Citizens of Washington:

I am pleased to present to you “Opportunities for Washington,” our performance review of state government operations. For such a time as this, state government has an opportunity and a need to significantly change how it does business. As Governor Gregoire and the Legislature deal with the state’s difficult financial challenges, this review reflects our first such effort to help.

It contains ideas and recommendations to save money, to streamline government programs and functions and to provide better service to citizens. The review also identifies areas in which we can direct performance audits in the near future. Those audits are intended to identify actionable efficiencies.

We have long advocated a state performance review to help make government work better for all of us. When the Governor asked us for reform ideas to achieve meaningful change, we were well positioned to respond and pursue this review.

We conducted the review under performance audit authority granted by Initiative 900, which was approved overwhelmingly by state citizens in 2005. To date, we have completed 23 audits identifying billions of dollars in unnecessary spending, potential cost savings and economic benefits and recommending numerous ways to improve state and local government operations.

This performance review effectively accompanies our performance audit work. For this review, we confined the scope to a select number of money-saving and relevant issues, enabling us to examine ideas and issues in a constrained time period and to provide information and analysis in advance of the 2010 legislative session.

We hope this report is useful and we welcome comments and suggestions to help us in future performance reviews.

Sincerely,

BRIAN SONNTAG, CGFM
WASHINGTON STATE AUDITOR
How to Use This Report

Overview
The three primary sections of Opportunities for Washington describe the individual projects that comprise the 2009 State Government Performance Review conducted by the Washington State Auditor’s Office.

While the entire report comprehensively describes the 2009 review, each section may be considered separately from the overall product.

Section 1: Shared Services
This describes the results of two projects conducted at the request of the Governor to evaluate information technology and lease management services at several state agencies.

Section 2: Government Reform Ideas
This section includes reports on six individual analyses of agencies, programs or services conducted by our staff. Each project report describes specific opportunities for improvement and identifies options for the Governor and policy-makers.

Section 3: Performance Audit Planning Assessment
This section summarizes the results of an assessment of management and performance improvement systems at 38 state agencies. This part of the review was designed to identify areas of state government that likely would benefit from performance audits under Initiative 900.

The assessment will be used by our Office to develop its work plan for future I-900 performance audits. The next performance audit work plan will be published in early 2010.

Publication
The report is being published primarily as an online document. Links are available to individual sections and appendices, as reflected in the table of contents. The appendices include the reports of consultants on the evaluations of information technology and lease management and other information used in the course of the review. The appendices will be posted to the State Auditor’s Office Web site as they become available.

A limited number of printed copies of the body of the report, excluding appendices, will be distributed in January 2010 to the Governor, Legislature and agencies that participated in the project. However, the primary means of publication and distribution will be electronic.

In accordance with the Americans with Disabilities Act, the report will be made available in alternative formats upon request. Please call (360) 902-0370 or e-mail auditrequests@sao.wa.gov for more information.

Corrections
Several corrections were made after this report was published online on December 17, 2009. The revised version, dated January 2010, reflects the following changes:

Lease Management. Page 11 was revised to state that the agencies participating in the project have lease management costs ranging from $200 to $1,000 per thousand square feet (not per square foot) per year. This version also corrects the number of leases managed and the square footage occupied by those agencies.

Medicaid Pharmacy Overpayments. The opportunity statement on page 24 was revised to clarify that Department of Social and Health Services achieved a 162 percent return on investment for Medicaid pharmacy audits during fiscal years 2007 and 2008. Complete information for fiscal year 2009 was not available for this report, so the statistics showing audit costs and recovery totals on pages 24 and 25 reflect two years of audit activity, not three.

Liquor Sales and Distribution. Five-year revenue projections for three retail sales options (Options 4, 5 and 6) were recalculated to reflect the liquor markup rate of 51.9 percent that took effect August 1, 2009. Several estimates in the earlier version of this report were based on the previous markup rate of 39.2 percent. The effect of this revision was to reduce the total five-year increase in state revenue projected for these three options. Revisions were made in several places on pages 26 through 33.

Performance Audit Planning Assessment. The tables on page 43 were revised to place in priority order the elements of Initiative 900 and the result areas of the Priorities of Government that are likely to produce higher-impact improvements if they are the focus of future performance audits.
Executive Summary

This 2009 performance review contains the results of our examination and analysis of some critical issues to help state government meet its financial difficulties. Conducted under our performance audit authority granted by Initiative 900, the review offers ideas and suggestions to save money, to increase revenue from untapped and allowable sources, to make significant reforms of state services and to identify potential opportunities for further efficiencies and improvements in the future.

We recognize the Governor and Legislature face major challenges and decisions in 2010 and beyond to guide state government through the present economic crisis. At the same time, citizens demand that the state spend their tax dollars properly, efficiently and effectively. In that spirit, we were uniquely positioned to use this review and contribute timely and useful information for those decisions.

This year’s review has three key elements

When Washington voters approved Initiative 900 in 2005, they entrusted the State Auditor’s Office with the responsibility to review and analyze the performance of all levels of state and local government – and to make recommendations to save money and improve results. The 2009 Performance Review responds directly to that mandate. This year’s review focuses on state government in response to the ongoing budget crisis that is forcing changes in almost every agency and program. We are committed to working with the Governor, state policymakers and agency administrators to identify opportunities to make state programs and services:

• Faster and more results-oriented.
• More streamlined and less costly.
• More accountable and responsive to the public’s priorities.

The 2009 review contains three primary elements:

Shared Services. We evaluated how to improve the efficiency and effectiveness of state information technology and lease management services. This evaluation was designed to support the Governor’s overall shared services initiative.

Opportunities for Reform. In the face of ongoing budget pressure, we identified practical opportunities to improve the performance of state programs, hold down costs and increase revenue. This part of the review began with the question, “Is this a core function and an appropriate line of business for state government?”

Directions for Future Performance Audits. This part of the review was a broad-based assessment of state government to identify state programs and functions that could benefit from a performance audit. The assessment will provide important information to help the Auditor’s Office develop its work plan for future performance audits under the authority of Initiative 900.

Shared Services: IT and lease management

State government provides many services required by all agencies in their day-to-day operation, such as information technology (IT) support, property management and purchasing. These “shared services” can be costly, especially when they are replicated at many state agencies.

At the Governor’s request, we reviewed information technology and lease management to:

• Evaluate how state government provides these services today and how much they cost.
• Identify the costs of comparable services in the public and private sectors.
• Recommend strategies to improve state service and reduce costs to taxpayers.

Information technology results
Key recommendations:

• Before consolidating additional IT services, the Department of Information Services (DIS) should create a customer-focused culture; adopt competitive pricing; standardize and simplify service offerings; establish service-level agreements; provide detailed statements of work; and re-evaluate the current cost-recovery model.
• Reduce the number of agency data centers and servers.
• Consolidate mainframes, servers, data storage and e-mail administration under one shared service provider.
• Improve disaster recovery capabilities and IT security across state government.
• Revise DIS fee structure to serve agencies at more competitive prices.

State agencies already share some IT services, but further consolidation would require DIS to make operational changes that could take two to three years. Before agencies could reduce costs, the state would need to make up-front investments and significantly change current IT business practices.

Lease management results
Key recommendations:

• Establish a comprehensive, statewide real estate strategy that contains targets for “lease vs. own” and savings based on negotiated lease agreements.
• Change the lease management system by designating the Department of General Administration to manage leases as a statewide portfolio. Currently, the Department focuses primarily on individual transactions.
• Substantially change current information and management systems to improve communication and coordination among agencies.
Executive Summary

Establish lease management performance and accountability targets for all agencies.

Some of these improvements would require up-front investments before savings could be obtained. Some actions could be taken within 18 months; others would require two to three years.

Opportunities for Reform

Deep budget cuts and ongoing deficits are forcing Washington state leaders to fundamentally rethink the way government delivers services to citizens.

Our analysis of selected reform ideas identifies several opportunities to improve programs and services, generate additional revenue without raising tax rates and change the way the state provides two programs – liquor sales and printing services – that many believe are outside the core of critical state government activities.

Options to improve efficiency and increase revenue were evaluated in-depth for five reform ideas. Key conclusions:

- Washington likely could increase revenue by several million dollars and bring unregistered businesses into the state tax system by conducting an amnesty program to collect delinquent debts.
- The state could increase its collection of delinquent debts by more than $5 million in the first year by participating in a U.S. Treasury program in which government vendor payments are garnished to satisfy overdue tax obligations before the payments are made.
- The Department of Social and Health Services could increase the amount of Medicaid pharmacy overpayments it recovers by expanding its small but effective audit program that consistently recovers more funds than it spends for audits.
- State agencies could reduce printing costs and improve service by changing the Department of Printing business model to better respond to agency needs and to reflect 21st century advances in technology.
- Washington could increase revenue from liquor sales and distribution by up to $350 million over five years beginning in fiscal year 2012 if it sold the state distribution center and auctioned licenses to sell liquor to private-sector businesses.

Performance Audit Planning Assessment

As part of the review, we conducted a broad assessment of state government functions and services to help us decide where to direct our regular performance audits in the near future. The assessment was initiated in the belief that every government program – including those in our Office – can be improved.

The assessment evaluated the management, budget and accountability systems in place at 38 agencies that together account for more than 70 percent of the state government operating budget. Working closely with agency staff, we identified several elements of I-900 and several performance goals identified in the state’s Priorities of Government for which performance audits could lead to significant improvement.

We will evaluate findings from the assessment and other information – including data about agency results and suggestions from citizens and state policy-makers – to develop work plans for future state government performance audits. The next work plan is scheduled to be released early next year.
State government provides many services required by all agencies in their day-to-day operation, such as information technology support, property management and purchasing. These services can be costly, especially when they are replicated at many state agencies. Large public and private organizations are benefitting from various approaches to sharing these services.

Early this year, Governor Chris Gregoire directed state agencies to evaluate the shared services of IT, fleet management, property management and human resources systems to identify options to standardize or centralize current operations and to reduce costs.

To support this initiative, the Governor asked State Auditor Brian Sonntag to evaluate IT and lease management. Our evaluation had three main purposes:

• To evaluate how state government currently provides these services and how much they cost.
• To identify best practices and the costs of comparable services in the public and private sectors.
• To recommend strategies to improve service and reduce costs.

For each evaluation, we identified a small group of state agencies to participate in the project and hired technical experts to develop analytical models, review data and help develop recommendations. By focusing the 2009 evaluations on limited numbers of agencies, we were able to complete the 2009 projects in time for legislative consideration and to develop tools that can be used to evaluate additional agencies and other shared services in the future.

**Labor union contracts and contracting out**

Many of the state employees whose jobs would be affected by the adoption of these options are represented by unions and covered by existing collective bargaining agreements. Management would be required to fulfill any bargaining obligations or contractual requirements if any of the options were adopted. The extent of that bargaining obligation would depend on the provisions of the option adopted. Also, the competitive contracting provisions of state law (RCW 41.06.142) could apply to any option under which the agency contracted out work that had been performed by state employees.
Background

Washington state government provides information technology services in three main ways:

- Agencies use internal resources to purchase services and to fund staff positions to support IT investments.
- DIS provides some services in its role as the state’s central IT agency.
- Services are purchased from private sector vendors.

Several agencies have their own mainframes, support their own servers, have service desks and manage voice and data network services. State law does not specifically require agencies to obtain the lowest-cost service or to obtain service from DIS. DIS provides mainframe, server hosting, storage, service desk and voice and data network services to any state agency that requests its support. These shared services are provided under a model that requires DIS to recover all of its direct and indirect costs.

The amount state government spends for information technology is not clear. Neither the state nor individual agencies have been able to track IT costs to the extent needed to answer questions about the total cost of IT.

Within the IT portfolios reported to DIS by the 76 largest agencies, not including the public two-year and four-year colleges and universities, IT cost a total of $673 million for fiscal year 2009.

We recognize that legislators and other interested parties have raised questions about how the state’s IT costs compare to those of other public and private-sector organizations. The state does not have the information needed to reliably compare IT costs. As a result, this review was designed to identify comparable technology functions and services.

The state also does not provide comprehensive services to agencies in two other important IT areas – disaster recovery and security. The Legislature has not approved individual agency requests for funding of disaster recovery solutions. As a result, the state’s delivery of services to the public is vulnerable to a power outage or other significant interruption.

Project approach and objectives

We reviewed these IT issues to examine operations and costs in fiscal year 2009; to evaluate current services; to identify best practices; and to develop recommendations on how to work more effectively within a shared services model. We chose five agencies to represent the range of IT services required throughout state government: the departments of Corrections, Information Services, Revenue and Transportation and the Office of Financial Management. Selection criteria included the size, complexity and geographic distribution of their information technology assets.

The review focused on the following services:

- Mainframe
- Servers
- Voice and data networks, including telephone systems
- Service desk
- Storage
- End-user computing

Business application support and development was not included in the scope of the review, which was focused on IT infrastructure.
We worked with a consulting firm to conduct this review, which relied on data from participating agencies about their technology infrastructure, costs and service performance. Agency data was verified in follow-up personal interviews and data accuracy was validated by representatives at each agency.

The objectives of the study were to:

- Develop standard definitions for services so that the data would be consistent.
- Establish a reliable, comparable baseline of current total costs and services.
- Examine the rates that DIS charges for its services to agencies.
- Calculate the total cost of current services for fiscal 2009, including personnel, physical facility, licensing, energy use and maintenance costs.
- Compare the total cost of services listed above to those of other public and private organizations to highlight areas for potential savings or service improvements.
- Recommend alternative pricing and shared service options to improve service delivery and reduce costs.

Total cost of current services

The state cannot easily track the total cost of information technology within current financial systems. For this study, the five agencies used their best available financial data, performed calculations based on agreed assumptions and made estimates when faced with incomplete data.

The graphic above summarizes fiscal year 2009 spending for staff and services from DIS and services from third parties at the five agencies. The five agencies spent nearly $95 million on IT infrastructure services alone.

Savings opportunities

This review found the greatest opportunity for percentage cost savings is within application servers. This savings is estimated at 15 percent to 20 percent, or a range of $1.6 million to $2.1 million for the five agencies reviewed. Cost savings of 10 percent to 15 percent could be realized for most of the other services we reviewed. Total potential savings from taking advantage of shared service opportunities at the five agencies is $6.6 million to $9.7 million annually. The following table shows the specific opportunities by service type.

The costs used for this analysis are the portion of total costs that are most likely to produce savings.

When the potential cost savings for the five agencies are applied across state government, efficiencies could be significantly greater.

<table>
<thead>
<tr>
<th>Services</th>
<th>Costs at all 5 agencies</th>
<th>Potential annual savings</th>
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<tbody>
<tr>
<td>Mainframe</td>
<td>$14.3 million</td>
<td>$1.4 million - $2.1 million</td>
</tr>
<tr>
<td>Application servers</td>
<td>$10.7 million</td>
<td>$1.6 million - $2.1 million</td>
</tr>
<tr>
<td>E-mail/utility servers</td>
<td>$4.2 million</td>
<td>$0.4 million - $0.6 million</td>
</tr>
<tr>
<td>Shared storage</td>
<td>$3 million</td>
<td>$0.3 million - $0.4 million</td>
</tr>
<tr>
<td>Managed network services</td>
<td>$22 million</td>
<td>$2.2 million - $3.3 million</td>
</tr>
<tr>
<td>End-user computing</td>
<td>$8.1 million</td>
<td>$0.4 million - $0.8 million</td>
</tr>
<tr>
<td>Service desk</td>
<td>$2.8 million</td>
<td>$0.3 million - $0.4 million</td>
</tr>
<tr>
<td>Total</td>
<td>$65.1 million</td>
<td>$6.6 million - $9.7 million</td>
</tr>
</tbody>
</table>

Source: Technology Partners International, agency data

Comparison with the marketplace

The review compared infrastructure costs at the five agencies to a range of costs in the external marketplace. The consultant obtained public- and private-sector market data for the past 18 months. The comparative data came from organizations that have similar size, scope, complexity, types of technology and number of service locations.

