement often includes funds already obligated for the future.

A complicating factor is that in many cases, a cash balance shown in an end-of-year financial statement often includes funds already obligated for the future. These obligations, for items such as potential payouts to employees for accrued annual leave, are accounted for in the fund balance as future liabilities. An additional complicating factor with certain funds is that operating expenses might need to include additional items, such as a percentage of the cost of goods sold or inventory at the VDC. Whether or not these types of costs are included can have major implications on whether an ISF appears to have above- or below-threshold cash balances.

According to DGS, ISF cash balances fluctuate for a variety of reasons, including the fund collecting more or less in revenue than its operating expenses and the fund purposefully accumulating cash reserves for large expenditures on equipment, then making those purchases. Several ISF fund managers and DGS staff have indicated it is their preference to pay cash for these large items, such as scientific equipment or information technology upgrades, rather than taking loans and paying interest.

JLARC policy stipulates that in the event of an accumulated surplus, disposition of the surplus shall be determined by the Commission. Currently, however, there is no standardized or agreed-upon approach to formally identify the amount of a cash balance that is unobligated and what to include in operating expenses that should be used to calculate the percentage. There is also no formal approach to identify the reason for fluctuating cash balances over time; whether a rate change or return of customer funds is necessary because the fund is collecting too little or too much in revenue; or if the fund is purposefully accumulating reserves to prepare for capital expenditures. The lack of such an approach reduces the transparency of ISF operations, and unnecessarily complicates deciding whether a change in ISF rates is necessary or cash balances should be reduced or increased.

Recommendation (2). The Department of General Services (DGS) should develop specific cash balance thresholds for each internal service fund it operates. DGS should also identify criteria for above-threshold accumulation of reserves, purposes for which reserves may be used, and conditions for returning excess reserves to customer agencies. DGS should submit the proposed cash balance and reserves plan to the Joint Legislative Audit and Review Commission for approval in order for it to be used during the FY 2011–2012 budget development and appropriations process.

Chapter

3 Virginia Distribution Center

In Summary

The Virginia Distribution Center (VDC) provides its State agency customers with low-cost products that have resulted in cost avoidance for the State of between nine million and 15 million dollars per year. This is more than four times VDC's annual operating expenses—a strong indicator of VDC's value as a centralized source of products for State agencies. VDC's State agency customers report that they are satisfied with VDC's products and services. The VDC has operated in recent years with a net profit of between zero and three percent of revenue. This indicates that VDC is fully recovering its product, shipping, and operating costs through what it charges customer agencies. The VDC customer base evolves over time based on a variety of considerations, including the specific product needs of potential customers. VDC's current customer base includes organizations that operate with both general and non-general funds. In FY 2008, local governments comprised about 20 percent of total VDC revenue.

The Virginia Distribution Center (VDC) sells non-perishable food, food-related, and housekeeping products to State and local agency customers. The goal of VDC is to provide quality products at the lowest possible prices for its customers. It does this by leveraging the collective buying power of State and local agencies, which allows it to purchase bulk goods at reduced prices.

JLARC staff published a detailed review of VDC in 2001. The review made recommendations to improve VDC operations and financing. Many of these recommendations have since been implemented (Appendix C).

VDC SELLS FOOD AND HOUSEKEEPING PRODUCTS TO STATE AGENCIES

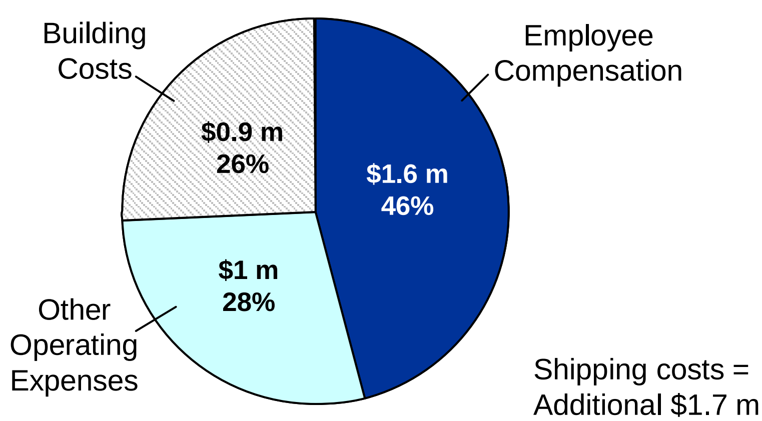
As prescribed by the State *Agency Procurement and Surplus Property Manual* (published under the authority of Section 2.2-111 of the *Code of Virginia),* VDC is a mandatory procurement source for State agencies, meaning that State agencies must purchase food and housekeeping items that are available from VDC. In special cases, such as when a particular type of product is needed or VDC is out of stock, waivers may be granted to allow agencies to purchase items from another source. VDC is not a mandatory procurement source for local entities, though many make use of VDC.

VDC Charges Agencies a 12 Percent Fee to Procure and Deliver Products; Revenue Is Primarily From DOC and DMHMRSAS

VDC offers over 950 different products to its State and local customers. Products are non-perishable and generally fall into the categories of food/food-related items, such as frozen meats or canned goods, and housekeeping products, such as floor care products and paper towels. VDC purchases these products from private vendors in bulk and stores them at its central warehouse in eastern Henrico County. VDC does not purchase products based on specific customer orders, but rather estimates the product types and amounts its customers will need based on their purchasing history. State and local agency customers then place their orders with VDC and receive deliveries of their products from several days to several weeks later, depending on when deliveries are needed. The payment (or revenue) received from customers allows VDC to cover its product, shipping, operational, and building costs.

VDC's major operating expenses include employee compensation, building costs, and other operating expenses such as repair and maintenance costs (Figure 4). Employee compensation, including salaries, benefits, and wages, is the largest component and makes up 45.8 percent of total operating costs. Building costs related to the Treasury loan taken by VDC in 2000 to pay for the construction of a new central warehouse is the next largest single category of costs.

Figure 4: Major VDC Operating Expense Categories, FY 2008



Source: JLARC staff analysis of DGS data.

VDC is scheduled to pay off the central warehouse loan by 2018. In addition to personnel and building costs, VDC has approximately $1 million in other operating costs. VDC also paid approximately $1.7 million in shipping costs in FY 2008, although VDC does not treat shipping costs as an operating cost but rather includes shipping in the product price charged to the customer (which is how these costs are frequently treated by private vendors).

VDC Customer Charge

Since 2003, VDC's full charge to its customers is the cost of goods sold multiplied by 112 percent. The cost of goods sold is the cost of the products purchased plus the shipping cost.

Customer charge = (Cost of goods sold) * (1 + mark-up rate)

Cost of goods sold = product cost + shipping cost

To cover its operating expenses, VDC charges a mark-up rate on the cost of the goods sold to its customers. This mark-up rate has been 12 percent since 2003. VDC customers also pay an additional one percent fee for transactions made using eVA, the State's web-based procurement system. These fees are paid into the enterprise fund that supports eVA's activities.

VDC reported total sales of approximately $36 million in FY 2008. In FY 2008, the Department of Corrections (DOC) comprised 52 percent and the Department of Mental Health, Mental Retardation and Substance Abuse Services (DMHMRSAS) made up about 20 percent of VDC sales. Other major customers include higher education institutions, Department of Juvenile Justice facilities, local governments, and regional jails.

VDC's product sales are about evenly split between food and housekeeping products. Food and food-related products comprise the majority of purchases for DOC and DMHMRSAS. The majority of products purchased by other State agencies and localities are housekeeping products.

VDC Built a Central Warehouse in 2001

One of the most significant changes affecting the operations and financing of VDC over the past decade has been the construction of a central warehouse to store products before they are shipped to customers. VDC's original warehouse was located in the City of Richmond. However, in 1997 a decision was made to construct a new central warehouse on State-owned land in eastern Henrico County. The eastern Henrico warehouse opened in the spring of 2001 at which time the Richmond warehouse was closed. The construction of the new warehouse was financed through a $12 million Treasury loan. The debt service on this loan was one of the major factors behind increasing the mark-up rate from eight to 12 percent in 2003.

VDC reported a variety of reasons why a new central warehouse was necessary. The old warehouse was actually a series of different buildings, some of which could only be accessed by crossing outside bridges between the buildings. The layout of the buildings was disjointed, and the roof was too low to allow for vertical expansion of storage space. There was also no climate control for dry storage and insufficient freezer storage space, requiring VDC to rent off-site freezer storage. In addition, there were only four in-bound and four out-bound loading docks—some of which were situated in unusual locations that limited truck access.

In contrast, the central warehouse features numerous improvements when compared to the old warehouse (Exhibit 2). For example, the facility utilizes modern vertical storage techniques, has climate control for dry storage and sufficient on-site freezer capacity, and has 28 dock doors that are conveniently located on one side of the facility, several of which have special accommodations for refrigerated products.

Other Benefits of Central Warehouse

The new warehouse has allowed VDC to support third-party projects for State and federal entities, such as emergency planning operations. For example, in the aftermath of Hurricane Isabel in 2003, VDC provided working space, resources, and living quarters for the Virginia National Guard to distribute water and ice.

Exhibit 2: New Central Warehouse Built in 2001 Features Improvements When Compared to Old Warehouse

	Old Warehouse	New Warehouse
Loading Docks		
Inventory Storage Racks		

Source: Photographs provided by VDC.

VDC PRODUCTS COST LESS THAN ALTERNATIVES AND MOST AGENCIES ARE SATISFIED WITH VDC SERVICES

It appears that VDC operations are consistent with the basic policy objective for ISFs to operate in a businesslike manner. A key indicator in this respect is whether the price that VDC charges is equal to or less than other alternatives. Other indicators are whether VDC customers are satisfied with VDC's products and service.

VDC Appears to Provide Low-Cost Products That Yield Cost Avoidance Substantially Higher Than Costs to Operate VDC

One of VDC's primary purposes is to offer products at lower prices than customers can find on the local market. This is accomplished primarily through combining the product needs of individual agencies so that the collective purchasing power of the State allows VDC to negotiate lower prices with vendors. A key indicator of this purchasing power is the annual market basket survey, a methodology to calculate cost avoidance. VDC asks certain customers to determine what they would pay for specified VDC products from vendors in the local market. VDC then compares its prices to those of the local vendors to determine the percent cost avoidance that its customers realize by purchasing products from VDC. This methodology appears reasonable and is generally consistent with the method used in the 2001 JLARC review of VDC (though the JLARC review obtained local prices from government agencies using prime vendors for comparable products).

Using this method, VDC estimates its customers realized cost avoidance that ranged between $9.3 and $15.7 million annually from 2003 to 2008 (Table 3). This cost avoidance is driven by annual food costs that were between 29 percent to almost 50 percent higher from alternative sources. Annual housekeeping product costs were between 25 percent and 68 percent higher from non-VDC sources.

