State of Arizona Office of the Auditor General

PERFORMANCE AUDIT

UNIVERSITIES' AUXILIARY ENTERPRISES

Report to the Arizona Legislature
By Douglas R. Norton
Auditor General
July 1998
Report No. 98-11

DOUGLAS R. NORTON, CPA
AUDITOR GENERAL

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

DEBRA K. DAVENPORT, CPA
DEPUTY AUDITOR GENERAL

July 8, 1998

Members of the Arizona Legislature

The Honorable Jane Dee Hull, Governor

Dr. Frank H. Besnette, Executive Director
Arizona Board of Regents

Dr. Clara Lovett, President
Northern Arizona University

Dr. Lattie Coor, President
Arizona State University

Dr. Peter Likins, President
University of Arizona

Transmitted herewith is a report of the Auditor General, A Performance Audit of the Universities' Auxiliary Enterprises. This report is in response to a July 10, 1998, resolution of the Joint Legislative Audit Committee. The performance audit was conducted in response to the requirements of A.R.S. §41-2958.

This is the third in a series of four reports to be issued on the universities. The report addresses changes that are needed for the universities to successfully review services for privatization, and recommends several ways the universities could improve the way they operate their auxiliary enterprises. Auxiliary enterprises represent a wide variety of activities and services, including bookstores, student housing, intercollegiate athletics, and parking services. While the universities have privatized some services already, they need to improve their collection of performance, service, and financial information in order to conduct systematic privatization reviews of other services. In addition, we recommend that universities actively pursue more opportunities for partnerships with local governments and others to improve operations or reduce costs, and implement standardization policies for purchasing commonly used supplies and equipment. We also recommend that the Board of Regents develop guidelines for each auxiliary enterprise regarding the planning and accumulation of financial reserves to adequately address long-term capital needs.

As outlined in their response, the universities agree with all of the findings and recommendations.

My staff and I will be pleased to discuss or clarify items in the report.

This report will be released to the public on July 9, 1998.

Sincerely,

Douglas R. Norton
Auditor General

Enclosure

2910 NORTH 44th STREET • SUITE 410 • PHOENIX, ARIZONA 85018 • (602) 553-0333 • FAX (602) 553-0051

SUMMARY

The Office of the Auditor General has conducted a performance audit of auxiliary enterprises at Arizona's universities. This audit was conducted pursuant to a June 10, 1996, resolution of the Joint Legislative Audit Committee. It is the third in a series of four performance audits of the universities performed in response to the requirements of A.R.S. §41-2958.

Auxiliary enterprises are business functions operated by universities that directly or indirectly provide services to students, faculty, or staff and charge a fee related to the cost of services. Auxiliary enterprises represent a very wide variety of activities and services on college campuses and can include bookstores, student housing, intercollegiate athletics, and parking services. Auxiliary enterprises include several "internal service departments" that provide a specific type of service to college or university departments and are supported by internal charges to the using department's operating budget. Internal services include functions such as copy services, office machine repair, and motor pools.

Auxiliary enterprises and internal services at Arizona's three universities account for a substantial amount of university resources, although the exact amount is unknown. In fiscal year 1996-97, Auxiliary Enterprise Fund revenues alone totaled approximately $110 million at Arizona State University, $36 million at Northern Arizona University, and $143 million at the University of Arizona. For this audit, many auxiliary enterprises on each campus were reviewed to obtain a general understanding of the issues. In addition, six auxiliary enterprises on all three campuses (bookstores, dining services, motor pool, copy services, campus health, and parking and transit services) were examined in depth to evaluate opportunities for improved efficiencies.

Universities Need Information and Guidance to Adequately Assess Services for Privatization

(See pages 5 through 14)

Because auxiliary enterprises are essentially business functions, they are frequently considered to be potential candidates for privatization. However, fulfilling a 1996 mandate from the Legislature requiring the universities to assess whether auxiliary enterprises and internal services should be self-operated or privatized will be difficult to accomplish unless changes are made. Studies performed to date, as well as best practices cited in literature, suggest that the universities may need to collect more performance, service, and financial information to enable them to conduct systematic privatization reviews. For example, ASU and NAU need to determine relevant indirect costs, such as

utility and payroll processing costs, associated with self-operating services to ensure fair comparison of the financial benefits of self-operation versus privatization. Additional information will also allow the universities to target services for review and determine what is expected from auxiliary services.

In addition to increased information, privatization committees also need to know how important cost savings are as compared to other concerns such as the effect of privatization on local businesses. Studies performed by the universities to date have either been redone or continued because university administrators were not convinced that the reviewers adequately considered the potential to privatize services. Accordingly, the Board of Regents should provide policy guidance on how factors such as privatization's potential effect on students, university employees, or the surrounding community should influence the decision to privatize a service.

Steps Can Be Taken to Improve the Management of Auxiliary Enterprises

(See pages 15 through 19)

All three Arizona universities could improve the way they operate their auxiliary enterprises. First, they should each consider implementing or expanding innovative business practices already occurring at the universities. For example, the universities could increase the use of public-private partnerships, such as the partnership the University of Arizona formed with a private developer to build a parking garage. Second, to increase efficiency and reduce costs, the universities should standardize and consolidate the purchase of supplies and equipment such as computers and copy machines. By standardizing the purchase of copy machines, rather than allowing each department to individually purchase them, Arizona State University has been able to purchase a popular model of copy machine at a savings of approximately 25 percent below the state contract.

The universities could also improve the operation of their auxiliary enterprises by ensuring that the rates charged for the services and the money that they save are sufficient to meet long-term capital replacement needs. The University of Arizona's experience with its student union demonstrates the need to set money aside in reserves. UA's failure to set money aside over the years for union renovations has resulted in the University having to ask students to help finance needed building renovations through a designated student fee, an approach that has been unsuccessful to date. To help ensure that money is adequately saved for future building and equipment needs, the Board of Regents should direct the universities to establish financial planning guidelines to help ensure that auxiliary enterprises and internal services set aside sufficient reserves.

Other Pertinent Information
(See pages 21 through 27)

The report also presents other pertinent information about the benefits, risks, and other considerations concerning privatization of the bookstores at the three universities and dining services at the University of Arizona. Our preliminary analysis suggests that privatized bookstores have the potential to increase sales, which may possibly result in more money being returned to the universities. Similarly, privatizing UA's dining services would likely reduce its high labor costs and potentially increase the financial return to UA. However, these greater potential returns can only be confirmed after an RFP is issued and proposals are received and evaluated. Further, even if greater returns are possible, other factors that might affect the decision to privatize need to be considered. These factors include lower-quality or more costly services to students, the potential for local community resistance, and the impact on employees.

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INTRODUCTION AND BACKGROUND

The Office of the Auditor General has conducted a performance audit of auxiliary enterprises at the state universities. This audit was conducted pursuant to a June 10, 1996, resolution of the Joint Legislative Audit Committee. This is the third audit in a series of four performance audits of the universities conducted under the requirements of A.R.S. §41-2958. The two previous audits pertained to space utilization at the universities and the viability of the research parks at ASU and UA.

Overview of University Auxiliary Enterprises and Internal Services

An "auxiliary enterprise" is a business function operated by colleges or universities that directly or indirectly provides a service to students, faculty, or staff and charges a fee related to the cost of these services. Auxiliary enterprises represent a very wide variety of activities and services on college campuses and can include bookstores, student housing, student unions, intercollegiate athletics, student health, parking and transit services, student associations and recreation, and public events. The term "auxiliary enterprises" often refers to services provided to individuals in the university community rather than to departments within the institution. These enterprises are essentially managed as self-supporting activities. Sometimes auxiliary enterprises also generate revenues in excess of expenditures that are used to support additional campus activities. All auxiliary enterprise activities should contribute and relate directly to the college or university's mission, goals, and objectives.

In addition to enterprises that sell goods or services to customers, university auxiliary enterprises include several "internal service departments." Service departments provide a specific type of service to college or university departments and are supported by internal charges to the using department's operating budget. Internal services include functions such as copy services, office machine repair, printing services, telephone and data communication systems, a central store, and motor pools. Such a service might be purchased from a local business, but for reasons of convenience, cost, or control, it is often provided more effectively through an institutional service department. However, internal service departments are generally still expected to be self-sufficient and generate adequate revenues to pay for all operating expenses, including employee salaries and benefits, costs of materials, and maintenance and equipment replacement costs.

Auxiliary enterprises and internal services can be operated by the institution itself or by a contracted provider. Most often, the institution operates the enterprise, owns the property and equipment, and employs the managers and staff. However, universities privatize (contract with private providers) for the operation of many enterprises. In these cases, the contractor sometimes pays the institution a percentage of sales or a fixed dollar amount to provide the service. However, the institution is still responsible for establishing the contractor's mission and standards.

Auxiliary Enterprises Involve Significant Financial Resources

Auxiliary enterprises and internal services account for a significant amount of university resources, although the exact amount devoted to auxiliary enterprises and internal services is unknown. In fiscal year 1996-97, Auxiliary Enterprises Fund revenues totaled approximately $110 million at Arizona State University (ASU), $36 million at Northern Arizona University (NAU), and $143 million at the University of Arizona (UA). These monies predominantly consist of revenue generated through the sale of goods and services. Some auxiliaries and internal services also receive General and designated funds monies, although the total amount cannot be easily determined since General and designated funds monies actually used for auxiliaries are not accounted for separately. A review of individual auxiliaries' budgets found that student health services and intercollegiate athletics at the three universities, as well as public events at ASU and UA, are examples of auxiliaries receiving these other state monies.

