



Report of the Vermont State Auditor

December 5, 2008

AGENCY OF
TRANSPORTATION
RAIL REPORT

Vermont Agency of
Transportation Rail Section
Contract Audit

Thomas M. Salmon, CPA
Vermont State Auditor
Rpt. No. 08-12

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**THOMAS M. SALMON, CPA
STATE AUDITOR**



**STATE OF VERMONT
OFFICE OF THE STATE AUDITOR**

December 5, 2008

The Honorable Gaye Symington
Speaker of the House of Representatives

The Honorable Peter D. Shumlin
President Pro Tempore of the Senate

The Honorable James Douglas
Governor

Mr. David Dill
Secretary, Agency of Transportation

Dear Colleagues,

On behalf of State Auditor Tom Salmon, CPA, I am pleased to provide you this audit report of the Agency of Transportation's Rail Section contracts and agreements. The audit was conducted at the request of AOT management in an effort to identify areas where improvements need to be made.

Like many other states, Vermont's finances are showing the effect of the weakening economy. There is pressure on available public funds for transportation, both at the Federal and State level. There is also more focus on the needs for rail to expand its ability to provide transportation for people and products. It is critical for the State to ensure it is receiving all of the revenues it is entitled to under its rail operating agreements. It is also important that funds spent to improve and upgrade rail lines be used in the most efficient and effective manner.

We believe that AOT has become complacent in its Rail Section transactions and needs to improve its processes, contracts and the oversight of subcontractors.

We noted four key findings which are addressed in more detail in subsequent pages:

- 1. AOT and its railroad subcontractors did not adequately follow procurement regulations, resulting in \$7.2 million of recent contracts not being competitively bid.**
- 2. Oversight and administration of rail contracts need improvement.**

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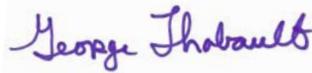
3. Lease revenues and the performance of leaseholders are not being verified, and AOT has forgone \$37,000 in interest revenues from late payments of monthly leases.

4. AOT does not have adequate procedures to correct audit findings and to follow up on approximately \$436,000 in questioned costs from past Rail Section audits.

In its response to the draft report, the Agency indicated that it generally supports the recommendations in the report and pledged to develop new procedures on a number of key issues, and to report its progress to the State Auditor on a quarterly basis. This response is heartening and bodes well for cost-effective administration of the Rail Section. The full AOT response is in Appendix V.

We would like to thank the management and staff of the Agency of Transportation for their cooperation and professionalism. If you would like to discuss any of the issues raised by this audit, please contact the Auditor's Office. Thank you.

Sincerely,



George Thabault
Deputy State Auditor

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Abbreviations

AAG	Assistant Attorney General at AOT
AOT	Agency of Transportation
BGS	Buildings and General Services
FHWA	Federal Highway Administration
FRA	Federal Railroad Administration
GMRC	Green Mountain Railroad Corporation
OTM	Other Track Material
SAO	State Auditor's Office
VRS	Vermont Rail Systems (or its related affiliate)
VTR	Vermont Railway, Inc.
VTRANS	Vermont Agency of Transportation
WACR	Washington County Railroad Company

Introduction

In April 2008, the Vermont Agency of Transportation (AOT) expressed concerns to the State Auditor's Office (SAO) about the results of a recent audit of twenty-two contracts issued by AOT's Operations Division's Rail Section.¹

The contracts were between AOT and Vermont Railway and Green Mountain Railroad, two companies of the Vermont Rail System (VRS), a privately held, affiliated group of short-line rail transportation companies that operates in Vermont.²

Among the deficiencies were contract wording, weaknesses in AOT oversight and weaknesses in VRS's project oversight and accounting procedures. AOT management met with SAO, and requested that SAO review the Rail Section contracting procedures, related accounting records and project documentation records. We chose to review four contracts, two leases, AOT procurement policies and resolution of previous audit findings.

The primary objectives of our audit were:

1. To assess whether the AOT follows applicable Federal, State and Agency procurement requirements and procedures.
2. To review and assess the administration and oversight of selected AOT rail contracts.

¹ Agreed-Upon Procedures Report for State of Vermont, Agency of Transportation Vermont Rail System – Consolidated Close-Out Audits (TG Associates, CPAs, PLLC, October 10, 2007).

² Vermont Railway purchased the Clarendon and Pittsford RR in 1972, acquiring a portion of the D&H line in 1983, adding the Green Mountain Railroad in 1997, and recently bringing the Washington County Railroad and the New York & Ogdensburg Railway into the Vermont Rail System.

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3. To determine if AOT has an effective process in place to ensure that rail contract audit findings are resolved and that questioned costs are either reimbursed to the State or formally waived.

Highlights: Report of the Vermont State Auditor

Agency of Transportation Rail Section Contract Audit

(December 5, 2008, Rpt. No. 08-12)

Why We Did This Audit

At the request of AOT management, we agreed to review the administration and oversight of Rail Section contracts and other agreements with the general goal of assessing performance and recommending steps for improvement.

What We Recommend

We made a variety of recommendations pertaining to contract awards, oversight and administration, adherence to laws and Federal and State regulations and fiscal management.

We recommended that AOT strengthen and clarify the language within its agreements, improve the oversight of contracts, enforce penalties for violations of the terms and conditions of its contracts and lease agreements, and provide for better fiscal management of its contractors and service providers.

Findings

Based upon the results of our examination of four contracts, two leases and the resolution of the previous questioned costs and recommendations of other auditors, it is our opinion that there is inadequate oversight by AOT of its Rail Section contracts to ensure the protection of State resources.

The State has entered into long-term lease agreements and project contracts which do not protect the best interests of the State. We believe that the language in these documents is ambiguous in some key areas and, coupled with weak oversight by AOT's Rail Section, it increases the risk of potential abuse and non-compliance by the contracted railroads.

Auditors noted that:

- The AOT Rail Section entered into a construction contract for \$4,677,727 without putting the contract out to bid and without the approval of the Secretary of the Agency of Administration.
- \$82,401 in State funds from salvage proceeds is being held by the Railroad for offset against future invoices rather than being returned to the State.
- Railroads have been allowed to pay lease revenue to the State up to 6 months late without assessment of interest, as allowed by contract, and without verification of the amount of revenue upon which the lease fee is based. AOT did not assess interest of approximately \$37,000 on late payments.
- AOT lacks a process to resolve audit findings and has yet to collect or resolve approximately \$436,000 in questioned costs resulting from past audits.
- Insurance coverage held by the subcontracted Railroads is not verified and may be significantly less than the amount required of other vendors through the State's Risk Management Division.

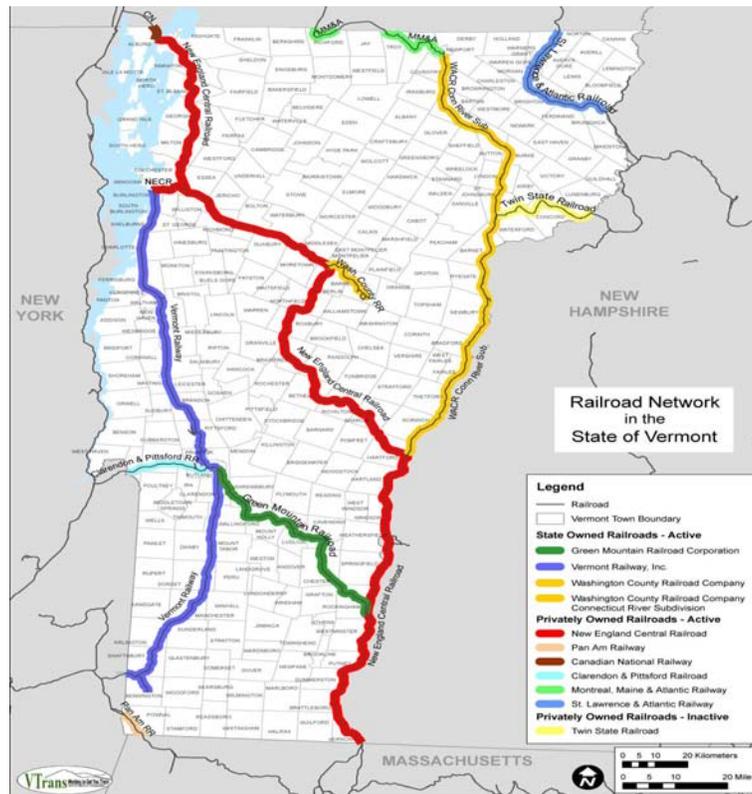
AOT and the rail contractors we reviewed are not adhering to a number of critical State policies and regulations which are designed to ensure cost-effective rail operations. As Vermont aspires to increase the economic and environmental benefits of rail activity in the State, it is imperative that AOT adhere to policies and procedures that promote competitive bidding and diligent oversight of rail revenue and expenditures.

Background

The Vermont Agency of Transportation's rail mission is the preservation, improvement and promotion of rail transportation and its infrastructure to assure safe, reliable, cost-effective, and environmentally responsible movement of people and goods in the overall transportation system, thereby contributing to Vermont's quality of life and economic well-being.

The oversight of the railway network in Vermont is the responsibility of the Vermont Agency of Transportation Rail Section. Vermont's rail system consists of approximately 748 miles of track or rail right-of-way. The State owns approximately 427 miles, of which 305 miles are currently active. Ten railroad companies operate or have the rights to operate on the rail lines in Vermont.