Throughout this time, these cost avoidances for agency customers reported by VDC have been substantially higher than VDC's

Table 3: Estimated Costs Avoided by Customer Agencies Purchasing From VDC

	Percent Cost Avoidance					
	2003	**2004**	**2005**	**2006**	**2007**	**2008**
Food	38.44%	39.20%	45.78%	37.11%	49.51%	29.08%
Housekeeping	68.14	51.20	36.61	25.39	50.31	60.96
	Estimated Dollar Cost Avoidance ($ in millions)					
	$13.2 m	$11.7 m	$11.1 m	$9.3 m	$15.7 m	$15.1 m

Source: VDC.

This level of payback, being 444 percent of operating costs, is perhaps the strongest indicator of VDC's value as an ISF.

operating expenses, which are covered through its mark-up rate. For example, the estimated cost avoidance of $15.1 million in 2008 is more than four times VDC's operating expense and building costs of $3.4 million in that year. This level of payback, being 444 percent of operating costs, is perhaps the strongest indicator of VDC's value as an ISF.

Agencies' opinions further underscore VDC's cost-effectiveness for the State. In a JLARC staff survey of State agencies about DGS ISFs, 85 percent of VDC's customers either agreed or strongly agreed that VDC offers products at a price that is competitive with the private sector (see Appendix B for more information about the survey). Interviews with several State agency customers also indicate that VDC provides products at prices that are often significantly lower than can be found on the local market. For example, one customer stated that if VDC is out of stock for certain food items, it must pay from 71 percent more to twice the price to purchase these products from local private vendors.

VDC's Customers Are Generally Satisfied With Its Products and Service

Based on several measures, it appears that VDC's customers are receiving their products when needed and are satisfied with VDC's products and service. For example, the fill rate is a measure of the proportion of warehouse stock items delivered compared to the number of items ordered by customers. Thus, the fill rate is an indicator of the warehouse's ability to keep needed items in stock and available for delivery to its customers. VDC reported that its fill rate as of December 2008 was 98 percent.

VDC's Quality Assurance Program

To help ensure product quality, the VDC maintains a Quality Assurance Program, which performs scheduled and random evaluations of commodities to make sure they adhere to required or agreed-upon specifications. For example, the quality assurance lab has equipment to test the break strength of paper products and linens, the hardness of stainless steel flatware, and the percentage of fat in ground beef. The lab also responds to specific customer complaints about product quality.

Based on the JLARC staff survey, it appears that VDC's customers are largely satisfied with its products and services. Over 91 percent of State agency customers either agreed or strongly agreed that VDC provides products in a timely manner, and over 88 percent of customers agreed or strongly agreed that they were generally satisfied with VDC's services. A slightly lower share, though still a majority of 79 percent, reported that VDC provides products of sufficient quality.

About two-thirds of agencies agreed or strongly with the statement that they would use VDC even if it were not required. Reasons agencies cited for disagreeing with the statement included that the large quantities offered by VDC are a problem for their agency. Several agencies with institutionalized populations reported that they were not always made aware of an out-of-stock product until the day of the scheduled delivery. In some cases, it is a product for which they must quickly find a replacement and often at a higher cost. These agencies indicated that it would be helpful if VDC could notify them of out-of-stock products sooner. Several State agencies also mentioned that occasionally local product deals arise that are cheaper than what VDC can provide. These agencies suggested VDC could simplify the method of allowing them to take advantage of such deals.

VDC APPEARS TO BE RECOVERING ITS EXPENSES OVER TIME

As indicated previously, VDC charges its customers to cover the cost of the products purchased, shipping, and VDC's operating expenses. State agencies do not pay actual shipping costs based on the amount of products purchased and distance products are shipped, but rather pay an average shipping fee that covers VDC's shipping costs in aggregate. The difference between what VDC collects through customer charges and what it pays for product, shipping, and operating costs is either a net operating gain or loss. The relatively small net operating gain VDC has experienced in recent years suggests that VDC operations are largely consistent with the second JLARC policy objective of making agencies pay the full cost of services received.

VDC Operating Between Zero and Three Percent Net Operating Gain in Recent Years

VDC had a cumulative net operating gain between FY 2004 and FY 2008 of about $2.3 million. This represents about 1.6 percent of VDC's total operating expenses during the time period. Between FY 2004 and FY 2008, VDC's annual net operating gain ranged from $226,708 to $774,192—between zero and less than three percent of revenue each year.

In FY 2008, VDC collected $33.6 million in revenue from sales to its customers and had $3.4 million in operating expenses. The approximately $30 million difference between revenue and operating expenses largely represents the cost of the products that VDC purchases from private vendors and then sells to customers agencies.

Over the past five years, both VDC's revenue and operating costs have increased modestly. Revenue increased by 30.1 percent during this time period as a result of increased sales to customers. Operating costs, including costs associated with VDC's central warehouse, increased 39.7 percent between FY 2004 and FY 2008. Some of the largest increases in operating costs were for personnel related costs, such as employer retirement contributions, health care, and salary increases.

Cash Balance Threshold Varies Depending on How Operating Expenses Are Calculated

VDC's unique structure presents several possible methods to assess its cash balance. VDC does not include its building costs as an operating expense on its gain and loss statements, which suggest its end-of-year cash balance could be calculated as a percentage of all operating expenses excluding its building costs. The cash balance could also be assessed against its total operating expenses like other DGS ISFs. A third method would be to calculate its cash balance as a percentage of operating expenses, plus one month's worth of the cost of goods sold. The one-month timeframe may make sense because VDC reports it typically has 30 days to pay vendors from when it receives the products. Table 4 shows VDC's historical cash balances as a percentage of these three potential methods. Depending on the method used, VDC's cash balance has been either above, within, or below a given thresholds. This underscores the importance of Recommendation 2 addressing an agreed-upon and standardized method to calculate cash balances as a percentage of operating expenses.

Since FY 2004, VDC's cash balance steadily increased up to $2.5 million in FY 2007, and then dropped to $1.9 million in FY 2008. VDC has indicated that it is trying to purposefully accumulate a cash balance to purchase a new warehouse inventory management system, which is part of the reason why its cash balance is currently above the 25 percent of annual operating expenses threshold.

Table 4: Historical VDC Cash Balance as Percentage of Various Measures of Operations and Funding

		Cash Balance as a Percentage of		
Fiscal Year	**Cash Balance**	*Operating Expense, Excluding Building Costs*	*Operating Expense*	*Operating Expense + 1/12 Cost of Goods Sold*
2008	$1,961,102	78%	58%	33%
2007	2,563,797	106	77	45
2006	2,343,904	122	94	48
2005	1,069,210	62	42	23
2004	550,381	32	23	13

Source: JLARC staff analysis of VDC gain and loss statements, FY 2004 - FY 2008.

VDC CUSTOMER BASE INCLUDES NON-STATE AGENCIES AND HAS EVOLVED OVER TIME

JLARC's 2001 review recommended that VDC develop a marketing plan to add new customers, including more local customers. Since that time, VDC has developed a marketing plan that includes web postings, fax, e-mail and mail distribution; introductory letters and marketing packages sent to potential customers; marketing initiatives for green products; and VDC participation in conferences, expos, and regional meetings.

VDC Customer Base Has Evolved Since 2001 JLARC Review

There have been a number of significant changes to VDC's customer base since JLARC last reviewed VDC in 2001. Several changes reduced sales or the customer base, while others increased the customer base. The net effect of these changes has been that total sales in FY 2008 ($36.4 million) were comparable to total sales reported in FY 2000 ($38.1 million).

Higher Education as VDC Customers

JLARC's 2001 review of VDC found that VDC did not stock the range of food products needed by many retail-oriented customers, including four-year universities. Thus, JLARC noted that the universities may be better served by the use of a prime vendor, and this appears to be the trend that higher education has followed, particularly the four-year institutions.

Since 2000, several major factors reduced VDC's sales and customer base, including

- VDC revenue from higher education, including community colleges, dropped from $3.1 million to $1.6 million. This reduction is consistent with trends identified in the previous JLARC staff review of VDC.
- As part of an effort in 2002 to reduce State costs through outsourcing, DOC privatized the food service operations at the Greensville and Sussex II correctional centers—the largest and fourth largest VDC customers in FY 2000. This privatization resulted in a substantial drop in VDC revenue from these customers.

Additionally, DOC noted its inventory and portion control procedures have lowered the amount of food it has needed in recent years. There has also been growth in DOC's internal agribusiness program, which has reduced the amount of canned or frozen fruits and vegetables that prisons need to purchase from VDC.

Since 2000, there have been some increases in DOC's customer base that have somewhat mitigated these reductions. For example, two new correctional facilities—Green Rock Correctional Center and Pocahontas State Correctional Center—were added as VDC customers in FY 2007. The combined sales to these two facilities in FY 2008 was over $1 million. A suggestion in the 2001 JLARC report was also that VDC pursue adding regional jails to its customer base, and it appears VDC has done this. In FY 2000, VDC reported five regional jails as customers. By FY 2008, VDC listed 15 regional jails as customers. Sales to localities also increased during the time period.

Localities Comprised About One-Fifth of Total VDC Revenue in FY 2008

As noted previously, DOC and DMHMRSAS comprise more than 70 percent of VDC's total revenue. Other State agencies, including higher education, comprise about eight percent. The remainder of VDC's revenue comes from local governments, regional jails, and to a lesser extent, other states. Local government customers purchased $5.6 million in food, food-related, and housekeeping products from VDC in FY 2008. Examples of some of the largest local customers include local jails and juvenile detention centers. Sixty-one different local governments purchased products from VDC in FY 2008. As shown in Table 5, three quarters of this revenue came from VDC's ten largest local government customers.

Table 5: VDC's Top Ten Local Government Customers

	FY 2008 Purchases	
Local Government	*$ Amount Purchased*	*Cumulative Percent of Total Local Purchases From VDC*
Henrico	$728,382	13%
Chesterfield	709,264	26
City of Richmond	594,218	36
Virginia Beach	491,520	45
Chesapeake	346,608	51
Rockingham	301,102	57
Fairfax County	288,409	62
Petersburg	275,410	67
Loudoun	263,163	72
Newport News	205,827	75

Note: Purchase data based on sales prices current as of 2009.

Source: JLARC staff analysis of customer data provided by VDC.

A variety of considerations impact whether additional customers such as local governments are feasible for VDC. Local product needs, the locality's distance from VDC, local storage capacity, and whether there is sufficient scale such that VDC can bring its purchasing power to bear and obtain lower prices, are all key factors that determine whether including additional local government customers is worthwhile. VDC should continue to look for opportunities to further expand its customer base to (1) reduce product costs through increased scale and purchasing power and/or (2) include additional non-State funded customers where practical to potentially reduce the mark-up rate applied to all customers.

Chapter 4 Real Property Management

In Summary

The Bureau of Facilities Management (BFM) reports that its rental rate for State-owned office space is lower than the average charged by private landlords. BFM also indicates it is difficult to maintain a cash balance that is sufficient to cover large cash expenditures, such as when capital equipment fails and needs to be replaced. BFM should develop a mechanism, consistent with agreed-upon cash balance thresholds, to facilitate better planning and funding for these repairs not included in agency maintenance reserves. The State is currently centralizing agency leases with private landlords within the Division of Real Estate Services (DRES). During the centralization, DRES has reported cost avoidance and savings that are substantially greater than its operating costs. However, there is no complete inventory of State-owned property holdings and leases. To better identify further cost-saving opportunities, DRES should develop specific actions and milestones to complete and maintain a real property inventory.

