City of New York

OFFICE OF THE COMPTROLLER

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MANAGEMENT AUDIT

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Audit Report on the Department of Education's Awarding of Milk Distribution Contracts

ME12-093A

February 26, 2014

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February 26, 2014

To the Residents of the City of New York:

My office has audited the adequacy of the Department of Education's (DOE) controls over the awarding of milk distribution contracts. We audit processes such as this to ensure that City agencies are operating in the best interest of the public.

The audit concluded that DOE's controls over the awarding of milk distribution contracts were adequate as they relate to many aspects of the contract award process. However, DOE did not adequately review the financial capacity of the vendors that were awarded milk contracts. In addition, DOE lacked adequate procedures for detecting the warning signs of possible collusion. As a result of those deficiencies, the risks that a financially unsound vendor could be awarded a major contract or that collusion could occur and go undetected are increased.

To address these issues, the audit made nine recommendations, including that DOE: develop and implement adequate written procedures that are sufficiently detailed to govern the review of the financial capacity of the lowest bidders for milk distribution contracts; ensure that the contract files contain adequate evidence of the review of the financial capacity of the lowest bidders; develop and implement adequate written procedures that are sufficiently detailed to detect the warning signs of possible collusion; and identify any warning signs of possible collusion and explain and support its conclusions relative to their significance.

The results of the audit have been discussed with DOE officials, and their comments have been considered in preparing this report. Their complete written response is attached to this report.

If you have any questions concerning this report, please e-mail my audit bureau at audit@comptroller.nyc.gov.

Sincerely,

Scott M. Stringer

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THE CITY OF NEW YORK
OFFICE OF THE COMPTROLLER
BUREAU OF AUDIT
MANAGEMENT AUDIT

Audit Report on the Department of Education's Awarding of Milk Distribution Contracts

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AUDIT REPORT IN BRIEF

This audit determined the adequacy of the Department of Education's (DOE) controls over the awarding of milk distribution contracts. The scope of this audit covers the period from April 2008 through June 2013.

DOE provides education to over one million pre-kindergarten to 12th grade students in more than 1,700 New York City public schools. These schools serve over 850,000 meals per day to their students.

In May 2008, DOE solicited bids for five-year contracts to supply and deliver milk to schools. DOE awarded milk distribution contracts totaling $134,139,354 to three vendors covering eight aggregate classes (geographical zones) in the City. Beyer Farms, Inc. (Beyer) was awarded a contract amount of $111,207,157 for Brooklyn zones 1 and 2, Queens zones 1 and 2, and the Bronx zones 1 and 2. Elmhurst Dairy, Inc. (Elmhurst) was awarded a contract amount of $17,647,481 for Manhattan, and Bartlett Dairy, Inc. (Bartlett) was awarded a contract amount of $5,284,716 for Staten Island. These distribution contracts became effective on November 1, 2008, and were set to expire on August 31, 2013.

In October 2008, Beyer and Elmhurst requested and obtained approval from DOE to subcontract to Bartlett the delivery of milk in Queens zones 1 and 2, the Bronx zones 1 and 2, and Manhattan. DOE's approval of the subcontracting was based on the understanding that Beyer and Elmhurst, as the principal contractors, were responsible for all contractual terms, conditions, and requirements.

On December 11, 2012, Beyer declared bankruptcy and closed its operations. Beyer notified DOE that it could no longer perform milk distribution services under its contract. DOE was able to award contracts to two vendors to continue the distribution of milk to the schools without interruption.

Audit Findings and Conclusion

DOE's controls over the awarding of milk distribution contracts were adequate as they relate to many aspects of the contract award process. In reviewing DOE's controls over the awarding of milk distribution contracts, we found that: DOE's controls over the receipt of the bids were adequate; the contract files generally contained, with some exceptions, the required documentation in support of DOE's awarding of the contracts; the Request for Bids (RFB) and contract award processes were followed in the proper sequence; and DOE selected the lowest bidder for each geographical zone based on accurate bid tabulations.

However, DOE did not adequately review the financial capacity of the vendors that were awarded milk contracts. In addition, DOE lacked adequate procedures for detecting the warning signs of possible collusion. As a result of those deficiencies, the risks that a financially unsound vendor could be awarded a major contract or that collusion could occur and go undetected are increased. To ensure that the contracts are awarded to the lowest responsive and responsible bidder, DOE needs to strengthen its controls in these areas.

Audit Recommendations

To address these issues, the audit recommends, among other things, that DOE:

- Develop and implement adequate written procedures that are sufficiently detailed to govern the review of the financial capacity of the lowest bidders for milk distribution contracts.
- Ensure that the contract files contain adequate evidence of the review of the financial capacity of the lowest bidders.
- Develop and implement adequate written procedures that are sufficiently detailed to detect the warning signs of possible collusion.
- Identify any warning signs of possible collusion, review them, and then explain and support its conclusions relative to their significance.

Agency Response

DOE officials generally agreed with the audit's nine recommendations, but disputed most of the findings upon which the recommendations were based. We found DOE's arguments against these findings to be unpersuasive. Accordingly, we stand by our findings. A detailed discussion of DOE's arguments is presented in the body of this report, and the full text of the DOE response is included as an addendum to this report.

INTRODUCTION

Background

DOE provides education to over one million pre-kindergarten to 12th grade students in more than 1,700 City public schools within 32 districts. These schools serve over 850,000 meals per day to their students. The DOE Office of School Support Services Division of School Food (School Food) is the office primarily responsible for providing the meals. School Food must ensure that contracted food distribution vendors are providing healthy food choices for the students and are maintaining high nutritional standards, including serving primarily low-fat and fat-free milk to students. This audit focuses on DOE's controls over the awarding of milk distribution contracts.

The awarding of milk distribution contracts is initiated through a competitive sealed RFB process. According to DOE, the length of the process for each milk distribution contract from the time that specifications are developed by School Food until the contract period begins is about five to six months. A description of the detailed milk distribution contract award process is provided in the Appendix to this report.

In May 2008, DOE solicited bids for five-year contracts to supply and deliver milk to schools. Eight vendors responded to the solicitation. One vendor (Teri Nichols) submitted a "no bid" response[1], while the following seven vendors submitted actual bids: Bartlett; Beyer; Cream-O-Land Dairies, LLC. (Cream-O-Land); Derle Farms, Inc. (Derle); Elmhurst; Maramont Corporation (Maramont); and Oak Tree Farm Dairy, Inc. (Oak Tree). DOE awarded milk distribution contracts totaling $134,139,354 to three of these vendors covering eight geographical zones in the City. On August 20, 2008, Beyer was awarded a contract amount of $111,207,157 for Brooklyn zones 1 and 2, Queens zones 1 and 2, and the Bronx zones 1 and 2. On August 27, 2008, Bartlett was awarded a contract amount of $5,284,716 for Staten Island, and on September 11, 2008, Elmhurst was awarded a contract amount of $17,647,481 for Manhattan. These distribution contracts became effective on November 1, 2008, and were set to expire on August 31, 2013.

In October 2008—less than two months after the contracts were awarded and before the contracts became effective (November 1, 2008)—Beyer and Elmhurst requested and obtained approval from the Executive Director of the Division of Contracts and Purchasing (DCP) to subcontract to Bartlett the delivery of milk in Queens zones 1 and 2, the Bronx zones 1 and 2, and Manhattan. DOE's approval of the subcontracting was based on the understanding that Beyer and Elmhurst, as the principal contractors, were responsible for all contractual terms, conditions, and requirements, including ensuring that Bartlett delivered milk in a timely manner. Consequently, the subcontracting resulted in Bartlett being responsible for delivering milk within four boroughs to about 70 percent of the City's schools, including the borough of Staten Island that it was directly contracted to handle, while Beyer was responsible for delivering milk in Brooklyn zones 1 and 2 to about 30 percent of the City's schools.

On December 11, 2012, Beyer declared bankruptcy and closed its operations. Beyer notified DOE that it could no longer perform milk distribution services under its contract. DOE was able

[1] DOE maintains a list of vendors interested in being solicited for bids by category of goods and services. A vendor that fails to respond to a solicitation on three consecutive invitations within a category may be removed from the list. To avoid being removed, a vendor may submit a "no bid" response—which is still considered a response—to a solicitation.

to find two vendors to continue the distribution of milk to the schools without interruption. DOE entered into two nine-month Buy-Against contracts[2]—one with Bartlett totaling $8,795,575 to cover the zones in Queens and the Bronx, and a second with Elmhurst totaling $5,810,930 to cover the zones in Brooklyn.

DOE has reported that a total of $107,962,778 has been spent on the milk distribution and Buy-Against contracts through May 31, 2013.

Objective

To determine the adequacy of DOE's controls over the awarding of milk distribution contracts.

Scope and Methodology Statement

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. This audit was conducted in accordance with the audit responsibilities of the City Comptroller as set forth in Chapter 5, § 93, of the City Charter.

The scope of this audit covers the period from April 2008 through June 2013. Please refer to the Detailed Scope and Methodology at the end of this report for the specific procedures and tests that were conducted.

Discussion of Audit Results

The matters covered in this report were discussed with DOE officials during and at the conclusion of this audit. A preliminary draft report was sent to DOE officials on August 8, 2013, and was discussed at an exit conference held on August 30, 2013. On September 24, 2013, we submitted a draft report to DOE officials with a request for comments. We received a written response from DOE officials on October 9, 2013. In their response, DOE officials generally agreed with the audit's nine recommendations, but disputed most of the findings upon which the recommendations were based. We found DOE's arguments to be unpersuasive. Accordingly, we stand by our findings.

A detailed discussion of DOE's arguments is presented in the body of this report, and the full text of the DOE response is included as an addendum to this report.

[2] When a vendor defaults on an existing contract for goods or services and there is a continued need for them, DOE may obtain the required goods or services from a successor vendor under a Buy-Against contract. The term of this contract is not to go beyond the remainder of the term on the original contract.

FINDINGS AND RECOMMENDATIONS

DOE's controls over the awarding of milk distribution contracts were adequate as they relate to many aspects of the contract award process. (A description of DOE's milk distribution contract award process is provided in the Appendix to this report.) However, DOE did not adequately review the financial capacity of the three vendors that were awarded milk contracts. In addition, DOE lacked adequate procedures for detecting the warning signs of possible collusion.

In reviewing DOE's controls over the awarding of milk distribution contracts, we found that:

- DOE's controls over the receipt of the bids by the DCP Innovation and Vendor Resources (bid opening) unit were adequate. Upon receipt, bids were time and date stamped and recorded in a log. Prior to the bid opening, the bids are stored in a secure location.
- The contract files of the DCP Food unit (of the Transportation, Food, and Facilities unit), as well as those of the DCP bid opening, DCP Vendor Research and Price Analysis (Vendor Research), and School Food units, generally contained, with some exceptions, the required documentation in support of DOE's awarding of the contracts. The documentation included, among other things, the solicitation, the pre-bid conference attendance sheet, vendors' responses to the solicitation, the tabulation of the bids, requests for comprehensive background checks, printouts of reports generated from LexisNexis and Dun & Bradstreet, inspections of the bidders' premises, and the authorizations for the contract awards.
- The RFB and contract award processes were followed in the proper sequence.
- DOE selected the lowest bidder for each geographical zone based on accurate bid tabulations.
- The three vendors that were awarded milk distribution contracts were, in fact, responsive to the RFB. Specifically, each vendor provided a certification of general, automobile, worker compensation, and employer liability insurance; detailed executive information; the name and address of the vendor that was to supply the milk products; and evidence of prior experience.
- The milk distribution contracts and the Buy-Against contracts were all registered with the Office of the City Comptroller. The Buy-Against contracts were properly published in the City Record and on the DOE website within 30 days of registration.

However, these positives are diminished by the deficiencies stated earlier. As a result of those deficiencies, the risks that a financially unsound vendor could be awarded a major contract or that collusion could occur and go undetected are increased. To ensure that the contracts are awarded to the lowest responsive and responsible bidder, DOE needs to strengthen its controls in these areas. These matters are discussed in greater detail below.

DOE Did Not Adequately Review the Financial Capacity of the Three Vendors That Were Awarded Milk Contracts

DOE did not adequately review the financial capacity of the three vendors that were awarded milk distribution contracts. In fact, one of the three vendors (Beyer) went bankrupt during the period of the contract, requiring that DOE enter into Buy-Against contracts with the two remaining vendors to avoid any disruption in milk distribution to schools.

