CONTENTS

EXECUTIVE SUMMARY

The audit showed that privatization did not result in a $1.6 million savings as predicted by the Commonwealth Health Center (CHC) because the savings prediction did not take into account revenues received while being operated by CHC. Our review showed that in privatizing, CHC is losing about $260,000 per year or $1.3 million over the five-year contract period. The audit also showed that equipment costing $427,717 was sold for $147,662, the net book value which, however, may have no relationship to actual useful life or market value (included was equipment costing $159,054 which was transferred at no cost because it was fully-depreciated for accounting purposes). Furthermore, the privatization of the CHC laboratory resulted substantially in a private monopoly through which the Clinical Laboratories of the CNMI (CL-CNMI) is allowed to control the cost of laboratory services to the public.

INTRODUCTION

This audit was requested by the Chairwoman of the House Committee on Health, Education, and Welfare. The request included an audit of the cost savings and overall financial benefit to the CNMI Government of the privatization of the CHC laboratory. We also reviewed other financial aspects of the privatization including the sale of the CHC laboratory equipment and the effect of the privatization on the cost of laboratory services in the CNMI.

The CHC laboratory was privatized by contracting a private laboratory, the Clinical Laboratories of the CNMI (CL-CNMI), for five years and three weeks beginning on December 11, 1995. Accordingly, the Department of Public Health (DPH) sold the existing laboratory equipment, and office furniture and equipment to CL-CNMI, as well as laboratory supplies, materials, chemicals, and other agents used in testing. In addition, the laboratory space and six units of government-owned housing were leased to CL-CNMI.

The accounting firm of Deloitte & Touche was contracted by DPH to prepare an analysis to assist in the privatization of the laboratory. Deloitte & Touche stated in a letter report that the privatization of the laboratory will create real cost savings of approximately $1.6 million annually, aside from producing new rental revenue on the lease of the laboratory space. The $1.6 million savings consists of laboratory operating expenses which, according to Deloitte & Touche, will be avoided because of the privatization. This audit was made to determine the real financial benefit resulting from privatization of the CHC laboratory to the CNMI Government.

Furthermore, DPH stated in a hearing held earlier this year by the House Committee on Health, Education, and Welfare that the cost of laboratory services under CL-CNMI is probably lower than that of CHC. This audit was also performed to determine the real effect of the privatization on the cost of laboratory services in the CNMI.

The objectives of our audit were to determine whether (1) the privatization of the CHC laboratory resulted in an annual $1.6 million savings as provided by CHC to the House Committee on Health, Education, and Welfare, (2) the laboratory equipment was sold at fair market value, and (3) the privatization will increase the cost of laboratory services in the CNMI.

FINDINGS

Profitability of the CHC Laboratory

Deloitte & Touche reported that the privatization of the CHC laboratory will create real cost savings of approximately $1.6 million per year. In addition, the privatization allowed CHC to generate annual rental revenue of $186,700. Our audit showed, however, that (1) the cost savings is actually a transfer of operating costs to CL-CNMI and a more realistic estimate of such cost transfer is about $1,386,730 per year, (2) privatization did not result in a $1.6 million annual savings because the savings projection did not take into account revenues received while being operated by CHC, and (3) in privatizing, according to fiscal year 1995 records, CHC is losing about $260,000 per year (**Appendix A**), or $1.3 million over five years, the term of CL-CNMI's current contract. This occurred because the decision to privatize the laboratory did not consider the net financial effect of such action on the CNMI Government.

<u>Subsequent Action</u>

After receiving our draft report, CHC made a new estimate showing annual savings of $4,374 after including fiscal year 1994 revenues lost. The correct figure may never be known because records are not available from which a completely accurate computation can be made. The exact figure, however, is not that important. What is important is that full disclosure be made prior to privatizing. It appears to us that revenues were ignored purposely to mislead Government officials into believing that substantial amounts of money are being saved.

Sale of CHC Laboratory Equipment

The laboratory services agreement between DPH and the contractor stated that the laboratory furniture and equipment were to be sold at their assessed fair market value. Our audit showed, however, that (1) the selling price of the laboratory equipment was practically the same amount computed by Deloitte and Touche as the net book value of the items, and (2) much of the laboratory equipment had "0" net book value and, accordingly, was transferred at no cost to CL-CNMI. This occurred because DPH used the net book value in pricing the equipment instead of determining its actual fair market value. As a result, equipment costing $427,717 was transferred to CL-CNMI for $147,662, the net book value which, however, may have no relationship to actual useful life or market value (included was equipment costing $159,054 which was transferred at no cost because it was fully-depreciated for accounting purposes).

Effect of the Privatization on the Cost of Laboratory Services

One of the general goals of privatization should be to ensure that privatization does not cause an increase in the cost of services. Accordingly, the government should not create a monopoly, should promote competition, and should develop a regulatory mechanism to protect against price increases. Our audit showed, however, that the privatization of the CHC laboratory resulted substantially in a private monopoly through which CL-CNMI is allowed to control the cost of laboratory services to the public. This occurred because the contract signed by DPH and CL-CNMI did not provide for any control by DPH over the rates of laboratory tests. As a result, the cost of laboratory services in the CNMI can increase, and for many tests has increased, at the will of the contractor.

RECOMMENDATIONS

Accordingly, we recommend that before proceeding with the privatization of any other operations of CHC, the Secretary of DPH should:

1. Prepare a profit and loss analysis to determine if the privatization will result in an overall financial benefit to the CNMI Government. The analysis should determine if the returns from selling an operation or activity will exceed the returns from government ownership.

2. Establish the fair market value of assets to be sold by determining the actual worth of the items instead of using book values.

3. Establish regulatory mechanisms to control the cost of services being privatized if a private monopoly or near-monopoly environment is being created.

DPH'S RESPONSE AND OPA'S COMMENTS TO THE RESPONSE

In his letter response dated August 12, 1996 (**Appendix B**), the DPH Secretary generally presented arguments against the points raised in the draft audit report. Although the response did not present concise comments to the audit report, we believe that the following are the main arguments by the DPH Secretary:

Profitability of the CHC Laboratory

In the letter response, DPH stated that (1) CHC's operation of the laboratory was not profitable as its recomputation still resulted in a small savings, (2) the privatization resulted in a total first year advantage of $300,573, and (3) the findings of the Office of the Public Auditor (OPA) contained only soft figures and did not provide sufficient hard numbers.

<u>OPA's Comments</u>

The DPH Secretary's response consists mainly of opinions and arguments without accompanying supporting documents. During our exit conference on July 24, 1996, we specifically requested the DPH Secretary to provide OPA with all necessary documents which could support DPH's arguments against the matters discussed in the draft audit report. However, the DPH Secretary's letter response dated August 12, 1996 did not provide any supporting documents to substantiate DPH's comments to the draft audit report. Nevertheless, we analyzed the opinions presented in the response to determine whether the arguments have merit and have revised our report where appropriate.

Regarding DPH's comments to the findings presented in Part 1, OPA concludes that the comments were lacking either in merit or supporting documents. Accordingly, OPA maintains the position that (1) CHC's operation of the laboratory was profitable as our computation showed an annual net profit of $260,019, (2) the privatization did not result in a first year advantage of $300,573 but instead annual net profit of $260,019 was lost, and (3) OPA's figures were reliable as they were based on official DOF expenditure reports and DPH's own records.

In addition, DPH failed to disclose or recognize revenue until OPA made the computation. Regardless of whether OPA's figures are more correct is not nearly as important as the fact that Government officials should be furnished all relevant information not just information favoring and information slanted toward privatization.

