
Secretary of State

State of Oregon

DEPARTMENT OF CORRECTIONS

Prison Construction

Procurement and Contract Development



Audits Division

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Auditing for a Better Oregon

The Honorable John Kitzhaber
Governor of Oregon
State Capitol
Salem, Oregon 97310

David Cook, Director
Department of Corrections
2575 Center Street NE
Salem, Oregon 97310

This report contains the results of our audit of the Department of Corrections (department). It is the second in a series of reviews of the department's prison construction program. Following a July 1998 report on infrastructure planning and development, this audit focuses on the selection methodology used by the department to procure the services of construction contractors and the department's contract development practices.

With an estimated total cost of over \$1 billion, the department's prison construction program is the largest such program in Oregon history. By 2008, the department plans to increase prison capacity to accommodate an expected inmate population of more than 14,000, which is 79 percent over current population levels. At the time of our review, the department had two projects under construction with a third project planned to begin in spring of 1999.

While the department faces a significant challenge in managing a program of this size and complexity, we believe that by implementing our recommendations for contract procurement and development, the department can better protect and maximize the state's investment in prison construction.

OREGON AUDITS DIVISION

John N. Lattimer
Director

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EXECUTIVE SUMMARY

Prison Construction: Procurement and Contract Development

Background and Purpose

The Department of Corrections is in the early stages of a major \$1 billion prison construction program.

The Department of Corrections (department) is in the early stages of a major prison construction program. As of March 1998, the department housed 7,806 inmates with 69 inmates housed out-of-state. To accommodate expected inmate population growth, the department is planning to construct an additional 11,000 beds at a cost of more than \$1 billion. The expected increase in inmate population is primarily caused by Ballot Measure 11. This measure, passed by Oregon voters in 1994, established minimum sentencing guidelines for specified violent crimes. The department is currently constructing two new prisons: a medium-security prison in Ontario (Snake River-II) and a medium-security prison in Umatilla (Two Rivers). A third facility, a women's prison and intake center in Wilsonville, is scheduled to begin in the spring of 1999. The department's prison construction program is the largest such program in Oregon history, with the Snake River-II project alone being recognized as the largest state-financed construction project ever.

This audit is the second in a series of reviews of the department's prison construction program. The purposes of this audit were to review the selection methodology used by the department in procuring services of the construction manager/general contractor (CM/GC), architect, project management, and materials testing firms, and to perform a review of the department's contract development practices involving these four firms.

Results in Brief

Our report presents findings, conclusions, and recommendations in two areas:

We found that the department should improve its processes for contractor selection, decision documentation, and determination of contract cost.

We also found opportunities for the department to improve its establishment of contract cost limits and controls over contract amendments.

- **Construction Contract Procurement.** We found opportunities for improvement in the department's processes for contractor selection, decision documentation, and determination of contract cost. For the three construction projects referenced above, we found that selection panel composition, training, and appearance of fairness can be improved. Improvements can also be made in documenting the selection process and award decisions; we found incomplete and conflicting documentation for existing projects. Finally, we noted that the department should place more emphasis on contract price for CM/GC firms. This includes ensuring that the department has a clear understanding of cost proposals made by firms and conducting the analytical review necessary to determine if the proposed fees are reasonable. To improve construction contract procurement, **we recommend** that the department develop processes to ensure that selection panels are experienced and objective, ensure that the selection process and award decisions are fully documented, and assess whether contract cost and amounts proposed by CM/GC firms are reasonable.
- **Construction Contract Procurement.** We found opportunities for improvement in the department's processes for contractor selection, decision documentation, and determination of contract cost. For the three construction projects referenced above, we found that selection panel composition, training, and appearance of fairness can be improved. Improvements can also be made in documenting the selection process and award decisions; we found incomplete and conflicting documentation for existing projects. Finally, we noted that the department should place more emphasis on contract price for CM/GC firms. This includes ensuring that the department has a clear understanding of cost proposals made by firms and conducting the analytical review necessary to determine if the proposed fees are reasonable. To improve construction contract procurement, **we recommend** that the department

develop processes to ensure that selection panels are experienced and objective, ensure that the selection process and award decisions are fully documented, and assess whether contract cost and amounts proposed by CM/GC firms are reasonable.

- **Contract Development.** We found that the department can improve its establishment of cost limits and its control over contract amendments. For the Snake River-II project, we noted opportunities for the department to specify cost limits and improve the timeliness of contract amendments. For example, the department did not establish an initial total contract cost with the materials testing firm and allowed the amount paid to grow 86 percent over the original amount proposed by the firm. To improve its contract development practices, **we recommend** that the department establish contract cost limits as well as a process for improving its control over contract amendments.

Agency Response

The Department of Corrections generally agreed with the conclusions and recommendations in this report.

Background and Introduction

Oregon Has Begun a Major Prison Construction Program

To handle an expected increase in prison population, the department has begun a \$1 billion prison construction program.

The Department of Corrections (department) is in the early stages of a major prison construction program. The department is responsible for exercising custody over offenders during their incarceration. In November 1994, Oregon voters passed Ballot Measure 11, which established minimum sentencing guidelines for specified violent person-to-person crimes. These new sentencing requirements are the primary cause for the significant increase in prison population expected in the coming years. By 2008, Oregon's prison population is expected to grow to more than 14,000 inmates, an increase of 79 percent over the current population. As of March 1998, the department has 12 existing institutions housing 7,806 inmates; 69 other offenders are housed out-of-state. To handle the expected increase, the department has begun an aggressive prison construction program with plans to expand prison capacity by more than 11,000 beds. The department's construction program began in 1995 and has an estimated total cost of more than \$1 billion.