Section 1.24 (e) of the RFB for the milk distribution contracts states that a “bidder must submit upon request a balance sheet, income statement, statement of earnings, and all related footnotes and attachments for its operations for the past three (3) years. The last year must be certified by an independent Certified Public Accountant [CPA].”

DOE did obtain financial statements from each of the three winning bidders for the prior three calendar years. However, there was no evidence of an adequate DOE review of the financial statements. In relation to Elmhurst and Bartlett, there was no evidence in the contract files that the Calendar Year 2007 financial statements for these vendors had been certified by independent CPAs as required. We did find, however, an accompanying letter that was attached to the Calendar Year 2007 financial statement for Beyer indicating that the statement had been certified by an independent CPA.

Through interviews with various DCP officials, we attempted to determine who was responsible for reviewing financial statements and what the review should involve. The Chief Administrator of the Vendor Research unit stated that the comprehensive background checks that his unit performs generally do not include a review of the vendors’ financial statements because the unit lacks the expertise to do so.

The Chief Administrator of the DCP Food unit stated that her unit is responsible for obtaining vendors’ financial statements for the previous three years. However, because her staff does not include accountants, only a cursory review of a vendor’s assets and liabilities is performed. She stated that her unit might review a vendor’s bank statements and lines of credit.[3] However, there was little evidence in the files that such reviews were conducted.

The Executive Director of DCP stated that DOE sometimes conducts site visits to vendors prior to awarding a contract. According to emails provided to us by DOE, DCP and School Food visited Beyer on August 20, 2008, which is the same day that the vendor was notified that it was being awarded a contract to handle school milk deliveries in six of the eight zones in the City. The Executive Director stated that observing the vendor’s facility and operation and questioning the vendor’s representatives were important components of DOE’s determination as to whether the vendor would be a responsible contractor. We did not find any evidence in the contract files of the results of the site visit to Beyer.

While such a visit can be helpful, particularly if conducted in advance and not on the same day that the contract is awarded, the lack of an adequate review of vendors’ financial statements prevented DOE management from ensuring that the lowest bidders were, in fact, responsible. One of the factors to consider in determining that a bidder is responsible is whether it has the financial resources to fully perform the contract. DOE’s inadequate financial review raised the risk that DOE was entering into a contract with a vendor that would not be able to fully meet its contractual obligations.

Financial Weakness of Beyer

The financial statements on Beyer for Calendar Years 2004 through 2007 indicated that Beyer had a high risk of financial failure at the time that it was awarded its milk distribution contract.

[3] A line of credit is a source of funds generally offered by financial institutions, such as credit card companies and banks, from which borrowers can draw money.

The statements indicated that Beyer did not have the financial resources to fully perform the contract. On December 11, 2012, Beyer declared bankruptcy and permanently closed its operations. On December 6, 2012, DOE had been informed by Dean Foods, a parent company of Tuscan/Lehigh Dairies, Inc. (Tuscan), that Tuscan had terminated its June 26, 2003, milk supply agreement with Beyer as a result of "Beyer's persistent default in its payment obligations." According to Tuscan's termination letter to Beyer, Tuscan had made many attempts to reach a resolution with Beyer; however, Beyer continued "to fall farther and farther behind on its payment obligations." The letter stated that as of December 5, 2012, Beyer owed Tuscan more than $19.8 million.

Once the decision to award a contract has been made, the DCP Food unit prepares the Request for Authorization (RA), which documents the procurement process, determinations, and approvals associated with the award. The approved RA for the milk distribution contracts stated that "a cursory review of vendors' financial statements did not indicate any risk associated with doing business with these vendors." However, the only document we found in the contract files indicating any type of review of the financial capacity of these vendors was a single handwritten note attached to Beyer's financial statement for Calendar Year 2007. This note made the following observations concerning the financial stability of Beyer:

- "Large number of car notes (22)
- Notes secured by equipment
- Truck leases
- Lines of credit secured by corporate assets
- Notes payable to other companies Elmhurst, Tuscan, etc.
- Everything (the whole company + equipment) appears to be on 'Margin.' What measures have you (Beyer) taken to ensure survival should the credit lines/loans get called by the lenders."

Surprisingly, we did not find any evidence in the contract files that the above-mentioned concerns were ever addressed by DOE. After several inquiries, we discovered that the note had been written by a Procurement Analyst in the DCP Food unit. The Procurement Analyst explained that he wrote the note because he was originally concerned as to whether Beyer had the financial capability to distribute the milk since DOE was considering awarding most of the geographical zones to the vendor. However, he explained that "someone made a determination that Beyer was in good financial standing." When we questioned the Chief Administrator of the DCP Food unit about the Procurement Analyst's note, she stated that his concerns did not prevent DOE from awarding a contract to Beyer because the Procurement Analyst, not being an accountant, lacked expertise in this area.

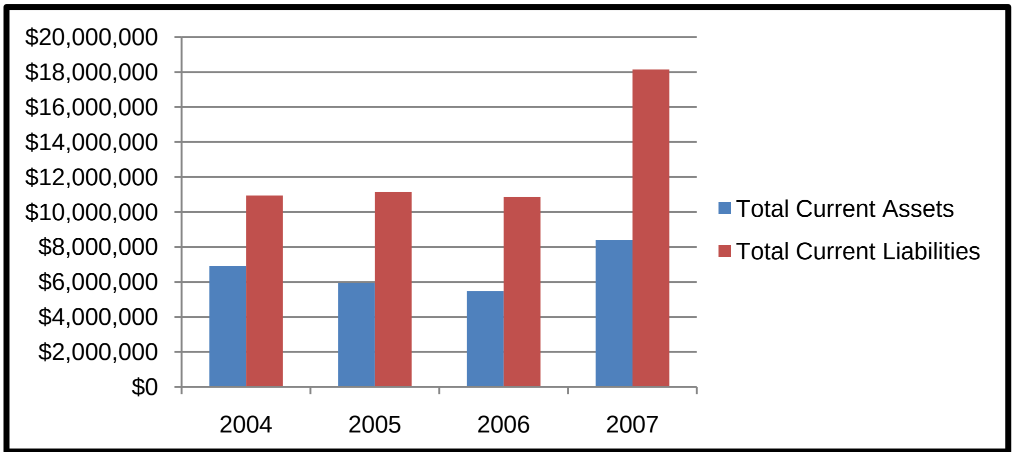
However, if DOE officials had performed an adequate financial review of Beyer's statements, they would have seen the financial instability of Beyer. The statements show that:

- Beyer's net income decreased 72 percent from Calendar Year 2006 to Calendar Year 2007, going from $1,451,866 to $399,904.
- In Calendar Year 2006, Beyer's total current liabilities (e.g., accounts payable, lines of credit, and notes payable) exceeded total current assets (e.g., cash, accounts receivable, and investments) by $5,369,554. In Calendar Year 2007, Beyer's total current liabilities exceeded total current assets by $9,745,462. Chart I shows the

comparison of Beyer's total current assets to total current liabilities for Calendar Years 2004 through 2007.

Chart I

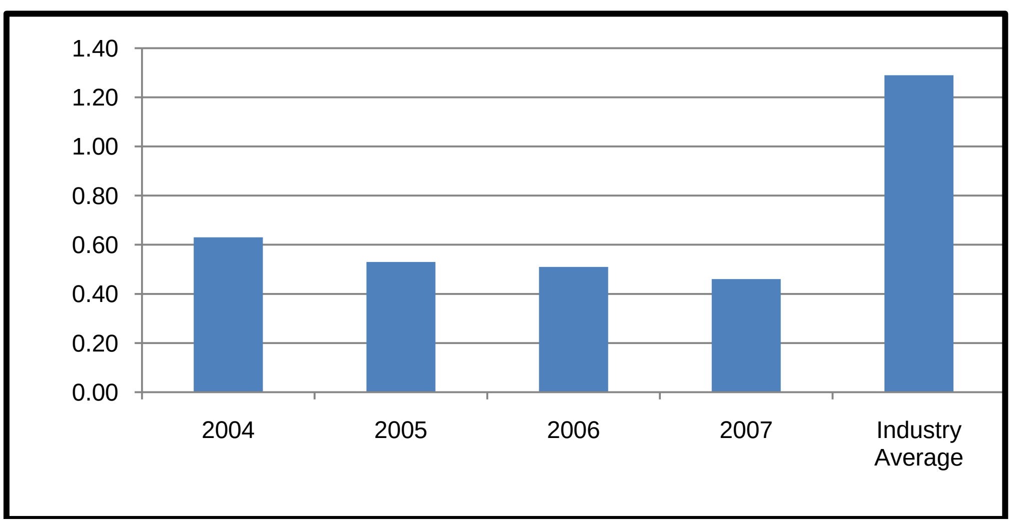
Comparison of Beyer's Total Current Assets to Total Current Liabilities for Calendar Years 2004–2007



- Beyer's current ratio (current assets divided by current liabilities) was 0.46 in Calendar Year 2007. According to businessdatascreener.com, the average ratio for food distribution companies between 2007 and 2012 was 1.29. A ratio far below 1.29 is an indication that a company may have trouble paying off its short-term obligations with its short-term assets. Chart II shows Beyer's current ratio for Calendar Years 2004 through 2007 compared to this industry average.

Chart II

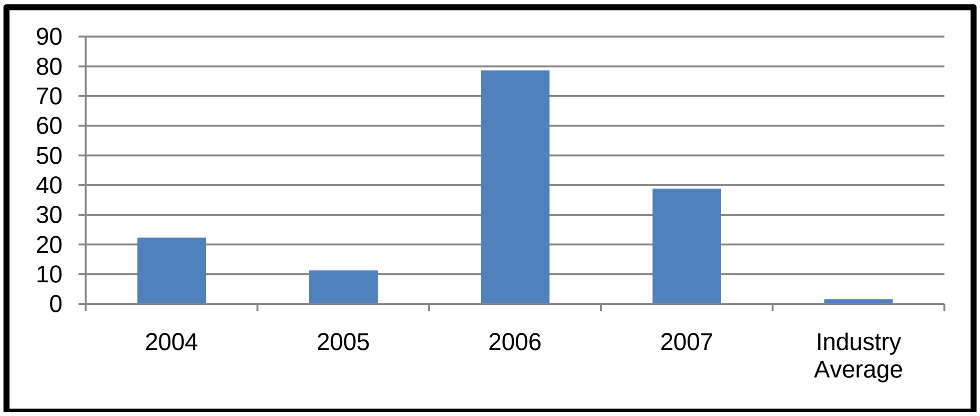
Beyer's Current Ratio for Calendar Years 2004–2007 Compared to Industry Average



- Beyer's debt-to-equity ratio (total liabilities divided by total ownership equity) in Calendar Year 2007 was 38.8. According to businessdatascreener.com, the average ratio for food distribution companies between 2007 and 2012 was 1.54. A ratio far above 1.54 is an indication that a company has been aggressive in financing its growth with debt, relying more on the capital of external lenders than on ownership capital. In other words, more of the company's assets were financed by debt than by equity. Chart III shows Beyer's debt-to-equity ratio for Calendar Years 2004 through 2007 compared to this industry average.

Chart III

Beyer's Debt-to-Equity Ratio for Calendar Years 2004–2007
Compared to Industry Average



DOE officials stated that DCP's Vendor Research unit also collects information regarding a vendor's financial condition from sources other than financial statements, such as Dun & Bradstreet (D&B), LexisNexis, and other commercial databases. They explained that "Beyer's D&B 'Supplier Risk Score' was '1' the lowest level of risk." We confirmed that the level of risk reported by D&B on July 20, 2008, was low. DOE officials also stated that Beyer's D&B "PAYDEX" score of 76 indicated that it was reasonably current in terms of paying its bills.[4]

However, our review of the LexisNexis report on Beyer (copyrighted 2008), which was in the contract file, indicated that Beyer used many of its assets as collateral for a variety of debt. These assets included accounts receivables, inventory, equipment, and fixtures. This is disconcerting because the Vendor Research unit indicated that there were no adverse findings based on the LexisNexis report. The LexisNexis report stated that there were 37 active Uniform Commercial Code (UCC) filings (a legal form that a creditor publicly files to give notice that it has an interest in the personal property of a debtor) involving financing transactions between Beyer and various lenders—three were lines of credit, and 34 were loans. According to Beyer's Calendar Year 2007 financial statement, current and long-term liabilities totaled more than $23.5 million. We believe that the information in the LexisNexis report should have prompted DOE to examine Beyer's financial standing in greater detail.

