

November 20, 2002

The Honorable Mark S. Schweiker
Governor
Commonwealth of Pennsylvania
225 Main Capitol Building
Harrisburg, Pennsylvania 17120

Dear Governor Schweiker:

This report contains the results of our performance audit of Contract No. SP1611200001 (“Contract”) between the Pennsylvania Department of Education (“PDE”) and Edison Schools Inc. (“Edison”). Pursuant to the Contract, PDE paid Edison \$2.7 million to analyze the financial and academic problems of the Philadelphia School District (“District”) and submit a report to PDE presenting options for solving those problems. The Contract and the resulting report are of great interest to families in the District and all state taxpayers, particularly in light of subsequent events such as the Commonwealth’s takeover of the District, the Commonwealth’s investment of a significant amount of additional dollars in the District, and Edison’s selection to manage twenty public schools in the District.

This performance audit covered the term of the Contract from July 27, 2001, through December 31, 2001. The five audit findings detailed in this report raise serious concerns about the procurement and oversight of the Contract. As a result, we have offered eleven recommendations to improve PDE’s procurement of future contracts and its oversight of the vendors selected to perform those contracts. We have also included an observation about Edison’s record-keeping system and a recommendation for improving that system for work performed under future contracts.

Chapter I of this report discusses how the procurement process which resulted in PDE’s awarding of the Contract to Edison appears to have been conducted in violation of the Commonwealth Procurement Code and, furthermore, appears to have been unnecessary in the first place due to the volume of information already available about the District’s problems. Chapter II explains that Edison’s qualifications appear to have been irrelevant to PDE’s decision to award the Contract to Edison, and that no basis appears to exist to support PDE’s assessment that Edison’s multimillion-dollar fee was reasonable. Finally, Chapter III reports that Edison violated the Contract by retaining three subcontractors without PDE’s prior approval.

The Honorable Mark S. Schweiker
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We sent PDE a draft version of this report on October 17, 2002, and received its written response on November 7, 2002. PDE's response has been incorporated into this report, followed by our comments. PDE declined our offer to discuss the contents of this report at an exit conference.

In closing, I have been appalled at the lack of cooperation and professionalism demonstrated by PDE throughout the course of this audit. PDE management repeatedly refused to provide information and documents needed to conduct the audit. This lack of cooperation forced us to make the same requests several times and, ultimately, to draw conclusions based on the information and documents that PDE was willing to provide to us.

Furthermore, the response that we received from Secretary of Education Charles Zogby to one of our requests was shocking in its arrogance and contempt for this Department and the taxpayers of this Commonwealth. Secretary Zogby has also exhibited a disturbing level of disrespect for the hardworking career government auditors of this Department.

As a result of PDE's actions, the completion and release of this audit was significantly delayed. However, our recommendations have general application to PDE's procurements and we encourage PDE to implement them for future contracts with Edison and other vendors.

Sincerely,

Robert P. Casey, Jr.

*A Performance Audit of the Pennsylvania Department of Education’s
Contract No. SP161120001 with Edison Schools Inc.*

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EXECUTIVE SUMMARY

**CHAPTER I – THE DEPARTMENT OF EDUCATION’S
UNNECESSARY AND UNLAWFUL PROCUREMENT**

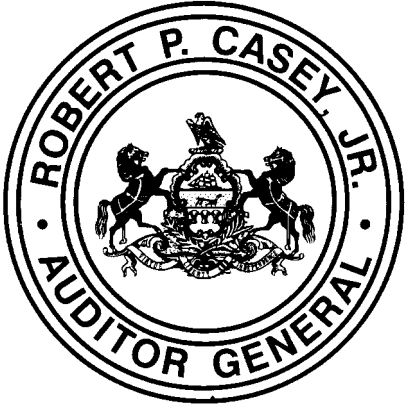
FINDINGS	SUMMARY
<p><u>Finding I-A:</u> The Contract appears to have been unnecessary, given the analyses of the Philadelphia School District’s (“District”) financial and/or academic problems which had already been conducted by July 2001.</p>	<p>The existence of reports already prepared about the District’s financial and academic problems, the Pennsylvania Department of Education’s (“PDE”) own data, and Standard & Poor’s imminent analysis of the District strongly suggests that one more report about the District was not necessary, particularly when that report would cost Pennsylvania taxpayers \$2.7 million in addition to the significant amount of public funds that had already been spent.</p>
<p><u>Finding I-B:</u> PDE appears to have unlawfully circumvented state competitive bidding requirements by improperly awarding the Contract to Edison Schools Inc. (“Edison”) as an “emergency procurement.”</p>	<p>PDE has maintained that the 60-day deadline for Edison to submit its report to the Governor regarding the District’s problems and for the Governor to then submit a proposal to Philadelphia Mayor John F. Street for solving those problems created an “emergency” which justified PDE’s circumvention of the competitive bidding process normally required by state law. However, it appears that this self-imposed deadline – and not any circumstances beyond PDE’s control – created the “emergency” asserted by PDE.</p>
RECOMMENDATIONS	
<p>PDE should do the following:</p> <ul style="list-style-type: none">• Refrain from spending public funds on future contracts when the goods or services contracted for are already readily available to PDE;• Consider the length of the procurement process when agreeing to deadlines for submitting work to other entities based on the work of needed vendors;• Comply with the competitive bidding requirements established by the Commonwealth Procurement Code;• Award contracts in circumvention of the competitive bidding requirements based on the “emergency procurement” exception only in cases of true emergency;• Solicit telephone bids from potential vendors for an emergency procurement whenever practical; and• Maintain documentation of communications with prospective vendors, particularly those considered for an emergency procurement.	

**CHAPTER II – EDISON’S QUALIFICATIONS
AND MULTIMILLION-DOLLAR FEE**

FINDINGS	SUMMARY
<p><u>Finding II-A:</u> Edison’s qualifications appear to have been irrelevant to PDE’s awarding of the Contract.</p>	<p>PDE failed to demonstrate that it conducted a serious evaluation of Edison’s qualifications or that it contacted or even considered any other firms to analyze the District. It appears that no other vendors were considered for the project and that Edison was awarded the no-bid Contract regardless of its qualifications.</p>
<p><u>Finding II-B:</u> No basis appears to exist to support PDE’s assessment that Edison’s fee was reasonable.</p>	<p>PDE failed to demonstrate that it conducted a serious evaluation of the reasonableness of Edison’s \$2.7 million fee. It appears that there was no basis to support PDE’s assessment that the fee was reasonable. We could not determine for ourselves whether Edison’s fee was reasonable.</p>
RECOMMENDATIONS	
<p>PDE should do the following:</p> <ul style="list-style-type: none"> • Award future contracts to vendors who are the most qualified to perform the required work and who charge the most reasonable fees; • Perform and document procedures enabling PDE to conclude that future vendors who receive contracts from PDE are the most qualified vendors to perform the required work; • Perform and document procedures enabling PDE to conclude that the fees charged by future vendors who receive contracts from PDE are reasonable; and • Obtain formal written price quotes from prospective vendors prior to awarding future contracts and commencing negotiations regarding the contract terms. 	
OBSERVATION	
<p>Although Edison was able to support the amounts billed to PDE under the Contract, its record-keeping system needs improvement. Therefore, in future contracts, PDE should require Edison to establish a better system for tracking employee time according to project and to assign the responsibility for developing and overseeing the system to an employee with adequate authority.</p>	

CHAPTER III – EDISON’S USE OF NON-APPROVED SUBCONTRACTORS

FINDING	SUMMARY
<p><u>Finding III:</u> Edison violated the Contract by retaining three subcontractors not approved by PDE.</p>	<p>Edison violated the Contract by failing to obtain PDE’s written approval for all subcontractors. Because PDE had not approved three subcontractors, it should have questioned their use.</p>
RECOMMENDATION	
<p>In future contracts, PDE should exercise greater oversight over its vendors to ensure that they request approval for all subcontractors when required by contract.</p>	



***A Performance Audit of the Pennsylvania Department of Education's
Contract No. SP1611200001 with Edison Schools Inc.***

BACKGROUND

For decades, the Commonwealth of Pennsylvania (“Commonwealth”) and the City of Philadelphia (“City”) have undertaken efforts to address various financial and academic problems existing in the Philadelphia School District (“District”). On July 27, 2001, the Pennsylvania Department of Education (“PDE”) requested approval from the Pennsylvania Department of General Services (“DGS”) to obtain an analysis of the financial and academic situation of the District from Edison Schools Inc. (“Edison”).

Edison claims to be the nation’s leading for-profit operator of public schools. Despite its experience in managing schools, albeit with mixed results, Edison itself conceded to the Department of the Auditor General (“Department”) its lack of experience in conducting such an analysis. Regardless, PDE needed DGS’s approval in order to proceed via an “emergency procurement” rather than the competitive bidding process normally required by state law. DGS granted verbal approval at that time and written approval four days later.

Although numerous analyses of the District’s financial and/or academic problems had already been conducted and issued by various public and private entities by that time, PDE entered into Contract No. SP1611200001 with Edison, effective July 27, 2001 (“Contract”). The no-bid Contract required Edison to analyze the District’s academic and fiscal problems and provide a report to PDE presenting options for solving those problems. As compensation for this work, as well as for costs incurred by Edison and its subcontractors, PDE agreed to pay Edison a maximum of \$2.7 million.

The Contract required Edison to submit a draft report to PDE on September 14, 2001, and a final report on September 21, 2001. The Contract anticipated that Edison would continue to be involved with the Commonwealth’s efforts to reform the District even after it submitted its report. For example, the substantive terms of the Contract were referred to therein as “Phase I” and the Contract expressly required Edison “to provide advice and assistance” to the Commonwealth based on the options presented in the report.

On July 30, 2001, Pennsylvania Governor Thomas J. Ridge, PDE Secretary Charles Zogby, Philadelphia Mayor John F. Street, and District officials entered into a Memorandum of Understanding (“MOU”) as the culmination of negotiations between the Commonwealth and the City over how best to solve the District’s problems. The MOU required Governor Ridge to obtain an analysis of the District’s financial and academic situation and, based on that analysis, provide Mayor Street with a proposal to address the District’s problems. The proposal was due by September 29, 2001, after which time the parties would spend one month seeking to reach agreement on a long-term solution and, in the event that they were unable to reach such agreement, a contingency plan for transitioning complete control of the District to the Commonwealth. The MOU provided that the Commonwealth would assume control of the

District if the parties were unable to reach agreement on a long-term solution to the District's problems by 11:59 p.m. E.S.T. on October 29, 2001.

These various deadlines were impacted by the tragic events of September 11, 2001 and their ripple effects on the leadership of this Commonwealth. On October 5, 2001, Governor Ridge resigned from his office to become U.S. Director of Homeland Security, causing Lieutenant Governor Mark S. Schweiker to succeed to the office of Governor. In order to allow time for the new Governor to familiarize himself with the situation in the District before commencing negotiations with Mayor Street, the MOU was amended to extend the deadline for the Commonwealth's proposal to Mayor Street to October 31, 2001; the negotiation period and the timing of a potential state takeover of the District were extended by one month as well. The Contract was also amended three times, ultimately extending the deadline for Edison's report to PDE to October 29, 2001.

Edison submitted its report to PDE on that date. PDE requested certain changes, which Edison made before delivering its report on the following day. The Report was titled, *Strengthening the Performance of the Philadelphia School District: Report to the Governor of Pennsylvania* ("Report") and dated October 30, 2001. It was 80 pages long, plus 5 appendices which included reports on specific issues by other entities, several of which were subcontractors of Edison and were paid pursuant to the Contract and Edison's own subcontracts.

On the same day that Edison submitted the final version of the Report with PDE's changes, Governor Schweiker signed Act 83 of 2001. That law, which amended Act 46 of 1998, provided for the creation of a School Reform Commission ("Reform Commission") following a declaration by Secretary Zogby that the District was under "financial distress." The Commission would assume the duties of the District's school board in the operation of the District. The law specifically allowed the Reform Commission to enter into agreements with for-profit organizations to operate public schools or carry out the Reform Commission's duties.

On November 1, 2001, Governor Schweiker submitted the Edison Report to Mayor Street, along with his own proposal for solving the District's financial and academic problems based on the Report. In mid-November 2001, the two officials commenced the negotiations required by the MOU, but were unable to agree on other issues prior to the November 30, 2001, deadline set by the MOU. Yet the Commonwealth did not assume control of the District at that time because Governor Schweiker and Mayor Street agreed to continue their negotiations.