Figure 1 Vermont Rail Network



Source: Vermont State Rail & Policy Plan 2006

The majority of rail traffic in Vermont is freight-related, although passenger ridership has experienced steady growth. At present, it is the policy of the State through AOT to support and promote passenger rail service in Vermont.

It is AOT's practice to enter into long-term lease agreements with private companies to operate and maintain the 427 miles of rail lines owned by the State. In this report, these are referred to as the master leases. The Fiscal Year (FY) 2007 revenue from two of the leases of Vermont Railway and its sister company, Green Mountain Railroad, was \$605,748. AOT's Operations Division, through its Rail Section, provides oversight on these leases which describe what type of annual track maintenance and expenditures are required. Major railway upgrades and construction projects, such as installation of heavier track to facilitate higher train speeds, are contracted for separately.

According to the Vermont State Rail and Policy Plan,¹ the Rail Section assists the rail operators in the overall planning, budgeting and the obtaining of Federal and State funding to improve and upgrade the railways. For FY2007 and FY2008, the Rail Section had \$16.3 million in active rail improvement projects and an additional \$20.1 million in engineering and service contracts.

For FY2009, the AOT total budget is \$412.2 million, with the Rail Section allocated \$16.8 million. The Rail Section currently has eight of the approximately 1,000 Agency staff positions.

There are three major components to a rail system. These are the track, the bridges and grade crossings.² The physical condition of the rail system varies across the State and there has been a concerted effort by the Vermont Legislature, AOT, and the State's private rail operators to improve and upgrade Vermont's rail system. These improvements are intended to accommodate expected increases in freight and rail passenger volume and to adapt to changes in rail industry standards, such as the increase in the carrying capacity of freight railcars.

The improvement and upgrading of rail lines require the use of specialized equipment and specific knowledge and skills. It is common practice of the

¹ The Vermont Agency of Transportation has developed the Vermont State Rail & Policy Plan to provide a strategic policy framework for maintaining and enhancing the state rail system. The complete document may be accessed at www.vermontrailroads.com/VRPP.htm.

² A grade crossing is a place where a road crosses a railroad or two rail lines cross at the same level.

AOT Rail Section to contract with and utilize the lessee rail operator's staff and equipment to perform major upgrades and construction projects. This is a practice widely used in the rail industry and is commonly referred to as using "railroad forces or force accounts³." State and Federal regulations allow for the use of force accounts when the resources (i.e., equipment, personnel, etc.) are not otherwise available. Vermont's Administrative Bulletin No. 3.5, "Contracting Procedures," and the Federal Code of Regulations also require that contracts, even for the use of force accounts, must be awarded through a process of open and competitive bidding except in emergency situations.

The four contracts we reviewed were construction contracts and each had the specifications of work to be performed using private railroad forces, with overall project oversight managed by AOT's Rail Section.

AOT has an agreement with Vermont Railway, Inc. and its other related companies applicable to project work, which outlines responsibilities of each of the parties when railroad forces are used. The agreement establishes procedures to ensure proper internal controls over each project, especially in the areas of project management, procurements and financial accounting and reporting by Vermont Railway and its sister company, Green Mountain Railroad. These controls are to be reviewed, monitored and the completed projects audited by the AOT Finance and Administration Audit Section or other auditors contracted by AOT.

Scope and Methodology

In order to assess the administration and oversight of Rail Section contracts within AOT, we conducted interviews with the AOT Director of Finance and Administration, AOT Operations Director, AOT Audit Chief and members of his audit staff, Assistant Attorney General for AOT, the Contract Administration Chief and the Rail Section Project Manager. We also reviewed the following documents, among others:

- Statutory references to the Rail Section of AOT;

³ The term "force account" means using company/railroad owned resources, i.e. labor and equipment, which are a part of a particular railroad's corporate organization. The term also encompasses the resources or services of an entity, which is not a part of that particular railroad's corporate organization, when a current contractor retainer contract or cooperative maintenance agreement/ mutual aid is in effect.

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- Federal procurement regulations for the FWHA and the FRA;
 - State of Vermont administrative bulletins and procurements polices and practices;
 - Agency and specific AOT Rail Section internal policies and procedures;
 - Legislative reports and the minutes of the Vermont Rail Council⁴;
 - The long-term operating lease agreements between the State and the railroads operating State-owned rail lines;
 - The contracts, invoices, correspondence and other supporting documentation for each of four projects we reviewed;
 - The “force account” agreement between AOT and VTR;
 - Project documentation and correspondence within the Rail Section’s project management files.

We obtained a list of current project agreements and construction contracts from the AOT Rail Section. SAO selected four contracts based on interviews with Rail Section personnel and analytical reviews. These four contracts totaled \$7.2 million dollars or approximately 44 percent of the total active rail construction and railway upgrade contracts during Fiscal Years 2007 and 2008. We believe that these four contracts provided a sufficient basis to meet the objectives of our review.

The contracts reviewed were:

No. 06RA18 – A contract between AOT and Green Mountain Railroad Corporation (GMRC) for rail and bridge deck upgrades. The rail upgrade is from Chester to Cavendish. Bridge deck upgrades are in Ludlow,

⁴ An organization created by executive order to provide advice to the Governor and the AOT on rail issues within the State. The Council’s website can be accessed at http://www.vermontrailroads.com/rail_council.htm

Cuttingsville and Clarendon. The cost of the contract is not to exceed \$300,000.

No. 06RA20 - A contract between AOT and Vermont Railway, Inc. (VTR) for the installation of 3.25 miles continuous welded rail from Ferrisburgh to Charlotte. The cost of the contract is not to exceed \$826,109.

No. 08RA04 – A contract between AOT and Vermont Railway, Inc. for the installation of 19,500 rail crossties and the re-decking of four bridges from Manchester to Rutland. The cost is not to exceed \$1,325,639.

No. 08RA11- A contract between AOT and Vermont Railway, Inc. for the installation of 12,000 rail crossties, 13,000 tons of ballast from Proctor to Florence and from Salisbury to Middlebury and the purchase of 137,360 linear feet of 115-lb. continuous-welded rail, 82,370 tie plates and 82,500 new anchors. The cost of the contract is not to exceed \$4,677,727.

We traced the application of procedures to the tested project files. We also reviewed previous audit reports to determine if there were any outstanding findings and/or questioned costs.

We reviewed each selected contract to assess that the contract contained sufficient monitoring standards and that contract problems and any questioned project costs are adequately documented and corrected on a timely basis.

To assess whether AOT and its contractors follow applicable Federal, State and Agency procurement requirements, we conducted a walk-through of key processes within the Rail Section and determined the applicability of Federal regulations and the State's Administrative Bulletin No. 3.5, "Contracting Procedures," for each selected contract. Our testing included the review of all cost estimates, required approvals, invoices submitted by contractors and subcontractors, the subsequent payments to these vendors and correspondence between the parties.

Authoritative guidance for the Rail Section is cumbersome. A Guidance Chart of Authority is depicted at Appendix I but does not attempt to define the level of hierarchy for all of the situations encountered in the Section's operations. A decision tree, as seen in Table 1, demonstrates the guidance that prevails at specific decision steps in the State's rail operations.

Table 1 Decision Tree

			Vermont Statute and Annual Appropriations	Code of Federal Regulations	Vermont State Bulletin 3.5	AOT Contracting Plan	Force Agreement	Maintenance Rail Agreements
Step 1	Vermont State Rail and Policy Plan Development		X					
Step 2	Define project.							
		Emergency repair.	X	X	X			
		Non-emergency upgrade	X	X	X	X		
		Normal maintenance of rail lines.	X	X	X			X
		Project requires use of railroad forces	X	X	X		X	
		Project does not require use of railroad forces (material purchase only)	X		X			
Step 3	Define funding source.							
		Federal funds.		X				
		State funds.	X		X			

Generally Accepted Government Auditing Standards (GAGAS) require that we plan and perform the audit to obtain sufficient, appropriate evidence to that provides a reasonable basis for our findings and conclusions. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions.

We performed this audit from April 2008 to September 2008 in accordance with GAGAS, except for the standard that requires that our system of quality control for performance audits undergo a peer review every 3 years. Because of fiscal considerations, we have opted to postpone the peer review of our performance audits until 2010.

Finding 1

AOT and Its Railroad Subcontractors Not Adhering to Procurement Regulations

AOT has the responsibility to ensure that the State's resources are being used in the most fiscally sound manner. The Governor's Executive Order No. 3-20 requires all agencies of State government to adopt and implement the following policy:

“The State of Vermont recognizes the important contribution and vital impact which small businesses have on the State's economy. In this regard, the State prescribes to a free and open bidding process that affords all businesses equal access and opportunity to compete for State contracts for goods and services.”

\$7.2 Million in Contracts Not Competitively Bid

Criteria: Bulletin No. 3.5 describes the “simplified” or the “standard” competitive bid processes that depend upon the anticipated costs of the procurement of goods or services. The simplified bid process, used in contracts for services less than \$100,000, requires that three qualified vendors be notified about a proposed contract. The standard bid process requires a more formal system of broadly publicized, competitive bidding, fully detailed at Appendix II, and also provides a public record to support significant purchasing decisions.

The State's contracting procedures provide an exception to the competitive solicitation process which allows AOT to “sole source” vendors in unusual circumstances, such as emergencies.

