OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

Special Review

Department of Administration State Food Contract

NOVEMBER 2, 2000 **00-51**

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OFFICE OF THE LEGISLATIVE AUDITOR
State of Minnesota • James Nobles, Legislative Auditor

Representative Dan McElroy, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

David Fisher, Commissioner
Department of Administration

We have conducted a special review of the State of Minnesota's contract with Alliant Foodservice. Alliant provides food for many state institutions, including the state correctional facilities, the regional treatment centers, and the veterans' homes. We conducted the review in response to a request by the Department of Administration's Materials Management Division. Specifically, the division raised questions about the reasonableness of certain prices being charged by Alliant. Our scope included the state's current contract with Alliant, which became effective on February 6, 1995, and has been extended through November 30, 2000.

Our objective in conducting this special review was to answer the following questions:

- Did Alliant Foodservice overcharge the state for food under the existing contract?
- Did the Department of Administration properly oversee and monitor the state food contract?

This report contains the results of our review. It is intended for the information of the Legislative Audit Commission and the management of the Department of Administration. This restriction is not intended to limit the distribution of this report, which was released as a public document on November 2, 2000.

/s/ James R. Nobles

James R. Nobles
Legislative Auditor

/s/ Claudia J. Gudvangen

Claudia J. Gudvangen, CPA
Deputy Legislative Auditor

End of Fieldwork: September 5, 2000

Report Signed On: October 30, 2000

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Audit Participation

The following members of the Office of the Legislative Auditor prepared this report:

Claudia Gudvangen, CPA	Deputy Legislative Auditor
Jeanine Leifeld, CPA	Audit Manager
Marla Conroy, CPA	Director of Investigations

Exit Conference

We discussed the findings and recommendations with the following representatives of the Department of Administration at the exit conference held on October 4, 2000:

Kirsten Cecil	Deputy Commissioner
Kent Allin	Assistant Commissioner
Paul Stembler	Materials Management Assistant Director
Betsy Hayes	Materials Management Analyst
Brenda Willard	Materials Management Acquisition Manager

We also discussed the report in subsequent meetings on October 9 and on October 23, 2000. Greg Huwe, a representative of the Attorney General's Office, was present at these subsequent meetings.

Report Summary

We have conducted a special review of the State of Minnesota's contract with Alliant Foodservice. We conducted the review in response to a request from the Department of Administration's Materials Management Division. Alliant provides food to many state facilities, including the state correctional institutions, the regional treatment centers, and the Minnesota veterans' homes. The state paid Alliant approximately $9.8 million for food in fiscal year 1999.

Our objective in conducting this special review was to answer the following questions:

- Did Alliant Foodservice overcharge the state for food under the existing contract?
- Did the Department of Administration properly oversee and monitor the state food contract?

Key Conclusions

We reviewed Alliant's prices for the week of December 27, 1999, and did not find any specific instances where Alliant's state food prices deviated from the pricing methodology outlined in the 1995 contract. Alliant had documentation to support the prices it charged the state under the 1995 contract. Alliant properly applied the contract markup percentages and guaranteed bid allowances in computing the state price. Our conclusion is based solely on the pricing methodology and other explicit provisions in the 1995 contract. We did not attempt to apply any "implied" requirements or contract standards. In addition, having not found any unallowed pricing by Alliant for the week we tested, we decided not to test further.

We also decided not to test Alliant's prices further because we concluded that certain aspects of both the Department of Administration's bid process and its subsequent 1995 contract with Alliant did not ensure that the state received the best possible prices for its food purchases. We found that the department did not clearly define vendor cost as part of the request for bid process. We also found that the department did not structure its contract with Alliant to promote competition and obtain the lowest food prices possible for the state.

The Department of Administration did not adequately monitor its contract with Alliant. We found no evidence that the department verified Alliant's prices at any time during the five-year contract period. In the absence of a price audit, the department had no assurance that Alliant's sales prices were accurate and reflected the guaranteed bid allowances. In addition, the department did not monitor food price fluctuations for reasonableness. The department's reliance on state facility staff to review and question the food vendor's pricing was insufficient to ensure that the state received the best possible prices for its food purchases.

Chapter 1. Introduction

Background

We have conducted a special review of the State of Minnesota's contract with Alliant Foodservice (formerly Kraft Foodservice). Alliant provides food to many state facilities, including the state correctional institutions, the regional treatment centers, and the Minnesota veterans' homes. The state paid Alliant approximately $9.8 million for food in fiscal year 1999. Other governmental units are also allowed to purchase food under this contract. We conducted the review as a result of a request by the Department of Administration's Materials Management Division. Specifically, the division raised questions about the reasonableness of certain prices being charged by Alliant under its current food contract.

