



March 26, 2014

To: Finance and Administration Committee

From: Darrell Johnson, Chief Executive Officer

Janet Sutter, Executive Director
Internal Audit Department

Subject: Review of Oversight Controls and Contract Compliance Related to the Metrolink Service Expansion Program

Overview

The Internal Audit Department has completed a review of oversight controls and contract compliance related to the Metrolink Service Expansion Program. Based on the review, the Southern California Regional Rail Authority has complied with the provisions of the Metrolink Service Expansion Program cooperative agreement; however, the Internal Audit Department recommended that Southern California Regional Rail Authority management implement controls to effectively manage cost-plus fixed-fee agreements. In addition, the Internal Audit Department offered two recommendations to Orange County Transportation Authority project management to strengthen controls over consultant rates and escalation, and to improve consultant oversight and invoice review controls.

Recommendations

Direct staff to implement recommendations provided in the Review of Oversight Controls and Contract Compliance Related to the Metrolink Service Expansion Program, Internal Audit Report No. 11-510, March 4, 2014, Reissued.

Background

On November 14, 2005, the Orange County Transportation Authority's (OCTA) Board of Directors adopted the Metrolink Service Expansion Program (MSEP), which authorized staff to begin implementation of high-frequency rail service between the Fullerton and Laguna Niguel/Mission Viejo Metrolink stations in Orange County.

Project Management

On June 26, 2007, to assist with the MSEP, OCTA contracted with PB Americas, Inc. (PB Americas) under Agreement No. C-6-0165 for project management consultant services (Project Management Agreement). Services provided by PB Americas include project management assistance, coordination between utilities, cities, and Metrolink member agencies, environmental review, preparing independent cost estimates, document control, and project control/invoice review.

MSEP Cooperative Agreement

OCTA and the Southern California Regional Rail Authority (Metrolink) entered into the MSEP cooperative agreement (MSEP Agreement) on April 23, 2007. The MSEP Agreement establishes roles, responsibilities, funding, and processes for the project management and implementation of rail infrastructure improvements to accommodate 30 minute commuter rail service. It stipulates that OCTA is responsible for all actual costs and expenses of the service expansion, while Metrolink is responsible for the delivery of the commuter rail service, including track and signal improvements, project management, and construction services.

Discussion

The Internal Audit Department (Internal Audit) noted claims made by three Metrolink contractors for additional overhead costs for prior years. The basis of the claims is the result of Metrolink's use of cost-plus fixed-fee agreements that allow contractors to bill at a provisional overhead rate until an actual overhead rate can be calculated after the end of each year. Contractors that experience indirect costs higher than the provisional rate may claim additional costs and request adjustment; however, contractors that experience lower indirect costs have little incentive to initiate such adjustments. Metrolink does not have a mechanism in place to require contractors to submit an audited overhead rate at the end of each year so that the appropriate adjustments can be made. Internal Audit recommended that Metrolink develop policies and procedures to effectively manage cost-plus fixed-fee contracts. Metrolink management stated that going forward it will not use provisional rates, and all new contracts will require fixed fully-loaded hourly rates.

During review of the Project Management Agreement, Internal Audit identified a blended overhead rate that was negotiated for one sub-consultant where the lower field overhead rate would have been more appropriate. Also, Internal Audit identified weaknesses related to control of escalation on consultant labor

costs and the use of labor rate ranges without the addition of contract language requiring payroll registers be provided with invoices so that direct labor rates can be verified as required. Internal Audit recommended management enhance procedures to address these issues, and management indicated that procedures governing time-and-expense contracts, labor rate ranges, and escalation have been strengthened.

Finally, Internal Audit noted inconsistencies in billed hours and reimbursements related to one sub-consultant staff. Internal Audit offered recommendations to strengthen controls related to invoice review and consultant oversight. Management obtained reimbursement for unauthorized cell phone expenses. Management also indicated that current procedures require additional supporting documentation for fieldwork performed by consultants, and cell phone expenses are now limited to a lower fixed rate in contract agreements.

The report was originally issued on February 14, 2014, but was reissued at the request of OCTA's Chief Executive Officer to include additional background information and management response.

