



U.S. Department
of Transportation
Federal Highway
Administration

Memorandum

Subject: **INFORMATION:** Local Public Agency
Stewardship Issues

Date: February 13, 2012

From: David A. Nicol
Director, Office of Program Administration

In Reply Refer To:
HIPA-10

To: Directors of Field Services
Division Administrators

On July 15, 2011, the Office of Inspector General (OIG) issued a report, *Federal Highway Administration's Oversight of Federal-Aid and Recovery Act Projects Administered by Local Public Agencies Needs Strengthening*. You will find a copy of the report on OIG's Web site at <http://www.oig.dot.gov/library-item/5596>. The OIG recommended that FHWA:

1. Establish uniform procedures and criteria to assess State oversight of LPAs.
2. Develop a process to assess the effectiveness of LPA corrective action plans.
3. Develop division-based plans to increase State oversight of seven project activities where the OIG found a high level of noncompliance with Federal requirements.
4. Assess the cited transactions with unsupported costs and develop a recovery plan.

To address the first two recommendations, FHWA will issue guidance to help field offices more consistently and effectively assess and correct State LPA oversight. To address the fourth recommendation, FHWA has agreed to review the cited unsupported transactions and develop a recovery plan. Efforts are underway to fulfill these commitments.

This memorandum addresses the third recommendation by providing guidance to divisions on project activities the OIG determined to have a high incidence of noncompliance. The items cited by the OIG included change orders and claims, project bidding/contractor selection/unbalanced bid analysis, utility agreements and reimbursements, consultant selection and billings, construction pay quantities and progress payments, project reporting and tracking, and quality assurance procedures. While these concerns arose from a review of LPA-administered projects, they also can occur on State DOT-administered projects.

Please review your stewardship programs and include activities and reviews as needed to ensure compliance with requirements in the cited areas. If you have any questions, please contact Mr. Robert Wright at 202-366-4630 or Mr. Peter Kleskovic at 202-366-4652.

Attachment

Discussion of Office of Inspector General Recommendations On Transactions with High Levels of Noncompliance

From November 2009 to April 2011, the Office of Inspector General (OIG) conducted an audit of Federal Highway Administration (FHWA) oversight of projects administered by Local Public Agencies (LPA). The purpose of the audit was to assess the role and effectiveness of FHWA's efforts to improve State oversight of LPA-administered projects. The OIG conducted the audit at FHWA Headquarters and divisions, selected State departments of transportation (DOTs), and related LPAs. The audit's objectives were to assess the extent of LPA compliance with Federal requirements and the effectiveness of FHWA's actions. Four States were selected for field reviews. The field review included site visits to projects developed by LPAs under the American Recovery and Reinvestment Act (Recovery Act) and other Federal-aid highway programs.

On July 15, 2011, the OIG issued its report, *Federal Highway Administration's Oversight of Federal-Aid and Recovery Act Projects Administered by Local Public Agencies Needs Strengthening* (<http://www.oig.dot.gov/library-item/5596>). As discussed in the report, the OIG compiled a list of 5,934 projects and 829 LPA sponsors. From this list, the OIG selected 29 LPAs that administered 59 Recovery Act and non-Recovery Act Federal-aid projects review. The selection was based on project status and location. The field reviews focused on LPA construction projects to verify compliance with Federal regulations.

The OIG conducted compliance reviews in 12 key project activities related to requirements under Title 23 and Title 49, Code of Federal Regulations (CFR). These reviews identified a range of errors, with seven of the activities having error rates at or above 39 percent. In addition, the OIG found at least one issue of noncompliance with Federal requirements in 52 of the 59 LPA projects reviewed. Based on this review, the OIG recommended:

Develop a Division Office-based plan that will increase state oversight in the seven project activities in which we identified a high level of noncompliance with Federal requirements

The seven activities that the OIG identified as having a significant number of recurring noncompliance involved a lack of documentation for the following actions:

- Change orders and claims
- Project bidding/contractor selection/unbalanced bid analysis
- Utility agreements/reimbursements
- Consultant selection and billings
- Construction pay quantities and progress payments
- Project reporting and tracking
- Quality assurance procedures

The following discussion addresses these observations.