The Department Plans to Build Several New Facilities

The department has plans to construct more than 11,000 new prison beds.

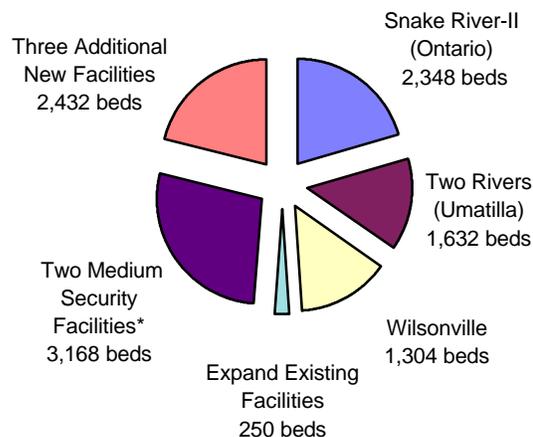
The following identifies the department's plan for construction of new facilities based upon the April 1998 prison population forecast issued by the Department of Administrative Services. The department is currently involved in constructing two medium-security facilities with another planned to begin in the spring of 1999:

- The first facility will add 2,348 medium-security beds to the existing Snake River Correctional Institution in the eastern Oregon city of Ontario. The first phase of construction (Snake River-I) was completed in 1991. This second phase of construction (Snake River-II) began in late 1995 and is expected to be completed in September 1998 at an estimated total cost of \$175 million.

- The second facility (Two Rivers) is a new medium-security complex in Umatilla designed to house 1,632 inmates. Construction of the Two Rivers complex began in May 1997 at an estimated cost of \$150 million. This project's expected completion date is in November 1999.
- Construction of a third facility in Wilsonville is planned to begin in the spring of 1999 with a projected completion date of August 2001. This 1,304 bed facility will serve as an intake center for both men and women and as a correctional institution for women at an estimated cost of \$151 million.

In addition to the construction projects described above, by 2008 the department also plans to add 2,342 beds by constructing three other facilities: one more medium-security prison and two minimum-security facilities. To provide 250 more beds, the department plans to expand three existing minimum security facilities: Powder River Correctional Facility, South Fork Forest Camp, and Shutter Creek Correctional Institution. The estimated completion date for these projects is August 2001. Finally, the department has two additional medium security institutions on its construction plan with completion dates to be determined. These two facilities will add 3,168 more beds. The combined total capacity for these new facilities is 11,134 beds.

**Planned Prison Construction through 2008
(by number of beds)**



*These two facilities have to-be-determined completion dates.

The Department Is Using the CM/GC Approach for Its Current Construction Projects

The CM/GC approach is a fast-track process by which a single firm provides both construction management and general construction services.

To construct its new facilities, the department is using a method known as the construction manager/general contractor (CM/GC) approach, along with a guaranteed maximum price. The CM/GC approach is a fast-track process by which a single firm is hired to provide both construction management and general construction services. Under this process, the site work, building foundation, and other early construction work may be designed and bid before the design for later stages of the construction is completed. Subsequent parts of the project also can be designed, bid, and started in stages.

The CM/GC firm is selected through a competitive procurement process that is primarily based on qualifications. The firm provides professional management services for the construction project and assumes responsibility for competitively bidding and awarding construction trade contracts and managing and coordinating the activities of the trade contractors. In addition, prior to the beginning of construction work, the CM/GC firm works with the department and the architect to determine a guaranteed maximum price for the project. The guaranteed maximum price is the fixed total cost limit of the project and can be negotiated as early as the schematic design phase. The CM/GC firm assumes the risk for completing the project within the guaranteed maximum price amount, thereby providing the state with a known upper limit project cost before construction starts and with general protection against cost overruns.

The CM/GC approach differs from the traditional method of public construction contracting, known as the “design/bid/build” approach. Under the traditional approach, work is done sequentially with the design fully completed before construction begins. Instead of a procurement based on qualifications, work is competitively bid based on completed architect documents and construction contracts are awarded to the lowest qualified bidder. Because the steps in this process are consecutive, the traditional design/bid/build approach usually requires more time.

When the CM/GC Method Should Be Used

The CM/GC method is most effective when time and cost are critical but the public agency's in-house management resources are limited.

The Department of Corrections has the necessary exemption to use the CM/GC method at its discretion.

According to the Oregon Public Contracting Coalition, the CM/GC method can be an effective alternative to the traditional design/bid/build process. With proper application, key benefits can include lower costs, faster schedules, higher quality, and fewer lawsuits. Because of the complexity and relative sophistication of the CM/GC process, however, public agencies must have the experience and expertise needed to administer the process effectively. A common misunderstanding of the approach is that the public agency will have a minimal project management load. To the contrary, the public agency's role is more intensive at all stages than it is in the design/bid/build process, and the active involvement and decisionmaking of the agency remain essential. The CM/GC method is most effective when time and cost are critical but the public agency's in-house resources for managing the construction contracts are limited.¹ Generally, the CM/GC method should be used when at least two of the following criteria justify an alternative contracting procedure as being in the best interest of the public, taxpayers, and other stakeholders.

- There is a need for time savings.
- There is a need for cost savings.
- The project has significant technical complexities.
- The process for selecting a CM/GC will not diminish competition or encourage favoritism.²

The department has used the CM/GC method for prison construction projects since 1990, when construction began on the Oregon Corrections Intake Center and Snake River-I. For its current construction projects, the department determined that the CM/GC approach is appropriate to use because of time and budget constraints and the technical complexity associated with the projects.