DOE officials stated that even though Beyer went bankrupt, it happened toward the end of the contract term. We acknowledge that the bankruptcy happened near the end of the contract

[4]The D&B PAYDEX is a dollar weighted indicator of a business's payment performance based on the total number of payment experiences in D&B's file. The D&B PAYDEX ranges from 1 to 100, with higher scores indicating better payment performance.

term. However, our review of the financial statements and the 2008 LexisNexis report on Beyer revealed that the vendor was not financially stable and that it was aggressive in financing its growth with debt. Therefore, Beyer was at a high risk for bankruptcy even at the onset of the contract term. Upon learning of Beyer's bankruptcy in December 2012, DOE was able to find two vendors to continue the distribution of milk to the schools without interruption. We believe that if DOE does not perform proper financial reviews on future milk contracts, there might be similar contract defaults that might not work out so favorably. Such defaults might occur much earlier in the contract period, and replacement vendors might not be as readily available or as willing as they were in this case to take on the remainder of the contract without a significant increase in the price. A disruption of milk deliveries to schools might also ensue.

DOE also stated that because the bankruptcy occurred towards the end of Beyer's contract term, DOE benefited from low prices for the milk distribution for the majority of the term. As stated in Section 2-05 of DOE's *Procurement Policy and Procedures*, however, the award of a contract to a vendor based on "lowest evaluated price alone can be false economy if there is subsequent default … resulting in additional contractual and administrative costs." It further states that while "it is important that DOE purchases be made at the lowest price, this does not require an award to a contractor solely because that contractor submits the lowest offer."

Due to Beyer's bankruptcy, DOE entered into two nine-month Buy-Against contracts—one with Bartlett to service schools in the Bronx and Queens and one with Elmhurst to service Brooklyn schools. These contracts had the same prices, terms, conditions, and requirements as the Beyer contract, except that Bartlett did not agree to the 2 percent prompt-payment discount to which Beyer had agreed. Nonetheless, DOE officials stated that DOE will deduct the loss of this discount from money owed to Beyer.

> ***DOE Response:*** "… it is our position that a more comprehensive analysis of Beyer's financial position at the time of award does not result in the black-and-white conclusion reached by the Comptroller. …
>
> "The Comptroller's analysis appears to have involved only two financial ratios (current ratio and debt-to-equity ratio) that were examined in isolation."
>
> ***Auditor Comment:*** DOE notes two ratios that we present in the report--the current ratio and the debt-to-equity ratio--but does not discuss two other indicators that we also present in the report. These are the 72 percent decrease in Beyer's net income between 2006 and 2007 and the extent to which total current liabilities exceeded total current assets, which rose from a differential of about $5.4 million in 2006 to a differential of about $9.7 million in 2007.
>
> ***DOE Response:*** "The Comptroller accurately states that Beyer's current ratio was 0.46, but then uses a ratio of 1.29 as its benchmark for comparison. … A comparison with a more appropriate benchmark, that is, the current ratio for Elmhurst, a company that was - and still is - the industry leader in the greater New York City area, would have yielded a result different from that reached by the Comptroller and would have shown that Beyer's current ratio was aligned reasonably well with that of its competitors, a particularly important consideration as the DOE was considering potential vendors from the limited pool of respondents and not the industry nationwide."
>
> ***Auditor Comment:*** For its analysis, DOE's decision to use the current ratio for Elmhurst as its benchmark is a curious choice because Elmhurst is known primarily for being a milk

producer, not for being a milk deliverer. In fact, during the preceding contract period between 2003 and 2008, Elmhurst did not have a milk delivery contract with DOE. Even under the 2008 contract, Elmhurst subcontracted all of the milk delivery for which it was awarded responsibility to Bartlett. Further, since Bartlett had 82 percent of the school milk delivery contract for the 2003 to 2008 period, DOE would have much more reasonably selected Bartlett's current ratio to be its benchmark. Had DOE compared Beyer's current ratio to Bartlett's, it would have found that Bartlett's current ratio for Calendar Year 2007 was 1.45, which was not only much better than Beyer's ratio of 0.46 (and Elmhurst's of 0.66), but also better than the benchmark of 1.29 that we used (the average ratio for food distribution companies).

DOE Response: "The Comptroller also points to Beyer's debt-to-equity ratio as a source of concern. Although the Comptroller accurately states that this ratio indicates the company 'has been aggressive in financing its growth with debt,' this does not necessarily mean a company is likely to fail. Notably, Beyer's year-to-year comparison shows an improving debt-to-equity ratio."

Auditor Comment: While Beyer's debt-to-equity ratio improved between Calendar Years 2006 and 2007, decreasing from 78.62 to 38.81, it followed a significant increase in the ratio between Calendar Years 2005 and 2006, going from 11.25 to 78.62. Therefore, within a three-year period, Beyer's debt-to-equity ratio fluctuated considerably and was, for the most part, significantly above the 1.54 benchmark (the average ratio for food distribution companies). On the other hand, Elmhurst's debt-to-equity ratios for Calendar Years 2005 through 2007 were 9.10, 6.79, and 9.42, respectively, while Bartlett's were 4.36, 6.14, and 3.28, respectively. Elmhurst's and Bartlett's ratios were clearly a great deal closer than Beyer's to the 1.54 benchmark.

DOE Response: "The DOE recognizes that current ratio and debt-to-equity ratios are important indicators. Nonetheless, they are by no means the only ones that can be considered in assessing a company's financial stability. When considering the ability of a company to repay its debts, another key metric is the 'times-interest-earned' ratio. Times-interest-earned is calculated by taking the company's income before interest and taxes and dividing that by the interest expense. It is a clear way to show, from the income statement, how readily a company can make its interest payments. In 2007, Beyer's times-interest-earned ratio demonstrated that it was generating income sufficient to meet the interest payments on its debt. Significantly, this ratio exceeded that of its competitor Elmhurst, an industry leader."

Auditor Comment: Not knowing the structure of Beyer's debt instruments (e.g., when full payments for the loans were due or whether the interest rates were fixed or adjustable) limits the significance of this indicator.

DOE Response: "Also an important consideration is the company's 'debt-to-assets ratio.' … the debt-to-assets ratio can readily show how heavily leveraged a company is. Beyer's debt-to-assets ratio in 2007 was comparable to that of Elmhurst's. Moreover, a historical review of this number shows an improvement in Beyer's financial position, with the ratio having decreased over the several years prior to 2007."

Auditor Comment: Since the debt-to-assets ratio is a comparison of total liabilities to total assets, one must consider the proportion of tangible and intangible assets that comprise the total assets in order to properly assess this ratio. Tangible assets are assets that can be physically identified, such as cash, equipment, inventory, real estate, and accounts receivable. On the other hand, intangible assets are non-monetary assets that have no physical existence, such as goodwill and brand and trade names. The market value of tangible assets is much easier to determine than is the market value of intangible assets. In addition, the liquidity of tangible assets is much higher than is the liquidity of intangible assets. As a result, a business operating with considerable debt and total assets consisting largely of intangibles is less likely to be able to pay its creditors.

Calendar Year 2007 financial statements for all three vendors showed that Bartlett's and Elmhurst's total assets did not include any intangible assets, contrary to Beyer's total assets of over $24.1 million, which consisted of intangible assets totaling about $13.5 million (56 percent) and tangible assets totaling about $10.6 million (44 percent). Including intangibles, Beyer's debt-to-assets ratio of 0.97 was comparable to Elmhurst's and Bartlett's ratios, which were 0.90 and 0.77, respectively. However, when intangible assets are excluded, Beyer's debt-to-assets ratio increased to 2.21, significantly exceeding the ratios of Elmhurst and Bartlett.

DOE Response: "The Comptroller acknowledged that the DOE's use of Dun and Bradstreet … indicated that Beyer was 'reasonably current in terms of paying its bills' *and that it had the lowest level of risk according to D&B's Supplier Risk Score*. Despite this, the Comptroller points to a 2008 Lexis/Nexis report identifying a number of collateralized assets (civil liens) as evidence that the DOE should have determined that the company was in financial distress."

Auditor Comment: We concur that the Beyer 2008 D&B report indicated that Beyer's PAYDEX score indicated that it was reasonably current in terms of paying its bills. However, the fact that a vendor is paying bills on time does not indicate, in and of itself, that a company is financially stable. If a company is meeting its payment obligations through a heavy use of debt, then good payment records are not surprising at all and are certainly not indications that the company is financially viable. As we previously pointed out, Beyer was much more heavily financed by debt than by equity, which increased the risk of bankruptcy. D&B's Supplier Risk Score, which predicts the likelihood that a supplier will cease business operations over the next 12-month period, is of limited significance when considering the financial viability of a company to handle its responsibilities over a five-year period.

DOE Response: "Financial responsibility is determined neither by any single source of information nor any single result obtained from a data source. The DOE collects information regarding a vendor's financial condition using multiple sources such as Dun & Bradstreet, Lexis/Nexis and other commercial databases."

Auditor Comment: We agree with DOE that a variety of financial data should be collected and reviewed when determining whether a vendor is sufficiently stable financially to handle a large DOE milk delivery contract. However, financial indicators should be viewed as a totality and not as separate indicators. The fact that some indicators are positive and some are negative should not necessarily lead one to be inconclusive about the financial stability of a company. If a negative indicator (such as a high debt-to-equity ratio) provides an explanation for a positive indicator (such as a company paying its bills on time), then such a positive is of limited significance.

DOE Response: "Moreover, the DOE generally does not focus on civil liens, but on liens and warrants filed by government entities, which might indicate a vendor's less-than-satisfactory attitude towards addressing its government obligations.

"The 'Vendor Review Work Sheet' from Beyer's background file, which was available to the Comptroller, clearly noted the existence of the civil liens."

Auditor Comment: DOE is incorrect in its statement that its Vendor Review Work Sheet noted the existence of civil liens. The only liens that the Work Sheet referred to were tax liens. We believe that both civil and government liens should be reviewed by DOE because they are indicators of a vendor's financial stability.

DOE Response: "The Comptroller further relies on a note by a DOE procurement analyst stating several possible sources of concern regarding the company's financial position. … However, those issues were weighed against additional information that supported a conclusion that Beyer was operationally and financially responsible. In fact, the DOE performed a site visit at Beyer's offices. … The DOE determined that the company had an efficient routing system and sufficient trucks and personnel to service the awarded areas.

"In addition, the vendor's past performance was given weight in the DOE's decision to award."

Auditor Comment: We did not find any evidence in the contract files that the financial concerns identified on a note written by a DOE Procurement Analyst were ever considered by DOE in its review of Beyer's financial stability. We were informed by the Chief Administrator of the DCP Food unit that the concerns of the Procurement Analyst did not prevent DOE from awarding a contract to Beyer because the Procurement Analyst, not being an accountant, lacked expertise in this area. Thus, we concluded that the note was given very little, if any, weight. We also question whether conducting a one-day site visit on the same day that a vendor is awarded the contract is a significant step in determining whether a vendor is financially responsible. Furthermore, we did not find any evidence in the contract files of the results of the site visit to Beyer.

However, although DOE and the auditors disagree on the indicators that should have been considered in analyzing Beyer's financial condition in 2008, we are encouraged by DOE's responses to the recommendations, which indicate that certain steps will be taken to address the concerns expressed in this report.

Recommendations

DOE should:

1. Develop and implement adequate written procedures that are sufficiently detailed to govern the review of the financial capacity of the lowest bidders for milk distribution contracts. The procedures should identify, among other things, the documents (e.g., financial statements) that should be reviewed; the tools (e.g., financial ratio and trend analyses) that should be used to determine the financial position of a vendor; and the criteria by which the financial standing of a vendor should be evaluated.

DOE Response: "While the DOE already has processes in place to determine the financial capacity of low bidders, it does not disagree with the recommendation to refine these procedures. A vendor's financial condition will continue to be considered among other relevant award criteria."

2. Ensure that the most current financial statements submitted by the lowest bidders on milk distribution contracts are certified by an independent CPA.

DOE Response: "The DOE agrees with this recommendation and will implement it beginning with the next milk distribution procurement."