Change Orders and Claims

This observation dealt with a lack of documentation showing that LPAs had performed cost analyses for negotiated contract change orders.

For highway projects on the National Highway System (NHS), 23 CFR 635.120(e) requires agencies to perform and document a cost analysis for each negotiated contract change. The analysis should evaluate the separate cost elements of the change, to support reasonableness of the negotiated price. If appropriate, the agency may document price reasonableness by a comparison with average unit bid prices. The analysis should address the impact of the change on the critical path and the need for contract time extensions.

For highway projects off the NHS and non-highway projects, the agency may follow State procedures. While 23 CFR 635.120(e) does not apply, the cost principles in 2 CFR 225, Appendix A, Section C, concerning allowability, still apply. An important factor in determining allowability is that the cost be reasonable.

Suggested Actions: FHWA divisions should:

1. Work with their State DOT to agree on a method and the level of detail required for conducting cost analyses for negotiated contract changes.
2. Ensure that State DOT LPA program guidance requires a cost analysis for each negotiated contract change for LPA projects on the NHS.
3. Encourage their State DOT to adopt procedures comparable to those in 23 CFR 635.120(e) for projects off the NHS to maintain a uniform change order process.

Project Bidding, Contractor Selection, and Unbalanced Bid Analysis

This observation dealt with a lack of documentation showing that the LPA had conducted a bid analysis.

For highway projects on and off the NHS, 23 CFR 635.114(c), (d), and (e) applies. It requires the agency to check the apparent low bidder's unit bid prices for reasonable conformance with the engineer's estimated prices. Bids with extreme variations from the engineer's estimate or where obvious unbalancing of unit prices has occurred require careful evaluation. Where obvious unbalanced bid items exist, the agency's decision to award or reject a bid shall be supported by written justification. The purpose is to help ensure that the executed contract will result in the lowest final cost. A bid that is mathematically but not materially unbalanced may still be awarded. When a bid is mathematically and materially unbalanced, steps are needed to protect the Federal interest. These can include not awarding the contract or awarding the contract with limits on Federal participation.

Suggested Action: FHWA divisions should ensure that State LPA program guidance has bid analysis procedures that apply to LPA projects.

Utility Reimbursements

This observation dealt with two issues – (1) a lack of documentation that the LPA had reviewed utility invoices and (2) insufficient documentation within project diaries to establish that utility work was performed and determined to be acceptable.

A utility's use of the rights-of-way must be covered by a written agreement between the utility and the State DOT or LPA on all projects involving the use of Federal-aid funding.

For federally reimbursable utility relocations, the utility agreement shall be supported by plans, specifications when required, and itemized cost estimates of the agreed upon work. When the utility work can be clearly defined and the cost accurately estimated, payment on a lump sum basis may be justified if a detailed estimate is included in the agreement.

LPAs are required to document in the project records, including daily diaries, that they have verified that utility work was completed as required. They are also to ensure that utility costs comply with the Federal cost principles (Common Grant Rule, 49 CFR 18.22(b)). Costs determined to be unallowable under these principles are not eligible for Federal-aid reimbursement. Agencies must establish controls to ensure that invoiced costs are allowable (allocable, reasonable, and necessary); that the State has authority to participate in the cost; the costs are supported by source documents; and the work was completed.

Interim and final bills for work completed should follow the format of the initial utility agreement and should include the applicable items identified in the cost estimate that supported the utility agreement. When the estimate and final billing are made on the basis of actual costs, the invoice should itemize the specific work that was completed and the associated costs, including dates when the work was performed, location of the work, labor, overhead, construction costs, travel, materials and supplies, and equipment and salvage credits. Agency project records must support the accuracy of the utility invoice.