Audit Scope and Methodology

To obtain a general understanding of the issues, many auxiliary enterprises on each campus were reviewed. In addition to the three main campuses, auxiliary enterprises at ASU East and West were also included. Some of the auxiliary enterprises and internal services reviewed were intercollegiate athletics, facilities management, student housing, college stores, public events, and telephone and data communication services. However, due to time limitations, the audit focused on six auxiliary enterprises found on all three main campuses: bookstores, dining services, motor pool, copy services, campus health, and parking and transit services. The auxiliaries selected for more in-depth examination represent a cross-section of large and small campus services provided to students, faculty, and staff.

To determine opportunities for improved efficiencies for the six selected auxiliary enterprises at each university, information was obtained and analyzed from a variety of sources. Interviews were conducted with university administrators, business officers, auxiliary directors, and staff to determine each auxiliary enterprise's structure and operations. Budgets and other financial information were analyzed with regard to auxiliary fund balances, revenue sources (such as rates and charges for services), expenditures (such as cost of goods sold and labor costs), equipment and building reserve accounts, and transfers into and out of specific auxiliary accounts. Criteria used to evaluate the operation and management of auxiliary enterprises was also gathered and reviewed from a variety of sources. Interviews were conducted with auxiliary directors and university administrators in other states and representatives of national organizations. In addition, literature, journal articles, books, reports, and expert studies were reviewed from national organizations and universities to determine appropriate benchmarking criteria and standards for evaluating the operation and management of university auxiliary enterprises.

In addition to a specific review of the six auxiliary enterprises and internal services, the audit also assessed how each university is developing and implementing a competitive government program, as required by the Board of Regents. Since few studies have been performed to date, the audit primarily focused on changes that would be needed to successfully implement such a program. Representatives were interviewed from the Board of Regents, the Governor's Office for Excellence in Government, and the State Procurement Office. The Arizona *Competitive Government Handbook* was reviewed, as well as privatization literature from national associations such as the Council of Higher Education Management Association, the National Association of College Auxiliary Services, the Council for the Advancement of Standards in Higher Education, the National Association of State Budget Officers, and the National Association of College and University Business Officers. Individuals from other states' universities were contacted regarding their experiences with privatization and contracted auxiliary services, including university representatives from California, Florida, Georgia, New Mexico, North Carolina, Idaho, Ohio, and Pennsylvania. Finally, interviews were conducted with university administrators, college business officers, and members of privatization councils and committees.

As part of the audit work, auditors attempted to determine whether auxiliary enterprises and internal services at the three universities are financially self-sufficient. However, it was not possible to determine with any certainty whether auxiliaries and internal services are self-sufficient since university financial records do not lend themselves to this type of analysis.

This report presents information and analysis in three areas:

- A finding that the universities need better information and guidance in order to adequately assess which auxiliary services should be privatized,
- A finding that the potential exists for universities to improve their management of auxiliary enterprises, and
- Other pertinent information analyzing some of the benefits, risks, and other considerations concerning privatization of university bookstores and campus dining services.

This audit was conducted in accordance with government auditing standards.

The Auditor General and staff express appreciation to the Arizona Board of Regents, and the administrators and staff of Arizona State University, Northern Arizona University, and the University of Arizona for their cooperation and assistance throughout the audit.

FINDING I

UNIVERSITIES NEED INFORMATION AND GUIDANCE TO ADEQUATELY ASSESS SERVICES FOR PRIVATIZATION

To fulfill a legislative mandate requiring the universities to assess services for possible privatization, changes are needed. The assessments performed to date and literature suggest that a systematic process is needed for evaluating whether auxiliary and internal services should be privatized. To determine whether contracting with a private vendor could benefit campus services, the universities need to be able to identify viable privatization candidates, compare the financial benefits of internal versus external service providers, and choose the appropriate provider after considering financial benefits and other factors. To accomplish this, the universities need to make changes to ensure that needed performance, service, and financial information is available. Additionally, the Board of Regents should provide guidance to the universities' privatization committees regarding how to weigh potential cost savings or enhanced revenue against other factors.

Background

In 1996, the Legislature passed A.R.S. §41-2772, requiring the Board of Regents to develop a plan comparable to the State's Competitive Government Program to review services for possible privatization. In turn, the Board required the three universities to begin assessing whether services should be privatized. The goal of the State's Competitive Government Program is for state agencies to assess their current functions and determine the most cost-effective method of delivering their services. According to the National Association of College Auxiliary Services, such reviews can also improve the efficiency of a self-operated service. Reviews provide an understanding of where a particular service is "in regard to its cost of operation, efficiency and effectiveness, whether it is functioning as it should, and its future course."

Prior to the 1996 mandate, the universities had contracts for service delivery with over 120 private vendors, achieving a level of privatization similar to other universities nationally. Services such as dining services, childcare, and janitorial services have been either completely or partly privatized by at least one of the three universities. Since the mandate, the universities, on behalf of the Board of Regents, have conducted a total of five privatization reviews. The UA has conducted studies of its bookstore, motor pool, and printing and publishing services. A limited study of UA's dining services was also performed in 1997. (The study was limited due to the uncertain future of the student union.) NAU is in the process of reviewing its student health center. ASU has contracted with a consultant to review its bookstore. The universities will likely conduct more privatization reviews in the future since the Board of Regents has emphasized the need for them.

Determining Whether Services Should Be Privatized Will Require Universities to Perform Systematic Reviews

The universities should employ a systematic process to help university officials in charge of assessing services for privatization make these difficult decisions. According to these privatization assessment team members, as well as university administrators, past experience suggests two reasons why a systematic process may be beneficial:

- First, a systematic process may help ensure administrators that all relevant information is considered before a decision is made to privatize or self-operate a service. Such assurance may be necessary since three of the five privatization reviews performed at NAU and UA are being performed again or continued because administrators were not convinced that the reviewers adequately considered the potential to privatize services.

- Second, a systematic process can help identify which method of service delivery is most beneficial to a university, even when the distinctions between privatization and self-operation are not readily apparent. A UA administrator noted that the university has already privatized services that were easy targets for privatization because they had significant performance problems. He suggested that the benefits of privatizing other services are not as obvious.

The State of Arizona's *Competitive Government Handbook*, as well as other literature and interviews with national experts, suggest that systematic privatization reviews should include the following core activities:

Deciding the service functions to be examined—Since almost any campus auxiliary enterprise has the potential to be privatized, it is critical to target the best candidates for review to ensure that such reviews are cost-effective. Potential candidates for privatization can be identified by considering: 1) the current performance of the auxiliary enterprise; 2) the potential for an outside vendor to perform the service; and 3) the potential for some benefit to be derived from privatizing the service. Further, other campuses' experiences with privatizing a service can provide a good indication whether a service should be reviewed.

Identifying the ideal service specifications—Before comparing the potential benefits of privatizing an auxiliary enterprise to maintaining it in-house, the universities must determine what specific services the auxiliary should provide. If an RFP is ultimately drafted, it should include concrete service specifications defining the types, quantity, and quality of services desired from a vendor.

Assessing legal, monitoring, risk, and transition issues—After defining the services to be considered for privatization, the universities must identify factors that would affect their ability to effectively privatize the function, such as statutory restrictions, existing contracts, or legal barriers. The universities should also establish a plan specifying how privatized services would be monitored, how the risk of contractor default would be decreased, and how the universities and the vendors would fulfill any obligations to current campus employees. And, as part of this plan, the universities should consider the effect these considerations will have on cost or potential revenues associated with privatizing the function.

Comparing the financial benefits of contracting-out versus self-operation—Comparing the potential financial benefits of keeping services in-house versus contracting-out is necessary to determine whether university auxiliary enterprises and internal services should be self-operated or privatized. The universities should consider all relevant costs and revenues, including personnel, conversion, and contract monitoring costs.

Balancing financial benefits against other factors—Finally, even when privatization clearly offers financial benefits, universities need to consider other factors. Such factors should include the potential risk that service quality might diminish, the risk that prices students pay might increase, and the risk that service disruption or contractor default may occur. Also, factors such as privatizations's impact on the service's employees and the local community should also be considered.

As further illustrated in Figure 1 (see page 8), each of these steps involves consideration of numerous factors. See the Appendix (pages a-i through a-ix) for a more detailed discussion of how the potential for privatization should be assessed.

Universities Currently Lack Information Needed for Privatization Reviews

The universities currently lack information needed for effective privatization studies. To identify viable privatization candidates and service expectations, the universities may need to collect information that is currently not gathered and solicit input from the campus community on what services are desired. To compare the financial benefits of privatizing versus self-operation, the universities need to develop methods to identify all relevant costs associated with delivering a service internally. Finally, the Board of Regents and university presidents need to provide guidance on how to weigh the potential financial benefits of privatizing a service against other factors.

Figure 1

The Universities: Auxiliary Enterprises
Privatization Assessment Model

Decide Which Service Functions Will Be Examined

Consider these factors:
— How well is the current service performing?
— Could an outside vendor provide the service?
— What benefits would privatization create?

Identify Service Specifications

Consider these factors:
— What level and quality of service do we want?
— Are we currently getting services we don't need or can't really afford?

Assess Legal, Monitoring, Risk, and Transition Issues

Consider these factors:
— Are there any issues or impacts that are so negative or insurmountable as to rule out privatizing?
— How should a contractor's performance be monitored, and how should a contractor's potential default be mitigated?
— What obligations would the university or the contractor have to current employees?