DGS manages two ISFs involved in real property management. The Bureau of Facilities Management (BFM) operates and maintains office space used by State agencies. The Division of Real Estate Services (DRES) centrally administers agency leases with private landlords. The Commonwealth currently manages its real property in four primary ways: (1) State-owned, managed, and maintained through BFM; (2) State-owned, agency managed and maintained, (3) leased from private landlords, managed through DRES; and (4) leased from private landlords, agency managed.

BFM OPERATES AND MAINTAINS STATE-OWNED PROPERTY

Section 2.2-1129 of the *Code of Virginia* places responsibility for all public buildings, grounds, and property in the Capitol area not in the charge of others, with DGS. Within DGS, BFM is responsible for operating and maintaining State-owned buildings in the Capitol area. BFM manages approximately 5.3 million square feet of space in about 40 State-owned buildings and more than 6,000 parking spaces in about 20 State-owned parking facilities.

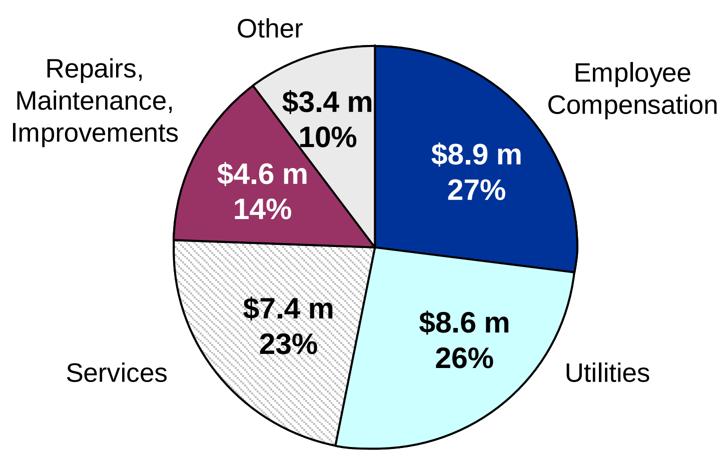
BFM Operations

The *Code* grants DGS responsibility for assigning office space to agencies in the Capitol area, as well as for contracting for water, electricity, gas, sewer service, heating, and other services as required. The BFM ISF is the method by which DGS recovers the cost of operating and maintaining office space for agencies. To recover these costs, BFM charges agencies a rental rate per square foot as well as varying hourly rates for special maintenance activities. BFM charges a single rate of $13.83 per square foot for office space. BFM derives this rate by projecting the costs to maintain and operate facilities under its responsibility, then projecting revenue by the type of facility (for example, office space, storage, laboratory space, Governor's mansion, and the State library). BFM then adjusts the required rental rate so that the sum of total revenue covers the projected maintenance and operating costs for all facilities. This process does not necessarily result in charging agencies rates consistent with the quality or age of the space they occupy, but is intended to ensure that the total amount of rental payments BFM collects will be roughly equal to its expenses.

In FY 2008, BFM collected more than $33 million in revenue from agencies. There are three major categories of BFM revenue. The largest category of revenue is rent payments from tenant agencies, which in FY 2008 totaled $26.4 million, or about 80 percent of total revenues. The two remaining major revenue categories are agency repayments for maintenance work and special maintenance projects, which were $3.5 and $2.7 million, respectively.

BFM's total operating expenses in FY 2008 were about $33 million. As shown in Figure 5, the largest single category of operating

Figure 5: Major BFM Operating Expense Categories, FY 2008



Source: JLARC staff analysis of BFM profit and loss statement.

expenses for BFM was employee compensation, which totaled about $8.9 million. Utilities charges, the largest of which are electrical costs, were the second largest category at about $8.6 million. Other major operating expense categories include payments for services, such as custodial services, and repairs, maintenance, and building improvements.

BFM serves about 75 agencies. The largest agency sources of BFM revenue include general government functions through DGS, legislative agencies (including the Senate and House of Delegates for the General Assembly Building, State Capitol, and several special maintenance projects), the Departments of Health and Transportation, and the Supreme Court. These five sources alone comprised nearly half of the ISF's total revenue in FY 2008.

BFM Operates in a Businesslike Manner

It appears that BFM is operating in a manner consistent with the first basic objective for ISFs to operate in a businesslike manner. For example, BFM has a goal to charge agencies lower rent for office space than what is charged by private landlords. BFM tracks progress related to this goal by benchmarking the rate it charges agencies for office space to what is otherwise available in the Richmond area. Using two sources for comparison (see sidebar), BFM found that in FY 2008, the Richmond market value for office space was $16.54 per square foot. BFM currently charges agencies $13.83 per square foot for office space. This suggests that in aggregate, BFM is charging agencies less to rent office space than other alternatives. It does not mean, however, that a given agency could not find less expensive office space (or higher quality or newer office space for the same rent rate). Rental rates in the private sector are influenced by market demand, and therefore can fluctuate based on market conditions. In contrast, BFM rental rates are based on maintenance and operating costs, which can lead to less volatile rates for State agencies.

Market Rent for Comparison to BFM

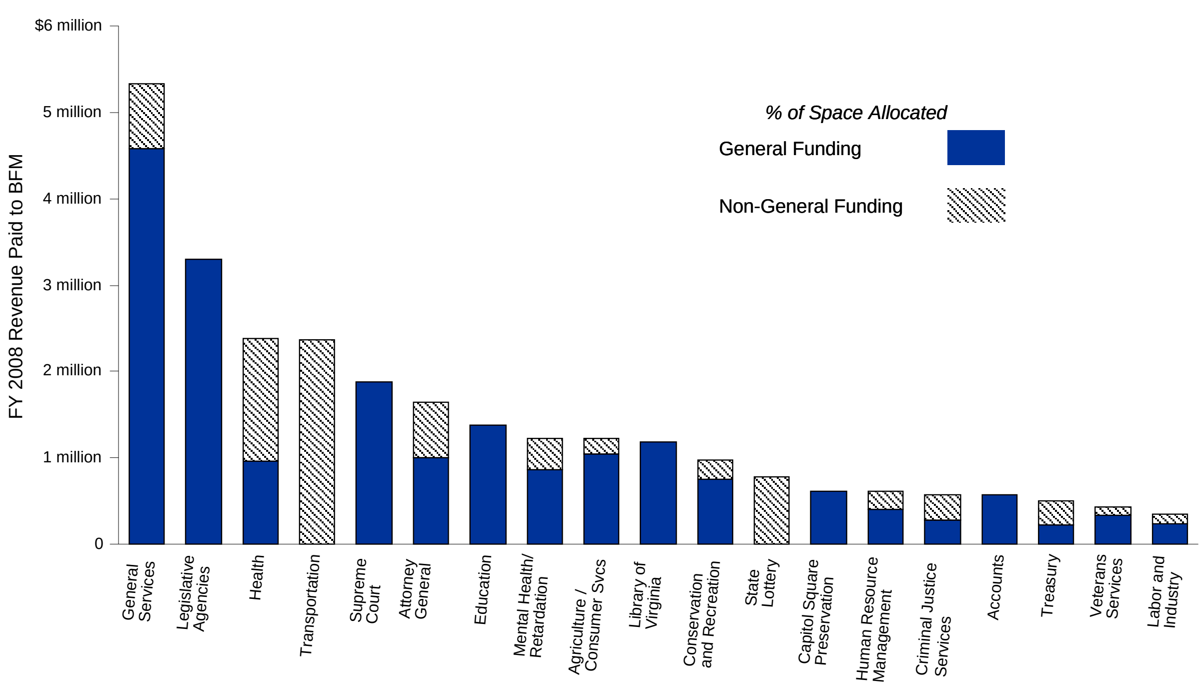
According to BFM, it conducts its benchmarking of rates using (1) what State agencies pay to occupy private office space in the Richmond Metro area as tracked by the Division of Real Estate Services, and (2) office space rental costs as tracked by the Grubb & Ellis Downtown Richmond Office Market Survey. BFM reports most State agencies occupy class B or C space, and the market rates for comparison include a blend of class A, B, and C space.

BFM does not maintain any data regarding the quality or timeliness of its maintenance activities. However, the JLARC staff survey of agencies indicates that approximately three-fourths of BFM customer agencies reported that it responds to maintenance requests in a timely manner and that the maintenance performed is of sufficient quality. Moreover, 85 percent of agencies responding were generally satisfied with BFM's services.

BFM had a cumulative loss between FY 2004 and FY 2008 of more than $4 million. This is about three percent of BFM's total operating expenses during the same time period. This cumulative loss is largely attributable to FY 2006 when operating expenses increased 28 percent from the previous year to more than $34 million. This loss was primarily driven by acquisition of property totaling more than $5.5 million. BFM indicates this was due to a one time leasehold buyout of tenants in the Old City Hall building. Since that time, BFM has operated at a gain of between one and two percent in FY 2007 and FY 2008. This raises less concern, therefore, that the fund will not, over time, collect sufficient revenue to cover operating expenses. However, current budget constraints may place pressure on customer agencies' ability to pay the current rates charged. This trend will be further exacerbated if at the same time there are increases in the largest drivers of BFM's operating expenses—in particular, health insurance and retirement benefits costs for BFM employees and utility costs.

BFM does not collect revenue from agencies that occupy State-owned space not operated and maintained by BFM. Largest among these are agencies with substantial holdings outside the Richmond metro area and substantial non-general funding, in particular colleges and universities. However, in terms of State-owned space operated and maintained by BFM, it appears the ISF is operating consistent with the third basic objective regarding equitable recovery of costs across fund types. Thirteen of the largest agencies in terms of revenue to BFM allocate at least some portion of their space to non-general funding (Figure 6). Largest among these was the Virginia Department of Transportation, which accounted for about $2.4 million in non-general fund revenue in FY 2008.

Figure 6: General / Non-General Fund Space Allocation for Major BFM Revenue Sources



Source: JLARC staff analysis of Department of Planning and Budget and Department of General Services data.

BFM Cites Funding Challenges for Remodeling Office Space for New Tenants and Large Equipment Failures

As noted in Chapter 1, DGS ISFs' end-of-fiscal-year cash balances as a percentage of annual operating expenses have tended to vary widely. BFM's cash balance has fluctuated between $9.34 million in FY 2004 and $10.96 million in FY 2008. During the time period, BFM's cash balances ranged from 27 to 37 percent of annual operating expenses. As noted earlier, these cash balances can include funds that are already obligated and show up in the fund balance, but have yet to actually be spent. BFM's cash balance at the end of FY 2008 was 33 percent of its annual operating expenses. However, its FY 2008 fund balance (which DGS calculates by subtracting total liabilities from total assets) was negative.

