



COMMONWEALTH of VIRGINIA

Joint Legislative Audit and Review Commission
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Philip A. Leone
Director

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December 3, 2003

MEMORANDUM

TO: Philip A. Leone

FROM: Glen S. Tittermary

A handwritten signature in black ink that reads "Glen S. Tittermary".

SUBJECT: VITA Internal Service Fund Rate Approval

On October 6, 2003, the Virginia Information Technologies Agency (VITA) requested approval from the Joint Legislative Audit and Review Commission (JLARC) of a reduction in the existing Unisys CPU rate in the computer services internal service fund. Subsequently, on October 27, 2003, VITA requested approval for new rates to recover the costs of new services to be provided pursuant to the consolidation of IT functions in VITA. VITA's requests are attached for your reference. The new rates generally cover the provision of services related to the acquisition, operation, maintenance, and support of servers previously operated by individual agencies, and to the acquisition, maintenance, and support of desktop and laptop PCs previously owned and maintained by agencies. After submission of the request, VITA revised the rates to correct several calculation errors. The rates shown in this memo (not the original request letter) were the rates authorized by the Information Technology Investment Board at its meeting on December 1, 2003.

Reduction of Unisys CPU Rate

VITA is requesting a reduction of the existing Unisys CPU rate from \$.0088 per second to \$.00858 per second. The purpose of the reduction is to avoid overcharges to the Department of Social Services (DSS) which will re-

sult from the DSS conversion from a shared MAPPER 1 region to a dedicated MAPPER I region. Because of differences in the way that VITA bills for shared and dedicated MAPPER regions, the existing rates would result in overcharges to DSS of about \$300,000 after the conversion. The rate reduction makes the conversion revenue neutral for VITA and expense neutral for DSS. There is no cost or operational impact on any other State agency as a result of this rate reduction. **I recommend that the Commission approve the rate reduction as requested, to be effective November 1, 2003.**

Background and Assumptions for New VITA Rates

From its creation, the Department of Information Technology (DIT) had three internal service funds which it used to finance mainframe computer services, telecommunications services, and systems development services provided to customer agencies. The services provided by DIT are now provided by VITA, and the billing rates for those existing services were approved by the Commission without modification for VITA's use in July 2003.

The rates for which VITA is seeking approval in the pending request are for services not previously provided by DIT. VITA will provide these new services as a result of the consolidation of certain IT functions which the executive branch agencies currently perform themselves. The legislation creating VITA and mandating the consolidation of these IT functions also requires VITA to fund the services through its three internal service funds.

Development of the new rates required that VITA complete several steps. These steps included: (1) identification of the services to be provided, (2) identification of the units by which to measure the use of services by customers, (3) estimation of the volume of services to be provided, and (4) estimation of the costs to provide the services. The information from the completion of these four tasks makes it possible to calculate unit costs, or billing rates. These tasks were complicated by the phased implementation of the consolidation of IT functions in VITA, since the volume of services and associated costs will vary almost continuously over the course of the next 18 months as memoranda of agreement are executed with customer agencies. To avoid the problem of rates that need to be continuously revised, VITA staff based the calculation of rates on projected service volumes and costs for the

fully implemented consolidation. VITA's rate calculation spreadsheets are attached.

Rates for Desktop Services

As part of the consolidation of IT functions, VITA will be responsible for purchasing, maintaining, and supporting desktop PCs and laptops in all executive branch agencies. Upon execution of the memorandum of agreement with each agency, VITA takes ownership of the agency's desktop and laptop PCs, and provides all future maintenance and support. At the end of a four-year replacement cycle, VITA will also be responsible for purchasing the replacement PCs. To recover both the operational and capital costs for desktop and laptop PCs, VITA has proposed a flat monthly rate for two categories each of desktop and laptop PCs, as shown in Table 1.

Table 1
Monthly Rates for Desktop Services

<u>Billing Item</u>	<u>Rate</u>	
	<u>Standard</u>	<u>High-End</u>
Desktop	\$94.70	\$107.70
Laptop	\$204.03	\$218.03

The difference in rates for the standard and high-end configurations is entirely the difference in the assumed purchase costs and does not reflect any difference in assumed support and maintenance costs. The rates are based on cost recovery for 49,588 desktop PCs and 8,133 laptops. Assuming full implementation of agency consolidations, these rates are projected to generate approximately \$76.3 million annually.