On May 2, 2000, the Department of Administration's Materials Management Division contacted the Office of the Legislative Auditor concerning "some irregularities in the prices actually being charged agencies for food under the current contract." These potential irregularities came to the division's attention during its bid process to establish a new statewide food contract. The Department of Administration had issued a request for bid for a prime vendor food contract on December 8, 1999. The new food contract was to replace the existing contract with Alliant Foodservice, which was set to expire on January 31, 2000. The department conducted the bid opening on January 4, 2000.

After the bid opening, the Materials Management Division received two complaint letters from unsuccessful bidders. These bidders claimed that Alliant Foodservice, the current prime food vendor, used unreasonable supplier prices in its bid. As a result of these complaints, the division conducted its own internal review, including requesting supplier invoices from Alliant. The division identified substantial differences between price quotes that Alliant provided as part of its bid and the prices Alliant was charging state facilities for the same products. After its internal review, the division decided to suspend the awarding of the new food contract. The division contacted us and requested assistance with a contract audit and advice on how to proceed. Table 1-1 provides a sample of pricing differences the Materials Management Division identified.

Table 1-1 Price Differences
Alliant Foodservice – Bid Price vs. Facility Price
For the Week of December 27, 1999

Item Name	Bid Price (1)	Facility Price (2)	Price Difference	Percent Difference
Carrots	$5.98	$10.03	$4.05	67.73%
Peas	8.30	10.89	2.59	31.20%
Peas and Carrots	7.88	10.25	2.37	30.08%
Apple Juice	5.63	8.24	2.61	46.36%
Grape Juice	7.92	11.13	3.21	40.53%
Pineapple Juice	7.76	11.06	3.30	42.53%
Diced Chicken	16.72	24.15	7.43	44.44%
Eggs	4.28	8.43	4.15	96.96%
Ketchup	8.67	11.22	2.55	29.41%
Tomato Sauce	9.70	11.54	1.84	18.97%

(1) Bid price reflects Alliant Foodservice response to the Department of Administration's request for bid. Vendors were required to use the week of December 27, 1999, to determine market prices for the bid. Markup percentages ranged from 4.5% to 5.5% on items other than fresh produce, where the markup percentage was 10%.
(2) Facility price reflects the same or a comparable item from Alliant's State of Minnesota facility food order guide effective for orders delivered after December 31, 1999. Markup percentages ranged from 5% to 6% on items other than fresh produce, where the markup percentage was 10%.

Sources: Bid and facility prices were provided by the Department of Administration. Extensions were auditor calculated.

After conducting a preliminary review of the complaint, we concluded that there was sufficient basis to conduct a full investigation. This report provides the results of our special review.

Objective and Methodology

Our objective in conducting this special review was to answer the following questions:

- Did Alliant Foodservice overcharge the state for food under the existing contract?
- Did the Department of Administration properly oversee and monitor the state food contract?

In conducting this investigation, we analyzed the Alliant (formerly Kraft Foodservice) 1995 and January 2000 bid proposals. We compared Alliant (Kraft) bid prices to the prices it charged to state facilities. We did not perform an extensive audit of Alliant food pricing and invoices over the five-year contract period.

We interviewed current staff from the Department of Administration's Materials Management Division. We compared Administration's 1995 and 2000 requests for bid documents. We reviewed protest letters submitted to the Department of Administration by unsuccessful bidders both in 1995 and after the January 4, 2000, bid opening. We met with Alliant Foodservice representatives on two occasions to discuss the company's business practices, pricing strategies, and to review selected documentation supporting bid and invoice prices.

We reviewed Alliant's prices for the week of December 27, 1999. The conclusions in this report are based solely on the pricing methodology and other explicit provisions in the 1995 contract. We did not attempt to apply any "implied" requirements or contract standards.

We consulted with the Attorney General's Office about various legal aspects of the state's contract with Alliant. However, we do not think that our conclusions require us to refer this report to the Attorney General for legal action. On the other hand, we assume that the Department of Administration can still take whatever action against Alliant it thinks is warranted.

We consider certain information that we obtained in the course of this review to be nonpublic data under the Minnesota Data Practices Act. First, selected portions of the January 2000 bid proposals are nonpublic. The information read at the Department of Administration's bid opening are public data. However, since that bid was subsequently suspended, the remainder of the information contained in the responder's proposals are nonpublic pursuant to the provisions of Minn. Stat. Section 16C.06 Subd. 3. On the other hand, once the 1995 bid was awarded, all information contained in the responses became public information.

We also consider information obtained from Alliant Foodservice to be nonpublic data. Alliant claimed information supplied to us was nonpublic based on the trade secret provisions contained in Minn. Stat. Section 13.37 Subd.1 (b). As a result, specific information concerning Alliant's pricing methods are not included in this report.