3. Ensure that the contract files contain adequate evidence of the review of the financial capacity of the lowest bidders. This evidence should clearly support the assessment of the vendor that is contained in the RA.

DOE Response: "The DOE believes it sufficiently performed its due diligence regarding the financial capacity of the milk distribution vendors and that its files adequately reflect such. Nonetheless, we agree that more thorough summaries of its findings will present a clearer record of its decision-making in this regard. Beginning in fall 2011, the DOE expanded the details contained in its internal summaries to include more of the information uncovered during a responsibility determination."

4. Monitor the loss of the 2 percent prompt-payment discount in the Bronx and Queens to ensure that the loss is deducted from the money owed to Beyer.

DOE Response: "The DOE agrees with this recommendation."

DOE Lacks Adequate Procedures Designed to Detect the Warning Signs of Possible Collusion

DOE lacks adequate procedures designed to detect the warning signs of possible collusion. As a result, the risk that collusion could occur and go undetected is increased.

Bid rigging is a form of collusion intended to create the false appearance of competitive bidding. Through such a scheme, competitors coordinate their bids in an attempt to collectively control the market for a particular product. Once control is achieved, higher prices follow. Collusion is illegal and vendors colluding are subject to criminal prosecution by the Antitrust Division of the United States Department of Justice.

We identified various warning signs pointing to possible collusion (i.e., the coordination of bids) among some of the bidders for the milk distribution contracts, including:

- connections among the vendors;
- questionable bidding patterns; and
- a bidder being selected to serve as the subcontractor for two other bidders.

While these warning signs in and of themselves are not evidence that collusion actually occurred, we believe that these signs indicate that further review by DOE of possible collusion was warranted before it decided to award these contracts. We asked DOE officials whether they had written procedures designed to detect the warning signs of possible collusion. They stated that DOE employees are required to report suspicion of corruption or fraud to the Special Commissioner of Investigation (SCI). Moreover, they stated that SCI has provided contract management training to many DOE staff during the past two years and that this topic was a major emphasis of that training.

The Chief Administrator of the Vendor Research unit acknowledged that his unit does not have a written document listing the “red flags” to use as a guide when conducting the comprehensive background checks. He stated that he would be concerned about having a formal document listing all of the “red flags” because he believes that his staff might just pay close attention to the “red flags” identified on the list and overlook others not identified. The Chief Administrator further stated that determining whether a vendor is responsible is a “judgment call” and that some findings are adverse but not necessarily noteworthy. He stated that his unit looks for “anything that jumps up as an anomaly.”

The Chief Administrator of the DCP Food unit pointed out that even if there are adverse findings, a vendor could still be awarded a contract for various reasons, such as the vendor having already corrected the problems. However, the justifications must be noted in the RA. We found little evidence in the contract files that the warning signs of possible collusion that we noted were identified or reviewed by DOE. In addition, none of these signs were mentioned in the RA.

We discussed the issue of possible collusion with DOE officials. According to these officials, the bidding on the milk distribution contract was, in fact, competitive. They also stated that the price analysis that was conducted indicated that the prices offered by those awarded contracts were “excellent.” However, DOE provided insufficient evidence to support its contention that the prices that it obtained for these contracts were excellent. (This issue is discussed in further detail later in this report.)

Because DOE officials rely on the competitive bidding process to ensure that they receive services at the lowest prices, they should identify any warning signs of possible collusion, review them, and then explain and support their conclusions on the significance of the warning signs. The competitive process only works when competitors set prices honestly and independently.

Connections among Four of the Seven Bidders

We found certain connections among four of the seven bidders—Bartlett, Beyer, Derle, and Elmhurst. While these connections do not mean that collusion actually occurred, they created an environment in which the likelihood that some of the four vendors might have coordinated their bids was increased.

- The four bidders are located in close proximity to each other in Jamaica, Queens.

  The Chief Administrator of the Vendor Research unit stated that the close proximity of these vendors to one another was not significant because it is not uncommon for vendors in certain industries to be located in the same area.

- Three of the bidders (Bartlett, Beyer, and Derle) reported that they would use the fourth bidder (Elmhurst) as their milk processor.

  DOE officials stated that because Elmhurst is the only milk-processing vendor in the City, there is nothing unusual about all of these vendors using Elmhurst to process the milk.

- LexisNexis reports (copyrighted 2008) cited various financial obligations among some of the bidders. For example, a LexisNexis report on Bartlett revealed three active UCC filings involving financing transactions between Bartlett (debtor) and Elmhurst (secured party). The original filings dated back to 1996. In addition, the report revealed Bartlett as the owner of three vehicles, two registered in 2005 and the other in 2007, in which Elmhurst was one of the lien holders. A LexisNexis report on Elmhurst revealed Derle as the owner of three vehicles, registered in 1998, for which Elmhurst was the sole lien holder, and one vehicle, also registered in 1998, for which Elmhurst was one of the lien holders. A LexisNexis report on Beyer revealed one active UCC filing involving a financing transaction between Beyer (debtor) and Elmhurst (secured party). The original filing dated back to 2007.

  The Chief Administrator of the Vendor Research unit stated that these financial obligations are "relevant to consider but are not uncommon" in the milk industry. He further stated that "it's a judgment call." He explained that while he would note such obligations, he might conclude that they are not problematic.

- A LexisNexis report (copyrighted 2008) on Beyer identified the names of two executives. One individual was reported as being an owner but not an officer of the company, while the other individual was reported as being an owner as well as the chairman and chief executive officer. The individual who was reported as being an owner but not an officer of Beyer was identified as being the president of Derle on the Bidder Information Certification and Signature Page of Derle's bid. Thus, it appears that this individual was connected to both bidders at the time of their bid submissions.

  The Chief Administrator of the Vendor Research unit stated that his unit only conducts comprehensive background checks on vendors deemed by the DCP Food unit to be the lowest responsive bidders. According to DOE officials, it would be "extraordinarily wasteful to conduct background checks on bidders with little or no prospect of receiving an award." DOE did not conduct a background check on Derle because it was not the lowest bidder. However, because the Vendor Research unit is responsible for conducting comprehensive background checks on the lowest bidders, including their principal owners and affiliates, a more thorough review of one of Beyer's principal owners might have identified his connection to Derle.

While the first three connections might reflect milk industry practices, they nonetheless create an environment in which the likelihood of collusion is increased. The latter connection is more troubling in that a person who is an owner of one bidder and the president of another would very likely know the prices that each of the two bidders would be offering.

Questionable Bidding Patterns among Four Bidders

When comparing the total cost per milk container proposed by each of the seven bidders for each of the four largest quantity milk products, certain questionable bidding patterns emerged that indicated the possibility of collusion among some or all of the four vendors.

The bidding patterns for the Staten Island and Manhattan zones raise the most questions. Table I shows the comparison of the bids submitted by each of the seven vendors for the largest quantity milk product (a half-pint container of chocolate fat-free milk). These patterns were also present relative to the bidding for the other three large quantity milk products.

Table I

Comparison of the Bids Submitted by Each of the Seven Bidders for the Largest Quantity Milk Product

Half-Pint Container of Chocolate Fat-Free Milk							
Geographical Zone	Bartlett	Elmhurst	Beyer	Derle	Cream-O-Land	Maramont	Oak Tree
Manhattan	***$0.2422***	***$0.2283***	***No Bid***	***$0.2504***	No Bid	No Bid	No Bid
Bronx 1	$0.2422	$0.2283	$0.2050	$0.2404	No Bid	No Bid	No Bid
Bronx 2	$0.2422	$0.2283	$0.2050	$0.2404	No Bid	No Bid	No Bid
Queens 1	$0.2422	$0.2283	$0.2050	$0.2384	No Bid	No Bid	$0.2200
Queens 2	$0.2422	$0.2283	$0.2050	No Bid	No Bid	No Bid	No Bid
Brooklyn 1	$0.2422	$0.2283	$0.2050	$0.2404	No Bid	No Bid	No Bid
Brooklyn 2	$0.2422	$0.2283	$0.2050	$0.2404	$0.2232	$0.3095	No Bid
Staten Island	***$0.2230***	***$0.2383***	***No Bid***	***No Bid***	$0.2432	No Bid	No Bid

Neither Beyer nor Derle bid on the Staten Island zone, while Elmhurst raised its bid for Staten Island by one cent per container relative to its consistent bids for the other seven zones and Bartlett lowered its bid for Staten Island by approximately two cents per container relative to its consistent bids for the other seven zones. Bartlett won the contract. Had Elmhurst and Bartlett not adjusted their bids for the Staten Island zone, Elmhurst would have won the contract.

In Manhattan, Beyer did not bid on the zone, while Elmhurst and Bartlett maintained the same prices they offered in all of the other zones except Staten Island. Curiously, Derle raised its prices for each of the four largest quantity milk products by approximately one cent per container relative to its fairly consistent bids for five other zones. Despite these increases in prices, Derle still had the best price (by a very small margin) for one of these four products. However, had Derle not adjusted its bids upward, it would also have had the best bids in the Manhattan zone for two more of these four products. Nonetheless, Derle still would not have won the Manhattan contract due to the fact that its bids for the largest quantity product (a half-pint container of chocolate fat-free milk) in the other five zones were already significantly above Elmhurst's bid for Manhattan.

According to the Antitrust Division of the United States Department of Justice, bid rigging involves vendors agreeing in advance which vendor will submit the winning bid for a contract to be awarded through the competitive bidding process.[5] The losing bids are "complementary" rather than competing and "are not intended to secure the buyer's acceptance, but are merely designed to give the appearance of genuine competitive bidding." DOE officials argue that because it is normal for vendors to adjust their bids from zone to zone due to the unique challenges each zone can present and the individual circumstances of each vendor, the bidding patterns shown above do not present any indications of collusion. We continue to believe that the questionable bidding patterns shown above, in conjunction with the other indicators of

[5] *Price Fixing, Bid Rigging, and Market Allocation Schemes: What They Are and What to Look For*, Antitrust Division of the United States Department of Justice, http://www.justice.gov/atr/public/guidelines/211578.pdf, 24 Oct. 2007. Accessed 6 Aug. 2013.
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possible collusion presented in this section of the report, raise some concerns as to whether the vendors might have coordinated their bidding on these contracts.

One Bidder Selected to Be Subcontractor for Two Other Bidders

Bartlett, the vendor awarded the Staten Island contract, was selected by Elmhurst to be its subcontractor to deliver milk to Manhattan schools and by Beyer to be its subcontractor to deliver milk to schools in the Bronx and Queens. These developments raise further questions about the relationships among the vendors located in Jamaica, Queens.

On July 14, 2008, six days after the July 8, 2008, bid opening, Bartlett formally asked DOE to investigate Beyer's bid, claiming that Beyer approached Bartlett, among others, to potentially serve as subcontractors. However, Beyer did not disclose in its bid, as required, an intent to subcontract the milk delivery portion of its contract. Bartlett cited Beyer's failure to do so as one of the reasons its bid should be rejected. Bartlett followed up on this issue by filing a complaint on September 12, 2008, with SCI for the New York City School District claiming that if an investigation of Beyer is not conducted, then Bartlett intended to pursue all of its legal and administrative options. On September 15, 2008, SCI referred the matter to DOE's Office of Special Investigations, which on September 18, 2008, referred the matter to DOE's Office of Legal Services. On October 1, 2008, the Chief Administrator of the DCP Food unit sent an e-mail to various DOE officials stating that the inquiries of Bartlett regarding Beyer were reviewed during the "evaluation process and DCP found no irregularities with Beyer's bid. We, therefore, proceeded making an award to Beyer as they were the lowest responsible bidder for 6 of the 8 geographical award areas."

The milk distribution RFB required that a bidder provide notice by the time of the bid opening if it intended to use a subcontractor. The bids were submitted by Beyer on July 3, 2008, and by Elmhurst on July 7, 2008. Originally, Elmhurst wanted to use Derle as a subcontractor. There was an August 25, 2008, letter from Elmhurst to DOE requesting permission to subcontract the actual delivery of the milk to Derle. Elmhurst's justification was that Derle had served the City schools for over 20 years and had "been a distributor of Elmhurst since 1996." Subsequently, however, Elmhurst changed its mind and decided to use Bartlett as its subcontractor rather than Derle. There was an October 9, 2008, letter from Elmhurst to DOE requesting permission to use Bartlett as its subcontractor for Manhattan. Elmhurst's justification was that Bartlett had successfully delivered milk to the City schools for the previous 10 years. In addition, there was an October 10, 2008, letter from Beyer to DOE asking for permission to use Bartlett as its subcontractor for Queens and the Bronx.