BFM noted the challenge of maintaining an appropriate level of cash reserves, particularly in the context of two types of large expenditures. BFM indicates there is currently no mechanism to pay for altering or remodeling office space prior to new tenants occupying the space. BFM also noted that facilities it manages are typically supported by a capital outlay maintenance reserve, which covers most significant repairs and equipment replacements. However, there are periodically equipment failures that require additional funds not included in an agency's appropriation. These failures, such as replacing chillers, elevator control systems, air handlers, or failed fire alarm systems, typically must be fixed immediately and can cost hundreds of thousands of dollars.

Recommendation (3). The Departments of General Services and Planning and Budget should agree on a mechanism to facilitate planning and funding for equipment repairs or replacements not included in agency maintenance reserve funds. This mechanism should be consistent with the established thresholds for cash balances pursuant to Recommendation 2.

DRES ADMINISTERS LEASES FOR MOST STATE AGENCIES

Prior to the establishment of DRES, agencies administered their own leases, including locating space and negotiating leasing price and terms. This approach was highly decentralized. DGS's only involvement was to either recommend approval, recommend changes, or not recommend approval prior to an agency entering into a lease with a private landlord. In 2004, Governor Warner signed Executive Order 75 to further centralize lease administration in pursuit of cost savings through increased State bargaining power, agencies sharing common space, agency collocations, and setting occupancy space standards consistent with federal and private sector benchmarks. This move towards centralized leasing was initially phased in by DRES helping agencies during the lease process. DRES then began to take over new leases as previous leases expired, then moved to directly administering leases on behalf of most agencies.

DRES Operations

DRES acts as a liaison between State agencies and the landlord who owns the space being leased by the agency. Agencies submit requests for office space to DRES, which then reviews the space request, attempting to balance cost savings and agency needs using statewide square footage standards. DRES seeks to identify suitable space and negotiates lease terms with the landlord on behalf of the agency. After a lease is negotiated and signed, DRES then pays rent to the landlord on behalf of the agency and also monitors other activities and payments during the lease, including maintenance. During the lease cycle, DRES bills agencies for its services to recover its costs. The revenue DRES collects includes both the amount of the rent and a fee based on the lease value.

In some instances, DRES may believe it is most cost effective for an agency to purchase existing or build new space rather than enter into a lease. In those cases, DRES coordinates and negotiates the purchase for those agencies it supports, then transfers management of the facility to BFM or other owning agencies. Additionally, DRES administers leases for private sector tenants in BFM owned and operated buildings and charges BFM a fee for lease administration.

In addition to locating new properties, DRES also disposes of surplus real estate no longer in use by agencies. DRES is allowed to collect actual direct costs for the time to coordinate the property sale. DRES currently outsources much of the appraisal work, but is in the process of developing this capability in-house.

In June 2008, JLARC approved a fee of 3.25 percent on single agency leases and five percent on multiple agency "master" leases. The fee is applied to the value of the rent payment that DRES makes to the landlord on behalf of agencies. As shown in Table 6, DRES expects to collect a total of $1.8 million in ISF fees during FY 2009 on annual lease expenses of $52.7 million. As of spring

Table 6: FY 2009 Projection of DRES-Managed Leases and Fees

Type of Lease	Lease Expense	ISF Fees
Single Agency Leases (3.25%)	$44,985,703	$1,462,035
Master Leases (5%)	7,717,281	385,864
All DRES Leases	*$52,702,984*	*$1,847,899*

Source: DRES estimates based on amounts collected through January 2009 and projected to the remainder of FY 2009.

2009, DRES centrally administered about 420 leases. It also has plans to absorb another 130 leases from the Department of Health over this year.

DRES's largest customers in terms of revenue include the Departments of Social Services, Corrections, Rehabilitative Services, and Motor Vehicles. DRES, however, does not manage all State agency leases. For example, DRES does not manage the 319 store leases for the Department of Alcoholic Beverage Control (ABC), but rather reviews them and charges a one-time fee of $250. The main reason for this exemption is that the space is used for the sale of alcoholic beverages, which is different from traditional office space. Since ABC's lease management office already possessed the skills needed for leasing this type of space, ABC has been exempted from the statewide lease consolidation. Independent agencies also manage their own leases and are charged one-time fees for the review. DRES does not manage leases for institutions of higher education.

DRES Claims Cost Savings and Other Benefits, Though Agencies Express Concern About Centralization

Because DRES has operated as an ISF for less than a full fiscal year, it is too early in the transition to centralized lease administration to assess DRES against the objectives for ISFs. This is largely because DRES has rapidly expanded the portfolio of leases that it manages and continues to directly receive general fund appropriations. In FY 2008 and FY 2009, DRES has $828,142 budgeted in general funds, but these dollars go to reimburse agencies for the general fund dollars that they spend on the ISF for lease management. DPB indicates these appropriations will be made directly to agencies in the next biennial budget.

As a result of these operational and financial transition issues, DGS has not yet completed a full fiscal year operating gain / loss statement for DRES. This makes it difficult to accurately assess whether DRES is operating in a businesslike manner and charging agencies a rate sufficient to cover its operating expenses. However, a comparison of resources devoted to leasing prior to DRES implementation, cost avoidance from the transition to centralized lease administration, and JLARC staff survey results provide some perspective on the initial years of DRES implementation.

The majority of the fees that DRES collects from agencies go towards employee compensation. As of January 2009, DRES employed 16 staff, seven of whom were customer transaction managers that deal directly with agencies and landlords. DRES's current staffing is not substantially different from that reported by agencies for lease activities prior to DRES implementation (Table 7).

Table 7: Agency Estimates of Staffing Devoted to Lease Activities Prior to DRES Implementation

Full-Time Equivalent Staffing for Leasing Prior to DRES Implementation	Number of Agencies Reporting	Equivalent Statewide Staffing
< 0.25	17	< 4.25
0.25	5	1.25
0.5	3	1.5
1.0	2	2.0
1.0 or >	6	> 6.0
Total Equivalent Statewide Staffing		*10.75 to 15 or >*

Source: JLARC staff survey.

The objective of the centralization, however, was not necessarily to reduce the number of staff devoted to leasing activities statewide. Rather, Executive Order 75 was intended to reduce total leasing costs and improve several aspects of statewide leasing. According to DRES, prior to centralized lease management, agencies could not independently capitalize on the negotiating power of the State, nor could they identify opportunities to colocate with other agencies. There was also no formal mechanism to enforce per-person square footage standards. DRES also notes that in many cases, because agencies did not routinely negotiate leases, they did not possess sufficient leasing expertise. This at times led to agencies negotiating overly expensive leases or those with illegal clauses.

Since its implementation, DRES has tracked the cost savings it has identified through centralization. In general, these savings are either due to (1) renegotiation / relocation, (2) reducing excess space / collocation, or (3) decisions to purchase existing or build new space rather than leasing. Because of the buying power of a consolidated lease portfolio, DRES is able to renegotiate existing leases or relocate to comparable space for a reduction in overall lease cost. DRES also creates savings through office space reduction, either by eliminating unnecessary excess space or by collocating offices. Collocation of offices often has the added benefit of reduced cost per square foot due to economies of scale and shared common areas such as conference rooms. Lastly, DRES may choose to build or purchase properties in lieu of leasing. By transferring those agencies from private leases to the state rent plan, DRES not only creates agency savings but keeps the funding flow within the Commonwealth's accounts.

DRES estimates that over the life of current agency leases, centralization will have saved \$63.9 million on agency leases totaling \$278.9 million in total rent over the lease term. Annualized, these savings amount to just under \$8 million (Table 8). This is approximately four times the value of what agencies will be paying

Table 8: Estimated Savings from Centralization of Lease Administration

Type of Savings	Average Annual Savings
(1) Renegotiation/relocation	$4,318,700
(2) Reduction/collocation	2,777,800
(3) Building/purchasing	824,900
Annual Total	*$7,921,400*

Source: JLARC staff analysis of DRES estimates.

DRES in fees each year. JLARC examined these savings estimates for individual leases and found DRES's estimation methods to be reasonable.

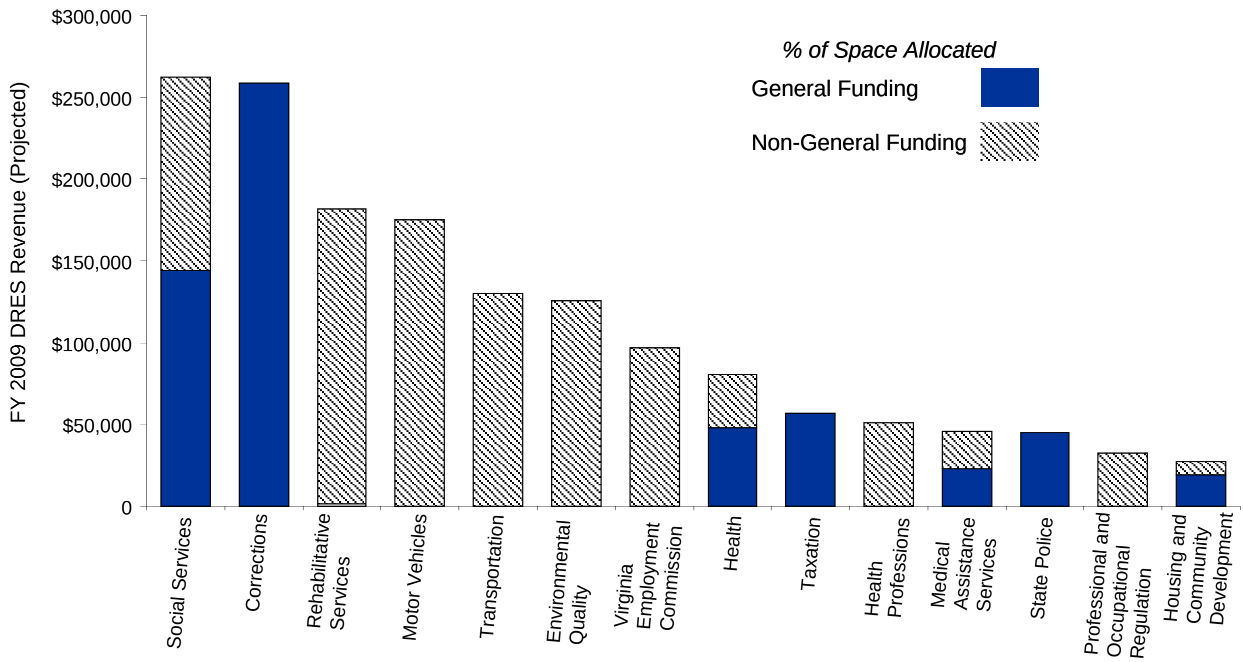
As might be expected with any transition from decentralized to more centralized services, agencies report some concern about DRES implementation thus far. Only 20 percent of agencies responding to the JLARC staff survey of State agencies agreed that DRES services were cost effective for their agency. Similarly, just more than 20 percent agreed that centralized lease management through DRES had reduced the burden of managing their leases.

Through the survey, agencies expressed concerns regarding the fact that responsibility for some lease accounting and recordkeeping processes remains with the agency, despite the fact that DRES administers the leases. In addition, agencies took issue with the reduction in their level of control and input into the decision-making process on leases. Some agencies noted that DRES did not adequately understand agency missions or effectively communicate the reasons for its decisions. Lastly, some agencies questioned the cost avoidances cited by DRES, for reasons including that their individual agency did not receive any additional funds resulting from cost avoidances (though some savings may have accrued to the State as a whole).