The new deadline was set for December 21, 2001. On that day, Commonwealth and City officials reached agreement for the Commonwealth to take control of the District with the District's cooperation. Secretary Zogby signed a "Declaration of Distress," which allowed the official formation of the Reform Commission. Consequently, at 12:01 a.m. on Saturday, December 22, 2001, the Commonwealth assumed control of the District.

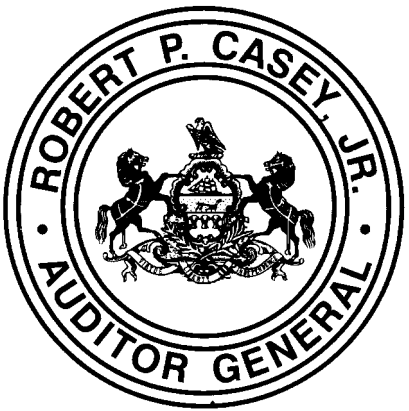
The Department of the Auditor General commenced this audit of PDE's Contract with Edison on January 29, 2002. Questions had been raised by public officials and others as to how PDE awarded the no-bid Contract to Edison, how Edison spent its \$2.7 million fee, and how much money Edison's subcontractors received for their work on the Report. Therefore, we

sought to evaluate PDE's actions in awarding the Contract and both parties' compliance with certain terms of the Contract.

Chapter I of this report explains how this procurement appears to have been unnecessary and conducted in an unlawful manner. Chapter II concerns Edison's qualifications to analyze the District and the multimillion-dollar fee that it was paid to conduct that analysis. Finally, Chapter III discusses Edison's use of subcontractors not approved by PDE to assist Edison in its work.

While we were conducting this audit, public officials at the city, state, and federal levels began calling for investigations into the activities of Edison and PDE. In August 2002, at the request of Philadelphia Congressman Chaka Fattah, the Office of Inspector General at the U.S. Department of Education ("OIG") commenced an investigation into the Reform Commission's awarding of a five-year, \$60 million contract to Edison to manage 20 elementary and middle schools in the District, the largest-ever experiment in privatizing public education. At the same time, we were encountering difficulties in obtaining documents and information from PDE needed for our audit, particularly with regard to whether an emergency procurement had been justified. Therefore, we advised OIG of the status of our audit, believing that the very same question lay at the heart of both this audit and OIG's investigation: *Did public officials, including Secretary Zogby, violate state laws and regulations in directing millions of dollars of public funds to a for-profit company?*

In order to expedite the completion of our audit and the provision of our findings to OIG, we decided to draw conclusions based on the information and documents obtained from PDE and other sources and issue this report, rather than continue to pursue the information and documents at issue. OIG has since declined to review the second contract awarded to Edison.



AUDIT OBJECTIVES AND METHODOLOGY

By correspondence dated January 29, 2002, we notified the Pennsylvania Department of Education that we were commencing a performance audit of Contract No. SP1611200001 between PDE and Edison for the period July 27, 2001, through December 31, 2001. The Contract required Edison to undertake an analysis of the financial and academic problems of the Philadelphia School District. We wanted to evaluate PDE's actions in awarding the Contract and both parties' compliance with certain terms of the Contract.

We conducted this audit in accordance with applicable *Government Auditing Standards* issued by the Comptroller General of the United States and under the authority of Sections 402 and 403 of The Fiscal Code. Section 402 authorizes the Department to conduct "special audits" of the affairs of executive agencies whenever the Auditor General has determined such audits to appear necessary. Section 403 authorizes the Department to audit the accounts and records of "every...public agency" receiving state funds in order to determine if the funds were expended for their intended purposes.

The specific objectives of this audit were to determine:

1. Whether PDE complied with laws and regulations in awarding the Contract to Edison, including those regarding the "emergency procurement" of services;
2. Whether PDE performed adequate procedures to conclude that Edison was the most qualified vendor for the emergency procurement of services and that Edison's fee was reasonable;
3. Whether PDE paid Edison in accordance with the terms of the Contract and received all deliverables required by the Contract; and
4. Whether Edison had sufficient documentation to support the amount billed to PDE under the Contract, including amounts billed for subcontract costs incurred by Edison.

We performed field work from January 29, 2002, through August 14, 2002. Our findings related to the first three objectives are presented, respectively, in Chapters I, II, and III of this report. We did not have significant findings with regard to the fourth objective, but did make an observation that is discussed at the end of Chapter II.

In order to complete our audit objectives, we

- Reviewed applicable and relevant laws, regulations, and policies;
- Reviewed the following documents: the Contract and its amendments; Edison's agreements and correspondence with its subcontractors; a memorandum from PDE to the Pennsylvania Department of

General Services, dated July 29, 2001; the Memorandum of Understanding between various Commonwealth and District officials, dated July 30, 2001, and its amendments; invoices submitted by Edison to PDE for payment and supporting documentation; the Edison Report, dated October 30, 2001; the executive summary of Governor Schweiker's proposal to reform the District, dated November 1, 2001; and related documents;

- Reviewed and analyzed the written responses of PDE and Edison to our requests for documents and information;
- Conducted interviews with staff and management at Edison;
- Sent confirmations of Contract duties and qualifications to staff and management at Edison;
- Reviewed the websites of PDE, Edison, and the District;
- Reviewed reports prepared by various public and private entities regarding the District's financial and/or academic problems; and
- Reviewed relevant reports in the news media.

We were unable to perform the following procedures due to the refusal by PDE to provide certain documents and information upon request:

- We could not review the connection asserted by PDE between the emergency procurement and a federal court's stay of legal proceedings in ongoing litigation between the District and Commonwealth officials;
- We could not review PDE's claim that its staff was familiar with Edison based on Edison's work in the Chester Upland School District; and
- We could not review PDE's claim that personnel from other Commonwealth agencies had determined that Edison's fee was reasonable.

CHAPTER I

THE DEPARTMENT OF EDUCATION'S UNNECESSARY AND UNLAWFUL PROCUREMENT

Our first objective was to determine whether PDE complied with laws and regulations in awarding the Contract to Edison, including whether PDE was justified in awarding the Contract as an “emergency procurement” without conducting the competitive bidding process normally required by state law. We have concluded that:

- The Contract appears to have been unnecessary, given the analyses of the District’s financial and/or academic problems which had already been conducted by July 2001; and
- PDE appears to have unlawfully circumvented state competitive bidding requirements by improperly awarding the Contract to Edison as an “emergency procurement.”

FINDING I-A: *The Contract Appears to Have Been Unnecessary, Given the Analyses of the District’s Financial and/or Academic Problems Which Had Already Been Conducted by July 2001.*

PDE commenced the procurement at issue in order to obtain an analysis of the District’s financial and academic problems and options for solving those problems. However, PDE itself collects a variety of financial and academic data from every school district in the Commonwealth, which should have informed it of the District’s problems. Moreover, as listed in Table I-1, numerous analyses of the District’s financial and/or academic problems *had already been conducted and issued* by various entities other than PDE by July 2001.¹

¹ In November 1998, the *Philadelphia Daily News* reported on this multiplicity of reports:

By the time audits now in progress are complete, the School District of Philadelphia will have been audited 34 times since 1995. ...[T]he auditors are now tripping over each other. ...‘We have had so many audits that we now have auditors charging taxpayers for quoting other auditors instead of doing their own work,’ said district spokeswoman Barbara Grant. ...[W]e tried to tally the cost of the 34 audits....[W]e were able to come up with a total of \$1,704,941 for 11 audits....

In December 2001, while Governor Schweiker and Mayor Street were in the midst of final negotiations over the fate of the District, the same newspaper stated that it has “lost track of how many audits of the public schools by how many different entities have been conducted over a decade....”

TABLE I-1

***Reports Released Before July 2001
Regarding the District's Financial and/or Academic Problems²***

Date of Report	Author of Report	Issues Addressed in Report
1/24/96	Greater Philadelphia First ("GPF") (regional business and civic leadership organization), at District's request	identification of \$30-45 million in annual savings which could eventually be achieved through improved management of transportation, facilities, human resources, management information systems, and food services functions
1/26/96	Arthur Andersen LLP (accounting and consulting firm), retained by the Commonwealth at a reported cost of \$500,000	identification of over \$100 million in potential cost savings and analysis of school reform budget
7/10/96	GPF	identification of \$6 million in annual savings achievable through improved purchasing practices
1/24/97	GPF	follow-up to its prior reports
9/19/97	Office of Phila. City Controller ("City Controller") (government auditor of the District and the City)	review of expenditures of school reform funds
1998	Consortium for Policy Research in Education ("CPRE") (university research organization)	analysis of District's reform efforts in the areas of standards and accountability, teaching practice, decentralization, and student support
1/15/98	City Controller	analysis of District's budget and expenditures of school reform funds, identification of innovative methods for generating additional funds, and recommendations for improving educational performance
1/26/98	GPF	follow-up to its prior reports

² This list is not intended to be exhaustive.

Date of Report	Author of Report	Issues Addressed in Report
10/5/98	Irvin R. Davis (District's former managing director), retained by PA House of Representatives ("PHR") at a reported cost of \$50,000	analysis of District's budget and identification of potential cost savings
11/12/98	PricewaterhouseCoopers (accounting and consulting firm), retained by PHR at a reported cost of \$472,955	analysis of District's expenditures and operations and their impact on educational and non-educational activities, and identification of cumulative potential cost savings of \$572 million over 5 years
12/10/98	City Controller	performance audit of resource allocation, cost containment, revenue generating opportunities, and expenditures of school reform funds
5/19/99	GPF	follow-up to its prior reports
5/21/99	PA Department of the Auditor General ³	audit which found serious truancy problem, social promotion of chronic truants, uncertified/improperly certified teachers, and inaccurate reporting of financial data to PDE
12/28/99	City Controller	audit of District's financial statements which found deficient internal controls over textbooks and other educational materials, payroll, real and personal property, petty cash, student activity funds, and transportation funds
1/25/01	City Controller	audit of District's financial statements which found improper expenditures of capital project funds, deficient internal controls over real property, incorrect accounting of capital expenditures and benefits payments, and duplicate payment of invoices
5/01	CPRE	analysis of District's efforts in recruiting and retaining quality teachers and recommendations for improvement

³ This audit covered state fiscal year ("SFY") 1993-94 through SFY 1995-96.

This list clearly demonstrates that information regarding the District's financial and academic problems was readily available to PDE from a variety of public and private sources, including private firms or individuals to whom the Commonwealth had already paid over one million dollars. During our audit field work, we found that Edison had many of these reports in its possession, suggesting that Edison or its subcontractors had reviewed them.

We sought to determine whether the reports listed in Table I-1 contained information on the same topics addressed in the Edison Report. The Contract required Edison to "gather and analyze data for the general categories listed in the Project Keystone Due Diligence Focus attached hereto...." That document listed 24 topics required to be addressed in the Edison Report. We compared the list of topics with the full text and/or executive summary of 13 of the reports listed in Table I-1 and found that *at least 75% of the topics required to be addressed by Edison had already been discussed* in at least one of the prior reports listed in Table I-1. It is possible that the remaining topics were addressed by other pre-existing reports not listed in Table I-1.

Furthermore, by the time that PDE entered into the \$2.7 million Contract with Edison to report on the financial condition and academic performance of the District, PDE had already entered into a three-year, \$7.5 million contract with Standard & Poor's ("S&P").⁴ Pursuant to that contract, S&P would conduct an independent analysis of the financial condition and academic performance of every school district in the Commonwealth. PDE was expecting S&P's first report imminently.

S&P has described the contents of its report as follows:

[The report] includes over 1,500 pieces of information for every district. The data were provided by the state, The College Board, ACT Inc., the National Center for Education Statistics, and the U.S. Department of Commerce. The information is analyzed to provide observations on student results, spending, return on resources, learning environment (such as class and school sizes, staffing levels, technology, [and] safety), financial environment (such as revenue sources, reserve levels, tax and debt burdens), and demographic environment (such as socioeconomic characteristics).

⁴ According to its website, S&P, a division of the global information services provider The McGraw-Hill Companies, "provides independent financial information, analytical services, and credit ratings to the world's financial markets."