On October 15 and 17, 2008, the DCP Executive Director informed Elmhurst and Beyer, respectively, that their requests to subcontract with Bartlett for the delivery of milk had been approved. Consequently, the subcontracting resulted in Bartlett being responsible for delivering milk to almost 70 percent of the City's schools within four boroughs, including the borough of Staten Island for which it had already been awarded the primary contract. Prior to the subcontracting, Bartlett was only responsible for delivering milk to about 6 percent of the City's schools.

The Chief Administrator of the Vendor Research unit stated that a bidder being selected as the subcontractor for two other bidders is something "worth noting," but does not necessarily indicate collusion. Other DOE officials stated that they saw nothing wrong with the subcontracting as long as the vendors received the necessary DOE approvals. They also explained that because Bartlett had already performed services (supplying and delivering milk to about 80 percent of the City's schools under the previous milk contract), they were content with having Bartlett serve as the milk delivery subcontractor for three boroughs. The DCP Executive Director stated that because Bartlett was awarded a primary contract for only one zone, the vendor ultimately "needed to do what it had to do" in order to financially survive, even if it involved subcontracting.

According to the Antitrust Division of the United States Department of Justice, subcontracting arrangements are often part of a bid-rigging scheme. In this scheme, certain "competitors" agree in advance either not to bid or to submit a losing bid. In return, these "competitors" might receive subcontracts from the successful low bidder. Although it might appear that Bartlett was an entirely independent bidder for the milk contracts in that it initially contested Beyer's bid, in the end Bartlett received all of the milk delivery subcontracts awarded by Beyer and Elmhurst.

Prior Instances of Collusion

There were prior instances of collusion among two of the vendors awarded milk contracts. Specifically, a 2008 Dun & Bradstreet report on Elmhurst in the contract files stated that on November 9, 1981, Elmhurst and 15 other milk distributors were indicted by Grand Juries of the State of New York for violations of Sections 340 and 341 of the General Business Law of New York. The indictment issued by the Supreme Court of the State of New York for the County of Kings against the milk distributors included Elmhurst and Beyer as two of the milk distributors charged with "the crime of combination in restraint of trade and competition" (i.e., of conspiring to fix prices and allocate customers). According to court records we obtained from the Kings County Clerk's Office, Elmhurst and Beyer pled guilty to the charges on November 18, 1982; Elmhurst paid a fine of $40,000, while Beyer paid a fine of $10,000.

The Elmhurst Vendor Review Work Sheet (Work Sheet) prepared by the Vendor Research unit reported the Elmhurst conviction. However, neither the Elmhurst Work Sheet nor the RA included an explanation as to why the Elmhurst conviction was not deemed by DOE to be a concern. When we questioned the Chief Administrator of the unit about this, he stated that although the finding was worth noting, the case was so old that it was not a significant issue. The Chief Administrator again explained, "It's a judgment call." We do note, however, that the summary prepared by the Vendor Research unit for the 2012 Elmhurst Buy-Against contract reported the conviction and detailed the reasons it was not a concern for DOE. Specifically, DOE determined that there were no key personnel at Elmhurst in 2012 who were also key personnel at Elmhurst in 1981. (Our review also found that there were no key personnel at Elmhurst in 1981 who were also working at Elmhurst in either 2008 or 2012 when the original and Buy-Against contracts, respectively, were awarded.) Therefore, DOE concluded in 2012 that the 1982 conviction did not affect its determination that Elmhurst was a responsible vendor.

More troubling, however, is the fact that we found no information or assessment in the Beyer contract files about the Beyer conviction. The 2008 D&B report on Beyer and data in the City's Vendor Information Exchange System (VENDEX) indicate that an individual reported as being a Beyer official in 2008 had worked there since 1977. There is no evidence that DOE considered the implications of this person continuing to work at Beyer in 2008 when determining whether Beyer was a responsible vendor.

> ***DOE Response:*** "Having brought to the process their prior experience with milk distribution procurements, the DOE managers understood that geographical clustering among the bidders is the way business is done when there is only one milk processor (Elmhurst) in New York City capable of supplying milk in the quantities required by the DOE … And so,

that the milk distributors' operations were located in proximity to the milk processing plant was deemed by DOE managers to be suggestive of pragmatic business decisions that would drive cost efficiencies.

"With regard to the financial obligations, and using prior experience as the guide, it is not uncommon for businesses within an industry to sell machinery or lease space to one another depending upon their respective volume of business at any given time."

Auditor Comment: In its response, DOE treats each indicator separately and then questions whether it, as a stand-alone consideration, is an indicator of possible collusion. DOE fails to recognize that it is the sum total of the indicators of possible collusion that raises concerns, not any one indicator in and of itself. Furthermore, DOE's discussions of these specific indicators of possible collusion have several shortcomings.

For example, concerning the geographical, operational, and financial connections among the bidders, DOE fails to recognize that while these connections do not mean that collusion actually occurred, they created an environment in which the likelihood that some of the four vendors <u>might</u> have coordinated their bids was increased.

DOE Response: "Seeing as the Department often receives several bids that will never be acted upon for each bid that results in a contract, we take the position that expending resources to perform background checks on losing bidders would not be prudent."

Auditor Comment: DOE's failure to identify the connection between Beyer and Derle (i.e., that in 2008 one of the owners of Beyer was also the president of Derle) cannot be attributed to DOE's reasonable policy of not performing a background check on a losing bidder (such as Derle). Rather, the failure can be attributed to the inadequate background check that DOE conducted on a *winning* bidder (Beyer). Had DOE conducted a more thorough background check on the owners of Beyer, the connection between Beyer and Derle might have been discovered.

DOE Response: "The DOE does not believe the bidding pattern surrounding the Staten Island geographical zone rises to the level of concern the Comptroller ascribes to it. That the bids were not consistent among the distributors within the zones was viewed as expected when bidders factor in transport logistics, such as traffic congestion and parking, and incidental expenses, such as tolls. Similarly, it is not at all unusual for bidders to bid only certain areas."

Auditor Comment: We continue to believe that these patterns, in conjunction with all of the other indicators presented in this report, raise concerns of possible collusion.

DOE Response: "… the Report references a complaint by Bartlett surrounding Beyer's bid. That complaint, which was referred by the DOE to the Office of the Special Commissioner of Investigation for the New York City School District (SCI) was referred back by SCI to the DOE where it was reviewed. Not only do these facts demonstrate that the DOE did, in fact, perform due diligence in this matter, but the fact that Bartlett complained to the DOE about Beyer's bid does not support a conclusion that the two vendors may have engaged in collusion. We also note that the Comptroller's analysis ignores the fact that the vendors were forthright about their intentions and requested the necessary approvals which enabled the DOE to address any concerns that those requests might have presented at that time."

Auditor Comment: We believe that DOE needs to be more cautious about subcontracting arrangements as they can be part of a bid-rigging scheme whereby certain "competitors" agree in advance either not to bid or to submit a losing bid and, in return, receive subcontracts from the successful low bidder. In this case, Bartlett was awarded the responsibility for delivering milk to the schools in four boroughs—in Manhattan, Queens, and the Bronx through its subcontracts and in Staten Island through its primary contract.

DOE Response: "… in 1982, Beyer and Elmhurst pleaded guilty in their corporate capacities to charges of 'combination in restraint of trade and competition' and were fined $10,000 and $40,000, respectively. The Comptroller acknowledges that this matter was referenced in the Elmhurst file in 2008, and that in 2012, by way of explaining why the conviction did not preclude a contract award, the file included that 'there were no key personnel at Elmhurst in 2012 who were also key personnel at Elmhurst in 1981.' … While it is true that the Beyer file did not contain information regarding the conviction, the inclusion of that information in the Elmhurst file and the fact that both vendors were receiving awards under the same milk bid, demonstrates an awareness of the matter by the DOE. Furthermore, while a change in management, as was the case with Elmhurst, is a significant mitigating factor when making a responsibility determination under these circumstances, the continued presence of the Beyer employee is mitigated by the fact that, at the time of the 2008 award, Beyer had operated for more than twenty years without any further implication in collusive activities."

***Auditor Comment*:** DOE incorrectly states that both the Elmhurst and Beyer convictions were referenced in the 2008 Elmhurst contract file. In fact, there was no evidence in either the Elmhurst or Beyer contract files that DOE was aware of the 1982 Beyer conviction. We became aware of the Beyer conviction only through our own research, not from any information in DOE's contract files on Elmhurst or Beyer. We found the actual indictments of Elmhurst and Beyer on the American Bar Association website and obtained court records on the convictions from the Kings County Clerk's Office. Therefore, it appears that when DOE determined in 2008 that Beyer was a responsible vendor, it was unaware of the Beyer conviction and of the fact that an individual reported as being a Beyer official in 2008 had worked there since 1977.

In summary, we are concerned that DOE failed to identify the connection between Beyer and Derle and that it was apparently unaware of the prior conviction of Beyer for combination in restraint of trade and competition. More fundamentally, we are concerned that DOE appears to evaluate each indicator of possible collusion as a separate issue rather than evaluate the significance of the sum total of the indicators. Nonetheless, we are encouraged by DOE's responses to the recommendations, which indicate that certain steps will be taken to address the concerns expressed in this report.

Recommendations

DOE should:

5. Seek assistance from various sources, such as the Antitrust Division of the United States Department of Justice, to research and identify the warning signs of possible collusion.

DOE Response: "That the Comptroller disagrees with the DOE's analysis, and possibly the conclusions, does not mean such an analysis was not performed. The DOE will continue to seek assistance from appropriate sources as applicable."

6. Develop and implement adequate written procedures that are sufficiently detailed to detect the warning signs of possible collusion. The procedures should include, among other things, the different forms of collusion that could exist; the patterns of bidding that might arouse suspicions; conditions favorable to collusion; and the steps to be taken when the possibility of collusion has been identified (such as requesting and reviewing any subcontracts between the primary contractors and competing bidders).

DOE Response: "The DOE agrees that procedures can be created addressing the warning signs of collusion."

7. Ensure that the comprehensive background checks on the lowest bidders include, among other things, a review of not only the vendors but also of the owners, executives, and affiliates listed on the Bidder Information Certification and Signature Page of the bid and in the background reports it obtains from LexisNexis and others.

DOE Response: "The DOE's process, as evidenced by documentation provided to the Comptroller, already includes a review of the prime vendor, owners, executives, and affiliates."

Auditor Comment: We acknowledge that DOE's process includes a comprehensive background review of the winning bidders' owners, executives, and affiliates identified on the bids. However, we do not believe that DOE fully understands the intent of our recommendation. DOE's process should include a review of not only the owners, executives, and affiliates identified on the winning bids but also those listed on other key reports it reviews, such as those from LexisNexis and Dun & Bradstreet.

For example, Beyer's bid identified two executives: the president and the secretary. DOE appropriately conducted background checks on these two executives. However, the 2008 LexisNexis report on Beyer in the Beyer contract file referred to an additional individual as an owner of the company. DOE did not conduct a background check on this individual. Upon further review, we found that this owner was identified on Derle's bid as being the president of the company. Had DOE conducted background checks on the additional owners, executives, and affiliates listed on the other key reports it reviewed, this connection between Beyer and Derle might have been identified. Accordingly, we reaffirm our recommendation.

8. Identify any warning signs of possible collusion, review them, and then explain and support its conclusions relative to their significance.

DOE Response: "Since fall 2011, the Vendor Research and Price Analysis Unit expanded the summary document prepared at the conclusion of background checks so as to more fully describe the information discovered during that process."

Flawed Price Analysis

DOE officials insist that they obtained excellent prices from the selected vendors. A 2008 price analysis by DOE included in the approved RA showed that the average annual milk cost of the prior contracts between Fiscal Years 2004 and 2008 would rise by 37 percent under the new contracts. DOE stated that this compared favorably to the 81 percent increase in the cost of a one-half pint container of 1 percent low-fat milk during this five-year period. However, the 81 percent increase only relates to the cost of converted raw milk and does not include additional processing, packaging, transportation, profit margin, and other associated costs, which constitute about 50 percent of the per-container prices the vendors charge DOE. DOE provided no information on increases in these additional costs during the five-year period. Comparing the increase in total costs to the increase in the cost of converted raw milk is a flawed analysis.

