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January 7, 1993

The Honorable Robert J. Del Tufo
Attorney General of New Jersey
Justice Complex
CN 080
Trenton, NJ 08625

Re: FY '89 Budget Overexpenditures in the
Division of Developmental Disabilities (DDD)

Dear Mr. Del Tufo:

On April 3, 1989, the late Eddie C. Moore, Director of the Division of Developmental Disabilities (DDD), testified before the Assembly Appropriations Committee. No record was made, and recollections differ significantly about what he told the Committee. For weeks afterwards the media reported that Moore's division had greatly exceeded its budget by awarding unauthorized contracts to providers of services for the disabled. His superior, Department of Human Services (DHS) Commissioner Drew Altman, asked the Attorney General to investigate for possible criminal acts. Later, DHS conducted an internal audit. At your request, the Commission also reviewed the matter. Eventually, Moore's name became associated with a law making it a criminal offense for a public employee to intentionally spend more money than his budget allows.

A state grand jury indicted Moore on March 14, 1990, on charges unrelated to the overspending. Moore died in January 1991, before the case could go to trial.

The DHS audit, concluded in the summer of 1992 prompted an administrative order designed to prevent future overspending. After the DHS audit was concluded, the Commission examined the facts, considered the DHS solution and assessed its effectiveness. DHS has defined a narrow problem and devised a narrow solution. The solution is adequate as far as it goes, but, in the opinion of the Commission, it does not go far enough.

The Commission believes that the DHS system of contracting

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with third parties to provide services to the developmentally disabled is overburdened by regulations and does not allow for competition. Many of the regulations are necessary only because competition has been stifled. The system is inefficient and ineffective, and its legality is questionable.

The Division of Criminal Justice (DCJ) Investigation

DCJ investigators examined DDD fiscal procedures to establish the cause of the overexpenditures and to determine if laws were broken. DCJ found that in 1988-89, as in prior years, Moore worked zealously to increase community-based residences and services for the developmentally disabled. He signed contracts obligating DDD to pay third-party providers of the new "placements." He worked from a spending plan that DDD submitted each year to DHS. Appropriations below those necessary to fully fund the spending plan led to preparation of a separate "deficit reduction plan," which, in turn, called for curtailed spending on individual contracts, reduction of the total number of contracts and recouping excess reimbursements previously made to providers. The deficit could also be reduced by obtaining greater contributions from the federal government, collecting miscellaneous funds from other government sources or seeking supplemental appropriations from the legislature.

DCJ found that contract approval at DDD was informal. Moore entered into verbal agreements which exceeded spending limits on existing contracts. DCJ found that in order for the spending plan and deficit reduction plan to mesh, "budgetary gymnastics" were necessary at each year's end. When DDD personnel adept at these skills were transferred, no system was in place to guard against deficit spending far greater than that experienced in previous years.

Moore had "overcommitted" beyond his ability to correct. No certain dollar amount has been officially attached to his overexpenditure -- probably because in the end the FY 1989 budget gap was closed using techniques similar to those employed in prior years. The best estimate of the total was \$17 million.

DCJ investigators concluded that Moore was not solely responsible for what happened. Blame could be shared with DHS superiors. DDD was operating with an improvised system of contract award and management. DCJ "found inadequate internal mechanisms sufficient to have communicated to Director Moore (or any signatory to a contract) information concerning a contract's relationship to the budgetary constraints." Also, "The fiscal workings of DDD were mismanaged, not with intent to intentionally bankrupt [DDD], but rather due to a breakdown in the exercise of fiscal responsibility by many of those responsible and not by one or two individuals."

In conclusion, DCJ made three investigative findings:

- DHS and DDD failed to heed the advice of previous audits concerning the strengthening of contract administration and fiscal responsibilities.
- In FY 1989, DDD failed to implement its own spending plan and deficit reduction plan. These failures were directly a result of Moore's poor fiscal management, which was reflected in the contract administration and approval process.
- DHS failed to monitor adequately the implementation of DDD's FY 1989 spending and deficit reduction plans.

DCJ also determined that there was insufficient proof that Moore had intentionally overspent his budget. You referred this matter to the Commission "for possible recommendations with respect to correcting management policies and procedures which led to the overexpenditures, as well as practices relating to the awarding of contractual services and payment for those services."

The DHS Account and What the Account Did Not Cover

The DHS internal audit covers the period July 1, 1989, to April 30, 1990. DHS later issued a report, "Operational Audit of Department Contracting." The report states that the audit was conducted at the request of DHS Commissioner Alan J. Gibbs with the goal of preventing another overspending incident. In response to the findings and recommendations of the auditors, the Department prepared an Administrative Order, dated June 19, 1992, detailing "Contract Inventory Accounting Procedures." The audit report, accompanied by the order, was provided to the Commission by DHS Commissioner Gibbs on July 15, 1992.