In addition to this wealth of raw data, S&P produces “12-15 page summaries of [each] district’s strengths, challenges and concerns, risks, and other key factors...[which] address a district’s performance on statewide and national assessments, dropout rates, class size, teacher salaries, and how much and where schools are spending money.” S&P’s findings are made available to the general public via the Internet, allowing any interested person to compare a particular district’s performance over time, to the state average, and to other districts.

S&P released its first report on October 3, 2001, only two weeks *after* the original deadline for Edison’s report and almost one month *before* Edison actually submitted its own report. S&P’s report included an analysis based on the District’s financial and academic data from the 1996-97 through 1998-99 school years.⁵

The existence of reports already prepared about the District’s financial and academic problems, PDE’s own data, and S&P’s analysis strongly suggests that one more report about the District was not necessary, particularly when that report would cost Pennsylvania taxpayers an additional \$2.7 million.

FINDING I-B: *PDE Appears to Have Unlawfully Circumvented State Competitive Bidding Requirements by Improperly Awarding the Contract to Edison as an “Emergency Procurement.”*

State Competitive Bidding Requirements

State law requires Commonwealth agencies to award all contracts through a competitive bidding process, except in certain cases such as emergencies. As discussed below, PDE failed to provide sufficient evidence justifying its circumvention of the competitive bidding requirements. Based on the documents and information provided to us, there appears to have been no basis for awarding the Contract to Edison as an emergency procurement.

⁵ Subsequent reports were released on May 7, 2002 and June 2, 2002. This information is available at www.ses.standardandpoors.com. According to S&P’s cumulative analysis of District data from the 1996-97 through 1999-2000 school years:

Relative to other school districts in Pennsylvania, Philadelphia City School District generates exceptionally below-average student results with spending that is comparable to statewide levels....[E]ven if spending were the sole determinant of student performance (which is not the case), then the theoretical cost of bringing Philadelphia’s student achievement levels up to the state average would still be extraordinarily high and, in all likelihood, prohibitive. As a result, strategies to improve the district’s student achievement levels will need to focus on matters that include, but also go well beyond, the discussion of monetary inputs.... On balance, this evaluation of the district’s performance points to serious challenges and concerns, particularly in the area of student results.

On May 15, 1998, Governor Ridge signed into law Act 57 of 1998, which included the Commonwealth Procurement Code (“Code”). The Code was intended to modernize and streamline the purchasing practices of state government. The Code places with the Pennsylvania Department of General Services (“DGS”) the responsibility for supervising the procurement of supplies and services by executive branch agencies under the control of the Governor. As part of its duties, DGS has issued *The Field Procurement Handbook* (“*Procurement Handbook*”), which contains state procurement policies, procedures, and guidelines.

With certain exceptions, the Code requires Commonwealth agencies to award all contracts through a competitive bidding process. One exception to the Code’s competitive bidding requirements allows a so-called “emergency procurement” in two situations: (1) “when there exists a threat to public health, welfare or safety,” or (2) “when...circumstances outside the control of the agency create an urgency of need which does not permit the delay involved in using more formal competitive methods.” Although the awarding agency is permitted to bypass the competitive bidding requirements in such “emergency” situations, the *Procurement Handbook* states that the agency must nevertheless obtain verbal approval from DGS’s Director of the Bureau of Purchases (“DGS Director”) for all emergency procurements which exceed \$3,000, “unless the agency can establish that because of the nature or time of the emergency, proper DGS officials were not available or that time would not permit prior contact with [DGS].”

Following verbal approval by DGS, the agency must solicit telephone bids from two responsible contractors, “if practical.” The agency must also send a “confirmation memorandum” to the DGS Director which “explain[s] the nature of the emergency and indicates that prior approval was obtained from the Director.” The DGS Director must then approve this written confirmation of his or her prior approval. The *Procurement Handbook* includes a sample memorandum that the awarding agency can tailor to serve as its confirmation memorandum. The confirmation memorandum also satisfies the Code’s requirement that the agency include “[a] written determination of the basis for the emergency and for the selection of the particular contractor” in the agency’s contract file.

PDE’s Emergency Procurement of the Report from Edison

PDE provided us with a copy of its confirmation memorandum to the DGS Director dated July 29, 2001 (“Confirmation Memorandum”). The DGS Director approved the Confirmation Memorandum by handwritten notation on the document dated July 31, 2001. Following the format of the sample memorandum, the Confirmation Memorandum begins, “This will confirm that on July 27, 2001, I requested your approval to proceed with the emergency procurement of an educational and financial analysis of the Philadelphia School District to be conducted by a team led by **Edison Schools**.”⁶ The existence of the Confirmation Memorandum indicates that DGS had granted verbal approval for the procurement at that time.

⁶ Emphasis in original.

As the basis for the emergency procurement, PDE informed DGS that – using the language of the Code – “[c]ircumstances outside the control of the agency created an urgency of need which did not permit the delay involved in using more formal, competitive methods.” PDE explained that the Memorandum of Understanding between Governor Ridge, Mayor Street, PDE Secretary Zogby, and representatives of the District required “the Governor, through the Department of Education and its Secretary, to arrange for an analysis of the educational and financial management of the Philadelphia School District conducted by such entities and/or individuals as determined by the Governor.”⁷ PDE further explained that the MOU required the Governor “to examine the analysis, and, no later than September 30, 2001, to provide to the Mayor, [sic] a proposal to address the current educational and financial situation in the Philadelphia School District.”⁸

As a result, PDE informed DGS, “the Department of Education must, without delay, immediately proceed with the emergency procurement of the educational and financial analysis of the Philadelphia School District to be conducted by a team led by Edison Schools.” This urgency was also apparently the basis for PDE’s determination that solicitation of telephone bids from several potential vendors would not be practical.

In other words, PDE maintained that the 60-day deadline established by the MOU created an “emergency” which justified PDE’s circumvention of the normal competitive bidding requirements in awarding the multimillion-dollar, no-bid Contract to Edison. However, this argument collapses under the weight of the evidence, including PDE’s own responses to our requests for additional documents and information.

⁷ The Confirmation Memorandum was referring to Paragraph 6 of the MOU, which provides:

The Governor, through the Department of Education and its Secretary, will arrange to have an analysis of the educational and financial management of the Philadelphia School District conducted by such entities and/or individuals as determined by the Governor. To the extent feasible in the time available, the analysis will assess and evaluate the entire operations of the Philadelphia School District including, but not limited to, all financial, administrative, educational, facilities, and related operations of the School District.

⁸ The Confirmation Memorandum was *attempting* to refer to Paragraph 8 of the MOU, which provides:

The Governor will examine the...analysis [of the District’s financial and academic problems], and, no later than September 29, 2001, will provide to the Mayor, [sic] a long-term proposal to address the educational and financial situation in the School District, including options to improve the educational performance and financial condition of the School District.

Note the one-day discrepancy between the Confirmation Memorandum and the MOU regarding the date of the Governor’s submission of the analysis and his reform proposal to Mayor Street.

Lack of “Emergency” Justifying Circumvention of Bidding Requirements

1. PDE Awarded Contract to Edison Before Report Deadline Was Set

The Confirmation Memorandum relied upon by PDE contains several errors with regard to key dates set forth in the MOU. First, the Confirmation Memorandum refers to the “August 1, 2001 Memorandum of Understanding,” but, as PDE later conceded to us, the MOU was dated July 30, 2001. Second, the Confirmation Memorandum states that the MOU required Governor Ridge to provide his proposal to Mayor Street by September 30, 2001. However, Paragraph 8 of the MOU clearly set the original deadline as September 29, 2001. The period of negotiation between the parties following submission of the proposal and the date of termination of the MOU were also incorrect. These mistakes most likely occurred because – despite the Confirmation Memorandum’s references to the MOU in the past tense – the Confirmation Memorandum *predated* the MOU.

Consequently, as indicated in Table I-2, PDE received approval for the Contract and commenced the Contract *before* the 60-day deadline was set by the MOU.

TABLE I-2

Chronology of “Emergency Procurement” and Establishment of Deadline

Date	Event(s)
July 27, 2001	<p>PDE <u>requested and received verbal approval</u> from DGS to proceed with the “emergency procurement” of an analysis of the District.</p> <p><u>The Contract between PDE and Edison became effective</u>, setting a deadline of September 21, 2001 for submission of Edison’s report to PDE.</p>
July 29, 2001	<p>PDE sent DGS the Confirmation Memorandum, <u>confirming DGS’s prior verbal approval</u> of the “emergency procurement.” (DGS approved the Confirmation Memorandum two days later.)</p>
July 30, 2001	<p>In the MOU, PDE and other parties <u>agreed to the deadline</u> of September 29, 2001 for submission of a reform proposal from Governor Ridge to Mayor Street based on an independent analysis of the District.</p>

The Secretary of Education himself was a party to the MOU that set the deadline for Governor Ridge's proposal. This chronology raises the question of whether the self-imposed deadline established in the MOU truly created an "emergency" for PDE, or whether it was merely a ploy to justify a *prior* unlawful circumvention of the competitive bidding requirements.

We were rebuffed several times by PDE in our attempts to obtain information and documents that would help us to answer this and many other questions pertinent to our audit. We finally attempted to bring this audit to a close by making a final request for documents, limited to the following:

1. All documents prepared between September 1, 2000 and July 30, 2001, inclusive, regarding the need for or the feasibility of the Commonwealth of Pennsylvania (and/or its employees, representatives, or agents) to undertake or commission an analysis of the academic and/or fiscal situation of the District.
2. All documents prepared between September 1, 2000 and July 30, 2001, inclusive, regarding the qualifications of Edison (and/or its employees, representatives, or agents) to undertake or commission an analysis of the academic and/or fiscal situation of the District.
3. All documents representing, containing, or referring to communications between the Commonwealth of Pennsylvania (and/or its employees, representatives, or agents) and Edison (and/or its employees, representatives, or agents) between September 1, 2000 and July 30, 2001, inclusive, regarding the retention of Edison to undertake or commission an analysis of the academic and/or fiscal situation of the District.

We believed that such documents would clarify the chronology of when PDE began considering hiring Edison to analyze the District, relative to (1) when Secretary Zogby and the other parties to the MOU agreed to the 60-day deadline for completion of Governor Ridge's proposal, and (2) when Edison was formally hired to conduct the analysis which would form the basis for that proposal. Prior to this request, PDE had only told us that Edison was initially contacted "sometime in mid-July 2001" and that PDE could not find any correspondence between it and Edison before the execution of the Contract.

PDE's response to our final document request appeared to claim that the documents requested did not exist.⁹ When a multimillion-dollar, no-bid contract is granted to a vendor to prepare a report on a subject as already well-documented as the challenges of the Philadelphia School District – particularly a report which suggests retaining the vendor itself to solve the District's problems – auditors are naturally skeptical that no evidence exists regarding the selection of that vendor. We find it difficult to believe that not a single piece of paper or other communication exists which indicates *when* PDE began considering hiring Edison to analyze the District.

Instead of cooperating with our final document request, PDE argued that “because the Commonwealth Procurement Code places sole responsibility for approval of emergency procurements with the Department of General Services, which did approve this contract, any such conclusion by you, to the contrary, has no legal significance.” Despite PDE's assertion, DGS's approval does not foreclose our inquiries or findings regarding an alleged “emergency procurement.”

As already discussed, the *Procurement Handbook* requires the DGS Director to approve – first verbally and then in writing – an agency's request for an emergency procurement. However, the mere granting of such authority to DGS does not mean that all approvals given by DGS pursuant to this authority are *per se* in accordance with law. The Code itself recognizes that the determination of the existence of an “emergency” cannot be “clearly erroneous, arbitrary, capricious or contrary to law....”

Moreover, DGS's approval does not negate the authority granted to the Department of the Auditor General to audit the contract resulting from such approval. Nothing in the Code or elsewhere in state law shields DGS's approval from our post-audit review. To the contrary, Section 563 of the Code requires contracting agencies to retain “[a]ll procurement records...for a minimum of three years from the date of final payment under the contract,” and to make “all retained documents...available to the...Auditor General...upon request.” Unlike an independent determination made by the Department of the Auditor General, DGS's approval is hardly an independent assessment that could justify PDE's circumvention of the normal competitive bidding requirements, given the fact that both DGS and PDE are controlled and ultimately directed by the Governor.