Summary

Based on the review, Metrolink has complied with the provisions of the MSEP Agreement; however, Internal Audit recommended that Metrolink management implement controls to effectively manage cost-plus fixed-fee agreements. In addition, Internal Audit has offered two recommendations to OCTA project management to strengthen controls for setting consultant rates and escalation, and to improve consultant oversight and invoice review controls.

Attachment

- A. Review of Oversight Controls and Contract Compliance Related to the Metrolink Service Expansion Program, Internal Audit Report No. 11-510, March 4, 2014, Reissued

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ORANGE COUNTY TRANSPORTATION AUTHORITY INTERNAL AUDIT DEPARTMENT



Review of Oversight Controls and Contract Compliance Related to the Metrolink Service Expansion Program

Internal Audit Report No. 11-510

March 4, 2014
Reissued



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Conclusion

The Internal Audit Department (Internal Audit) has completed a review of oversight controls and contract compliance related to the Metrolink Service Expansion Program (MSEP), Agreement No. C-6-0820 (Agreement). Based on the review, the Southern California Regional Rail Authority (Metrolink) has complied with the MSEP Agreement; however, Internal Audit recommended that Metrolink management implement controls to effectively manage cost-plus fixed-fee agreements. In addition, Internal Audit offered two recommendations to Orange County Transportation Authority (OCTA) project management to strengthen controls over consultant rates and to improve consultant oversight.

Background

On November 14, 2005, the OCTA Board of Directors adopted the MSEP, which authorized staff to begin implementation of high-frequency rail service between the Fullerton and Laguna Niguel/Mission Viejo Metrolink stations in Orange County.

Project Management

On June 26, 2007, to assist with the MSEP, OCTA contracted with PB Americas, Inc. (PB Americas) under Agreement No. C-6-0165 for project management consultant services (PM Agreement). Services provided by PB Americas include project management assistance, coordination between utilities, cities, and Metrolink member agencies, environmental review, preparing independent cost estimates, document control, and project control/invoice review. The PM Agreement had an initial term of five years with two, one-year options and a maximum obligation of \$5 million. As of June 2013, the contract has been amended eighteen times, increasing the maximum obligation amount to \$15.5 million. Amendments to the agreement included revisions to the rate schedules, changes to the scope of work, addition of sub-consultants, extensions of contract term, and increases in maximum obligation.

MSEP Cooperative Agreement

OCTA and Metrolink entered into the MSEP Agreement on April 23, 2007. The MSEP Agreement establishes roles, responsibilities, funding, and processes for the project management and implementation of rail infrastructure improvements to accommodate 30 minute commuter rail service. It stipulates that OCTA is responsible for all actual costs and expenses of the service expansion, while Metrolink is responsible for the delivery of the commuter rail service, including track and signal improvements, project management, and construction services. The

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MSEP Agreement has been amended twice to modify the scope of work, increase the maximum obligation from \$87.873 million to \$99.965 million, disclose new funding sources, and amend and/or clarify responsibilities and requirements of Metrolink and OCTA. Through September 2013, OCTA has paid Metrolink \$85.154 million under the MSEP Agreement.

Through the MSEP Agreement, OCTA and Metrolink agreed to a cash flow payment mechanism in which OCTA would advance monies to Metrolink on a quarterly basis based on Metrolink's expected cash needs for the MSEP. Metrolink provides OCTA with a quarterly report demonstrating projected expenditures for the following quarter along with expenditures to date. The advance request is reviewed by OCTA's project management and PB Americas for reasonableness prior to issuing payment.

Objectives, Scope and Methodology

The objectives were to review OCTA oversight controls and to assess compliance with the MSEP Agreement with Metrolink and the PM Agreement with PB Americas.

The methodology consisted of reviewing applicable contract agreements, Metrolink and OCTA policies and procedures, and compliance requirements related to MSEP expenditures. Key controls over OCTA payments made to Metrolink as well as Metrolink's expenditures related to MSEP were identified and tested for compliance with policies and procedures and contractual compliance. Additionally, OCTA's controls over compliance with Proposition 116 and Proposition 1B were documented and observed. Furthermore, Internal Audit reviewed the PM Agreement and tested controls over the amendment process and performed control and compliance testing of OCTA expenditures made to PB Americas.