Compare the Financial Benefit of Contracting vs. Self-Operation

Consider these factors:

Operating the function internally
— Personnel costs
— Building costs
— Equipment costs
— Insurance and risk costs
— Material costs
— Relevant indirect costs

Using an outside vendor
— Payments by the university to the vendor
— Revenue gains or losses attributed to privatization
— Contract monitoring costs
— Conversion costs

Balance Financial Benefits Against Qualitative Factors and Decide Whether to Privatize

Consider these factors:
— Degree of risk associated with contracting-out, such as the potential for lower-quality services, increased prices, legal/financial exposure, and disruption of service
— Effect on university employees
— Effect on the surrounding community

Source: Auditor General staff analysis of privatization literature.

Information needed to select good privatization candidates—To target university services for review, information is needed about the quality and level of a service's current performance. "Benchmark" data that enables the comparison of auxiliaries' performances to their counterparts at peer institutions can provide such information. For example, bookstores at the State's three universities annually benchmark their respective revenues and expenditures against the 61 schools participating in the Western College Bookstore Association Operating Survey. However, such information is not available for other auxiliary services. For example, NAU privatization assessment committee members noted that the lack of adequate benchmark data hampered their ability to assess their student health center. A national expert on auxiliary enterprises also confirmed that national benchmark information is not always available, especially for smaller auxiliaries or internal services. He also noted it can be costly to participate in or gather information for national benchmark efforts.

Despite these difficulties, the universities may still want to attempt to collect benchmark data since it can be valuable not only in assessing privatization potential, but can also improve auxiliary performance. Indeed, the Association for the Study of Higher Education notes that "Benchmarking can be used to evaluate and improve practices." When national benchmarking data is not readily available, universities could share performance information with other universities.

In addition to benchmarking, the universities can also solicit information regarding possible privatization opportunities from vendors of widely privatized services. University officials can contact vendors and solicit informational materials about privatized services, to determine if privatization appears worthy of further investigation. However, it appears that the universities infrequently contact vendors of certain services for such information. For example, even though bookstores are one of the most frequently privatized services nationally, bookstore vendors reported that they had not discussed privatization with the three Arizona universities until recently.

Defining service expectations requires input from campus community—Determining what the universities expect from their auxiliary enterprises is an important step when considering privatization. However, those reviewing auxiliaries for possible privatization may find it difficult to determine what auxiliaries should be doing since some enterprises do not have mission statements or strategic plans. Further, auxiliary enterprises often define for themselves what they should be providing. For example, when the UA recently developed an RFP to privatize its motor pool, it used specifications developed by the current motor pool, including its estimate of the University's enhanced fleet needs. The University did not perform an external analysis to determine whether these specifications will meet its future needs.

Determining what the campus reasonably expects from its auxiliary enterprises could assist the universities when they develop RFPs to ensure that the optimal type, mix, and level of services are specified. If service specifications are set too low or are too general, the university may lose valuable aspects of a current service if privatization occurs. If service specifications are set too high, privatization can perpetuate inefficiencies that currently exist. Indeed, the Council of Higher Education Management Associations notes that auxiliaries "might be incurring higher operating expenses in an attempt to achieve a level of service quality that is beyond their customers' expectations." Auditors found several examples of auxiliaries performing a high level of service that may or may not reflect the university's demands. For example:

- ASU's Store, which is responsible for mailing packages for the campus community, provides free pick-up and wrapping services to campus departments;
- ASU's bookstore provides free gift wrapping to students at Christmas;
- NAU's bookstore delivers books at no extra charge to the Navajo reservation; and
- UA's health services annually provides a $55,000 grant to a campus center that deals with acquaintance rape and relationship violence.

The universities could establish several methods of determining service expectations for their auxiliaries, including performing customer surveys or focus groups, or involving university administrators in the development of mission statements.

Determining privatization's financial benefit requires consideration of all relevant costs— ASU and NAU may have difficulty comparing the financial benefits of privatization versus self-operation since many costs associated with delivering a service are not known. The two universities have not identified the indirect costs, such as utility and payroll preparation costs, associated with delivering auxiliary and internal services. A study UA performed ten years ago suggests that these costs can vary widely. For example, the study found that institutional overhead represented only 3 percent of the bookstore's operating budget, compared to 24 percent in another auxiliary unit.

The universities need to identify the relevant indirect costs associated with an auxiliary enterprise or internal service because a private vendor would also bear such costs. If such costs are not identified, the comparison could be skewed in favor of the internal service provider. Identifying indirect costs also has other benefits, even if the service remains in-house. It can help to ensure that rates charged to internal departments or to students and faculty are appropriate and that the auxiliary enterprise or internal service is financially self-sufficient.

ASU and UA also may have difficulty comparing the financial benefit of privatizing versus self-operated services unless they develop appropriate models for making such comparisons. A model provides a format for identifying costs and revenues, to ensure that all relevant information is considered. NAU has developed a model for making a financial comparison. UA has not developed a model to date, but officials say that they are in the process of developing one. ASU indicates it plans to consider types of cost and revenues identified in Arizona's *Competitive Government Handbook* when comparing an internal versus external vendor's performance. However, ASU also plans to consider the increased welfare costs to the State if privatization is to occur and employees lose their benefits as part of its cost comparison. Such welfare costs may be difficult to estimate and may skew a financial comparison in favor of an in-house vendor.

Policy guidance needed for weighing financial benefits and other factors—The literature on privatization, and past experience in Arizona, suggests that privatization decisions are rarely made based solely on the potential financial gains. Practical and political reality often require some consideration of other factors, such as the impact on employees and the impact on the local community. Staff who conduct privatization studies need policy guidance on the relative importance of these issues. As noted earlier, previous privatization studies performed at NAU and UA have been continued or repeated because institutional leaders did not believe all issues were adequately addressed. To help in developing such guidance, the Board of Regents or its designee may wish to consider the following questions:

- If potential financial gain to the university is the only issue making privatization appear attractive, how much potential financial gain must be possible for a service to be privatized?

  UA's initial study of its bookstore demonstrates the need for guidance in this area. The privatization assessment team determined that privatization should not occur, noting that the only potential benefit appeared to be for a one-time infusion of money to the university. A new study will be performed because UA's leaders believed the initial study placed too much emphasis on retaining the bookstore in-house. However, a UA administrator recently questioned how much financial benefit needs to exist before a service is privatized.

- What role should the potential effect on employees play in a committee's recommendation to privatize a service? Should privatization be attempted if it means that current employees would lose their jobs or their benefits? If services are privatized, should the universities require vendors to hire former employees, even if such a stipulation reduces the university's financial benefit or limits the number of vendors interested in a contract?

  The Council of Higher Education Management Associations states that "The impact on human resources is a major consideration in making the contract management/self-operation decision." Nationally, some universities have chosen to retain functions in-house in order to fulfill commitments to their employees. Similarly, individuals involved in NAU's privatization review process have indicated that it is unlikely that some services will be privatized due to the impact this would have on low-income employees.

- What role should the effect on local businesses play in deciding whether to privatize a service?

  A privatized campus service may compete with other small businesses in a community, prompting challenges of unfair competition, according to the Council of Higher Education Management Associations. Arizona's campuses could face such challenges from neighboring businesses. For example, a UA official reported that local merchants would resist any future privatization of the university bookstore.

  Local community concerns have also affected decisions to contract services in the past. In 1992, UA generated an RFP to consolidate the purchase of travel services, hoping to save money on travel expenses. However, the RFP was challenged by local travel agencies who were apparently concerned that they would lose their share of UA's travel business. The RFP was retracted.

- Should Arizona's universities be on the forefront of privatizing services, or should they lessen the associated risks by privatizing only those services with a successful track record for privatization nationally?

  NAU's privatization assessment team cited concerns with these risks in its recommendation against privatizing health services. Specifically, the team noted the excellent performance of current health center operations, the small number of private student health care centers operating nationally, concern about the financial stability of any potential provider, and the instability of the health care industry as reasons not to privatize health services. NAU's administration rejected the committee's recommendation, citing the desire to consider other factors besides risk before making a final decision. As a result, NAU has issued a Request for Information to identify potential student health service providers.

- How should the universities weigh the risk associated with a vendor delivering lower-quality services against potential financial benefits?

  Some universities nationally have decided not to privatize a service based primarily on how well the current service is performing. For example, the University of New Mexico decided not to outsource its bookstore after noting that privatization might affect service quality.

- What role should the potential effect on the prices students pay play in the decision on whether to privatize? Should contractors be required to keep prices low, even if it affects the potential financial return to the university?

  Officials at each of the three universities have expressed concern that privatization might affect the prices students pay. They note that they have a mandate to keep education as free as possible.

Recommendations

1. The universities should gather information to enable them to determine whether services should be privatized or self-operated. This information should include:

    a. Benchmark information

    b. Information regarding privatization possibilities gained through contacts with vendors of widely privatized services; and

    c. Service expectations for auxiliary enterprises and internal services. The universities should consider using customer surveys, focus groups, or mission statements to ensure service expectations are adequately defined.