To use this alternative method, agencies must have an exemption to Oregon Revised Statute 279.015, which requires that all public improvement projects be procured through competitive bid. The exemption provision requires agencies using an alternative contracting approach to develop findings showing that the alternative approach is unlikely to encourage favoritism or

¹ *Project Delivery Options: An Introduction to Corrections Construction*, 1993; National Institute of Justice.

² *CM/GC White Paper*, April 1997; Oregon Public Contracting Coalition.

substantially diminish competition, and that using the approach will result in substantial cost savings to the state. The Department of Administrative Services considers several agencies as having the organizational capability to use the CM/GC method at their discretion. These agencies therefore have a class exemption to the public procurement statute under Oregon Administrative Rule 125-310-0220(4). These exempt agencies are the Department of Corrections, the Oregon University System, and the Department of Administrative Services. Other agencies that wish to use the CM/GC approach must receive approval from the Department of Administrative Services.

The department has hired four primary contractors to assist with its prison construction program: a CM/GC firm, an architect, a project management firm, and a materials testing firm.

Roles and Responsibilities

For the Snake River-II, Two Rivers, and Wilsonville construction projects, the Department of Corrections has involved four primary contractors: the CM/GC, the architect, a professional project management firm, and a materials testing firm. The following describes the general roles and responsibilities of these four firms and the department in the construction process.

The CM/GC Firm is responsible for coordinating and managing the building process with the department, the architect, and other firms working on the project. Responsibilities include providing construction management services in the programming, planning, design, and construction phases of the project. The CM/GC firm also is responsible for working with the architect and the department to provide a project GMP and for ensuring that the project is constructed within that amount.

The Architect is responsible for providing design and construction administration services. These services include programming and master planning, architectural programming, schematic designs, design development, construction documentation, bidding, construction contract administration, interior design and space planning, and supplemental services.

The Project Management Firm is responsible for providing a full range of project management services, including overseeing the CM/GC firm and construction activity; providing technical advice and assistance regarding cost estimates, code requirements, consultant services, and construction procedures; and participating in the design and construction process to ensure that the project is completed on time and on budget. The department hires this firm to represent the interests of the department.

The Materials Testing Firm has the responsibility to provide independent laboratory testing and special inspection services required by the Uniform Building Code. Services include the testing and inspection of earthwork, soil compaction, asphaltic concrete paving compaction, unit masonry, precast concrete, structural steel welding, and metal fabrication. The tests and inspections are conducted throughout the course of the construction project to ensure construction performance quality.

The Department of Corrections is responsible for managing the procurement of the key firms working on the construction projects, developing and administering contracts, and ensuring that the construction projects receive adequate oversight and supervision. To manage its construction program, the department reorganized its Facilities Division in July 1997, creating three separate sections: new construction, facilities services, and community development. Each section is headed by a manager who reports directly to the department's assistant director of business and finance. Also, for each construction project, the department created a separate team including a facilities specialist, a community liaison representative, and an operations manager. The project teams report directly to the assistant director for business and finance and the department's top management.

Objectives, Scope and Methodology

We focused our research on the department's selection of four primary contractors and the department's contract development practices.

This audit is the second in a series of audits of the Department of Corrections' prison construction program. The first audit, a review of the department's processes for planning and developing infrastructure needed to serve new prisons, was also released in July 1998.

The purposes of this audit were to (1) review the selection methodology used by the department to procure the services of the CM/GC, architect, project management, and materials testing firms for each of the three referenced construction projects; and (2) perform a review of the department's contract development practices for the Snake River-II project.

To accomplish these objectives, we interviewed personnel from the department as well as other independent professionals and state officials knowledgeable in these fields. We reviewed applicable contracts, laws, rules, policies and procedures, and records related to the department's current construction projects. We researched relevant standards for effective practices described in professional literature.

In addition to the objectives described above, we conducted preliminary testing of contractor payments related to the Snake River-II project. At the time of the release of this report, the testing of this financial data is still in progress and the results will be reported later.

We conducted our audit from July to December 1997 in accordance with generally accepted government auditing standards. We limited the scope of our review to the topic areas specified in this section.

Chapter 1: Construction Contract Procurement

Improved Contract Procurement Practices Would Benefit the Department

Opportunities exist to improve the department's processes for contractor selection, decision documentation, and determination of contract cost.

An important aspect of contracting is a fair and open selection process. A strong contract procurement process helps protect and maximize the state's investment in prison construction by ensuring that the state contracts with the best qualified firm at the best price. One of the perceived concerns regarding the construction manager/general contractor (CM/GC) approach is the potential for a flawed rating and selection process.³ Our review of the Department of Corrections' (department) procurement process noted opportunities for improvements in the processes used for contractor selection, decision documentation, and determination of contract cost for its construction projects. By making improvements in these areas, the department can better ensure that the contracting process is fair and open and can reduce the state's risk of paying more than necessary for prison construction.

Background

For the Snake River-II, Two Rivers, and Wilsonville projects, the department required all firms to submit a written proposal in response to a published request for proposals (RFP). Proposers were asked to respond to several questions outlined in the RFP document. Based on the evaluation of these proposals, top scoring firms were invited to participate in an interview process from which the department selected a final candidate. To evaluate, score, and rank both the proposals and the interviews, the department used selection panels. Candidates were evaluated based on several criteria, including experience, expertise, approach, and cost. Although construction-related procurements are based primarily on qualifications, price is an element that needs to be considered and given adequate weight.