The resulting analysis provides a reliable comparison and reveals opportunities for savings and gaps and risks in service delivery. However, this analysis should not be considered an
“apples to apples” comparison. A direct comparison was not always possible because the state does not track the same financial and business data elements that are used by the private sector.

Some key observations:

- IT salaries in state government tend to be lower than the marketplace.
- State staffing ratios for managing IT infrastructure services tend to be lower than those in the marketplace – indicating that staff levels are being stretched beyond market norms.
- Current state disaster recovery capabilities are less than what exists and is used in the marketplace.
- State agencies have very few agreed-upon service levels compared to the marketplace.
- With the exception of DIS, many state IT operations are not supported 24 hours, year-round with staff on-site as in the external marketplace.

Key actions should precede further efforts

The state's current IT environment reflects a limited shared services approach, with DIS providing some central services and agencies frequently providing their own IT support or contracting for it.

Based on our five-agency evaluation, we recommend DIS make the following changes before it further consolidates or shares information technology infrastructure services:

Create a customer-focused culture

Shared service providers must be customer-focused to succeed. They must be aligned with customers’ current and future service requirements. This would require discussions between the agencies’ chief information officers and state government IT leaders about current and future requirements, technology ideas, strategic direction, service performance and customer satisfaction.

Standardize and simplify service offerings

IT services should be standardized and communicated through a simplified catalog. The current practice of customizing “boutique” solutions and preparing individual pricing for each agency is not a sustainable operating model. Agency customers need clarity and predictability about the services they are buying, including their cost and the levels of support.

Provide detailed statements of work

Standard services should be supported by detailed statements of work. This approach provides clarity on what support activities will be provided and will eliminate costly support redundancies or gaps between the service provider and agency support personnel.

Improve service-level agreements

Agreements between the service provider and the agencies should be improved regarding service levels, including action plans when service levels are not achieved.

Price services consistently with the market

Pricing should include all elements required for a given service and agencies should be charged based on their use. This approach should result in pricing that is easier to understand and validate.

Re-evaluate the current cost-recovery model

The practice of requiring DIS to recover all of its direct and indirect costs should be reconsidered. The current model prevents DIS from offering many IT services at a competitive price to state agencies.

Also, the current biennial rate-setting process requires service providers to set rates about 15 months in advance. This creates a delay between price-setting and the use of services. Frequently, newer or less expensive technology becomes available in the meantime. As a result, agencies often seek cheaper technology solutions on their own.

A more effective rate structure would reflect user-driven costs and would eliminate cross-subsidization. E-mail accounts and data storage are examples of services that should be charged back to agencies on a per-use basis. In contrast, strategic or systemic costs, such as enterprise architecture and policies and the development of new technologies, should be funded by appropriation and not charged back to agencies.

Recommendations

After taking these key actions, the state should consider the following recommendations:

Reduce the number of agency data centers

The state should consider significantly reducing the number of data centers through consolidation to reduce costs and risks. This applies to all agencies that have data centers.

Consolidate IBM mainframes

A number of agencies provide mainframes that run 24 hours a day, seven days a week to manage business application processing. The cost to run these applications could be significantly reduced by consolidating them into the existing shared services’ IBM mainframe environment at DIS.

In addition, DIS could further reduce costs over time by reducing dedicated processing environments and migrating to primarily shared processing environments.

Standardize and centralize IT support

By standardizing service delivery processes and tools across the state, including remote diagnostic support, software distribution and inventory management tools, state agencies could provide more cost effective services. Changing to standard processes and tools would allow service desk operations to:

- Consolidate the functions within agencies, especially for the most basic level of support.
- Provide a shared service desk function for multiple agencies.
- Use consistent best practices for recording service requests and reporting.
Use the server environment more efficiently
A server technology is emerging to use computer equipment and resources more efficiently. Further efficiencies can be gained by increasing the use of this technology. To do so, however, will require agency business and application resources and a clearly prioritized consolidation plan.

Use network resources more efficiently
This includes bandwidth and equipment. State agencies should continue to use networks provided by DIS. Network efficiency could be gained by consolidating data centers as mentioned above because it would eliminate duplication and use existing resources.

Develop a comprehensive disaster recovery plan
The lack of a comprehensive disaster recovery plan to support critical agency IT operations is a significant risk to state government. For instance, not having access to Department of Corrections’ offender information could affect public safety and state revenue would be directly affected by any interruption to the Department of Revenue’s tax collection applications.

We recommend DIS more aggressively seek funding of a comprehensive disaster recovery solution for all agencies that enables it to recover critical applications on mainframes and servers and addresses equipment failures and the loss of data center capability.

DIS should improve shared storage pricing
Given the rapidly increasing use of state information from internal and external customers and a corresponding demand from state agencies, we recommend DIS provide a competitively priced shared storage solution to state agencies.

Consolidate e-mail administration
The state is considering e-mail service as a shared service opportunity. E-mail is a viable opportunity for consolidation and we recommend DIS include e-mail administration (such as creating mailboxes, allocating space and setting passwords) as part of the central service. This would eliminate the need for each agency to provide its own e-mail administration.

Lessons from other organizations’ efforts
As Washington considers shared services options to reduce cost and improve performance, policy-makers should keep in mind the lessons learned from other entities that have consolidated or shared services.

Up-front investments will be required and it can take considerable time to break even. Another mid-sized state that is consolidating IT infrastructure for 12 agencies required an initial investment of $70 million to $90 million to standardize equipment and service processes and to contract for disaster recovery and security services. It expects to break even in 36 months.

Some agency IT costs will increase and others will decrease as the state migrates to a new, simplified IT pricing structure.

It may not make sense for some agencies to consolidate IT functions because of their low costs for providing required services, dedicated funding sources or special revenue requirements.
Lease Management

Opportunity
Washington could identify a statewide real estate strategy to improve the efficiency and reduce the cost of its lease management activities. The state could manage leases more actively by using commercial real estate brokers for lease transactions and centralizing lease data and payment systems.

Options
The most promising opportunities to share services, improve efficiency and cut costs would require state agencies to establish a statewide strategy. A long-term real estate strategy should include “lease vs. own” targets and a roadmap for decision-making that supports state goals for efficiency and cost containment. The state should:

- Manage leases as a statewide portfolio. To make best use of space and contain costs, the Department of General Administration (GA) should comprehensively manage state leasing activities and policies instead of placing its highest priority on individual transactions. GA could accomplish this by contracting with commercial real estate brokers to carry out individual transactions.
- Centralize the lease payment system to reconcile all expenses and track facility costs over time.
- Develop a shared, multiagency lease management information system.
- Review and manage space standards to ensure the state does not pay for excess space.
- Contract with commercial real estate brokers in lease transactions to help reduce the state’s lease costs and improve lease rates and terms.
- Establish internal project tracking and related management systems to improve communication among agencies.
- Routinely compare state lease rates with private-sector market data to ensure the state is paying competitive rates.
- Establish performance targets for all agencies engaged in leasing activities and establish clear points of comparison with the private marketplace.

Key issues
General Administration and the Office of Financial Management would need to make major system changes to obtain significant efficiencies, especially to use the state’s purchasing power to obtain favorable lease terms and appropriate spaces for agencies.

Some improvements could be made during the current biennium, but others would require two to three years.

Some of the improvements would require up-front investments.

Background
Washington houses its 103 state agencies, not including higher education institutions, in 14 million square feet of space in more than 1,000 locations, according to the Office of Financial Management (OFM), which estimates 73 percent of the space is leased and 27 percent is owned.

To determine whether lease management could be improved or costs reduced in an expanded shared services model, the State Auditor’s Office conducted a lease management cost and services study. The study was designed to:

- Develop standard definitions for lease management services.
- Determine the total cost of lease management services in 10 state agencies.
- Document current processes, performance measures and financing.
- Identify promising opportunities to improve service and reduce costs.

Central service agencies’ roles
The Department of General Administration provides real estate services to all state agencies, commissions and educational institutions except those that have been granted authority by state law. GA is required to determine the location, size and design of real estate for those agencies. Approximately 90 agencies use GA to manage their leases. Those agencies occupy about 11.5 million square feet of leased space, which represents more than $180 million in lease payments per year. In some cases, agencies lease space in state-owned buildings.

Until 2007, when House Bill 2366 was enacted, OFM historically has had limited involvement with real estate management. The legislation directed OFM to develop a strategic six-year facility plan, establish a pre-design process for new space, gather facilities inventory data and oversee procurement and management of state agency office and warehouse space. Today, OFM approves leases that exceed $1 million annually, leases for space under development and long-term leases.
Renewal process
Currently, the renewal process for one lease takes approximately 18 months. Participants include the landlord, the agency that occupies the space, GA and, in some cases, the Attorney General’s Office and OFM. The timetable may take longer if extensive improvements are needed to meet the agency’s needs.

Staff from the agencies that participated in this project stated the process is complex, that few performance standards or customer satisfaction measures are in place and that little information is available about the status of lease requests during the renewal process.

Fee structure
GA’s fee structure is based on a cost-recovery model and relies on several revenue sources.

GA charges agencies for standard lease renewals based on an estimate of the cost of the services it provides, such as lease negotiations. In addition, GA includes charges in the estimates for its statewide policy and planning related to leases. Consequently, its charges to agencies likely overstate the actual cost of lease renewal activities for specific transactions.

Further, the current fee structure does not consider performance and therefore provides no incentives for GA to improve the renewal process. Finally, the current model does not enable GA to fully recover its costs, in part because it has not increased the hourly rate it charges for staff work since 2001, and commissions GA charges for new lease services have declined due to fewer and smaller new leases. GA asked OFM in April 2009 for approval to increase the hourly fee.

The current fee structure is unsustainable and presents significant financial risk. After accounting for cash and revenue carry-forwards, GA’s Real Estate Services Division is expected to have a deficit of more than $200,000 in the current biennium.

How we conducted the evaluation
We conducted the cost and services study with the assistance of a consulting firm. Ten agencies participated in the project: Agriculture, Attorney General, Corrections, Employment Security, Financial Management, General Administration, Labor & Industries, Licensing, Social and Health Services and Transportation.

The agencies were selected because they occupy approximately 65 percent of the square footage GA manages. They have 531 active leases totaling almost 7.7 million square feet. Office space comprises at least 95 percent of the total leased space. Space for support functions, including storage and warehouses, comprises the other 5 percent.

The agencies’ lease management costs totaled about $3.9 million in fiscal year 2009. About $2.2 million was paid to GA for lease management services, with the remainder used for the agencies’ internal staff costs. Agencies’ costs range from about $200 to $2,013,000.

<table>
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<tr>
<th>SERVICE PROVIDED</th>
<th>FEE STRUCTURE</th>
<th>BUDGETED FOR 2009-11 BIENNIUM</th>
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<tbody>
<tr>
<td><strong>LEASE RENEWAL SERVICES</strong></td>
<td>Appropriated Funds Allocated to Agencies</td>
<td>$2,446,000 (51%)</td>
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<tr>
<td></td>
<td>Allocation basis (based on total pool of leases in privately-owned buildings):</td>
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<td>% of total leases</td>
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<td></td>
<td>% of total leased square feet</td>
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<td></td>
<td>% of total monthly rent costs</td>
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<tr>
<td><strong>NEW LEASE SERVICES</strong></td>
<td>Commissions</td>
<td>$347,000 (7%)</td>
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<tr>
<td>10,000+ sf</td>
<td>2.5% of gross rent associated with first five years of lease term</td>
<td></td>
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<tr>
<td>5,001 - 10,000 sf*</td>
<td>+ 1.25% of gross rent associated with year six and beyond, if applicable</td>
<td></td>
</tr>
<tr>
<td>1 - 5,000 sf</td>
<td>Hourly Fees $83.25/hour</td>
<td>$2,013,000 (42%)</td>
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<td>* At RES Manager discretion, may be billed hourly</td>
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<td><strong>REIMBURSABLE SERVICES</strong></td>
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<td>Billed to Agencies at Actual Cost</td>
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<tr>
<td><strong>DELEGATIONS</strong></td>
<td>Flat Rate $250 per lease delegation</td>
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<td><strong>PASS THROUGH COSTS</strong></td>
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Conclusions and recommendations

Overview of an optimal system
Washington state has a significant amount of leased space, but does not approach lease management in a strategic and focused manner. Based on our review of the state’s current system and best practices in the public and private sectors, we suggest that an optimal lease management system would include:

- A comprehensive statewide real estate strategy and supporting policies.
- Systems and processes that would allow the use of a statewide strategy.
- An organizational structure that would support the real estate strategy of managing the state’s investments as a portfolio.

Real estate portfolio management is designed to maximize the value of leased assets by developing a comprehensive strategy; performing ongoing evaluation and tracking of lease holdings statewide; identifying cost reduction opportunities and ensuring that decisions and portfolio planning align with the overall strategy.

Under an optimal system:

- A single agency would provide real estate services to all other agencies. This agency would focus on the state’s entire real estate portfolio, including owned and leased space. Portfolio managers within the agency would focus on optimizing the entire state portfolio consistent with the overall state real estate strategy. The agency would actively manage all leased space and not be solely transaction-focused or react after a lease expires.
- The agency would contract with commercial real estate brokers for services to obtain the most favorable terms and conditions. However, it would oversee the brokers’ work and make final real estate decisions.
- The optimal fee structure for lease management services would reflect the level of effort and services provided by the agency.
- A second agency would provide oversight for transactions that exceeded a specified value or size.
- Each client agency would have liaisons to work with the portfolio managers and communicate the agency’s specific needs.

The state does not have clear goals or objectives related to leasing or real estate. Many leases expire before new leases are in place, which diminishes the state’s negotiating position with property owners. More importantly, the state has not used its purchasing power to obtain the best space and improve lease rates and terms.

We recommend significant improvements to the lease management system and business model.

GA should build its capacity to act as the state’s real estate portfolio manager. OFM should retain its oversight role for large transactions. Agencies’ facility liaison functions should be preserved.

The proposed major changes would require an investment of time and resources, but could reduce costs and generate significant efficiencies.

Conclusions and recommendations are organized by five topic areas. Each section includes a brief description of the opportunity, an assessment of the current situation and recommendations for improvement.

Statewide strategy, policy and oversight

Opportunity
GA should approach the state’s real estate as an asset and develop a formal, long-term strategy that comprehensively addresses acquisition, leasing, disposition and management. It should have a comprehensive, real-time facilities database. It should use its position as a large tenant to identify savings across leased and owned properties. Strategies should include space standards reviews, agency co-location, lease renegotiation and other strategies.

Current situation
Without a statewide real estate strategy, space-related decisions are being made by GA, OFM and the individual agencies on a case-by-case basis. While agency needs are met, the perspective of the state as a whole is not well-represented. For example:

- No statewide strategy for lease management or leased space has been developed.
- Without a statewide strategy and clear definition of roles and responsibilities, over the last two years OFM has taken on some functions that should be done by GA (such as enforcing space standards and identifying opportunities to use leased space that is vacant). While this has produced some savings, it has created confusion about lease management roles and responsibilities. Because of the time needed to review transactions, OFM may have delayed the acquisition of leased space.
- The state budget process does not support up-front investments that result in long-term savings or improvements to quality of space. For example, if an agency proposes consolidation of several spaces into one location, this may not be approved due to high up-front costs of relocation and consolidation, even though this may save a significant amount over time and improve the agency’s service provision.