Any contract or agreement involving the accommodation or relocation of utility facilities that uses Federal-aid funding must comply with the Buy America provisions (Title 23, United States Code (U.S.C.), Section 313, and 23 CFR 635.410). Information regarding these Buy America requirements is available at: <http://www.fhwa.dot.gov/utilities/buyam.cfm>.

Information about other Federal interests and issues to consider in the estimating, eligibility, and acceptance of costs on projects using Federal-aid funding may be found in the *FHWA Program Guide: Utility Relocation and Accommodation on Federal-Aid Highway Projects*, which is available at: <http://www.fhwa.dot.gov/reports/utilguid/>.

Suggested Actions: FHWA divisions should ensure that:

1. State LPA program guidance includes requirements for LPAs to document that they have reviewed utility invoices to ensure reasonableness.
2. State LPA program guidance includes requirements to document within project diaries that the required utility work was performed and determined to be acceptable.

Consultant Selection and Billings

This observation dealt with a lack of documentation that the LPA had used competitive negotiation/qualifications based selection procurement processes to select consultants; that independent cost estimates were not prepared prior to negotiation of the compensation; and that invoices were approved with limited review.

Consultant services funded in whole, or in part, with Federal-aid shall be procured and administered in accordance with the Common Grant Rule (49 CFR 18). Contracts for engineering and design-related services utilizing Federal-aid and that are directly related to a construction project must comply with the requirements of 23 U.S.C. 112 and 23 CFR 172. Engineering and design-related services are defined as "program management, construction management, feasibility studies, preliminary engineering, design, engineering, surveying, mapping or architectural related services."

In general, competitive negotiation procedures, commonly referred to as qualifications-based selection, must be followed when procuring engineering and design-related services with Federal-aid funds where those services are directly related to a construction project (40 U.S.C. 1101-1104 (Brooks Act), 23 U.S.C. 112(b)(2)(A), and 23 CFR 172.5(a)(1)).

Upon completion of the qualifications-based evaluation and ranking of proposals, the contracting agency negotiates with the most highly qualified firm to arrive at a fair and reasonable compensation for the solicited services considering scope, complexity, professional nature, and estimated value. Prior to receipt of the consulting firm's cost proposal, the contracting agency must prepare an independent estimate of the cost of the work to be performed. This estimate is the basis for negotiations and to ensure the services are obtained at a fair and reasonable cost.

If the indirect cost rate of the consulting engineering firm has been approved by a cognizant agency, the LPA must use this approved rate for contract estimation, negotiation, administration, reporting, and payment. Administrative or de-facto ceilings on indirect cost rates are not allowed (23 U.S.C. 112(b)(2)(C) and (D) and 23 CFR 172.7).

The two alternative procurement methods that may be used in limited cases are small purchase and simplified acquisition and noncompetitive procedures (23 CFR 172.5(a)(2) and (3)). Small purchase procedures involve contracts with a total cost below the lesser of the Federal simplified acquisition threshold (currently established at \$150,000) or the State's established threshold. Small purchase and simplified acquisition procedures for engineering and design-related services need not follow a competitive negotiation and qualifications-based selection process. Agencies should, however, ensure that an adequate number of qualified firms are considered.

Noncompetitive procurement requires the FHWA division's prior approval. Situations where this method may be used are limited to services that are available only from one source, when an emergency exists that does not permit the time needed to conduct competitive

negotiations, or when competition is determined to be inadequate after solicitation from a number of sources.

State DOTs and LPAs are required to comply with the Federal cost principles (48 CFR 31) to determine costs for personal services contracts with commercial, for-profit entities such as consulting engineering firms (Common Grant Rule, 49 CFR 18.22(b)). Costs determined to be unallowable under these cost principles are not eligible for Federal-aid reimbursement. Agency controls must ensure that invoiced costs are allowable (allocable to the project, necessary, and reasonable; that the State has authority to participate in the cost; are consistent with the terms of the contract; and are adequately supported by source documentation and verification of the completed work (49 CFR 18.20)).