Rates for Server Operations and Support

The consolidation of IT functions also requires VITA to assume ownership and responsibility for servers currently owned and operated by executive branch agencies. Upon execution of the memorandum of agreement with each agency, VITA takes ownership of the customer agency servers and operates, maintains, and supports those servers. VITA also assumes responsibil-

ity for acquisition, licensing, and support of system and applications software on the servers. At the end of the three-year replacement cycle for the servers, VITA will be responsible for all replacement costs. To recover the operational and capital costs for servers, VITA has proposed a flat monthly rate for each of three tiers of servers as shown in Table 2. The tiers are based on the expected annual operational and capital costs of the servers. Separate rates are requested for servers using the NT and UNIX operating systems. For example, annual costs for a tier 1 NT server range from \$547 to \$5,999. Annual costs for tier 3 UNIX servers range from \$17,500 to \$29,999.

Table 2
Monthly Rates for Servers

<u>Billing Item</u>	<u>Rate</u>		
	<u>Tier 1</u>	<u>Tier 2</u>	<u>Tier 3</u>
NT Servers	\$338.00	\$1,335.99	\$2,775.12
UNIX Servers	\$430.76	\$1,619.76	\$3,526.10

The higher UNIX server rates are based on an examination of the support costs incurred by agencies currently operating the servers as well as VITA's own experience in operating servers using both NT and UNIX operating systems. Once fully implemented, VITA expects to operate 1,818 NT servers and 1,150 UNIX servers, generating approximately \$20.2 million annually.

To recover the software costs, VITA is proposing a flat monthly fee for each of five tiers based on the annual costs for licensing and support. The software rates are shown in Table 3.

Table 3
Monthly Rates for Software

<u>Billing Item</u>	<u>Rate</u>				
	<u>Tier 1</u>	<u>Tier 2</u>	<u>Tier 3</u>	<u>Tier 4</u>	<u>Tier 5</u>
Software	\$312.66	\$3,012.06	\$10,054.78	\$23,641.14	\$51,556.84

The rates in Table 3 are expected to generate approximate \$21.3 million in revenue once the consolidation is fully implemented.

Rates for Other New Equipment and Services

VITA has also developed rates for certain other equipment and software for which it will be responsible as IT functions are consolidated. The rates are intended to recover the equipment capital costs as well as maintenance and support. Recovery of equipment capital costs is based on either a three-year or five-year replacement cycle, depending on the type of equipment. In some cases, such as for printers and scanners, the recovery includes only purchase costs and VITA administrative expenses such as procurement and indirect overhead. The rates for these other items are shown in Table 4 and Table 5.

Table 4
Monthly Rates for Other Equipment

<u>Billing Item</u>	<u>Rate</u>
Network Equipment – Data	7.70 % of purchase price
Network Equipment – Voice	4.54 % of purchase price
Other Hardware	5.95 % of purchase price

The rates in Table 4 are expected to generate approximately \$37.9 million annually.

Table 5
Other Charges

<u>Charge Item</u>	<u>Charge</u>
Additional PC Hardware (printers, scanners, etc.)	Purchase price + 8.9%
Additional PC Software (Visio, MS Project, etc.)	Purchase price + 8.9%
Wireless Handheld Devices (Blackberry, Pocket PC, Palm)	Purchase, license, maintenance, and usage + 8.9%

The 8.9 percent surcharge is based on the current rate of overhead recovery. No estimate of the revenue from the charges in Table 5 is available.

JLARC and APA Analysis of the VITA Rate Calculations

The fundamental purpose of a review completed by JLARC staff in response to an internal service fund rate request is to ensure that the proposed rates recover the costs associated with the services provided. Customer agencies should not be paying more than necessary, but VITA should generate sufficient revenue to remain financially sound.

To determine if the VITA rates were appropriate, JLARC staff examined the projected expenses for the new services, reviewed the projected profit and loss statement, reviewed estimates of the financial impact of the rates on customer agencies, and examined recent financial statements for VITA and DIT. Because of certain questions and concerns regarding the projected profit and loss statement, staff from the Auditor of Public Accounts (APA) were requested to review all relevant financial documentation. APA staff also provided advice on the soundness of certain assumptions used in the projections of expenses and revenues. The APA staff were able to provide immediate assistance because of their ongoing involvement in a review of VITA systems and internal controls (a copy of the special review objectives is attached).

Concerns and Reservations

Based on the reviews completed by JLARC and APA staffs, several concerns related to VITA's calculation of the rates were identified.