Recommendation
A statewide real estate strategy would formalize the state’s goals and objectives and communicate them to all parties. It would provide a roadmap for decision-making that would support state goals for efficiency and cost containment. The primary responsibilities of strategic planning and portfolio management should reside within GA. OFM should retain oversight on large transactions and input on the statewide strategy.
The strategy should describe:

- Vision, goals and objectives.
- Strategy for leased vs. owned space.
- The extent of OFM’s involvement in the lease management process, including its oversight role and thresholds for its review of agency leases.
- Budgetary processes or requirements that would affect long-term cost savings. We recommend facility relocation or consolidation analyses weigh the cost of up-front investments (e.g. moving costs) against long-term benefits (e.g. service delivery improvements, reduced operating costs), at least for the term of the lease.

**Portfolio management and lease administration**

**Opportunity**
Portfolio management should identify opportunities for consolidation, co-location and long-term savings through lease renegotiations. The state should have accurate and current lease information to improve the use of space, to renegotiate rates and terms as appropriate and to reconcile lease payments with contract terms. Portfolio management would help the state put in place the statewide real estate strategy. Centralized administration and improved information would help the state save money and improve results.

**Current situation**
The state does not review or manage leases as a portfolio. GA focuses on individual lease transactions, while OFM focuses on lease oversight and the six-year facility plan. In addition:

- Multiple lease data systems produce inconsistent and inaccurate data and documentation.
- A decentralized lease payment system does not support efficient cost management and reconciliation to identify possible overpayments on leases.
- GA’s fee structure does not cover all of its costs.

**Recommendations**
We recommend two major changes and three improvements to the current system.

**Major changes:**
- GA should focus on portfolio management, which currently represents more than $180 million in annual lease payments. Contracting with commercial real estate brokers to carry out lease negotiations, facility audits, space availability analysis and market rate comparisons would free up agency staff to focus on portfolio management. Also, recruiting managers with commercial real estate expertise would help GA carry out the overall real estate strategy and help ensure such positive outcomes as timely and competitive lease renewals.
- GA should develop a centralized lease payment system to permit reconciliation of all expenses – especially to recover any overpayments – and to track facility costs over time.

**Improvements to the current system:**
- GA and OFM should institute a shared lease management database. We recommend a Web-based, off-the-shelf system that could be viewed and edited by multiple parties and would contain electronic copies of all leases and related documents.
- GA should review and manage space standards to ensure the state does not pay for excess space.
- GA should redesign its fee structure to ensure cost recovery and to improve incentives for high-quality, cost-effective outcomes. However, this should not occur until changes to the lease management system have been made, to avoid spending resources on another fee structure update.

**Leases**

**Opportunity**
The state should use its considerable buying power and its position as a large lease holder to influence favorable lease terms. The state should focus on portfolio-level strategic lease management to identify opportunities to consolidate, co-locate, relocate and obtain long-term savings.

**Current situation**
Our evaluation noted several shortcomings:

- The state does not actively manage leases as market conditions change. For example, the state could benefit if it reviewed and renegotiated selected leases in response to the recent recession-driven shift in the real estate market.
- Many leases expire before they are renewed, which reduces or eliminates the state’s negotiating power.
- GA focuses on transactions and reacts to issues as they arise.
- GA’s current fee-for-service funding system focuses on service for specific transactions and discourages GA from strategically managing the state’s lease portfolio.

**Recommendations**

**GA should engage commercial real estate brokers to help with lease negotiations.** Unlike the fee-for-service model, the number of commercial real estate brokers would directly correspond to the demand for space and services. This new approach would have the following characteristics:

- The state’s lease transaction costs would be reduced. Currently, GA pays leasing agents’ salaries and benefits. GA could set up a system through which commercial real estate brokers would receive a commission on lease transactions from the property owner – a standard practice in the private sector. In addition, many entities with real estate broker contracts have negotiated a fee sharing agreement whereby some percentage of the broker commission is returned to the entity.
- GA staff could focus on portfolio-level strategic lease management. This would put the state in position to conduct more active lease negotiations to improve rates.
and lease terms with property owners. GA's contracts with commercial real estate brokers should include provisions to evaluate performance and mitigate potential conflicts of interest. GA should retain lease decision-making authority, provide oversight and monitor performance.

Also, GA should revise its standard lease language for deferred maintenance and should clarify what “corrective actions” will be taken against nonresponsive property owners. This will strengthen the state's position in overall lease management.

Project management and communication

Opportunity

The agency responsible for portfolio management should develop internal data and analytical systems to ensure managers receive the information they need to oversee the statewide real estate portfolio. Also, excellent communication is vital between portfolio managers and client agencies.

Current situation

We identified the following shortcomings:

• GA lacks sufficient lease management tools. For example, it has no internal project tracking system, which makes it difficult for managers to identify lease renewals that require additional attention, such as deployment of additional staff, to ensure the transactions are completed before the existing leases expire.

• Communication between GA, OFM and client agencies is inconsistent, fostering a lack of trust that contributes to inefficiencies and duplication.

Recommendations

GA should make several changes to more effectively manage state leases. The agency should:

• Track and report the use of staff time. A full time-keeping system would show where effort is being spent and how best to distribute the costs of those efforts.

• Establish internal project tracking and related management systems.

• Provide regular project updates to client agencies and conduct a customer satisfaction survey at the end of each project.

Performance and accountability

Opportunity

Performance measures should be designed to assess whether a project, process, individual or team is achieving intended goals. Performance measures promote organizational learning and performance data help identify areas for improvement and measure the effects of process changes.

Current situation

The state lacks consistent performance management and accountability structures for lease management. Very little data is available to assess the competitiveness of the state's lease performance, including rates, terms and other pertinent information.

GA does not track any lease management performance measures. In addition, some participating agencies said they are not sure what tasks the Department is performing and do not understand what services they are paying for.

OFM has established performance targets related to turnaround times for project review. However, agency interviews reveal OFM does not consistently meet these targets and it is unclear whether results are tied to employee performance reviews.

For the most part, client agencies do not have formal performance measures to track and assess results.

Recommendations

All agencies engaged in lease management should develop clear performance targets and points of comparison to the private sector. Targets could include the following:

General Administration

• Contract with commercial real estate brokers and return 1 percent of their fees to support other GA leasing functions.

• Reduce the $180 million spent annually on leases by 5 percent in the next year by renegotiating existing leases. (This could result in a $9 million savings in the first year.)

• Renew 98 percent of all leases before they expire.

Office of Financial Management

• Review and respond to lease requests within 10 working days.

Agencies

• Review and respond to requests for information within 10 working days.

Comparisons to the private sector would reveal whether the state is receiving competitive rates. This information would strengthen the state's position in negotiations with property owners. It would help portfolio managers identify trends in specific markets and develop statewide leasing strategies.
IN THIS SECTION

• Introduction
• Washington Amnesty Program
• U.S. Treasury State Reciprocal Agreement Program
• Medicaid Pharmacy Overpayments
• Liquor Sales and Distribution
• Department of Printing
• Washington State Ferries Division
Introduction to Government Reform

Overview

Deep budget cuts forced by the nation’s recession are prompting many state leaders to fundamentally rethink the way government delivers services that citizens count on and how to save money in other areas of government to pay for them.

Our review reflects the need to find new ways to operate and presents opportunities legislators and executive agencies can consider to improve state government’s efficiency and results.

The government reform ideas that follow comprise one of the three major components of our 2009 performance review. The other key elements – an evaluation of the shared services of information technology and lease management and a performance audit planning assessment – are described elsewhere.

Our reform initiative builds on work that began after the 2009 legislative session, when the economic situation made it increasingly evident that government must identify the most promising opportunities to provide better, faster and more efficient services to the public and to identify new opportunities to save money or raise revenue.

This report includes our analysis of ideas we collected from a number of people: our own staff, legislators, state agency employees, public policy specialists and other creative thinkers.

We also reviewed reform initiatives in other states and at the federal level and our own audits and examined studies and reports from the Legislature, public policy institutes and state boards, commissions and agencies.

We opted not to pursue reform ideas that already were being studied: the possible consolidation of natural resource agencies and functions; the reorganization of the recently renamed Department of Commerce; and health-care reform, which is being considered by Congress and will affect all 50 states.

To select the ideas included in this report, we asked these questions:

• Is the program or service a core function of government?  If not, could it be scaled back, made more efficient or eliminated?
• Could costs be reduced or state revenue increased?
• Could program effectiveness be improved?
• Has the idea produced positive results elsewhere?
• Are there opportunities to consolidate or streamline programs?
• Could some programs be transferred to the private sector?
• Would the reform benefit the broad public interest rather than narrow special interests?

Six ideas selected for analysis

Ultimately, we selected six reform ideas. Of these, five are detailed in the report:

• A one-time amnesty program for delinquent taxpayers.
• Participation in a state-federal partnership to collect outstanding debt.
• Options to increase the state’s collection of Medicaid overpayments for pharmaceuticals.
• Options for Washington’s liquor sales and distribution system.
• Improving the financial sustainability of the Department of Printing.

In these reports, we identify specific opportunities and options, describe how we did our work and identify steps that could be taken in the near term to make reforms and generate new revenue or save money.

We determined one reform idea – possible options to increase competition in the state ferry procurement process – needed a more detailed review than we were able to complete in a short time.

Labor union contracts and contracting out

Many of the state employees whose jobs would be affected by the adoption of these options are represented by unions and covered by existing collective bargaining agreements. Management would be required to fulfill any bargaining obligations or contractual requirements if any of the options were adopted. The extent of that bargaining obligation would depend on the provisions of the option adopted. Also, the competitive contracting provisions of state law (RCW 41.06.142) could apply to any option under which the agency contracted out work that had been performed by state employees.
Washington Amnesty Program

Background
Amnesty programs offer a one-time waiver of some or all penalties and interest for delinquent or unregistered taxpayers who settle their unpaid accounts during a specific period of time. Taxpayers are provided an opportunity to eliminate delinquent tax liabilities and to comply with state registration requirements. Governments receive a one-time revenue boost and bring unregistered taxpayers into the system.

These amnesty programs began during the recession of the early 1980s and since then, only four states – Washington, Alaska, Utah and Wyoming – have not operated one. This year, 13 states are offering programs to increase revenue without boosting tax rates and to increase compliance without expanding enforcement activity.

Amnesty programs do come with costs. These include lost penalties and interest, advertising and staffing needs. Further, some revenue collected during amnesty programs is actually revenue that would be collected anyway but is collected during the amnesty program.

Washington is owed at least $1.6 billion in delinquent receivables
Three agencies in Washington – the departments of Revenue, Employment Security and Labor & Industries – are owed approximately $1.6 billion in delinquent debt. Of this amount:

- $586 million is owed to the Department of Revenue, as of October 2009.
- $214 million is owed to the Department of Labor & Industries, as of June 2009.
- $146 million is owed to the Employment Security Department, as of June 2009.

In addition, the agencies have approximately $605 million in delinquent debt considered to be uncollectible. For example, Revenue reports $152 million is owed by defunct corporations that have no assets.

In fiscal year 2009, the three agencies collected more than $19.6 billion, including at least $676 million in delinquent receivables. Specifically:

- Revenue collected $16.7 billion in taxes, including 97.5 percent on time and $533 million in delinquent receivables.
- Employment Security collected $1 billion in unemployment insurance premiums and claim overpayments, including 99 percent of unemployment insurance premiums on time and at least $22 million in delinquent premiums.
- Labor & Industries collected $1.9 billion in workers' compensation premiums and other revenue, including $121 million in delinquent amounts.

A performance audit of the state's debt collection practices by our Office in 2008 reported that the programs reviewed at these three agencies used the majority of best practices related to debt collection. The agencies reported that the practices not used at the time have since been put in place. The $1.6 billion in delinquent receivables owed represents less than 8 percent of the total revenue collected by the agencies in one fiscal year.

This review was designed to identify how other states’ recent amnesty programs were designed and the amount collected; to determine whether an amnesty program would work for Washington state's main revenue collection agencies; and to consider the effects of an amnesty program on Washington.
About amnesty programs

During the last two years, 16 states used amnesty programs to collect more than $1.4 billion in delinquent debt. Hawaii and Oregon ran amnesty programs for the first time. Amnesty programs can increase revenue without boosting tax rates and increase compliance without expanding enforcement activity.

The number of amnesty programs each year tends to follow changes in the U.S. economy. During a recession, more states seem willing to sacrifice penalties and interest to quickly collect money to pay for state services.

In general, amnesty periods last two to four months and allow debtors to avoid criminal prosecution and some or all penalties or interest, if accounts are settled during the amnesty period. Amnesty programs help bring unregistered and under-reporting businesses into the system and make it easier for delinquent debtors to settle their accounts. Recent amnesty programs have collected between $2.5 million and $750 million. In Alabama’s recent amnesty program, only penalties were waived and the state collected approximately $8.1 million. Arizona’s latest amnesty program waived all penalties and half of the interest and raised about $32 million.

Debtors eligible for amnesty usually do not include those in the appeal process, under audit, or convicted of or under investigation for violating a state revenue law. However, some states, including Vermont, allowed taxpayers under appeal to qualify if they dropped their appeals and accepted the amounts due. Other states, such as Arizona and Maryland, let those under audit take advantage of amnesty benefits.

Amnesty programs typically include most taxes administered by the state and generally apply to all tax periods. Some states also include withholding taxes and other debts. Nevada included only sales and use tax, the modified business tax and business license fees and its amnesty program returned $40.6 million. New Jersey included all state tax liabilities except unemployment and disability insurance and raised $750 million. Arizona limited eligible tax periods to those since its last amnesty program; therefore, if a delinquent taxpayer who was eligible for the earlier amnesty program did not participate, he or she would not be eligible again.

Most states require taxpayers to complete an amnesty application disclosing information about taxed activities and completed or amended tax returns. Some are more interested in delinquent debt than requiring applications or tax returns and allow the use of spreadsheets or other documentation to identify tax liabilities. Illinois, for example, allowed any documentation as long as it supported the amount due.

Usually, debts must be paid during the amnesty period or shortly thereafter. Some states allow payment plans, but they are usually short-term and require a down payment. Typically, interest waivers apply only to the amounts paid during the amnesty. Virginia allowed payment plans during its recent amnesty program, but waived penalties and half the interest only for bills paid in full by the time the program ended. Oregon also allowed payment plans, but would not waive any penalties or half the interest until amounts due were paid in full. Oklahoma allowed payment plans as long as the taxes due were paid within seven months of the end of the program.

To encourage participation in an amnesty program, some states assess a penalty or increase interest rates for those who do not participate. Oregon’s recent amnesty program included a 25 percent penalty. Florida and New Jersey both increased the interest rates. Another strategy is to emphasize that enforcement activities will target eligible taxpayers who do not come forward. Hawaii, Vermont and Florida used this strategy in their marketing campaigns.

Finally, to ensure amnesty collections are not later reduced, most states require taxpayers to waive rights to appeal and to refunds of amounts paid during the amnesty. Sometimes, the amount due is required with the amnesty application. In these cases, if amnesty is denied, the state sometimes retains the payment and applies it to the amount due.

Amnesty estimates

Estimating how much a state will receive during an amnesty program helps states manage how much to spend on the program. However, we found the methodologies used to forecast amnesty results vary and do not predict actual results. Methodologies do not or cannot consider factors such as current collection efforts, tax types, the age of the debts considered for amnesty or whether these are personal or business taxes. Further, it was not always clear whether states’ figures removed program costs, such as staffing and marketing.