Condition Found/Cause: The four contracts we examined, totaling \$7.2 million, were given to the Railroads that hold the maintenance leases on the lines without having gone out for competitive bid nor were these contracts sent to the Secretary of the Agency of Administration identifying them as sole-source contracts as required by Bulletin No. 3.5.

Further, AOT is using the Railroads force accounts for procurement tasks that could be done by State personnel. On contract 08RA11, the Railroad was used as a broker for the material rather than using AOT or other State staff to manage the purchasing process. Further, the material did not need to be purchased by the Railroad as there was no emergency and the material would not be used for many months. Force account contracts are intended to be used when the resources (i.e., expertise and/or equipment) are not available

within the State workforce. The AOT Rail Section has become accustomed to using force accounts for all purchasing and construction activity that pertains to rail.

Effect: Sole-source contracts deny businesses fair access and opportunity to compete for State contracts. It also denies the State the ability to establish the best price in the market.

Using force contracts unnecessarily – for material purchases; for construction contracts where other vendors might offer a better price and higher quality; or for procuring transportation and handling of ties and other materials – increases the risk that the State may not complete rail improvement projects in the most cost-effective manner.

Recommendation: AOT should competitively bid all major rail projects as required by the State’s contracting procedures. Also, procurement of substantial material and supplies should be delegated to the purchasing group within the Department of Buildings and General Services (BGS).

Procurement ‘Best Practices’ Not Being Followed

We believe there is inadequate oversight by AOT of its railroad contracts to ensure that State and Federal competitive bidding procedures and requirements are being fulfilled.

Criteria: Bulletin No. 3.5 Section XII states that when a contract involves subcontracting, the contract should encourage the contractor to follow the spirit and intent of the Bulletin by engaging in a fair and open bidding process and establishing clear contract clauses to help monitor the subcontractor’s performance.

The standard rail contract states that the Railroad is acting on the State’s behalf and unless otherwise approved by the State, procurement of materials and supplies must be done through a system of adequate price competition.

Further, all of the contracts tested included an attachment by reference of *23 CFR Part 140, Subpart I, Reimbursement for Railroad Work* which states:

Materials and supplies, if available, are to be furnished from company stock, except they may be obtained from other sources near the project site when available at less cost. Where not

available from company stock, they may be purchased either under competitive bids or existing continuing contracts, under which the lowest available prices are developed. Minor quantities and proprietary products are excluded from these requirements.

The force agreement with VTR indicates that AOT recognizes that under certain conditions, the railroad may choose to use contractors with whom it has established a long-term working agreement. In this event, the agreement must be reviewed and accepted by AOT and a copy of the current executed agreement filed with AOT. This “preferred contractor retainer contract” must include the various rates to be charged by the preferred contractor. The “preferred contractor” must file Section One of VAOT AF-38, Consultant Financial Background Questionnaire, with AOT’s audit section.

Condition Found/Cause: Contract 08RA11 involved VTR seeking procurement of \$3.8 million in rail and other track material (OTM). The Railroad did not obtain a competitive bid on this contract. The amount of the procurement was well above the authorized dollar amount requiring the obtaining of a competitive bid as per contract terms. This also violated the Federal regulations that VTR agreed to as a condition of the contract.

We noted instances where the hiring of sub-contractors by VTR for disposal of salvage material indicated that there was a solicitation for bid, but the evidence of the simplified or competitive bid provided to the project manager was insufficient or non-existent. For example:

- For contract 08RA04, responses from the three solicited vendors resulted in one vendor who declined to bid, and two vendors who did not submit complete bids, with one of these earning the contract award.
- On contract 06RA18 the Program Manager for VTR attached a quote from a vendor for scrap rail pickup and indicated that this was the winning bidder. No other quotes were attached.
- In both cases AOT’s program manager approved the bid process used by VTR without giving the company feedback, and AOT subsequently paid the respective invoices.

We noted that VTR used selected vendors without having these vendors approved by AOT, and without the company filing a required preferred contractor retainer contract with AOT.

For instance, in each of the four contracts we reviewed, a company was sub-contracted by VTR and GMRC to perform trucking services. This company has personal ties with two supervisory employees of VTR. We also noted in one of the contracts (08RA18) that these same two employees are owners of yet another trucking company that was utilized. According to the Special Agreements Administrator of the Contract Administration Division, neither of the trucking companies is considered “preferred contractors” for use on rail contracts. We requested copies of required the AOT AF-38 from AOT’s Audit Section. We were informed that the Audit Section had not received these documents from VTR as required by the force agreements.

The Audit Section at AOT has indicated that they repeatedly requested from VTR that the documentation noted above be filed with their office. At the completion of our fieldwork, VTR was still in non-compliance with this requirement. Additionally, we were unable to locate any of these required documents at AOT.

Using a company controlled by VTR employees on projects in which they are also performing duties as supervisory employees is a conflict of interest, defined as follows in Bulletin No. 3.5.

Conflict of Interest is defined as a pecuniary interest of an employee, or the appearance thereof, in the award or performance of a contract, or such an interest, known to the employee, by a member of his/her current or former family or household, or a business associate.

Effect: Without an effort by AOT to ensure compliance by its subcontractors, there is no assurance that the vendor selected will charge the best price or do the best job. Further, AOT is putting the State at risk for repayment of Federal funds by not ensuring that the subcontractor complies with the requirements outlined in the Code of Federal Regulations.

Recommendations:

1. AOT should ensure that bid documents submitted by its subcontractors for approval by AOT are compliant with State and Federal procurement procedures. If the Railroad is granted the authority and responsibility of soliciting bids on behalf of the State, AOT must provide the oversight to ensure that the process is open and that the bid accepted is in the best interest of the State.
2. Invoices submitted to AOT for payment in cases where AOT has not approved the subcontractor should be rejected.

-
3. AOT must obtain the AOT AF-38 form for any vendors (or subcontractors) qualifying as preferred vendors.
-

Authorization for \$4.6 Million Contract Not Received

Criteria: According to the AOT Contracting Plan, the Secretary of the Agency of Administration, or his/her designee, must give prior approval for any construction contract over \$3 million. (See Appendix III for a chart of required approvals.) The request for approval must be submitted to the Department of Finance and Management at least one week before the planned contract execution date.

If approval is not received from the Secretary within 5 working days from submission to the Department of Finance and Management, AOT may assume the contract is approved and proceed with award and signing of the contract.

Condition Found/Cause: AOT Rail Section entered into a construction contract for \$4,677,727 without any evidence that it had submitted a request to Finance and Management for approval by the Secretary of the Agency of Administration.

The contract (08RA11) mistakenly states that the approval of the Secretary is not required although State procedures indicate otherwise.

Effect: The amount of this contract exceeds the approved authorization limits granted to AOT by the Secretary of the Agency of Administration's waiver dated June 27, 2007. Avoiding review increases the risk that a financial transaction not in the best interest of the State could occur without detection.

Recommendation: The Rail Section should follow AOT's approved contracting plan so that all construction contracts in excess of \$3 million are reviewed and approved by the Secretary of the Agency of Administration. Further, AOT should ensure that the Secretary of Administration's approval is indicated in the contract when required by State regulations.

Finding 2

Oversight and Administration of Rail Contracts Needs Improvement

Contracts and Lease Agreements Weakened by Vague or Nonexistent Language

Criteria: The use of contracts is a mandatory requirement that provides significant value to the State of Vermont from a financial controls perspective.

The Department of Buildings and General Services (BGS) has statutory responsibility⁵ to contract for purchases for State government. The Agency of Administration's Bulletin No. 3.5 "Contracting Procedures" stipulates the terms under which purchases may be made unless other arrangements have been approved by the Secretary.

AOT has been granted authority by the Secretary to use a standard contract in the Rail Section for its construction contracts.

AOT also has obtained waivers from the Agency of Administration that modify certain requirements of Bulletin No. 3.5., one of which is to increase the threshold for the use of the standard bid process from \$100,000 to \$250,000. However, the higher amount is only applicable to rail contracts that are fully funded by the State. In rail contracts using Federal funds, the Federal government requires a competitive bid process for contracts over \$100,000.

Any change or substitute language to the State's standard provisions must be approved by the Attorney General prior to contract signing, or in the case of changes to the insurance provisions, by the Director of Risk Management. Standard insurance coverage provisions are intended to cover most situations encountered. Modifications to the insurance requirements may only be undertaken with a waiver from either the Director of Risk Management or the Attorney General.

Moreover, Bulletin No. 3.5 indicates that penalties or "liquidated damages" and retainage should be considered for all contracts, whether required or not, and in all contracting plans⁶. Penalties should be assessed if the contractor

⁵ Title 29 V.S.A. §902

⁶ Contracting plan is the waiver that AOT has obtained for changes to certain of Bulletin No. 3.5 procedures.

fails to perform the work as required by the contract. Examples are failure to meet schedules; failure to maintain performance and staff levels; or failure to maintain other measurable standards.

Conditions Found/Cause: We noted that some sections of the standard rail contracts are weak, giving rise to ambiguous interpretation which can put the State at financial risk. The sections under discussion are those pertaining to:

1. Procurement methods;
2. Insurance coverage; and
3. Monitoring, penalties and retainage.

The contracts contain a standard clause that directs the Railroads to procure the material for contracts by selecting vendors “through a system of adequate price competition, which shall include, at a minimum, the evaluation of detailed written estimates from at least three qualified vendors.” The clause does require the State’s bidding process be used, nor does it specify the dollar amount under which the method of procurement may be made without a formal bid process.