Responding agencies were somewhat less concerned about the quality and timeliness of DRES services. About 40 percent of agencies were satisfied with the quality of service they receive from DRES, and 43 percent reported that DRES addresses agency concerns in a timely manner. The remaining agencies were indifferent or disagreed that they received quality and timely services, indicating room for improvement in terms of agencies' perceptions of DRES as the centralized administrator of agency leases.

Finally, it does appear that DRES is recovering costs across various fund types. Fifty-eight percent of DRES revenue comes from non-general funds, and general fund expenditures are refunded to the agency. As shown in Figure 7, many of DRES's largest custom-

Figure 7: DRES Revenue Includes General and Non-General Funds



Source: JLARC staff analysis of DRES projected revenue estimates.

ers in terms of revenue, including the Departments of Motor Vehicles and Transportation, use all non-general funds to pay fees to DRES.

Lack of Complete Centralized Information About Statewide Real Property Hinders Ability to Identify Further Cost-Saving Opportunities

Currently the DRES centralized database on real property does not include complete and current information about all the State's real property holdings and leases. DRES has been tasked by executive order with collecting information about the totality of State real property. According to DRES, the State cannot have confidence that it is effectively utilizing its real property assets without a centralized repository that includes square footage, cost, and staffing associated with the property. Having this information about both State-owned and leased property managed either through BFM, DRES, or by agencies themselves would allow central identification of potential cost-saving opportunities.

DRES maintains a central repository of information about the State's real property through its Integrated Real Estate Management System (IREMS). As of spring 2009, DRES had migrated data from a previous system into IREMS and had largely populated the system with information, such as square footage and cost, about the leases that it manages on behalf of other agencies. However, there are still significant gaps in information about leases managed by agencies and State-owned property not managed by BFM. The lack of this information hinders the ability to identify additional opportunities to colocate agencies, reduce per-person square footage to the statewide standard if possible, or identify and sell surplus State-owned property.

The Haymarket Field Unit property provides a recent, illustrative example underscoring the importance of maintaining updated and centralized information about the State's real property holdings. The correctional field unit has been vacant for nearly two decades, but not declared surplus property until recently. This property was deactivated in 1991 and was identified in JLARC's 1995 *Review of State-Owned Real Property* as a property not currently in use, but one which the Department of Corrections (DOC) saw as viable for later use. According to DOC, the property has not been used and was formally declared surplus to DGS just recently—only after DOC offered the sale of that property as a part of its budget reduction plan.

Without a complete and current centralized system for State-owned and leased property, it is not possible to determine how many other such properties are vacant or underutilized. In the current budget climate, it is particularly important to continue to identify cost-saving opportunities related to the State's real property holdings. DGS realizes the importance of collecting and maintaining this information, and DPB has indicated there could be ways to use the capital budgeting process to collect more complete property records from agencies. Neither agency, however, has articulated a specific approach or timeframe to collect the information.

Recommendation (4). The Department of General Services should identify specific actions and milestones necessary to collect and maintain key data, including use, cost, and square footage, for all of the State's owned and leased property.

Chapter 5 Surplus Property Management

In Summary

The State has two internal service funds that dispose of State and federal surplus physical property. Both of these funds are operated by the Office of Surplus Property Management (OSPM) and both funds have historically had operating gains. Most customers believe these services are cost effective for their agency and most customer agencies are generally satisfied with the services provided. Despite the funds' past operating gains, DGS is concerned that certain changes in State agency operations will reduce the funds' future revenue streams and sustainability. These include reductions in the amount of surplus State property, including vehicles from the Virginia Department of Transportation and computers from the Virginia Information Technologies Agency. OSPM is currently exploring opportunities to broaden the funds' revenue bases by providing surplus services to localities, and using contract auctions and Internet sales.

Sections 2.2-1124 and 2.2-1125 of the *Code of Virginia* define surplus property and direct DGS to dispose of surplus materials according to procedures that it establishes. Section 2.2-1123 designates the Division of Purchases and Supply (DPS) within DGS as the State agency responsible for acquiring surplus personal property from the United States government. The Office of Surplus Property Management (OSPM) within DPS is charged with this responsibility.

OSPM DISPOSES OF SURPLUS PROPERTY FOR STATE AND FEDERAL AGENCIES

OSPM is responsible for the disposition of surplus physical property, which is defined as all physical personal property that is determined to exceed the needs of State government by the management of a State agency or institution. This includes items such as office furniture, used cars and trucks, fire equipment, generators and motors, heavy machinery and equipment, kitchen equipment and supplies, tools, lab equipment and supplies, cleaning equipment and supplies, computers, printers, and copiers. The mission of the office is to

- re-utilize surplus property, providing substantial savings to taxpayers, and
- sell surplus to the general public at competitive prices, helping the Commonwealth to recover its investment.

OSPM manages both the Federal Surplus Property and State Surplus Property ISFs. Federal property is received from the U.S. General Services Administration (GSA) and other federal entities and is available to State and local government agencies and institutions, and to certain health, educational, and other qualified organizations. The only fees collected are service fees to cover the costs of warehousing and transportation in accordance with the Virginia State Plan of Operation. The State Surplus Property program sells surplus property from State agencies to other State agencies, localities, qualified non-profit organizations, and the public. The prices for State surplus property are based on fair-market value assessments.

OSPM sells surplus property from its warehouse distribution center in Richmond, a retail store in Wytheville, and through public auctions. OSPM also sells property via the Internet. If an item is put up for sale on the Internet, the property is "sold in place," meaning the property remains at the agency and the agency does not have to transport the property to the OSPM warehouse. The agency also receives a portion of the proceeds from the sale. If an agency drops off surplus property at the warehouse to reutilize or sell, it is required to transport the property to the OSPM warehouse at its own cost and does not receive any of the proceeds.

Total revenues for the OSPM internal service funds (including State and federal surplus) were $2.7 million in FY 2008. This revenue comes from either

- service fees charged to process federal property being made available to agencies, localities, and eligible non-profits,
- revenue generated from the sale of surplus property located at OSPM's warehouse and retail store, or
- fees charged for (1) sales of property on the Internet, (2) sales of surplus heavy equipment and vehicles using third-party private auction houses, and (3) conducting live auctions at the agency location.

The fees charged to agencies for disposing of surplus property vary with the method used to sell the property. The fees normally range from seven to 15 percent.

OSPM OPERATIONS ARE CONSISTENT WITH ISF OBJECTIVES

It appears that both the State Surplus Property (SSP) and Federal Surplus Property (FSP) ISFs are operating in a manner consistent with the three basic policy objectives for internal service funds. However, operating gain and loss and cash balances need to be treated differently for these ISFs. State surplus property that is sold by OSPM has already been purchased and used by a State agency. The fact that OSPM realizes an operating gain, therefore, is more desirable than the alternative of giving the property away or sending it to a landfill. Similarly, the FSP gain is the result of the sale of property that is donated to the State by the federal government. The different nature of the fund gains underscores the importance of having different thresholds for gains, losses, and cash balances for each of the DGS ISFs as noted in Recommendation 2.

Customers Are Generally Satisfied With State and Federal Surplus Services

A JLARC staff survey of State agencies about the use of internal service funds indicates that agencies are generally satisfied with OSPM's services. Approximately 94 percent of the agencies responding to the survey said they use OSPM to either dispose of or purchase surplus property, and 79 percent of those who use OSPM's services said they were satisfied. Eighty-one percent of agencies responding agreed that OSPM is a cost-effective method to dispose of surplus property, and 65 percent agreed that OSPM is a cost-effective option to purchase surplus property (29 percent had no opinion about this question or said it was not applicable).

Although several agencies indicated that OSPM staff are very helpful, some agencies expressed concerns with OSPM. The most commonly cited concerns were that agencies have to pay the cost of transporting their surplus property to OSPM's warehouses and that agencies do not receive a portion of the proceeds when their surplus is sold through the warehouse. In addition, several agencies reported that it is not always clear what OSPM considers surplus and what is trash.

SSP and FSP Produce Operating Gains, Which Has Resulted in Accumulated Cash Balances

As noted in Chapter 2, the SSP and FSP were the most profitable DGS ISFs on a percentage basis between FY 2004 and FY 2008. During this time, the SSP operated at a cumulative operating gain of $861,355, or 14 percent of cumulative operating expenses. The FSP operated at a cumulative gain of $431,384, or 18 percent of operating expenses. The gain for SSP indicates that, in general, SSP is able to obtain value for property that State agencies deem they no longer need that is greater than the costs of disposing of the property. The gain for FSP represents new funds the State would otherwise not have, and therefore higher gains are more desirable.

State Surplus Property Cash Balance

While reviewing OSPM's 2007 request to change its rate structure, JLARC staff noted that the SSP cash balance at the end of FY 2008 was going to be above the threshold of 25 percent of annual operating expenses. DGS used the excess cash to address several safety and structural problems at the Richmond warehouse identified in a DHRM survey, including upgrades to bring the electrical system to code, improve ventilation, and replace the septic system with sewer.

Both funds also had the highest cash balances as a percentage of their respective operating expenses. As of FY 2008, the cash balances were $731,153 for SSP and $696,171 for FSP. OSPM recently addressed several safety and structural problems at its warehouse with the accumulated SSP cash balance (see sidebar). The FSP cash balance was 224 percent of the fund's operating expenses. OSPM's State Plan of Operation, which it must have to receive surplus property from the federal government, allows a cash balance equal to two years of expenses. The same plan also specifies that the revenue derived from the sale of federal surplus property (which includes the revenue in the cash balance) can be used to cover all direct and indirect costs of the agency, including personnel, capital purchases and improvements, equipment, and maintenance.

DGS CONCERNED THAT CHANGES IN REVENUE STREAM MAY AFFECT FUTURE SUSTAINABILITY OF OSPM ISFs

OSPM reports that changes in State government operations may have a significant effect on the SSP revenue stream in the future. These changes are likely to erode a substantial portion of the State fund's revenues over the next several years. The changes include:

- The Virginia Department of Transportation (VDOT) has been outsourcing road construction and maintenance work to private companies, which reduces VDOT's fleet of equipment and in turn reduces the revenue VDOT and OSPM receive from the sale of this equipment. OSPM estimates that revenues from the sale of VDOT equipment make up about 25 percent of the fund's revenue stream.
- The Virginia Information Technologies Agency (VITA) has outsourced computer services to Northrop Grumman. All computers purchased by Northrop Grumman for State agencies will be the property of Northrop Grumman, and will not be available surplus for OSPM to sell. OSPM estimates that revenues from the sale of computers currently make up about 10 percent of the fund's current revenue stream.
- Three major universities that are part of the Higher Education Restructuring Act—the University of Virginia, Virginia Tech, and William and Mary—are no longer required to surplus their equipment through OSPM. (Virginia Commonwealth University will also soon be covered by the act.)