³ According to the Washington Procurement Roundtable. The Washington Procurement Roundtable is a group formed in the state of Washington by contractors and other industry participants to foster a positive dialogue on key issues affecting the construction industry.

The Process for Selection Panels Can Be Improved

Selection panels should be experienced and objective.

Our review of the department's processes and procedures related to selection panels identified opportunities for improvements in the areas of panel composition, selection, scoring, and objectivity. To maintain fairness in the selection process, it is important for public agencies to ensure that selection panels are experienced and objective.

State requirements for CM/GC firm selection found in OAR 125-310-0220 are limited to ensuring that contractual requirements and evaluation criteria are clearly stated in the solicitation document; these requirements do not address selection methodology. Available industry information related to the CM/GC process, however, does make suggestions for firm selection.⁴ This information recommends that CM/GC selection panels should:

- include members from outside the staff of the public agency with agency representation being limited to no more than 40 percent;
- consist of at least five members;
- consist of members with sufficient expertise and experience; and
- be rotated from project to project to avoid favoritism.

The recommendation for panel rotation is also included in the department's construction project management systems manual, which states that the selection panel for interviews should include a minimum of 50 percent who did not sit on the first proposal evaluation committee. While the department agrees that these are good standards to strive for, it does not believe that implementation is feasible due to staffing limitations.

⁴ *GC/CM White Paper*, November 1996; Washington Procurement Roundtable.

According to the Attorney General's Model Public Contract Rules Manual, guidelines should be developed to make scoring more consistent and defensible.

Additional steps to preserve fairness in the selection process include the publication of panel membership, prohibition of pre-bid contact, a requirement that all questions and answers be in writing, and adequate training of panel members. The Attorney General's Model Public Contract Rules Manual provides recommendations to make scoring more consistent and defensible for architect, engineer, and related service contracts. These recommendations include developing a scoring range for the selection criteria. For example, if the total points are 20, then a score of 17 or above would be excellent, a score of 13 to 16 is very good, 9 to 12 is average, and so on. The need for providing scoring guidelines is also reinforced in industry information related to CM/GC selection.⁵ This information states that proposal reviewers be educated on what is important to the agency and what constitutes a superior, appropriate, and inferior answer to the request for proposal's questions.

The department did not have a formal written process in place to ensure that selection panel members were objective and received consistent scoring criteria.

Although recommended panel composition includes both agency and non-agency personnel with a maximum of 40 percent representing the agency, we found that in most cases panel members were primarily department staff. For example, the selection panels for the Two Rivers and Wilsonville prisons consisted almost exclusively of department staff. Further, panel members were not rotated between the proposal and interview evaluation phases for the Snake River-II project and some panel members were repeatedly involved in the selection processes for all three projects. In addition, we noted that the department did not establish a process to ensure that panel members have the appropriate expertise and experience or maintain documentation of that expertise and experience. We also noted no formal written process to ensure that panel members were provided with information on consistent scoring criteria. We did find memos to selection panel participants explaining each criterion and the total points each criterion was worth. These memos, however, did not provide the guidance recommended by the Attorney General by which raters are given scoring ranges with definitions. Finally, we also identified panel members who appear to have previous relationships with proposing firms. For example, one of the four proposing project management firms for the Two Rivers and Wilsonville projects had selection panel members as references. While our review did not detect any improprieties in the department's selection process, the appearance of fairness in the department's process can be improved. One method to preserve the appearance of fairness is to limit participation of individuals

⁵ CM/GC White Paper, April 1997; Oregon Public Contracting Coalition.

referenced by proposing firms in the selection process. In response to the example noted above, department officials told us they saw nothing improper with this situation since the proposing firm was comprised of former department employees who possessed unique expertise.

Documentation of the Selection Process and Award Decisions Can Be Improved

Our review of the department's selection process identified improvements that would ensure that the process and award decisions are fully documented. Full documentation will provide the department with assurance that the selection process is followed and with the support needed to show how decisions were made if challenged.

Documentation to support the selection process and award decisions is critical.

Documentation is a critical element to support the selection process and award decisions. The department's selection process allows any proposer who claims to have been adversely affected or aggrieved by the selection of a competing proposer to protest the award decision. Although statute and administrative rule requirements do not address the documentation required to be maintained by agencies for CM/GC contracts and architect, engineer and related service contracts, the state has established such requirements for another contract type: personal services. When contracting for personal services, agencies are required to maintain a complete record of the actions taken, including the following information:

- a copy of the request for proposals;
- a list of prospective contractors who were requested to submit proposals;
- the method used to advertise or notify other possible prospective contractors;
- a copy of each proposal received;
- the method of evaluating each proposal;
- the record of negotiations and results;
- how the contractor was selected, including the basis for awarding the contract; and
- the resulting contract, if awarded.

The department could not provide documentation to clearly support how selection decisions were made.

Our review found that the department has not maintained adequate documentation for its selection of the four primary construction contractors. For example, the department could not provide us with documentation to clearly support how selection decisions were made for all four firms for the Snake River-II project. We also noted some instances of insufficient documentation for the Two Rivers and Wilsonville projects. For example, the documentation provided for the selection of the project management firms for the Two Rivers and Wilsonville projects did not clearly show who was involved in evaluating firm interviews. Available documentation indicated that individual scores for two panel participants, although summary scoring information suggests that five panel members were involved in scoring the interviews. Further, the importance of fully documenting the selection process and award decisions was also noted by the department in an internal audit issued in 1991. This audit reviewed documentation available for the Snake River-I project, and auditors found that scoring changes were not fully documented. The audit recommended that the department's contract files fully document the reasons for contractor selection. According to the department in September 1997, a system for tracking contract documentation will be set up.