Amnesty forecasts and reported return

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<td>32 million</td>
<td>129.6 million</td>
</tr>
<tr>
<td>Alabama</td>
<td>2009</td>
<td>3 million</td>
<td>8.1 million</td>
</tr>
<tr>
<td>Connecticut</td>
<td>2009</td>
<td>40 million</td>
<td>25 million</td>
</tr>
<tr>
<td>Delaware</td>
<td>2009</td>
<td>10 million</td>
<td>22 million</td>
</tr>
<tr>
<td>Louisiana</td>
<td>2009</td>
<td>150 million</td>
<td>303.7 million</td>
</tr>
<tr>
<td>Maryland</td>
<td>2009</td>
<td>5 million – 10 million</td>
<td>9.6 million</td>
</tr>
<tr>
<td>New Jersey</td>
<td>2009</td>
<td>100 million</td>
<td>750 million</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>2009</td>
<td>10 million – 20 million</td>
<td>32.2 million</td>
</tr>
<tr>
<td>Hawaii</td>
<td>2009</td>
<td>7 million</td>
<td>14.4 million</td>
</tr>
<tr>
<td>Arizona</td>
<td>2009</td>
<td>5 million</td>
<td>32 million</td>
</tr>
</tbody>
</table>
What we did
Our review focused on the departments of Labor & Industries, Employment Security and Revenue. As of June 30, 2009, they accounted for 66 percent of the state's short-term accounts receivable balance, which includes delinquent and non-delinquent debt. It should be noted that 20 percent of the remaining balance is receivables at the Department of Social and Health Services. Most of this is child support, which is not eligible for an amnesty program.

Labor & Industries
The accounts receivable balance at Labor & Industries as of June 30, 2009, was $221 million. Of this amount, $214 million was considered delinquent, most of which included unpaid employer premiums for industrial insurance and overpayments of benefits. Industrial insurance premiums are used to compensate eligible employees who are injured while working, to fund permanent and partial disability claims and to pay survivors of deceased injured workers. Overpayments are the result of paying recipients too much in benefits.

Labor & Industries has indicated it is willing to consider some type of amnesty program. The agency recognizes a large portion of those who owe it are delinquent due to the recent economic downturn and wants to help these debtors settle their balances. The Department already has expanded collection activities, including allowing payment plans to more debtors. If Labor & Industries were to operate an amnesty program, it would like the program to:

- Operate six to eight weeks.
- Waive penalties and at least half, if not all, of the interest.
- Apply to all delinquent accounts except fraudulent accounts, debtors convicted or under criminal investigation for breaking a state revenue law, or accounts under audit.
- Allow unregistered businesses to participate if they register with the state.
- Allow payment plans for debtors meeting certain criteria.
- Use only existing collection staff, supported with exchange time or overtime.
- Spend $250,000 to $500,000 in advertising, using as many low-cost methods as possible.

Employment Security
Employment Security’s accounts receivable balance as of June 30, 2009, was $454 million. Of this amount, $146 million was considered delinquent. The Department has two main accounts receivable types: unemployment insurance premiums paid by employers and unemployment insurance claim overpayments.

If Employment Security were to operate an amnesty program, Washington would actually lose money to fund its current operations. The Department must deposit premiums and overpayments with the federal government and can use these funds only to pay unemployment claims. The only funds collected from delinquent revenue that remain with Washington are assessed penalties and interest, which are used for the state’s unemployment-related administrative costs. Therefore, an amnesty program that waives penalties and interest would actually decrease the state’s operating funds. If the unemployment insurance fund were in danger of going bankrupt, an amnesty program would make sense. However, the current fund balance is more than sufficient to cover unemployment claims and Employment Security has strategies to keep the balance from dropping too much.

Revenue
More than 53 percent of the state’s short-term receivables were owed to Revenue as of June 30, 2009, mostly excise tax. It collected $16.7 billion in fiscal year 2009, 97.5 percent of which was voluntarily paid. As of October 2009, Revenue had $586 million in delinquent revenue and an additional $337 million in uncollectible accounts. Revenue collects almost all of the state’s general fund revenue, which is used to pay for state programs and services. A portion of Revenue’s delinquent debt is paid voluntarily within 30 to 60 days from the due date. Revenue estimates approximately $161 million in remaining debt would be available for an amnesty program, if deemed appropriate.

Our 2008 Collection of State Debt performance audit commended Revenue for excellent performance and found it used all eight best practices presented in the report, in addition to other best practices.

Revenue operates a Voluntary Disclosure Program, which is similar to an amnesty program. The program allows unregistered businesses to voluntarily register and in return, Revenue waives most penalties. Since 2003, the program has registered 766 businesses and collected $39.3 million in unpaid taxes. The program does not offer any waiver of interest, unlike a typical amnesty program.

Revenue also offers amnesty to taxpayers as part of the Streamlined Sales Tax project. When taxpayers registered with a state in which they did business but were not registered, they were offered amnesty on uncollected Washington sales or use tax. The amnesty period began July 1, 2007, and ended June 30, 2009, and registered 660 businesses. While Revenue has good procedures in place to collect delinquent debt, there is still approximately $161 million that Revenue agrees could be collected. Even if an amnesty program did not result in a huge return, it still would be a success if it produced a positive return on investment.

Given the potential costs of an amnesty program, discussed later in the report, and Revenue’s robust collection efforts, further study should be conducted to determine if it would be appropriate. Revenue leaders stated they were hesitant to participate in an amnesty program without further study.
Options in detail

Amnesty programs are not the answer for every agency with delinquent revenue. Each agency has unique revenue streams, a different client base and different levels of enforcement. Each agency should carefully consider if an amnesty program is appropriate.

The Legislature could pass a law authorizing an amnesty program in Washington state that allows agencies to waive penalties and a portion of interest during the amnesty program, since current state law does not allow this for all types of debt included in this report.

The decision to operate an amnesty program should be made by each agency. If an agency operates an amnesty program, it should take into account busy tax periods, since tax practitioners typically help delinquent taxpayers prepare their amnesty returns. Also, any amnesty program should occur within the next calendar year, since the goal of an amnesty program is to bring a large amount of money into the state to help with the budget deficit.

Possible challenges

We found the state should consider the costs of an amnesty program. These include administrative costs, such as marketing and staff time, lost penalties and interest and revenue the state would have received without an amnesty program. For example, in 2002, New York grossed more than $599 million through its amnesty program, but netted $82.9 million. It is important to consider these costs so that an amnesty program does not cost a state more money than it generates.

Accelerated revenue

Some argue that amnesty programs shift revenue that states would collect anyway into a single, short time period. As soon as an amnesty program is announced, some delinquent taxpayers will wait to pay until the amnesty program starts. Also, because so many delinquent taxpayers pay past-due amounts during the amnesty program, normal collections after the program may decline. While some new revenue is introduced during an amnesty program, a large portion likely is revenue the state would have collected anyway.

Estimates for New York’s 2002 program showed $131 million in accelerated revenue. Some states attempt to mitigate accelerated revenue by limiting eligible taxpayers to those with older debt or by the number of employees at a business. New York limited eligible tax periods to those two years prior to the program. New York and Maryland excluded businesses with more than 500 employees. These strategies attempt to preserve revenue for future periods, while still bringing in new money.

Penalties and interest

Penalties and interest are lost through amnesty programs and can greatly reduce a program’s return. However, waived penalties and interest is a program’s primary incentive to bring delinquent and unregistered taxpayers forward. One way to limit this cost is to limit the amnesty program to older debt periods that are considered more uncollectible.

Staffing and advertising

Most states used existing staff to operate their amnesty programs and authorized overtime or exchange time if needed. Other states hired temporary workers to assist with the increased volume of collections. Oklahoma hired a contractor to assist with its program. New York also reported e-filing reduced the staff time necessary to operate an amnesty program.

Using existing staff for an amnesty program diverts them from their regular collection duties, which may mean a decline in regular collection efforts. New York, for example, estimates it lost $74.2 million in regular collections during its 2002 amnesty program.

Advertising is important to the success of an amnesty program. Delinquent taxpayers need to know how to qualify for waived penalties and interest. Some states ran successful advertising campaigns using existing resources and others brought in large returns by investing $1 million or more in advertising. Arizona used existing resources and brought in $32 million, while New Jersey spent $2.2 million and received $750 million. The state needs to balance the cost-benefit of any advertising related to an amnesty program. All of the states we reviewed used their Web sites as part of their marketing strategy. Other free or low-cost marketing techniques include news releases, industry word of mouth, mailings to delinquent taxpayers and social media, such as Facebook and Twitter.

Perception

Those who pay on time may wonder why those who don’t are granted waivers from penalties and interest. One way to mitigate this is to advertise any programs the state already offers in an effort to help delinquent taxpayers catch up. Also, a state does not want delinquent taxpayers to wait for the next amnesty program in order to avoid penalties and interest, rather than paying their taxes on time. The best way to mitigate this is to not offer amnesty programs too frequently. Recent research found that repeated amnesties cause long-term revenue loss, which grows with the quantity and frequency of repeated amnesty programs. This research also suggests that amnesty programs should only be offered once.
**Background**

Congress authorized the State Reciprocal Agreement Program as part of the Debt Collection Improvement Act of 1996, but a pilot project to test the program did not begin until 2005. The program allows states to work with the U.S. Treasury to collect unpaid state and federal debts. Before state or federal payments are made, agencies determine whether the vendors owe them money. If so, the payments are reduced before they are sent and the amounts deducted are applied to the relevant state or federal debt balance.

During the pilot program, Treasury worked with two states, Maryland and New Jersey, to determine how it might work. During the first year of operation, the two states collected $20.7 million withheld from more than 10,000 federal vendor payments. At the same time, the states reduced almost 2,000 state payments to cover $1.3 million owed to the federal government.

Each state spent about $1 million to start the program, mostly to modify computer systems. These costs were recouped during the first few months of operation. New Jersey reported that simply notifying debtors of the new state-federal partnership motivated many to settle their accounts, resulting in collections of approximately $12 million before the program began.

After it decided the pilot program was successful, Treasury made the State Reciprocal Agreement Program available to all states.

**A new tool for state debt collection**

The State Reciprocal Agreement Program could improve Washington’s collection efforts. Before this program was offered to the states, they could only garnish federal payments for income tax they were owed and delinquent child support obligations. Washington, which does not have an income tax, could not intercept federal vendor payments to cover other taxes or insurance premiums.

For example, a construction company based in Washington could have a contract to provide services to a federal agency. If the firm owes past-due taxes to Washington state, the U.S. Treasury would reduce the firm’s payment by the amount owed to the state and send the state a check to settle the overdue account.

Our 2008 Collection of State Debt performance audit found the departments of Revenue, Employment Security and Labor & Industries generally did a good job collecting delinquent revenue. In fiscal year 2009, they collected at least $676 million. However, despite those efforts, delinquent debt at the three agencies included:

- $586 million at the Department of Revenue, as of October 2009.
- $214 million at the Department of Labor & Industries, as of June 2009.
- $146 million at the Employment Security Department, as of June 2009.

In addition, the agencies have approximately $605 million in delinquent debt considered uncollectible. Revenue reports that $20.7 million of its delinquent debt is currently in payment plans.

This program could increase debt collection in Washington, including “uncollectible” debt not usually targeted for collection by agencies, because the data provided to the federal government identifies all debt up to 10 years old. Some uncollectible accounts are in bankruptcy and are not eligible for the program. The program also could improve collection from out-of-state debtors, because garnishing payments to federal vendors allows states to collect from businesses based in other states.
Washington could increase collections
To determine whether states are good candidates for the State Reciprocal Agreement Program, the state and federal governments conduct a test match of delinquent state accounts with federal vendor payments.

This fall, Employment Security and Labor & Industries sent information on about 33,000 delinquent accounts, with debts totaling $80.2 million, to the Treasury Department. Treasury found that 237 federal vendors owed the state a total of $422,098 in delinquent debt. Treasury estimated that based on this sample, Washington could collect more than $5 million during the first year of the new program. Based on 237 offsets each month, an administrative fee of $17 per offset would reduce the state’s increase in collections by less than $50,000.

The Department of Revenue is prohibited from sharing tax data with any federal agency except the Internal Revenue Service, so it could not participate in the test match. Revenue accounts for approximately 60 percent of the delinquent revenue at the three state agencies, so it is very likely Treasury’s $5 million annual estimate is understated.

Collections from this program may decrease over time, because as federal payments are used to fulfill Washington state tax obligations, the pool of eligible debt and available payments may decrease.

Before Maryland and New Jersey participated in the pilot project, they also completed a test match. Not including state income tax debt, Maryland matched 256 delinquent accounts with federal vendor payments totaling $180,942. New Jersey matched 187 delinquent accounts with federal vendor payments totaling $204,498. Based on Treasury’s methodology, those returns would have projected annual collections of about $2 million for Maryland and $2.5 million for New Jersey. Actual first-year collections in both states exceeded initial estimates – Maryland collected $6.9 million and New Jersey $13.9 million.

Given that Washington matched a comparable number of accounts, had a larger dollar amount subject to offset and did not include Department of Revenue debt in program estimates, it is likely Washington’s actual collections could also exceed the Treasury estimate.

Up-front costs quickly recouped
The participating states identified information technology upgrades as the major cost of getting the program up and running. Treasury requires all debt be forwarded to it from a single system. In order to make their systems compatible with the Treasury system, Maryland and New Jersey spent approximately $1 million each on system upgrades. New Jersey also spends $5,000 per month in recurring charges. When the program began, New Jersey recovered its start-up costs in one month and Maryland did so in three months.

### Federal Payments Offset State Debt
1. State sends Treasury current debt file, which Treasury compares against outgoing federal debt
2. Treasury reduces federal payments by state debt amounts and sends to state resulting funds to reduce state debt

### State Payments Offset Federal Debt
1. State sends Treasury outgoing payment file, which Treasury compares against federal debt
2. Treasury sends state a report showing state payments matched with federal debt
3. State reduces payments by federal debt amounts and sends to Treasury resulting funds to reduce federal debt

<table>
<thead>
<tr>
<th>Washington’s data test compares favorably</th>
<th>Maryland</th>
<th>New Jersey</th>
<th>Washington</th>
</tr>
</thead>
<tbody>
<tr>
<td>Records matched</td>
<td>256</td>
<td>187</td>
<td>237</td>
</tr>
<tr>
<td>Dollars subject to offset per test match</td>
<td>$180,942</td>
<td>$204,498</td>
<td>$422,098</td>
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<tr>
<td>Estimate of annual return</td>
<td>$2,171,304</td>
<td>$2,453,976</td>
<td>$5,065,176</td>
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<tr>
<td>Actual first-year return</td>
<td>$6,861,042</td>
<td>$13,854,548</td>
<td>Not applicable</td>
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</table>
Government Reform - U.S. Treasury State Reciprocal Agreement Program

<table>
<thead>
<tr>
<th>Pilot states’ return on investment</th>
<th>Maryland</th>
<th>New Jersey</th>
</tr>
</thead>
<tbody>
<tr>
<td>Implementation costs*</td>
<td>$1,314,629</td>
<td>$740,000</td>
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<tr>
<td>Annual collections</td>
<td>$6,861,042</td>
<td>$13,854,548</td>
</tr>
<tr>
<td>Average monthly collections</td>
<td>$571,754</td>
<td>$1,154,546</td>
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<tr>
<td>Return on investment - month 1</td>
<td>-57%</td>
<td>56%</td>
</tr>
<tr>
<td>Return on investment - month 2</td>
<td>-13%</td>
<td>210%</td>
</tr>
<tr>
<td>Return on investment - month 3</td>
<td>30%</td>
<td>362%</td>
</tr>
<tr>
<td>Annual return on investment**/***</td>
<td>422%</td>
<td>1,643%</td>
</tr>
</tbody>
</table>

*New Jersey amount includes one month of recurring charges - $5,000

**New Jersey calculation includes 12 months of recurring charges - $60,000

***Annual return on investment = (Annual Collections - Implementation Costs)/Implementation Costs

Washington would need system changes

Most agencies in Washington use their own accounts receivable systems, which agencies report is necessary due to their unique revenue streams. Creating a single repository for all debt owed to the state could be time-consuming and relatively expensive.