⁹ We have had to interpret PDE's response due to its lack of clarity on this issue. At the end of its four-page letter, PDE informed us that “we have no further documents to provide.” However, in the very next sentence, PDE expressed its “unwillingness” to provide any additional documents for this audit. As stated in our response to its letter, we concluded that PDE was “*telling the taxpayers of Pennsylvania that not a single piece of paper or other communication exists which indicates when PDE began considering hiring Edison to conduct the study of the District.*” PDE has not contradicted this conclusion.

2. PDE Participated in the MOU Which Set the Report Deadline

PDE's response to our final document request makes it difficult to believe that circumstances outside of its control suddenly gave rise in July 2001 to an unexpected external demand justifying an emergency procurement. PDE argued that it was justified in awarding the contract to Edison because it was suddenly faced with a 60-day deadline for Governor Ridge's submission to Mayor Street of an analysis of the District's academic and fiscal problems and a proposal to solve those problems. PDE emphasized that the deadline was established by *others* – PDE was simply “made aware” of discussions between Governor Ridge and Mayor Street and the need to conduct an analysis of the District on an expedited basis and merely served as “a nominal party” to the agreement between the two officials.

However, PDE either ignored or significantly discounted the fact that Secretary Zogby himself signed the MOU that established the deadline for the analysis. Even if Secretary Zogby had not signed that document, the suggestion that the Department of *Education* and the Secretary of *Education* were mere bystanders to the events leading up to *the largest state takeover of a school district in the history of the United States of America* is simply not credible.

3. PDE's Knowledge of Problems Contradicts Claim of “Emergency”

After attempting to convince us that the report deadline justified the emergency procurement, PDE asserted that the deadline “only *indirectly*...justified the emergency procurement.”¹⁰ According to PDE, the *direct* justification was “the long-standing financial and academic problems in the Philadelphia schools.” We question how those problems could simultaneously be both “long-standing” and an “emergency.”¹¹ As discussed in Finding I-A, PDE was already well aware of the District's financial and academic problems by July 2001, due to the numerous analyses of those problems that had been conducted and issued by various public and private entities. Therefore, PDE cannot claim that such problems suddenly constituted an “emergency” justifying circumvention of the competitive bidding requirements.

Furthermore, PDE's discussion of its own attempts to address the District's financial problems contradicts its claim of an unforeseen crisis, as well as its claim of serving as a mere spectator to the events preceding the Contract. To the contrary, PDE presented a persuasive case that it had been aware of the precarious nature of the District's fiscal situation, had been preparing to react to it, and had been advising and consulting with the Governor – all well *before* the formal decision was made to analyze the District.

¹⁰ Emphasis added.

¹¹ A similar paradox was contained in an earlier explanation from PDE:

The completion of the analysis [of the District] was a prerequisite to providing a plan to the Mayor to fulfill the Governor's obligation under the MOU. That was the catalyst to the emergency procurement that formed the basis of an analysis that allowed the parties to the MOU to address the larger Philadelphia crisis, *which clearly could not be resolved overnight.* (Emphasis added.)

PDE explained to us that the District had only been able to remain solvent during the 2000-01 state fiscal year (“SFY”) by using its fund balance to partially offset an operating deficit and by obtaining special financial considerations from the Commonwealth, including \$363 million in the form of advances of the District’s basic education subsidy. PDE further explained that it had projected that the District would incur an operating deficit of \$176 million for SFY 2001-02 in addition to a carryover deficit of \$40 million from the previous year and that the District would only have been able to remain solvent if the Commonwealth were to provide additional special financial considerations, including an additional \$350 million in subsidy advances.

Based on these events, according to PDE,

[t]he Commonwealth believed that unless the District took decisive measures during the coming months, there was a real possibility that the District would be unable to meet its payrolls during the 2001-2002 school year. Indeed, quick action was needed just to ensure that schools opened on time in September 2001. Moreover, unless the District’s fiscal measures also were carefully planned, the District would experience large and increasing deficits for years.

In addition, PDE explained that the MOU required PDE to provide subsidy advances to the District so that the District could continue its normal operations, particularly meeting its payroll on August 2, 2001, and opening its schools on September 6, 2001. The first advance payment was due by July 31, 2001, the day after the MOU was signed. “However,” according to PDE, “the Mayor and the Governor knew that making advance subsidy payments was only a short-term response to one of a number of issues that were facing the [D]istrict.” As a result, Governor Ridge proposed that the Commonwealth analyze the District’s educational and fiscal concerns “before electing any course of action,” which led to the 60-day deadline for the submission of a proposal to Mayor Street as the starting point for discussions regarding a long-term solution for the District’s problems.

This chronology makes it difficult to believe that the District suffered from an unforeseen financial crisis that justified an emergency procurement of an analysis of the District. At best, PDE presented evidence that an emergency existed which required the Commonwealth *to advance funds* needed for the operation of the District during the 2001-02 school year. PDE provided no explanation – apart from the deadline created by the MOU – why an analysis of the District had to be completed within 60 days, which would have been too late to significantly affect the 2001-02 school year.

4. Extensions of Two Additional Report Deadlines and Fact that Edison Performed Substantial Portion of Work During Extended Period Contradict Claim of “Emergency”

The MOU originally required Governor Ridge to submit the required analysis of the District and his reform proposal to Mayor Street by September 29, 2001. The analysis would form the basis of discussions between the officials between September 29 and October 29, 2001. If they could not reach agreement on a long-term solution for the District’s problems by 11:59 p.m. E.S.T. on October 29, 2001, the Commonwealth would then assume complete control of the District.

However, Amendment Number 1 to the MOU, dated September 28, 2001, stated that the parties had agreed to amend the deadline for submission of the analysis and proposal to Mayor Street “due to state and national intervening events....” Therefore, the deadline for submitting the analysis and proposal was extended to October 31, 2001. The negotiation period and the timing of a potential state takeover of the District were also extended by one month accordingly.

The “events” referenced in the amendment were, of course, the tragic events of September 11, 2001, and their ripple effects on this Commonwealth. Nine days after the attacks, U.S. President George W. Bush announced the creation of a new federal Office of Homeland Security and appointed Governor Ridge as its first director. Governor Ridge immediately resigned from the governorship of Pennsylvania effective October 5, 2001, at which time Lieutenant Governor Mark S. Schweiker would succeed to the office. Prior to leaving office, Governor Ridge sought the amendment to the MOU in order to allow time for his successor to become familiar with the situation in the District before commencing negotiations with Mayor Street.

By the time that Governor Schweiker assumed office and, perhaps more significantly, by the time that the MOU was amended, PDE’s Contract with Edison had already been amended twice. Based on the original timetable set by Governor Ridge and Mayor Street, the Contract originally required Edison to submit its report to PDE by September 21, 2001. However, as indicated in Table I-3, this deadline was extended three times, setting a final deadline of October 29, 2001.

TABLE I-3

Deadline Extensions for Submission of Edison Report to PDE

Contract Version	Draft Report Deadline*	Final Report Deadline	Number of Days that Final Report Deadline Was Extended	
			From Prior Deadline	Cumulative
Original (July 27, 2001)	9/14/01	9/21/01	N/A	N/A
Revised (Sept. 21, 2001)	9/27/01	9/28/01	7 days	7 days
Second Revision (Sept. 27, 2001)	10/15/01	10/22/01	24 days	31 days
Third Revision (Oct. 23, 2001)	unchanged	10/29/01	7 days	38 days

*The Contract and its amendments required Edison to submit a “substantially complete draft report” to PDE prior to submitting its “detailed final report.”

Edison implied that the first extension was needed due to the terrorist attacks and their aftermath. Based on our conversations with Edison personnel, a one-week extension appears reasonable because of school closings and transportation difficulties in the days following the attacks. However, we were not presented with any evidence – related to September 11th or otherwise – supporting the two *additional* extensions of the report deadline.

It does not appear unreasonable for Governor Schweiker to have extended by one month the deadline for his submission of the report and his reform proposal to Mayor Street. However, that extension did not necessitate extending the deadline for Edison’s submission of its report to PDE. To the contrary, the extension of the period of time for Governor Schweiker to review the report *increases* the importance of Edison submitting its report on time, in order to allow the new Governor the maximum amount of time to familiarize himself with the District’s problems before developing his proposal to solve those problems and commencing negotiations regarding the future of the District.

The only evidence “supporting” the second and third extensions granted to Edison appears to be that Edison was not going to meet the new deadline of September 28, 2001. As Table I-4 demonstrates, *a substantial portion of the work performed by Edison occurred after the first deadline had passed.* In particular, Edison billed PDE for \$391,250 for work performed by Edison employees between September 30 and October 27, 2001.

TABLE I-4

Payments Made to Edison by PDE

<i>Time Period of Invoice</i>	<i>Number of Edison Employee Days Billed</i>	<i>Amount Billed for Edison Employees*</i>	<i>Amount Billed for Edison's Subcontractors</i>
8/2/01-9/2/01	288.00	\$585,504	\$274,177
9/3/01-9/29/01	209.06	\$425,016	\$515,303
9/30/01-10/27/01	192.45	\$391,250	\$508,750
TOTAL	689.51	\$1,401,770	\$1,298,230
<u>TOTAL BILLED AND PAID:</u>			\$2,700,000

**Due to rounding by Edison on the invoices submitted to PDE, amounts billed for Edison employees do not always equal the product of the number of employee days billed and the daily rate of \$2,033.*

PDE's extensions of the report deadline by one month, allowing Edison and its subcontractors to finish performing a substantial portion of the work required for the project, contradict its claim that an "emergency" existed which required the immediate preparation of a report regarding the District's financial and academic problems. We also note that Edison failed to submit a draft when the original deadline was still operational. The Contract required Edison to submit a "substantially complete draft report" to PDE prior to submitting its "detailed final report." The draft and final reports were originally due by September 14 and 21, 2001, respectively. However, the parties did not act to extend those deadlines until September 21, 2001.

While a short extension of time appears reasonable due to the terrorist attacks, we were not presented with any evidence supporting an extension of the draft deadline for an additional eighteen days (i.e., until October 15, 2001). When we asked PDE to provide a copy of the draft report and evidence that it had been received by the new deadline, PDE responded as follows: "The report was hand-delivered on the date as required. No copy of the draft is in the possession of [PDE]. Comments were made on the draft and returned to the vendor as a work in progress."

5. Subcontract Terms Undercut Claim of “Emergency”

As previously discussed, the original deadline for Edison’s submission of the report to PDE was September 21, 2001. However, several of Edison’s subcontracts indicate that Edison did not expect to meet that deadline prior to its extension, raising the question of whether an emergency truly existed – or, at least, whether Edison itself believed that an emergency existed.

Edison contracted with MetaMetrics, Inc. to analyze and report on student achievement in the District between 1996 and 2001. However, the subcontract did not require MetaMetrics to submit its report to Edison until September 27, 2001, six days *after* the original deadline for Edison’s report to PDE. Although MetaMetrics’ “[d]raft conclusions” were due on September 14, 2001, we question whether Edison could have received such conclusions from MetaMetrics and incorporated them into its own draft report due to PDE on the same date.

Edison also contracted with The Rise Group, L.L.C. (“Rise”) to analyze the District’s facilities and capital budget and identify potential opportunities for improvements and cost savings. In particular, the subcontract required Rise to:

- Review Edison’s needs, goals, and requirements for review of the District’s facility program;
- Review applicable project documents and data, including the District’s capital budget and operating budget, facility usage, and demographics;
- Review other available information and, if possible, conduct interviews with key management personnel;
- Review the facility management structure, budget, and components from the standpoint of industry practice, operating performance, and overall status;
- Identify potential opportunities and options for improvements and cost reductions; and
- Prepare and submit a report addressing the District’s capital budget.

Paragraph 2 of the subcontract required Rise to perform these tasks “between the date hereof [i.e., the date of the subcontract] and October 1, 2001....” The subcontract was dated September 10, 2001. These dates lead to one of two conclusions – *either* Edison expected Rise to complete its work quickly enough to allow Edison to review, analyze, and integrate it into Edison’s own report which was due to PDE eleven days later, on September 21, 2001, *or* Edison did not expect Rise to complete its work until October 1, 2001, ten days after Edison’s report was due to PDE. Both scenarios make us wonder whether Edison believed that an emergency existed, because *either* Edison waited six weeks from the commencement of the project to engage this subcontractor, allowing little time for the completion of the subcontract and, as a result, the report itself, in order to meet the original deadline, *or* Edison did not anticipate that the subcontractor would complete the subcontract until well after the original report deadline and, as a result, did not anticipate meeting that deadline itself.