OSPM has been implementing a variety of changes to offset the likely decline in its revenue. For example, OSPM is attempting to bring in more non-State revenue from localities. In 2009, the General Assembly passed HB 1838, which amends the *Code of Virginia* to allow the State to provide surplus property management ser-

OSPM has been implementing a variety of changes to offset the likely decline in its revenue.

vices to local public bodies. This service may improve the value the localities receive for their surplus property. In addition, if local governments choose to use OSPM's services, the increase in non-State revenue could help to offset the likely decrease in revenue described above. OSPM has also opened a retail store in Wytheville for public sales on a regular basis instead of infrequent sales and is experimenting with fixed price public sales at its Richmond warehouse.

OSPM has also changed some of its processes to increase revenues and recover the maximum amount of dollars for agencies. For example, OSPM is increasing its use of contracted auction services to handle heavy equipment and vehicles sales. Prior to this change, OSPM staff would travel to agency facilities and hold an auction one to two times per year. This process required a large investment in time, space, and expense to maintain equipment waiting for auctions. In addition, many sales of property at agency locations were handled using the sealed bid process, which was time consuming, costly, and tied up agency space while the sale was being processed. Finally, as stated earlier in this chapter, OSPM now uses Internet sales, which lowers transportation costs for agencies and broadens the customer base to improve sales revenue. However, the increased use of Internet sales may also decrease the fund's revenues because the agencies receive the majority of the proceeds.

Chapter

6 Division of Consolidated Laboratory Services

In Summary

The Division of Consolidated Laboratory Services (DCLS) internal service fund has several unique characteristics that make it different from the other DGS internal service funds. In particular, only a small portion of DCLS's total funding is derived from the ISF. While the two largest customers included in the fund are the Virginia Department of Agriculture and Consumer Services (VDACS) and the Department of Environmental Quality (DEQ), DCLS also conducts tests for other State agencies. DCLS conducts timely and accurate testing for DEQ and VDACS, and both agencies report they are satisfied with the services provided by DCLS. However, revenue collected through the ISF may not be equal to actual operating expenses. Because of this, and the fact that not all of DCLS's State agency customers are included in the fund, DGS should evaluate the DCLS ISF and determine whether it wishes to continue to operate DCLS as an ISF, with appropriate cost recovery, or discontinue operating DCLS as an ISF.

The Division of Consolidated Laboratory Services (DCLS) tests food products, animal feeds, water, soil, air, motor fuels, and human and animal tissue specimens. These tests are performed on behalf of State agencies, local governments, federal agencies, and other states. DCLS performs over four million tests per year with the goal of helping ensure the safety and health of the State's citizens and environment.

DCLS ISF HAS SEVERAL UNIQUE CHARACTERISTICS

DCLS was formed in 1972 when laboratories from several Virginia agencies were combined to provide more efficient and cost-effective laboratory testing to State agencies. While DCLS serves over 25 State agencies, not all of its services to these agencies are part of the ISF. For example, much of the work performed for the Virginia Department of Health (VDH), one of DCLS's largest customers, is not part of the ISF because these tests are funded with general, federal, and enterprise funding.

ISF Created Through an Agreement Between DCLS and DEQ

DCLS's internal service fund is unique because it was created in 1994 by an agreement between DCLS and the Department of Environmental Quality (DEQ) management. The ISF was created to restrict the number of tests submitted and improve DCLS's efficiency. At the time, DCLS felt that DEQ inspectors were submitting too many samples, and this was causing an increase in DCLS's turnaround times. To address this issue, DCLS and DEQ agreed that an ISF should be created and that DEQ should pay for the costs of its tests. In 1994, a total of $1.3 million in general funds was transferred from DCLS to DEQ. The *Summary of 1994 Budget Actions, March 12, 1994*, states that this transfer allows "DEQ to purchase analytical testing services from either private laboratories or the state lab, based on competitive pricing." DCLS and DEQ formalized the terms and conditions through an interagency agreement.

In 1996, the General Assembly added the Virginia Department of Agriculture and Consumer Services (VDACS) to the DCLS internal service fund. A total of $360,000 was transferred from DCLS to VDACS to "allow VDACS to purchase, from either public or private sources, certain analytical services now performed by DCLS." The reasons for including VDACS in the ISF are unclear; unlike DEQ, neither VDACS nor DCLS requested that VDACS be included in the fund. In addition, both DCLS and VDACS state that the funding that was transferred from DCLS to VDACS did not cover the cost of VDACS's testing needs at that time.

Today, the terms and conditions of the services provided by DCLS to its customer agencies are still agreed to through interagency agreements, which is unique among the ISFs. The two agreements outline the scope of services that DCLS provides, turnaround times and other operational issues, billing procedures, and other technical issues. The actual rates that DCLS charges for each test are included in a separate Catalogue of Services developed by DCLS.

ISF Is a Small Portion of DCLS's Total Budget and Does Not Include All State Agency Customers

Another unique characteristic of the DCLS ISF is that not all of DCLS's customer agencies are included in the fund. Approximately 91 percent of DCLS funding comes from general funds, federal trust funds, and an enterprise fund. Only the remaining nine percent is from the ISF. In FY 2008, total revenue for the fund was $2.3 million, and the fund was allocated 35 full-time equivalent employees, which represents 15 percent of DCLS's maximum employment level.

DEQ is the internal service fund's largest customer, comprising 57 percent of the fund's revenue in FY 2008. DCLS analyzed 40,319 samples for DEQ in 2008, which included chemical testing of sediments, soils, environmental samples, and water samples. DCLS also performs tests to determine the level of toxics in State waters, including the Chesapeake Bay and its associated tributaries. DEQ indicates that, with a few minor exceptions, its DCLS testing is funded with general funds.

VDACS is the ISF's second-largest customer, comprising 23 percent of the fund's revenue in FY 2008. DCLS analyzed 6,575 samples for VDACS in 2008. Tests conducted for VDACS include testing to ensure food quality, and determine adulteration or misbranding of feeds, fertilizers, and pesticides. VDACS reports it pays for DCLS testing with a mix of general and non-general funds.

The remaining 20 percent of the fund's revenue comes from other State agency customers. For example, DCLS charges the Virginia Department of Transportation to test motor fuels and the Virginia State Lottery to test lottery tickets.

VDH is the largest State agency that interacts with DCLS, but is not included in the ISF. According to DCLS staff, DCLS was originally part of VDH and retained the responsibility to provide public health testing services when DCLS was consolidated under DGS. Funding was never removed from the DCLS operating budget and transferred to VDH to support its testing requirements as it was for DEQ and VDACS. However, VDH does reimburse DCLS for testing services that are above and beyond standard requirements that are mutually agreed upon by DCLS and VDH.

DCLS CONDUCTS ACCURATE TESTS IN A TIMELY MANNER FOR VDACS AND DEQ

The unique nature of DCLS operations makes it difficult to determine whether its tests are offered at competitive rates. However, it does appear that DCLS testing is of good quality, is provided in a timely manner, and that VDACS and DEQ are generally satisfied with DCLS services.

Proficiency Testing

Proficiency testing is a method of externally validating the accuracy of laboratory performance. A proficiency testing provider sends blind samples to DCLS, which then analyzes the samples and returns them to the proficiency testing provider. The proficiency testing provider then calculates the percentage of samples that DCLS staff identified accurately.

DCLS monitors its performance through two performance measures: accuracy and timeliness of testing services. To assess accuracy, DCLS subscribes to 19 proficiency testing programs that help it assess testing of samples submitted by DEQ and VDACS. Over a five-year period, DCLS's accuracy ranged from 95.4 percent (in 2006) to 99.1 percent (in 2007). DCLS's goal for all of its testing services is 99 percent or better.

DCLS measures its timeliness based on the number of days between the date the sample is received by DCLS and the date the test results are reported to the customer. In 2008, for all types of tests conducted by DCLS (not just ISF tests), DCLS met or exceeded its customers' expectation for receiving test results an average of 98.83 percent of the time.

Overall, both DEQ and VDACS appear to be satisfied with the testing services provided by DCLS. Both indicated that DCLS generally provides high-quality services at a reasonable price, and that the turnaround times are adequate, with minor exceptions. DCLS staff hold monthly or quarterly meetings with customer agency staff, so when the agencies do have concerns, they can be addressed during these meetings.

SEVERAL ASPECTS OF DCLS OPERATIONS RAISE QUESTIONS ABOUT CONTINUANCE UNDER CURRENT ISF STRUCTURE

The key questions for review of ISFs in Chapter 1 provide a framework to assess both operational and financial aspects of ISFs. As discussed above, DCLS provides accurate testing in a timely manner. In addition, VDACS and DEQ report they are generally satisfied with the service they receive from DCLS. However, applying other key questions to the DCLS ISF raises questions about continuing the ISF under its current structure.

Revenue Collected Through ISF May Not Be Equal to Actual Operating Expenses

One of the key oversight questions for ISFs is whether the revenue collected through the ISF is equal to its operating expenses. Analysis of recent DCLS revenue and operating expenses suggests this may not be the case. The amount of revenue that the DCLS ISF collects should be determined by (1) the volume of testing it conducts and (2) the rate that it charges to conduct each test. However, as noted in Chapter 1, it can be challenging to accurately predict changes in agency use of ISF services. This is the case for DCLS as well, with DCLS testing varying amounts of samples for DEQ and VDACS each year.

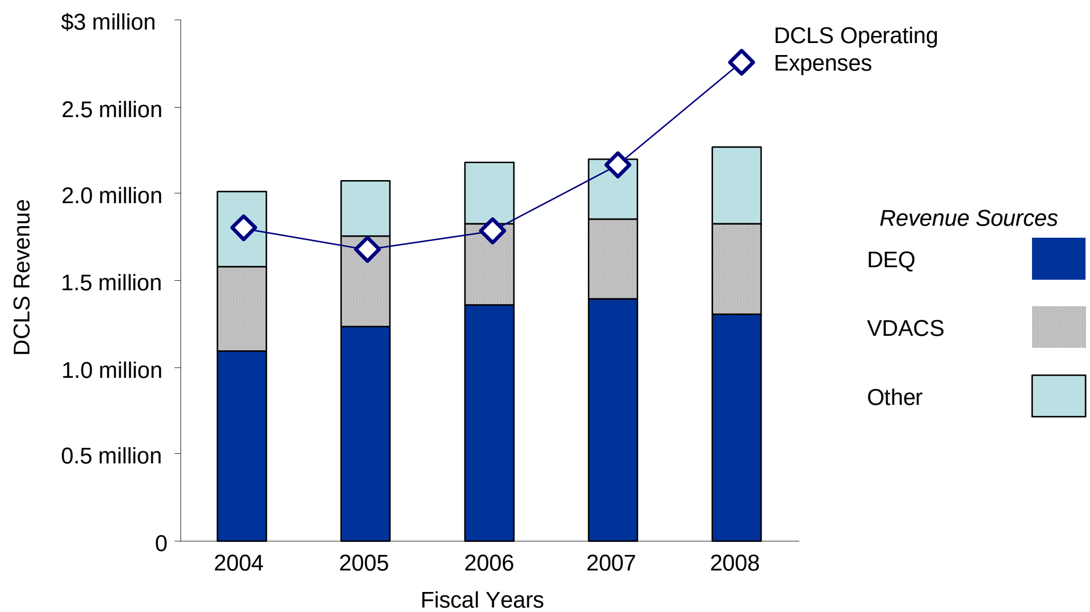
DCLS sets the rate per test every five years as part of the renegotiation of the interagency agreements. DCLS calculates the rates by multiplying the time it takes to perform a test by the labor rate. DCLS then adds the cost of supplies and materials, equipment depreciation, maintenance costs, and building rental costs. An overhead factor is also added to the rate. According to DCLS, the last rate increase was in 2005.