Sale of CHC Laboratory Equipment

The letter response indicated agreement with the recommendation to sell assets at their fair market value, however, the response stated that (1) DPH cannot agree that there was a material difference between the fair market value and the net book value of the laboratory equipment, (2) the laboratory equipment had significantly decreased in value and therefore it was prudent not to provide a salvage value for this equipment, (3) the "package deal" arrangement on the sale of the laboratory equipment resulted in a better deal for DPH instead of selling the equipment on a piece-by-piece basis, and (4) DPH does not agree that laboratory equipment should have been leased because CHC would gain no benefit in retaining title to old and obsolete equipment.

OPA's Comments

Regarding DPH's comments to the findings presented in Part 2, OPA concludes that the response generally lacks documents to support DPH's position. Accordingly, DPH's comments do not show a basis to revise the audit findings.

Effect of the Privatization on the Cost of Laboratory Services

In the letter response, DPH (1) did not specifically address the finding that CL-CNMI is a private monopoly but instead DPH emphasized its higher priority to provide quality service, (2) provided various situations where competition can exist, and cost of services can be contained, and (3) stated that it would have been inappropriate and unlawful for DPH to include provisions in the contract to monitor CL-CNMI's fees, or to approve CL-CNMI's fee schedules.

On the issue of monopoly, DPH stated that the delivery system in the CNMI is similar to that of a small hospital in the U.S. farm belt where it is the only facility within a 200-mile radius.

<u>OPA's Comments</u>

Regarding DPH's comments to the findings presented in Part 3, OPA concludes that DPH (1) did not specifically address our finding about the transfer of a government monopoly to a private monopoly, (2) did not provide adequate evidence that competition on laboratory services has existed in the CNMI, and (3) provided legal analysis showing that the CNMI Government cannot control prices of existing private companies unless approved by the Legislature under its police powers, and inappropriately applied that analysis to this instance involving a contract between the CNMI Government and a private company wherein the parties are generally free to contract as they wish.

In addition, from the personal experience of OPA staff members from the U.S. farm belt, there are no places with an area 400 miles in diameter (200-mile radius) in the U.S. farm belt where only one hospital and laboratory is available. This is another example of DPH's over/under statements when its purpose is served.

As for controlling prices, normally the parties to a contract are free to set whatever terms and conditions they agree upon. In fact, the CNMI has existing contracts which contain price controls.

We inquired from officials and a consultant of the Governor's office about the CNMI Government's plans for privatization and were told that a committee was established to consider what should be privatized. Also, we were told that DPH undertook privatization without asking for the committee's consideration and advice. In addition, although DPH has expressed the opinion that it cannot control prices of the CL-CNMI laboratory without legislation, DPH never consulted with or notified the Legislature that such action was necessary. While there appears to be no legislation, policies, or procedures regarding who should make the decisions to privatize, it appears to us that privatization of the CHC laboratory is a more important step than, for instance, contracting out services such as gardening. Accordingly, all concerned parties including the Governor, the privatization committee, and the Legislature should have been, but were not, fully and accurately informed about all aspects.

Accordingly, DPH's comments do not provide a basis for revising the audit findings. However, we revised recommendation no. 3 to require DPH to at least monitor the prices charged by CL-CNMI since the contract has already been signed.

Control Over Privatization in the CNMI should be Established

The question arises as to where the authority to privatize is vested. Here in the CNMI, some may argue that there is broad statutory authority to enter into contracts, thereby privatizing government operations; however, there appears to be no legislation, policies, or procedures regarding who should make decisions to privatize. Information available to us shows that other jurisdictions have addressed the issue in specific terms. For instance, Guam prohibits privatization without legislative approval.

Also, we did not find any CNMI policies, procedures, or regulations setting forth requirements to be met before contracting-out (privatizing) government operations. Information available to us shows that in the U.S. Federal Government, the Office of Management and Budget (OMB) has issued Circular A-76 setting forth a mandatory process for executive agencies to follow when they contract-out to commercial activities, such as a requirement that an existing in-house activity shall not be converted to a private contract on the basis of economy unless the projected cost advantage to the government is at least 10 percent of Government personnel cost. In addition, the U.S. Congress has specifically directed the Department of Defense to give notice to Congress and make certain reports prior to conversion from in-house production to contract.

We believe that legislation establishing authority to decide on privatization of government operations would help ensure that certain objectives of privatization are attained and related matters are addressed. In our opinion, establishing specific requirements helps ensure that relevant information about the privatization, such as cost comparison analysis or profit/loss analysis, is provided to decision makers *before* undertaking any privatization of government operations.

We are providing this information for the Legislature, the Executive branch, and autonomous agencies with a strong suggestion that some control over privatization in the CNMI be established.

STATUS OF AUDIT RECOMMENDATIONS

All three recommendations are open and accordingly, we need additional information to resolve or close these recommendations. The status of recommendations and the additional information required to resolve or close them are shown in **Appendix C** of the audit report.

Introduction

Background

Chairwoman Maria "Malua" T. Peter of the House Committee on Health, Education, and Welfare requested that we review the cost savings and the overall financial benefit to the CNMI Government of the privatization of the CHC laboratory and the effect of the privatization on the cost of laboratory services in the CNMI.

The CHC laboratory was privatized by contracting a private laboratory, the Clinical Laboratories of the CNMI (CL-CNMI), to provide laboratory services to the public and private sectors of the CNMI for five years and three weeks beginning on December 11, 1995. In contracting the laboratory services at CHC, the Department of Public Health (DPH) also sold to CL-CNMI the existing laboratory equipment costing $427,717, as well as expensed office furniture and equipment, for $165,421, and laboratory supplies, reagents, and materials for DPH's purchase cost of $194,078. In addition, the laboratory space, including the pathology post-mortem room, was leased for $143,500 per annum, and six units of government-owned housing were leased for $43,200 per annum, for a total of $186,700 in yearly rental income.

In addition, a letter report prepared by the accounting firm of Deloitte & Touche stated that the privatization of the CHC laboratory will create a real cost savings of approximately $1.6 million annually, aside from producing new rental revenue on the lease of the laboratory space and housing units. The $1.6 million savings consists of laboratory operating expenses which, according to Deloitte & Touche, will be avoided because of the privatization.

Based on the above, DPH was expected to benefit in yearly cost savings and rental income totaling $1,786,700, as well as from the one-time revenue on the sale of the laboratory equipment, furniture, and supplies totaling $359,499. This audit was performed to determine the real financial benefit from the privatization of the CHC laboratory to the CNMI Government.

Furthermore, DPH stated in a hearing held earlier this year by the House Committee on Health, Education, and Welfare that the cost of laboratory services under CL-CNMI is probably lower than it was under CHC. This audit was also performed to determine the real effect of the privatization on the cost of laboratory services in the CNMI.

Objectives, Scope, and Methodology

The objectives of our audit were to determine whether (1) the privatization of the CHC laboratory resulted in an annual $1.6 million savings as provided by CHC to the House Committee on Health, Education, and Welfare, (2) the laboratory equipment was sold at fair market value, and (3) the privatization will increase the cost of laboratory services in the CNMI.

The scope of our audit was limited to the evaluation of the cost savings and rental income on the privatization against the foregone revenues from CHC's discontinuance of its laboratory operations, comparison of the rates of laboratory services before and after the privatization, and review of the laboratory equipment's depreciation schedule prepared by Deloitte & Touche. We reviewed the cost savings computation of Deloitte & Touche and prepared independent cost computations.

As part of our audit, we obtained additional information through interviews with employees of DPH, Deloitte & Touche, and CL-CNMI. Also, we obtained relevant documents and reports from the Department of Finance and at CHC.

Prior Audit Coverage

The Office of the Public Auditor has not audited the CHC laboratory prior to this audit.