2. To ensure that the financial benefits of privatizing a campus service versus maintaining it in-house are adequately compared:

    a. ASU and NAU should identify relevant overhead costs associated with delivering a service internally; and

    b. ASU and UA should use cost models that allow them to compare the financial benefits of delivering a service internally versus externally. Such a cost model should closely approximate the model described in the Appendix (see page a-i) or Arizona's *Competitive Government Handbook.*

3. The Board of Regents should provide policy guidance on the relative importance risk, human resource, and community impact concerns should play when assessing services for possible privatization. In order to help develop such guidance, the Board or its designee may wish to consider the following questions:

    a. If potential financial gain to the university is the only issue making privatization appear attractive, how much potential gain must be possible for a service to be privatized?

    b. What role should the potential effect on employees play on a committee's recommendation to privatize a service? Should privatization be attempted if it means that current employees would lose their jobs or their benefits? If services are privatized, should the universities require vendors to hire former employees, even if such a stipulation reduces the university's financial benefit or limits the number of vendors interested in a contract?

    c. What role should the effect on local businesses play in deciding whether to privatize a service?

d. Should Arizona's universities be on the forefront of privatizing services, or should they lessen the associated risks by privatizing only those services with a track record for successful privatization?

e. How should the universities weigh the risk associated with a vendor delivering lower-quality services against potential financial benefits?

f. What role should the potential effect on the prices students pay play in the decision on whether to privatize? Should contractors be required to keep prices low, even if it affects the potential financial return to the university?

FINDING II

STEPS CAN BE TAKEN TO IMPROVE THE MANAGEMENT OF AUXILIARY ENTERPRISES

All three Arizona universities could improve the way they operate their auxiliary enterprises. First, they should each consider implementing or expanding innovative business practices already occurring at the universities. For example, the use of public-private partnerships could be increased. Second, the universities should standardize purchases of equipment and services because it is more efficient and saves money. Finally, the universities should ensure that long-term capital replacement needs are adequately considered.

Innovative Business Practices Could Be Expanded

The universities should expand innovative business practices used to reduce costs for certain auxiliary enterprises at the three main campuses. By expanding the use of existing cooperative agreements with local communities, schools, or businesses, universities can reduce costs for auxiliary services. In addition, if universities seek grants in areas where other universities have succeeded in obtaining grants, operating expenses can be defrayed.

Additional partnerships can help reduce costs and increase service**—**Arizona's universities have engaged in a wide range of partnerships with local government, business, and the other universities to help cut costs and increase service. Some of the successes at one campus may be replicated at the other universities or in other auxiliary enterprises. For example:

- **Partnerships with local government—**ASU and the City of Tempe formed an intergovernmental agreement in 1994 for free public transportation in the Tempe area. By forming this agreement, ASU avoided a $1 million expense for shuttle replacement, lowered its annual operating costs by 25 percent, and increased the number of students riding the shuttle. The City, which was able to purchase the buses using federal transportation grant monies, also benefits because the shuttle reduces traffic and parking congestion, and gives students better access to downtown merchants. NAU and UA, which currently operate their own campus shuttles, could benefit from a similar agreement with their communities. NAU already has five bus stops on campus for Coconino County public transit buses. In addition, UA and the City of Tucson could build on an existing agreement in which the University subsidizes local public bus passes for students, faculty, and staff, as a means to encourage alternative transportation to and from campus.

- **Partnerships with private companies—**UA and a private developer collaborated on a 1,038-space campus parking structure in 1996. This collaboration allowed for faster construction and saved money for UA because the developer was able to use a design-build method of construction that streamlined the building process, which the University could not do on its own. While UA has found such public-private collaborations beneficial and plans to use these arrangements in the future, ASU has not entered into a design-build partnership with a private developer to build parking structures to date. ASU may wish to explore such an option in the future since there is a substantial need for additional parking both at ASU and in the City of Tempe.

- **Partnerships among the universities—**The three universities have an agreement to purchase furniture and related services from a sole provider. As a result of this agreement, the universities receive a 50 percent or greater discount on purchased furniture, which is guaranteed to meet university specifications. The three universities also have a tri-university agreement to purchase health insurance for students, which lowers individual costs through increased participation. Although interviews with national experts suggest that coordinating multi-university agreements may be difficult, evidence shows that forming additional cooperative agreements might be useful and effective. For example, Ohio State University is developing a purchasing consortium with other Big 10 Conference schools, and also partners with approximately 40 other Ohio public colleges and universities to purchase equipment, paper, and office supplies. Similarly, the University of California and California State University systems cooperatively purchase items such as medical supplies and office equipment.

***Grants can help pay auxiliary expenses*—**UA and NAU's successes in obtaining federal and state grant monies to help pay for some of the campuses' health center programs can possibly be replicated elsewhere. UA's Campus Health Service and NAU's Fronske Health Center have each secured grant monies for prevention and education programs, amounting to over $1.7 million and $35,000, respectively. Grant-funded prevention programs include substance abuse and domestic violence. Also, UA works cooperatively with major private drug companies in collecting data that provides the university with additional monies. UA's success in securing grants and contracts is not related to the University's research hospital, but is a result of UA hiring a full-time employee to seek the many health-related grants available. ASU, whose health center currently receives no grant monies, may be able to defray expenses by obtaining grants. In addition, university auxiliary enterprises, such as music camps, may also be able to obtain grants because of the community services they provide.

Standardized Purchasing Can Improve Efficiency and Reduce Costs

UA and NAU could increase efficiency and reduce costs by adopting or broadening a policy requiring departments to purchase standardized goods and services. ASU currently has a policy in place that requires departments to purchase “common use” supplies and equipment such as computers and copy machines from one or a limited number of predetermined vendors. UA has no such policy in place, and NAU has a policy that extends only to some items, such as printers and computers, but not other items, such as copy machines. As a result, ASU’s purchasing department is able to negotiate better prices with vendors since purchases are made in volume. For example, ASU has a contract with one vendor for the provision of most of the University’s 600 photocopiers. By standardizing the purchase of copiers, ASU has been able to save money in excess of the amounts quoted in the state contract. For example, a popular model of copier purchased through the state contract at $5,999 costs ASU only $4,594. ASU’s standardization policy also ensures that its departments choose copiers that fit their needs, since choices are limited and departments are required to work with Copy Services to choose an appropriate machine.

Evidence suggests that UA and NAU should adopt a standardization policy similar to ASU’s. The American Purchasing Society cites the benefits of centralized purchasing, noting that it provides cost savings through economies of scale. Moreover, it enables knowledgeable buyers to negotiate better agreements with vendors and tailor purchases to department needs. Interviews with private copy machine vendors confirm that cost savings of 10 to 15 percent off prices currently listed on the state contract are possible through such an agreement. A pilot project UA is currently considering to centrally purchase some university copy machines may provide further evidence of possible cost savings.

Auxiliary Services Should Accumulate Greater Financial Reserves for Future Needs

Like other business enterprises, university auxiliaries must adequately plan for future financial needs, such as capital improvements and equipment purchases. Accordingly, auxiliaries need to structure and periodically review the rates they charge and the money they are saving to ensure adequate revenue reserves are accumulated for future expenses. The National Association of College and University Business Officers (NACUBO) believes long-range financial planning is essential to successfully managing auxiliary services, and the foundation of financial planning is adequate funding of equipment reserves.

Most of the campus auxiliary enterprises reviewed do a good job of planning for future needs and accumulating sufficient reserves to pay for service improvements. For instance, parking and transit services at each university incorporate reserves into their budgets each year to fund parking lot maintenance and construction. Bookstores at ASU, NAU, and UA are also good examples of auxiliaries that have successfully reserved substantial revenues for future needs. However, of the six auxiliaries reviewed systemwide, two at UA have not reserved as much money as they could have for future financial needs, and this has negatively affected their ability to provide services. Examples include:

- **The University of Arizona Student Union—**A Board of Regents report has concluded that UA needs a new Student Union. However, according to a UA administrator, poor planning by administrators and the failure to save dining service revenues (a primary revenue source for the union) has left UA with limited options for building. Currently, $14.2 million is needed to address union building code compliance deficiencies alone. An additional $46 million is required to build the type of student union that university administrators believe will meet students' needs. According to a 1997 Board of Regents summary, lack of long-term planning has contributed to the student union's "dysfunctional and deteriorating" condition. Over the years, money from dining services has not been set aside for maintenance or future renovations. While the University would still be facing some need for capital even if routine maintenance was adequately performed and financial reserves were accumulated, it may not have been forced to seek financial support in the form of students paying fees to build the new union, an approach it tried unsuccessfully in 1997.

- **Motor Pool Fleet at the University of Arizona—**Due in part to overly conservative depreciation practices, the UA's Motor Pool fleet is too small to meet departments' rental needs, and continues to diminish in size. Low depreciation rates have contributed to a situation where the Motor Pool does not have sufficient reserves to replace high-mileage vehicles. As a result, the 1993 rental fleet of 135 vehicles has currently been reduced to fewer than 90, with half of these vehicles needing replacement by 1999. Accordingly, UA administrators are now intending to either privatize the Motor Pool, or take out a bank loan to purchase new vehicles. UA may have had the option of replacing more high-mileage vehicles through equipment reserves if depreciation rates had been set appropriately. UA administrators contend that rates were set to comply with a federal requirement that internal services charge actual costs only to federally funded research programs. However, auditors found that rates could have been set higher without jeopardizing federal compliance by using a depreciation schedule that more accurately reflects actual vehicle usage. UA set its rental rates based on an expected vehicle life of eight and ten years; when in fact, high utilization reduced actual vehicle life to approximately five to six years. The UA Motor Pool should have based its depreciation schedules on annual vehicle mileage.

Financial planning guidelines could help university auxiliary enterprises and internal services establish a solid financial base that includes sufficient reserves. Currently, the Board of Regents has no policies that direct universities to develop and accumulate financial reserves for the auxiliaries' future needs. The two UA examples illustrate the need for financial planning guidelines. However, only six of many auxiliaries were reviewed at each university, and other examples may exist where financial reserves are inadequate for the auxiliary's future needs. NACUBO states that even if reserves are not required, "Good business practices indicate that they should be established."

Recommendations

1. Universities should actively encourage and pursue partnership opportunities to operate auxiliary enterprises on campus.