A less expensive option would be for the Office of Financial Management (OFM) to develop a system to collect agency’s delinquent account information and forward it to the Treasury Department. OFM staff said they could likely revise an existing system and that the project would fit well with other work they are currently performing.

If OFM developed a central application, the individual agencies would not need to make major changes to their own accounts receivable systems beyond ensuring they contained the fields required by the Treasury Department. Employment Security staff said they are developing a new accounts receivable system and they could add fields during development. However, as the project moves forward, this will become more expensive. Labor & Industries was unable to provide an estimate for this report, but is researching the potential cost.

Given the test match results and experiences of the two pilot states, it is likely Washington would quickly recoup any start-up costs.

Next steps

To enable Washington to participate in the program, at least four steps would be required:

- The Legislature and Governor would be required to enact legislation authorizing the state to participate in the Reciprocal Agreement Program. In addition, individual agencies may require specific authorization to share debtor information with the Treasury Department. The Department of Revenue data sharing statute would require modification in order to share debtor information with the Treasury.

- Washington would need to enter into a reciprocal agreement with the U.S. Treasury Department to spell out program details, including precedence of debt owed to the state and other procedural matters. This agreement should consider other Washington agencies besides Employment Security and Labor & Industries that may benefit from participation in the program, particularly the Department of Revenue.

- Because the federal government requires data about debt owed to the state to be sent from a single application, OFM would need to develop an application that manages communication between Washington and the U.S. Treasury. The application would process money received from the U.S. Treasury to reduce state debt and the reduction of state payments to reduce federal debt.

- Participating agencies would need to modify accounts receivable systems to add the system fields required by the Treasury Department. If other agencies participate, they should also consider any required system changes.
Opportunity
The Department of Social and Health Services could increase the amount of Medicaid Pharmacy overpayments it recovers by expanding its small but effective audit program that produced an average 162 percent return on investment during fiscal years 2007 and 2008.

Options
Invest in additional resources. By increasing the number of staff dedicated to recovering pharmacy overpayments, DSHS could review more claims and identify more incorrect payments.

Take action within DSHS to prevent inappropriate payments from occurring. Some states have contracted with private businesses to reduce the amount of inappropriate payments at the point of sale.

Key issues
Current DSHS efforts are effective but limited. DSHS recovered 45 percent of every dollar audited in its effort to identify and recover incorrect Medicaid payments for prescription drugs that should be covered by other insurers. However, it reviews only 4.8 percent of the payments.

Prevention efforts could improve the rate of correct payment. Prevention would not eliminate the need for audits, but could reduce the rate of incorrect payments at the point of sale.

Background
Medicaid, a state-federal program that pays health care costs for low-income residents, is meant to be the “payer of last resort,” meaning states and service providers are required to identify and bill insurance companies and other payment sources before they submit claims to Medicaid.

Pharmacies submit Medicaid claims through an electronic point-of-sale system. If DSHS files within the system indicate a client has coverage other than Medicaid, the system will not process the claim. However, pharmacies can override the system and submit the claim to DSHS for payment through Medicaid. The override function uses a set of other-coverage codes that provides justifications for why Medicaid should pay the bill.

The use of other-coverage codes supports timely service to Medicaid clients. Their use is often legitimate – for example, when an insurer does not cover a particular medication for which Medicaid is required to pay. However, it also creates a relatively high risk that Medicaid will pay for prescriptions that are the responsibility of other parties, such as insurance companies.

When DSHS identifies an incorrect pharmacy benefit payment, the agency attempts to recover it from the pharmacy that submitted the claim. The federal share of recovered funds must be returned to the federal government; the state share is returned to the general fund.

This project was designed to identify the magnitude of pharmacy claims processed through the use of other coverage codes that are not being audited; to determine whether DSHS should increase its audit efforts or take other steps to increase the recovery of incorrect payments; and to consider actions that could help prevent inappropriate claims at the point of sale.

Past audits identified opportunity
We reviewed past audits by our Office of the Medicaid program to gauge the effectiveness of the DSHS audit process. Our Office audits the Medicaid program annually.

DSHS uses a risk assessment to prioritize and target pharmacy claims with high potential for a return of investment. We found the process to be effective; our audit of fiscal year 2007 found approximately 43 percent of the payments audited by DSHS during that period were inappropriate and subsequently recovered. While DSHS effectively identifies high-risk payments, it is able to dedicate only limited resources to the process, so it reviews only a small percentage of total pharmacy claims at risk.

Options in detail
Invest in more DSHS audits
DSHS could raise more money from the collection of inappropriate pharmacy claims than it would cost to identify them through audits. In fiscal years 2007 and 2008, DSHS experienced an average 162 percent return on investment.

While the current audits are effective, DSHS audited only approximately 4.8 percent of the pharmacy third-party liability claims at risk. DSHS agrees its efforts are constrained by available resources. The program now has the equivalent of two full-time employees.

Because of DSHS’ practice of assessing risk and prioritizing high-risk claims for audits, we would not anticipate that level of return could be assumed for all pharmacy claims.

Fiscal years 2007 - 2008

<table>
<thead>
<tr>
<th>Overpayments recovered</th>
<th>$1,036,002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit costs</td>
<td>$394,600</td>
</tr>
<tr>
<td>Net return</td>
<td>$641,402</td>
</tr>
</tbody>
</table>

$641,402 = 162% return
Medicaid pharmacy claims

$2.8 million total claims audited

$1.34 billion in total claims

$58.7 million in total claims paid using override code

$2.8 million total claims audited

$2.8 million = 4.8%

of audited amount was recovered

$1.45 million total overpayments identified by audit

$1.28 million total overpayments recovered following audit

processed through the use of other-coverage codes. However the high success rate, coupled with the limited amount of audit coverage, indicates increased third-party liability audit efforts would produce a positive rate of return.

As part of our performance review, we obtained the amount of pharmacy third-party liability audit coverage from DSHS. Pharmacy claims processed by the point-of-sale system over the past three years totaled approximately $1.34 billion, $58.7 million of which was processed using other-coverage codes that indicate the potential for third-party liability. Of the amount processed using these codes, approximately $2.8 million, 4.8 percent of the total, was audited.

DSHS had two full-time staff complete 37 of these audits over the past three years. Of the $2.8 million audited, approximately $1.45 million, 51 percent, was identified as inappropriate. DSHS had recovered approximately $1.28 million from pharmacies as of November 6, 2009, or 88 percent of the amount identified.

Audits in 2007-08 produced 162 percent return

DSHS reported annual costs of just under $100,000 per full-time auditor to perform pharmacy audits, including salaries, benefits, travel, supplies and overhead costs such as office space. During fiscal 2007-08, the last years for which complete audit results are available, costs were $394,600 and recovery totaled $1,036,002 – a net return of $641,402 or 162 percent.

Take action to prevent inappropriate payments

Some states have contracted with private vendors to perform cost containment and cost avoidance activities. These activities include a real-time system that determines client eligibility, identifies the appropriate payer and facilitates the billing and receipt of payment from the other payer on behalf of the pharmacy provider.

During our review, we contacted two service providers that provide these types of systems. The vendors asserted cost-avoidance systems could be in operation three to four months after a valid contract was signed.

While no up-front costs are charged to the state or pharmacies for system implementation and training, the costs associated with these systems may include a flat fee, a per-member processed/per-month model or retaining a percentage of the cost avoidance activity performed.

The Department reports it would incur costs to make changes to existing systems that would allow it to interface with the vendor systems. Work of this nature would most likely not be feasible until the ProviderOne system is implemented and stabilized in late 2010. ProviderOne will be DSHS’ primary provider payment processing system, consolidating many electronic and manual processes into one central location. DSHS also indicated it is assessing options to enhance third-party liability reviews and will have results by early 2010.

Challenges

Funding for additional resources. While the optimal level of third-party liability audit coverage is not known, it is apparent DSHS has an opportunity to increase the level of effort and maintain a positive return on investment. Funding for additional auditors could come from a shift in DSHS’ use of current resources or an additional appropriation. Either option would require the identification of the cost associated with the reallocation of the resources.

Contractor costs. It is not possible to project the total costs of prevention systems, as different pricing models exist. Vendor fees for service would be negotiated during the bid and contracting process. Additional costs to DSHS to develop an interface with the vendor system are not known at this time.
Opportunity

Washington could increase revenue by as much as $277 million over five years by changing the current model of wholesale and retail liquor sales.

Options: Six alternatives were evaluated

Preserve the current system. Under the status quo, the Washington State Liquor Control Board is projected to return $2.36 billion to state and local governments between 2012 and 2016 through its mix of 315 state and contracted retail outlets. The current system is used as a baseline of comparison for the options provided below.

Convert all state-owned liquor stores to contracted stores. This could increase five-year revenue by as much as $9 million or reduce it by as much as $47 million. The state would continue to regulate the liquor system and the number of retail outlets would not change.

Privatize the state distribution center in Seattle. The sale of the center would generate one-time revenue of about $33 million.

Privatize retail sales and increase the number of stores. The state would auction retail licenses and increase the number of stores from the current 315 to 372. This would generate an additional $130 million to $244 million over five years.

Privatize the retail sector and allow market factors to determine the number of retail outlets. This would increase revenue by $43 million to $162 million over five years and increase the number of retail outlets to about 1,000 by 2016.

Completely privatize liquor distribution and sales and tax spirits at a flat rate. This option would convert Washington from a “monopoly” state to a “license” state and increase five-year revenue by about $86.8 million. The number of retail outlets may increase to over 3,300.

Key issues

One of the criteria for our reform effort was whether or not a program or service is considered a core function of government. While the public safety and enforcement functions of the Liquor Control Board are clearly core functions of government, the sale and distribution functions emerged as key areas to evaluate for our review.

We conducted our review to identify options the state may consider regarding liquor sales and the effects the options have on liquor taxes, state revenue expectations and cost. We designed the project to look at ways liquor distribution and sales could be more effective, efficient and/or economical. The review did not examine or attempt to quantify the social effects of these options.

Revenue would be maximized at $277 million if the state sold the distribution center to raise $33 million, auctioned retail licenses and increase the number of stores from the current 315 to 372 to increase revenue by up to $244 million over five years.

Enforcement costs could increase under some of these options. Our analysis assumes enforcement would remain a key responsibility of the Liquor Control Board but did not examine or attempt to quantify possible effects on the budget.

If the retail system were privatized, retail liquor prices would be based on retailer markup rather than the uniform pricing system we currently have.

The cost of liquor to licensees may increase under privatization.

Background

The Washington State Liquor Control Board was created in 1933 and consists of three Board members appointed by the Governor and 1,160 full time employees. In addition to the wholesale and retail sale of liquor, the Liquor Control Board is tasked with licensing all establishments selling alcoholic beverages and enforcement of liquor and tobacco laws. The current system consists of a distribution center in Seattle, 160 state employee-operated stores and 155 contractor-operated stores.

In fiscal year 2008, the Liquor Control Board brought in $322 million in taxes and net operating income in addition to its $97 million state appropriation. Revenue from liquor sales supports the operation of state and local governments, health services, as well as research and education on alcohol issues. The 2009-11 state operating budget provides for five new state-operated stores and 10 new contracted stores.

Washington is classified as a monopoly state, meaning it is directly involved in the sale of liquor and adds markup to the cost of liquor before it is taxed by the state. Thirty-two other states are classified as license states, which allow the private sector to handle wholesale distribution and retail sales of liquor and place a flat per-gallon tax on sales. The term “control state” can be misleading in that all states control and regulate the sale of alcohol to some degree. In this sense, every state is a “control state,” whereas only 18 are monopoly states. The extent to which this monopoly extends differs from state to state. On average, state revenue from liquor sales is higher in monopoly states than license states.
The distribution center
The distribution center in Seattle is the only liquor warehouse in the state. Liquor in the warehouse functions on a bailed system under which manufacturers or distillers own the liquor until it is shipped to Liquor Control Board stores. Private trucking companies have contracts with the state to deliver liquor to retail outlets. The state also sells liquor to tribes and the military, which sell it at retail outlets.

Contract stores
The state owns the liquor in contract stores, which receive a commission on the liquor they sell. All net income above the commission comes back to the state. The current commission rate for 153 of 155 contract stores decreases as sales increase. The commission for sales above $21,000 per month tops out at 6.45 percent. These contract stores are located primarily in rural areas. The other two contract stores are provided a flat commission rate of 9.65 percent, a rate that will be used as more contract stores open in metropolitan rather than rural areas.

Liquor revenue
Washington liquor is marked up and taxed prior to sale. Markup is the gross profit the state makes on the sale of liquor. Liquor is also taxed prior to sale. Taxes provide revenue to specific Legislative mandates. A portion of markup supports the operations of the retail liquor stores and the excess profit received from sales is returned to state and local governments.

The public pays the highest markup and taxes. Restaurants and lounges receive a 15 percent discount on liquor purchases and pay lower taxes. Markups and taxes also are reduced for sales to tribes and military bases.

Liquor tax policies greatly influence prices among the states. License states set a flat tax on liquor and issue licenses to distributors and retailers to sell the product. A flat tax is a set amount per gallon applied to the size of the bottle sold. Nationwide, flat tax rates in the 32 license states range from $1.50 to $12.80 per gallon. For comparison purposes, California has a flat tax rate of $3.30.

By contrast, control states mark up the liquor before applying taxes. State liquor tax rates are published by the Tax Foundation, which follows methodology prescribed by the Distilled Spirits Council of the United States (DISCUS) to calculate implied (or effective) tax rates for control states.

Where does liquor revenue go?
Fiscal year 2008

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>General fund</td>
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<tr>
<td>Research</td>
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<tr>
<td>Education and prevention</td>
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<tr>
<td>Health services</td>
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<tr>
<td>Cities and counties</td>
<td>$60.7M</td>
<td>18.8%</td>
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</table>

Source: Liquor Control Board 2008 annual report, Page 19

Implied rates reflect taxes and markup rates
With the recent increase in markup, Washington has the highest liquor tax rate in the nation at $25.73 per gallon. Unlike taxes, increases in the markup rate in Washington do not have to receive a two-thirds majority vote of the Legislature. The state estimates the markup increase, from 39.2 to 51.9 percent, that took effect August 1, 2009, will return $40 million a year to state coffers. It is scheduled to expire after fiscal year 2011.

In addition to the markup rate, other costs are built into the cost of liquor in Washington before it is officially “taxed.” Specifically, each liter cost is increased by $1.90 before the 51.9 percent markup is applied, and then the $1.90 is backed out of the cost. This practice results in an additional 99 cent increase on each liter sold. Also, the Liquor Control Board applies surcharges of 36.7 cents on each liter to pay for construction and building maintenance costs at the distribution center.

These adjustments produce a taxable base for liquor that consists of:

- The cost from the manufacturer, including federal taxes.
- The delivery cost to the state.
- A markup of 51.9 percent plus 99 cents per liter.
- Surcharges of 36.7 cents per liter.

Taxes are then applied to the marked up taxable base and include a percentage tax and a per-liter tax. Retail customers are taxed at 20.5 percent of marked-up cost plus $3.77 per liter, while licensees (generally restaurants and lounges) receive a discount of 15 percent of the marked-up cost before being taxed at 13.7 percent plus $2.44 per liter. Tribal and military sales establishments also receive discounts and lower tax rates.