The insurance coverage section on the contracts has been struck and a separate clause added to require the Railroad to keep in force the minimum insurance coverage stipulated in the railway operating lease agreements. The lease agreements require the Railroads to carry insurance coverage up to specific dollar levels set at the inception of the leases in the early 1990s. Removal of this clause also eliminates the contractual requirement for VRS to supply a current insurance certificate that shows the level of insurance coverage the Railroads maintain. A valid certificate will allow AOT to verify that the railroad is providing adequate insurance coverage to satisfy both State and Federal expectations.

According to the Assistant Attorney General in AOT (AAG), the reason the standard clause is stricken from the rail contracts as a standard practice is that the clause includes wording pertaining to Workers Compensation insurance coverage to which Railroads are not subject⁷. However, since the contracts are specifically written for the rail projects, the clause could be rewritten to remove the non-applicable wording as opposed to removing the entire clause, which eliminates the need for the Railroad to keep in force coverage

⁷ Railroads are subject to the Federal Employers Liability Act which was written to specifically cover railroad workers injured on the job.

requirements at the State's current levels. The coverage stipulated in the aged operating leases may not be keeping pace with current requirements.

In our discussions with AOT's in-house AAG, the State's Risk Management Manager and AOT's Contract Administration group, we found that there is an awareness of this risk and that there have been discussions to effect change. However, contracts have continued to be written allowing this omission. The director of the State's Risk Management Division has not been actively consulted during the initial approval process of the rail contracts, and he believes the liability coverage should be raised to a higher dollar limit.

The standard rail contract does not include provisions for either the required monitoring standards nor for penalties or retainage to be imposed in the event of nonperformance by the Railroad. An essential element of maintaining cost controls for force account work is inspection and monitoring.

Effect: In regard to procurement of goods and services VRS appears to be interpreting the procurement clause loosely and may not be obtaining materials and supplies in the most responsible, effective, and efficient manner. The Railroad bidding process and contract awarding may be for its own convenience and interests, rather than the State's.

Regarding the insurance needs, inadequate specification of insurance requirements exposes the State to unnecessary financial loss. Deliberate exclusion of the insurance clause from the contracts is imprudent and subjects the State to unnecessary risk.

Further, without penalty provisions within the rail contracts to motivate the Railroad to complete a project within AOT's desired timeframe, the Rail Section faces the risk of not achieving its overall goals and objectives. By not including provisions defining expectations of contract monitoring and penalty for nonperformance, AOT has effectively eliminated valuable leverage it may have if the Railroad does not perform up to expectations or in a timely fashion, putting the State at a higher financial risk.

Recommendations:

- AOT's Contract Administration group and the AAG should work together to develop a standard contract that is annually sent for approval to the Secretary of Administration. Each contract should clearly indicate the procurement regulations, insurance coverage, and performance expectations for carrying out the contract as required by the State's current contracting procedures of the Agency's approved Contracting Plan. Railroads, as well as any other contractor, should be

held accountable and make their best efforts to meet the terms of their contractual agreements with AOT. AOT should include enforceable penalty or liquidated damages clauses in rail contracts as recommended by Bulletin No. 3.5.

- Insurance requirements need to be considered and coverage verified for each contract to ensure that current requirements are met. AOT should require all subcontractors to show evidence of current coverage by submitting an insurance certificate annually. A copy of the insurance certificate should be included in each project file.
- AOT should withhold approval to commence a project for which a railroad has contracted if the proper proof of insurance coverage has not been obtained.

Salvage Proceeds of \$82,401 Not Returned to the State in a Timely Manner

Criteria: Within a contract there may be salvage material recovered which is to be sold and the resulting proceeds applied to the contract to reduce the total cost. This is consistent with Federal regulations, under which any income or other credit received or accrued shall be remitted to the State either as a cost reduction to the contract or by cash refund. The areas of budgeting, capitalization, Federal reimbursement and cash flow must be considered when determining how to treat salvage proceeds. Tracking the proceeds to the appropriate project is essential.

Condition Found /Cause: Net proceeds from disposal of salvage have been treated by the Railroad as offsets to contract invoices submitted to the State. The Railroad has the responsibility for disposal of the salvage and collecting the funds. It then credits invoices to the State for salvage proceeds. The State will receive \$0 invoices until the salvage proceeds are exhausted. Invoices that itemize costs are not entered into the AOT accounting system to record capital expenditures since the net amount with the reduction of salvage proceeds is \$0. While this netting of salvage value against invoices is allowable under Federal reimbursement guidelines, it does not allow for a clear trail in accounting for the actual cost of the project.

On one of the tested contracts, the work was completed in August of 2007 leaving additional salvage proceeds without any further invoices against which the proceeds could be netted. In December 2007, an amendment to the contract was required to extend the contract length until the Railroad would remit the remaining \$29,304 in salvage proceeds. During the course of the

audit in July, we noted that this money had still not been received by the State. According to the Business Manager for the Rail Section, an invoice to the Railroad had been prepared for these proceeds but had not yet been sent. According to a Rail Section project manager, there is an additional \$53,097 in salvage value on other contracts that remains to be remitted to the State for a total of \$82,401.

Effect: Offsetting salvage proceeds against invoices gives the Railroad control and use of State funds until the funds are used up. The treatment of the net amount of salvage proceeds as offsets to invoices is allowable by the standard rail contracts.⁸ However, the Railroad has a history of not returning salvage proceeds to the State after the contracts are complete⁹.

Recommendation: Salvage proceeds should be returned directly to the State immediately upon receipt by the Railroad. AOT should develop a procedure to record the proceeds as offsets to the expenditure account while the project is still open. This will allow AOT to better track the salvage proceeds, receive them on a timely basis, and properly include them in the project.

State-owned Inventory Not Being Controlled

Criteria: Contract 08RA11 specifies that VTR would purchase “Other Track Material” (OTM) consisting of 82,370 relay DS tie plates and 82,500 tie plates. According to the contract, all of this is to be stored in a secure location by the Railroad at its own risk pending subsequent installation of track by a contractor hired by the State (to be determined in a separate project.)

Condition Found/Cause: The Railroad frequently unloads track and OTM and leaves this inventory within the railroad’s right-of way as a normal delivery practice. Material may be idle for months until installed. For example, the OTM pictured below, with a value of \$804,000, is being stored by VTR in an unsecured location at the side of the railway bed in Florence. (See Figures 2 & 3). These pictures were taken in May 2008 and the material is still at this location as of the date of this report. The Railroad is apparently following the allowed inventory storage procedures as outlined in the “New

⁸ AOT amended this practice after our observations on the issue; AOT now requires the Railroad to remit the proceeds directly to the AOT without offsetting any invoices.

⁹ Agreed-Upon Procedures Report for State of Vermont, Agency of Transportation, Vermont Rail System – Consolidated Close-out Audits, (TG Associates CPAs, PLLC, October 10, 2007).

Procedures for State and Federal Force Account Projects” dated August 13, 2004, instead of adhering to the actual contractual language.

Figure 2: OTM – Tie Plates



Source: AOT Rail Section

Figure 3: OTM – Bags of Anchors



Source: AOT Rail Section

Effect: Contract 08RA11 specifically requests that OTM shall be “stored in a secure location.” The Railroad appears to be in breach of this requirement. The OTM may be stockpiled by the Railroad at the side of a railway bed due to the perceived economic advantage of storing materials closer to proposed projects. However, the lack of proper inventory control over these materials can lead to theft, misappropriation, damage and/or potential delays in projects. The Railroad has experienced theft using this method of “warehousing OTM” on a prior GMRR project in Cavendish. The project was adversely affected by this theft and the State ended up bearing the

additional cost for the losses. The recent increase in prices and demand for scrap metals worldwide puts OTM stored in unsecured locations at even greater risk of loss.

Recommendation: The State should enforce the contract and have the OTM placed under secure conditions. AOT Rail Section employees should be performing periodic or random inventory counts and inspections to ensure that a loss of materials has not occurred. The State could consider using existing AOT locations such as the Agency's own regional salt sheds as areas to stockpile or secure these materials.

Invoices Submitted Untimely and Inaccurately

Criteria: According to the terms of the contracts, VTR is to submit project invoices with any underlying supporting documentation every two weeks.

Condition Found/Cause: We noted in several instances where project invoices were not submitted in a timely manner. In one case, VTR submitted an invoice for labor charges covering a period greater than 9 months. Although the invoice was out of compliance, it was approved and paid by AOT. Our testing of contract payments indicated that VTR frequently does not submit invoices on a timely basis, creating budgetary and project status concerns with AOT's Rail Section Management.

The Project Manager reviews invoices for accuracy of material procurement charges, machine usage fees, employee wages and fringe benefit rates. Errors or omissions are corrected. In all contracts tested we noted that this process is being followed. We noted no issues that were left unresolved with the invoice amounts although there were a considerable number of adjustments made. We noted on one contract that AOT's Project Manager corrected 21 percent of the invoices submitted by the Railroad.

We believe that the level of scrutiny given to the invoices by the Project Manager is prudent considering the number of invoices submitted by the Railroad that require adjustments. In our opinion, untimely submission of invoices by the Railroad is fostered by AOT's failure to enforce contract provisions.