To compound matters, the indices calculated by DOE were not comparable to each other. To determine the increase in annual milk costs, DOE compared the average cost during the prior contract period (Fiscal Years 2004 to 2008) to the anticipated annual cost of the first year of the new contracts (Fiscal Year 2009). To determine the increase in converted 1 percent low-fat raw milk prices, however, DOE used a different approach. DOE compared the milk prices for just two points of time: March 2003 (which preceded the prior contract period) and April 2008 (which was toward the end of the prior contract period). DOE then mistakenly compared its calculated increase in annual milk costs to its calculated increase in converted raw milk prices despite the fact that they were calculated in different ways (the former using an average annual cost over five years as the base cost and the latter using the milk price at a particular point in time prior to the five-year period as the base price). Had DOE calculated the increase in the annual milk cost from the first year of the prior contract (Fiscal Year 2004) to the first year of the new contract (Fiscal Year 2009), which would have been roughly comparable to the method it used to calculate the increase in converted raw milk prices, it would have seen that annual costs would increase by 52 percent, not by 37 percent.

Another 2008 price analysis by DOE found in the contract files showed that the annual cost would increase by 18 percent between Fiscal Year 2008 (the last year of the prior contracts) and Fiscal Year 2009 (the first year of the new contracts). This significant increase alone raises doubts about DOE's assertion that it obtained excellent prices for these contracts. Furthermore, DOE's analysis showed that the annual cost would increase between 11 and 36 percent in the three boroughs in which a subcontractor (Bartlett) would deliver the milk (the Bronx, Manhattan, and Queens), but would only rise 3 to 4 percent in Brooklyn and would actually fall 10 percent in Staten Island—the two boroughs in which the primary contractors would deliver the milk. This analysis raises questions as to whether anticipated subcontracting costs for the primary contractors and subcontracting revenue for the subcontractor factored into the prices that the bidders submitted.

Recommendation

9. DOE should ensure that it uses comparable indices in its contract price analyses.

DOE Response: "The DOE concurs with the recommendation."

DETAILED SCOPE AND METHODOLOGY

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. This audit was conducted in accordance with the audit responsibilities of the City Comptroller as set forth in Chapter 5, §93, of the City Charter.

The scope of this audit covers the period from April 2008 through June 2013.

To obtain an understanding of DOE's responsibilities and regulations governing the awarding of food distribution contracts, we reviewed the following:

- Various DOE procurement documents, including its *Procurement Policy and Procedures*, effective January 27, 2010, and its *OTPS Standard Operating Procedures*, effective July 2008;
- The Office of the City Comptroller's Directive #1, Principals of Internal Control; and
- DOE's Calendar Year 2011 Agency Financial Integrity Statement and Checklist.

In addition, we reviewed a report issued on December 13, 2011, by the Office of the City Comptroller, entitled *Audit Report on the Department of Education's Food Distribution Vendor Contracts,* and a report issued on February 4, 2004, by the Special Commissioner of Investigation for the New York City School District, entitled *Investigation Report on Problems with Food Procurement within the NYC Department of Education*.

To obtain information about DOE's awarding of milk distribution contracts during the audit scope period, we reviewed the following:

- The Request for Bids, Serial #BO708, that was issued by DOE in May 2008 for the supply and delivery of milk, along with associated amendments;
- The approved Request for Authorization for the three vendors awarded the milk distribution contracts in August and September 2008;
- The approved RA for the two vendors awarded the Buy-Against milk distribution contracts in December 2012;
- The milk distribution contracts with Beyer, Elmhurst, and Bartlett for the period from November 1, 2008, through August 31, 2013; and
- The Buy-Against contracts with Bartlett and Elmhurst.

We reviewed the Division of Contracts and Purchasing and the Office of School Support Services of School Food organization charts provided to us by DOE and identified the officials and units involved in the awarding of food distribution contracts. Next, to gain an understanding of the responsibilities of these officials and the controls in place in relation to the contract award process, we interviewed various DCP officials, including the Executive Director; the Chief

Administrators of the Transportation, Food, and Facilities; Innovation and Vendor Resources; Vendor Research and Price Analysis; and Policy and Public Affairs units; and the Director and two Procurement Analysts in the DCP Food unit. In addition, we interviewed various School Food officials, including the Director of Contract Management and the Contract Manager. We also conducted a walk-through of the DCP bid opening unit where RFBs are received, date and time stamped, recorded in a log, and stored in a secure place until the bid opening.

We interviewed various officials in DOE's Office of the General Counsel, including the Director of the Office of Special Investigations and the Deputy Counsel of the Office of Legal Services, to gain an understanding of how a complaint made by one of the milk distribution bidders against another bidder was investigated and resolved.

We documented our understanding of the food distribution RFB and contract award processes in written narratives and prepared a detailed flowchart illustrating these processes up to the point of contract registration with the Office of the City Comptroller. To ensure that our perception of the processes and controls was accurate and complete, we verified our understanding with DOE officials. We then assessed the processes and controls to determine whether DOE properly segregated duties and had properly identified and addressed areas of potential risk.

To assess the reliability of the contract data obtained from DOE's Contract Tracking System (CTS) for the three milk distribution vendors, we obtained the actual contracts from the DCP Food unit for each of these vendors and compared the estimated contract amounts recorded in CTS to the amounts recorded in the actual contracts.

We verified that the contracts were registered with the Office of the City Comptroller by reviewing the Comptroller's Office Omnibus Automated Image Storage and Information System (OAISIS). We also reviewed VENDEX for the results of any contract performance evaluations conducted by City agencies on the vendors and any cautionary information provided by City agencies and law enforcement organizations on the vendors.

In addition, to ensure that the two Buy-Against milk distribution contract awards were handled properly, we verified that they were registered with the Office of the City Comptroller and that they were published in the City Record and on the DOE website within 30 days after registration.

We reviewed all of the documents in the hard-copy contract files of the DCP Food, bid opening, Vendor Research, and School Food units for each of the milk distribution vendors—Beyer, Elmhurst, and Bartlett. We noted the date of each document, the type of document, the key information contained in the document, and the names of DOE officials, external persons, or business entities mentioned in the document. Next, we assembled the information in chronological order. Our purpose was to determine whether the files contained the required documentation in support of DOE's awarding of the contracts, including the following:

- Solicitation;
- Pre-bid conference attendance sheet;
- DOE answers to the questions posed by prospective bidders;
- Vendors' responses to the solicitation;

- Bid tabulation;
- Requests for and results of comprehensive background checks (e.g., in LexisNexis);
- Correspondence (e-mails, memos, letters) between DOE and bidders regarding requests for documentation;
- Correspondence among DOE officials about the past performance of vendors;
- Inspections of bidder's and/or subcontractor's premises; and
- Authorizations for the awards.

In addition, we ascertained whether DOE's RFB and award processes were followed in the proper sequence.

We reviewed the bids for the milk distribution contracts submitted by the seven vendors. The vendors were required to provide certain information on Bid Blanks for each of seven milk products, including the number of milk containers per case, the proposed milk brands, the unit prices per container, and the delivery mark-up prices per case.[6]

For every product on each Bid Blank, we calculated the total cost per milk container by dividing the delivery mark-up price per case by the number of containers per case and then adding this amount to the unit price per container. We then calculated the monthly cost by multiplying the total cost per milk container by the monthly quantities of containers that would be needed as estimated by DOE. We added the monthly costs for the seven milk products and compared this total monthly amount to what was actually recorded on the Bid Blank by the vendor for the geographical zone. We identified any discrepancies.

In addition, we reviewed DCP's bid tabulation. We determined whether the monthly bid prices recorded on the tabulation for each vendor were accurately derived from the prices recorded on the Bid Blanks. We then determined whether the lowest bidder for each geographical zone was selected by DOE.

Based on information recorded on the Bid Blanks, we analyzed the vendors' bid prices to determine whether there were any unusual bidding patterns that suggested the possibility of bid rigging, a form of collusion that undermines the competitive bidding process. We also reviewed whether there were any interrelationships among the bidders.

We developed a checklist of documents required to be submitted by the vendors as part of their bids and verified the submission of these documents. Our purpose was to determine whether the three vendors that were awarded milk distribution contracts were, in fact, responsive to the RFB. The documents included the following:

- Evidence of prior experience and ability to perform;
- Evidence that the bidder had adequate equipment and organization to ensure prompt and efficient service;

[6] For each geographical zone, bidders were required to bid on the following seven milk products: one-half pint container of whole milk, one-half pint container of low-fat milk, one-half pint container of skim milk, one-half pint container of chocolate fat-free milk, one quart container of whole milk, one quart container of heavy cream, and one quart container of half and half.

- Affirmation that the bidder did not owe any City taxes and was not a defaulter on any City contracts;
- General company information, including the company address, telephone number, contact person, and federal tax identification number;
- Certification of general, automobile, worker compensation, and employer liability insurance;
- Detailed executive information, including the names of the president, secretary, and treasurer;
- Affidavit from an authorized representative attesting that the declarations in the bid were true; and
- Name and address of the vendor that was to supply the bidder with the milk products.

We reviewed the financial capacity of the three bidders awarded milk distribution contracts. We determined whether DOE had requested and reviewed financial statements from each of the three bidders for the previous three years (i.e., Calendar Years 2005, 2006, and 2007) and whether the financial statements for Calendar Year 2007 were certified by an independent Certified Public Accountant as required by §1.24 of the RFB.[7] In addition, we analyzed the information presented in the financial statements for the previous years, including total current assets (e.g., accounts receivable), total current liabilities (e.g., accounts payable), ownership equity (e.g., retained earnings), income (e.g., net sales), salaries and wages, and net income/loss. To help us analyze the data to determine the financial position of the bidders, we used tools such as financial ratio and trend analyses.

We reviewed the approved RA and determined whether DOE performed an adequate price analysis (e.g., comparing proposed prices to prior contract prices or to current market prices) prior to the awarding of the milk distribution contracts to ensure that the bid prices were fair and reasonable.

To obtain a better understanding of the vendors' responsibilities, we observed the delivery of milk to four schools on January 8, 2013; February 1, 2013; and February 11 and 12, 2013. We obtained from School Food a list of schools in each borough that showed for each school the days of the week that milk was delivered. We judgmentally selected Murry Bergtraum High School in Manhattan and randomly selected Public School 71 in Queens, Public School 50 in Staten Island, and Junior High School 62 in Brooklyn for these observations.

[7] The financial statements consist of the balance sheets (i.e., assets, liabilities, and ownership equity) and income statements (i.e., revenue and expenses) pertaining to a vendor's operations.

DOE Milk Distribution Contract Award Process

The milk distribution contract award process begins when DOE's Transportation, Food, and Facilities unit in the Division of Contracts and Purchasing makes a determination via DOE's Contract Tracking System that a food distribution contract is going to expire within one year. DOE's Office of School Support Services Division of School Food is then responsible for developing the specifications for the items to be included in the Request for Bids. At this point, the DCP Food unit (of the Transportation, Food, and Facilities unit) adds the standard terms and conditions for the RFB and works in conjunction with School Food to fine-tune the specifications to ensure that the RFB language is cost effective for DOE. Once the RFB language is finalized by both parties, the DCP Food unit prepares the Executive Summary in order to release the RFB solicitation to the public. After the Executive Summary has been approved by the Chief Administrator of the DCP Food unit, the DCP Executive Director, and the DOE Chancellor, the DCP Food unit then prepares the RFB for public release. Finally, once the RFB has been approved by DOE's Office of the General Counsel, it can be made public.