More Emphasis Should Be Placed on Contract Price

Statutes require that every effort be made to construct public improvements at least cost.

Our review found that limited emphasis was placed on contract price for CM/GC firms. Although CM/GC contract procurements are primarily based on qualifications, price is a factor that agencies need to consider and give adequate weight. In addition, it is important that agencies have a clear understanding of the cost information proposed by prospective firms.

According to ORS 279.023, "it is the policy of the state of Oregon that public agencies shall make every effort to construct public improvements at the least cost to the public agency." Our review of the scoring practices of other states noted methods that have increased emphasis in cost control. For example, in the state of Washington, CM/GC procurements have followed an approach by which firms compete first on qualifications, experience, and other factors exclusive of price. Under this method, top-scoring firms are considered equally qualified and then must compete solely on price. The selected CM/GC firms must provide a sealed bid specifying distinct dollar amounts for pre-construction services, fees, and general conditions. The state of Washington

The department gave limited emphasis to contract cost and agreed to CM/CG fees without first determining whether the proposed fees were reasonable.

then selected the lowest bidder based on the total combination of amounts proposed for these three areas.

In addition to placing appropriate emphasis on the scoring of contract cost, it is also important that agencies have a clear understanding of the cost proposals made by firms. According to industry information, owners (state agencies in this context) commonly take a passive role once the RFP has been released.⁶ To protect the owner's best interest, however, the owner should actively control or manage the bidding process. There are many reasons a bidder may price a proposal unreasonably high. Some of the common reasons include complementary bidding, bidder error, bidder misunderstanding of the scope of work or the RFP documents, perceived risk on the part of the bidder, and bidder uncertainty. Therefore, it is important that the owner take an active role in negotiating the contract cost and not rely solely on the bid documents.

Our review found that the department weighted CM/GC contract cost as approximately 10 percent of the overall proposal evaluation score. Although this weighting methodology may be consistent with a qualifications-based procurement, it could allow a proposing firm with high qualifications and a substantially higher cost to be awarded the contract. Our review also found that the department accepted the fee amounts submitted by the CM/GC firms in their initial proposal documents and did not negotiate or conduct the analytical review necessary to determine whether the proposed fees are reasonable. According to department staff, the department did not request additional information to substantiate the proposed fee. The following describes the CM/GC fee amounts agreed to for each project:

- Snake River-II: 3.95 percent
- Two Rivers: 2.4 percent
- Wilsonville: 2.35 percent

When low emphasis is placed on contract cost, the department may be paying more than necessary for contracted services. In the case of CM/GC fees, even a small decrease in the fee percentage can result in substantial cost savings. For example, if a CM/GC fee of 4 percent on a project with a total cost of work of \$150 million was slightly reduced to 3.5 percent, there would be a savings of \$750,000. Because of this potential for a substantial impact on cost savings, it is important that the department take an active role in negotiating CM/GC fees and confirming that fee amounts proposed are reasonable. While services included in a CM/GC fee can vary by project, in the state of Washington,

⁶ Managing Construction Contracts, 1992; Robert D. Gilbreath.

where increased emphasis was placed on project cost, the CM/GC fee on a \$121 million prison construction project was 1.85 percent.

Recommendations

To improve its procurement process for construction contractors, we recommend that the department take the following actions:

1. Develop a process for ensuring that selection panels:
 - contain an appropriate balance of agency and non-agency personnel;
 - have the appropriate expertise and experience;
 - are adequately rotated between proposal and interview selection phases and between projects;
 - are provided with adequate guidance on how to evaluate and score proposals and interviews. As it develops guidance methods, the department may want to consider establishing scoring ranges, along with definitions for each range, for panel members to use when evaluating proposals and interviews; and
 - are free from potential conflicts of interest.
2. Develop a process for ensuring that selection process and award decisions are fully documented. The documentation maintained should clearly indicate selection panel participants, decisions made, and the bases for all decisions.
3. Develop a process for ensuring that the contract cost amounts proposed by CM/GC firms are reasonable. The department also should consider increasing the emphasis placed on contract cost in its selection process to make price more competitive.

Chapter 2: Contract Development Practices

Stronger Contract Development Practices Would Better Protect the Best Interests of the Department

Opportunities exist to improve the department's establishment of contract cost limits and its control over contract amendments.

Once a successful bidder is selected, the next stage in the process is to develop a contract. At this time, the duties, responsibilities, rights, and monetary consideration between the department and the selected firm are reduced to writing. Contract formulation is critical to the construction project's success because the acceptance of imprudent terms and conditions can have an impact on both project cost and quality. To ensure that the best interests of all parties are well protected, it is important that the department have a strong contract development process. Our review of the department's contract development practices for the Snake River-II project's four primary contractors noted areas in which the department can improve its establishment of contract cost limits and its control over contract amendments.

Contract Cost Limits Can Be Improved

The department allowed the materials testing firm to propose new contract amounts which increased the total contract cost by 86 percent.