First, the data on the inventory of IT equipment and staffing positions used to calculate the rates were from the VITA "due diligence" survey of the in-scope agencies. Therefore, the data are self-reported by the agencies, which were unaware of the importance of accurate reporting on the survey. VITA staff have found numerous errors in the data but no systematic verification and revision of the information has been made. Both JLARC and APA staff have also identified errors in the due diligence data. Currently, no other data are available for developing the proposed rates. Since these data are the

basis of the units of service to be provided, inaccuracies affect the estimations of costs and revenues as well as the rates.

Second, the projected profit and loss statement double counts revenue in the telecommunications fund because revenue for equipment that is already leased to agencies by VITA has not been removed from the new revenue stream that includes both equipment cost and support. This error could amount to as much as \$3 million in FY 2005 and \$5 million in FY 2006. The projected profit and loss statement is attached for your reference.

Third, the projected profit and loss statement understates expenses by between \$13 and \$18 million because VITA has classified some overhead costs as startup projects and has assumed it will receive general funds for those costs. Since these costs appear to be more appropriately considered as VITA overhead, they should have been included in the overhead expenses to be recovered through the proposed rates. By assuming that general funds will be available for these overhead costs, the amount of expenses shown on the projected profit and loss are too low. In other words, the internal service fund rates proposed by VITA in the pending request would have to be increased to cover the additional expense. This has a significant impact on the future financial viability of the operation, since the current rates may result in insufficient revenue to cover expenses. This will result in operating losses and a reduction of the retained earnings for the three internal service funds. This may also adversely affect VITA's cash position, necessitating treasury loans to cover operating costs such as payroll.

Fourth, the current VITA billing system will not accommodate the new services or billing rates. VITA has proposed the use of Excel spreadsheets as a temporary solution for billing the small agencies, and has further proposed modifications to its existing billing system to be completed before it begins to bill the medium and large agencies in 2004. These are temporary solutions, and a new billing system will likely be needed over the long term. VITA has not begun the planning process for such a new system.

Fifth, VITA plans to credit agencies for the remaining value of equipment transferred to VITA, but has not taken the necessary steps to implement the credits to agencies. For example, the current billing system cannot accommodate the credits, and VITA has not adequately assessed the impact of various methods for implementing the credits on either its short-term or

long-term financial situation. Since the credits could amount to as much as \$42 million dollars, how the credits are made to agencies could have a significant financial impact on VITA.

Finally, the rates do not reflect any effort on the part of VITA to implement the efficiencies anticipated by the consolidation of IT functions in VITA. In fact, because of the need to upgrade the equipment, software, and infrastructure in agencies as the memoranda of agreement are executed, the initial costs reflected in the proposed rates may be higher than the current IT expenses in agencies. Some smaller agencies may have insufficient funds to pay for VITA services. Even among the larger agencies the impact could be significant. The Department of Social Services, for example, has determined that the proposed rates will cost the agency \$10 million more than it is currently spending on IT. If the costs of services provided by VITA prove to be significantly higher than the costs agencies incurred providing the services themselves, the success of the entire consolidation could be jeopardized.

Recommendation

Despite the concerns raised by JLARC and APA staff, the Commission should approve the requested rates. With the consolidation progressing largely on schedule, VITA needs to be able to charge for the services it is currently providing. Without the ability to recover the costs it incurs to provide new services, VITA would be forced to discontinue the consolidation process or place the agency at risk of financial collapse. While the rates should be approved, the Commission should insist that VITA meet certain conditions to ensure that the concerns outlined in this memorandum are addressed.

Accordingly, I recommend that the Commission approve the rates requested by the Virginia Information Technologies Agency with the following conditions:

- (1) the rates shall be effective from November 1, 2003, to September 30, 2004;**
- (2) VITA shall develop and promulgate a policy for implementation of equipment credits by January 15, 2004;**

- (3) VITA shall not negotiate reduced rates, discounts, or variations from the approved rates with individual agencies;**
- (4) VITA shall not accelerate from the statutory schedule the consolidation of any agencies prior to the development and deployment of a billing system that has been certified by the Auditor of Public Accounts to have appropriate audit systems and internal controls; and**
- (5) VITA shall provide each month to the Joint Legislative Audit and Review Commission and the Auditor of Public Accounts a report on profit and loss showing actual retained earnings.**

The failure of VITA to comply with any of the conditions set out in the Commission's approval should be cause for an immediate review and reconsideration of the rates by the Commission.

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