These agencies are required to prepare and maintain written procedures for each method of procurement used for engineering and design-related services (23 CFR 172.9(a)). State DOTs may require LPAs to follow the State's procurement procedures that have been approved by FHWA. A State DOT may also approve LPA-written procurement procedures after determining that they comply with applicable Federal and State laws and regulations.

Approval by the FHWA division must be obtained before procuring a consultant to serve in a management role on behalf of the agency (23 CFR 172.9(d)). Consultants serving in management roles do not relieve the agency of its responsibilities in the oversight and administration of the Federal-aid funds. Also, conflict of interest considerations may limit the ability of consultants serving in a management role, such as a City/County Engineer, from participating in other roles, contracts, or project phases (23 CFR 1.33).

Information on the procurement, management, and administration of engineering and design-related services can be found at: <http://www.fhwa.dot.gov/programadmin/consultant.cfm>.

Information on Federal cost principles applicable to consultant costs can be found at: http://www.access.gpo.gov/nara/cfr/waisidx_10/48cfr31_10.html.

Information about allowable costs, auditing, reporting, and other related requirements is available in the AASHTO *Uniform Audit and Accounting Guide* at: http://audit.transportation.org/Documents/2010_Uniform_Audit_and_Accounting_Guide.pdf.

Suggested Actions: FHWA divisions should ensure that State DOTs are either requiring LPAs to follow the FHWA-approved State DOT procurement procedures or that State DOTs are reviewing and approving LPA procurement procedures. Divisions also should ensure that the established procurement policies and procedures specify that:

1. LPAs are estimating the value of the proposed services as the basis for negotiation of fair and reasonable compensation with the selected consultant.
2. Adequate documentation is maintained to demonstrate compliance with procurement requirements.
3. Invoiced consultant costs are reviewed for consistency with Federal cost principles, terms of the contract, and status/progress of the work completed.

Construction Pay Quantities and Progress Payments

This observation dealt with a lack of documentation to support progress payments for completed work.

For construction projects on the NHS, 23 C.F.R. 635.123 requires contracting agencies to have procedures that ensure the quantities of completed work are accurately determined. The LPA is required to inspect and verify delivery and quality of materials and their satisfactory incorporation into the project. Support for payments for completed work should be in inspector reports, daily diaries, and engineering calculations.

For construction projects not on the NHS or other Federal-aid projects, the documentation of quantities of work and progress payments must be done in a manner that supports a determination that contract requirements were met and the work was completed in reasonable conformance with the contract requirements (49 C.F.R. 18.42).

Suggested Action: FHWA divisions should ensure that State LPA program guidance has requirements for documenting and supporting progress payments for completed work.

Project Reporting and Tracking

This observation dealt with a lack of documentation of LPA oversight of key contract provisions. Problems include insufficient documentation of reviews of certified payrolls; lack of documentation of disadvantaged business enterprise (DBE) commercially useful function reviews; and lack of documentation of the contractor's construction activities in daily diaries:

Prevailing Wage and Payroll Requirements: The Davis-Bacon Act requires payment of prevailing wage rates to all laborers and mechanics on Federal or federally assisted

construction contracts. The Act's requirements are invoked through "related act" provisions of Federal programs. The U.S. Department of Labor has overall program responsibility. State DOTs or LPAs are responsible at the project level.

For Federal-aid highways, 23 U.S.C. 113 implements Davis-Bacon provisions and is applicable to all Federal-aid construction contracts exceeding \$2,000 and to related subcontracts located within the Federal-aid highway right-of-way. It does not apply to highways classified as local roads or rural minor collectors. Federal-aid projects outside of the Federal-aid highway right-of-way are subject to the Contract Work Hours and Safety Standards Act requirements. For additional information, see <http://www.fhwa.dot.gov/construction/contracts/080625.cfm>.