Findings and Recommendations

Financial Effect of the CHC Laboratory Privatization

The audit showed that privatization did not result in a $1.6 million annual savings because the savings prediction did not take into account revenues received while being operated by CHC. Our review showed that in privatizing, according to fiscal year 1995 records, CHC is losing about $260,000 per year (**Appendix A**), or $1.3 million over five years, the term of CL-CNMI's current contract. The audit also showed that equipment costing $427,717 was sold for $147,662, the net book value which, however, may have no relationship to actual useful life or market value (included was equipment costing $159,054 which was transferred at no cost because it was fully-depreciated for accounting purposes). Furthermore, the privatization of the CHC laboratory resulted substantially in a private monopoly through which CL-CNMI is allowed to control the cost of laboratory services to the public.

PART 1 - PROFITABILITY OF THE CHC LABORATORY

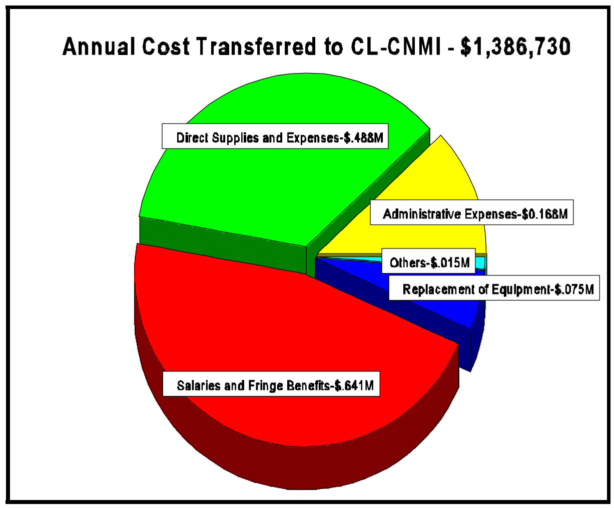
Deloitte & Touche reported that the privatization of the CHC laboratory will create real cost savings of approximately $1.6 million per year. In addition, the privatization allowed CHC to generate annual rental revenue of $186,700. Our audit showed, however, that (1) the cost savings are actually a transfer of operating costs to CL-CNMI and a more realistic estimate of such cost transfer is about $1,386,730 per year, (2) privatization did not result in a $1.6 million annual savings because the savings prediction did not take into account revenues received while being operated by CHC, and (3) in privatizing, according to fiscal year 1995 records, CHC is losing about $260,000 per year (**Appendix A**), or $1.3 million over five years, the term of CL-CNMI's current contract. This occurred because the decision to privatize the laboratory did not consider the net financial effect of such action on the CNMI Government.

Discussion

Prior to the privatization of the CHC laboratory, DPH contracted the accounting firm of Deloitte & Touche to prepare certain financial information and analysis. One of the requirements of CHC was the determination of the operating cost of the laboratory. In its letter report dated December 7, 1995, Deloitte & Touche stated that CHC was incurring $1.6 million annually for the operation of the laboratory which could be avoided if the operation was contracted to a private company.

Our audit showed that the $1.6 million termed as "cost savings" was not a cost savings because it was only an estimate of the operating costs that would be transferred by DPH to CL-CNMI as a result of the privatization. Such cost savings should be more appropriately called transfer of operating cost or simply "cost transfer."

We reviewed Deloitte & Touche's computations for the $1.6 million cost transfer and noted that estimates for some of the operating expenses were higher than actual figures. For instance, the amount of personnel cost was based on budgeted amounts instead of actual expenditures for salaries and fringe benefits. We learned that expenditure reports for fiscal year 1995 were not yet available when Deloitte & Touche made the estimate. Also, the $1.6 million included items which were not avoided by the privatization, such as expenses for utilities and cleaning services. The lease agreement between DPH and CL-CNMI covering the lease of the laboratory space provides that DPH shall continue to pay for utilities, housekeeping and cleaning, garbage disposal, and security services.



To determine a realistic amount of the operating cost that was transferred to CL-CNMI, we identified those expenses which were avoided by privatizing the laboratory based on fiscal year 1995 expenditure reports from the Department of Finance. Our computations show that total annual operating costs of $1,386,730 could be avoided by the privatization. The chart at the right shows the breakdown of the $1,386,730 cost that was transferred to CL-CNMI. Although the computed cost transfer consisted mainly of recurring expenses close to $1.3 million which are directly attributable to the laboratory, it also included about $90,000 in yearly replacement cost of furniture and equipment, and allocated expenses for communications, fuel and lubricants, office supplies, and personnel training.

In privatizing the laboratory, DPH has transferred certain costs and generated rental revenue but it has also lost the revenue from operation of the laboratory. As part of our analysis, we estimated the amount of revenue generated by the laboratory using fiscal year 1995 figures. Based on available information, the laboratory generated a net realizable revenue of $1,833,449 per year. This amount is more than the combined cost transfer and rental income from the privatization of $1,573,430. Therefore, CHC's direct operation of the laboratory was more profitable in terms of overall financial benefit than contracting it to a private company. This resulted in an estimated foregone net income of about

$260,000 per year (rounded off) from the privatization of the laboratory, as shown in the following table.

Particulars		Amount
Net Realizable Revenue from Laboratory Operations		$1,833,449
Less: Cost Transfers		
Expenses Directly Identifiable to the Laboratory	$1,297,093	
CHC Expenses Allocated to the Laboratory	14,637	
Estimated Yearly Replacement Cost of		
Furniture and Equipment	75,000	1,386,730
Estimated Net Profit on the Operation of the Laboratory by CHC		$446,719
Less: CHC's Rental Revenue on the Lease of Laboratory Space		186,700
Foregone Profit on the Privatization of the Laboratory		$260,019

The laboratory services agreement between DPH and CL-CNMI is for five years and three weeks from December 11, 1995. Therefore, the potential loss to the CNMI Government on this contract would be about $1.3 million ($260,000 times five years). The details of the above computation are presented in **Appendix A.**

We believe that the profitability of the laboratory was not a factor in deciding to privatize the laboratory. Based on our discussions with DPH employees knowledgeable about the privatization, DPH proceeded with the privatization without preparing a comparative profit and loss analysis. Furthermore, we were told that the determination of the revenue generated by the laboratory was not a priority when the privatization of the laboratory was being planned.

Subsequent Action

After receiving our draft report, CHC made a new estimate showing annual savings of $4,374 after including fiscal year 1994 revenues lost. The correct figure may never be known because records are not available from which a completely accurate computation can be made. The exact figure, however, is not that important. What is important is that full disclosure be made prior to privatizing. It appears to us that revenues were ignored purposely to mislead Government officials into believing that substantial amounts of money are being saved.

PART 2 - SALE OF CHC LABORATORY EQUIPMENT

The laboratory services agreement between DPH and the contractor stated that the laboratory furniture and equipment were to be sold at their assessed fair market value. Our audit showed, however, that (1) the selling price of the laboratory equipment was practically the same amount computed by Deloitte and Touche as the net book value of the items, and (2) much of the laboratory equipment had “0" net book value and, accordingly, was transferred at no cost to CL-CNMI. This occurred because DPH used the net book value in pricing the equipment instead of determining its actual fair market value. As a result, equipment costing $427,717 was transferred to CL-CNMI for $147,662, the net book value which, however, may have no relationship to actual useful life or market value (included was equipment costing $159,054 which was transferred at no cost because it was fully-depreciated for accounting purposes).

Discussion

Section 3.1 of the laboratory services agreement approved by DPH states that the laboratory furniture and equipment were to be sold to CL-CNMI for a total sum of $165,421, the assessed fair market value of such furniture and equipment.

Our audit showed, however, that the assessed fair market value of the laboratory equipment included in the contract was practically the same amount estimated by Deloitte & Touche as the net book value of the items. Deloitte and Touche computed a net book value of $147,662 on capitalized equipment (those items costing $500 and above) and $17,591 on expensed items for a total of $165,253. The capitalized equipment was depreciated using the straight-line method[1] over estimated life of six years, except for six storage containers which were depreciated over ten years. In addition, according to Deloitte & Touche, the value of the expensed items (those amounting to less than $500) was determined based on judgment and on available catalogs. We did not review the value of the expensed items because it was insignificant compared to the laboratory equipment.