Our review found that the department can improve its establishment of contract cost limits. For example, the department entered into an agreement with a firm for materials testing services. While the department requested the firm to propose the total cost of providing services over the life of the construction project, it did not include the proposed total cost of \$615,000 in the contract agreement. Rather, the department contracted for the firm's services for three months at a cost of \$43,340, with an option to amend the contract to extend services throughout the project. As the department continued to extend the services of the materials testing firm, it allowed the firm to propose new contract cost amounts that substantially increased the total amount paid for these services over the life of the project. As a result, the total contract amount grew to more than \$1.14 million, an increase of 86 percent over the original proposed amount.

The department allowed the CM/GC firm to perform millions of dollars in general conditions work without establishing specific cost limits.

Another example of cost limits not being established is in the work allowed to be self-performed by the CM/GC firm. This work is commonly known as “general conditions” work and is work that is temporary in nature. General conditions work can include site supervision, temporary sanitation, temporary water, safety, debris removal, dust control, and winter protection. It is important that the department establish a maximum dollar amount for this work as the cost can be substantial. For example, at the Snake River-II project the amount specified by the CM/GC firm for general conditions work was approximately \$9.1 million. As of December 1997, with around nine months remaining on the project, expenditures for general conditions work had exceeded the original amount by more than \$2.6 million.

Controls Over Contract Amendments Can Be Improved

Inadequate controls over contract amendments can lead to duplication of services, increased project costs, or reduced service levels.

In addition to improving its establishment of contract cost limits, the department can also improve its management of contract amendments. Inadequate controls over contract amendments can lead to duplication of services, increased project costs, or reduced service levels.

We found, for example, that the department had two active contracts for the same services. Prior to hiring the materials testing firm, the department had these testing services included as part of its contract with the architect. After the department contracted with the materials testing firm, seven months passed before the department amended the architect’s contract to remove these services. During that time, the potential existed for duplicate charges as two firms had contract authorization to perform the same services. Although we did not note any expenditures by the architect for performing materials testing services, the department was exposed to paying an additional \$500,000 for these services.

The department incurred millions in costs related to inmate labor without an agreement with the CM/GC specifying how the funds should be spent.

Furthermore, we noted that the department does not have an active agreement with the CM/GC regarding inmate labor. In its RFP, the department requested that the CM/GC firm maximize the use of inmate labor on the project. The department's contract with the CM/GC firm, however, does not address the use of inmate labor and expectations for the work program. In February 1997, the department began the process of developing an amendment to the CM/GC contract to address inmate labor. When we requested a copy of the signed amendment in September 1997, however, the department was not aware of the status of this amendment. After further research, the department found that the amendment had not been executed. It appears that the department did not actively manage this amendment to ensure that it was completed. As a result, the department has limited assurance that the inmate work program is being operated and that dedicated resources are being spent as intended. In this case, the resources expended by the CM/GC firm without a contractual agreement with the department are substantial. For example, our review of project expenditures noted that as of December 1997, more than \$2.9 million has been incurred by the CM/GC firm for costs relating to inmate labor.

Recommendations

To improve its construction contract development practices, we recommend that the department take the following actions:

1. Ensure that detailed contract cost limits are adequately established to protect the state from cost overruns. For contracts in which work is authorized in phases, the department should establish the total contract amount up front. Requested increases to established contract cost amounts should be closely monitored to ensure that the increases are justified.
2. Establish a process for ensuring that contract amendments are developed on a timely basis and then manage this process to ensure that developed amendments are fully executed.

Other Matters

During the course of our audit work, other matters came to our attention that are important for the department to review and consider. These areas were outside the scope of our review; therefore, we performed limited audit work in these areas.

Construction Cost Incentives

There are no incentives for CM/GC firms to come in under budget.

Our review of the department's construction contracts noted that although there are penalties for not meeting established time frames and budgets, there are no incentives for CM/GC firms to come in under budget. According to the department, the time savings of the project is most critical. Therefore, penalties have been established such as monetary damages of \$6,000 per day for each day that the CM/GC firm does not meet the completion date for the Snake River-II project. According to industry information, contracts with a guaranteed maximum price usually include a savings provision under which the contractor and owner share in the savings on a specified percentage basis.⁷ Cost savings can be defined as the difference between the guaranteed maximum price (GMP) and the actual cost of work including the CM/GC fee. This type of incentive could encourage CM/GC firms to be economical and efficient with the state's financial resources and provide the state with greater opportunity for prison construction projects to come in under budget. Now, all construction cost savings accrue solely to the state, a practice which does not provide CM/GC firms with any incentive to come in under the GMP. According to the department, having the cost savings accrue solely to the state creates a positive situation as the department can use the cost savings to add additional features to the project. However, this arrangement reduces the likelihood that projects will come in under budget. As its prison construction program continues, the department should explore whether it would be beneficial to use construction cost incentives.

⁷ *Controlling Construction Costs*, 1996; R.L. Townsend & Associates.

Timing of CM/GC Fee Agreement

The department agreed to CM/GC fees without knowing the guaranteed maximum price for each project.

By agreeing to CM/GC fees early, the department will pay the CM/GC firm for the Umatilla project almost \$300,000 more than anticipated.