Chapter 2 provides our conclusion on the reasonableness of Alliant's pricing, in relation to the Department of Administration's bid and contract process and provisions. Chapter 3 discusses the department's process for monitoring the prime food vendor contract.

Chapter 2. Bid and Contract Provisions

Chapter Conclusions

In 1995, the Department of Administration dismissed a complaint about the state's food contract, including allegations of overcharging. In retrospect, the department's failure to reassess its process for awarding the prime food contract in 1995 allowed concerns about food pricing to remain unresolved for another five years. Although Administration made some improvements before publishing the 2000 request for bid, many of the same issues and concerns came to light again when the department attempted to rebid the prime food contract.

We reviewed Alliant's prices for the week of December 27, 1999, and did not find any specific instances where Alliant's state food prices deviated from the pricing methodology outlined in the 1995 contract. Alliant had documentation to support the prices it charged the state under the 1995 contract. Alliant properly applied the contract markup percentages and guaranteed bid allowances in computing the state price. Our conclusion is based solely on the pricing methodology and other explicit provisions in the 1995 contract. We did not attempt to apply any "implied" requirements or contract standards. In addition, having not found any unallowed pricing by Alliant for the week we tested, we decided not to test further.

We also decided not to test Alliant's prices further because we concluded that certain aspects of both the Department of Administration's bid process and its subsequent 1995 contract with Alliant did not ensure that the state received the best possible prices for its approximately $9.8 million per year food purchases. We found that the department did not clearly define vendor cost as part of the request for bid process. We also found that the department did not structure its contract with Alliant to promote competition and obtain the lowest possible food prices for the state.

On December 13, 1994, the Department of Administration issued a request for bid for the state's prime food vendor. The successful bidder was to be awarded a five-year contract as prime food vendor, providing food to many state facilities, including the state correctional institutions, the regional treatment centers, and the Minnesota veterans' homes. Kraft Foodservice was the state's incumbent prime food vendor in 1994. As a result of the request for bid, the Department of Administration awarded Kraft Foodservice the state's prime foodservice contract for the five-year period from February 6, 1995, to January 31, 2000. In 1995, Kraft Foodservice was sold and its name changed to Alliant Foodservice.

In the 1994 request for bid, the department asked potential vendors to bid on a "market basket" of 65 commonly purchased food items. The bidders were to use market prices for the week of December 12, 1994, to determine the cost for each food item. The department proposed a "cost-plus" format where bidders were to use their actual costs plus a markup percentage to arrive at a state price for each item. It is our understanding that the cost plus format is commonly used in the food distribution industry. Under this format, the prime vendor contract would not set constant food prices. Rather, food prices would be allowed to fluctuate with market conditions. The proposed markup percentages were to remain in effect for the entire term of the contract. Bidders could quote a price for the brand listed or, in some cases, were allowed to substitute an equal brand in their bid.

The request for bid also discussed the application of freight costs to the state pricing calculation. It stated that "freight costs and delivery costs shall be included in the prices of the food products." There are two types of freight costs, inbound and outbound. Inbound freight covers the cost of delivering the supplier or manufacturer's food products to the food vendor's warehouse. Outbound freight covers the cost of delivering food products to state facilities from the vendor's warehouse.

As a result of the 1995 bid opening, two unsuccessful bidders filed protests with the Department of Administration's Materials Management Division. These protests questioned the legality of the "cost-plus" format and Kraft Foodservice's bid prices. One vendor also alleged that Kraft was overcharging the state under the terms of the existing (pre-1995) food contract. The vendor came to that conclusion by comparing items on Kraft's bid proposal to identical or similar items that Kraft was selling to the state under the pre-1995 contract. In response to the allegation, the director of the Materials Management Division wrote the following in a February 13, 1995, letter to an unsuccessful bidder:

> With regard to your concern that Kraft Foodservice has been overcharging the State, your conclusions are erroneous. Clearly, the prices submitted by Kraft Foodservice for the new State contract are different than the prices charged through the existing contract even though the brands are the same. Prior to the submission of their proposal, Kraft Foodservice solicited and received price reductions from manufacturers based on the volumes of their purchases and length of commitment. This made it possible for them to lower their prices for the new contract. Until the start of the new contract, Kraft Foodservice would, of course, charge the State the old, higher prices.

In retrospect, the department's dismissal of the complaint and failure to reassess its process for awarding the prime food contract in 1995 allowed concerns about food pricing to remain unresolved for another five years. Although Administration made some improvements before publishing the 2000 request for bid, many of the same issues and concerns came to light again when the department attempted to rebid the prime food contract. The division also received complaints after its January 2000 bid opening. This time, the department did not dismiss the complaints. Instead, it conducted a preliminary investigation, referred the matter to the Office of the Legislative Auditor, and began a detailed review of its process relating to the food contract.