Our review of Deloitte & Touche’s net book value computations showed 61 items of laboratory equipment with total cost of $427,717, which consisted of $159,054 in fully-depreciated equipment and $268,663 in partially-depreciated equipment. The fully-depreciated equipment represents a majority of the 61 items of laboratory equipment as shown in the computation. This equipment was

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[1] The formula in computing straight-line depreciation is: Acquisition Cost minus Salvage Value, divided by Estimated Useful Life. The salvage value is an estimate of the fair value of the item at the end of its estimated useful life. Useful life is frequently a book life which may have to do with accounting practices rather than an actual useful life.

transferred at no cost to CL-CNMI because the net book value computation was used in determining the selling price. We believe that these items should have been sold at some cost because our discussions with an officer of CL-CNMI showed that these items are still being used.

We noted that the straight-line depreciation computed by Deloitte and Touche did not consider the salvage value of the items. Because no salvage value was considered, all the items in the depreciation schedule would eventually have “0" net book value at the end of their estimated book life. Although it is probable that the acquisition cost of $159,054 would not be significantly recovered, the equipment should have been sold at useful life or market value. For instance, an arbitrary recovery rate of 20 percent would have given the CNMI Government $31,810 in additional revenue from the sale of this equipment.

For equipment which was not fully depreciated, the depreciation schedule showed total cost of $268,663 with 45 percent accumulated depreciation, or a net book value of $147,662. This equipment could be undervalued because it was sold at practically half its cost even though most items were purchased from 1991 to 1995.

The laboratory equipment will not revert back to the CNMI Government after the term of CL-CNMI’s contract because DPH has sold them to the contractor. To avoid total loss of the laboratory equipment, DPH should have negotiated a lease with CL-CNMI because in a lease arrangement the CNMI Government retains ownership of the equipment. The government may sell its assets in a privatization process instead of leasing them but it should provide protection against possible undervaluation of the assets. As a protection against undervaluation of assets sold, other governments use “clawback”, which is a practice of sharing in some future profits earned by the private company that took over the assets. A typical clawback may specify that if the private company sells the assets over a certain period at specified amounts, a portion of the proceeds will go to the government.

This situation occurred because DPH used the net book value in pricing the equipment instead of determining its useful life or actual fair market value, and without providing protection against undervaluation of the assets sold. In addition, we believe that a better approach in pricing material assets, such as the laboratory equipment, is by estimating the actual worth of the equipment instead of relying on book values.

As a result, equipment costing $427,717 was sold for $147,662 which was net book value but which may have no relationship to actual useful life or market value. Included in the total cost of $427,717 was equipment costing $159,054 which was transferred at no cost to CL-CNMI because it was fully-depreciated for accounting purposes.

PART 3 - EFFECT OF THE PRIVATIZATION ON THE COST OF LABORATORY SERVICES

One of the general goals of privatization should be to ensure that privatization does not cause an increase in the cost of services. Accordingly, the government should not create a monopoly, should promote competition, and should develop a regulatory mechanism to protect against price increases. Our audit showed, however, that the privatization of the CHC laboratory resulted substantially in a private monopoly through which CL-CNMI is allowed to control the cost of laboratory services to the public. This occurred because the contract signed by DPH and CL-CNMI did not provide for any control by DPH over the rates of laboratory tests. As a result, the cost of laboratory services in the CNMI can increase, and for many tests has increased, at the will of the contractor.

Discussion

One of the general goals in privatizing government services should be that the government ensure that the cost of such services to the public does not increase after privatization. If the service being privatized is a monopoly, it may need to be broken up prior to privatization or regulations may need to be established to protect consumers. A report issued by the U.S. General Accounting Office (GAO) dated December 15, 1995 regarding the privatization practices of foreign governments showed that some governments that privatized monopolies either (1) tried to create competition by eliminating statutes that prevented competitors from entering the market, or (2) broke up monopolies, thereby creating competition. The same GAO report stated that many governments continued to regulate their former monopolies of public services even after breaking them up. The report stated that this was necessary to protect the interests of the consumers by controlling the rates and services. In addition, the report stated that some governments regulate price increases to ensure that increases in the cost of services are no more than-and usually less than-the rate of inflation.

Our audit showed, however, that privatization of the CHC laboratory transferred a government monopoly to CL-CNMI, a private laboratory affiliated with the Clinical Laboratories of Hawaii. Before the privatization took effect on December 11, 1995, the CHC laboratory was the only major provider of laboratory services in the CNMI. Aside from being CHC's only provider of laboratory services, the CHC laboratory also handles the laboratory needs of the Tinian Health Center (THC) and Rota Health Center (RHC) for tests which are not available at those sites. We learned that THC and RHC were issued certificates that allowed them to handle only certain laboratory tests (procedures). There are at least two private clinics on Saipan that provide laboratory services but available testings on site are limited to only a small number of tests compared with the CHC laboratory. There is also one Health Maintenance Organization on Saipan but services, including laboratory services, are provided only to its members. Accordingly, the CHC laboratory has no viable competitor in the CNMI and has, for all practical purposes, a monopoly on laboratory testing in the CNMI.

When the CHC laboratory was privatized on December 11, 1995, DPH knew that the privatization would increase the cost of certain types of laboratory tests. A comparison of CHC's existing laboratory fees with CL-CNMI's proposed fees was conducted by Deloitte & Touche which reported to DPH by letter dated December 7, 1995 that CL-CNMI's proposed rates would minimally increase the cost of laboratory services. Deloitte & Touche estimated that the potential price increase that could result from the privatization would not be more than $1.03 per procedure, on average. In an interview, the Manager of CL-CNMI told us that the proposed rates are the ones currently being charged to patients.

Our comparison of CHC's fees with those of CL-CNMI, however, showed that the majority of the laboratory procedures, where a direct one-to-one comparison between CHC and CL-CNMI rates could be made, would increase after the privatization, with price increases ranging from a few cents to more than $30 per test. Out of the 132 laboratory procedures we compared, CL-CNMI's fees were higher than CHC's on 74 laboratory procedures, 19 of which were higher by at least 50 percent. The privatization also caused the fees of some laboratory procedures to decrease; however, we believe that the overall net effect of the privatization is an increase in the cost of laboratory services in the CNMI. We projected the possible total cost of the 132 procedures using the recorded number of tests for these procedures during the first half of fiscal year 1995. Our projection shows that the increase in total cost of 74 procedures is 12 percent greater than the decrease in the cost of the other 58 procedures.

After CL-CNMI acquired operation of the CHC laboratory, it was also allowed to control the cost of laboratory services to the public, as it has no major competitor in the CNMI and there was no regulatory mechanism to monitor the fees charged to patients. Although the Manager of CL-CNMI stated that an increase in fees is not being planned, we believe that CL-CNMI will eventually increase its fees, especially if significant losses are being incurred for some services. A typical example of such losses involve services to indigent patients since purportedly nobody is denied services at the laboratory. Prior to the privatization, the cost of these services was absorbed by the CNMI government, and consequently by a broad base of taxpayers. With the onset of the privatization, such losses can only be absorbed by increasing the fees charged to paying patients.

This resulted because the contract signed by DPH and CL-CNMI did not provide for any control of the rates of laboratory tests that would be charged by CL-CNMI. The contract only required CL-CNMI to maintain its fees at an "affordable" level, but did not define what is "affordable." In addition, the contract did not include provisions to monitor the fees, such as periodic reports on laboratory rates or consultation with and approval by DPH of proposed increases in fees that will be charged to patients. Since there are no major competing providers of laboratory services in the CNMI, DPH should have established a regulatory scheme to control the cost of laboratory services after privatization.