Most of the revenue received by the Liquor Control Board is distributed to the entities or programs identified in state law (RCW 82.08). Revenue that exceeds the amounts directed to various programs by state law are referred to as excess revenue and are distributed as follows: 50 percent to the state, 40 percent to cities and towns and 10 percent to counties.

Our approach
We used the Liquor Control Board’s forecasting and distribution model and modified it as necessary to arrive at the financial projections for the options identified. The Board’s model uses actual revenue, expenditure and tax data from 2004-09 and relies on budget projections for 2010 and 2011. Data sources
include the state's Accounting & Financial Reporting system (AFRS) and the point-of-sale system at liquor stores. The AFRS system is audited annually by our Office. We audited the point-of-sale system in 2007 and found its information to be reliable.

We also examined the operating structures of liquor sales and distribution systems in other states to identify options for consideration in Washington. We contacted the National Alcohol Beverage Control Association and Distilled Spirits Council for national statistics to be used as we calculated potential cost-savings.

We used the markup rate that is in effect for the 2009-11 biennium. We do not expect any changes to the current system based on our analysis could take effect before 2012, so our review projected financial effects for 2012-16.

The first option, maintaining the state's current retail and wholesale operating structure, was used as the baseline to compare fiscal results to the other options presented.

Results in brief

We analyzed six options the state may consider to determine whether there are more efficient, effective, or economical methods to sell and distribute liquor:

The options are:
1. Continue operations with no changes
2. Convert all state stores to contract stores
3. Privatize the distribution center
4. Privatize retail outlets by auctioning licenses
5. Privatize retail outlets with no limit on licenses
6. Quit liquor sales and impose a flat liquor tax

Option 1: Maintain the state's current retail and wholesale operating structure

Result: The state would receive total net revenue of $2.36 billion from 2012 to 2016.

Under this option the state would continue to operate state stores and contract stores. The number of stores is scheduled to increase by 15 during the 2009-11 biennium; however, we used the current number of stores in our analysis for baseline calculations. The contractors would continue to be paid the current commission rates based on net sales (total sales less sales discounts).

- 22.07 percent for the first $10,500 in monthly sales.
- 8.21 percent for the next $10,500 in monthly sales.
- 6.45 percent for any monthly sales over $21,000.
- A base rate of $480 to $630 based on monthly net sales.

The state would continue to operate the distribution center with state employees. Retail outlets would sell to the public and to businesses, which in turn would resell liquor for on-site consumption. In our state, these businesses are referred to as licensees and receive a 15 percent discount on purchases. They also are charged a lower tax rate than the public. A 3 percent growth rate in liter sales was applied to all years in our analysis based on the Board's projected growth rate for 2011.

The average retail shelf price of a 750 ml bottle is $17.95.

Option 2: Convert state stores to contract stores

Result: The state could reduce its five-year return by about $47 million or increase it by about $9 million compared to the current structure depending on the number of stores converted and the commission rate applied.

Contract stores are located primarily in rural areas. Liquor sales may not be the only business done by the contractor. Under the sub-options discussed below, these stores will continue to operate as contract stores using the current commission rate.

State stores are generally leased for 10 years. The Liquor Control Board would have to pay approximately $34 million to buy out the remainder of the leases if it were to close all state stores. To avoid the cost of lease cancellations, our analysis of this option assumes the state would phase in the conversion to contract stores as the leases expire beginning in 2010. The conversion process would be complete in 2019.

The same 3 percent growth rate in liter sales discussed in Option 1 has been used for the analysis of the contracted store option. Three sub-options are available for converting stores to contract models:

Convert all state stores to contract stores using the current commission rate. This would return about $9 million more over the five-year period than the current operating structure. The Liquor Control Board does not expect contractors would financially be able to run state stores in metropolitan areas using the current rate commission. This would result in a reduction of 797 employee positions.

Convert all state stores to contract stores using the flat commission rate. The Liquor Control Board has proposed a flat commission rate of 9.65 percent of net sales with no base rate for any future contract stores based on business assumptions including store locations, size, turn rates, etc. No fiscal comparison was provided comparing variables for this rate. We reviewed documentation that indicates rents are higher in state stores in metropolitan areas and contract stores must pay state and local business and occupation taxes not paid by state stores. Using the 9.65 percent rate under this option the state would lose $47 million compared to the current operating structure over five years. This would result in the same reduction of 797 employee positions.

Convert only 37 stores using the flat 9.65 percent commission rate. The Liquor Control Board provided an analysis identifying only 37 state stores that could be more profitable as contract stores. Converting only this number of stores using the 9.65 percent commission rate would result in approximately $3.1 million additional revenue over five years compared to the current operating structure. Converting the 37 stores would result in a reduction of 189 employees.

The average retail shelf price of a 750 ml bottle would remain unchanged at $17.95.
## Costs and Revenue Associated with Six Options

<table>
<thead>
<tr>
<th>Option number</th>
<th>Option description</th>
<th>Revenue to state from annual operations fiscal years 2012 – 2016 (in billions)</th>
<th>One-time revenue/ expenditures (in millions)</th>
<th>Total return to state, fiscal years 2012 – 2016 (in billions)</th>
<th>Number of Liquor Control Board FTEs</th>
<th>Shelf price (average 750 ml bottle)</th>
<th>Five-year revenue change compared to now (in millions)</th>
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<td>Current model</td>
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<td>Convert to license state (flat tax)</td>
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<td>$2.448</td>
<td>228</td>
<td>$18.21 - $20.01</td>
<td>$86.8</td>
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* Auction revenue every 10 years  

Source: State Auditor’s Office projections based on Liquor Control Board data
Option 3: Privatize or contract out the operation of the Seattle distribution center

**Result:** The state would benefit from a one-time cash return of approximately $33 million dollars from the sale of assets.

Sale of the distribution center land and building would result in a one-time return of $25.6 million. Sale of equipment valued at $16 million would return about $8 million. This option could be combined with any of the other options presented for retail stores. Privatizing the distribution center would result in a reduction of approximately 83 of the current 98 employee positions with approximately 15 state employees retained to handle purchasing under most options.

In 2009, Liquor Control Board spent $6.9 million in direct costs and allocated more than $1 million in indirect costs to distribution center operations for total warehouse costs of $7.9 million. The state shipped 4.66 million cases; the storage cost was $1.70 per case.

Our review of other control states distribution systems found:

- Michigan contracts with private companies to run its three warehouses. The warehouse and delivery cost of $6.97 per case includes doorstep delivery to privately owned retail outlets and restaurants/lounges.
- Pennsylvania contracts for warehousing and trucking from two privately owned warehouses and has one state-owned warehouse. It delivers to only retail outlets for an average of $2.45 per case. Pennsylvania estimates warehousing is 60 percent of the cost, or approximately $1.47 per case.
- In Ohio, the distiller incurs the warehouse costs and includes them in the price of liquor it charges the state.
- Iowa contracted operation of its warehouse but reverted to a state-run warehouse when the contractor went bankrupt. Iowa has a cost per case of $2.05.

We estimate only a minimal effect on costs if Washington were to privatize operation of its warehouse. Our current rate of $1.70 per case is somewhat higher than Pennsylvania pays its private warehouse operators of $1.47 per case, but the volume shipped by this state is 4.6 million cases compared to 13.5 million cases in Pennsylvania. We believe $1.70 per case is a reasonable expectation for a privately run warehouse. The cost could be handled in the same manner as Ohio by having the distillers contract for storage with the private warehouse company and build the cost into the liquor price charged to the state.

Option 4: Auction licenses for retail outlets and allow controlled increases in number of stores

**Result:** State revenue could increase by $130 million to $244 million over the return from the current operating structure, including one-time revenue.

This option would completely remove the state from retail liquor sales and allow citizens to bid for the rights to open retail outlets and receive the profits. The state no longer would have direct costs related to operating these stores or pay commissions to contractors. A total of 819 state employee positions would be eliminated.

Following the assumptions of the West Virginia model, the rights to operate the stores would be auctioned to the highest bidders for 10-year terms. The number of stores is allocated by region. The current operators of contract stores may not be able to compete with bids of larger retailers.

West Virginia held public bids in August 1990, January 1991 and May 1991. This resulted in the sale of all 98 zones offered and the possibility of 214 privately owned liquor stores being opened in West Virginia. The sale of state owned liquor stores and the conversion of state-owned liquor inventories resulted in profits of $26.5 million to the West Virginia general revenue fund or revenue equaling 38.7 percent of one year’s net sales.

Option 4 assumes Washington state would put up 372 outlets for bid in 2012. This is the number of stores identified in Optimal Size and Location of Washington State Liquor Stores, a 2006 report commissioned by Liquor Control Board. We applied a 30 percent auction return rate to 2011 projected net sales results for an expected return of $205 million from the auction process. This option assumes the bids are paid the year of auction. Policy-makers may elect other payment schedules.

Based on the West Virginia model, we assume private retail outlets also would be assessed an annual license fee of $1,000 per store for additional revenue of $372,000 each year beginning in 2012.

Lease cancellation charges of $34 million could be avoided by legislative action. However, the Liquor Control Board would still be responsible for $1.2 million in lease improvement costs.

The state would provide a cost structure that would allow private retailers to make a profit. This option assumes retailers would receive the same 15 percent discount as current licensees and that the state would tax all liquor at the lower licensee rates of 13.7 percent of the marked up cost and $2.44 per liter. Licensees would purchase liquor from the private retail outlets at a markup percentage determined by the state or governing body.

Private retailers would be subject to state and local business and occupation taxes providing additional revenue to the state.

We calculated revenue using both pessimistic and optimistic projections of 4 percent and 6 percent in liter sales. The pessimistic projection forecasts a 4 percent growth in revenue including the 3 percent the Liquor Control Board uses for its projections in 2011 and 1 percent due to increased accessibility if retail outlets increase from 315 to 372. Additionally, discussions with the private retail industry leads us to believe the growth potential under privatized retail outlets could exceed our 6 percent optimistic growth assumption.

This option assumes the state would not set a minimum shelf price on liquor. We assume an average 25 percent retail markup based on DISCUS pricing methodology. Discussion with a large private retailer indicates the actual retail markup could
be as low as 13 percent and if shelf price is not set by the state, consumers could see a reduction in liquor prices. The retail shelf price would range from $15.77 at 13 percent markup to $18.57 at 33 percent markup.

Option 5: Privatize all retail outlets and allow the market to determine the number of stores

**Result:** From 2012 to 2016, the state would receive $43 million to $162 million more than under the current operating structure, including one-time revenue.

The number of retail outlets would reflect market demand. The state would issue licenses to retailers at a cost of $1,578 per year, the national high-range price average for a retail license. Based on the average adult population to retail outlet in other control states, the number of stores would increase from 315 to around 1,000 within five years. New licensing revenue generated in 2012 would be $1 million, increasing to $1.6 million by 2016.

We calculated increased sales at a pessimistic 6 percent growth rate and an optimistic growth rate of 8 percent in liter sales due to the increased availability through additional outlets.

As discussed in option 4:

- **Legislative action** would be required to avoid $34 million in lease cancellation charges.
- **Privatizing the retail operations** would reduce 819 state employee positions.
- **Private retailers** will be provided the same 15 percent discount as current licensees. It is further assumed the taxes applied to all liquor would be at the lower licensee rates of 13.7 percent of the marked up cost and $2.44 per liter.
- **The state would not set minimum prices** for liquor sold in retail outlets. Retailers could charge more or less if market conditions allow.
- **Licensees would purchase liquor from the private retail outlets** at a state-authorized markup percentage.
- **Retail operations previously run by the state** would be subject to state and local business and occupation taxes, providing increased revenue to the state.
- **The retail shelf price** would range from $15.77 with 13 percent markup to $18.57 with 33 percent markup.

Option 6: Change from monopoly to license state

**Result:** From 2012 to 2016, the state would receive $86.8 million more than under the current operating structure. This includes one-time revenue.

This option would completely privatize the sale of liquor in Washington. The distribution center would be sold and companies would be able to bid for the right to distribute liquor in the state. The distributors would purchase liquor directly from manufacturers. Based on other states’ experience, we anticipate one to three distributors would compete for business statewide.

The duties of the Liquor Control Board would be limited to licensing and enforcement of liquor and tobacco laws. The appropriation for Liquor Control Board operations under this option would be $26.5 million per year. This would result in a reduction of 932 employee positions.

Under this model, a flat tax would be applied at the distributor level and, using DISCUS assumptions, the distributors would apply a 20 percent markup on cost and tax and retailers would apply a 25 percent markup.

The number of retail outlets would grow to as high as 3,357 outlets if most grocery stores, convenience stores, drug stores and club retailers decide to purchase licenses. Licenses would be sold at a cost of $1,578 per outlet, the average cost of a retail license nationwide.

We anticipate the volume of liter sales under this model could increase as much as 14.7 percent, the average consumption percentage difference between control and license states and have spread the increase over the five year period.

Since the state no longer would sell liquor inventory, this option includes a one-time return to the state of approximately $58.9 million as current liquor inventory is sold to new private liquor store owners.

As discussed in option 3:

- **Sale of the distribution center** would result in one-time revenue of $25.6 million.
- **Sale of distribution center equipment valued at $16 million** would be $8 million.
- **Warehouse operations previously run by the state** would be subject to state and local business and occupation taxes, providing new revenue to the state.

As discussed in option 4:

- **A change in state law** would be needed to avoid lease buyouts of $34 million.
- **Retail operations previously run by the state** would be subject to state and local business and occupation taxes.
- **The average retail shelf price of a 750 ml bottle** would range from $18.21 with 13 percent retail markup to $20.01 with 33 percent markup.
Possible challenges

Social effects
The National Institute of Health (NIH) gathers alcohol consumption data for all 50 states and Washington D.C. We separated this data into groups to identify the average consumption rate in license states, partial control states (states that control either the distribution or sales of liquor, but not both) and full control states. Between 1997 and 2007, the average annual alcohol consumption in partial control states and full control states were, respectively, 0.65 and 0.66 gallons per capita for people over the age of 14. License states had a higher consumption rate of 0.76 gallons during the same period. Based on NIH data, it would be reasonable to assume that Option 6 — getting out of liquor sales and placing a flat tax on liquor — would have the most significant impact on alcohol consumption in our state.

Labor union contracts and contracting out
Many of the state employees whose jobs would be affected by the adoption of these options are represented by unions and covered by existing collective bargaining agreements. Management would be required to fulfill any bargaining obligations or contractual requirements if any of the options were adopted. The extent of that bargaining obligation would depend on the provisions of the option adopted. Also, the competitive contracting provisions of state law (RCW 41.06.142) could apply to any option under which the agency contracted out work that had been performed by state employees.

<table>
<thead>
<tr>
<th>States</th>
<th>Spirits Tax (Per Gallon)</th>
<th>States</th>
<th>Spirits Tax (Per Gallon)</th>
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<tbody>
<tr>
<td>1. Washington</td>
<td>$25.73</td>
<td>27. Tennessee</td>
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</tr>
<tr>
<td>2. Oregon</td>
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<td>26. New Jersey</td>
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</table>
Unemployment Costs
Because state agencies do not pay into the unemployment insurance system as private companies do, the Board would have to absorb the full cost of unemployment benefits for any employees whose jobs are affected by a change in Board operations. Currently, jobless benefits may be provided to eligible recipients for up to 59 weeks. Washington state statistics from September 2009 indicate that on average, unemployment recipients receive benefits for 17 weeks. We were unable to obtain statistics more specific to Washington state retail workers for this analysis.