Conclusion

We reviewed Alliant's prices for the week of December 27, 1999, and did not find any specific instances where Alliant's state food prices deviated from the pricing methodology outlined in the 1995 contract. Alliant had documentation to support the prices it charged the state under the 1995 contract. Alliant properly applied the contract markup percentages and guaranteed bid allowances in computing the state price. Our conclusion is based solely on the pricing methodology and other explicit provisions in the 1995 contract. We did not attempt to apply any "implied" requirements or contract standards. In addition, having not found any unallowed pricing by Alliant for the week we tested, we decided not to test further.

We also decided not to test Alliant's prices further because we concluded that certain aspects of both the Department of Administration's 1995 bid process and its subsequent 1995 contract with Alliant did not ensure that the state received the best possible prices for its approximately $9.8 million per year food purchases. These issues are discussed in Findings 1 and 2.

1. The Department of Administration did not clearly define "vendor cost" as part of the request for bid process.

The 1995 prime food vendor request for bid required bidders to use a "cost-plus" format. Under this format, the request allowed bidders "a percentage of mark-up over acquisition and freight costs for each food category." By using cost-plus, the state's price was directly contingent on the bidder's wholesale cost. The bidder's opportunity to influence its underlying vendor cost had an immediate affect on the bidder's ranking among its competitors during the bid process. In fact, half of the total points the department awarded to bidders during the bid evaluation process came from food pricing. In reviewing the 1995 prime food vendor bid, we found several areas where the department did not clearly define vendor cost and allowed for judgment in determining those prices:

- We found no evidence that the department performed a preaward audit of the successful bidder's vendor costs in 1995. In fact, correspondence dated February 1, 1995 between an unsuccessful bidder and the contract administrator indicates that the Materials Management Division did not intend to perform a pre-award audit in 1995. Because of this, the department did not verify that the vendor costs used in the bid were accurate, supported by supplier invoices, and complete. The department did not review the successful bidder's freight costs to ensure that costs were accounted in the bid and properly supported. Although the request for bid required vendors to include both inbound and outbound freight costs in the state price, there is a risk that bidders could decide not to include freight when determining state prices on the bid. Foregoing freight could substantially decrease the state's cost for that item for the bid – a decrease that may not be realized on subsequent facility prices. To ensure that the vendor cost figures on the bid responses were fair and accurate, the department should have performed a preaward audit on the successful bidder before awarding the 1995 contract. The department should have investigated any bid prices that were unusually low. When Alliant's bid pricing came under scrutiny after the 2000 bid opening, Administration requested documentation from Alliant to support its bid prices.

- The request for bid allowed vendors to "quote a price for the brand listed or . . . specify an equal brand" for some items. The successful bidder, Alliant (Kraft) Foodservice, substituted internal Kraft brands in several cases on its bid response. Bidders may have more flexibility in setting prices on internal (proprietary) products than on name brand products from external suppliers. Because of the risk that bidders might change their internal pricing structures after the bid proposal, the department should carefully weigh the ability of bidders to substitute proprietary label products for brand name products in future bids.

- The department allowed the successful bidder to deduct guaranteed bid allowances when determining its vendor costs. The 1995 market basket included 65 commonly ordered items. The successful bidder provided the state with bid allowances on all 65 of the market basket items, guaranteed for the term of the contract. Alliant (Kraft) Foodservice was the only vendor in 1995 to propose guaranteed bid allowances for the term of the contract. This was a point of contention when unsuccessful bidders disputed the department's decision to allow Alliant (Kraft) Foodservice's bid allowances. Although Alliant (Kraft) provided guaranteed bid allowance for the 65 market basket items, the facility order guide routinely included over 3,000 items. Because of this disparity, it would have been possible for bidders to provide the state with discounts on their bid responses for the market basket items only. These price allowances would lower the state's long-term price for certain items, but may not result in overall competitive food pricing to the state. In future bids, the department should consider either increasing the number of items included in the bid market basket or limiting the allowability of guaranteed bid allowances.

The department identified certain risks that it should consider when developing and evaluating future food contract bids. We agree that a more clearly defined request for bid would help to ensure that the state receives the best possible prices for its food purchases.

Recommendations

- *The Department of Administration should perform a preaward audit of the successful bidder's vendor costs, including freight, before awarding its next prime food vendor contract.*

- *The department should reassess its policy of allowing brand substitutions on its next prime food vendor contract.*

- *When bidding its next prime food vendor contract, the department should consider either increasing the number of items included in the market basket or limiting the allowability of guaranteed bid allowances.*

2. The Department of Administration did not structure its contract with Alliant (Kraft) Foodservice to promote competition and to obtain the lowest food prices possible for the state.

The structure of the department's 1995 prime food contract did not adequately promote competition for the state's food purchases. In addition, some provisions of the contract were unclear and allowed the successful bidder opportunities to interpret the contract to its advantage.