Edison’s subcontract with Public Financial Management (“PFM”) raises a similar issue. Edison contracted with PFM to analyze the District’s finances. In particular, the subcontract required PFM to:

- Analyze the District’s operating budget and projection of future finances;
- Evaluate the District’s collection and use of all federal, state, and local revenue;
- Analyze the appropriateness of major District expenditures;
- Assess the fiscal impact of various reform options;
- Analyze the District’s debt and recommend debt management strategies;
- Analyze the characteristics of the District’s entire workforce;
- Assess the fiscal impact of the major provisions of the District’s labor contracts and proposed changes to the contracts;
- Identify strategies to redesign compensation, benefits, and work rules;
- Recommend best labor practices;
- Assess the District’s business support operations and recommend reforms; and
- Provide strategic advice as Edison develops other reform options.

The subcontract stated that PFM “anticipate[s] being actively engaged in this work through September 29, 2001 and expect[s] that we will potentially be required to provide additional support to your review efforts through October 31, 2001.” Edison signed the subcontract on August 24, 2001. These dates also make us wonder whether Edison believed that an emergency existed, because *either* it waited four weeks from the commencement of the project to engage PFM, allowing little time for the completion of the subcontract and, as a result, the report itself, in order to meet the original deadline, *or* it anticipated that PFM might not complete the subcontract until well after the original report deadline and, as a result, might not meet that deadline itself.

6. PDE Refused to Explain How Stay of Case Related to “Emergency”

Finally, the Confirmation Memorandum explains, as part of the basis for the emergency procurement, that the MOU “provides a temporary stay on the legal proceedings in the case of David Powell, et al. v. Thomas J. Ridge, Governor of Pennsylvania, et al., Civil Action No. 98-CV-1223 (E.D. Pa.) for a ninety day period.”¹² On March 9, 1998, the District and District officials, the City of Philadelphia and its Mayor, children attending public school in the District and their parents, and education and minority advocacy organizations had commenced a lawsuit in federal court against Governor Ridge, the Secretary of Education, the Chair of the State Board of Education, and the State Treasurer.¹³ The plaintiffs alleged that the statutory formula used by the Commonwealth to allocate federal education funds among Pennsylvania school districts violated federal law and regulations by discriminating against students based on race, color, and national origin. They asked the court to declare that the defendants had discriminated against minority students in the District and to issue an injunction prohibiting the defendants from continuing to do so.

The U.S. District Court for the Eastern District of Pennsylvania initially dismissed the case in November 1998. However, the U.S. Court of Appeals for the Third Circuit reversed that decision in August 1999 and returned the case to the district court. In June 2000, at the plaintiffs’ request, the district court stayed all proceedings until after enactment of the Commonwealth’s budget for SFY 2001-02 the following June. The expiration of that “first” stay in June 2001 meant that the case would resume.

¹² Despite the assertion of the Confirmation Memorandum, the MOU did not stay the proceedings. Rather, Paragraphs 1 and 2 of the MOU state that the parties agreed *to ask the court* to grant a stay of the proceedings.

¹³ After the complaint was filed, the original plaintiffs were joined by the Philadelphia Federation of Teachers and its president, and the original defendants were joined by the Speaker of the Pennsylvania House of Representatives, the President Pro Tempore of the Pennsylvania State Senate, and the chairs of the House and Senate Education Committees.

On August 2, 2001, pursuant to the MOU, the parties filed a joint motion to stay the proceedings again until October 29, 2001, the date by which the Commonwealth would “assume complete control” of the District under Paragraph 10 of the MOU if the parties were unable to agree on a long-term solution to the District’s financial and academic problems. The court issued an order staying the proceedings on December 12, 2001.¹⁴

We were unable to evaluate the asserted relationship between the stay of proceedings in the Powell case and the emergency procurement at issue. PDE provided copies of the pleadings and court order regarding the motion to stay the proceedings. However, PDE twice refused to provide any other documents or information, based on vague and unsubstantiated claims of privilege.

Summary of Finding I-B

In summary, PDE provided no evidence of an emergency which required an analysis of the District to be completed within 60 days or which required PDE to bypass the normal competitive bidding requirements in order to obtain such an analysis. Instead, PDE’s responses to our requests for an explanation simply stated that “[t]he terms of the MOU governed the timing of the analysis.” It appears that the self-imposed deadline established in the MOU – and not any circumstances beyond PDE’s control – created the “emergency” asserted by PDE. As a result, we believe that PDE could have delayed this procurement to allow time for competitive bidding by all interested vendors.

Recommendations:

Based on the documents and information that were made available to us, we have concluded that the Contract appears to have been unnecessary, given the information about the District’s financial and/or academic problems which was available, or about to become available, to PDE by July 2001. Even if the Contract had been necessary, PDE appears to have unlawfully circumvented state competitive bidding requirements by improperly awarding the Contract to Edison as an “emergency procurement.” Therefore, we recommend that PDE:

¹⁴ On December 12, 2001, the court stayed proceedings in the case “pending resolution of the appeal in South Camden Citizens in Action v. New Jersey Dept. of Environmental Protection, 145 F.Supp.2d 505 (D.N.J. May 10, 2001).” That case involved the issue of whether private parties have the right to sue to enforce a federal regulation, which the Powell plaintiffs were attempting to do. The court’s order responded to a different motion – by the defendants alone – to stay all proceedings in the case. The court did not act upon the joint motion for a stay until March 6, 2002. Because the court had already issued an order staying all proceedings in the case, and because the joint motion had asked for a stay until October 29, 2001 and that date had already passed, the court denied the joint motion as moot.

- Refrain from spending public funds on future contracts when the goods or services contracted for are already readily available to PDE;
- Consider the length of the procurement process when agreeing to deadlines for submitting work to other entities based on the work of needed vendors;
- Comply with the competitive bidding requirements established by the Commonwealth Procurement Code;
- Award contracts in circumvention of the competitive bidding requirements based on the “emergency procurement” exception only in cases of true emergency;
- Solicit telephone bids from potential vendors for an emergency procurement whenever practical; and
- Maintain documentation of communications with prospective vendors, particularly those considered for an emergency procurement.

PDE'S RESPONSE TO CHAPTER I

Finding I-A: The Contract *Appears To Have Been Unnecessary, Given The Analysis Of The District's Financial and/or Academic Problems, Which Had Already Been Conducted by July 2001.* (emphasis added)

The Department disputes this finding. Your conclusion that “numerous analyses of the District’s financial and/or academic problems *had already been conducted and issued* by various entities other than PDE by July 2001” (emphasis in original) ignores several essential facts. On the whole, the sixteen “reports” listed in Table I-1 were not helpful in assessing the current educational and fiscal situation facing the District in the summer of 2001.

1. The reports cited in your table were virtually all obsolete by the summer of 2001.
 - a. As you know, the fiscal situation in Philadelphia changed constantly during the period from 1996-2001. The District frequently projected large deficits at the outset of a fiscal year, yet somehow arrived at a surplus by year’s end. In that context, relying on reports that analyzed the District’s finances even a year earlier would have been irresponsible. Most of the reports listed in your report were far older than that.
 - b. Even the very valuable Pricewaterhouse Coopers (PwC) report, by summer 2001, could not serve as a guide for understanding the District. It would be inappropriate for the Governor to rely upon a three-year old analysis of the District’s curriculum and educational program in order to consider a declaration of distress in Philadelphia in late 2001.
2. Most of these reports focused on fiscal issues, not educational ones. Thus, they lacked the critical focus on the relationship between the District’s fiscal situation and its academic program. Even those reports that did consider both issues were missing key data for decisions to be made in 2001. For example, although the PwC report contains very valuable insights into the District’s curriculum selection process, it did not make the specific observation that Edison did about numbers of different curricular programs which would be key to any long-term academic success for students in a District of this size. The Edison report addresses these issues, *as they existed at the time* and noted that in English language arts, math and science, students in different classes within the same grade were having different learning experiences because their teachers used so many different programs.

3. Finally, the Auditor General’s reliance on the work of Standard and Poors (S&P) to critique the award of this contract to Edison has not been described in context. First, S&P’s data was also based on financial and academic data from the 1996-97 through 1998-99 school years. The Department agrees that S&P’s School Evaluation Services report on the Philadelphia School District is an extremely thorough analysis of district-level data. However, that report has some inherent limitations. It is, by its nature, limited to an analysis of *reported* data. Because of this, it does not consider day-to-day operational matters or more qualitative information that are not reflected in data reports. Thus, while it provides a valuable resource for decision makers, its own authors warn that it should not be used--in isolation--to make decisions about policies or programs in a particular school district.¹

In summary, it was critical for the Governor to have current information about the District’s fiscal and academic program in order to make decisions about the future of the District.

¹ In this vein, the following caveat appears in S&P’s School Evaluation Services report on the Philadelphia School District.

Data Content:

Any serious analysis of school systems must consider numerous factors related to educational performance and the need for resources. SES assembles hundreds of different data points for each school system. It should be noted that certain important data, including, but not limited to, school facility conditions, graduation rates, and parental involvement, are not available from the Commonwealth of Pennsylvania. Moreover, there are many important aspects of schooling that are difficult to measure or are not well documented. While these factors should be considered when a community or its leaders are determining the overall value and return of its schools, such factors fall outside the SES framework because they are not readily or uniformly available, and because their criteria vary from one community to another. SES is not an all-encompassing “final word” on schools, but rather one means of school evaluation to be considered together with other measures, including those of a more qualitative nature.

Finding I-B: PDE *Appears* to have Violated State Law by Awarding the Contract to Edison as an “Emergency procurement”. (emphasis added)

The Department disputes this finding. The Department entered into its contract with Edison Schools, Inc. in full accordance with the Commonwealth Procurement Code. Neither the Secretary nor PDE concocted an “emergency” to circumvent the bidding requirements of the Code. The Secretary did not set the sixty-day deadline contained in the MOU. Mayor Street did.

Your characterization that the academic and fiscal crisis in Philadelphia could not be both long standing and an “emergency” for purposes of this procurement focuses on the wrong facts. The Edison contract was not awarded to solve the problems of the Philadelphia School District. Rather, the contract was awarded to analyze existing conditions and present current and potential options to the Governor. *That product* was needed in a short timeframe. There was no expectation that the Edison deliverable would solve the problem itself.

Your opinion that the Department could have initiated the traditional bidding process also ignores the limitations of that very procurement process and the realities that existed in July 2001 as well as those imposed by the original terms of the MOU. The Governor and Mayor agreed that within a month of the MOU’s execution, the Governor would provide a plan to the Mayor for the District after which the parties would negotiate a mutual agreement to address the educational and financial situation in the School District by October 29, 2001. Under the traditional bidding process, no vendor would have been able to complete the work to satisfy the MOU’s conditions since the Department would have had to develop a Request for Proposal, provide public notice of a desire to enter into a contract, give potential vendors a reasonable time to respond, evaluate the proposals, select a vendor, and then negotiate and finalize a contract in the same month that work needed to be performed.

1. The Contract Was Not Awarded Until After the MOU Was Signed. The Department Only Obtained Emergency Approval Prior to the Report Deadline and Did So Properly.

The date of the Confirmation Memo and its reference to an August 1, 2001 MOU does not support the conclusion that the Department circumvented procurement requirements. In fact, the dates show that the Department took proper steps to ensure that no time was lost after the MOU was indeed executed. The reason the Emergency Purchase Confirmation Memo predates the MOU was that the Department needed to be prepared to ensure that no time was wasted in obtaining the approvals needed so that the vendor could begin work as soon as the MOU was executed. Based on the discussions between the Governor and the Mayor, the Department expected the MOU to be executed by NLT August 1, 2001.

The fact that it was executed earlier merely shows that the Department was wise in obtaining advance approval.²

The Department obtained emergency approval prior to the report deadline being set; however, it did not execute the SPC formalizing the contract with Edison until August 1. As a consequence the, Statement of Work incorporated in the SPC correctly cross-references the date of the MOU which was July 30, 2001.

2. The Department's Role in the MOU.

Your conclusions in connection with this issue do not negate the existence of the emergency and only serve as a personal and subjective attack on the Secretary and have no place in an audit document.

3. The Department's Knowledge of Problems in the District Does Not Contradict the Claim of Emergency. Rather, This Knowledge Demonstrates that the Department Was in the Best Position to Judge the Existence of Conditions, Which Constituted an Emergency.