The scope of this review is limited to the MSEP Agreement with Metrolink and OCTA's management of the project, including project management consultant services provided under the PM Agreement. The review period will cover from June 2006 to June 2013.

We conducted this performance audit in accordance with Generally Accepted Government Auditing Standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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Audit Comments, Recommendations and Management Responses

Procedures for Cost-Plus Fixed-Fee Contracts

As of this review, Metrolink had received claims from three contractors that performed work on the MSEP Project. The basis of the claims stems from the use of cost-plus fixed-fee contract agreements which state that the "...Consultant will be reimbursed for its actual overhead and G&A cost incurred as applied to the contract on a basis consistent with federal cost principles." The contract language allows contractors to initially use a provisional indirect rate for billing purposes until the actual indirect rate is calculated after year-end.

Metrolink does not have a mechanism in place that requires contractors to submit an audited indirect rate report after year-end so that adjustments can be made to account for the difference between the provisional rate and the actual rate. Contractors who experience indirect rates higher than their provisional rate may submit a claim for additional costs for multiple years. Whereas, contractors with an actual indirect rate lower than their provisional rate have little incentive to notify Metrolink and provide credit for past overbillings.

One contractor has already settled with Metrolink for \$291,891.34. Of that amount, \$45,694.43 was expensed to the MSEP Project. Two other claims have not yet been settled.

Recommendation 1:

Metrolink should develop policies and procedures to effectively manage cost-plus fixed-fee contracts, including a protocol for reconciling contractors' actual versus provisional indirect rates and making the appropriate adjustments on an annual basis.

Metrolink Management Response:

Provisional Rates are allowed under FAR 42.7 and the FTA. The bench of Contracts E736 A, B and C, for Project and Construction Management, were the only contracts that included a "provisional" rate clause when these contracts were awarded. Historically, these contracts have always been awarded on the basis of a fully loaded labor rate. Going forward, the SCRRA will not be using provisional rates for any of these contracts but will be requiring fixed fully loaded hourly rates. These contracts were awarded in August 2009. In early 2010, the then CEO requested that all increases to contracts be frozen and formally requested that all contractors reduce their overhead and profit rates in exchange of a time extension. Staff took an

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action to the April 22, 2010 board. RailPros, in accordance with the contract requirements, submitted their request for an adjustment to their overhead rate. Staff denied the request to increase overhead for RailPros in 2010 due to the CEO's directive. At the time of exercising the option, a pre-award audit, as required by the contract was conducted. The results indicated that RailPros' overhead rates had increased. At that time, staff increased RailPros' overhead rates to accommodate the increase going forward for the option years. In accordance with the contract requirements, RailPros requested an adjustment to their overhead rates retroactively in the amount of \$700,000 plus. Following an audit conducted by SCRRA's outside auditors, and negotiations with staff, a settlement was reached with RailPros for a reduced rate.

Controls over Consultant Rates and Escalation

The PM Agreement with PB Americas is a time and expense agreement that includes several sub-consultants. OCTA pays labor rates based on actual pay rates with an overhead and profit multiplier. In addition, OCTA negotiates rates at which consultants will be reimbursed for other direct costs. During testing, Internal Audit noted the following issues related to rates:

- The rates for sub-consultant Hatch Mott MacDonald (HMM) were derived using a blended overhead rate rather than the lower field rate. Since HMM staff typically works out of OCTA offices or in the field, the lower field rate would have been more appropriate. For the period January 31, 2010 through November 30, 2012, the higher billing rates resulted in approximately \$19,000 in increased costs to OCTA.
- While the agreement limits sub-consultant labor escalation to 4 percent, it does not contain language limiting the escalation for PB Americas' staff. This has allowed PB Americas to request annual rate increases without limitation. For example, for the fiscal year (FY) 2011-12, labor rates for 15 staff were increased between 4.52 and 14.31 percent. In addition, an amendment to establish the FY 2011-12 rates was not processed or effective until March 5, 2012. Despite this, during the period July 1, 2011 through March 5, 2012, PB Americas was compensated at rates higher than the existing FY 2010-11 rates.
- Typically, time and expense agreements include specific labor rates for consultant staff and these rates are verified against payroll registers prior to execution of the contract. However, this PM Agreement included rate ranges for certain labor classifications rather than specified rates. To ensure billing rates under these labor classifications are based on actual pay rates, procedures to both verify and track the pay rate of each staff would need to be performed;

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however, the agreement does not require payroll registers be provided so that pay rates can be verified.