The provisions covering payrolls and pay statements were prompted by the Copeland Act to protect workers from paying employers for the "privilege" of being employed (29 CFR Parts 3 and 5 and 23 CFR 635.118). They require contractors and subcontractors to furnish weekly certified payroll statements to the contracting agency. Contracting agencies should review the payroll statements for completeness and certification, and

"spot-check" items, such as: classification, hourly rate, authorized deduction, fringe benefits, overtime hours and rate, and net wages paid. Employee interviews should be made to validate certified payroll statements.

DBE Requirements: Title VI of the Civil Rights Act of 1964 forms the foundation for the DBE program and is codified in 23 U.S.C. 140(c), with regulatory policy in 49 CFR Parts 21 and 26 as well as 23 CFR 200 and 230.

All Federal-aid projects are subject to DBE program requirements. Each State must have an approved DBE program and annual goals to ensure compliance with requirements.

The DBE requirements in Federal-aid highway contracts are contract provisions and should be administered as such. Actions required in an approved program will include “good faith effort” determinations, replacement or substitution of DBEs during the contract, crediting DBE participation, program monitoring, record keeping and reporting requirements of the contracting agency and contractor, and sanctions for non-compliance.

Two forms of DBE fraud and abuse are certification of an ineligible firm and failure by a certified DBE to perform a “commercially useful function.” Certification addresses the nature of a firm's ownership and structure and is the first safeguard for preventing fraud and abuse. “Commercially useful function” is concerned with the role the DBE plays in a project and is a second line of defense against fraud and abuse. Commercially useful function reviews occur during the project and are a part of a program’s approved monitoring and reporting requirements. Items to review include the DBE's management of the work; whether the DBE utilizes its work force, whether the DBE owns or rents its own equipment, and whether the DBE furnishes its materials.

Construction Management Documentation: Construction management requires an understanding of the risks and resources in the implementation of a highway project. Good construction management practices, including the oversight of project operations and project progress, quality assurance, and general contract administration procedures, are essential elements in the success of any construction project. Key to that success is the initiation and maintenance of source and summary documentation to support project completion in accordance with plans, specifications and estimates and State and Federal requirements.

Basic construction management documentation such as diaries, project quantity records, and engineering measurements and calculations are born of an evolving state-of-the-practice. These document requirements are outlined in State DOT policies and procedures for construction project administration and management and are often included in the State DOT Construction Manual. An LPA can develop similar procedures or adopt State procedures depending on the State’s policies and other requirements.

Suggested Actions: FHWA divisions should ensure that:

1. State DOTs are providing adequate oversight of LPA projects and ensuring that all contract provisions, including prevailing wage and payroll requirements and DBE program requirements, are being fulfilled.

2. State DOT program guidance includes requirements for effective construction contract administration and documentation to support progress payments and the work completed.

Quality Assurance Procedures

This observation dealt with LPAs not meeting key aspects of a quality assurance program, such as testing, to ensure that materials and workmanship met contract specifications, including the assurance of adequate documentation.

All Federal-aid projects on the NHS are subject to quality assurance procedures (23 CFR 637). This includes LPA-administered projects. For projects off the NHS, States and LPAs can use established procedures approved by the State DOT for materials acceptance. State and LPA procedures used for non-NHS projects must satisfy the intent of Federal requirements. Materials used in the pavement structure or in bridges should be tested. Small quantities or non-critical items (e.g., concrete for fence posts or sidewalks) may be accepted with limited or no testing with visual inspection from approved suppliers.

Suggested Actions: FHWA divisions should:

1. Ensure that State and LPA quality assurance procedures and practice for materials and testing used for NHS projects comply with 23 CFR 637.
2. Verify that State and LPA quality assurance procedures and practice for materials and testing used for non-NHS projects satisfy the intent of Federal requirements.