DOE's Innovation and Vendor Resources (bid opening) unit in DCP is responsible for publishing the RFB in the City Record and on the DOE website. All prospective bidders interested in the RFB must register with the DOE website in order to download it. The DCP Food unit then contacts prospective bidders who downloaded the RFB to invite them to attend a pre-bid conference. This conference gives them an opportunity to discuss the procurement requirements outlined in the RFB with School Food and the DCP Food unit. All questions or comments posed by the prospective bidders are to be addressed by the DCP Food unit and posted on the DOE website. The DCP Food unit is responsible for making any necessary amendments to the RFB, which might result in a revised RFB-submission date. The amendments are then mailed to all prospective bidders and posted on the DOE website.[8]

Bidders are required to submit their completed RFBs either by mail or in person to the DCP bid opening unit before the RFB submission due date and time. Once the bids are received, they are date and time stamped, recorded in a log, and stored in a secure place until the bid opening. This event is attended by the general public, bidders, and the DCP bid opening unit. Information from each submitted bid, including each bidder's name and bid price, are read aloud and recorded by the DCP bid opening unit. The recorded information and the submitted bids are then forwarded to the DCP Food unit where a tabulation of the bids is prepared and the lowest bidder is selected.[9]

The DCP Executive Director then makes a determination as to whether the lowest bidder is responsive based on the results of the review conducted by the DCP Food unit. A responsive bidder is one that complies with all significant terms, conditions, and requirements of the solicitation (e.g., provides certifications of bidder information; affirmations of having no City tax debts; certifications of general, automobile, worker compensation, and employer liability insurance; and samples of food items for inspection).

Once the lowest bidder is deemed responsive, the DCP Food unit completes a Vendor Responsibility Check Form requesting that DOE's Vendor Research and Price Analysis (Vendor Research) unit in DCP conducts a comprehensive background check. This check includes reviewing VENDEX and other sources of background information on the bidder, principal

[8] Any significant amendments must first be approved by the Office of the General Counsel prior to release.

[9] If there is a tie between the two lowest bidders, the DCP Executive Director must select a bidder in the following order of preference: New York City bidder, New York State bidder, or the bidder selected through a drawing.

owners, and affiliates, including LexisNexis, Westlaw, Dun & Bradstreet, Hoovers, ChoicePoint, and the Federal Debarment List. The results of the background check are then submitted to the DCP Food unit.

If the lowest bidder had a previous food distribution contract with DOE, the DCP Food unit then requests for School Food to provide a statement regarding the bidder's past performance. In addition, School Food and the DCP Food unit may decide to inspect the bidder's and/or subcontractor's premises to determine if the facilities and equipment comply with the RFB as well as with Federal, State, and City health codes. Based on the results of the background check, the bidder's past performance, and the inspection of the premises, the DCP Executive Director then makes a determination as to whether the lowest responsive bidder is responsible. A responsible bidder is one that has the capacity (e.g., the financial and personnel resources) to fully perform the contract requirements and has the necessary business integrity. Finally, prior to awarding the contract, a price analysis (e.g., comparing proposed prices to prior contract prices or to current market prices) is conducted by either DCP's Food or Vendor Research unit to determine whether the bid price is fair and reasonable.

Once the contract award decision has been made, the DCP Food unit prepares the Request for Authorization, which documents the procurement process, determinations, and approvals associated with the award. After the Request for Authorization has been approved by the Chief Administrator of the DCP Food unit, the DCP Executive Director, the Chief Executive Officer of School Food, the DOE General Counsel, the DOE Contract Compliance Officer of the Office of Equal Opportunity, and the DOE Chancellor, the contracts can be awarded and sent to the Office of the City Comptroller for registration.

Department of Education

Dennis M. Walcott
Chancellor

Kathleen Grimm
Deputy Chancellor

October 9, 2013

Honorable H. Tina Kim
Deputy Comptroller for Audit
The City of New York
Office of the Comptroller
One Centre Street
New York, NY 10007-2341

Re: Audit Report on the Department of Education's Awarding of Milk Distribution Contracts (ME12-093A)

Dear Ms. Kim:

This letter submitted on behalf of the New York City Department of Education ("DOE"), with the attached response to recommendations ("Response"), constitutes this agency's formal response to the City of New York Office of the Comptroller's ("Comptroller") draft audit report titled *Audit Report on the Department of Education's Awarding of Milk Distribution Contracts.* ("Report").

The audit, the scope of which morphed during implementation from the DOE's award of food distribution contracts to a focus only on milk, began with an entrance conference held on December 8, 2011. At that time, the milk contracts had been active for a little over three years. Now, nearly two years later, we are responding to a Report that raises two points, the first concerning the DOE's examination of one of the winning bidder's fiscal viability and the second concerning the DOE's response to indicia of "the warning signs of possible collusion" among the bidders – at least as perceived by the Comptroller. As the DOE's position relative to those issues is addressed fully in the appended *Response to Recommendations and Findings,* the objective of this letter is to provide context.

The Office of SchoolFood ("SchoolFood") is responsible for managing the DOE's food service program ensuring that safe, nutritious, and appetizing meals are available to New York City students. Staff within SchoolFood design the breakfast, lunch, snacks and supper menus; select the components and ingredients that make up each meal; and place orders with contracted distributors according to the required quantities. They also perform tests to ensure that the food provided under the DOE's meal programs meet the highest health and taste standards.

SchoolFood currently provides approximately 850,000 meals a day to schoolchildren within the five boroughs at over 1,200 locations each day of the school year and at over 1,000 locations during the summer months. SchoolFood seeks to increase participation by offering more nutritious and delicious breakfast, lunch, snack and supper meals, and to develop healthy eating habits within the student body. The breadth of products purchased by the DOE for the Food Program includes frozen foods, fresh produce, grocery, milk, baked goods and non-food related kitchen items.

During School Year 2012-2013, SchoolFood purchased over 100 million half pint containers of milk, all produced and manufactured locally in New York, which were consumed in our breakfast, lunch, afterschool, holiday and weekend programs. Most schools have multiple deliveries each week between the hours of 7:30 AM and 1:30 PM, some daily. Milk is delivered by the distributors directly to SchoolFood kitchens on various floors of our school buildings, even to those without elevator access, loading docks or available parking.

And, so, while the Comptroller may be critical of certain aspects of the DOE's procurement of contracts for the Citywide door-to-door distribution of milk to schools, the one thought that should not get lost in the Report's lengthy, chart-filled narrative is that every day, without a break attributable to contract implementation, high quality milk is delivered to the schools at a competitive cost. In the end, the procurement has proven to be a service to the schools and a savings to this City's taxpayers.

Very truly yours,

Kathleen Grimm

Kathleen Grimm

cc: Andrew Buher, Chief Operating Officer, Chancellor's Office
Eric Goldstein, Chief Executive Officer, Office of School Support Services
David Ross, Executive Director, Division of Contracts and Purchasing
Marlene Malamy, Deputy Auditor General, Office of Auditor General
Elizabeth Rose, Chief of Staff, Division of Operations

NEW YORK CITY DEPARTMENT OF EDUCATION RESPONSE TO FINDINGS AND RECOMMENDATIONS

The following, with the attached cover letter from New York City Department of Education ("DOE") Deputy Chancellor Kathleen Grimm, comprises the response to the City of New York Office of the Comptroller's ("Comptroller") draft audit report titled *Audit Report on the Department of Education's Awarding of Milk Distribution Contracts.* ("Report").

Background

In 2008 the DOE released a Request for Bids ("RFB") in connection with the supply and delivery of milk to schools. Eight companies responded: Beyer; Bartlett Dairy, Inc. ("Bartlett"); Elmhurst Dairy, Inc. ("Elmhurst"); Derle Farms, Inc. ("Derle"); Maramont Corporation; Teri Nichols; Cream-O-Land Dairies, LLC; and Oak Tree Farm Dairy, Inc. Of these bidders, Bartlett, Beyer, and Elmhurst were selected on the basis that they submitted the lowest responsive bids among eight geographical zones and were determined by the DOE to be responsible vendors.

The DOE Division of Contracts and Purchasing ("DCP") reviewed bid pricing, the submissions, and the organizational capacity of the prospective awardees to ensure that the bids were responsive. Responsibility was determined, in part, based upon background checks performed on the prospective awardees by DCP. The three selected bidders were awarded five-year contracts for the supply and distribution of milk.

Notwithstanding the DOE's review, one of the vendors, Beyer, declared bankruptcy and was unable to continue performing after providing satisfactory service through four-and-one-half years of the five-year contract term. The DOE used the buy-against procedures set forth in its Procurement Policy and Procedures to secure an alternate vendor at the same price, albeit losing a 2% prompt payment discount that the DOE would have received from Beyer. Despite the company's bankruptcy and subsequent contractual default, and taking account for the loss in prompt payment discounts for the last six months of the contract, the DOE saved in excess of $10,000,000 as a result of the contract it had awarded to Beyer.

DOE Response to Findings (Recommendations 1 – 4)

The Comptroller asserts that the DOE failed to adequately review bidders' financial capacity and indicates that while the DOE received financial statements from the three winning bidders, "only a cursory review" of the vendors' assets and liabilities was performed. Beyer's declaration of bankruptcy in December 2012 is used as evidence of this deficiency.

The Comptroller's conclusions rely heavily on an analysis of the "financial weakness of Beyer." The analysis, which concludes that "the [financial] statements indicated that Beyer did not have the financial resources to fully perform the contract," relies upon the following observations:

- Beyer's net income decreased 72% between 2006 and 2007.
- In 2006 and 2007, Beyer's total current liabilities exceeded total current assets.

- Beyer's current ratio was 0.46 in 2007 when the average ratio for food distribution companies between 2007 and 2012 was 1.29, indicating the company may have trouble paying short-term debts using short-term assets.
- Beyer's debt-to-equity ratio was 38.8 in 2007 when the average ratio for food distribution companies between 2007 and 2012 was 1.54, meaning more of the company's assets were financed by debt than by equity.

As explained below, it is our position that a more comprehensive analysis of Beyer's financial position at the time of award does not result in the black-and-white conclusion reached by the Comptroller.

Use of Financial Ratios

The Comptroller's analysis appears to have involved only two financial ratios (current ratio and debt-to-equity ratio) that were examined in isolation. The current ratio compares current assets with current liabilities and, therefore, is a measure of the company's ability to repay its short term liabilities using only its liquid assets. The Comptroller accurately states that Beyer's current ratio was 0.46, but then uses a ratio of 1.29 as its benchmark for comparison. That benchmark, however, is an industry average calculated using data for the several years *following* the contract award. A comparison with a more appropriate benchmark, that is, the current ratio for Elmhurst, a company that was - and still is - the industry leader in the greater New York City area, would have yielded a result different from that reached by the Comptroller and would have shown that Beyer's current ratio was aligned reasonably well with that of its competitors, a particularly important consideration as the DOE was considering potential vendors from the limited pool of respondents and not the industry nationwide.

The Comptroller also points to Beyer's debt-to-equity ratio as a source of concern. Although the Comptroller accurately states that this ratio indicates the company "has been aggressive in financing its growth with debt," this does not necessarily mean a company is likely to fail. Notably, Beyer's year-to-year comparison shows an improving debt-to-equity ratio.

The DOE recognizes that current ratio and debt-to-equity ratio are important indicators. Nonetheless, they are by no means the only ones that can be considered in assessing a company's financial stability. When considering the ability of a company to repay its debts, another key metric is the "times-interest-earned" ratio. Times-interest-earned is calculated by taking the company's income before interest and taxes and dividing that by the interest expense. It is a clear way to show, from the income statement, how readily a company can make its interest payments. In 2007, Beyer's times-interest-earned ratio demonstrated that it was generating income sufficient to meet the interest payments on its debt. Significantly, this ratio exceeded that of its competitor Elmhurst, an industry leader..

Also an important consideration is the company's "debt-to-assets ratio." Since a company's total assets are equal to the total liabilities plus shareholder's equity, the debt-to-assets ratio can readily show how heavily leveraged a company is. Beyer's debt-to-assets ratio in 2007 was comparable to that of Elmhurst's . Moreover, a historical review of this number shows an improvement in Beyer's financial position, with the ratio having decreased over the several years prior to 2007.

A year-to-year comparison of other factors is also highly informative. Beyer's revenue growth in 2007 and 2006 exceeded that of Elmhurst. While Beyer's operating income decreased in 2007, indicating that expenses grew more than revenues had, Beyer was in a stronger position than Elmhurst, whose operating income declined by an even greater amount during that same period. Moreover, Beyer's operating income grew in 2006, while Elmhurst's operating income was flat.

The more quickly a company gets paid on its accounts receivables, the greater its ability to pay short term liabilities through sales. Therefore, another key factor to consider in a company's performance is its average collection period. Average collection period is calculated by dividing the total accounts receivable by the sales per day. In 2007, Beyer was able to collect on its sales in less than half the time it took Elmhurst to collect on its accounts receivable.