Effect: Contract expenditures represent decreases in the financial resources available to AOT to meet its commitments. Consideration must be given to budgetary concerns and legal compliance issues as they are affected by the timing of expenditure recognition. Maintaining a reasonable degree of accuracy in identifying, estimating, and accumulating contract costs is essential in determining the amount of contract revenues and related costs as

well as the ability to measure contract progress. Lack of timely reporting of expenditures may result in over- or understating expenditures due to transactions not recorded in proper period.

Recommendation: We recommend that AOT implement policies and procedures to ensure that invoices are submitted correctly and on a timely basis. The time period should be stipulated in the applicable clause in the standard rail contract. Invoices should not be accepted if submitted outside of the time parameters established.

Finding 3

Lease Revenue and Performance Are Not Being Verified

Lease Revenue Calculations Are Not Verified

Criteria: Four of the 10 railroad companies that operate or have trackage rights on active lines in Vermont have long-term lease partnerships with the State of Vermont. These closely held companies are a part of Vermont Rail Systems and are accorded trackage rights on 53 percent of the State's total rail lines. We reviewed two of VRS lease agreements, which became effective in 1990 and 1992.

The lease agreements require that VRS maintain the leased lines in good operating condition and allow the Railroads to collect revenue from operations, paying to the State monthly rental payments equivalent to a specific percentage of the Railroad's operating revenue¹⁰ on the leased rail lines. The percentage to be paid is based on tiered schedules laid out in the lease agreements.

The lease also requires the Railroads to provide financial information, when requested, for substantiation of the monthly operating lease payments paid to AOT.

Conditions Found/Cause: AOT is receiving monthly rental payments but does not know if the payment calculated by the Railroad is correct. We

¹⁰ These operating revenues are based on accounts specifically defined within the lease agreements according to Account 501 of the Uniform System of Accounts for Railroad Companies and include items such as freight tariffs, mail transport, among others.

observed that there was no underlying documentation provided by the Railroad with the monthly rental payments to indicate how the rental payment is calculated. We also noted unsubstantiated miscellaneous additions and deletions from previous rental payments made.

Inquiries of Finance and Administration, Audit Section and Rail Section staff revealed that there was no readily available documentation or knowledge of how the Railroad's operating revenues were defined and calculated. Upon request, we were able to locate this specialized accounting information (promulgated by the Federal Code of Regulations) with the assistance of the AOT Assistant Attorney General. Compounding this lack of knowledge by the staff interviewed was the fact that these regulations are not easily obtainable without substantial legal research tools. The cause of this condition is; 1) staff turnover since the lease's inception, 2) not having an appropriate level of documentation available to which staff may refer, and 3) a lack of training for financial and audit staff.

Effect: Because it is not possible to verify or audit the monthly rent amounts paid by the railroad, AOT could be losing money it is due and not realize it.

Recommendations:

1. The Business Manager of the Rail Section at AOT should be verifying the operating lease rental income from the Railroad on a regular basis. AOT should require its vendor to supply verification of the rent calculation and provide the underlying documentation for calculation. The Finance and Administration Division should put a process in place to annually validate the calculations. If the Railroad does not provide the requested data, AOT should seek suspension of any subsidy or railway maintenance payments until the railway information is made available and verified as to its completeness, accuracy, authenticity and validity. AOT could also enforce the termination clause of the operating lease.
2. AOT Rail Section and Audit Section staff should have the appropriate knowledge and information to be able to verify the operating lease rental income from the Railroad. Management at AOT should provide the staff with necessary information and ensure that current staff receives adequate on-going training. Lease and contract files should have adequate documentation when referencing specific accounting methodologies. Although the lease requires financial information to be retained by the Railroad for a period of 3 years, the AOT Secretary should require a retention period of 7 years to mirror State guidelines.

Lease Payments are Consistently Late and AOT Failed to Collect Interest Penalties of \$37,000.

Criteria: The two lease agreements reviewed provide the State with revenue of approximately \$44,000 and \$7,000 per month, respectively. The lease with VTR has generated \$2,338,000 in rental income to the State over the past 5 years, while the lease with GMRC has generated \$413,000 over the same period.

Under the terms of the lease agreements, the monthly installments are to be paid by the 15th of the third succeeding month. Late payments will accrue interest at the prevailing prime rate.

Condition Found/Cause: We evaluated the rental payments over the past 5 years under both of the leases reviewed. We noted that over the 5-year period payments were made on time only six times on one contract and only 16 times on another. Average days to pay are 178 and 156, respectively. While there were letters sent by the AOT to the Railroads asking for more timely payments, we noted no instances where monthly invoices were sent for the delinquent monthly payment with accrued interest.

Effect: We calculated the amount of interest forgone on the late payments on two of the leases over a 5-year period based on the prime rate as listed in *The Wall Street Journal*. Interest forgone is either the amount of interest accrued on the late payments or the opportunity cost of unearned interest on monies, if received timely, that were invested at the State's prevailing bond rates. If AOT had sent invoices to the Railroad accruing interest as required by the lease agreement, we estimate that there would have been additional revenue to the State of approximately \$37,000. Conversely, if VRS had paid on a timely basis, we estimate that the State would have been able to earn an additional \$24,000 from investable funds over that same period on the revenue from these two leases.

Recommendation: We recommend that the AOT follow the process laid out in the lease agreements and send invoices estimating revenue, including accrued interest, if applicable, to the Railroad if a payment is not received timely. VRS should continue to send in the actual amount of revenue based on the terms of the lease making adjustments to the estimated amounts where necessary.

Premature Lease Renewal Negates Ability of State to Monitor Contract Performance

Criteria: On September 19, 1990, the State entered into a long-term lease agreement with Vermont Railway to have VTR operate a section of railway

on the western side of the State. Article III of the lease agreement, “Renewal Privilege” speaks to the rights of renewal by VTR to this long-term operating lease. The article states:

If Railway performs the agreements on its part, then it shall have the right, at the expiration of the current term (January 5, 1994) to renew this lease for an additional 10-year term, up to a maximum of six times.

First Renewal Term	January 6, 1994 –January 5, 2004
Second Renewal Term	January 6, 2004 –January 5, 2014
Third Renewal Term	January 6, 2014 –January 5, 2024
Fourth Renewal Term	January 6, 2024 –January 5, 2034
Fifth Renewal Term	January 6, 2034– January 5, 2044
Sixth Renewal Term	January 6, 2044 –January 5, 2054

VTR may exercise its right of renewal of the lease agreement by providing the State with written notice not later than 1 year prior to the expiration of each existing term.

Condition Found/Cause: Vermont Railway requested its first renewal of the lease six months in advance of the requirements of the renewal article (letter dated July 1, 1992). On December 8, 1999, Vermont Railway requested renewal of the lease for the second renewal term, *more than 3 years in advance of the required date*. The AAG notified Rail Section management via memorandum that VRT had given its written notice in accordance with Article III. The memorandum states that the “only condition being that it must provide written notice to the State at least 1 year prior to the expiration of the current term” and that “no action on the part of AOT is required.” There was no mention of the performance aspects of this clause in the lease agreement contained in the memorandum, which states: “If Railway performs the agreements on its part, then it shall have the right.” The lease was renewed until January 5, 2014.

There is no written documentation other than the formal request nor did we find evidence as to why VTR requested the renewal 3 years early. We found no written evidence that AOT management questioned this request for early renewal or the incomplete interpretation of the lease agreement language.

Effect: Since the lease renewal was made early, AOT may not be able to cancel or re-negotiate the lease in the event that the State was not satisfied with the performance of VTR at any time in the 3 years remaining in the then current lease period. (In effect, the next lease term was approved for a 13-

year term instead of 10 years.) This practice of allowing automatic renewal of long-term agreements without appropriate review is not a prudent action for AOT.

Recommendation: AOT should strengthen the review of its lease renewals by considering contract goals and performance. AOT Rail Section management should maintain the analysis, interpretation and communication of this review as a part of its documentation that supports the rationale of its decision to renew or not renew this agreement. A procedure on how to assess performance should be developed.

Finding No. 4

AOT Lacks Process to Correct Audit Findings and Follow-up on Questioned Costs of \$436,000.

Criteria: According to the State's internal control standards put forth by the Department of Finance and Management:

Monitoring of internal control should include policies and procedures for ensuring that the findings of audits and other reviews are promptly resolved. Managers are to (1) promptly evaluate findings from audits and other reviews, including those showing deficiencies and recommendations reported by auditors and others who evaluate the department's operations, (2) determine proper actions in response to findings and recommendations from audits and reviews, and (3) complete within established timeframes, all actions that correct or otherwise resolve the matters brought to management's attention.

Condition Found/Cause: Our review of prior audit findings and questioned costs indicate that there are long-term problems with the ability of Rail Section management and other AOT staff to resolve outstanding audit items and questioned costs. Many of these long-standing issues are repetitive and revolve around the relationships and the responsibilities between the various departments within AOT as well as the Rail Section oversight of the railroads operating within Vermont.

We looked at the results of three previous audits and the resolution of the questioned costs, summarized in Appendix IV.