4. Extensions of the Report Deadline Do Not Contradict the Emergency.

The extension of the report deadlines is irrelevant to the existence of the original determination of an emergency, which was based on the real academic and fiscal crisis in the District and the original deadline imposed by the Mayor. Just as the contract documents were amended, so was the MOU. The determination of whether an emergency existed must be judged on the facts *as they existed at that time*. Subsequent events cannot be fairly used to evaluate the existence of an emergency that existed at the time the contract was awarded.

5. Subcontractor Terms Do Not Undercut the Emergency.

After the contract execution, Edison's arrangements with its subcontractors are irrelevant to PDE's assessment of the need for an emergency procurement.

6. The Department does not need to justify its claim of privilege in connection with pending litigation.

² In fact, Edison was only paid for work performed from August 1, 2001 through October 27, 2001. Table I-4.

**DEPARTMENT OF THE AUDITOR GENERAL'S COMMENTS
REGARDING PDE'S RESPONSE TO CHAPTER I**

Finding I-A

The Department of the Auditor General retains the original finding and recommendations. While we can appreciate the administration's need for "current information" before developing a proposal to solve the District's problems, we find it difficult to believe that the fundamental nature of those problems or the steps needed to address them could have changed so dramatically as to require an entirely new analysis costing \$2.7 million of public funds. In fact, a comparison of the information contained in the Edison Report with the information contained in the reports listed in Table I-1 indicates that they did not. The Edison Report no doubt contains much useful information and analysis, but does not appear to add a significant amount of new material *needed* to develop a proposal to address the District's problems.

We were surprised by PDE's statement that the previous reports regarding the District's financial and academic problems "were not helpful," particularly in light of the fact that several of those reports were prepared at the request of individuals at the highest levels of state government, including the Governor and the Majority Leader of the Pennsylvania House of Representatives. By its statement, PDE appears to be calling into question whether the procurement of those specific reports had been a prudent use of public funds. We also found PDE's statement surprising because, as already stated, at least 75% of the topics required to be addressed by Edison had already been discussed in at least one of the pre-existing reports, several of which were cited by Edison.

Finally, contrary to PDE's suggestion, it is not our position that the S&P analysis could have completely replaced the Edison Report. We simply cited the S&P analysis as another source of valuable information, along with the reports listed in Table I-1, that PDE could have used to reduce or eliminate the scope of work contracted for with Edison.

Finding I-B

The Department of the Auditor General retains the original finding and recommendations. During the course of our audit, PDE refused to comply with our requests for documents and information that might have justified its circumvention of the competitive bidding requirements of the Commonwealth Procurement Code. As a result, we were forced to proceed based solely on a limited amount of documents and information and, based thereon, we concluded that there appeared to have been no basis for awarding the Contract to Edison as an "emergency procurement." PDE's response to our draft report did not include any new information leading to a different conclusion. In particular, PDE continues to refuse to explain *when* it began considering hiring Edison to analyze the District, particularly relative to when the parties to the MOU established the 60-day deadline for the submission of Governor Ridge's proposal to Mayor Street to address the District's problems.

PDE originally disclaimed responsibility for the 60-day deadline by stating that it was set by Governor Ridge and Mayor Street. Therefore, in the finding, we questioned how PDE and Secretary Zogby could make such a claim given their role in the MOU and the events leading up to the Commonwealth's takeover of the District. Contrary to PDE's assertion, raising such a question does not constitute a "personal and subjective attack" on Secretary Zogby. More importantly, we note that PDE has now changed its recitation of the underlying facts, stating in its response that Mayor Street alone set the deadline. PDE also states, incorrectly, that the deadline was only 30 days.

PDE argues that any events which occurred before or after the awarding of the Contract are irrelevant to the issue of whether or not an emergency truly existed justifying circumvention of the competitive bidding requirements. We disagree. Although the determination of whether an emergency procurement was justified may not hinge solely on such events, they – combined with the other factors discussed in this finding – raise reasonable questions regarding the actual existence of an emergency.

For example, it is reasonable to ask why the Edison Report initially needed to be completed and the Governor's proposal submitted to Mayor Street all within 60 days, in light of the subsequent multiple extensions of the deadlines. This question becomes more significant given the fact that Edison performed a substantial portion of the work *during the extended period*. Similarly, it is equally reasonable to question the 60-day deadline in light of the terms of Edison's subcontracts that indicate that Edison *did not expect to meet its deadline* for submitting its report to PDE. In addition, it is reasonable to ask how the District's problems could have been characterized as an "emergency" in light of *PDE's awareness of those decades-long problems*.

Finally, contrary to PDE's assertion, it does have to justify its claim of privilege. PDE based its circumvention of the competitive bidding requirements in part on the temporary stay on the legal proceedings in the Powell case. PDE cannot use a vague and unsubstantiated claim of privilege as a shield against our reasonable request for an explanation about the relationship between the stay and the emergency procurement at issue. Had it desired to do so, PDE could have answered our questions without compromising any privilege which may actually exist.

CHAPTER II

EDISON'S QUALIFICATIONS AND MULTIMILLION-DOLLAR FEE

As discussed in Chapter I, the MOU required the Ridge administration to analyze the District and submit a report to Mayor Street by September 29, 2001. PDE informed us that “[t]he Governor and the Secretary of Education believed that it was necessary to retain an outside vendor to conduct this analysis given the expertise that was needed and the time frame involved.” The second objective of this audit was to determine whether PDE performed adequate procedures to conclude that Edison was the most qualified vendor to analyze the District’s academic and fiscal problems and that Edison’s \$2.7 million fee was reasonable.

We have concluded that:

- Edison’s qualifications appear to have been irrelevant to PDE’s awarding of the Contract; and
- No basis appears to exist to support PDE’s assessment that Edison’s fee was reasonable.

FINDING II-A: *Edison’s Qualifications Appear to Have Been Irrelevant to PDE’s Awarding of the Contract.*

As discussed below, PDE failed to provide evidence that it performed adequate procedures to conclude that Edison was the most qualified vendor to conduct the required analysis of the District or that it contacted or even considered any other firms to perform the analysis. Based on the documents and information that were provided to us, it appears that Edison’s qualifications were irrelevant to the awarding of the Contract.

PDE told us that the Confirmation Memorandum from PDE to DGS dated July 29, 2001 “outlines the qualifications of the vendor that were considered” by PDE. However, as “[t]he basis for the selection of this particular contractor,” the document merely recites almost verbatim the promotional information about Edison from Edison’s website. This information briefly describes Edison’s experience and theory regarding *managing* schools; there is no information on Edison’s website or in the Confirmation Memorandum about whether Edison has experience in *analyzing* the academic and fiscal situation of a large urban school district. The reason for the absence of such information is that, according to Edison executives, the Contract to analyze the District was the *first* contract of its type ever performed by Edison.

Edison's inexperience may explain why the Confirmation Memorandum also states the following:

Assembling a team of qualified knowledgeable professionals in a short period of team [sic] is essential to the success of this project. Edison [S]chools have [sic] the ability and resources *to reach out to qualified consultants* throughout the country to participate in this team.¹⁵

In fact, the first page of the Edison Report explains that "Edison collaborated with several community and professional entities in assessing the [District]."¹⁶

In addition, PDE told us that "the Secretary of Education and others within [PDE] were already familiar with the existing wide range of professional national resources available to that company...." PDE also stated that it was "not unfamiliar" with Edison's work due to Edison's experience in the Chester Upland School District. After being placed on the Commonwealth's Education Empowerment List of struggling school districts, Chester Upland had selected Edison – through the district's board of control and in consultation with PDE – to manage most of the public schools in the district.

In order to determine the extent of PDE's familiarity with Edison, we asked PDE to identify *which* PDE employees were involved with Chester Upland's contract with Edison and what role those employees played with regard to that contract. However, PDE twice refused our requests for that information. Therefore, we could not determine the extent of PDE's familiarity with Edison's work.

Finally, PDE responded that "the personal representation of Edison personnel that it could assemble and deploy this team...formed the basis of [PDE's] belief that this undertaking would occur within the short time frame agreed to in the MOU." The unnamed "Edison personnel" were later identified as Edison's Founder and Chief Executive Officer and Edison's Executive Vice President of Development. Such "representations" do not change the fact that, as previously discussed, Edison did not have any prior experience in performing this type of contract.

In order to determine whether PDE performed adequate procedures to conclude that Edison was the most qualified vendor to analyze the District, we also requested documents and information regarding *other* firms contacted by PDE. In response, PDE stated that it "has determined that no additional information needs to be supplied." Yet PDE had never – and still has never – provided us with the names of any other firms that it contacted or considered for the Contract. Furthermore, PDE has never stated that it did, in fact, contact or even *consider* any firms other than Edison.

¹⁵ Emphasis added.

¹⁶ The Edison Report then asserts that, regardless of the assistance of others, "the findings in this report are Edison's own."

Therefore, PDE failed to demonstrate that it conducted a serious evaluation of Edison's qualifications or that it contacted or even considered any other firms to perform the required analysis. PDE's assertion that "no other single entity known to PDE (then or now) could have undertaken the study on the required timeline" – without providing any evidence to support such a claim – did not further our search for the truth in this matter. Based on the documents and information provided to us, we have concluded that Edison's qualifications appear to have been irrelevant to PDE's awarding of the Contract.

FINDING II-B: *No Basis Appears to Exist to Support PDE's Assessment that Edison's Fee was Reasonable.*

As discussed below, PDE failed to provide evidence that it performed adequate procedures to conclude that Edison's \$2.7 million fee for analyzing the District was reasonable. Based on the documents and information that were provided to us, there appears to be no basis to support PDE's assessment that Edison's fee was reasonable.

The Contract provided that Edison "shall be compensated for [its] work, including all time, materials and expenses incurred by [Edison] and its subcontractors in an amount not to exceed Two Million Seven Hundred Thousand Dollars (\$2,700,000.00)." PDE explained that it "believed that the fee quoted by Edison...was reasonable given the number of personnel assembled for a team deployed to conduct such a comprehensive review in such a short time frame." When we requested documentation supporting PDE's conclusion, PDE simply stated, "No documentation was sought," presumably meaning that PDE did not ask Edison for a quote in writing. When we followed-up by asking whether PDE had requested *any* quote from Edison before signing the Contract (i.e., either written or otherwise), PDE responded, "No formal quote was sought or required to be provided. The final amount was discussed among counsel drafting the contract along with the other terms and conditions."

Instead, PDE simply stated that it had concluded that Edison's fee was reasonable "after consulting with personnel from other Commonwealth agencies." However, PDE twice refused our requests that it identify *which* Commonwealth employees were consulted regarding the reasonableness of Edison's fee. Furthermore, PDE indicated that it did not even *have* such information, stating that "those communications would have taken place prior to the preparation of the contract," and that "a record of such communications was never created nor required to be created." Therefore, PDE failed to demonstrate that it conducted a serious evaluation of the reasonableness of Edison's \$2.7 million fee to analyze the District.

We also asked Edison how the Contract price was determined. Edison responded only that the price was negotiated between the parties and "reflected Edison's best assessment of the fair value of the services it and its subcontractors would provide." However, we question the quality of Edison's "best assessment," given the fact that the Contract was the first of its type ever performed by Edison.

On August 20, 2001, as required by the Contract, Edison submitted its budget for the project to PDE.¹⁷ The budget was not approved by PDE until September 18, 2001, almost one month later and, more importantly, only three days before the original due date for the final report. The budget broke down Edison’s \$2.7 million fee as follows:

TABLE II-1

Payments to be Made to Edison by PDE (Budgeted)*

<i>Firm Directly Performing Work</i>	<i>Fee to Be Paid to Edison</i>
Edison	\$1,525,000
Edison’s subcontractors	\$1,175,000†
TOTAL CONTRACT PRICE	\$2,700,000

*See footnote 17 regarding Edison’s budget.

†See Table III-1 for details regarding these six subcontracts.

Edison calculated the \$1,525,000 fee for its own work by multiplying 750 employee days by an average daily rate of \$2,033. According to Edison, PDE requested that a single daily rate be charged for any Edison employee working on the project, which would also include travel, lodging, overhead, and other incurred costs. Because those costs were not required to be billed separately, we could not determine for ourselves whether Edison’s daily rate – and, in turn, the total fee to be paid to Edison – was reasonable. Based on the documents and information provided to us, we have concluded that no basis appears to exist for PDE’s assessment that the fee was reasonable.