Among the options we analyzed, unemployment costs would be lowest under Option 3, in which the conversion of 37 state stores to contract stores would reduce the number of state employee positions by 83 at a cost of approximately $600,000. The largest effect would be under Option 6, with a reduction of 932 positions, reflecting complete privatization of the system with a cost of $6 million. These amounts are included in the returns to state calculated under the options.

Annual leave buyout
Employees who leave state service are entitled to receive payment for accrued annual leave, but these costs have already been incurred and are recorded as amounts payable. For that reason, we did not include these costs in our calculations.

Licensing costs
In 2009, the Board issued 15,838 licenses. We estimate the addition of retail outlets associated with various options would require one additional staff member for every 400 additional sales outlets.

Enforcement costs
The Board has 115 enforcement officers who routinely check grocery stores, convenience stores, restaurants, taverns and lounges to determine if they are selling alcohol to underage customers or to customers who are inebriated. Our options anticipate increases only in the number of retail outlets. If state stores are converted to contract stores, the number of outlets would not increase. If privatization were to occur at the retail level, many stores that sell beer and wine would add liquor. We would not expect the options discussed here to substantially increase the number of liquor outlets already being monitored by the Board. Liquor Control Board enforcement data for 2009 indicates its stores have 94 percent compliance, compared with approximately 74 percent for private enterprise. We did not attempt to quantify enforcement costs that may be required under the various options.
Opportunity
Washington could reduce costs and improve service delivery by changing the Department of Printing business model to more easily respond to fluctuations in demand and better reflect 21st century advances in technology and new media.

Options
- Change Printing's business practices to improve its financial condition and align with state law.
- Initiate a shared services review of printing to identify a successful long-term business model.

Key issues
One of the criteria for our reform effort was whether a program or service is considered a core function of government. Printing has been the subject of numerous previous studies, but given the seriousness of the state’s current financial stress and the trend toward re-evaluating administrative support functions, Printing emerged as a key area of focus for our review this year.
- Revenue has not been sufficient to cover Printing’s costs. Current trends indicate ongoing losses.
- Pricing practices do not always comply with the law.
- Centralized printing has been on the decline for the past 20 years. Information is increasingly available online.
- Printing is taking action to improve its business, but more is necessary to optimize agency performance.

Background
The Department of Printing operates today based on a set of laws that date to 1854. From the 1850s through the mid-1920s, printing services for the Territory and then the state of Washington were contracted out to a private printer. In 1925, the printer began receiving a monthly salary. Since 1933 the Department of Printing has been a state agency.

Printing is a self-supporting operation with no general fund appropriations. It handles its own hiring and employs approximately 130 people. During the past three years, annual sales volume ranged from $31 million to $36 million.

With copy machines, laser printers, digital printers and other advances in technology, the term “printing” has come to mean more than rotary and offset presses. At least 11 state agencies now have in-house print shops. Some go directly to printers in the private sector.

State law mandates that nearly all state agencies use Printing. Exemptions include universities and community colleges, the Supreme Court, the Court of Appeals, various agricultural commissions and Department of Social and Health Services facilities located outside of Olympia if the print job costs less than $1,800.

When an agency brings a print job to Printing, it decides to either print the job in house or to outsource it to the private sector if it is more economical to do so.

If Printing decides to do the work in house, state law requires the work be priced at actual cost. State law limits pricing to a publication called the Porte Publishing Company’s Franklin Pricing Catalogue. This catalog is no longer distributed through Porte Publishing. The Franklin Guide is now published annually by a different company, but it is still used to develop national average pricing. If the actual cost of producing a print job is lower than the Franklin Guide pricing, Printing must charge actual cost. If the actual cost of producing the job is higher than the Franklin Guide pricing, then Printing must charge the Franklin Guide price. This serves as a price escalation control in most cases, but it is important to note the Franklin Guide does not address all forms of printing.

Printing may decide it would be more economical to send the job to the private sector. In this case, state law allows Printing to do so and to charge the agency the cost as submitted by the private printer, including tax, plus a fee of up to 5 percent to help Printing cover administrative costs.

Financial challenges
Agencies rely more and more on electronic communication as a way of distributing information. Additionally, the Governor and Legislature have encouraged agencies to print fewer documents and make more information available on-line. These reductions have placed a financial strain on Printing. Revenues have fallen and expenses have not declined at the same rate.

The effect can be seen in Printing’s bottom line. During fiscal year 2008, Printing had almost $900,000 in profit; in fiscal year 2009 it experienced more than $1.35 million in losses. It lost $400,000 in the first three months of fiscal year 2010. Printing’s cash balance has declined from $3.2 million at the beginning of fiscal year 2009 to $1.4 million as of September 30, 2009. This is a loss of about $120,000 per month.

This trend indicates the need for significant cost reductions and/or revenue increases at Printing. If these changes do not occur, Printing may exhaust its cash balance within the next 18 months.
Printing states it has endured periods of financial loss in the past and made the necessary adjustments to balance its books. Management believes it can make the necessary changes to address the current deficit by the end of 2010. Thus far, Printing has responded by placing three machines in surplus, putting employees on unpaid furloughs and keeping more print jobs in house. Printing is committed to making further cuts if necessary.

What we did

As we looked at the complexities of the law that governs Printing and the challenges of pricing jobs in a modern print shop, we realized reform would require:
- Improvements to job-costing practices.
- Changes in pricing and job selection practices.
- Possible changes to the law.
- Stronger performance management practices.

The cost of an individual print job includes both direct and indirect costs. Direct costs include costs like the paper used in the job and the labor to do the work.

Indirect costs include costs like administrative time and utilities. These indirect costs are allocated to each print job. When Printing has a high number of jobs to print, a smaller portion of the indirect costs is allocated to each job and individual job costs will be lower. When Printing has a low number of jobs to print, a larger portion of the indirect costs is allocated to each job and individual job costs will be higher. The actual cost of an individual print job is impacted by the amount of work in the shop and this volume fluctuates continually.

Finding a way to determine the costs of print jobs has been a long-standing challenge for Printing. Costing concerns were noted as early as 1977, when the Legislative Budget Committee conducted a performance audit of Printing. The auditors wrote:

“Although existing legislation calls for the Printer to establish a standard cost system, when the auditor tried to determine if the rates charged for printing by the Public Printer were consistent with the true cost of the services provided, it was discovered that no comparison could be made. The existing accounting system does not match cost of various printing functions to the units of production or output of the functions…” (Legislative Budget Committee, 1977 audit, page 4)

In the past two years, Printing has taken significant steps towards the development of a reliable costing system. In February 2009, it implemented the Monarch system, which is Printing’s first electronic costing system. However, Printing does not use these costs as the basis for the prices charged to customer agencies. Rather, Printing generally prices print jobs at or around the national averages found in the Franklin Guide pricing. The result of this is that some jobs are priced at a profit and others are priced at a loss. When we asked Printing why it prices this way Printing stated it does this to keep prices consistent for its customers and the actual cost of a print job is affected by factors like volume of work in the shop and drying time. Profitable jobs also offset the losses from other jobs. While these practices may make good business sense, the law mandates Printing must price at cost, unless the costs are above Franklin pricing (RCW 43.78.080).

A pricing analysis was essential for three reasons:
- Printing is not currently recovering its costs.
- The law requires Printing to recover the cost of producing print jobs, but does not allow it to set prices higher than the Franklin Guide.
- It is important to know how prices at Printing compare with the private sector.

Printing losses exceed profits

We obtained costs of production and prices charged to agencies for all of the jobs produced by Printing since February 2009, when it started using its current job management system. We reviewed more than 5,000 print jobs and compared production costs to what was charged to determine whether Printing recovered its costs on the individual jobs and also if it recovered its total costs on these jobs.

Printing lost a total of $714,600 on 2,339 print jobs and generated $401,600 in profit on 2,678 jobs. This means Printing lost approximately $300,000 on more than 5,000 print jobs.
If Printing were to price all jobs at cost and outsource jobs when costs are higher than the Franklin Guide, the result would be a significant decrease in revenue. This would also entail an overall downsizing of the printing business, including staffing levels, facilities, equipment and other materials. For the jobs we examined, pricing profitable jobs at cost would have reduced revenue by approximately $400,000.

If Printing had outsourced the jobs that cost more than Printing could charge, the result would have been a revenue reduction of approximately $1.4 million. Department of Printing records show the cost of these jobs was approximately $2.1 million. Outsourcing the jobs would not automatically eliminate these costs. In fact, if this work were to leave Printing the immediate result would be an increase in downtime for staff and equipment, which would worsen the already concerning financial situation at Printing.

Printing reduced prices to keep jobs in house
We also looked at print jobs for which Printing obtained bids from private printers, even though it planned to do the printing in house. Using a statistical sample of the jobs that fit this description, we compared the Franklin Guide pricing to the lowest bids received from private print shops. We also compared the costs of printing these jobs to the prices charged to the customer agency.

Printing does not have a standard method of deciding which jobs should be printed in house versus outsourced. For many of the jobs we examined, Printing lowered its prices to beat the lowest bids from the private printers in order to keep the jobs in house, even when that meant Printing was charging less than its estimated costs. Printing lowered its prices below the Franklin Guide and below its costs for 36 percent of the jobs in our sample.

According to Printing, this was done because it did not have enough work to keep equipment and staff working at full capacity. For the jobs that Printing elected to keep in house, on average it lowered its prices to 29 percent below its estimated costs. If Printing were to keep these jobs in house and price the jobs using the Franklin Guide, on average the costs would have been 16 percent higher than the lowest bid from the private sector.

Our analysis of nine months’ data, as extrapolated to the population of these jobs, shows that Printing obtained bids on 84 jobs. We found:
- Printing had the lowest price on 22 jobs.
- On an additional 18 jobs, Printing’s standard price was within 30 percent of the lowest private sector bid.
- For the remaining 44 jobs, Printing was more than 30 percent higher than the lowest private sector bid.

Since Printing considers median prices as a measure of competitiveness, we also compared prices as charged by Printing with the median of the private sector bids. Printing’s price was lower than the median private sector bid for 56 of the 84 jobs in this series of print jobs.

Although our analysis indicates Printing does not always offer the lowest available price, Printing states it offers agencies additional value through its services and industry expertise. For example, Printing obtains bids from multiple private printers when it outsources print jobs. Printing states this results in lower prices for customer agencies than if these agencies did the bidding themselves. In addition, Printing represents its customers in disagreements with private printers.

Printing compares prices to private sector
In 2009, Printing compared its prices with those charged by other government printers nationwide and other private printers in the surrounding area. This comparison was intended to show how Printing’s prices compete with the private sector. The study included 17 print jobs, selected by Printing, to represent its normal range of work. We reviewed the study, documentation and underlying methodology and noted:
- Of the 17 jobs, Printing had the lowest price two times.
- On three other jobs, Printing did not have the lowest bid, but its prices were within 30 percent of the lowest bid.
- For the remaining 12 jobs, Printing was more than 30 percent above the lowest bid.

As noted above, Printing believes looking at median prices is a better way to gauge competitiveness. By this measure, the price charged by Printing was lower than the median private sector bid for 10 of the 17 jobs in the study. These results give an indication of how Department of Printing prices compare with prices at other government print shops and the private sector.

Benchmarking can be a valuable tool and Printing has taken an important step in comparing its prices to the private sector.
However, we identified a few limitations to the study, namely a relatively small number of bids from private printers, a wide variety of geographic locations for government printers and inconsistency in the grade of recycled paper represented in the bids. These factors are likely to have contributed to the large range of prices in the results. Controlling these factors might have produced different results, with Printing prices being either more or less competitive than the other printers. Printing could continue to refine this study as it incorporates lessons learned.

**Challenges for Printing**

Printing did not generate enough money in 2009 to cover its costs and current trends indicate ongoing losses. Many factors, including the state's ongoing budget deficit, are contributing to this situation. Other contributing factors include:

- Continuing declines in the printing industry.
- Additional costs unique to government.
- Customer actions impacting Printing.
- The law that governs Printing.
- Recently implemented information systems that are not fully functional.

**Continuing declines in the printing industry**

Printing as an industry has been on the decline for the past 20 years. Information is increasingly printed in house or available online and some magazines and newspapers have discontinued printed editions. According to the most recent statistics available from Printing Industries of America, 47,700 printing firms were operating in the United States in 2000. Eight years later the number had dropped to 36,500 firms; economists predict in 2020 there will be fewer than 27,000 firms. The number of people employed by the printing industry has fallen as well. In 2000, over 1.2 million people were employed in the industry; in 2008 there were only 976,000; estimates for 2020 are at 850,000 individuals.

As in many industries, the past year has been particularly challenging. “The sluggish economy and slowing print markets continued to pull down printers’ profitability over the prior year,” Printing Industries of America noted. “[At this rate] the industry will earn approximately $2.5 billion in total profits over the course of [2009], down significantly from the prior year’s approximate $5.4 billion in total profits.”

The same trends affecting private printers have also affected Printing, which identified the following as noteworthy trends:

**New technology:** Recent developments support faster, more cost effective delivery of services and have opened the door to complementary services (database management, address list management, variable data marketing, mailing services, fulfillment, alternative media such as CD, DVD). In some cases these complement printing; in other cases they displace it.

**Changes in clients’ print buying habits:** Shorter runs purchased just in time and the growing demand for precisely targeted, personalized, variable-content printing are two examples.

**Shifting volumes of print:** A lower cost for equipment point of entry and inability to see total cost of ownership has moved print away from centralized production and into the office environment.

**Additional costs unique to government**

Being a part of state government requires additional work and associated additional costs that do not occur in the private sector. For example, Printing must respond to public disclosure requests, which is a unique cost to government agencies.

In addition, Printing explained its labor costs are higher than those in the private sector. For many government positions, benefit packages are better (and therefore more expensive) than benefits offered in the private sector. Printing also noted state employees tend to stay in their positions longer and therefore earn more based on their years of service.

**Customer actions affect Printing**

Many agencies have in-house print shops and/or take their printing needs directly to the private sector. As noted above, at least 11 state agencies have in-house print shops. We are uncertain of the number of state agencies that outsource their printing needs. However, through a review of state agency purchases, it appears more than 30 agencies used private print shops during either fiscal year 2008 or 2009.

When other agencies establish their own print shops or go directly to the private sector, the volume of work at Printing declines. These practices do not take advantage of the economy of scale that could result from use of Printing and may not comply with state law.

Theoretically, a recent law that requires state agencies to use 100 percent recycled paper affects all state agencies equally. However, if Printing complies with the law and other agencies disregard it then Printing will be at a competitive disadvantage in comparison to agency print shops and private printers. Paper represents a significant portion of the cost of a print job and simply moving from 40 percent to 100 percent recycled content increases the cost of the paper by 16 percent. Moving from paper with no recycled content to paper with 100 percent recycled content increases the cost of the paper by 27 percent.

**The law that governs Printing**

The law that governs Printing limits its ability to respond to market conditions. As noted above, state law requires Printing to price all jobs at cost, not to exceed the Franklin Guide pricing. While this has not occurred regularly, when Printing complies it is at a distinct disadvantage in responding to the marketplace. Printing noted this during our review, stating: “Pricing restrictions such as the Franklin Guide limit flexibility to appropriately recoup costs in specific cost centers. The skewed cost model can be a disadvantage when comparing prices to the private sector, particularly to the local market.”

Also, during our analysis, Printing kept some jobs in house even though the cost to print the jobs was higher than the lowest private sector bid and lower than its own costs. Printing charged a price lower than the lowest private sector bid and
kept the jobs in house because it had idle capacity and it costs Printing more to have staff and equipment sit idle than it does to take a partial loss on print jobs. While this practice makes good business sense in order to offset indirect costs, the law does not allow Printing this flexibility.