Over the last five years, DCLS has shown a cumulative operating gain, but experienced a loss in FY 2008. DCLS had a cumulative gain of about $495,000 between FY 2004 and FY 2008, which is about 4.8 percent of the fund's total operating expenses during the time period. Between FY 2004 and FY 2008, DCLS's annual gain or loss ranged from a gain of $387,976 in FY 2006 to a loss of $510,264 in FY 2008. This recent loss in FY 2008 is largely the result of operating expenses increasing at a faster rate than DCLS's revenue in recent years (Figure 8). While revenue from DEQ, VDACS, and other miscellaneous sources grew 13 percent, DCLS operating expenses attributable to the ISF grew 54 percent in the last five years.

The ISF's operating expenses are partially determined by how much staff time DCLS allocates to the ISF. Most staff time is allocated between the ISF and other general funded work based on the percentage of time each DCLS staff member spends doing work for different customers. For example, a scientist who does water quality testing may have part of her time allocated to the ISF if the testing is routine testing for DEQ. But part of her time may also be allocated to the general fund if the testing is in response to an emergency.

Much of the increase in operating expense that occurred in FY 2008 was the result of DCLS reallocating the salaries of some staff to the ISF. This resulted in an increase in salary expense of 51 percent over FY 2007, or $424,169. This reallocation also caused employee benefit costs, such as retirement contributions and medical insurance, to increase. DCLS reports the reallocation was made because of increasing workload. In the years prior to the reallocation, VDACS testing did increase, though DEQ testing actually decreased. Specifically, VDACS testing volume increased from FY 2006 to FY 2007, then again in FY 2008. DEQ testing, however, declined from FY 2006 to FY 2007, then again in FY 2008.

Figure 8: DCLS ISF Revenue Has Not Kept Pace With Operating Expenses



Source: JLARC staff analysis of DCLS profit and loss statements.

To address the disparity between operating expenses and revenue from FY 2008, DCLS does not anticipate increasing its rates. Rather, DCLS reports that it will reduce its staffing allocations to the ISF and try to absorb as much as possible of the ISF salary expenses in its own general fund appropriation. DCLS noted that if it were to reduce staffing by the amount necessary to lower operating expenses to match revenue being collected, it would not be able to process the samples that VDACS and DEQ send to be tested. This potential inability to conduct tests for the rates it has been charging VDACS and DEQ suggests DCLS is not charging the actual costs of the tests. This is inconsistent with JLARC policy that requires ISFs to "establish procedures to ensure charges to customers are sufficient to recover the actual cost of providing service…".

All State Agency DCLS Customers Not Included in ISF

Another key oversight question for ISFs is whether the costs of service are shared by all users. When considering that DCLS also provides services to other State agencies outside the ISF, this is not the case. The largest agency not currently included in the ISF is VDH. When asked about the possibility of including VDH in the ISF, DCLS expressed concern that VDH and the local health departments may not be able to submit all necessary testing samples related to public health (such as rabies tests or tests related to food-borne illnesses) if they are required to pay for the tests themselves. This, in DCLS's opinion, could be a disincentive to submit samples, which could negatively impact public health. In addition, the Appropriation Act states that DCLS "shall ensure that no individual is denied the benefits of laboratory tests mandated by the Department of Health for reason of inability to pay for such services."

It is unclear whether it would be feasible to include other agencies in the ISF. One potentially complicating factor with including more agencies in the ISF is DCLS's need for stable funding. DCLS provides emergency analytical support for Virginia, neighboring states, and federal agencies in response to public health and environmental threats. This requires DCLS to maintain a certain level of emergency capabilities regardless of current need. State general funds provide relatively stable funding for DCLS to maintain these emergency capabilities, whereas the ISF revenue can fluctuate based on workload.

DGS Should Evaluate Feasibility of Continuing DCLS ISF in Its Current Form

The unique nature of the DCLS ISF, inadequate cost recovery for services provided, and inconsistent use of the ISF for all State

DCLS customers suggest the current approach to the DCLS ISF needs to be re-evaluated. Such an evaluation should address:

- Whether it is feasible for DCLS to charge VDACS and DEQ the actual cost of the tests it conducts. The interagency agreement between DCLS and VDACS is set to expire on June 30, 2009; the agreement with DEQ expires on June 30, 2010. The renegotiation of these agreements should ensure that there is the correct relationship between operating expenses and revenue collected through the rates charged.
- Whether it is feasible to include additional State agencies in the DCLS ISF. Potential advantages to broadening the fund could include reduced costs through eliminating excessive or unnecessary tests, reduced needs for general funds by including federal and other funding sources, and better ISF management. Potential disadvantages could include the additional administrative burden and hindrance of public health and emergency response capabilities.

If the evaluation finds that it is not feasible to charge the actual costs of tests or include additional State agencies, it may be necessary to discontinue operating DCLS as an ISF.

Recommendation (5). The Department of General Services (DGS) should evaluate the feasibility of including additional State agencies in the Division of Consolidated Laboratory Services (DCLS) internal service fund (ISF) and charging ISF customer agencies the actual cost of testing. DGS should submit the results of the evaluation to the Joint Legislative Audit and Review Commission, indicating whether DGS wishes to (1) continue to operate DCLS as an ISF, with appropriate cost recovery, or (2) discontinue operating DCLS as an ISF.

List of Recommendations:

Review of Department of General Services Internal Service Funds

1. The Department of Planning and Budget (DPB), with the assistance of the agencies that operate internal service funds (ISFs), should develop a proposed schedule for review and approval of changes to ISF rates and other charges that is better integrated with the biennial budget process. DPB should submit the proposed ISF rate approval schedule to the Joint Legislative Audit and Review Commission for its concurrence and implementation during the FY 2011–FY 2012 budget development and appropriations process.

2. The Department of General Services (DGS) should develop specific cash balance thresholds for each internal service fund it operates. DGS should also identify criteria for above-threshold accumulation of reserves, purposes for which reserves may be used, and conditions for returning excess reserves to customer agencies. DGS should submit the proposed cash balance and reserves plan to the Joint Legislative Audit and Review Commission for approval in order for it to be used during the FY 2011–2012 budget development and appropriations process.

3. The Departments of General Services and Planning and Budget should agree on a mechanism to facilitate planning and funding for equipment repairs or replacements not included in agency maintenance reserve funds. This mechanism should be consistent with the established thresholds for cash balances pursuant to Recommendation 2.

4. The Department of General Services should identify specific actions and milestones necessary to collect and maintain key data, including use, cost, and square footage, for all of the State's owned and leased property.

5. The Department of General Services should evaluate the feasibility of including additional State agencies in the Division of Consolidated Laboratory Services ISF and charging ISF customer agencies the actual cost of testing. DGS should submit the results of the evaluation to the Joint Legislative Audit and Review Commission, indicating whether DGS wishes to (1) continue to operate DCLS as an ISF, with appropriate cost recovery, or (2) discontinue operating DCLS as an ISF.

Appendix A Study Authorization

At the December 2008 JLARC meeting, the JLARC director informed members that staff would review the internal service funds managed by the Department of General Services during the spring of 2009. The review was conducted under the oversight responsibility for internal services funds granted to JLARC in §2.2-803 of the *Code of Virginia:*

> As to the operation of merchandising activities, or other centralized support services provided by one state agency to other state agencies for which charges are made, the system of accounting shall be designed to reflect all charges properly allocable so that the net profit or loss therefrom shall be reflected. In the furtherance of this objective the Joint Legislative Audit and Review Commission may direct the Comptroller to establish under such terms and conditions as they may determine internal service fund accounts on his books and record therein the receipts and expenditures of these several functions. The Comptroller shall provide the agencies responsible for the operations of these functions with working capital advances with which to finance the operations pursuant to appropriations made by law. The Joint Legislative Audit and Review Commission may direct the Comptroller to transfer excess fund balances to the general fund or to remove from his books internal service fund accounts that are no longer considered appropriate and record the necessary transfer of funds.

Appendix B Research Activities and Methods

JLARC staff conducted four major types of research activities to address the study mandate:

1. Analyzed existing datasets about internal service fund (ISF) operations and financing;
2. Interviewed Department of General Services (DGS) and ISF staff, major customer agencies, and other key stakeholders;
3. Developed and administered a survey to gain perspective about State agencies' use and opinions of the DGS ISFs; and
4. Interviewed and surveyed other states about their use of ISFs.

ANALYSIS OF EXISTING DATASETS ABOUT ISF OPERATIONS AND FINANCING

JLARC staff analyzed a variety of historical JLARC records regarding DGS rate requests. These included rate request submissions and JLARC staff materials submitted to the JLARC internal service fund review subcommittee. This also included previous JLARC staff reports.

DGS provided gain and loss statements for each ISF for FY 2004 to FY 2008. JLARC staff used these statements to assess historical gain and loss, cash balances, and major operating expenses and revenue sub-categories. DGS also provided JLARC staff with information about which agencies comprise ISF revenue.

INTERVIEWS WITH ISF STAFF, MAJOR CUSTOMER AGENCIES, AND OTHER KEY STAKEHOLDERS

JLARC staff conducted a variety of interviews with State agency staff regarding the DGS ISFs. These interviews included the DGS director and controller, and the fund managers and other staff at the Division of Consolidated Laboratory Services, Office of Surplus Property Management, Division of Real Estate Services, Bureau of Facilities Management, and Virginia Distribution Center.

JLARC staff also met with major ISF customers, including the Department of Corrections, Central Virginia Training Center, Southside Virginia Training Center, Department of Agriculture and

Consumer Services, and the Department of Environmental Quality. JLARC staff also met with key DGS ISF stakeholders at the Department of Planning and Budget and Auditor of Public Accounts.

SURVEY OF STATE AGENCIES ABOUT DGS ISFs

In the spring of 2009, JLARC staff surveyed State agencies about their use of and opinions regarding the DGS internal service funds. The survey was administered online using JLARC staff's survey software. A pre-test of a draft survey was conducted prior to administering the survey; no changes were necessary based on pre-test agency experiences.

A separate survey was created for each DGS service fund, except for the Division of Consolidated Laboratory Services due to the comparatively small number of agencies that use its services. Each survey asked the respondent to identify their agency and provide contact information. Each survey then included a short series of questions asking whether the agency used the ISF's services, and if so, the extent to which they agreed with statements about the ISFs service quality, timeliness, and other issues.

JLARC staff notified agency heads using the most recent list of agency head e-mails as maintained by the Department of Human Resource Management. The Department of Corrections, the Department of Mental Health, Mental Retardation and Substance Abuse Services, and the Virginia Community College System were asked to forward the e-mail notification to the appropriate facilities, institutions, and colleges under their purview.