¹⁷ Edison called this budget its “Preliminary Budget.” On November 16, 2001, several weeks *after* Edison submitted its Report to PDE, Edison submitted a “Final Budget” for the project to PDE, which was approved four days later. The “Final Budget” revised the payments to be made to Edison for its six original contractors according to the Preliminary Budget (see Table III-1) to conform to the costs *actually* incurred by Edison for those subcontractors (see Table III-2). Consequently, the “budget” for the subcontractors increased by \$123,230 or 10.5%. As demonstrated in Table II-2, Edison – either intentionally or unintentionally – had *understated* the costs for two of its original six subcontractors.

TABLE II-2

Edison’s Understatement of Amounts to be Paid to Subcontractors

Firm	Payment Per Preliminary Budget	Payment Per Subcontract	Variance
<i>McKinsey & Company</i>	\$350,000	\$490,000	\$140,000
<i>Nixon Peabody LLP</i>	\$140,000	\$141,300	\$1,300
TOTAL	\$490,000	\$631,300	\$141,300

Recommendations:

Based on the documents and information that were available to us, we have concluded that Edison's qualifications appear to have been irrelevant to PDE's awarding of the Contract and that no basis appears to exist to support PDE's assessment that Edison's fee was reasonable. Therefore, we recommend that PDE:

- Award future contracts to vendors who are the most qualified to perform the required work and who charge the most reasonable fees;
- Perform and document procedures enabling PDE to conclude that future vendors who receive contracts from PDE are the most qualified vendors to perform the required work;
- Perform and document procedures enabling PDE to conclude that the fees charged by future vendors who receive contracts from PDE are reasonable; and
- Obtain formal written price quotes from prospective vendors prior to awarding future contracts and commencing negotiations regarding the contract terms.

OBSERVATION: *Although Edison was able to Support the Amounts Billed to PDE Under the Contract, Its Record-keeping System Needs Improvement.*

As discussed in Finding II-B, we could not determine whether Edison's fee was reasonable. Our fourth objective of this audit was to determine whether Edison had sufficient documentation to support the amount billed to PDE under the Contract, including amounts billed for subcontract costs incurred by Edison. We found that Edison did have such documentation. However, despite the existence of such documentation, we observed that Edison's record-keeping system needs improvement.

The Contract required Edison to bill PDE for one-third of its payment at the end of the first 30 days of work, one-third upon delivery of the report, and the remainder 30 days following the delivery of the report. Table I-4 demonstrates that Edison billed PDE in this manner. Edison billed PDE a total of \$2.7 million, including \$1.4 million representing 689.51 employee days and \$1.3 million for six subcontractors.

We tested whether there was evidence that Edison employees actually worked the 689.51 days by reviewing Edison's internal records for 29 of the 50 employees who worked on the project. We chose those employees because Edison's records indicated that they all worked at least four days on the project. Edison's internal records of those employees' time consisted primarily of weekly e-mails sent by them to Edison's Executive Assistant to the Executive Vice President ("Executive Assistant") indicating how much time they spent on the project during a particular week.

Edison informed us that it did not normally track its employees' time according to project and that it was forced to create a system to track time in this manner for the Contract. The Executive Assistant was assigned this duty based on her ability to be persistent in obtaining information from other employees. She is not an accountant and did not track employee time as part of her regular job duties. Moreover, while she was assigned the responsibility for developing and overseeing the system used to track employee time for this project, she lacked the authority to force employees to submit their time.

With regard to employees for whom sufficient documentation was lacking, we used travel expense reports to substantiate the time worked by accepting days recorded for those employees if they appeared to have been in the District during that time. We also compared the days recorded for employees with Edison's internal leave records to determine whether time was recorded for an employee on a day when that employee was absent from work.

As demonstrated in Table II-3, we were unable to substantiate 104.74 days recorded to the project for 29 Edison employees. The unsubstantiated days include:

- Time recorded based on e-mails sent to the Executive Assistant after the contract period;
- Time recorded based on handwritten summaries by the Executive Assistant after verbal receipt of time from Edison employees, without any additional support;
- Time recorded in excess of the time reported in employee e-mails;
- Time recorded in conflict with employee leave records; and
- Time recorded without any support.

TABLE II-3

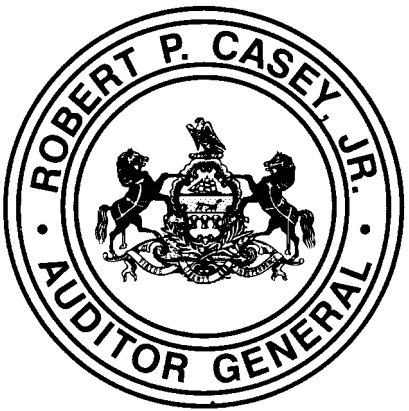
Comparison of Edison Employee Days Recorded with Days Substantiated

Number of Days Recorded by Edison for 29 Employees	Number of Days Substantiated	Number of Days Not Substantiated
799.64	694.90*	-104.74

**Includes 16 additional days not recorded for the employees by Edison, based on our review of employee e-mails and travel expense reports which indicate more time than the Executive Assistant recorded. We have given Edison credit for these unrecorded days, but note that they provide further evidence of poor record-keeping by Edison.*

Although Edison appears to have recorded more time for the 29 employees (799.64 days) than we were able to substantiate (694.90 days), it billed PDE for a lesser number of days (689.51 days).¹⁸ However, while Edison had sufficient documentation to support the amount billed to PDE under the Contract, its record-keeping needs improvement. Therefore, we recommend that, for work performed by Edison under future contracts, PDE require Edison to establish a better system for tracking employee time according to project and assign the responsibility for developing and overseeing the system to an employee with adequate authority.

¹⁸ We note that Edison claimed that all of its employees together worked a total of 32.29 days on the project beyond the number of days recorded for only the 29 employees whose records we reviewed. Edison's poor record-keeping suggests that it may not have been able to substantiate all of those additional days if it had billed PDE for them. Regardless, Edison was able to support 689.51 days and, in turn, the \$1.4 million billed to PDE for the services of Edison employees.



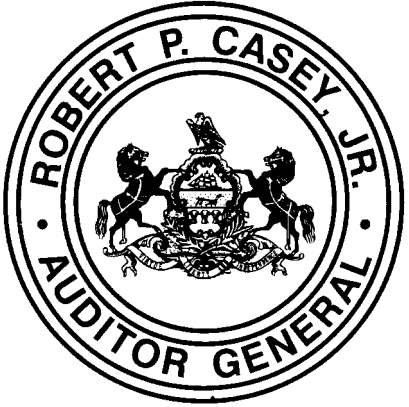
PDE'S RESPONSE TO CHAPTER II

Finding II-A: Edison Qualifications Appear to Have Been Irrelevant to PDE's Awarding of the Contract

The Department disputes this finding. First, the report does not question Edison's qualifications as a manager of large urban public schools. It also fails to acknowledge that this experience is essential to understanding the real day-to-day challenge a large urban school district faces on both academic and fiscal fronts. Given the number of schools operated by Edison in large urban areas, it indeed could have been considered one of the largest school districts in the nation. Edison brought this management experience to the table. The fact that Edison could easily and quickly assemble a team of other qualified and knowledgeable professionals was a key component in considering it for this project. The Department was aware of no other educational management organization that could easily combine both large urban school district expertise and the ability to attract other resources in such a short timeframe and direct the work that needed to be done. While the Auditor General is unwilling to recognize the value Edison brought to this project, the Department of Education clearly does.

Finding II-B: No Basis Appears to Exist to Support PDE's Assessment that Edison's Fee was Reasonable

The Department disputes this finding. The Department's contract with Edison for \$2.7M was a bargain given the level of resources and work that had to be done in such a relatively short timeframe. As you noted in Chapter I of your report, sixteen prior analyses of the District were conducted between 1996 and 2000. Your report does not provide a tally of the money spent on each of these prior analyses listed in Table I, but those monies clearly would exceed the amount spent here. And this report provided options to the Governor that later became part of **the Plan** that was actually implemented in the District.



**DEPARTMENT OF THE AUDITOR GENERAL'S COMMENTS
REGARDING PDE'S RESPONSE TO CHAPTER II**

Finding II-A

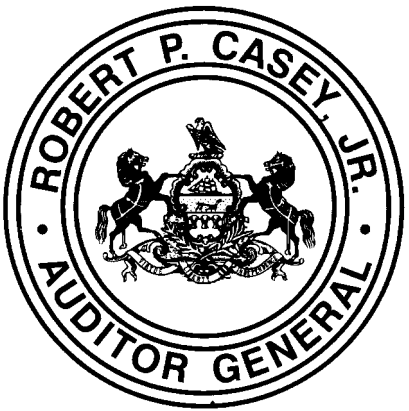
The Department of the Auditor General retains the original finding and recommendations. PDE clearly failed to understand the point of this finding. Our point was not whether Edison was, in fact, the most qualified vendor to perform the required analysis of the District – although the fact that Edison had never before performed a contract of this type certainly raises skepticism regarding Edison's qualifications. Rather, we examined whether, before awarding the Contract to Edison, PDE performed adequate procedures *to conclude for itself* that Edison was the most qualified vendor.

However, during the course of our audit, PDE refused to comply with our requests for documents and information that would have allowed us to understand the process used by PDE to assess Edison's qualifications. PDE failed to demonstrate that it conducted a serious evaluation of Edison's qualifications or that it contacted or even considered any other firms to analyze the District. In fact, based on the documents and information that were provided to us, it appears that no other vendors were considered for the project and that Edison was awarded the Contract *regardless of its qualifications*.

Finding II-B

The Department of the Auditor General retains the original finding and recommendations. PDE clearly failed to understand the point of this finding as well. Our point was not whether the amount of Edison's fee was, in fact, reasonable – although the fact that many previous analyses of the District had been conducted certainly raises skepticism regarding the appropriateness of paying Edison \$2.7 million to conduct yet another analysis of the District. Rather, we examined whether, before awarding the Contract to Edison, PDE performed adequate procedures *to conclude for itself* that Edison's fee was reasonable.

However, during the course of our audit, PDE refused to comply with our requests for documents and information that would have allowed us to understand the process used by PDE to assess the reasonableness of Edison's fee. PDE failed to demonstrate that it conducted a serious evaluation of Edison's fee. In fact, based on the documents and information that were provided to us, it appears that there was no basis to support PDE's assessment that the fee was reasonable. Furthermore, because PDE agreed to pay a flat daily rate for any Edison employee working on the project, which also included Edison's incurred costs for that employee, we could not determine for ourselves whether Edison's fee was reasonable.



CHAPTER III

EDISON'S USE OF NON-APPROVED SUBCONTRACTORS

Our third objective was to determine whether PDE paid Edison in accordance with the terms of the Contract and received all deliverables required by the Contract. We did not have significant findings with regard to this objective, but documents provided by Edison led us to a different finding that Edison violated the terms of the Contract.

The Contract required Edison to gather data about the District's financial and academic problems, analyze that data, and provide options to solve the problems identified by its analysis. The Edison Report, dated October 30, 2001, appears to satisfy these requirements. As discussed in Chapter I, the original deadline of September 21, 2001 for submission of the report to PDE was extended three times. According to PDE, "the final report was supplied on the [extended] due date, October 29, 2001. [PDE] requested cosmetic changes, which were made, and that report was then hand-delivered on October 30, 2001." The Edison Report was based in part on work performed by Edison's subcontractors; several of the subcontractors' deliverables were included as appendices to the Edison Report.

As discussed in Chapter II, the Contract also required PDE to pay Edison \$2.7 million for work performed by Edison and its subcontractors. The Contract required Edison to bill PDE for one-third of this fee at the end of the first 30 days of work, one-third upon delivery of the report, and the remainder 30 days following the delivery of the report. The parties complied with these payment provisions. However, we found that Edison retained three subcontractors that were not approved by PDE, in violation of the Contract.