2. NAU and UA should develop and implement standardization policies for purchasing commonly used supplies and equipment.

3. The Board of Regents should direct the universities to develop guidelines for each auxiliary enterprise and internal service regarding the planning and accumulation of adequate financial reserves so that long-term capital needs are addressed as much as possible.

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OTHER PERTINENT INFORMATION

As part of our audit of university auxiliary enterprises, the potential for privatizing two enterprises, bookstores and dining services, was reviewed. As discussed in Finding I (see pages 5 through 14), several factors need to be considered when determining whether to privatize these services. The potential for increased revenue, risks inherent to contracting for services, and the potential effect on public employees and the surrounding community might affect privatization decisions.

Privatizing University Bookstores

Privatizing university bookstores may possibly mean that more money would be returned to the universities than currently occurs, but there are other factors that need to be considered before a decision to privatize is made. While the three university bookstores already return money to their respective schools for future building and student service needs, a private vendor may return more dollars for such purposes. However, the potential for a greater return can only be confirmed after an RFP is issued and proposals are submitted.

***Privatized bookstores have the potential to increase sales*—**University bookstores yield considerable profits for their respective universities. During fiscal year 1996-97, profits amounted to approximately $1.5 million for ASU, $1.7 million for UA, and $121,000 for NAU. These dollars were used for purposes such as scholarships, student programs, and reserves for future buildings. When compared to peer institutions, ASU and UA's profits as a percentage of sales have been high over the past four years.

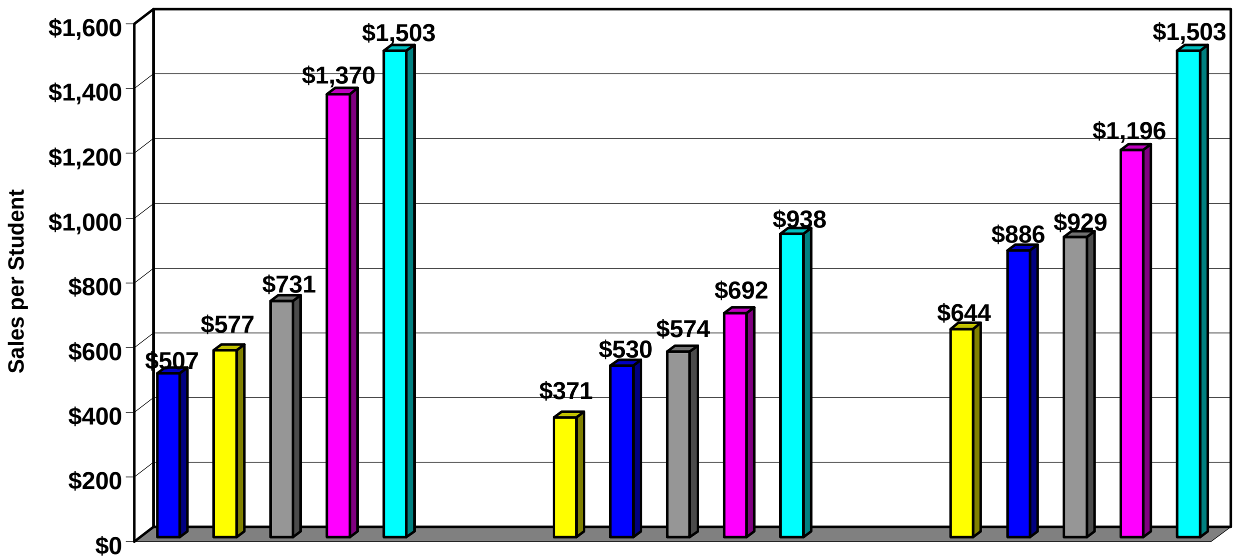
Although profits may be high as a percentage of sales, sales per student at the three universities are low. Therefore, the amount returned to the universities may not be as high as it could be. A comparison of sales per student during fiscal year 1996-97 found that Arizona bookstores had lower sales per student than peer institutions (see Figure 2, page 22). Results were similar during the three previous years.

One factor that may affect the bookstores' ability to realize their sales potential is their limited floor space. Indeed, in fiscal year 1995-96, ASU had the second smallest bookstore, yet the highest enrollment in the PAC 10 Conference. Further, a National Association of College Stores evaluation reported that the UA bookstore's physical size is insufficient to meet the campus community's needs.

However, an even more significant factor affecting sales potential is a statutory restriction affecting bookstores run by the universities. The three institutional bookstores are not allowed to sell many items that peer institutions and privatized bookstores can sell. Arizona Revised Statutes (A.R.S.) §41-2753 and Arizona Board of Regents Policy 1-105 stipulate that:

Figure 2

The Universities: Auxiliary Enterprises
Bookstore Operations
Total Sales per Student
A Comparison of Peers[1]
Year Ended June 30, 1997



Arizona State University and Peers

- University Colorado-Boulder
- Arizona State University
- University California-Davis
- University of Southern California
- University of Washington

Northern Arizona University and Peers

- Northern Arizona University
- University of Wyoming
- University of Nevada-Reno
- New Mexico State University
- University of Montana

University of Arizona and Peers

- University of Arizona
- University of Utah
- University of Oregon
- Brigham Young University
- University of Washington

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[1] Peers were selected in consultation with Arizona university officials and based on regional similarities and size.

Source: Sales per student are self-reported amounts submitted to the Western College Bookstore Association Financial Survey.

> *". . . .the universities shall not… provide to students, faculty, staff or invited guests goods, services or facilities that are practically available from private enterprise except as authorized by the Board [of Regents]."*

As a result, the universities prohibit or limit their bookstores' sales of profitable items such as candy, gifts, greeting cards, logo items, school and office supplies, and general and reference books. A comparison of Arizona's university bookstores to their peers shows that Arizona bookstores' non-textbook sales per student were low for fiscal year 1996-97 (see Figure 3, page 24).

Since privatized bookstores would not face the same statutory restrictions, privatizing the three university bookstores could increase sales. Greater sales, in turn, may mean that more money is returned to the university. Even though contractors retain a portion of bookstore profits, vendors assert that the percentage of gross sales they return to universities may approximate or even exceed the rate currently realized by the universities. Even if percentages remained constant, the schools could receive more money due to the increase in gross sales that a private company could achieve. Nonetheless, the potential for a greater return can only be confirmed after an RFP is issued and proposals are received.

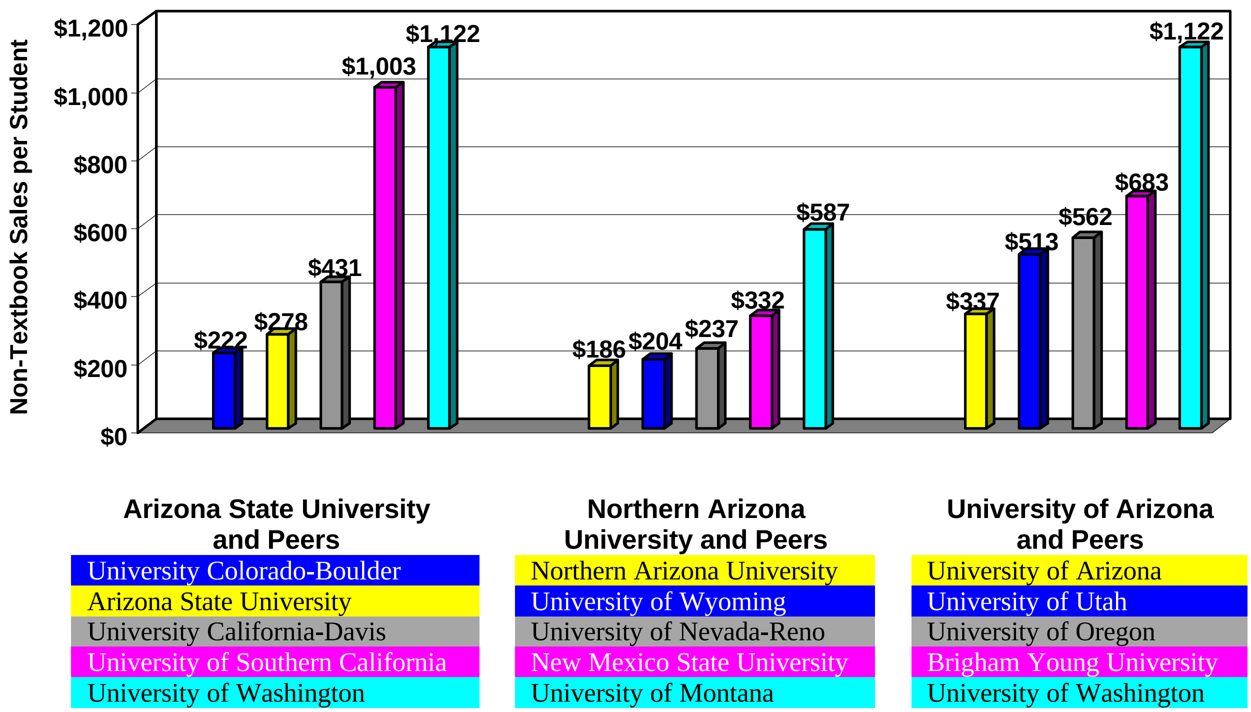
Other factors to consider—While increased revenue is important, it is not the only factor universities should consider when deciding whether to privatize their bookstores. Risks associated with privatizing, local community resistance, and the impact on public employees are other important variables.