As a result, the cost of laboratory services in the CNMI can increase at the will of the contractor. In addition, we believe that the cost of laboratory services in the CNMI has increased and will probably increase further as a result of the privatization.

CONCLUSION AND RECOMMENDATIONS

The audit showed that privatization did not result in a $1.6 million annual savings because the savings projection did not take into account revenues received while being operated by CHC. Our review showed that in privatizing, CHC is losing about $260,000 per year (**Appendix A**), or $1.3 million over the five-year contract period. In addition, 61 items of laboratory equipment with total cost of $427,717 were sold for $147,662 (a majority of the 61 items with a total cost of $159,054 were transferred at no cost to CL-CNMI) because in determining their selling price, DPH used net book values which may have no relationship to actual useful life or market value. Furthermore, the privatization of the CHC laboratory resulted in a private monopoly and CL-CNMI was allowed to control the cost of laboratory services to the public.

Accordingly, we recommend that before proceeding with the privatization of any operations of CHC, the Secretary of DPH should:

1. Prepare a profit and loss analysis to determine if the privatization will result in an overall financial benefit to the CNMI Government. The analysis should determine if the returns from selling an operation or activity will exceed the returns from government ownership.

2. Establish the fair market value of assets to be sold by determining the actual worth of the items instead of using book values. To protect the CNMI

Government against undervaluation, DPH could require a share of profits earned by the private company in disposing of the acquired assets.

3. Establish a regulatory mechanism to control the cost of services being privatized if a private monopoly or near-monopoly environment is being created.

DPH'S RESPONSE AND OPA'S COMMENTS TO THE RESPONSE

In his letter response dated August 12, 1996 (**Appendix B**), the DPH Secretary generally presented arguments against the points raised in the draft audit report. Although the response did not present concise comments to the audit report, we believe that the following are the main arguments by the DPH Secretary:

Part 1 - Profitability of the CHC Laboratory

In the letter response, DPH stated that (1) CHC's operation of the laboratory was not profitable and DPH's recomputation still showed a small savings from privatization, (2) the privatization resulted in a total first year advantage of $300,573, and (3) OPA's findings contained only soft figures and did not provide sufficient hard numbers. What follows are the details of DPH's comments to Part 1 of the audit report.

Net Profit or Loss on CHC's Operation of the Laboratory

DPH presented its computation of the estimated annual profit/loss of the CHC laboratory before privatization, which showed a net loss of $4,374 (indicating that CHC's operation of the laboratory was not profitable). DPH showed that by adding its net loss figure of $4,374 and the yearly rental income of $186,700, the annual advantage of the privatization amounted to $191,074.

The $4,374 net operating loss of the CHC laboratory that was computed by DPH differed significantly from OPA's computation which showed a yearly net income of $260,019. DPH presented a different figure for the estimated revenue, allowance for uncollectibles, and estimate of yearly replacement cost of laboratory furniture and equipment.

<u>Estimate of Revenue</u>. DPH argued that OPA's estimated annual revenue of $2.8 million (**Appendix A**) was overstated, specifically that the average unit price of $30 used by OPA in its computation was overstated. DPH believes that the actual average unit price is close to $25, and therefore this unit price was used by DPH in computing its estimated laboratory revenue of $2.4 million. DPH's

estimated revenue was also based on the fiscal year 1994 billing report which showed a total revenue of $2.4 million.

The $25 average unit price was determined by DPH using a simple average of the unit price of the ten most frequently ordered procedures (tests) shown in the fiscal year 1994 billing report. According to DPH, it did not average all the procedures because the less frequently ordered and higher priced procedures tend to skew the average unit price higher. DPH stressed this point by mentioning that the last ranked 181 procedures have an average unit price of $59.76, were ordered 595 times, and totaled $34,070.71.

<u>Allowance for Uncollectible Accounts and Yearly Replacement Cost of Laboratory Furniture and Equipment</u>. Another difference between OPA's analysis and CHC's computation was the higher cost and expenses computed by DPH. DPH computed its allowance for uncollectible accounts (bad debts) at 38 percent of the revenue (which was three percentage points higher than OPA's estimate of 35 percent) to account for Medicare, Medicaid, and others who do not pay the published fees. Also, DPH computed the estimated yearly replacement cost of laboratory furniture and equipment at $150,000 (twice as much as OPA's estimate) to include airconditioning and other major facility repairs and improvements.

Total First Year Advantage

DPH also computed the total first year advantage of the privatization by adding its computed yearly benefit of $191,074 and the one-time revenue on the sale of the laboratory furniture, equipment, supplies and materials totaling $359,499, and by deducting the amounts owed by DPH to outside laboratories amounting to $250,000, for a total first year advantage of $300,573.

OPA's Figures in the Audit Report

DPH, in effect, questioned the reliability of the figures presented in this audit report by stating that OPA's findings contained only soft figures and may be argued either way. According to DPH, OPA's figures do not provide sufficient hard numbers in which a true cost analysis can be arrived at. The response added that neither CHC nor DOF have an acceptable accounting system in place in order to prepare a profit and loss analysis. However, DPH concluded that the operation of the laboratory under the government system was not a break -even venture due to an inadequate accounting system and computer support, among other system deficiencies.

OPA's Comments

The DPH Secretary's response consists mainly of opinions and arguments without accompanying supporting documents. During our exit conference on July 24, 1996, we specifically requested the DPH Secretary to provide OPA with all necessary documents which could support DPH's arguments against the matters discussed in the draft audit report. However, the DPH Secretary's letter response dated August 12, 1996 did not provide any supporting documents to substantiate DPH's comments to the draft audit report. Nevertheless, we analyzed the opinions presented in the response to determine whether the arguments have merit and have revised our report where appropriate.

Regarding DPH's comments to the findings presented in Part 1, OPA concludes that the comments were lacking either in merit or supporting documents. Accordingly, OPA maintains the position that (1) CHC's operation of the laboratory was profitable as our computation resulted in an annual net profit of $260,019, (2) the privatization did not result in a first year advantage of $300,573 but instead annual profit of $260,019 was lost, and (3) OPA's figures were reliable as they were based on official DOF expenditure reports and DPH's own records.

Net Profit or Loss on CHC's Operation of the Laboratory

With regard to DPH's comments to our computation of CHC's profit from its operation of the laboratory, we do not see the need to revise our computation of the estimated annual profit of $260,019 because DPH's comments lack either merit or support. Accordingly, we did not change our estimate of the $2.8 million revenue, 35 percent allowance for uncollectibles, and $75,000 estimate of the yearly replacement cost of laboratory furniture and equipment.

Estimate of Revenue. In computing the laboratory revenue, OPA determined the total of all billable laboratory tests made in fiscal year 1995 which was multiplied by the weighted average unit price[2] of all such tests. The same approach was used by DPH, except that it used the simple average unit price[3] of only the ten most frequent tests. The resulting average unit price for DPH was less than OPA's figure by $5 per test. This was the main reason why DPH's computation resulted in a net loss. However, DPH's preferred method to use the simple average of only

[2] Weighted average unit price was computed by dividing the total dollar value of all the recorded billable tests made during the first six months of fiscal year 1995 by the total billable tests during the same period. The first six months of fiscal year 1995 provided the most recent recorded data.

[3] The simple average unit price was computed by summing up the individual unit prices based on CHC's billing report for fiscal year 1994, divided by the number of items summed.

the ten most frequent tests was not appropriate in estimating the total yearly revenue of the CHC laboratory.

On the computation of average unit price, DPH did not average all the procedures because the less frequently ordered and higher priced procedures purportedly tend to skew the average unit price higher. If such was the case, we believe we have addressed this by using the weighted average method, instead of the simple average method preferred by DPH. The weighted average method, as the term suggests, considers the weight of each item being averaged, in this instance the number of tests for each item. Such factor is not addressed by using simple average because this method considers each item equal in weight.