FINDING III: *Edison Violated the Contract by Retaining Three Subcontractors Not Approved by PDE.*

The Contract required Edison to "submit a budget and sufficient justification of subcontractor costs to the Commonwealth when seeking approval of such subcontractors under Paragraph 20 of the Phase 1 Terms and Conditions." Consequently, the Contract incorporated standard contract terms required for contracts executed by Commonwealth agencies, including Paragraph 20b, which provides:

The Contractor shall not subcontract with any person or entity to perform all or any part of the work to be performed under this Contract *without the prior written consent of the Contracting Officer*, which consent may be withheld at the sole and absolute discretion of the Contracting Officer.¹⁹

¹⁹ Emphasis added.

Pursuant to this provision, Edison sought and received approval from PDE to pay a total of \$1,175,000 for the following six subcontractors:

TABLE III-1

Payments to be Made to Edison by PDE for 6 Subcontractors (Budgeted)*

Firm	Duties to be Performed, According to Edison	Fee
<i>McKinsey & Company</i>	“process coordination and work flow management; central office review”	\$350,000
<i>Public Financial Management</i>	“budget analysis and modeling, review of workforce and business operations, debt management strategies, financial advise [sic]”	\$285,000
<i>Morgan, Lewis & Bockius LLP</i>	“review of governance, major contracts, collective bargaining agreements”	\$200,000
<i>Nixon Peabody LLP</i>	“review of special education and bilingual/alternative language services & related federal and state compliance issues”	\$140,000
<i>International Business Machines Company (“IBM”)</i>	“review of student information and financial information systems”	\$125,000
<i>MetaMetrics, Inc.</i>	“analysis of student achievement”	\$75,000
TOTAL	N/A	\$1,175,000

*See footnote 17 regarding Edison’s budget and the amounts to be paid to these subcontractors.

Table III-2 demonstrates that an additional \$123,230 was billed by Edison and paid by PDE for these subcontractors.

TABLE III-2

Payments Made to Edison by PDE for 6 Subcontractors (Actual)

Firm	Amount Paid	Variance From Preliminary Budget
<i>McKinsey & Company</i>	\$488,750	+39.7%*
<i>Public Financial Management</i>	\$285,000	0%
<i>Morgan, Lewis & Bockius LLP</i>	\$190,605	-4.7%
<i>Nixon Peabody LLP</i>	\$141,300	+0.9%*
<i>IBM</i>	\$117,575	-5.9%
<i>MetaMetrics, Inc.</i>	\$75,000	0%
TOTAL	\$1,298,230	+10.5%

*See footnote 17 regarding the increased amounts paid to these subcontractors.

In order to determine whether sufficient documentation existed to support these bills, we reviewed copies of each subcontract and their respective invoices and/or checks written by Edison. We also asked Edison for an explanation of its oversight of the subcontractors' bills, and received the following response:

Edison was in daily contact with each of its subcontractors. Edison's project managers reviewed and participated in the subcontractors' work, and Edison's constant oversight and coordination ensured that the subcontractors' invoices reflected appropriate costs for the work being performed and were in compliance with the terms of each subcontract.

We are satisfied that Edison maintained sufficient evidence to support the amounts billed to PDE for subcontractors under the Contract. However, during the course of our audit work, Edison informed us that it spent \$79,000 for three subcontractors *in addition to the six approved by PDE*, as demonstrated in Table III-3.

TABLE III-3

Edison's Three Non-Approved Subcontractors

Firm	Duties Performed	Amount Paid
<i>Harris Interactive</i>	survey experiences and satisfaction levels of District parents	\$52,000
<i>National Alliance for Safe Schools</i>	conduct limited assessment of the security operations of schools in the District	\$15,000
<i>The Rise Group, L.L.C.</i>	review the District's facilities and capital budget	\$12,000
TOTAL	N/A	\$79,000

Edison informed us that it had not sought and received approval from PDE for these three subcontractors pursuant to the Contract. Edison asserted that approval was not necessary because it had not sought separate reimbursement from PDE. Instead, it had absorbed the cost of the three subcontractors itself by paying them with funds paid by PDE for Edison's staff time. Edison also attempted to justify its failure to seek PDE approval by arguing that these three subcontractors were less costly than the other six which PDE had approved, that some of these three had been engaged after the original six, and that it used these three on a regular basis.

Because the Contract clearly requires PDE approval of subcontractors, we do not find any of Edison's arguments to be persuasive. In particular, Edison's argument that it had paid three subcontractors out of its own share of the total contract amount is a circular argument, because Edison would not have had to "incur" such costs if it had included those three subcontractors in the budget approved by PDE.

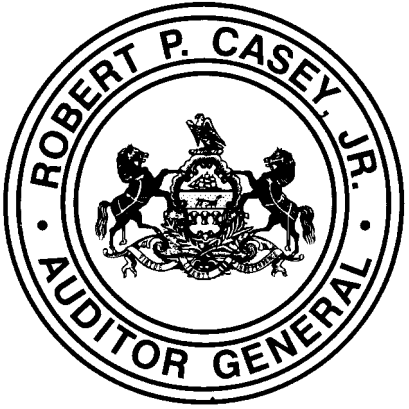
In addition, because PDE had not approved those subcontractors, it should have questioned their use. PDE was aware of at least one of the subcontractors because that subcontractor was identified on a list of subcontractors for whom Edison provided employee biographies on August 28, 2001. We do not know if or when PDE became aware of the other two subcontractors.

Recommendation:

We have concluded that Edison violated the Contract by retaining three subcontractors not approved by PDE. Therefore, we recommend that, in future contracts, PDE exercise greater oversight over its vendors to ensure that they request approval for all subcontractors when required by contract.

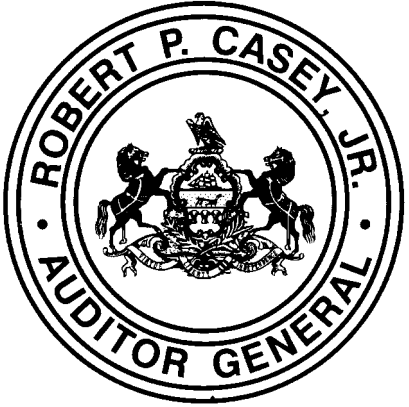
PDE'S RESPONSE TO CHAPTER III

Edison Schools did not seek reimbursement from PDE for these small subcontracts. Edison paid for the work performed by these subcontractors with its own money. It is Edison's position that Department approval was not required in this situation.



**DEPARTMENT OF THE AUDITOR GENERAL'S COMMENTS
REGARDING PDE'S RESPONSE TO CHAPTER III**

The Department of the Auditor General retains the original finding and recommendation. We were already aware that “[i]t is Edison’s position that [PDE] approval was not required in this situation.” However, PDE failed to express *its* position on this issue. As already discussed, Edison violated the Contract by failing to obtain PDE’s written approval for all subcontractors. The amount of the three subcontracts at issue and the fact that Edison paid those firms out of its own share of the total contract amount are irrelevant to the determination of whether Edison complied with the Contract. In particular, PDE’s statement that Edison paid those three subcontractors “with its own money” ignores the fact that Edison paid them out of the \$2.7 million of public funds which it received for the entire project, just as it paid the six approved subcontractors.



PDE'S RESPONSE TO THE BACKGROUND SECTION OF DRAFT AUDIT REPORT

The Department has reviewed the draft audit of Contract Number SP1611200001 between it and the Edison Schools, Inc. for an educational and financial analysis of the School District of Philadelphia.

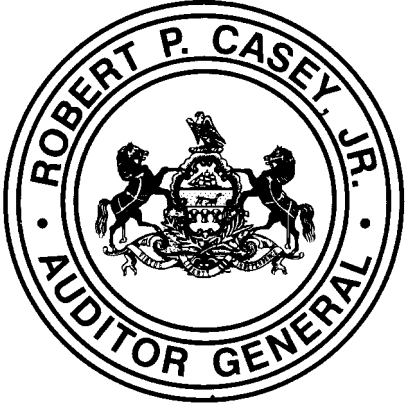
The Department must dispute the findings of your report, but will not engage in a refutation of the minutiae of the report in a point-by-point rebuttal. Rather, it will address major themes that it believes have been overlooked or underestimated during the review process. Our comments will follow the format you have adopted in the report.

Background

This discussion ignores information provided to the Auditor General regarding the timeline that formed the basis of the Memorandum of Understanding (MOU) between then Governor Tom Ridge and Philadelphia Mayor John Street. The background narrative acknowledges the MOU was a culmination of the negotiation between the Commonwealth and the City over how to best solve the School District of Philadelphia's academic and fiscal problems. However, the background discussion conveniently omits the fact that the Mayor insisted on the sixty-day timeframe in the MOU. The omission of this important fact is later repeated in Chapter I allowing you to mistakenly conclude that there was a "Lack of 'Emergency' Justifying Circumvention of Bidding Requirement."

The narrative also seems to suggest some relationship between the submission of the final version of the Edison Report to the Governor and the execution of Act 83 of 2001. The report ignores the fact that Section 696 of the Public School Code, 24 P.S. §6-696(a), had already provided for the creation of a School Reform Commission since the enactment of Act 46 in 1998, which amended the Public School Code of 1949. See March 10, P.L. 30, No. 14 §696, added 1998, April 27, P.L. 270, No. 46 §3. Your report also fails to recognize that prior to any declaration of distress the School District of Philadelphia already had the power to enter into agreements with for-profit organizations to operate public schools pursuant to its authority under the Education Empowerment Act, 24 P.S. §1704-B (a)(4). Further, regardless of Act 83, any School Reform Commission would have had this power under the prior provisions of 24 P.S. §6-696(i)(5).

The discussion in this section also outlines changes made to original deadlines in the MOU based upon the tragic events of September 11, 2001 and additional agreements between Governors Ridge and Schweiker and Mayor Street. The chronology outlined here and later repeated in Chapter I fails to acknowledge that the reasons for the emergency procurement should be based on facts as they existed at the time of the initial procurement and not subsequent events.



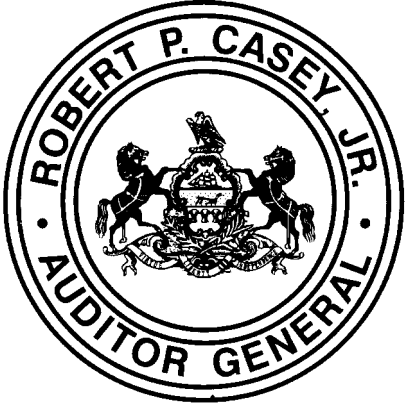
DEPARTMENT OF THE AUDITOR GENERAL'S COMMENTS REGARDING PDE'S RESPONSE TO THE BACKGROUND SECTION OF DRAFT AUDIT REPORT

PDE's responses to the findings in the various chapters of our draft audit report appear after the relevant chapters of this report, along with our comments to PDE's responses. However, PDE did provide comments regarding the "Background" section of our draft report, to which we briefly respond below.

PDE claims that our report "conveniently omits" the asserted fact that the 60-day deadline was solely the responsibility of Mayor Street. Our recitation of the chronology leading to PDE's awarding of the Contract to Edison was based on published reports and the limited information and documents that PDE was willing to provide during the course of our audit. According to PDE's response dated March 1, 2002, "[t]he parties settled upon a 60-day time frame for the analysis and the presentation of a proposed set of options from the Governor." Similarly, in a letter dated August 14, 2002, Secretary Zogby himself informed us that "the Governor and the Mayor were the two parties who decided upon the timeline set forth in the MOU." Yet regardless of which party may have initially proposed the 60-day deadline, both parties agreed to that and other terms in the MOU.

Contrary to PDE's assertion, our chronology does not "suggest some relationship" between the submission of the Edison Report to Governor Schweiker and Secretary Zogby's "Declaration of Distress" which allowed the official formation of the Philadelphia School Reform Commission. However, PDE *itself* suggests such a relationship in its response to Finding I-A, stating that the administration needed a current analysis of the District's financial and academic problems from Edison "in order to consider a declaration of distress in Philadelphia in late 2001." Moreover, while PDE is correct that the Reform Commission was originally authorized by Act 46 of 1998, PDE's response fails to acknowledge the reality that Act 83 of 2001 amended the Reform Commission's powers and structure, and did so in the context of the imminent state takeover of the District.

Finally, PDE argues that any events which occurred after the awarding of the Contract are irrelevant to the issue of whether or not an emergency truly existed justifying circumvention of the competitive bidding requirements. We disagree. As explained in our comments following PDE's response to Finding I-B, although the determination of whether an emergency procurement was justified may not hinge solely on such events, they – combined with other factors discussed – raise reasonable questions regarding the existence of an actual emergency.



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