Use of Financial Reporting Tools

The Comptroller acknowledged that the DOE's use of Dun and Bradstreet (D&B), a commercial database that provides expert analysis of the risk associated with a company, indicated that Beyer was "reasonably current in terms of paying its bills" *and that it had the lowest level of risk according to D&B's Supplier Risk Score.* Despite this, the Comptroller points to a 2008 Lexis/Nexis report identifying a number of collateralized assets (civil liens) as evidence that the DOE should have determined that the company was in financial distress.

Financial responsibility is determined neither by any single source of information nor any single result obtained from a data source. The DOE collects information regarding a vendor's financial condition using multiple sources such as Dun & Bradstreet, Lexis/Nexis and other commercial databases.

In the case of Beyer, the D&B Supplier Risk Score of 1 combined with Beyer's Paydex score of 76 were not only positive indicators that mitigated any concerns that may have arisen regarding the liens observed in Lexis/Nexis, but were comparable to the scores of other vendors in the New York City market receiving awards. Moreover, the DOE generally does not focus on civil liens, but on liens and warrants filed by government entities, which might indicate a vendor's less-than-satisfactory attitude towards addressing its government obligations.

The "Vendor Review Work Sheet" from Beyer's background file, which was made available to the Comptroller, clearly noted the existence of the civil liens. Furthermore, the record shows that the DOE had reviewed Beyer's financial condition in its totality. The Comptroller's claim, in hindsight, that it would have come to a different conclusion from that reached by the DOE does not mean the DOE failed to consider these facts and circumstances adequately.

The Comptroller further relies on a note by a DOE procurement analyst stating several possible sources of concern regarding the company's financial position, including notes payable, truck leases, and lines of credit secured by corporate assets. However, those issues were weighed against additional information that supported a conclusion that Beyer was operationally and financially responsible. In fact, the DOE performed a site visit at Beyer's offices, the purpose of which was, in part, to determine if Beyer had the operational capacity and financial ability to service the areas being awarded. The DOE determined that the company had an efficient routing system and sufficient trucks and personnel to service the awarded areas.

In addition, the vendor's past performance was given weight in the DOE's decision to award. Beyer had been doing business satisfactorily with the DOE for over 13 years. The record shows that Beyer performed under the audited contract without incident for over four of the five year contract period, during which the DOE saved in excess of $10,000,000 as compared to the next lowest bidder. Importantly, even when Beyer declared bankruptcy and was no longer capable of providing service, the DOE was able to secure alternate vendors at similar prices with no interruption of service.

Response to Recommendations 1 – 4

Recommendation 1. *The DOE should develop and implement adequate written procedures that are sufficiently detailed to govern the review of the financial capacity of the lowest bidders for milk distribution contracts. The procedures should identify, among other things, the documents (e.g., financial statements) that should be reviewed; the tools (e.g., financial ratio and trend analyses) that should be used to determine the financial position of a vendor; and the criteria by which the financial standing of a vendor should be evaluated.*

DOE Response. While the DOE already has processes in place to determine the financial capacity of low bidders, it does not disagree with the recommendation to refine these procedures. A vendor's financial condition will continue to be considered among other relevant award criteria.

Recommendation 2. *The DOE should ensure that the most current financial statements submitted by the lowest bidders on milk distribution contracts are certified by an independent CPA.*

DOE Response. The DOE agrees with this recommendation and will implement it beginning with the next milk distribution procurement.

Recommendation 3. *The DOE should ensure that the contract files contain adequate evidence of the review of the financial capacity of the lowest bidders. This evidence should clearly support the assessment of the vendor that is contained in the RA.*

DOE Response. The DOE believes it sufficiently performed its due diligence regarding the financial capacity of the milk distribution vendors and that its files adequately reflect such.

Nonetheless, we agree that more thorough summaries of its findings will present a clearer record of its decision-making in this regard. Beginning in fall 2011, the DOE expanded the details contained in its internal summaries to include more of the information uncovered during a responsibility determination.

Recommendation 4. *The DOE should monitor the loss of the 2 percent prompt-payment discount in the Bronx and Queens to ensure that the loss is deducted from the money owed to Beyer.*

DOE Response. The DOE agrees with this recommendation.

DOE Response to Findings (Recommendations 5 – 8)

The second prong of the Report deals at some length with the case the Comptroller has built to support the conclusion that without written protocols there is an increased "risk that collusion [among bidders] could occur and go undetected." Upon our request for clarification, the auditors opined that while the five-year milk distribution contracts that were the subject of the audit may have yielded favorable pricing and other advantageous terms, it may come to pass – not necessarily in the next contract cycle, which is almost upon us, and maybe not in the one thereafter, but at some point in the future – that we could see the price of school milk go up as a result of collusive bidding.

If the DOE missed indicia of potential risk – and we are not conceding we did - the Comptroller did not lift even a corner of the contracts for a peak at the circumstances that underlay the awards before registering contracts for an industry that historically had been a concern. And so, five years after the contracts were registered by that office, the Comptroller enters the picture to provide a primer on price fixing, wag a finger, and suggest that the DOE should have been more vigilant.

With respect to the Comptroller's belated call to vigilance, while acknowledging that there is no evidence that collusion actually occurred, the Report bundles together discrete circumstances that the Comptroller opines should have led the DOE to conclude that there *may have been* something nefarious afoot among the bidders such that further action was warranted to protect against future consequences. According to the Comptroller, that the DOE failed to do so bespeaks a lack of "adequate procedures designed to detect the warning signs of possible collusion." For the following reasons, we disagree.

Connections among Four of the Seven Bidders

The Comptroller finds several connections among four of the bidders. Specifically:

- Four bidders are located in the same geographic area; Jamaica, Queens.

- Three of the bidders reported they would use the fourth, Elmhurst, as their milk processor.
- Lexis/Nexis identified some financial obligations among some of the bidders.
- An individual identified as an "owner" of Beyer in a Lexis/Nexis report was identified as the President of Derle Farms (Derle) in its bid.

Having brought to the process their prior experience with milk distribution procurements, the DOE managers understood that geographical clustering among the bidders is the way business is done when there is only one milk processor (Elmhurst) in New York City capable of supplying milk in the quantities required by the DOE, and that only a handful of distributors can meet the DOE's exacting delivery schedules within the five boroughs. And so, that the milk distributors' operations were located in proximity to the milk processing plant was deemed by DOE managers to be suggestive of pragmatic business decisions that would drive cost efficiencies.

With regard to the financial obligations, and using prior experience as the guide, it is not uncommon for businesses within an industry to sell machinery or lease space to one another depending upon their respective volume of business at any given time. We are aware that such actions can result in liens of the type noted in Lexis/Nexis.

As to the individual identified in Lexis/Nexis as an "owner" of Beyer, the database did not connect the individual to Derle. Our review of Beyer's owners, therefore, did not show the relationship to Derle. This would only have been discovered if a background check had been performed on Derle, *a losing bidder*. Seeing as the Department often receives several bids that will never be acted upon for each bid that results in a contract, we take the position that expending resources to perform background checks on losing bidders would not be prudent.

Questionable Bidding Patterns among Four Bidders

The Comptroller identifies several patterns in the bids received that it believes could be an indication of collusion. Specifically:

- Bartlett submitted a lower bid for the Staten Island geographical zone than it had for other boroughs, while two of the other bidders submitted no bid at all.
- Beyer did not bid on the Manhattan geographical zone while the two of the other bidders kept their bids the same as other regions, and a fourth bidder raised its bid for that zone relative to other bids.
- Derle, for Manhattan, raised its prices for four of the largest quantity milk products relative to its "fairly consistent" bids in the other five zones.

Despite the DOE informing the Comptroller that "it is normal for vendors to adjust their bids from zone to zone due to the unique challenges each zone can present and the individual circumstances of each vendor," the Comptroller asserts that these bidding patterns are questionable in nature, particularly when combined with the "other indicators of possible collusion."

The DOE does not believe the bidding pattern surrounding the Staten Island geographical zone rises to the level of concern the Comptroller ascribes to it. That the bids were not consistent among the distributors within the zones was viewed as expected when bidders factor in transport logistics, such as traffic congestion and parking, and incidental expenses, such as tolls. Similarly, it is not at all unusual for bidders to bid only certain areas. In fact, while the Comptroller makes note of Derle's higher price in Manhattan, which by itself is unsurprising to us, that same the vendor bid a lower price in Queens 1 than elsewhere.

One Bidder Selected to Be Subcontractor for Two Other Bidders

The Comptroller points to the selection of Bartlett as a subcontractor for both Elmhurst and Beyer as an indicator of possible collusion. Nonetheless, the Report references a complaint by Bartlett surrounding Beyer's bid. That complaint, which was referred by the DOE to the Office of the Special Commissioner of Investigation for the New York City School District (SCI) was referred back by SCI to the DOE where it was reviewed. Not only do these facts demonstrate that the DOE did, in fact, perform due diligence in this matter, but the fact that Bartlett complained to the DOE about Beyer's bid does not support a conclusion that the two vendors may have engaged in collusion. We also note that the Comptroller's analysis ignores the fact that the vendors were forthright about their intentions and requested the necessary approvals which enabled the DOE to address any concerns that those requests might have presented at that time.

Prior Instances of Collusion

The Comptroller reaches into history to pull out a prior instance of collusion as evidence that there may have been collusion among the bidders for the audited contracts. Specifically, in 1982, Beyer and Elmhurst pleaded guilty in their corporate capacities to charges of "combination in restraint of trade and competition" and were fined \$10,000 and \$40,000, respectively. The Comptroller acknowledges that this matter was referenced in the Elmhurst file in 2008, and that in 2012, by way of explaining why the conviction did not preclude a contract award, the file included that "there were no key personnel at Elmhurst in 2012 who were also key personnel at Elmhurst in 1981." The 2012 file notation resulted from procedures instituted by the DCP Vendor Research and Price Analysis Unit post-2008 to provide more detailed background summaries.

To make a final point, the Comptroller raises that the Beyer file did not contain information regarding the matter of the 1982 conviction, noting that at least one individual involved with Beyer in 2008 had been there since 1977. While it is true that the Beyer file did not contain information regarding the conviction, the inclusion of that information in the Elmhurst file and the fact that both vendors were receiving awards under the same milk bid, demonstrates an awareness of the matter by the DOE. Furthermore, while a change in management, as was the case with Elmhurst, is a significant mitigating factor when making a responsibility determination under these circumstances, the continued presence of the Beyer employee is mitigated by the fact that, at the time of the 2008 award, Beyer had operated for more than twenty years without any further implication in collusive activities.

Response to Recommendations 5 - 9

Recommendation 5. *The DOE should seek assistance from various sources, such as the Antitrust Division of the United States Department of Justice, to research and identify the warning signs of possible collusion.*

DOE Response. That the Comptroller disagrees with the DOE's analysis, and possibly the conclusions, does not mean such an analysis was not performed. The DOE will continue to seek assistance from appropriate sources as applicable.

Recommendation 6. *The DOE should develop and implement adequate written procedures that are sufficiently detailed to detect the warning signs of possible collusion. The procedures should include, among other things, the different forms of collusion that could exist, the patterns of bidding that might arouse suspicions; conditions favorable to collusion; and the steps to be taken when the possibility of collusion has been identified (such as requesting and reviewing any subcontracts between the primary contractors and competing bidders).*

DOE Response. The DOE agrees that procedures can be created addressing the warning signs of collusion.

Recommendation 7. *The DOE should ensure that the comprehensive background checks on the lowest bidders include, among other things, a review of not only the vendors but also of the owners, executives, and affiliates listed on the Bidder Information Certification and Signature Page of the bid and in the background reports it obtains from LexisNexis and others.*

DOE Response. The DOE's process, as evidenced by documentation provided to the Comptroller, already includes a review of the prime vendor, owners, executives, and affiliates.

Recommendation 8. *The DOE should identify any warning signs of possible collusion, review them, and then explain and support its conclusions relative to their significance.*

DOE Response. Since fall 2011, the Vendor Research and Price Analysis Unit expanded the summary document prepared at the conclusion of background checks so as to more fully describe the information discovered during that process.

Recommendation 9. *The DOE should ensure that it uses comparable indices in its contract price analysis.*

DOE Response. The DOE concurs with the recommendation.