It was not appropriate that DPH averaged only the ten most frequent tests because the revenue being estimated was not just for the ten most frequent tests but for all billable tests done in fiscal year 1995. There were about 360 items in CHC's billing report, and to average only ten of them was inaccurate. Assuming, for further illustration, that the last ranked 181 procedures mentioned by DPH have extraordinarily high unit prices, excluding them in the weighted average unit price computation results in a $28.46 unit price. This amount is still closer to OPA's $30 unit price than to DPH's $25.

Furthermore, in estimating the revenue, DPH used the fiscal year 1994 billing report in determining the average unit price. OPA's basis, the first six months of fiscal year 1995, was more appropriate because the revenue being estimated was that of fiscal year 1995. Besides, the basis of the revenue should be consistent with the basis of the expenditures which was also that of fiscal year 1995.

DPH believes that its estimate, which was close to the revenue shown in the fiscal year 1994 billing report, was more realistic. However, we would like to point out that CHC's billing report was not reliable, and therefore DPH should not use the billing report as a benchmark in its estimate. According to Deloitte & Touche, laboratory charges were frequently lost or never entered into the billing system. We are not certain how many of fiscal year 1994 billable tests were not included in the billing report. For instance, DPH claims that billable tests in fiscal year 1995 were less than fiscal year 1994; however, billable tests of 94,023 in fiscal year 1995 were actually more than the 84,634 billable tests shown in the fiscal year 1994 billing report.

Allowance for Doubtful Accounts and Yearly Replacement Cost of Laboratory Furniture and Equipment. OPA used a 35 percent allowance for uncollectible accounts in determining the net realizable revenue of the laboratory. DPH increased the allowance for uncollectible accounts by three percentage points to 38 percent; however, it did not establish how the larger percentage was arrived at. Such increase was explained by stating only that it was to account for

Medicare/Medicaid and others who do not pay the published or adjudicated fees. Accordingly, we maintained the allowance for uncollectible accounts at 35 percent. Besides, we believe that 35 percent is a conservative rate since CHC had taken a number of steps to lessen uncollectibles, such as stricter admission standards and the hiring of a collection agency. In addition, privatization should not be used as a means to eliminate a poor collection process, and it remains to be seen if CL-CNMI has a better collection record.

With regard to the yearly replacement cost of laboratory furniture and equipment, DPH did not provide supporting computations for its $150,000 estimate. DPH merely stated that CHC laboratory services would require approximately $150,000 today to expand and renovate its facilities. This figure, we believe, is a one-time expense and therefore should not be included in the estimate of yearly replacement cost. Aside from improvements in laboratory furniture and equipment, we believe there was no pressing need for a major laboratory renovation in case CHC continued to operate the laboratory. We noted that DPH also considered airconditioning repairs in its estimate. Such repairs should be excluded because DPH's contract with CL-CNMI requires that central airconditioning repairs be paid by CHC. Accordingly, we maintained our estimate of the yearly replacement cost of laboratory furniture and equipment at $75,000.

Total First Year Advantage

In determining the first year advantage of the privatization, it was incorrect to include the one-time revenue on the sale of the laboratory furniture, equipment, supplies, and materials totaling $359,499 without deducting the corresponding cost of these items. The laboratory furniture and equipment were sold below cost, and this item had already been reported in Part 2 of this audit report. The laboratory supplies and materials, as mentioned in the laboratory services agreement between DPH and CL-CNMI, were sold at DPH's purchase cost for these items. This would not have an effect on the total financial benefit because DPH was simply reimbursed for its purchase cost. Likewise, the amounts owed by DPH to outside laboratories amounting to $250,000 should not be deducted in determining the total financial benefit because those amounts remain as a CHC's obligation regardless of the privatization.

OPA's Figures in the Audit Report

DPH claims that OPA's findings contained only "soft figures" and did not provide sufficient hard numbers in which a true cost analysis can be arrived at. This comment was made without providing reasonable evidence that the figures reported by OPA were not factual or were clearly erroneous. The issues raised by DPH were either lacking in merit or in supporting documents. Furthermore, DPH did not prepare a profit/loss analysis before privatizing the laboratory, which prompted OPA to use available information to determine whether CHC's laboratory operations resulted in a profit or loss. OPA's profit/loss analysis is reliable because it is based on official documents obtained from DOF, as well as records maintained by DPH itself. Although certain estimates were made, we believe that the result was reliable based on available documents. This shows that a profit/loss analysis can be prepared although DPH claims that an acceptable accounting system was not in place to prepare such analysis. DPH failed to disclose or recognize revenue until OPA made the computation. Regardless of whether OPA's figures are more correct is not nearly as important as the fact that Government officials should be furnished all relevant information, not just information favoring and information slanted toward privatization.

In addition, DPH's claim of an inadequate accounting system and computer support, and other system deficiencies, should not be a factor in determining whether or not the laboratory was a losing venture. We believe that privatization should not be an automatic option in addressing system or operational deficiencies. Privatization may eliminate these problems by passing them on to the private sector; however, the CNMI Government should first study all available options before divesting a government operation, activity or function. In this effort, a profit/loss analysis is needed to determine whether the divestiture will result in an overall financial advantage to the government. For instance, in issuing OMB Circular A-76, the U.S. Office of Management and Budget (OMB) recognized the necessity of preparing a comparative cost analysis before contracting-out government activities. This circular requires agencies to perform cost comparisons and mandates that an existing in-house activity shall not be converted to a private contract on the basis of economy unless the projected cost advantage to the government is at least 10 percent of the in-house personnel-related cost for the performance period. The ten percent margin is added to give consideration to the loss of productivity, the temporary decrease in efficiency and effectiveness, the cost of any personnel retained, temporary operation of facilities at reduced capacity and other unpredictable risks that result anytime a conversion is made. The circular also requires detailed records and documentation to support all elements of the cost study.

Additionally, in a case involving a decision to privatize the food service operations at Fort Knox, the U.S. Court of Appeals upheld governing statutes by deciding that the Secretary of Defense may not contract out services to a private company as a matter of discretion, nor may the decision rest on whether the Secretary deems the contract or the in-house service to cost less; instead, governing statutes require a measurable, objective comparison of costs. (Diebold v. United States, 947 F.2d 787, 789-97 (6th Cir. 1991)).

Part 2 - Sale of CHC Laboratory Equipment

The letter response indicated agreement with the recommendation to sell assets at their fair market value; however, the response stated that (1) DPH cannot agree that there was a material difference between the fair market value and the net book value of the laboratory equipment, (2) the laboratory equipment had significantly decreased in value, and therefore it was prudent not to provide a salvage value for this equipment, (3) the "package deal" arrangement on the sale of the laboratory equipment resulted in a better deal for DPH than would selling the equipment on a piece-by-piece basis, and (4) DPH does not agree that the laboratory equipment should have been leased because CHC would gain no benefit in retaining title to old and obsolete equipment. Following are the details of DPH's comments to Part 2 of the audit report.

Valuation of the Laboratory Equipment

CHC took the position that the net book value of the laboratory equipment is essentially the same as the fair market value. Furthermore, DPH stated that it cannot agree that there was a material difference between the fair market value and the so-called net book value determined for this equipment. The letter response provided a definition of "fair market value" and "net book value."

Salvage Value

DPH stated that it was prudent not to provide a salvage value for the laboratory equipment because (1) this equipment was already obsolete and unrepairable, and (2) the value of the equipment had significantly decreased due to relatively higher age of the items compared to items in other hospitals. Furthermore, DPH claims that if a private company were depreciating the same assets, they would most likely utilize an accelerated depreciation method. DPH added that this would have the effect of reducing the estimated useful life of the equipment to a more realistic three-to-five years.