- **Risk—**There are three types of risk associated with privatizing bookstores. First, a contractor might default on a contract. This risk appears to be relatively low since bookstores are one of the more widely privatized auxiliaries. In fact, 35 percent of all college and university retail stores are managed by private contract firms. Second, a contractor might deliver lower-quality services. This risk also appears low since universities that contract-out their bookstores appear satisfied with their decision. In fact, *The 1997 Contract Store Management Survey* reports that 92 percent of the 257 college administrators surveyed are very to somewhat satisfied with their private contractor's performance. Faculty members surveyed were also satisfied, although at a lower rate. The survey found that 66 percent of the 536 surveyed were very to somewhat satisfied. While these results suggest that privatized bookstores might be received favorably, it is important to note that Arizona's university bookstores are currently perceived to be performing well by university administrators as well as by peer institutions.

  The third risk associated with privatizing is that it might raise the prices students pay for textbooks. It is unclear how prices would be affected if Arizona's bookstores were privatized. According to *The 1997 College Store Contract Management Survey,* 56 percent of the college administrators surveyed stated that prices remained the same or decreased after the contractor began operating their store. However, the low

Figure 3

The Universities: Auxiliary Enterprises
Bookstore Operations
Non-Textbook Sales[1] per Student
A Comparison of Peers[2]
Year Ended June 30, 1997



1 Non-textbook sales also include general book and medical reference books.

2 Peers were selected in consultation with Arizona university officials and based on regional similarities and size.

Source: Non-textbook sales per student are self-reported amounts submitted to the Western College Bookstore Association Financial Survey.

prices that students currently pay at Arizona's three universities suggest that prices could increase. The bookstores keep prices low by maintaining their textbook margins at or below the industry average. In fact, the gross margin (selling price minus the cost to the store) for new textbooks is only 20 percent at ASU and 23 to 25 percent at NAU and UA. According to one consultant familiar with the bookstore industry, contract-managed stores maintain a 25 percent or higher margin on new textbooks.

To avoid the risk that textbook prices might rise, a contract with a private bookstore provider could stipulate that textbook prices remain constant. According to several private bookstore experts interviewed, this is not uncommon. Because bookstores make most of their money on the non-textbook items they sell, ranging from pens and paper to sweatshirts, keeping textbook prices constant may have little effect on the provider's return to the university.

- **Community effect—**Another factor to consider is the effect that privatization might have on the local community. Critics note that privatized university services may compete unfairly against other local vendors, since privatized university services benefit from operating on campus. Evidence suggests that this may occur if Arizona's universities privatize their bookstores. In fact, a UA bookstore administrator stated that local vendors may attempt to block any privatization attempts.

- **Effect on public employees—**Finally, the effect on university employees should also be considered. Privatizing the bookstores may mean that current bookstore employees lose their jobs. Representatives from other universities' recently privatized bookstores suggest that the effect of privatization on employees is sometimes mitigated by contract provisions. Two recently privatized bookstores have contracts that require the private vendor to retain all university employees for six months to one year. According to the bookstore managers, the bookstores plan to retain these employees beyond the first year. A third bookstore manager stated that the university offered bookstore employees a position with the new company, early retirement, or a transfer to another part of the university.

Privatizing Dining Services at the University of Arizona

Privatizing UA's dining services could improve the University's financial returns, although other important considerations may also influence its decision. Dining Services is one of the largest auxiliaries at all three universities. ASU and NAU have privatized their dining services, while UA's has remained self-operated, except for a brief experience privatizing a small portion of its dining operations two years ago. Evidence suggests that UA could also benefit from privatization, since high labor costs limit dining services' ability to generate revenue for other student union or future building needs. However, other factors need to be considered before privatizing dining services.

UA dining services' high labor costs limit its ability to generate money for other needs— Typically, universities rely on food services to support student union operations. UA's dining services currently generates less revenue for student union needs than the other two state universities' dining services. During fiscal year 1996-97, UA generated approximately $189,000 more in revenue than it expended for dining services, allowing it to support some student union operating expenses. However, ASU and NAU were able to generate more money for their unions through their contracts with private vendors during the same time period. Specifically, during fiscal year 1996-97, ASU and NAU received approximately $700,000 and $1 million, respectively, from their contracted vendors**.** These amounts represent a guaranteed minimum plus a percentage of sales stipulated in contracts with the vendors.

One reason for the low financial returns at UA is high labor costs. According to industry experts, privatized dining service operations generally have lower labor costs than institutionally run operations. In fiscal year 1996-97, labor costs as a percentage of sales were significantly higher at UA (49 percent), than NAU (32 percent), or ASU (37 percent). The high labor costs as a percentage of sales may be attributable in part to UA resuming operation of the Park Student Union food service from a contractor in 1996. However, UA's labor costs as a percentage of sales were also greater during the three previous years, ranging from 45 to 47 percent. These exceed or are at the high end of the food industry's norm of 35 to 45 percent.

While labor costs affect UA's ability to support its student union, two additional factors further limit its ability to generate more money for union operations. First, UA has experienced stagnant sales over the past several years. Low sales may be attributable at least in part to the building's outdated interior, which may not entice students to eat at the union (see Finding II, pages 15 through 19). Second, the type of dining services offered at UA also limits its ability to generate revenue. UA, unlike ASU and NAU, does not offer traditional meal plans. Meal plans, where a student buys a ticket good for a defined number of weekly meals, increase profits because students typically skip some of the prepaid meals. Instead, UA offers only cash / retail food services, while the other two universities offer cash / retail food services in addition to meal plans.

Other factors to consider—As when deciding whether to privatize bookstores, UA also needs to consider the potential risks, effect on employees, and community concerns when determining if it should privatize dining services and should weigh these factors against potential financial benefits.

- **Risks**—The risk that a contractor might prematurely terminate a contract appears relatively low since there are at least 46 providers available nationwide to provide food service operations on university campuses. Moreover, food operations are one of the most frequently contracted auxiliaries, operating about 50 percent of the college/university food service market. Nonetheless, the risk of contractor default does exist. UA unsuccessfully privatized the Park Student Union (the smaller of its two unions) in 1995 with a contracted food service provider. Both sides, however, agreed to terminate the five-year contract in 1996 due to both the University's and the vendor's dissatisfaction with the arrangement. As a result, both the contractor and UA lost large sums of money. UA reimbursed the contractor for capital improvements to the Park Student Union of approximately $297,000.

- **Effect on Public Employees**—The effect on public employees also needs to be considered when assessing whether privatization should occur. UA dining services currently employs approximately 150 full-time workers who could experience job loss or decreased benefits if privatization occurs. The university could choose to stipulate in an RFP and contract that the vendor must retain employees or maintain their current level of benefits. However, this might affect the University's financial return.

- **Community Effect**—The effect on the local community is another important consideration when deciding whether to privatize dining services. Similar to bookstores, a privatized food service operation might compete with local food vendors. Many local businesses could be affected. According to the Arizona Restaurant Association, there are approximately 43 sit-down and fast-food restaurants within a half-mile radius of the UA campus.

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Appendix

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June 30, 1998

Douglas R. Norton, Auditor General
Office of the Auditor General
State of Arizona
2910 North 44th Street, Suite 410
Phoenix, Arizona 85018

Dear Mr. Norton:

This is in response to your letter of June 25, 1998, transmitting a revised preliminary report draft of the performance audit of the Universities' Auxiliary Enterprises. Enclosed also are the universities' responses to the report draft.

The report is well written in general and is comprehensive and balanced in its approach to the complex topic of privatization. I would note that current privatization and partnership efforts of the universities are extensive and widespread. The report notes some of these efforts but we do believe that, in total, it could recognize more explicitly the widespread nature of the initiatives currently undertaken by the universities in this area.

FINDING 1, RECOMMENDATIONS 1-3

The findings of the auditor general are agreed to and the audit recommendations will be implemented.

With regard to recommendation 1.b., we note that the Arizona procurement code may inhibit the gathering of such information from vendors.

FINDING 2, RECOMMENDATIONS 1-3

The findings of the auditor general are agreed to and the audit recommendations will be implemented.

With regard to recommendation 3, we note that the capital needs of some auxiliary enterprises and internal service units may be addressed to some extent through other funding sources available to the universities and that it may not be appropriate to accumulate large financial reserves for such needs.

We appreciate the opportunities provided for us to discuss the preliminary drafts of the report and your offer to include our responses in the text of the published report.

Sincerely,

Frank H. Besnette
Executive Director

c: Arizona Board of Regents
    University Presidents
Encs.

June 30, 1998

Douglas R. Norton, Auditor General
Office of the Auditor General
2910 North 44th Street Suite 410
Phoenix AZ 85018

Dear Mr. Norton:

On behalf of Arizona State University, I am pleased to respond to the performance audit of university auxiliary enterprises. In general, the report presents a balanced analysis of a limited number of university auxiliary enterprises. Therefore, the findings are agreed to and the audit recommendations will be implemented.

Since the related topic of partnership and privatization opportunities is addressed at length in the report, I believe it warrants some additional comment here. As Dr. Besnette correctly observed in his letter, the universities have worked extensively on partnership and privatization opportunities and those efforts were not as fully recognized in the report as they might have been. Arizona State University has been and will continue to be actively engaged in the development of numerous partnership and privatization activities.

Your staff is to be commended for their approach in working with the universities in the development of this report.

Sincerely,

Lattie F. Coor
President

LFC:lv
/p

c: Frank H. Besnette, Arizona Board of Regents

June 30, 1998

Mr. Douglas R. Norton, Auditor General
Office of the Auditor General
2910 North 44th St., Suite 410
Phoenix, AZ 85018

Dear Mr. Norton:

Northern Arizona University appreciates the Auditor General's review of auxiliary enterprises. The review report provides many guidelines to help us review our current operations for efficiency as well as potential outsourcing. We especially appreciate the privatization assessment model and the reference information in the appendix. We also appreciate the willingness of your staff to work with us to refine this report.