The number of responses varied by survey. As shown in Table B.1, between 104 and 143 agencies responded to the surveys. This is between 59 and 81 percent of 177 agencies notified and requested to complete the survey.

Table B.1: Agency Response Rates to JLARC Staff ISF Surveys

ISF Survey	Responses	Response Rate[a]
Bureau of Facilities Management	114	64%
Virginia Distribution Center	143	81
Division of Real Estate Services	108	61
Office of Fleet Management Services	107	60
Surplus Property Management Office	117	66
Office of Graphic Communications	104	59

[a] There were 177 possible agency responses to the surveys.

Source: JLARC staff analysis.

INTERVIEWS AND A SURVEY OF OTHER STATES ABOUT THEIR USE OF INTERNAL SERVICE FUNDS

JLARC staff conducted phone interviews with lease administrators from Maryland and Florida regarding their management of real property. These interviews primarily focused on the extent to which these states centralized the management of their real property, and if so, the responsibilities and structure of the office responsible.

JLARC staff also asked the National Association of State Chief Administrators to distribute a questionnaire about other states' use of internal service funds. The questionnaire collected information about which centralized functions, if any, the state operated as internal service funds. It also asked about the legislature's role in internal service fund operations and oversight, and the incentive structure used for ISF fund managers. JLARC staff received 16 completed questionnaires.

Appendix C

Status of Recommendations from the 2001 JLARC Review of the Virginia Distribution Center

Recommendation	Status	Action Taken
1. The Department of Mental Health, Mental Retardation and Substance Abuse Services (DMHMRSAS) should evaluate on a facility-by-facility basis the carrying costs of different inventory levels compared to the transportation costs associated with different delivery frequencies. The department should require each facility to identify whether cost savings will accrue from the use of weekly deliveries from the Virginia Distribution Center (VDC). If cost savings or other efficiencies will not occur, then the department should reconsider instituting weekly deliveries at the facility. The department should consult with VDC in identifying transportation costs.	Ongoing	VDC has worked with the DMHMRSAS facilities to set up delivery schedules to the benefit of the individual facilities, and VDC continues to provide weekly deliveries to several facilities. DMHMRSAS facilities interviewed for the current review indicated they were satisfied with VDC's delivery schedule. Western State Hospital (WSH) indicated to VDC that, as a result of weekly deliveries, they have experienced savings in electricity, staffing, and fuel by converting a large freezer facility into a records storage facility and reducing the trips between the freezer and the kitchen. VDC reports that, as of 2005, its annual freight and labor costs have increased by about $30,000 due to the weekly deliveries to WSH.
2. The Department of General Services (DGS) should amend its mandatory source rule to allow agencies with retail-oriented operations to obtain their food from the source that provides the service level needed at the lowest total cost.	Partially implemented, no further action planned	Many customers with retail-oriented food service operations, in particular the universities, either 1) do not utilize cafeterias and, therefore, do not fit VDC's business model, or 2) make use of prime vendors. Prime vendors are not required to use VDC for their food products. According to VDC, amending the mandatory source rule could reduce the volume purchasing power which benefits all Commonwealth customers. Whereas it may reduce costs to one organization, overall the Commonwealth could lose through an increase in prices to all customers. This could have an adverse impact to smaller state agencies and erode the benefits of the VDC program. VDC further points out that while retail-oriented operations do not currently utilize the types of products that it carries, VDC could potentially service this type of operation in the future.

Recommendation	Status	Action Taken
3. Universities that currently use warehouses to store housekeeping products should conduct an assessment to determine whether it would be feasible and cost effective to eliminate their warehouses and develop prime vendor contracts that support "desktop" delivery of products on a frequent basis. Such an assessment should include determining whether the warehouse can be used for other needed purposes, and whether the savings associated with closing the warehouse would offset any cost increases in product prices from use of a prime vendor. DGS should exempt from the mandatory source rule any university that identifies a savings through the use of an alternative procurement approach, such as prime vending.	Partially implemented, no further action planned	VDC reports that it continues to work with the universities to meet their housekeeping requirements and with customers that have outsourced their housekeeping products to meet their needs. According to VDC, amending the mandatory source rule could reduce the volume purchasing power which benefits all Commonwealth customers. Whereas it may reduce costs to one organization, overall the Commonwealth could lose through an increase in prices to all customers. This could have an adverse impact on smaller state agencies and erode the benefits of the VDC Program.
4. DGS should ensure that VDC staff receive training on report development for an Oracle-based system.	Completed	The VDC Director and Systems Administrator participated in Crystal Report training. Train-the-trainer techniques are in place at VDC and additional staff members have been trained in Crystal Report writing.
5. The DGS information services staff or VDC staff should develop the management reports necessary for sound decision-making as soon as possible.	Ongoing	VDC indicates that VDC and DGS information services staff have the ability to create or modify management reports or products to meet agency challenges, streamline business processes, and make sound decisions. Examples include: -A new invoice/delivery ticket that helped streamline and increase the efficiency of the paper processing of manifests and invoices. The new ticket provides customers with more information in an easier-to-read, combined invoice/delivery ticket format; enables VDC staff to provide customers with electronic copies, upon request; and eliminates issues with the system-generated report, which previously had to be corrected manually. (August 07) -The invoice export report that streamlined the process of sending invoice data to DGS Fiscal Services. -The perpetual inventory audit trail that adds point-in-time inventory values to the warehouse management system stock log. -A new Return Authorization report to streamline the process of customer returns and give more staff access to information. VDC indicates that it regularly develops new reports to meet management's needs.

Recommendation	Status	Action Taken
6. VDC needs to place a high priority on developing a fill rate report that will identify fill rates by item and by agency. It should use the fill rate data to identify what products, if any, VDC is having trouble keeping in stock, and take appropriate steps to prevent stock-out problems.	Completed	VDC indicates it has developed two fill rate reports - one providing the fill rate by item and the other providing the information by customer. According to VDC, the reports are reviewed regularly and potential stock-out problems are addressed.
7. VDC should set specific performance objectives to reduce the length of time between order submission and delivery. Performance objectives should include incentives for the use of orders placed on-line. VDC should set an organization-wide objective of filling orders not later than six working days after receipt of an order or on the customer's requested delivery date, whichever is later.	Completed	VDC requests a five-business-day lead time for orders, but strives to deliver orders on the date requested by the customer. VDC reports that the results of a 2008 survey of customers indicated that 98% of responders were satisfied with VDC's delivery and scheduling. A separate JLARC survey also found that over 91% of State agency customers either agreed or strongly agreed that VDC provides products in a timely manner. VDC has also worked with customers to increase the percentage of orders that are received electronically from 56% of orders in 2001 to 92% of orders in January 2009. VDC reports continuing to work with customers to bring them on-line and provides ongoing training for on-line eVA customers.
8. VDC should send a notification to all its customers detailing its policies on substitutions and back orders. It should then make it a priority to call all customers which request calls prior to substitutions and to provide customers with sufficient advance notice of the delivery times for back orders. In particular, it should implement the advance shipping notice feature of the warehouse management system.	Completed	VDC reports it has notified all of its customers of its policies on substitutions and back orders. Notification detailing VDC's policies on substitutions and back orders were drafted and distributed with the July 2001 catalog mailing. Information continues to be posted on VDC website and included in the web-based version of the product catalog. VDC indicates that it hired staff and reorganized the VDC Customer Service Team to enhance customer service. The team handles exceptions, substitutions, directions, questions, comments, concerns, and compliments. If VDC does not expect to have enough product to fill customer orders, a member of the VDC Customer Service Team contacts customers to discuss possible substitutions. VDC has also improved its online Order Status Lookup feature to include an advance shipping notice.
9. VDC should develop a plan to reduce its inventory level while still providing a good order fill rate for agencies.	Completed	VDC has reduced its inventory since 2001, and continues to monitor inventory levels and fill rate to maintain a proper balance. VDC attempted to significantly reduce the inventory balance several years ago, but this negatively impacted the fill rate. VDC reports that inventory levels fluctuate based on buying patterns and customer demand.

Recommendation	Status	Action Taken
10. DGS should complete its assessment of options for eliminating VDC's operating loss, including possible adjustments to the VDC mark-up rate. Any proposed rate adjustments should clearly indicate the intended pay-off period for the Treasury loan. DGS should report on its assessment to JLARC by May 2001.	Completed	VDC has eliminated its operating loss, and has been operating at a net profit for the past five years. This is the result of several factors including implementing a JLARC-approved rate increase from 8% to 12%, extending the payoff date of the building loan from 2011 to 2018, and successfully marketing its products to new customers.
11. VDC should develop a marketing plan geared toward adding new State and local agencies to its customer base. Implementation of the plan should begin as soon as it moves to the new warehouse in the Spring of 2001.	Ongoing	VDC staff developed and periodically revises a Marketing Plan for adding new State and local agencies to its customer base. Examples of completed and ongoing marketing initiatives include: -Consolidated multiple data sources into a single contact database for marketing purposes. -Developed an introductory letter and marketing package to send to potential customers. Packages are tailored for potential customers needs. -Hosted VDC food shows and conducted regional meetings throughout the State. -Implementing target marketing through Web postings, fax, e-mail and mail distribution for product updates, select products, and notices. -Developing marketing initiatives for existing green products. -Participating in available conferences, expos, meetings, training, and seminars. -Partnering with eVA staff to develop a marketing strategy for localities and agencies. -Continuing to improve the VDC home page to enhance customer service, marketing efforts, and awareness of the onsite VDC Quality Assurance Laboratory.

Source: VDC and interviews with VDC customers.

Appendix D

Agency Response

As a part of an extensive validation process, State agencies and other entities involved in a JLARC assessment are given the opportunity to comment on an exposure draft of the report. Appropriate technical corrections resulting from comments provided by these entities have been made in this version of the report. This appendix includes a written response from the Department of General Services.

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June 2, 2009

Philip A. Leone, Director
Joint Legislative Audit and Review Commission
General Assembly Building, Suite 1100
Richmond, Virginia 23219

Dear ~~Mr. Leone~~ Phil,

As you are aware, we have been working with JLARC staff for the past several months on a review of all of the DGS internal service funds. Last week we were afforded the opportunity to review and discuss an exposure draft of the report with JLARC staff. Based on that review and discussion, I believe both DGS Management and JLARC staff feel the report accurately describes the DGS internal services funds and some of the more pertinent issues and concerns encountered in operating these programs.

I want to commend the JLARC staff assigned to this effort for their professionalism and willingness to listen to and consult with DGS staff. I feel the recommendations made in the report will help us in improving the overall operation of these programs.

If you or your staff should have any questions or need additional information, please do not hesitate to call me at 786-3311 or Bryan Wagner, DGS Controller at 786-7925.

Sincerely,

Rich

Richard F. Sliwoski, P. E.

C: Mr. Glen Tittermary, JLARC
Mr. Justin Brown, JLARC
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Consolidated Laboratory • Engineering & Buildings • Fleet • Graphics • Purchases & Supply • Real Estate • Surplus

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