- Four instances were identified in which sub-consultants billed for staff not included in the agreement.

Recommendation 2:

Internal Audit recommends the following:

- Management should assess the appropriate type of overhead rate when establishing contract rates, and the assessment should consider where the consultants will be working;
- All time-and-expense agreements should contain a limit on escalation as a budget and cost control;
- Management should formalize procedures for the use of rate ranges for non-key personnel. Procedures should include a methodology for setting rate ranges based on actual pay data, establishing an initial (or baseline) pay rate, controls to ensure that billed rates are based on actual rates, and a mechanism for tracking rate increases and ensuring billed rates do not exceed an escalation limit;
- Consultant staff should be added to agreements prior to performing work; and
- Management should only approve invoices that reflect rates effective at the time the work was performed.

Management Response (Finance & Administration):

Management has reviewed the recommendations and has developed procedures to prevent future audit findings. As noted, this contract was executed in 2006. Since then, the procurement procedures governing time and expense contracts have been strengthened. A pre-negotiation memo is now a process used by the contracts staff to prepare and reach agreement with the project manager. This memo outlines the parameters, including the limits on escalation rates, which staff will use for negotiated procurements especially for time and expense and architectural and engineering type procurements. A preferred position and fallback position are identified in the memo. This strategy allows both the contracts person and project manager to be in agreement before, during, and after negotiations.

A letter amendment process has also been adopted which allows changes to staffing, other than key personnel, to be made quickly. The letter amendment can be used to add staff up to 60 days after they perform work under the agreement. This provision allows necessary work to be performed and the consultant to be reimbursed for its effort.

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For personnel other than key personnel, labor rate ranges are being used in agreements, when appropriate. This allows for personnel in the same classification who earn different salaries to be used on contracts. Management recognizes the need to contain the firm's escalation of wages within the ranges and agrees to add contract language that controls annual rate increases without OCTA approval.

Sub-Consultant Oversight Controls

Billable hours for one HMM employee included many hours of work in the middle of the night. A cursory review of the employee's Outlook calendar suggests this work was performed approximately 8 hours per week from mid-March 2010 to mid-September 2012. Project management explained that this HMM employee was instructed to monitor the Metrolink electrical contractor; however, there is little evidence of the monitoring work other than the Outlook calendar. In addition, review of invoices from HMM noted that mileage for this staff person was claimed on days that no hours were reported on the timesheet.

Invoices from HMM included eight months of cell phone bills for this employee in amounts ranging from \$119.65 to \$136.61 per month. Cell phone charges were not approved for reimbursement per the PM Agreement at the time and these monthly amounts exceed the rates typically negotiated for reimbursement. Finally, we noted that the cell phone bills included both business and personal charges; however, OCTA reimbursed HMM in full.

Recommendation 3:

Internal Audit recommends the following:

- When authorizing after-hours work, monitoring work, or other work where there are few deliverables, project management should require evidence of work performed (e.g. diaries, field reports, logs), and
- Project management should question costs that are not part of the schedule of other direct costs as well as costs that appear higher than reasonable given the nature of the costs.

Management Response (Rail Programs & Facilities Engineering):

Management agrees with this recommendation, and currently requires daily reports, field logs, or other supporting documentation for after-hours or field work performed by consultants. Management agrees that there is a need to question other direct costs (ODCs) when they appear to be high and we have done so on other contracts.

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We will continue to review ODCs for reasonableness. More recent contracts limit ODCs for items such as cell phone payments and travel, and require that the ODCs be authorized by management prior to costs being incurred. HMM has reimbursed OCTA \$990.87 for the identified cell phone billing payments that were not approved for reimbursement.