As we reviewed information related to the department's selection process, we noted that the department agreed to CM/GC fees for the Snake River-II, Umatilla, and Wilsonville construction projects prior to knowing the project guaranteed maximum price. CM/GC fees are agreed upon at the time of contract signing. GMP amounts, however, have generally been determined two to five months after the contract signing. The CM/GC fee is based on a percentage of the total cost of work as established by the GMP. According to the department, the CM/GC fee is agreed to prior to calculation of the GMP because the project budget and the GMP amounts have not substantially differed. Our research of industry information did not identify any timing standards for CM/GC fee agreement. By agreeing to a CM/GC fee without knowing the project GMP, however, the department may be at risk of paying more than necessary for CM/GC services. For example, at the time the department agreed to a CM/GC fee of 2.4 percent for the Umatilla project, the estimated project budget was \$108 million. The GMP for the project, however, grew to \$120 million. By agreeing to the CM/GC fee early, the department will pay the CM/GC firm almost \$300,000 more than was anticipated based upon the project budget amount. If the GMP increases significantly over the project budget, a reduction in the CM/GC fee amount may be warranted. In this situation, the department may have missed an opportunity to leverage a reduction in the CM/GC fee once the GMP increased over the project budget amount. Waiting until the GMP is determined may provide the department with greater assurance that the CM/GC fee agreed upon is appropriate. Therefore, the department should explore whether it would be advantageous to adjust the timing of the CM/GC fee agreement.

Report Distribution

This report is a public record and intended for the Department of Corrections management, the governor of the state of Oregon, the Oregon Legislative Assembly, and all other interested parties.

Commendation

The courtesies and cooperation extended by the officials and staff at the Department of Corrections were commendable and much appreciated.

Audit Team

Drummond Kahn, Audit Administrator, MS, CGFM
Andy Bromeland, CPA
Marlene Hartinger, MM
Ann Takamura, MPA
Gary Colbert, Audit Administrator, MBA, CGFM, CFE

AGENCY'S RESPONSE TO THE AUDIT REPORT

June 16, 1998

Mr. John Lattimer, Director
Audits Division
Secretary of State
Public Service Building, Suite 500
Salem, Oregon 97310

DEPARTMENT OF
CORRECTIONS

OFFICE OF
THE DIRECTOR

Dear Sir,

With respect to the audit titled "PRISON CONSTRUCTION - PROCUREMENT AND CONTRACT DEVELOPMENT ISSUES", the Department wishes to acknowledge the cooperation and willingness of the audit team to address portions of the initial draft report where the Department felt clarification was necessary. Also, the Department agrees that the new construction program, necessary to accommodate the projected growth in the offender population, will benefit from experience and continued review internally as well as by outside sources such as your audit team. Continuous improvement of the means and methods by which we accomplish our construction objectives is clearly a Department goal. The following reply contains general information as well as an outline of your teams' specific recommendations and the Department's response.

General Information:

The Department's initial Long-Range Construction Plan reflected the capacity necessary to house the anticipated explosive growth in prison population predicted in the April 1996 Prison Population Forecast. The forecast, which was developed and issued by Department of Administrative Services, Office of Economic Analysis, indicated the prison population would expand from 8,717 as of July 1996 to 19,246 as of July 2005. The construction plan called for the addition of eight new prisons or prison complexes, and the expansion of four existing institutions by March 2005. To meet this schedule, the Department chose to use the construction manager / general contractor (CM/GC) process which, as noted in the audit, has the advantage of being a fast-track process. Subsequent prison population forecasts predict a slower growth in the inmate population, which will give the Department greater lead time before several of the facilities will be necessary. Unless circumstances change, future construction beyond the Women's Multi Custody / Intake Center, to be located in Wilsonville, will not require extraordinary means of fast-track construction. This will allow more time for program verification, planning, site development, design, and contract document preparation. The Department recognizes that the method of construction delivery which provides the greatest value for construction dollar spent should be used for future projects that do not warrant the fast-track project schedule. This may be the more traditional design /bid /build approach. Before each new project is established, an analysis will be conducted to determine the most appropriate method of construction delivery.

John A. Kithaber
Governor



2575 Center Street NE
Salem, OR 97310
(503) 945-0920
FAX (503) 373-1173

Results in Brief:

The Department concurs that the process used in the referenced projects for contractor selection, decision documentation, and determination of contract cost can be improved. The Department has taken the first step in ensuring that appropriate procedures are used with the establishment of a Project Management Procedures Manual for CM/GC construction projects. These procedures were not in place at the time of the audit. Although the current version of the Manual does address the selection process for the CM/GC and professional consultants, the Department recognizes the need for enhancement to those procedures to address issues surfaced in this audit.

Specific Recommendations:

Chapter 1 – Construction Contract Procurement

Recommendation: To improve its procurement process for construction contractors, we recommend that the department take the following actions:

1. Develop a process for ensuring that selection panels:
 - contain an appropriate balance of agency and non-agency personnel;
 - have the appropriate expertise and experience;
 - are adequately rotated between proposal and interview selection phases and between projects;
 - are provided with adequate guidance on how to evaluate and score proposals and interviews. As it develops guidance methods, the department may want to consider establishing scoring ranges, along with definitions for each range, for panel members to use when evaluating proposals and interviews; and
 - are free from potential conflicts of interest.

Response: The Department agrees in principle to the recommendation; however, reality prevented full implementation. A conscious effort was made to keep Department staffing to a minimum and to use professional consultants to the degree necessary. This limited the number of department staff who had the appropriate technical expertise. Therefore, rotation between the proposal and interview selection phases and between projects would have involved more staff than existed. Also, the involvement of selection panel members from outside the Department has been difficult to obtain. Relatively few individuals have the time available to devote to this type of activity. The Department's participants did have discussions and agreement on how to evaluate and score proposals and interviews; however, the process was not at that time reduced to a formal written document. (A procedure was developed in 1997.) Finally, it is recommended that the process be free from potential conflicts of interest. The text of the audit referenced an example where one of the four proposing project management firms listed panel members as references. In that case the Department would have had greater concern should that relationship not have been listed since the proposer was once on the Department's staff. The fact that someone then goes on to another career in the private sector should not eliminate them from bidding for work for which they are qualified, and perhaps uniquely knowledgeable.