- The contract did not provide sufficient incentive for the successful bidder to continually seek out the best food prices throughout the contract term. The prime food contract was based on a "cost-plus" format with standard mark-up percentages. It is our understanding that the cost plus format is commonly used in the food distribution industry. The contract allowed the underlying vendor cost to fluctuate with market conditions. In fact, because the mark-up percentage was fixed, higher wholesale vendor costs actually increased the successful bidder's revenue from the sale.

- The contract did not contain any caps or maximum contract increase amounts. In addition, the contract only required the prime food vendor to hold prices firm for one week. By not requiring any maximum increase amounts, the department allowed certain prices to fluctuate widely in relatively short periods of time. Due to the nature of food commodities, we understand that the state should expect wider fluctuations in food, especially fresh produce, than in other items that it buys. However, the department should consider capping certain food prices. As discussed in Chapter 3, Finding 3, at a minimum, the department should obtain explanations and documentation supporting any unusual price increases.

- The 1995 contract never required the successful bidder to honor the bid prices for specific items in any subsequent facility order guide. The bid prices were intended to be used only as a guide for evaluating potential vendor pricing and not as a basis for actual invoice pricing. As a result, the risk of underbidding prices existed. As seen in Table 1-1, at the time Alliant bid on the 2000 prime food contract, it was charging substantially higher prices for some items on its facility order guide than those quoted for the bid. We found the same situation during our review of the 1995 successful bid. Table 2-1 shows examples of bid prices quoted by the successful bidder and the related prices from one of the first facility order guides under the new contract.

Table 2-1 Price Differences
Alliant (Kraft) – Bid Price vs. Facility Price
1995 Contract

Item Name	Bid Price (1)	Facility Price (2)	Price Difference	Percent Difference
Mixed Vegetables	$8.14	$9.35	$1.21	14.86%
Fruit Cocktail	21.30	24.32	3.02	14.18%
Sliced Carrots	7.35	8.70	1.35	18.37%
Peach Slices	19.28	21.78	2.50	12.97%
Peas, Canned	11.85	14.53	2.68	22.62%
Ground Beef	19.74	22.89	3.15	15.96%
Cooked Squash, Frozen	15.50	18.16	2.66	17.16%

(1) Bid price reflects the Alliant (Kraft) Foodservice response to the Department of Administration's request for bid. Vendors were required to use the week of December 12, 1994, to determine market prices for the bid. Markup percentages ranged from 5 to 6% on items other than fresh produce, where the markup percentage was 10%.
(2) Facility price reflects the same item from Alliant's State of Minnesota facility food order guide effective for orders delivered after March 31, 1995. The March 31, 1995 guide represents one of the first pricing guides under the prime food vendor contract that became effective on February 6, 1995. Prices reflect the same markup percentages as those incorporated into the bid price.

Source: Auditor analysis of Alliant (Kraft) Foodservice 1995 proposal and March 31, 1995, price order guide.

- The contract did not make a clear distinction between inbound and outbound freight. Although the contract provided that "freight costs and delivery costs shall be included in the prices of the food products," the contract did not stipulate how outbound freight costs should be handled in calculating the state sales price. The contract did not specify whether outbound freight costs should be added before mark-up, included in the mark-up percentages, or added after mark-up. The department should clearly specify how the food vendor should handle both inbound and outbound freight in subsequent food contracts.

- The contract allowed Alliant (Kraft) Foodservice to retain all subsequent supplier promotional discounts. A contract addendum stated: "Kraft shall be entitled to retain all earned cash discounts and other supplier incentives." Because of this language, the state did not benefit from supplier promotional discounts given to Kraft over the term of the contract. In the January 2000 request for bid, the department addressed this issue by requiring the successful bidder to reflect any or all "temporary price reductions, promotional price offers, introductory pricing, or any other offers or promotions" in the price its charges to the state.

- Because of the extended length of the food contract, there was little competition for the state's food purchases. The 1995 prime food vendor contract made the successful bidder the primary provider of food to state facilities for five years. The length of the contract did not promote sufficient competition among food vendors. The department changed the contract period in the January 2000 bid proposal to a two-year contract period with the option to renew for up to 24 months.

Recommendation

- *The department should reconsider certain contract provisions for its prime food contract, including the following:*

  -- *consider price caps or maximum contract increase amounts for certain items,*

  -- *clearly define how the food vendor should account for inbound and outbound freight when calculating state food prices,*

  -- *ensure temporary promotional reductions are reflected in state prices, and*

  -- *decrease the length of the food contract to promote competition.*

Chapter 3. Contract Monitoring

Chapter Conclusions

The Department of Administration did not adequately monitor the Alliant Foodservice contract. We found no evidence that the department verified Alliant's prices at any time during the five-year contract period. In the absence of a price audit, the department had no assurance that Alliant's sales prices were accurate and reflected the guaranteed bid allowances. In addition, the department did not monitor food price fluctuations for reasonableness. The department's reliance on state facility staff to review and question the food vendor's pricing was insufficient to ensure that the state received the best possible prices for its food purchases.