Package Deal Arrangement

DPH believes that selling the equipment on a piece-by-piece basis would not have yielded any more than the "one-price-for-all" approach taken. DPH added that CL-CNMI would not have purchased some of the equipment had a "package deal" not been arranged for the contract.

Alternative Option to Lease the Equipment

DPH does not agree that the laboratory equipment should have been leased. According to DPH, CHC would assume older equipment at the end of the lease and would gain no benefit in retaining title to obsolete equipment. DPH added that it cannot be assumed that CL-CNMI would lease equipment where it had no control of the service contracts.

OPA's Comments

Regarding DPH's comments to the findings presented in Part 2, OPA concludes that the response generally lacks supporting documents to back up DPH's comments. Accordingly, OPA does not see a need to revise the audit findings based on DPH's comments. However, for discussion purposes, we will comment on the points raised by DPH.

Valuation of the Laboratory Equipment

DPH provided a definition of "fair market value" and "net book value"; however, the letter response did not adequately explain why the net book value of the laboratory equipment is essentially the same as the fair market value. DPH relied on its claim that some of the equipment was obsolete or unrepairable in justifying the transfer of the majority of laboratory equipment at no cost to CL-CNMI. We do not agree with DPH's point because, as mentioned in the audit report, some of the items transferred at no cost to CL-CNMI were still being used by CL-CNMI.

Some of the items in the letter response do not directly relate to the findings in the audit report. We stated in our findings that equipment was transferred to CL-CNMI at net book value which may have no relationship to actual useful life or market value (included was equipment which was transferred at no cost because it was fully-depreciated for accounting purposes). The finding points out only that the valuation method was not proper for determining the actual market value of the items, and does not specifically indicate that DPH would have received more for selling the equipment.

Salvage Value

The letter response did not provide adequate support to show that all the laboratory equipment had "zero" salvage value. DPH stated that several vendors or suppliers were contacted and they commented that the equipment would be worth nothing; however, evidence to show that the equipment was actually worth nothing was not provided to us. Likewise, there was no adequate evidence to show that the zero-valued equipment was worth nothing due to the relatively higher age of the items compared to equipment in other hospitals.

Regarding the use of the accelerated depreciation method, DPH should not confuse the depreciation methods used for accounting or tax purposes with the methods used to determine the actual fair market value of assets. Depreciation for tax or accounting purposes follow certain rules and principles which may have little or no relationship to actual useful life or actual fair market value of assets.

Package Deal Arrangement

We believe that the approach used by DPH to value the laboratory equipment was actually a piece-by-piece basis because each item was individually valued using a straight-line depreciation method. Nevertheless, we would like to point out that valuation of assets, be it a package or piece-by-piece, should be done during the feasibility study stage of privatization, and not after a private company (contractor) had been selected as was the case with the CHC laboratory. Proper planning dictates that before actual divestiture, the government should determine the actual worth of the assets to ensure that the return from selling the assets will be commensurate with the value of the assets being sold. Valuing the assets before selection of a contractor, or even including the sale of the assets in the evaluation of proposals, would give the government a good opportunity to get a better price for the assets.

Alternative Option to Lease the Equipment

OPA's point in mentioning the option to lease the laboratory equipment was the fact that in case DPH decides to terminate or not renew CL-CNMI's contract, DPH has no choice but to find another contractor or have it under government operation again. In case another contractor is not available, DPH would not be able to provide laboratory services unless it buys back the equipment previously sold to CL-CNMI or buy new equipment. DPH would have to negotiate with CL-CNMI to acquire its assets but there is no assurance that the government would get the same deal as the one given to CL-CNMI when it acquired CHC's laboratory equipment, in which most of them were transferred by DPH at no cost.

Part 3 - Effect of the Privatization on the Cost of Laboratory Services

In the letter response, DPH (1) did not specifically address the finding that CL-CNMI is a private monopoly; instead DPH emphasized that it gave higher priority to provide quality service, (2) provided various situations where competition can exist and cost of services can be contained, and (3) stated that it would have been inappropriate and unlawful for DPH to include provisions in the contract to monitor CL-CNMI's fees, or to approve CL-CNMI's fee schedules. The details of DPH's comments to Part 3 of the audit report are presented as follows:

Creating a Private Monopoly

On the issue of monopoly, DPH stated that (1) FHP and Saipan Health Clinic have labs and can provide competition, and (2) the delivery system in the CNMI is similar to that of a small hospital in the farm belt of the U.S. where it is the only facility within a 200-mile radius. DPH believes that quality of service is more important than the issue of whether or not the laboratory is a public or private monopoly. To illustrate this, DPH enumerated certain problems when the laboratory was still under the government, such as excessive cost of tests referred off-island. Also, DPH mentioned the situation of the laboratory under CL-CNMI in which Clinical Labs of Hawaii is used for about 30 percent of laboratory tests.

Situations for Competition and Cost Containment

DPH provided the following situations where competition can exist and cost of services can be contained:

- CHC consciously elected not to do certain procedures in its own laboratory, which presented opportunities for others to enter into the laboratory services market in the CNMI by either locating on-island or by providing service from off-island locations such as Guam and Hawaii.

- The insurance companies will always strive to keep costs down. Thus, Clinical Labs of Hawaii (CL-CNMI's affiliate) will probably negotiate contracts with the insurance companies that define the price and level of service.

- The reimbursement statute of Medicare, in many cases, determines the price list as does competition.

- In the United States, the health care industry is moving toward more Health Maintenance Organizations (HMOs) to contain costs.

Monitoring and Control of CL-CNMI's Fees

DPH does not agree that it would have been appropriate to include cost controls in the contract between DPH and CL-CNMI. According to the letter response, if such controls were required to be included in the contract, DPH may have later been subject to a lawsuit arising from its improper exercise of the state's police powers resulting in violation of CL-CNMI's constitutional rights. It contended that CL-CNMI has the general right to make business decisions free from government interference and restraint, including the right to determine the prices it needs to charge in order to continue in operation and make a reasonable profit. DPH cited a court case which emphasized this principle. Furthermore, DPH stated that the court case made clear that the ability of the government to regulate the prices of a private enterprise is derived through the police power of the Legislature. DPH added that it is this police power which enables the Legislature to establish economic policy and control industry as needed within the state.

DPH acknowledged that, at some time in the future, it may be necessary to specifically control the prices charged by CL-CNMI for laboratory services; however, the decision to control prices will be that of the Legislature, or upon delegation of its power, an executive branch agency authorized to act on behalf of the Legislature. DPH claimed that it did not have the power to establish price controls at the time the laboratory services contract was executed.

OPA's Comments

Regarding DPH's comments to the findings presented in Part 3, OPA concludes that DPH (1) did not specifically address the transfer of a government monopoly to a private monopoly, (2) did not provide adequate evidence that competition on laboratory services has existed in the CNMI, and (3) provided legal analysis showing that the CNMI Government cannot control prices of existing private companies unless approved by the Legislature under its police powers, and inappropriately applied that analysis to this instance involving a contract between the CNMI Government and a private company wherein the parties are generally free to contract as they wish. Accordingly, OPA does not see the need to revise the audit findings based upon DPH's comments. However, we revised recommendation no. 3 to require DPH to at least monitor the prices charged by CL-CNMI since the contract has already been signed. Following is a discussion of OPA comments stated above:

Creating a Private Monopoly

DPH did not specifically address the finding that the privatization of the CHC laboratory transferred a government monopoly to a private monopoly, except for stating that FHP and Saipan Health Clinic can provide competition and that CNMI's delivery system is similar to a small hospital in the U.S. farm belt where it is the only facility within a 200-mile radius. As mentioned in the audit report, there are at least two private clinics on Saipan that provide laboratory services, but available testings on site are limited to only a small number of tests compared with the CHC laboratory. There is also one Health Maintenance Organization on Saipan but services, including laboratory services, are provided only to its members. In fact, the solicitation of proposals from contractors for the operation of the CHC laboratory listed FHP and Saipan Health Clinic as among the clients of the CHC laboratory.