The report defines auxiliary enterprises very broadly and examines opportunities not only for contracting our services but also a broad range of partnerships and purchasing practices. We recognize that not all examples could be included within the body of the report. Therefore, we will take the opportunity as we respond to the recommendations to mention things that were not included in the report.

Response to Specific Recommendations:

Finding I Recommendations (pages 13 and 14)

1. The universities should gather information to enable them to determine whether services should be privatized or self-operated. This information should include:
    a. Benchmark information.
    b. Information regarding privatization possibilities gained through contact with vendors or widely privatized services; and
    c. Service expectations for auxiliary enterprises and internal services. The universities should consider using customer surveys, focus groups, or mission statements to ensure service expectations are adequately defined.

NAU agrees with the recommendation and it will be implemented. a. Benchmarking will be used, however, we recognize that benchmarking studies are somewhat skewed because they are generally comparing institutional services and the private sector does not provide similar information. b. Within the guidelines of the Arizona Procurement Code, we will contact vendors and solicit informational materials about privatized services to determine if privatization appears worthy of further investigation. c. We will enhance our current practices by expanding the use of these tools.

2. To ensure that the financial benefits of privatizing a campus service versus maintaining it in-house are adequately compared:
   a. ASU and NAU should identify relevant overhead costs associated with delivering a service internally; and
   b. ASU and UA should use cost models that allow them to compare the financial benefit of delivering a service internally versus externally…

NAU agrees with the recommendation and it will be implemented. a. NAU will develop a methodology to identify those relevant costs associated with delivering a service internally. When a specific enterprise/service is identified for potential privatization, this methodology will be used in addition to other factors to determine if that service should be self-operated or privatized.

3. The Board of Regents should provide policy guidance on the relative importance risk, human resource, and community impact concerns should play when assessing services for possible privatization.

NAU welcomes any guidance in this area the Board is able to provide and will assist the Board as necessary. We appreciate the recognition that in a public enterprise, in addition to cost, other factors must be considered.

Finding II Recommendations (page 19)

1. Universities should actively encourage and pursue partnership opportunities to operate auxiliary enterprises on campus.

NAU agrees with the recommendation and it will be implemented. The discussion in the report leading to this recommendation was much broader than partnerships to operate auxiliary enterprises. We would like to expand on the examples that were included in the report. One addition is to note that NAU is participating with the City of Flagstaff, Coconino County, the Flagstaff Public Schools, and Coconino Community College in a cooperative called the Alliance for the Second Century. The alliance is an effort to promote cooperation in the use of facilities, in contracts, in the purchase and use of large equipment, etc.

The report recognizes NAU's partnerships with the state's community colleges. In particular we would like to note that the partnership in Yuma includes participation in the Yuma Educational Consortium. Other members include Yuma Elementary School District No. 1, the Yuma Union High School District No. 70, and Arizona Western College. The consortium is designed to combine and share programs, resources, services, and personnel to achieve greater lifelong learning opportunities. Specific joint ventures include transportation, telecommunications, computing resources, library and media centers.

2. NAU and UA should develop and implement standardization policies for purchasing commonly used supplies and equipment.

NAU agrees with the recommendation and it will be implemented.

3. The Board of Regents should direct the universities to develop guidelines for each auxiliary enterprise and internal service regarding the planning and accumulation of adequate financial reserves so that long-term capital needs are addressed as much as possible.

The Board of Regents will respond.

Thank you for the opportunity to comment on this report.

Sincerely,

Clara M. Lovett

Clara M. Lovett
President

June 30, 1998

Douglas R. Norton
Auditor General
2910 North 44th Street, Suite 410
Phoenix, AZ 85018

Dear Mr. Norton:

I have reviewed the latest draft report regarding auxiliary services from the Auditor General's team received June 25, 1998. After consultation with the University of Arizona's team of administrators, the University concurs with the findings and recommendations of the report.

I commend your staff for their efforts in assessing an extremely complex subject. I especially appreciate that the privatization review, implementation and evaluation models have taken into account the particular circumstances of each community, i.e. Flagstaff, Phoenix and Tucson.

I also appreciate that your audit team made revisions to the last draft and incorporated some of our suggestions about potential impacts to students. In this regard, I would like to point out that Figure 1, Other Pertinent Information and the Appendix should be revised in order to reflect these changes throughout the report.

Related to this, I believe the report does not effectively acknowledge the role that affordability of higher education in Arizona should have in privatization decisions. As you know, the constitutional mandate for ABOR institutions is to provide college education that is as affordable as possible. Privatization initiatives must be evaluated in the context of this mandate.

Clearly, privatization is a complex subject that must be evaluated carefully in terms of our obligations to a wide array of constituents and stakeholders. This includes students (past, present and prospective) and their parents, University employees, residents of Arizona, the business community, the local community, employers, financial supporters (taxpayers, sponsors, donors, and customers), and others. The University of Arizona fully intends to balance these interests as much as possible as we implement the report's recommendations.

Regarding reserve balance recommendations, I will encourage our auxiliary units to accumulate appropriate, forward looking reserves. Clearly, decisions about reserves should be made in light of each auxiliary unit's circumstances and limitations.

We do want to go on record to say that the auxiliaries at The University of Arizona have explored, and implemented where appropriate, privatization opportunities.

Again, thank you for this opportunity to review and give input into this important audit process.

Sincerely,

Peter Likins
President

APPENDIX

FACTORS TO CONSIDER WHEN REVIEWING UNIVERSITY SERVICES FOR POSSIBLE PRIVATIZATION

As noted in Finding I (see pages 5 through 14), university privatization reviews should include several common steps, as detailed in this Appendix. Determining whether university auxiliary enterprises and internal services should be self-operated or privatized requires:

- Deciding which service functions should be examined;
- Identifying the ideal service specifications;
- Assessing legal, monitoring, risk, and transition issues;
- Comparing the financial benefit of contracting versus self-operation; and
- Weighing the financial benefit of privatization against other factors and selecting an internal or external provider.

While these steps are similar to those outlined in the Arizona *Competitive Government Handbook* for state agencies, literature reviewed, such as publications from The Council of Higher Education Management Associations (CHEMA), The National Association of College Auxiliary Service (NACAS), and studies conducted in other states provide further guidance on how the steps should be carried out in the university environment.

Deciding which functions should be examined—To ensure privatization reviews are cost-effective, universities must begin by targeting functions to review. NACAS indicates that "Almost any service that is provided by colleges and universities has the potential to be privatized." Targeting functions enables universities to limit costly reviews to only those services most likely to benefit from privatization.

Potential privatization candidates can be identified by considering:

- **The current performance of the service**. Good candidates for review include services that need to make changes to satisfy university needs or customer requirements. For example, services that are receiving poor reviews, services with high staff turnover, and services without sufficient volume to justify full-time staff or expensive equipment may be good candidates for privatization. Similarly, auxiliaries that will soon require service expansion or new capital may justify a review.

- **The potential for an outside vendor to perform the service**. Services with multiple financially viable vendors usually make better candidates for privatization than services with limited potential providers. Services that an outside vendor has expressed interest in providing may also be good candidates for review. Other signs of a good candidate include well-definable tasks, identifiable unit costs, and measurable service quantity and quality, enabling universities to monitor service delivery. Conversely, privatization should be avoided when few vendors exist, the marketplace is very unstable, the service is integrally related to the university's academic mission, or the service involves considerable policy discretion.

- **The potential for some benefit to be derived from privatizing**. Services with the potential for improved quality, increased revenue, or decreased costs through privatization are good candidates for review. These candidates include services that: 1) could benefit from economies of scale; 2) could benefit from greater purchasing power; 3) cannot presently maximize the return to the university due to wage or scheduling restrictions, purchasing regulations, or restrictions on what they can sell; and 4) are not currently subject to any competition.

Other campuses' successes with privatizing may provide a good indication that a service should be reviewed. Publications such as the *Privatization Survey Summary*, which is produced by the National Association of College Auxiliary Services, provide information about what types of university services have been privatized elsewhere. Also, information from vendors may alert universities to potential privatization opportunities. This information can be derived through informal contacts with individual vendors, non-binding meetings between a university and potential vendors in which privatization is explored, or through the Request for Information process. These contacts can also help the universities to develop service specifications if an RFP is developed.

***Identifying the ideal service specifications*—**Identifying service expectations is a key step in determining whether a service should be self-operated or contracted. Clearly defined service expectations enable universities to make valid cost comparisons between institutional and private providers and to ensure that they receive the required services from the chosen provider. According to CHEMA:

> *"Before an institution can select the operating approach that will best serve its customers, it needs to have a detailed understanding of the types of services that the functional area should be providing as well as the level of customer satisfaction with the services that are currently provided. The distinction between satisfaction and expectations is an important*

one. Even though a functional area is offering a world-class level of service, it will not be successful unless it is offering the services that customers desire or need. In addition, a function might be incurring higher operating expenses in an attempt to achieve a level of service quality that is beyond its customers' expectations."

To identify what services a functional area should be providing, university review teams should start by examining current auxiliary or internal service operations. According to CHEMA:

"By understanding what the current operation does well and what it does poorly, and more importantly, why it performs the way it does. . . the institution (will) be able to decide which operating alternative offers the best chance of replicating the strengths of the current organization while minimizing its weaknesses."