The 1995 contract with Alliant (Kraft) Foodservice allowed the department to conduct audits of the vendor's supplier invoices and freight bills for items purchased under the contract. The contract audit provision stated:

> Contract vendor's supply invoices and freight bills shall be available for inspection by the State of Minnesota by request with reasonable notice. Contract vendor shall cooperate with an annual audit by providing supply invoices and freight bills and itemized price lists for the food items and for the time period selected by the Contract Administrator.

The contract also required Alliant Foodservice to submit quarterly reports to the department regarding food items purchased by state agencies, including product description, pack size, and dollars spent per item. Alliant was also required to provide weekly mailings to the state facilities including market updates, price changes, order guides, and produce information. Additional reports included a distributor report card showing cases out of stock, cases damaged, and substitutions as a percentage of the total cases ordered.

Alliant Foodservice provided the state facilities with monthly order guides that listed products available under the contract. The order guide established the state price for each item. The contract required Alliant Foodservice to hold prices firm for a minimum of one week, and to change prices only when supplier or manufacturer costs changed. Therefore, in addition to the monthly order guide, Alliant provided each facility a weekly price change list that identified items with price fluctuations. Alliant sent invoices to each facility reflecting quantities ordered and order guide prices effective at the time of delivery.

As discussed in Chapter 2, Alliant Foodservice solicited and/or provided guaranteed allowances on 65 commonly purchased items. Alliant guaranteed these allowances for the five-year contract period. As an example, Alliant guaranteed a $6 rebate for General Mills Cheerios for the term of the contract. Alliant therefore agreed to ensure its cost reflected the $6 rebate when calculating the state sales price over the five-year contract period.

In its 1995 proposal, Alliant (Kraft) Foodservice stated that under the cost-plus contract, it defined its cost as the supplier's invoice cost, plus freight, less any off invoice allowances and bid allowances. The food vendor also stated in its bid proposal that it would be entitled to retain all earned cash discounts and other supplier incentives.

Conclusions

The Department of Administration did not adequately monitor the Alliant Foodservice contract. We found no evidence that the department verified Alliant's prices at any time during the five-year contract period. In the absence of a price audit, the department had no assurance that Alliant's sales prices were accurate and reflected the guaranteed bid allowances. In addition, the department did not monitor food price fluctuations for reasonableness. The department's reliance on state facility staff to review and question the food vendor's pricing was insufficient to ensure that the state received the best possible prices for its food purchases. These issues are discussed in Finding 3.

3. The Department of Administration did not adequately monitor the Alliant Foodservice contract.

The Department of Administration did not exercise several opportunities to review and monitor prices being charged under the 1995 contract. As a result, the department was not assured that the state was receiving the best possible prices on its food purchases.

- The department did not exercise its right to audit food prices during the five-year contract. The 1995 prime food vendor contract contained an audit clause that allowed the Department of Administration to audit Alliant Foodservice pricing under the cost-plus contract. Representatives from the Department of Administration and Alliant Foodservices could not recall an audit of the foodservice contract in the last five years. Representatives from Alliant told us that they believed the state may have conducted an audit "in the distant past, but nothing recently." The Department of Administration relied on state facility employees to monitor foodservice contract pricing. In response to an unsuccessful bidder's complaint in 1995, a contract administrator in the Materials Management Division stated:

> State institutions monitor food products and prices closely. In many cases, the contract vendor's prices decrease due to market conditions and those decreases are passed on to the State. Also, State institutions conduct, at random, annual audits of the contract vendor's food acquisition costs.

In the absence of an audit, the department had no assurance that Alliant complied with the terms of the cost-plus contract and continued to reflect all guaranteed bid allowances throughout the term of the contract.

- The department did not verify the reasonableness of the prices being charged under the food contract. Instead, the department relied on facility staff to report problems with the food vendor. We saw no evidence that the department ever compared the prices the state was being charged for food with prices charged to other governments or organizations. Such a comparison would provide the department with a means of determining whether the state is receiving competitive prices on the food it purchases.

- The department did not monitor price fluctuations for reasonableness. Again it relied on facility staff. The weekly price order change list provided a mechanism to review price changes. The report provided the item number, description, and old and new price for the week. The department, however, relied on state facility personnel to monitor facility food budgets and vendor pricing. We saw no evidence that the Department of Administration personnel ever questioned food prices or asked Alliant for additional documentation for significant price increases. However, the department stated that it had not received complaints from the facilities regarding Kraft Foodservice's pricing.