Recommendation:

2. Develop a process for ensuring that selection process and award decisions are fully documented. The documentation maintained should clearly indicate selection panel participants, decisions made, and the bases for all decisions.

Response: As noted previously, the Department agrees with this recommendation. Although the current version of the Project Management Procedures Manual for CM/GC construction projects does address the selection process for the CM/GC and professional consultants, the Department recognizes the need for additional procedures to address these issues.

Recommendation:

3. Develop a process for ensuring that the contract cost amounts proposed by firms are reasonable. The department should also consider increasing the emphasis placed on contract cost in its selection process to make price more competitive.

Response: As noted in the audit, CM/GC contract procurements are primarily based on qualifications, price is a factor that needs to be considered and given adequate weight. It needs to be clarified that even though the contract cost carried an approximate 10% weight in the CM/GC selection process, that does not mean the state is at risk for paying more for the construction project than necessary. All second tier contractors bidding on the actual construction activity are selected based upon competitive bids. The Department pays only for the cost of the work that is established by the result of the competitive bid process. It is true that the negotiated Guaranteed Maximum Price may be higher than the combined total of the competitive bids for the original project scope. However, the difference becomes savings for the state, or allows the Department the opportunity to adjust the project scope to address issues that may arise as the project progresses. For example, if a prison industry opportunity is identified which requires a larger industries building than originally provided for, any "additional" amount within the GMP could be used to enlarge the structure to the necessary size.

The audit text also contained the following statement: "Our review also found that the department accepted the fee amounts submitted by the CM/GC firms in their initial proposal documents and did not negotiate or conduct the analytical review necessary to determine whether the proposed fees are reasonable." The Department does not agree with this statement, nor does it feel the reference to a lower fee percentage established for a Washington project is relevant. A fee comparison is valid only in the circumstance where the scope of services, location, point in time, and construction market are comparable. This comparability with the Washington project is not evident from the information contained in the audit text. While the Department is unable to provide written documentation indicating how the CMGC fee for the SRCI project was negotiated, we believe the location and economic conditions during that time were taken into account and the fee is appropriate.

Chapter 2 – Contract Development Practices

Recommendation: To improve its construction contract development practices, we recommend that the department take the following actions:

- 1 Ensure that detailed contract cost limits are adequately established to protect the state from cost overruns. For contracts in which work is authorized in phases, the department should establish the total contract amount up front. Requested increases to established contract cost amounts should be closely monitored to ensure that the increases are justified.

Response: The example referenced in the audit text identified a contract which ultimately increased by 86% over the original proposed amount. That particular contract was amended twice. The first amendment included additional technical effort to accommodate the fast tract construction schedule plus a time extension; and the second covered inspection activity not identified in the original scope - plus a further time extension. Neither of these circumstances represented “cost overruns”, but rather additional effort. The Department is in full agreement that cost limits are appropriate where the full extent of the scope of necessary work is known for an original contract.

2. Establish a process for ensuring that contract amendments are developed on a timely basis and then manage this process to ensure that developed amendments are fully executed.

Response: The Department agrees. The text references an amendment which was to cover inmate work activities, an amendment which should have been in place. Since the audit, the Department has placed responsibility for construction related contracts and contract amendments with one position within the Facility Services section. That position is not the same charged with managing the contract for the new construction projects. It is hoped that this action will provide the necessary contract expertise and assist in completing any necessary amendments on a timely basis. It should also be recognized that the contract amendment process also includes review by the Attorney Generals’ Office for legal sufficiency. The time frame for that review is not controlled by the Department of Corrections.

Other Matters:

Construction Cost Incentives – The Department concurs that there are limited incentives for the CM/GC to bring the project in under budget and ahead of schedule. Under the current process, the Department either incurs savings to the state, or has the opportunity to reinvest all savings realized during the course of construction to add necessary elements not included in the original scope of the project. Perhaps an incentive would be to allow the CM/GC to keep some percentage of actual savings produced. As noted early in this response, the Department may not utilize the CM/GC process for future projects. However, if the CM/GC process is used, it is appropriate to explore incentives for the CM/GC to bring the project in under budget.

Timing of CM/GC Fee Agreement – The Department concurs that it agreed to CM/GC fees without knowing the Guaranteed Maximum Price for each project. The fixed fee was established as a percentage of the cost of work. The percentage rate is the figure that was agreed to by the parties involved, presumably to approximate a desired profit margin on a project of the magnitude anticipated. Again, should the CM/GC process be used in the future, this element will be further evaluated.

Should you or your audit staff have questions concerning this response, please do not hesitate to contact Sue Acuff, Assistant Director for Business & Finance (945-9007). Thank you for your assistance.

Sincerely,

David S. Cook
Director

Cc: Drummond Kahn
Sue Acuff
Les Dolecal
Dennis Laughery
Richard Ross
John Ruger

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Director

Deputy Director

Deputy Director

John N. Lattimer

Sharron E. Walker, CPA, CFE

Catherine E. Pollino, CGFM

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Oregon Audits Division
Public Service Building
Salem, Oregon 97310
503-986-2255 Hotline: 800-336-8218
Internet: Audits.Hotline@state.or.us
<http://www.sos.state.or.us/audits/audithp.htm>

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