DPH stated that CNMI's delivery system is similar to a small hospital in the U.S. farm belt where it is the only facility within a 200-mile radius. A 200-mile radius is a circle 400 miles wide (diameter). From the personal experience of OPA staff members from the U.S. farm belt, there are no such places. This is another example of DPH's over/under statements when its purpose is served. Nevertheless, since CHC is the only hospital in the CNMI, we believe that DPH should be concerned with the rates charged by CL-CNMI, especially the accommodation of indigent patients. DPH missed the point of our finding by focusing instead on the delivery of quality service. We do not question DPH's concern for quality service; however, DPH should understand the difference when a monopoly is transferred to a private company. Private companies, unlike government agencies, are motivated by profit and operations are conducted in such a way that the company earns a profit. As mentioned in the audit report, prior to the privatization, the cost of certain losses, such as for services to indigents, was absorbed by the CNMI government, and consequently by a broad base of taxpayers. With the onset of privatization, such losses can only be absorbed by increasing the fees charged to paying patients, or by cutting the services to indigents. Recent events have shown that there were instances when CL-CNMI turned away patients because those persons could not afford to pay the cost of services charged by CL-CNMI.

Regarding the quality of service, DPH mentioned that the laboratory under CL-CNMI uses Clinical Labs of Hawaii for about 30 percent of its tests. This shows that the previous practice of sending a significant number of tests to off-island laboratories has not yet stopped. Under the privatized laboratory, such off-island referrals have even increased from 15 percent in fiscal year 1995, as shown in CHC's record of billable tests, to about 30 percent at present. If the cost of services can be reduced by increasing off-island referrals, then perhaps there was no need to privatize the laboratory as CHC had been sending tests to off-island laboratories before privatization.

Situations for Competition and Cost Containment

DPH provided situations where competition could exist and cost of services could be contained; however, there was no evidence provided to us that the situations cited by DPH are existing and have, in fact, contributed to competition and cost containment in the area of laboratory services in the CNMI.

Monitoring and Control of CL-CNMI's Fees

Although DPH stated in the letter response that it did not have the power to establish price controls when the laboratory services contract was executed, this information was not provided to the House Committee on Health, Education, and Welfare during the oversight hearing conducted early this year. We believe that if DPH believed it lacked authority to control the rates charged by CL-CNMI, it should have sought legislative delegation of authority, or at least have informed the Legislature of any Constitutional restriction instead of simply going ahead with the privatization of the laboratory without protecting the public against price increases.

In addition, we inquired from officials and a consultant of the Governor's office about the CNMI Government's plans for privatization and were told that a committee was established to consider what should be privatized. Also, we were told that DPH undertook privatization without asking for the committee's consideration and advice. Furthermore, although DPH has expressed the opinion that it cannot control prices of the CL-CNMI laboratory without legislation, DPH never consulted with or notified the Legislature that such action was necessary.

While there appears to be no legislation, policies, or procedures regarding who should make the decisions to privatize, it appears to us that privatization of the CHC laboratory is a more important step than, for instance, contracting out services such as gardening. Accordingly, all concerned parties including the Governor, the privatization committee, and the Legislature should have been, but were not, fully and accurately informed about all aspects.

Nevertheless, the parties to a contract are normally free to set whatever terms and conditions they agree upon. The cases cited in DPH's response deal with situations where the government seeks to control prices for an existing business operation. The privatization of CHC's laboratory is an entirely different situation where the government is participating in *establishing* a new business. Certainly it is appropriate for a government which is transferring an ongoing business operation to a private company to negotiate and agree upon the terms and conditions under which such transfer will be made, including price controls for the public's protection. In fact, the CNMI has existing contracts which contain price controls.

DPH also stated that it would have been inappropriate and unlawful for DPH to include provisions in the contract to monitor CL-CNMI fees. However, CL-CNMI does have a contract with the Government to provide "affordable" rates. Accordingly, DPH as one of the contracting parties should at least require the contractor (CL-CNMI) to provide DPH the rates being charged to patients at all times and to notify DPH whenever there is an increase in these rates. Such information will be useful to DPH for the solicitation and evaluation of proposals when CL-CNMI's current contract expires.

As for DPH's claim that it lacked authority to control prices, such authority might be derived from its statutory duty to maintain and improve health conditions (1 CMC § 2603(a)). "Broad delegations involving the regulation of economic activity generally are permissible." U.S. v. Williams, 691 F.Supp.36, 48 (M.D. Tenn. 1988).

Control Over Privatization in the CNMI should be Established

The question arises as to where the authority to privatize is vested. Here in the CNMI, some may argue that there is broad statutory authority to enter into contracts, thereby privatizing government operations; however, there appears to be no legislation, policies, or procedures regarding who should make decisions to privatize. Information available to us shows that other jurisdictions have addressed the issue in specific terms. For instance, Guam prohibits privatization without legislative approval. Under the general provisions of the Guam Code, the Legislature has specifically provided:

> No office, department, agency, institution, board, bureau, commission, council, authority, committee of territorial government, branch, or the Guam Visitors Bureau, of the government of Guam may privatize any function, or transfer any real property of the government of Guam, without the approval of the Legislature. Any plan or action taken by an office, department, instrumentality, agency, institution, board, bureau, commission, council, authority, committee of territorial government, branch, or the Guam Visitors Bureau purporting to privatize a any function or transfer any real property of the government of Guam shall be transmitted to the Legislature which, by statute, may amend, approve, or disapprove the plan or the action taken. Any plan or action taken shall have no effect until legislative approval is obtained. (1 Guam Code Ann. § 1800 (1995 Update) (Emphasis added)).

In contrast, we did not find any CNMI policies, procedures, or regulations setting forth requirements to be met before contracting-out (privatizing) government operations. Information available to us shows that the U.S. Federal Government has established specific requirements to be met before privatization can be undertaken. For instance, in the U.S. Federal Government, the Office of Management and Budget (OMB) has issued Circular A-76 setting forth a mandatory process for executive agencies to follow when they contract-out to commercial activities. The circular specifically mandates that an existing in-house activity shall not be converted to a private contract on the basis of economy unless the projected cost advantage to the government is at least 10 percent of Government personnel cost.

In addition, the U.S. Congress has specifically mandated that the Department of Defense follow Circular A-76 in its contracting-out process. In 10 U.S.C. §2461, the Defense Department was directed to give notice to Congress and make certain reports prior to conversion from in-house production to contract. This provision specifically requires a detailed summary of the cost comparison study which shows that the government will save money by contracting-out.

We believe that legislation establishing authority to decide on privatization of government operations would help ensure that certain objectives of privatization are attained and related matters are addressed, including cost savings and the real effect of privatization on the financial position of the government, valuation of assets to be sold, control over the cost of services, and efficiency in providing services, among other issues.

In our opinion, establishing specific requirements helps ensure that relevant information about the privatization is provided to decision makers *before* undertaking any privatization of government operations. Such requirement can help avoid privatization that proves unwise and costly. Such relevant information includes a cost comparison analysis or profit/loss analysis which shows that contracting-out a government operation will save money either through cost savings or avoidance of losses.

We are providing this information for the Legislature, the Executive branch, and autonomous agencies with a strong suggestion that some control over privatization in the CNMI be established.

STATUS OF AUDIT RECOMMENDATIONS

All three recommendations are open; accordingly, we need additional information to resolve or close these recommendations. The status of recommendations and the additional information required to resolve or close them are shown in **Appendix C** of the audit report.

Appendices were not bound in this electronic version of the report. Please contact the Office of the Public Auditor to request for a copy should you need them.