An examination in March of 2002 by KPMG auditors resulted in questioned costs on the contract of \$179,029. Of this amount, VTR repaid \$8,587 to the State, leaving approximately \$170,442 unpaid. To recover this amount, on September 16, 2003 AOT and VTR entered into a mediation agreement settlement in which the Railroad was to re-pay AOT as follows:

Cash repayment	\$ 38,396
Perform additional work on the rail line	82,126
To be waived by AOT upon completion of the additional work	<u>49,920</u>
TOTAL	\$170,442

AOT staff was unable to locate records supporting AOT's receipt of the \$38,396 payment from VTR and provided VTR invoices totaling only \$41,098 of the \$82,126 due in other work. We have calculated the amount still due from VTR for this contract of \$129,315 (\$170,442 less \$41,098).

In September of 2007, external auditors from TG Associates issued a report in which the auditors state that "many of the observations noted in prior audit reports regarding deficiencies in contract wording, weaknesses in AOT oversight and weaknesses in VRS project oversight and accounting procedures continue to exist."¹¹

Because of this review, the auditor recommended a decrease in the contractor's reimbursable costs in the amount \$306,803. The contractor's response to the questioned costs was to agree to supply AOT with supplemental cost documentation in support of work they had performed on the project but did not seek reimbursement for these costs from AOT. As of the end of our current fieldwork, the contractor had yet to provide this additional information.

The total questioned costs from these two contracts that remain unpaid is \$436,118 (\$129,315 plus \$306,803).

Based on our interviews with AOT staff, it is apparent that many of these issues are due to a lack of clearly assigned responsibilities between groups and consistent application of the many agreements the Agency has with the Railroads.

¹¹ Agreed-Upon Procedures Report for State of Vermont, Agency of Transportation Vermont Rail System –Consolidated Close-Out Audits (TG Associates, CPAs, PLLC, October 10, 2007).

Effect: Failure to promptly resolve audit findings and questioned costs increases the risk of continued non-compliance with contracts and agreements and financial losses due to overcharges and other poor practices.

Recommendation: The AOT Finance and Administration Division should create a formal corrective action plan to address all current outstanding audit findings. These findings should be resolved within a designated timeframe. The corrective action plan should have all tasks identified, documented and described in adequate detail so that resolution efforts can be effectively monitored. A copy of the plan should be forwarded to the Secretary of Transportation for review. Periodic status reports on corrective actions should go to the Finance and Administration Director. The Division's Audit Section should actively pursue remuneration for actual questioned costs and research and resolve any identified questionable costs. Any settlement agreements should be included in the Rail Section's contract files.

Further, AOT should immediately collect the balance due and obtain the required documentation from the Railroad.

Conclusion

Based the results of our evaluation of selected AOT Rail Section contracts and leases and the administration of those agreements, it is our opinion that AOT has insufficient controls in place to ensure that the rail services provided are conducted in a cost-effective manner and in compliance with State or Federal regulations.

We believe there is a lack of appropriate oversight and monitoring by AOT of its railroad contracts to ensure that State and Federal competitive bidding procedures and requirements are being met. Contracts are being sole-sourced by AOT as well as its subcontractors, denying businesses equal access and opportunity to compete for State contracts for goods and services. Such weaknesses prevent the State from the best price possible for goods and services.

Contracts and leases contain ambiguous language which often necessitates additional documentation (i.e., the force agreements) to clarify intent. Moreover, the contracts are missing vital requirements of the Agency of Administration's Bulletin No. 3.5 which would aid AOT in ensuring subcontractors' performance is up to the standard expected.

We found several instances of non-compliance with State regulations and AOT's internal procedures, the most significant of which resulted in procurement of nearly \$4 million in materials by the vendor without the Secretary of Administration's approval.

AOT has become complacent in its Rail Section transactions and needs to improve its processes, contracts and oversight of subcontractors. Like many other states, Vermont's finances are showing the effect of the weakening economy. There is pressure on available public funds for transportation, both at the Federal and State level. At the same time, there is more focus on the need for rail to expand its ability to provide transportation for people and products.

It is critical for the State to ensure it is receiving all of the revenues it is entitled to under its rail operating agreements. It is also important that funds the State spends to improve and upgrade its rail lines be used in the most efficient and effective manner.

Agency Comments and Our Evaluation

On November 17, 2008 the Director of Finance and Administration at the Agency of Transportation provided a written response to this report on behalf of the Agency, which can be read in its entirety in Appendix V.

The Director indicated that the Agency generally supports the recommendations in the report and committed to providing the State Auditor with quarterly status reports on the resolution of the audit issues, beginning three months after this report is issued. Regular reports on corrective action steps will provide the State Auditor frequent opportunities to review and comment on the Agency's progress.

In his response, the Director did not explicitly address each of our recommendations; however, he described specific actions and commitments that the Agency of Transportation planned to take in response to this report and some of its recommendations.

Addressing the finding that the Agency did not competitively bid \$7.2 million in contract expenditures, the Director indicated that the Agency will "put all railroad construction projects out to competitive bid unless they relate to emergency work where safety or continuation of rail service is concerned."

The Agency will use a simplified bid process (providing three qualified vendors the opportunity to bid on a specific scope of work) or retainer contracts for small construction contracts – those under \$100,000. The Director did not specifically address our recommendation that the Agency provide oversight in cases where a vendor is granted the authority and responsibility of soliciting bids on behalf of the State. We will examine this issue further when reviewing quarterly progress reports from the Agency.

Responding to recommendations related to oversight and administration of rail contracts, the Director noted that the Agency had, among other steps, implemented a procedure to account for the return and processing of salvage payments. The Agency will also require, for each contract, a separate certificate of insurance assuring adequate coverage; further, the Agency will work with VRS to determine cost-beneficial methods to store and control other track materials (OTM). The Director did not specifically address our recommendation to develop a new standard rail contract that is sent each year for approval to the Secretary of the Agency of Administration. We will examine this issue further when reviewing quarterly progress reports from the Agency.

A significant finding of this report is that railroad lease revenue and railroad performance required by the lease are not being verified by the Agency on a regular basis. To address this condition, the Director indicated the Agency will require VRS “to submit supporting schedules documenting the correct calculation of lease payments.” The Agency will also consider the quality of performance by VRS before confirming that the railroad has properly exercised a lease renewal option, and will not confirm a lease renewal which is received more than six months before the notification deadline specified in the lease. The Director did not specifically address our recommendation for on-going staff training to improve the Agency’s ability to properly monitor lease payments and performance. Nor did the Director address the matter of collecting interest due the State from late monthly lease payments. We may provide additional comment on these matters when reviewing quarterly progress reports from the Agency.

Responding to our finding that the Agency did not have adequate procedures in place to correct Rail Section audit findings and to follow up on questioned costs of approximately \$436,000, the Director said the Agency intends to amend the August 13, 2004 agreement which outlines procedures for State and Federal force account projects. As part of this process, the Director said the Agency will determine the amount of questioned costs to be repaid and a schedule for repayment that does not negatively impact safety or continued rail operations in Vermont.

We are pleased that the Agency of Transportation is planning prompt action to address the deficiencies we noted in the area of railroad contracting and administration of leases. We look forward to reviewing reports of future improvements in the coming months.

		Vermont Statute and Annual Appropriations	Code of Federal Regulations	Vermont State Bulletin 3.5	AOT Contracting Plan	Force Agreement	Maintenance Rail Agreements
Step 1	Vermont State Rail and Policy Plan Development	X					
Step 2	Define project.						
	Emergency repair.	X	X	X			
	Non-emergency upgrade	X	X	X	X		
	Normal maintenance of rail lines.	X	X	X			X
	Project requires use of railroad forces	X	X	X		X	
	Project does not require use of railroad forces (material purchase only)	X		X			
Step 3	Define funding source.						
	Federal funds.		X				
	State funds.	X		X			

Appendix I - Guidance Chart

Guidance Document	Issuing Authority	Applicable to:
Bulletin No. 3.5 Contracting Procedures (December 29, 2006)	Vermont Agency of Administration	Contracts, procurement of goods and services
Bulletin No. 3.5 Waiver for AOT (February 7, 2007)	Secretary of Administration	Approvals on contracts
AOT Contracting Plan (June 8, 2007)	Secretary of Transportation; Secretary of Administration	Contracts, procurement of goods and services
AOT Contracting Plan (April 2, 1996) (Modified March 26, 2003 & August 29, 2003)	Secretary of Transportation; Secretary of Administration	Contracts, procurement of goods and services
Vermont Statute (19 V.S.A. Chapter 1 § 10e) (5 V.S.A. Part 4)	Vermont Legislature	Statement of Policy regarding railroads
Blanket Delegation of Authority (January 1, 2007-December 31, 2007)	Commissioner of Buildings and General Services	Procurement of used relay ties up to \$200,000 (no Federal funding)
Blanket Delegation of Authority (January 1, 2007 – December 31, 2007)	Commissioner of Buildings and General Services	Procurement of used relay rail up to \$1.5 million (no Federal funding)
Code of Federal Regulations (CFR) Title 23, Title 48, Title 49	U.S. Government	Railroad projects for which Federal funds are used
Asset Management Procedure	Department of Finance & Management	Management of capital assets in VISION
Construction Contracts	Secretary of Transportation; Secretary of Administration	Upgrades to State-owned rail lines; Maintenance and upgrade of bridges
Lease Agreements – VTR (July 19, 1990) GMRC (November 12, 1992) WACR (June 4, 2003)	VTR - Governor Kunin; GMRC – Secretary of Transportation; WACR – Secretary of Transportation	Maintenance of Rail lines
New Procedures for Railroad Force Account Projects (<i>aka Force Agreement</i>) (August 13, 2004)	Secretary of Transportation	Clarifies ambiguous sections of the contracts
General Policies and Procedures	Agency of Transportation	Covers doing business with the Vermont Agency of Transportation