To assess a functional area's current operations, the following may be reviewed:

- **Financial performance—**A review of the costs to provide a service and the revenue produced by a service historically may indicate where there are opportunities for improvement. Results should be compared to peer institutions.

- **Policies and procedures—**A review of policies and procedures can help to determine whether: 1) policies strike an optimum balance between efficiency and control; 2) current procedures make the best use of employees' time and abilities; 3) there is appropriate emphasis on customer service; and 4) the function operates consistently with industry standards.

- **Qualifications of staff—**CHEMA suggests that an independent party be used to conduct this assessment, such as a comparable manager at a peer institution.

- **Customer satisfaction—**This can be performed in conjunction with customer surveys that determine what functions a service unit should be providing.

- **Condition of infrastructure—**The degree to which infrastructure such as building and equipment can hinder a functional area's ability to provide quality service, minimize costs, and maximize revenues needs to be considered.

Assessing legal, risk, monitoring, and transition issues—Legal and other issues can influence the choice between privatization and self-operation. For example, universities may be restricted from turning over operations of an auxiliary to a vendor if revenue bonds that raised money for a facility specify that it must be self-operated. Conversely, some federal or state regulations may make privatization more attractive. For example, the federal government requires internal service departments to justify rates charged to departments that receive federal grants. Compliance with this mandate can be time-consuming for universities. If a service is privatized, the university does not have to perform such a review.

Any effect on a university's tax liability should also be considered before privatization occurs. For example, if a university contracts-out a bookstore or dining services, it can possibly trigger a federal tax liability. If the university does not play an active management role, any income from the contractor remains tax-free. However, if the university plays a more active management role or is involved in a joint venture with the vendor, then the income the university receives may be taxed by the Internal Revenue Service.

Other liability concerns should also be considered as part of a privatization review. The review needs to consider how each alternative would impact a campus' insurance premiums and the university's level of exposure to possible lawsuits. Such lawsuits can result from on-the-job injuries, on-campus accidents, or from damage suits relating to building or equipment failure.

Before a decision is made whether to privatize a service, it is also necessary to establish a plan detailing how privatized services are to be monitored. Such requirements would ultimately be included in an RFP and would affect the costs associated with monitoring and delivering the service. The plan might include specifications regarding:

- Periodic provider reporting;
- Review of provider reports or records; and
- On-site inspections and customer surveys.

It is also essential to determine what obligations the university or contractor would have pertaining to displaced university employees if a service is privatized. By developing a plan for addressing displaced employees, the university can also estimate how the plan will affect the potential financial benefits of contracting-out. Furthermore, the plan can be used to develop an RFP or contract language requiring a contractor to hire displaced university employees.

Options include:

- Eliminating an auxiliary's existing employees through attrition;
- Requiring a contractor to employ displaced employees (usually for a limited period of time);

- Requiring a contractor to make offers to displaced employees first;
- Buying out displaced employees' service credit;
- Transferring displaced employees to other university positions; and
- Laying off employees.

Developing a plan for potentially displaced employees may help mitigate these employees' concerns about privatization.

In addition to a personnel plan, other issues that might arise if a service is contracted out need to be considered. A plan needs to be outlined for transferring a service from an internal to an external service provider if the university chooses to privatize. Again, such a transition plan may affect any comparison of the financial benefits of contracting versus self-operation. A transition plan should consider:

- How existing capital assets, equipment, and inventories should be handled;
- What new equipment, forms, paperwork, or training will be needed;
- What current contractual or lease obligations have to be stopped, bought out, or transferred to a new contract provider; and
- How the university would redirect existing customers to a new service provider.

***Comparing the financial benefit of contracting versus self-operation*—**To determine whether university auxiliary enterprises and internal services should be self-operated or privatized, it is important to compare the financial benefits of providing a service internally versus externally. Relevant current and future costs associated with running a service internally that should be considered include:

- Personnel costs, including insurance and other benefits;
- Building costs, including land purchases, construction, and depreciation;
- Equipment purchases, leases, depreciation for new and old equipment, and repair costs;
- Insurance and other risk costs;

- Material and supplies costs; and
- Other relevant indirect costs.

The Arizona *Competitive Government Handbook* outlines indirect costs and how they should be calculated.

For outside vendors, present and future revenues that might be realized and costs that university might incur include:

- RFP development costs, including costs associated with developing specifications, disseminating an RFP, advertising, selecting a provider, handling protests, or rebidding;
- Contract development costs;
- Contract monitoring and support costs, including personnel and other costs for compliance review and audit, on-site visits, and customer surveys to ensure program satisfaction;
- Conversion costs, including start-up costs borne by the university; costs or revenues associated with inventory preparation or disposal; data conversion costs; fees associated with terminating leases; and direct university costs associated with the displacement of university workers;
- Possible lost revenues from grants or non-university-provided subsidies associated with the service not being provided by the university;
- Revenue guarantees and other expected financial gains associated with privatization, including estimated tax and lease revenues; and
- Loss of interest income attributed to not maintaining a service internally.

Vendors' cost and revenue information can initially be estimated using information provided informally by vendors or other universities. Such an estimate can allow the university to determine whether an RFP is worth developing. Ultimately, a true comparison of the financial benefit of privatizing versus delivering services internally cannot be determined until an RFP is issued and bids are received. It is essential to spread out conversion costs over time to make any comparison between an outside and internal vendor equitable. Oregon's guidelines for contracting public services state that "A reasonable break-even point of no more than three biennia should be used in deciding if contracting is cost effective. A break-even point beyond six years may be more speculative than your savings will sustain."

Weighing potential financial benefits against other factors—To assess auxiliaries for possible privatization, it is also important to weigh the potential financial gain from privatization against other factors. According to CHEMA, the relative importance that other factors play in selecting an operating model will vary from institution to institution.

A review of literature such as CHEMA's *Contract Management or Self-Operation: A Decision-Making Guide for Higher Education*, the Arizona *Competitive Government Handbook*, and the National Association of State Budget Officers' *Restructuring and Innovations in State Management*, in addition to interviews with Arizona universities' privatization assessment team members, suggests some common factors that should be considered when universities decide whether to privatize a service. The factors include:

- **Risk—**The degree to which contracting-out exposes the university to risks. One type of risk is the potential for contractor default. Those assessing the potential for privatization need to consider 1) whether the chances are high that a contractor might default on a contract, 2) what the consequences would be of any service interruptions; and 3) whether other contractors could provide a service.

  While the risk of contractor default always exists, it can be lessened in a number of ways, including:

  — Writing contract provisions to reduce the risk of service interruption, such as reporting requirements or liquidated damage clauses;

  — Maintaining ownership of capital equipment;

  — Developing a plan to deal with interruption of service;

  — Renting critical equipment and facilities to the private company;

  — Maintaining a list of alternative providers;

  — Requiring a contractor to be bonded; and

  — Slowly phasing in privatization until a contractor is determined to be reliable.

  A second type of risk that needs to be considered is the potential that service quality will deteriorate. Those assessing whether privatization should occur need to determine what effect contracting-out might have on quality, accountability, and responsiveness. As part of such an assessment, steps should also be considered to mitigate any risks associated with decreased quality, such as:

— Placing emphasis on oversight for quality control;

— Developing quality measures for monitoring contractor performance;

— Including language about acceptable quality levels in contracts;

— Building in incentives to providers for quality service;

— Running pilot projects to determine how well the contractor is able to provide services; and

— Requiring that private firms be bonded to ensure adequate performance.

A third type of risk is the degree to which contracting-out exposes the university to any financial and/or legal hazards. One such risk is that students will pay higher prices. As with other risks, the potential for price increases depends on what terms are included in a negotiated contract.

- **Effect on university employees—**Some literature suggests that privatization is not an attractive option if significant numbers of jobs will be lost, benefits will be sacrificed, and wages will be substantially reduced. For example, David Osborn, the author of *Reinventing Government*, states that "If competition saves money only by skimping on wages or benefits, governments should question its value." The American Federation of State, County, and Municipal Employees Union points out that there are "hidden" costs associated with displacing public employees, such as the cost of providing state-funded unemployment benefits and the decreased amount of money such employees will have to spend in the local community.

  However, others note that some public entities choose to privatize services in order to save employee-related costs. For example, a survey of Florida's state agencies found that reduction in labor costs was one of the reasons that services were privatized. Others also note additional benefits can occur from privatization. For example, Florida's Office of Program Policy Analysis and Government Accountability notes that the private sector enjoys increased flexibility in rewarding, motivating, and terminating employees. John D. Donahue, in his book *The Privatization Decision–Public End, Private Means*, notes that while lower-level civil servants sometimes earn less when a service is privatized, senior-level employees may earn more.

- **Effect on the surrounding community**—According to CHEMA, the concerns of the local business community are a factor that needs to be weighed when choosing an operating model. Small-town institutions that have historically been a major employer in the community need to anticipate the community's likely reaction to the introduction of a contract manager. Even if no employees lose their jobs or have their compensation reduced, the institution needs to anticipate how change will be perceived by local government, the press, and community leaders.

In considering the pros and cons of choosing an operating model, CHEMA also notes that is important to consider that contracting–out for a service may result in allegations of unfair competition. National organizations, such as the Business Coalition for Unfair Competition, state that there is no difference between the services a campus performs directly and those it contracts-out.

While the local business community's reactions are important to consider, there may be ways of minimizing adverse reactions to privatized services. CHEMA suggests that universities explore ways that local businesses provide campus services. Also, the University of Arizona has developed a business advisory committee that includes local business representatives as a means of gauging as well as mitigating local businesses' reactions to privatization efforts.

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