The report contains no explicit problem statement but does call for strengthened departmental control over contracting. By implication, the problem to be solved by DHS is that its divisions have had too much freedom, and DHS exercised too little control over third-party contracts. Under the new administrative order, DHS will perform functions once left to DDD staff: inventorying contracts, knowing the maximum that can be spent on any contract, limiting the authorization to spend and monitoring the spending on a continuing basis.

The DHS solution is narrow because the charge given the auditors was narrow. The chief objective of the DHS audit was "[t]o determine whether sufficient internal controls are in place to prevent overspending of contract budgets and to make recommenda-

tions for corrective actions to address identified weaknesses." In the past, no system of controls existed to monitor contract spending, which, in a cause and effect relationship according to the auditor's view of the problem, "resulted in contracts being issued in excess of available funding." The audit explicitly did not assess "provider selection, eligibility, or level of service." In contrast, the Commission looked at fundamental aspects of provider selection.

Based on its analysis of the facts, the Commission defines the problem to include the absence of competition in procurement, as well as deficient contract monitoring. The DHS system does not use competition to place the disabled in community placements. Moore could have done more for DDD clients within the allowed budget had contracts been awarded through "normal" procedures like those employed by the Purchase Bureau in the Treasury Department. DDD's system evolved as it did, differently, for two primary reasons: its history of privatizing institutional services and the interpretation and application of an Attorney General's Formal Opinion of long ago. The solution, in the Commission's view, is to improve procurement and bring DHS into compliance with state law.

Another Way to Solve the Problem

In your referral to the Commission, you asked whether the Treasury Department, through the Division of Purchase and Property, "should play a greater role in awarding and monitoring third-party contracts with consultants and service providers to state agencies."

DDD's contracts are different from most other state contracts in several ways. First, almost invariably they provide for the purchase of services for third parties, and nothing else. The law mandating deinstitutionalization requires that services be directed to the end of helping disabled persons become less dependent. Despite the law, DDD's contracts make no reference to client progress to be achieved and do not require that the provider assist the client to become independent.

Second, the contracts for community placement show that DDD has not strayed far from its institutional roots. Just as federal money comes to the state as reimbursement for expenses incurred in maintaining institutions at federal standards, DDD gives reimbursement contracts to providers who meet its standards. DHS has a Contract Reimbursement Manual which details policy on how contracts are to be administered. In the manual's introduction, the department identifies its responsibility in third-party contracts solely in terms of reimbursing the provider -- without mention of the client or a favorable outcome.

The choice of a reimbursement form of payment has important implications. Because it uses reimbursement to pay providers, the department must describe in advance, in the manual, what it will and will not pay for. According to the manual, in determining the "value" (in other words, what it will pay) of a "cost-related contract," the department undertakes a very detailed analysis of all the costs plus profits which might conceivably be submitted for reimbursement. The department determines the "allowability" of individual items of cost by looking at such factors as "reasonableness" and "allocability." The manual acknowledges that "[u]nder any given contract, the reasonableness and allocability of certain items of cost may be difficult to determine. This is particularly true in connection with not-for-profit provider agencies, which are diverse in nature and often not subject to effective competitive restraints." Nonetheless, the manual lists 28 allowable costs, from advertising to severance pay, and requires 25 pages to provide detail. Another seven pages contain detail on 15 non-allowable costs.

The described reimbursement process is extraordinarily complicated and labor intensive; yet it ignores contractor performance and client outcomes. The department's Contract Reimbursement Manual is one inch thick. It has a companion, the Provider Agency Contract Policy and Information Manual (one-half inch thick). This second manual includes circulars which "advise current and prospective agencies of the process to be followed in preparing and submitting a contract-proposal to the Department." Provider agencies are required to submit as part of the process such items as by-laws; "leases, mortgages and other essential documents"; applicable licenses, etc. The manual also covers department contract monitoring responsibilities "to ascertain if services are being delivered in the quantity and for the Unit Cost negotiated and agreed to in the Contract." Client progress to be achieved is ignored once again.

DHS has a request for proposals (RFP) process (N.J.A.C. 10:3-3.1 et seq.), which its divisions may use, but it bears little resemblance to that used by the Treasury Department's Purchase Bureau for most other state agencies. As written, the DHS process does not entice vendors; it makes vendors work hard to get the business. To illustrate, among other things, an "applicant" for a third-party services contract must provide in the proposal a needs justification for the service, which itself must include a statement of the nature of the problem, statistics and "relevant discussions of studies within the community." All told, there are 25 general requirements imposed on the applicant. In effect, it is up to the vendor to document that there is a reason to purchase the services.

In the DHS process, a panel is appointed to review the

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applicant's proposal. The panel must consider, "at a minimum," eight "general" criteria (e.g. "satisfactory documentation of need for services") and seven "specific" criteria (e.g. "adequacy and specificity of the outcome statements"). In addition, the applicant itself is evaluated on nine criteria. If the applicant survives evaluation, "negotiations shall proceed with the process of preparing and submitting a formal contract proposal package to the Department." There are prescribed forms to be used by the applicant.