Appendix II – Agency of Administration Bulletin 3.5

Section VI. The Bidding Process

A. STANDARD BIDDING

1. Bid Documents (“Requests for Proposals”)

Additional guidelines for the creation and issuance of Requests for Proposals (RFPs), including a sample RFP template, are available at <http://www.bgs.state.vt.us/pca/index.html>. The actual document is updated frequently to reflect changes in State law. The most current version can always be found at http://www.bgs.state.vt.us/PCA/pdf/rfp_shell.doc.

a. Cover Page: An RFP package should include a cover page that includes the following:

1. Name and address of contact person
2. Due date, time, and location of responses
3. Notification of the time and location for any scheduled bidders’ conference, including a statement as to whether attendance is a condition of selection
4. Any other special requirements of the RFP process

b. Introduction: The RFP itself should explain its purpose and the nature of the services that are sought, for example: “The purpose of this RFP is to obtain from independent management consulting firms proposals to perform a management study of the Section of Bulletin Creation.”

c. Brief description of the agency: The RFP should provide needed general information, such as the type of government unit, the agency’s statutory authority, budget size, number of employees, and population served, and its mission or purpose. For any associated governmental units, explain their involvement or relationship to the agency organization. Briefly explain the mission or purpose of the organization. It is usually efficient to supply information from existing documents as an attachment to the RFP. Also describe any recently published documents that may contribute to the scope of services, such as financial audits, program reviews, or technical studies.

d. Statement of work to be performed: The bid documents must include a statement of work to be performed and/or products to be delivered. The purpose of this statement is to provide prospective vendors with clear and concise but thorough information regarding the requested work. At a minimum, the statement should include in detail the following: a description of the work to be performed, a schedule (including when the work is to be completed, any interim completion dates and/or deliverables), the expected outcomes and/or products, and related performance and/or quality standards. A thorough and well-structured statement of work to be performed enhances the responsiveness of vendors during the solicitation process, promotes the reliability and comparability of proposals, and minimizes the need for contract negotiations and subsequent contract amendments.

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e. Context for the work and management structure: The bid documents should provide the vendor with a brief overview of the recent history leading to the agency's decision to seek a contractor. This overview will provide vendors with a better understanding of the purpose and context of the work. The bid document should include a statement about the management structure. A description in *general* terms of how the contract will be monitored by the contracting agency should be included along with a statement that a *specific* monitoring process will be defined in the contract with the selected bidder. The goal is for bidders to understand that the State is going to monitor their activities and performance under a contract in order to prevent problems or to detect them early, to determine any need for technical assistance, and to ensure that the contract terms are met and that State expenditures are appropriate, effective, and efficient.

f. Bid and contract requirements: Bid documents should clearly explain to bidders the procedural and substantive requirements of the bidding process. For example, the date, time, and address to which bids must be delivered should be explicitly stated. In addition, this section should include information regarding any on-location views of the work area, any pre-bid informational conferences, and any special requirements for submissions with the bid, such as bid bonds, qualification profiles, resumes of key personnel performing the work, etc. The bid documents should describe the key elements of the contract to be signed with the vendor winning the bid. The recommended method of meeting this requirement is to attach to the bid documents a copy of the basic contract documents which the selected vendor will be expected to execute. Each bid document must include a copy of Attachment C: Standard State Contract Provisions or its equivalent as approved by the Attorney General.

g. Price quotation form: The bid documents, except for those using a Qualifications-Based Selection process, should include a price quotation form. The form should explicitly allow for price quotations for the core services or products requested and for each incremental phase of a project if relevant. In any case, when contract extensions are contemplated, the quotation form should explicitly provide for a price quotation applicable to each such extension. Additionally, the form should allow for separate price quotations for optional services or products that an agency may consider adding to or deleting from the basic bid.

h. Basis for selection: The bid documents should clearly explain the selection criteria to be used by the agency. If certain factors in the selection process are relatively more important than others, the degree of such relative importance should be clearly stated and, if possible, quantitatively profiled.

2. Public Notice Regarding the Standard Bid

The opportunity to bid for the proposed work must be broadly publicized. At minimum, such solicitation shall include posting on the Electronic Bulletin Board (EBB), which is operated by the Agency of Commerce and Community Development as part of the Vermont Business Assistance Network (VBAN).

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Current instructions for posting on the EBB Can be found at the following link: <http://www.vermontbidsystem.com>.

Other methods of solicitation may include advertising in newspapers, direct mailings to potential vendors, direct mailings to vendors on a prequalified list (see Section VI B below), and/or publication in trade journals. It is important for an agency to maintain a list of those requesting bid documents. The time between the initial public notice and the opening of bids should be at least two weeks. For relatively complex work, additional time should be permitted to allow potential vendors a reasonable opportunity to obtain the documents and prepare a responsive bid.

3. Contractor Selection and Documentation

a. Selection: The bid most responsive to the selection criteria established in the bid documents should be accepted. When appropriate, a supervisor may establish a contract selection committee to review the bids and make a written recommendation. At minimum, the agency shall post public notification of its decision on the Electronic Bulletin Board.

b. Documentation: A complete copy of the bid documents, vendors solicited, price quotations, bids received, and any written selection justifications must be placed in the contract file. For cost-based bids, when other than the lowest bid is accepted, there must be documentation concerning the quality of services, products, or other relevant considerations offered by a higher priced vendor that justify the award of the contract to the higher priced vendor. For qualifications-based selection processes, documentation of the basis for ranking each bidder's qualifications must be placed in the contract file.

c. Apparent conflict of interest: If a reasonable person might conclude that a contractor was selected for improper reasons, the supervisor should disclose that fact in writing to the Attorney General and the Secretary and document the reasons why selecting the desired contractor is still in the best interests of the State.

4. Pre-Bid (Bidders') Conferences and Adjustments to Bid Documents

For large or complex work, it is recommended that the agency hold a pre-bid conference where agency staff can review with potential vendors the scope of services for the work and other content of the bid documents. Any change to the interpretation of the bid documents resulting from a pre-bid conference, or from any other information upon which the agency intends bidders to rely, such as responses to bidders' questions, should be broadly publicized, including at minimum a notice on the Electronic Bulletin Board.

5. The Bid Opening

A public bid opening and reading of bids should be the norm and is required for contracts over \$100,000. Two staff members from the agency administering the bid process should be in attendance at the bid opening. Bids that have not been received prior to the established time for the receipt of bids shall be returned unopened to the bidder. With the approval of the Attorney General, the State agency administering the bid process may waive technical non-compliance when

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doing so is in the best interest of the State. Such waivers must be fully documented and included in the contract file.

B. PRE-QUALIFIED BIDDING

In order to streamline the bidding process in cases where a type of work is routinely bid on, it can be more efficient for an agency to establish a list of pre-qualified vendors. A pre-qualified vendor is one who has been determined by an agency to be generally qualified to perform a type of work that is routinely put out to bid by the agency. All vendors who are determined qualified to perform the type of work for which the pre-qualification list has been established, and who so request it, should be included on the list by the agency.

At least once in a two year period, an agency using a pre-qualified bidding process must publicly solicit the opportunity to be placed upon the list. The agency should establish clear criteria for the qualifications that, if met, allow potential vendors to be included on the pre-qualification list. Additionally, during the period between formal list revisions, the agency must maintain an ongoing process that allows additional vendors to request review and inclusion on the pre-qualification list.

When soliciting bids from a pre-qualified list, the public notice requirement shall include the restriction that bidding is limited to those on that pre-qualification list and provide information as to how vendors can be included on this list in the future.

C. QUALIFICATION-BASED SELECTION

With the prior approval of the Secretary, in situations where the contract sought is for professional design services, such as architects or engineers, a Qualification-Based Selection process may be used. The first consideration in this process is the selection of the most qualified vendor who can meet the contract requirements; the second consideration is cost. Vendors are ranked by qualification, then cost is negotiated with the most qualified bidder; if this negotiation is not satisfactory to the State, cost is negotiated with the next most qualified bidder, and so on, until a satisfactory agreement is reached and a contract negotiated.

The Qualification-Based Selection is **required** for contracts that are supported by certain Federal funds if (1) the contract is for engineering and design services, (2) the contract is for \$100,000 or more, and (3) the services relate directly to a highway construction project. Under these circumstances, the prior approval of the Secretary is not required.

D. EXCEPTIONS AND WAIVERS

1. Sole Source

Every reasonable effort should be taken to promote a competitive solicitation process when selecting a contractor. However, in extraordinary circumstances, negotiating with only one contractor may be appropriate. Examples of when a sole source contract might be appropriate include when time is critical for performance of the required services (such as emergency repairs) and/or when only one contractor is capable of providing the needed service or product. In

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other than an emergency situation a supervisor desiring to execute a sole-source contract that has a value of greater than \$15,000 but no more than \$100,000 must forward a copy of the proposed contract, notice of intent to execute, and a justification for the contract to the Secretary at least two weeks prior to the planned execution date. If, by ten business days after receipt by the Secretary, the Secretary does not object, the contract may be executed. For sole source contracts having a value of more than \$100,000, the Secretary must approve the contract prior to its execution by the supervisor. At least four weeks should be allowed to obtain this approval.