**New information systems are not fully functional**

Printing does not possess the high-quality, timely information required to support well-informed decision making. In February 2009, Printing began using a new system called Monarch, which integrates key business functions: job costing, job pricing, print job management, financial accounting and financial reporting. While Monarch has greater capacity to generate high-quality information than systems used in the past, it is not yet fully functional. Printing is working to improve this system and expects it to be fully functional by December 2010. Once this system is functional and contains accurate data, Printing should have the information it needs to better manage performance. For example, it will be able to compare costing to pricing by product type and for the agency as a whole.

Printing's cost-finding system is built on a complicated model developed by a consultant and implemented in 2008. This model systematically categorizes and allocates costs to Printing cost centers, but has not been fine-tuned to develop accurate job costing. Therefore, Printing has been manually calculating production costs when it considers the option of outsourcing jobs. While these manual calculations help inform decisions, they do not include all direct and indirect costs. This leaves Printing susceptible to unknowingly accumulating losses.

**Options in detail**

Our objective was to determine whether more effective, efficient, or economical options are available for printing. While the review determined Printing's current business model poses challenges, this report does not make corrective recommendations. We identified options for Printing that would help improve Printing's financial condition and its level of compliance with state law. These options offer a starting point for reforming Printing.

Printing faces challenging decisions as it determines what actions are necessary to reform its business in a manner that will provide quality services in a sustainable manner.

**Change Printing's business practices**

Printing would have to make adjustments in order to align with state law. It would also need to take additional steps to improve its financial condition under this option.

Management would have to take the following actions:

- Develop criteria to better manage the ratio of in-house to outsourced jobs.
- Determine the effect of these adjustments on revenue potential.
- Downsize production to a level where revenue potential is sufficient to cover costs.

To make this model work, policymakers would have to define expectations for the Department of Printing and customer agencies. The state would need to:

- Define what the term printing means to state government in a 21st century context.
- Determine what agencies should be allowed to print in house.
- Develop a control for price escalation for the cases the Franklin Guide does not address.
- Determine how to enforce compliance for Printing and customer agencies.

These actions would help Printing better comply with state law, may improve its financial sustainability, preserve it as the single point of contact for the state's printing needs and maintain its outsourcing function. Improved pricing may increase customer use of Printing. Overall, this model should produce quality services and lower costs for the state.

However, some challenges are associated with this model. It could require significant downsizing of its print production and increase in the number of print jobs and dollars it outsources. Overall, Printing would experience a decrease in revenue potential, reduction in staff, reduction in equipment and lower administrative costs. Under this more specialized, cost-sensitive environment, Printing may be forced to outsource some jobs that agencies request – even if the agency is willing to pay extra for the job to be printed in house.

**Initiate shared services review of Printing**

Several options exist to merge Printing with other agencies. Under any reconfiguration, management will still need to address the fundamental problems with the current business and pricing model for Printing. A shared services review of printing functions at multiple state agencies could identify opportunities to reduce costs and improve service delivery through a different business model. Our lease management shared services review is an example.
Promising practices

During our analysis, we found these promising practices that merit further consideration:

Managed print services

There may be substantial savings for state agencies through improved management of printing services. Managed print services reduce costs through the removal of unnecessary equipment, competitive purchasing and good management and monitoring over time. It also provides flexibility to scale resources and cost to match business volume and staffing.

According to Gartner, a company that provides information technology research and advice, organizations that actively manage their printing can reduce costs by 10 percent to 30 percent. Gartner states most organizations do not understand their printing needs and have too much equipment and the wrong kinds of equipment for the number of users on staff.

Printing believes state agencies could save from $7.4 million to $9.5 million through managed print services and it has been advocating that agencies consider this option for the past four years. We have not verified Printing's estimated cost savings, but through consideration of Gartner's independent analysis it appears state agencies could realize significant savings if they actively managed office printing. Further study could validate this information.

While improved management of print services could save state agencies thousands of dollars, agencies could also choose to better manage their office printing through careful research and their own internal resources. Printing could potentially add value to the process in the role of an independent consultant; however, some agencies may welcome this assistance and others may resist it.

The Department of Ecology is working with Printing in a managed print services model. Printing estimates Ecology is saving $160,000 per year compared with the 2003-05 biennium. Ecology officials said the new practices also make it easier for them to manage printing services.

Operating like a business: Iowa case study

Printing and its customer agencies could benefit from changes to state law regarding flexibility in how Printing handles its pricing and flexibility in how agencies handle their printing.

The state printer in Iowa made this transition in 2005. In response to a significant budgetary shortfall, Iowa's Governor decided numerous state-provided services would become marketplace activities. A law was passed allowing agencies to handle their own printing services and giving the Iowa state printer more authority over its business practices.

Before this transition, the Iowa state printer projected losses of over $300,000 at the end of the fiscal year. Management recognized the urgent need to align expenses and revenue and made the following changes:

- Staff reductions from 21 to 12 employees.
- More operating time. The shop moved from 1.5 to three shifts and now runs 22 hours per day, including weekends.
- Greater consideration and implementation of employee suggestions. One employee suggested trying to consolidate operations. Following this suggestion, the print shop reduced its leased space by 30 percent, saving more than $15,000 annually.
- Renegotiated vendor contracts at a savings of $40,000 annually.
- Experimentation with new products and services.
- A weekly process to review vendor invoices for adequacy and accuracy. The initial effort discovered $50,000 in errors.
- Updated financial information at weekly staff production meetings.
- A new Web-based ordering system to better coordinate operations and speed turnaround time.

As a result, the Iowa state printer went from a projected deficit of $300,000 to a surplus of $150,000.

We identified this business model during our review as a reform effort recently completed in the state of Iowa. We did not evaluate this model as a potential option for Washington. As a result, we do not know how a change of this nature would impact Printing or its customer agencies.
Earlier this year, when we reviewed government reform ideas for the 2009 state government performance review, the perceived high costs of ferry procurement emerged as a significant issue.

The Transportation Department’s Ferries Division operates the largest and one of the oldest, ferry systems in the United States. The long-term plan for the ferry system calls for construction of 10 new ferries and the refurbishment of another one by 2030 to maintain the present size of the 28-vessel fleet.

The “Build in Washington” law (RCW 47.60.814(17)) states that in order for an interested party to participate in the request for proposal they must construct the vessel within the boundaries of the State of Washington. Currently, four shipbuilders in Washington have the capacity to construct ferry vessels and only one has submitted bids for the past several ferry construction contracts. These results have come under scrutiny by some state legislators, taxpayers and special interest groups who believe Washington state is paying too much for ferry construction.

Our 2009 review was designed to assess vessel procurement procedures and costs; to examine actual and perceived barriers to competition; and to identify alternative procurement practices for consideration by Washington policy-makers.

The review team met with numerous individuals with an interest in ferries and researched state and federal laws and regulations on ferry procurement and construction. The team also reviewed federal funding practices, labor and apprenticeship laws, bonding requirements and alternative models of ferry procurement and system operations.

Although we did an extensive review of the cost drivers, the short time available for this review precluded us from fully developing alternative options. Additional analysis would be required to evaluate the many underlying issues, policies, laws and procedures regarding ferry construction before options for reform could be presented. We will consider this opportunity as a possible future performance audit or review.
In this section

- Introduction
- Performance Audit Planning Assessment
- Addressing Important Agency Questions
- Potential Improvement Opportunities
Introduction
Performance audits of state and local governments in Washington are conducted under the authority of Initiative 900, which was approved by voters in November 2005 and enacted as RCW 43.09.470. Since then, our Office has independently selected audit topics in response to citizen input, audit experience, requests by the Governor and the Legislature and in response to emerging issues.

Performance audit planning is one of the three major components of the State Auditor's 2009 State Government Performance Review. The other key elements – an evaluation of the shared services of information technology and lease management and analysis of selected government reform ideas – are described earlier in this report.

Performance audit planning assessment
The performance audit planning assessment was initiated in the belief that every government program can be improved. Given the state’s extremely limited resources, it is more important than ever to identify areas of state government in which performance audits would be most likely to substantially improve efficiency and results.

The assessment is the first step of a two-step process. The first step, as outlined in this section, produced important information about the framework within which state government attempts to achieve citizens’ most important goals. The second step, which will be completed in early 2010, will be our performance audit work plan that will identify specific programs, agencies and multiagency functions for which performance audits will be conducted to lead to better results.

How we conducted the assessment
We adopted a best practice among government auditors for the 2009 performance review, to identify opportunities for future audits by evaluating the management systems that help agencies and programs achieve key missions.

We contracted with the Macias Consulting Group to develop a model to assess management, budget and performance improvement systems across state government. The project included the following key elements:

- Systems were assessed at 38 agencies. These executive cabinet agencies, higher education institutions and independently elected officials account for more than 70 percent of the state government operating budget. The agencies were selected based on the size of their budgets and the extent to which they contribute to one or more of the Priorities of Government.
- The project included an extensive review of existing information. To gain an understanding of agencies’ programs and goals, staff teams from the State Auditor’s Office and Macias reviewed:
  - Agency budget documents.
  - Performance and management reports.
  - Strategic plans.
  - Other published information, including several agencies’ applications for the Washington State Quality Award.
- Agencies provided information and clarification. The teams consulted with senior agency staff, including those responsible for internal auditing, to learn more about the agencies and to ensure existing information was clearly understood and accurately interpreted.

38 agencies participated in the performance audit assessment:

- Department of Agriculture
- Attorney General’s Office
- State Auditor’s Office
- Central Washington University
- Department of Commerce
- State Board for Community and Technical Colleges
- Department of Corrections
- Department of Early Learning
- Department of Ecology
- Employment Security Department
- Office of Financial Security
- Department of Fish and Wildlife
- Department of General Administration
- Office of the Governor
- Department of Health
- Health Care Authority
- Higher Education Coordinating Board
- Department of Information Services
- Office of the Insurance Commissioner
- Department of Labor & Industries
- Department of Licensing
- Liquor Control Board
- Military Department
- Department of Natural Resources
- Department of Parks and Recreation
- Department of Personnel
- Puget Sound Partnership
- Department of Revenue
- Secretary of State
- Department of Social and Health Services
- Washington State Patrol
- Superintendent of Public Instruction
- Department of Transportation
- Washington State Treasurer
- University of Washington
- Utilities and Transportation Commission
- Washington State University
- Workforce Training and Education Coordinating Board
Agency information was reviewed in relation to the elements of Initiative 900 and the Priorities of Government. This enabled the review teams to evaluate opportunities for performance improvement based on:

1. Citizens’ highest priorities for accountability as stated in Washington’s performance audit law.
2. The state’s highest priorities for performance as expressed in the system developed to ensure budget decisions support key statewide goals.

The model used to conduct the assessment is designed to be applied to additional agencies of state and local government in the future. While this year’s assessment was limited to state agencies, the model can be customized to fit different organizations, operating priorities and performance goals.

Addressing important agency questions
After the performance assessment teams reviewed existing documentation, they interviewed senior agency staff to address a broad range of questions, such as:

- How does the agency use performance data to support decision-making?
- Are there gaps in service within agency programs or unnecessary overlaps with programs in other agencies?
- Are opportunities being identified to transfer programs or services to the private sector or to use private-sector techniques to improve efficiency?
- How are discretionary cost-saving opportunities identified?
- How is technology being used to streamline agency operations, improve customer service or produce other benefits?
- How frequently does the agency update its information technology security systems?
- How does the agency manage its administrative functions?
- How are best practices identified and put into practice?

Potential improvement opportunities
The assessment shows opportunities for improvement exist within individual agencies and across several of the multiagency functions that support state government’s day-to-day operation.

Specifically, the assessment shows that performance audits are more likely to produce higher-impact improvements if we develop performance audit topics that focus on four of the nine areas designated for evaluation in I-900. These elements are shown in priority order in the accompanying table. We will continue to consider all I-900 elements in our performance audits.

<table>
<thead>
<tr>
<th>Initiative 900 elements</th>
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<td><strong>High-priority elements</strong></td>
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<td>1. Analysis of gaps or overlaps in programs or services and recommendations to correct gaps or overlaps</td>
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<td>2. Identification of agency programs or services that should be transferred to the private sector or would benefit from an improved business model</td>
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<td>3. Identification of services that can be reduced or eliminated</td>
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<td>4. Analysis of departmental performance data, performance measures and self-assessment systems</td>
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<td><strong>Lower priority elements</strong></td>
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<td>5. Analysis of the roles and functions of the department</td>
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<td>6. Feasibility of pooling information technology systems within the department</td>
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<td>7. Identification of cost savings</td>
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<td>8. Identification of best practices</td>
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<tr>
<td>9. Recommendations for statutory or regulatory changes that may be necessary for the department to properly carry out its functions</td>
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An important I-900 focal point – identifying opportunities for cost savings – did not rank among the factors that would most likely benefit from an audit at this time. This is most likely a result of the extensive budget-cutting that is occurring across state government. However, we expect opportunities to reduce costs will emerge when we evaluate three of the high-priority I-900 elements – possible gaps or overlaps in programs or services, agency programs and services that should be transferred to the private sector or would benefit from an improved business model; and services that could be reduced or eliminated.

The assessment also shows that performance audits are most likely to produce higher-impact improvements if we develop performance audit topics that focus on five of the 10 Priorities of Government result areas. These topics are listed in priority order in the accompanying table.

### Priorities of Government

<table>
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<th>Top five priorities</th>
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<td>1. Improve the security of Washington’s vulnerable children and adults</td>
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<td>2. Improve the safety of people and property</td>
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<td>3. Improve the health of Washingtonians</td>
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<td>4. Improve student achievement in elementary, middle and high schools</td>
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<td>5. Improve cultural and recreational opportunities throughout the state</td>
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<th>Other priorities</th>
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<td>6. Improve the value of post-secondary learning</td>
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<td>7. Strengthen government’s ability to achieve results efficiently and effectively</td>
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<td>8. Improve the economic vitality of businesses and individuals</td>
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<td>9. Improve the quality of Washington’s natural resources</td>
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<tr>
<td>10. Improve the statewide mobility of people, goods and services</td>
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The next step: A work plan

We will use the assessment as an important source of information to develop work plans for future I-900 performance audits. The next work plan is scheduled to be released in early 2010.

The assessment is especially important because the 38 agencies surveyed represent more than two-thirds of the state operating budget and make major contributions to achieving the Priorities of Government. However, other information will also be considered, including:

- **Agency performance and outcome data.** Further analysis will focus on data submitted by agencies to the Office of Financial Management through the Performance Measure Tracking System. The performance tracking system represents the only central and comprehensive collection point for performance data from all Washington state agencies. Data is updated regularly and is available to the public through the OFM Web site. All agencies are required to submit data and evidence of their effectiveness to OFM.

- **Policy and program priorities of the Governor and Legislature.** These leaders regularly express their priorities through budget proposals, legislation, executive orders, directives and other policy statements.

- **Suggestions from citizens and public interest groups.** We will continue to conduct town hall meetings, focus groups and citizen surveys to identify their most important priorities for government performance and accountability. We also consult regularly with public policy groups across the state.

- **Specific requests from state leaders,** including agencies and their employees. To date, some of the most productive performance audits were conducted in response to suggestions from state leaders. For example, Governor Gregoire requested the 2007 audit that led to major improvements in the state’s health professions quality assurance program. A number of possible performance audit topics were discussed with agency leaders during the assessment. We will also seek ideas from front-line staff, who are in a unique position to identify programs or services that could benefit from in-depth evaluation.

Ultimately, all performance audit work plans and topics chosen for audits reflect our independent judgment, as required by the national auditing standards that guide the work of our Office.
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