In addition to the RFP regulations, an applicant for a DHS contract must refer to another large body of regulations covering the Certificate of Need process (N.J.A.C. 8:33-1.1 et seq.) coordinated through the Department of Health. These same regulations cover all aspects of the health care system in New Jersey, including, for example, determinations of which hospital among several will be permitted to purchase MRI equipment.

Another set of regulations (N.J.A.C. 8:43-1.1 et seq.) governs the operation of "residential health care facilities." These regulations are detailed and exhaustive, requiring facilities to have everything from nonskid tread coverings on all stairways to a ventilation area equal to not less than four percent of the total floor area in rooms used by residents.

In sum, the system employed by DHS to achieve deinstitutionalization could hardly be more discouraging of competition. The regulations make a very difficult job even more daunting. But this does not have to be the case. Even though it has chosen a purchase of services solution (a tool of proven worth), DHS has not turned to established New Jersey procurement law for guidance. The rest of state government recognizes the importance of competition, but DHS does not acknowledge its place in the purchase of services for third parties.

With so much money at stake -- almost \$600 million for annual DHS contracts alone -- it is remarkable that the fundamental issue of whether competition is appropriate remains unsettled. The privatization of services formerly provided only through large public institutions is not so distinctive that it cannot include competition. Once a goal has been clearly identified, it should be possible to prepare simple requests for proposals designed to maximize competition for the contracts and quicken the pace of mandated deinstitutionalization.

If its regulations and the reimbursement form of contract serve important purposes, then DHS should seek help in finding ways to satisfy those purposes which are not inconsistent with competition. The Purchase Bureau has wide experience with competitive bidding on all types of goods and services and could assist. DHS

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can do the job itself, but first it must dismantle the barriers to competition.

The Commission believes the law requires competition. Making sure that DHS follows the same law as the rest of state government -- procurement through competition -- can be achieved by correcting an interpretation of law.

Attorney General Formal Opinion

DHS relies upon a 1976 formal opinion by the Attorney General (No. 21-1976) as its authorization to contract directly with providers for purchase of services on behalf of the developmentally disabled. The opinion was in response to the Treasury Department's inquiring under what conditions state agencies, such as DDD, may make purchases without going through the Division of Purchase and Property (P&P).

The opinion noted that P&P exercises "exclusive authority and duty to purchase all articles used or needed by the state and its using agencies," N.J.S.A. 52:25-6, and that the Director of P&P makes "all contracts or agreements, the cost or contract price whereof is to be paid with or out of state funds," N.J.S.A. 52:34-6. Although no distinction is drawn in the statutes, the opinion nonetheless concluded from the context that the Director's authority extends only to goods and services for the state's own consumption. The opinion advised that if there is no such "identifiable purchase interest" of the state, P&P has no role, and the using agency may directly create obligations upon the treasury without using P&P procedures.

Seventeen years later, DHS uses this opinion as its authority to exclude competition when the department enters into third-party purchase of service contracts. Freed from P&P procedures, DHS developed a system which did not incorporate competition for the purchase of services but required a wide array of regulations to compensate for the absence of market forces. Over time, regulations governing even minute matters have been put into place. As a result, changes to just DHS procurement procedures may not automatically produce a competitive environment. It will likely be necessary to also amend regulations which have no procurement relation but have the effect of making doing business with DHS so unattractive that true competition is impossible.

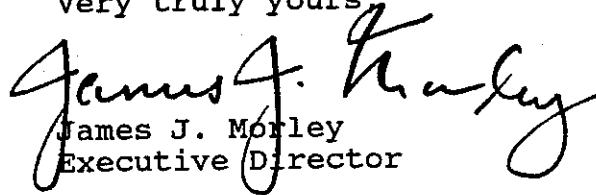
Doubtless, the opinion was never intended to exempt "using agencies" such as DHS from procurement law requiring competition. Nonetheless, that has been its result. If you concur that the law has been misinterpreted, you may wish to advise all departments that open public competitive bidding is required whenever state funds are used. The earlier opinion need not be reversed; a

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clarification would suffice.

Any other barriers to full and open competition should be dismantled. Current federal procurement law describes a system built around continual and ongoing elimination of impediments to competition. The federal government uses "Advocates for Competition" (41 U.S.C.A. § 418) to look for ways to promote competition. Perhaps if departmental inspectors general are created, their duties can include competition advocacy.

Very truly yours,


James J. Morley
Executive Director

JJM/JFV:clm

cc: Hon. James J. Florio
Governor

Hon. Donald T. DiFrancesco
President of the Senate

Hon. Garabed Haytaian
Speaker of the General Assembly

Hon. Samuel F. Crane
Treasurer

Hon. William Waldman
Acting Commissioner of Human Services