2. Waivers

The Secretary may waive provisions of this Bulletin on a case-by-case basis pursuant to a written request from a supervisor. Any such request must describe in detail the basis for the request and the specific component(s) of the contracting process for which the waiver is sought and must be granted prior to the signing of the contract by either the State or the contractor. Copies of all waivers granted by the Secretary, and the requests submitted therefore, must be retained in the contract file.

3. Contracting Plans

For specific classes of contracts exhibiting characteristics that cannot reasonably be accommodated within the requirements of this Bulletin, the Secretary may approve a written contracting plan that provides an acceptable alternative to any requirement of this Bulletin (for example, contracts with multiple training specialists that provide a particular kind of training to a specific group, such as police officers or casework specialists, and that takes place frequently on an annual basis but for which an exact time or number of trainings cannot be predicted accurately). *All such contracting plans approved pursuant to prior versions of this Bulletin must be resubmitted for renewed approval to the Secretary within 3 months of the effective date of this Bulletin revision.* Existing Contracting plans remain in effect until the Secretary has acted on the new request for approval.

Appendix III – Chart of Required Signatures and Approvals

** Monetary Thresholds, Exceptions, Waivers and Amendments	Authority	Competitive Requirements			Prior Approvals Required			
		Standard Bid	Simplified Bid	Qualification Based Selection	****			
					Secretary of Transportation	Attorney General	Finance & Management	Secretary of Admin
\$15,000 or less	Bulletin No. 3.5				X			
Greater than \$15,000 but less than \$250,000 ***	AOT Contracting Plan	X	X		X	X		
Greater than \$250,000	Bulletin No. 3.5	X		X	X	X	X	X
No-Cost Contract - all	Bulletin No. 3.5	X			X	X	X	X
Sole Source Greater than \$15,000 but not more than \$100,000	Bulletin No. 3.5				X		X	X
Sole Source Greater than \$100,000 (waiver letter plus contract)	Bulletin No. 3.5				X	X	X	X
Sole Source of any size in emergency situation (with notification to Sec of Admin)					X			
Maintenance Rental Agreements less than \$50,000	AOT Contracting Plan				X			
Duration - Greater than 2 Years or 4 years if renewal option is included in original contract (waiver letter plus contract)	Bulletin No. 3.5				X		X	X
Engineering contracts - additional year	AOT Contracting Plan				X		X	X
Engineering and statewide retainer contracts may extend for additional 3 years	AOT Contracting Plan				X		X	X

** Monetary thresholds are cumulative. If the original contract amount plus all amendments reaches a new threshold; the requirements for the higher threshold apply.

*** Note: If Federally funded the Standard bid process must be used if contract is greater than \$100,000

**** AOT AG may approve a standard contract as to form rather than each individual contract.

Appendix IV – Summary of Previous Audit Findings

In March of 2002, external auditors from KPMG submitted a report in regards to a specific contract with VTR¹. Among the findings were issues related to:

- The contract was not clearly written resulting in confusion for both parties.
- There appeared to be lack of adequate State oversight over contract administration.
- The contractor's billing processes contained numerous weaknesses.
- Inventory control was weak, and VTR did not maintain an inventory of construction materials. The State nor VTR could know whether the State is paying more or less, than they should for construction materials.

In August of 2002, external auditors from the audit firm of Mudgett, Jennet & Krough-Wisner performed a review of the internal operations of the Rail Section and issued a report in which the auditors had 20 findings². Among these findings were:

- The Rail Section lacks written processes and procedures.
- The Rail Section lacks process for establishing project timetables and expectations.
- Procurement procedures did not comply with Federal or State procurement requirements.
- No evidence of project progress and performance monitoring.
- Project agreement terms were not enforced.
- The operating lease terms were not enforced.

In September of 2007, external auditors from BST TG Associates issued a report in which the auditors state that “many of the observations noted in

¹ *Independent Auditor Agreed Upon Procedures Report; Submitted Cost Compliance Related Controls.* (KPMG, March 12, 2002).

² *Independent Accountant's Report On Applying Agreed-Upon Procedures,* (Mudgett, Jennett & Wisner, P.C, August 21, 2002).

Appendix IV – Summary of Previous Audit Findings

prior audit reports regarding deficiencies in contract wording, weaknesses in AOT oversight and weaknesses in VRS project oversight and accounting procedures continue to exist.”³ Examples of additional findings indicate:

- VRS was unable to provide support that some of its contractors had sufficient liability insurance coverage as required.
- VRS did not provide financial statements to AOT when requested as required in the force account agreement. The company referred to the absence of this requirement in the VRS operating lease agreements as its justification for not providing the information.
- The auditors found where AOT paid invoices twice.
- Credit for salvageable materials was not given to AOT as required in its agreements. There was a missing invoice supporting a charge to AOT and double billed equipment costs.

³ Agreed-Upon Procedures Report for State of Vermont, Agency of Transportation Vermont Rail System –Consolidated Close-Out Audits (TG Associates, CPAs, PLLC, October 10, 2007).

Appendix V – Agency Comments



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Agency of Transportation

November 17, 2008

Mr. George Thabault
Deputy State Auditor
Office of the Vermont State Auditor
132 State Street
Montpelier, VT 05633-5101

REPLY TO DRAFT RAIL AUDIT

Dear Mr. Thabault:

Thank you for the opportunity to include our comments in the audit report. We believe that the work done to date by the State Auditor's Office and VTrans, along with our planned course of action, will result in significant improvements in the rail program. We generally support the recommendations included in the report and are providing additional comments below.

The new Rail Program Manager is examining the business processes of the Rail Unit and will make procedural changes necessary to carry out the recommendations contained in the audit.

Reference Finding 1:

Although the use of preferred contractors is allowable for railroads under 23 CFR 646, VTrans will put all railroad construction projects out to competitive bid unless they relate to emergency work where safety or continuation of rail service is concerned. Small construction contracts, those under \$100,000, will be handled by a simplified bidding process and use of retainer contracts.

As stated in the audit, the Department of Buildings & General Services (BGS) does provide State-wide procurement services and we note that 5 VSA 3403(c) authorizes the Secretary of Transportation to contract for the rebuilding of State-owned railroad properties. We will use BGS to process procurements; however, since we will be competitively bidding contracts over \$100,000, we anticipate an infrequent need for BGS to procure goods. However, we will use BGS to manage major procurements made by VTrans for railroad ties and other track material. We also note that VTrans has a blanket delegation authority (BDA) from BGS to purchase steel rail up to \$1.5 million per year, and for ties up to \$200,000 per year, subject to restrictions on market value.

Since VTrans will be competitively bidding all construction contracts over \$100,000, we will also approve railroad subcontractors using the procedures outlined in the VTrans standard specifications for construction. Invoices submitted by the prime contractors will include invoices from approved subcontractors. Since the rail construction contracts will be competitively bid, the form AF-38 will not be required.



Appendix V – Agency Comments

RAIL AUDIT REPLY

November 17, 2008

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Reference Finding 2:

As stated above, we do not anticipate the need for BGS to frequently manage major procurements for rail construction projects since they will be competitively bid.

Each railroad construction contract will require a separate certificate of insurance assuring adequate coverage. Railroad construction contracts will not be approved by VTrans without a current insurance certificate.

The netting of salvage credits has been discontinued and we have implemented a procedure to account for the return and processing of salvage payments.

We will work with VRS to determine the most effective and cost beneficial manner to store and control other track materials. We concur that the current method employed by VRS is not acceptable. To minimize transportation and handling costs, we believe that the materials should be stored on railroad property rather than trucking the materials to VTrans' garages located away from the railroad.

To foster timely receipt of invoices, all future contracts for railroad construction will include a time period for submission of invoices involving routine work.

Reference Finding 3:

VTrans will require VRS to submit supporting schedules documenting the correct calculation of lease payments. Lease payments will be submitted directly to the Accounts Receivable Unit for immediate deposit.

The quality of performance by VRS, as determined by the Rail Program Manager, will be considered before VTrans confirms that the railroad has properly exercised a lease renewal option. These quality factors will include maintenance of the track, timeliness of invoice submissions, cooperation with VTrans contractors, and other factors as appropriate. VTrans will not confirm the railroad's proper exercise of a lease renewal which is received more than six months before the notification deadline specified in the lease.

Reference Finding 4:

VTrans will notify VRS of our intent to amend the August 13, 2004 agreement which outlines procedures for State and Federal force account projects. The new agreement will require audited financial statements by VRS to assure proper accountability of public funds. In conjunction with this requirement, we will determine the amount of questioned costs to be repaid and a schedule for such repayment. VTrans and VRS management will assure that any repayment schedule will not negatively impact safety or continuation of rail operations in Vermont.

Follow-up:

We will provide the State Auditor with quarterly status reports on the resolution of the audit issues, beginning three months after the report's issuance.

Appendix V – Agency Comments

RAIL AUDIT REPLY

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We appreciate the cooperation and professionalism exhibited by your staff during this audit, and we stand ready to coordinate with you to assure improvement in this important program. Thank you for your work.

Sincerely,



Thomas A. Daniel
Director of Finance and Administration

TD/ebs

cc: Dave Dill, Secretary of Transportation ✓
Sam Lewis, Director of Operations
Rob Ide, Rail Program Manager
John Dunleavy, Assistant Attorney General
Dan Peterson, Chief of Contract Administration
John Zicconi, Director of Communications