Recommendations

- *The Department of Administration should conduct periodic audits of food contract prices. The audit should include verification of all key contract pricing components, including a review of supplier invoices, freight charges, bid allowances, and other promotional price offers.*

- *The department should conduct periodic reviews of the price order guides and weekly price change lists to determine reasonableness of price fluctuations. The department should request documentation for any significant price increases.*

Representative Dan McElroy, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

David Fisher, Commissioner
Department of Administration

The response that follows from the Department of Administration focuses largely on what the department has done in recent years to improve its bidding process and contract monitoring procedures. The focus of the department's response requires us to again emphasize that our review focused on the requirements of the department's 1995 contract with Alliant.

As noted in the report, we conducted this review in response to a request from the department. The department assumed the result would be OLA criticism of Alliant. Instead, the result is criticism of the department for what we found to be serious shortcomings in the 1995 bid process and lax contract monitoring by the department for the past five years.

The department thinks the problems of the past have been fixed and is clearly disappointed with our decision to release this report. However, our obligation is to report what we found and recommend corrective action. We are pleased that, according to the department, those actions have already been taken.

/s/ James R. Nobles

James R. Nobles
Legislative Auditor

/s/ Claudia J. Gudvangen

Claudia J. Gudvangen, CPA
Deputy Legislative Auditor

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October 30, 2000

Ms. Jeanine Leifeld, CPA
Office of the Legislative Auditor
Room 140 Centennial Building
658 Cedar Street
St. Paul, MN 55155

Dear Ms. Leifeld:

The Department of Administration ("Admin") appreciates and welcomes the opportunity to formally respond to the Office of the Legislative Auditor's ("OLA") report dated October 24, 2000, regarding the state food contract.

With one exception, each recommendation in the OLA's report was initially made to the OLA auditors by Admin staff. Each of those recommendations had been fully implemented by Admin prior to issuance of the OLA report. Implementation was accomplished pursuant to the 1998 Procurement Reform Act or Admin's subsequent solicitations (issued in December 1999 and October 2000) for the statewide food contract. Despite the Department's broad agreement with the report's policy recommendations regarding the solicitation and contracting process, we take strong exception to (a) the thoroughness of the OLA's audit of the contract vendor, (b) the legal conclusions reached affecting the content of the report, and (c) the legal conclusions reached relating to the release of nonpublic information protected under Minnesota Statutes 13.39, subd. 1. while a civil investigation is pending.

Admin is responsible for approximately $1.4 billion of state purchasing per year. The Materials Management Division (MMD) within the Department acts as a central purchasing entity and also oversees acquisition activities delegated to state agencies. The Department has long recognized the importance of diligent contract monitoring and, with this philosophy in mind, sponsored procurement reform legislation and related policy changes in 1998. Prior to the reform activities, MMD staff spent a disproportionate amount of time processing routine purchases. Contract management, a responsibility shared between Admin and the agencies issuing orders against state contracts, was too frequently lax.

As part of the 1998 procurement reform, legislation was enacted to increase the dollar level at which the formal procurement process, including public notice and solicitation of sealed responses, applies. Increasing this limit enabled the Department to responsibly delegate more purchasing authority to agencies so that they could conduct the lower-dollar, less complex acquisitions. Raising delegation levels from $2500 to $25,000 (with training and testing) frees up Admin resources to focus on complex, higher-risk acquisitions and increased oversight and contract monitoring. Within the limitations of available resources, Admin works diligently to adhere to the Ventura Administration principle to "never forget, it's the people's money." To help set priorities, identify problems and partner with customer agencies, Admin has developed numerous forums to engage agency personnel in contract monitoring functions. These include on-line vendor performance reports and contract feedback forms, the creation of multiple contract user groups (including a panel of dieticians focused on the statewide food contract), a rigorous training and certification program and a Customer Assistance Section within the MMD to mediate problems between vendors and agencies.

This change in Admin philosophy and priorities is essential to an understanding of why certain concerns regarding the food contract were dismissed by the Department in 1995, but aggressively and proactively addressed when the contract was rebid in 1999.

Specifically, bid protests were rejected as lacking merit in 1995. Upon receipt of two similar bid protests following the public bid opening in January 2000, the Department conducted a pre-award audit. Admin's audit entailed a review of the apparent low bidder's supplier invoices and an extensive comparison of these invoices to the prices being charged under the current contract. Having found pricing irregularities, the Department immediately suspended the bid process. In May 2000, Admin sought the assistance of the OLA, believing the auditor could bring the most appropriate expertise and resources to the issue of unexplained pricing irregularities. At the same time, the Department conducted a detailed analysis of its 1995 and December 1999 requests for bids to insure that any structural or process deficiencies be corrected.

Upon receiving the OLA's initial draft report in September 2000, we were disappointed to learn that the OLA had done a review of only twenty food items during a one-week period and spent the remainder of the time focusing on this Department's 1995 contract documents and processes, each of which had undergone extensive change and revision subsequent to 1995.

The Department is also disappointed that the report presents former practices as if they are ongoing. The report makes recommendations for changes to areas that are no longer at issue. One example is the recommendation for "decreasing the length of the food contract" (page 12). The 1995 contract was a five year contract. However, legislation sponsored by the department in 1998 required that the original term of standard contracts not exceed two years. The 1999 solicitation was fully consistent with the 1998 legislation. The issue has been moot for several years. Similarly, recommendations regarding promotional price reductions have been implemented through changes in boilerplate contract terms standardized in 1998.

We regret that the OLA report often fails to recognize the improvements that have been made and to acknowledge that all recommendations except one were initially made by MMD staff. This regret is intensified because the audit tasks referred by Admin to the OLA in May 2000 currently remain unresolved and left for this Department and the Office of the Attorney General to further address.

The status of each of the specific recommendations in the OLA's report is noted below:

- Perform a pre-award audit: Admin's pre-award audit beginning in January 2000 identified the problems at issue. Admin will, of course, conduct an additional pre-award audit with respect to the current solicitation.

- Reassess allowance of brand substitutions: This policy change was made by Admin prior to and independent of any input from the OLA. The change is reflected in the current solicitation.

- Consider increasing the number of items included in the market basket or limiting the use of guaranteed bid allowances: Prior to receiving any related input from the OLA, Admin informed the OLA that the number of market basket items would be increased from 65 to more than 400 and that bid allowances would not be accepted. The current solicitation fully implements those changes. Additionally, to further reduce the risk of any bid price manipulation by vendors, Admin developed an innovative bid formula that assesses actual prices charged during a past point in time.

- Reconsider price caps or maximum contract increase amounts: This is the only recommendation in the report that the OLA authored independently. However, Admin discussed the idea with the OLA and several representative customer agencies and concluded that absolute maximums pose a risk to the state and that vigilant price monitoring better protects customer interests. Therefore, Admin management has determined that the recommendation is not in the state's best interest and will not be implemented at this time.

- Clearly define inbound and outbound freight charges: Regardless of whether the 1995 documents were sufficiently clear, the OLA has indicated that based on its review, the contract vendor interpreted and applied freight charges as intended by the state. Definitions have been revised in the current solicitation documents.

- Ensure temporary promotional reductions are reflected in state prices: As noted in the report, Admin had addressed this matter in its December 1999 solicitation.

- Consider decreasing the length of the food contract to promote competition: Admin sponsored legislation in 1998 to require that the original term of standard contracts not exceed two years. The food contract solicitation issued in December 1999 called for an original two year term. The revised solicitation issued in October brought the original contract period down to one year.

- Conduct periodic audits of food contract prices and conduct periodic reviews of the price order guides to determine reasonableness of price fluctuations: It is difficult for the individuals currently employed in Admin to know the degree to which former Admin employees monitored the contract pricing. However, prior to any involvement by the OLA, Admin policy and staff position descriptions required regular and documented monitoring of contract prices by MMD staff. The report comments on the insufficiency of monitoring by facility staff (purchasing agents and dieticians), but fails to fully note that some meaningful review was occurring. For example, the OLA working papers contain documentation of an interview with a facility staff person who acknowledged that she monitors pricing and conducts market research to ensure reasonableness. Her work to monitor pricing is consistent with the training and delegations provided to the facility dieticians and staff involved in ordering food from this contract. As described previously, Admin provides numerous forums for customers to raise concerns about any aspects of statewide contracts, including pricing. Over the life of the 1995 contract, Admin received no customer complaints or concerns pertaining to pricing.

Nevertheless, Admin is committed to reviewing its processes and making adjustments necessary to assure that circumstances such as that reported to the OLA for audit do not recur. As noted previously, MMD now requires its purchasing staff to document contract monitoring activities. With respect to the new food contract, Admin's written contract management plan will be on file as will documentation of the following:

- Weekly review of price increases and prompt investigation of any unexpected changes;

- Formal pricing verification, on at least a quarterly basis, including
  - Comparison of customer invoices to vendor price lists,
  - Review of vendor invoices from its manufacturers and suppliers,
  - Calculation of appropriate markups,
  - Comparison of vendor costs plus markup to prices charged;

- Customer contacts initiated at least quarterly to verify customer satisfaction.

Again, this Department appreciates the opportunity to respond to the report. We fully share the OLA's commitment to protecting the taxpayer and agency customers and believe that current practices play a vital and effective role in assuring that mutual objective.

Sincerely,

/s/ David Fisher

David Fisher
Commissioner