AUDIT REPORT

CITY OF NEW YORK
OFFICE OF THE COMPTROLLER
BUREAU OF MANAGEMENT AUDIT
WILLIAM C. THOMPSON, JR., COMPTROLLER

Audit Report on the Process by Which The Department of Education Awarded a Vending Machine License to the Snapple Beverage Group

ME04-123A

March 18, 2004

THE CITY OF NEW YORK
OFFICE OF THE COMPTROLLER
1 CENTRE STREET
NEW YORK, N.Y. 10007-2341

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WILLIAM C. THOMPSON, JR.
COMPTROLLER

To the Citizens of the City of New York

Ladies and Gentlemen:

In accordance with the Comptroller's responsibilities contained in Chapter 5, § 93, of the New York City Charter, my office has reviewed the processes by which the Department of Education awarded a vending machine agreement to the Snapple Beverage Group, Inc. and authorized Octagon, Inc. to serve as its marketing agent.

The results of our audit, which are presented in this report, have been discussed with Department of Education officials, and their comments have been considered in the preparation of this report.

Audits such as this provide a means of ensuring that City resources are used effectively, efficiently, and in the best interest of the public.

I trust that this report contains information that is of interest to you. If you have any questions concerning this report, please e-mail my audit bureau at audit@comptroller.nyc.gov or telephone my office at 212-669-3747

Very truly yours,

William C. Thompson, Jr.

William C. Thompson, Jr.

WCT/fh

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The City of New York
Office of the Comptroller
Bureau of Management Audit

Audit Report on the Process by Which the Department of Education Awarded A Vending Machine License To the Snapple Beverage Group

ME04-123A

AUDIT REPORT IN BRIEF

This audit of the New York City Department of Education (DOE) reviewed the processes by which DOE awarded a vending machine agreement to the Snapple Beverage Group, Inc. (Snapple) and authorized Octagon, Inc. (Octagon) to serve as its marketing agent.

In June 2003, DOE informed the schools that all existing vending machines selling beverages should be removed by the beginning of the 2003-2004 school year to allow for a centralized vending process. DOE centralized the vending process due to a new Chancellor regulation (Regulation A-812) on the nutritional content of the food and beverages being sold to students and the need for better controls over vending arrangements. In addition, DOE had an interest in establishing a concession and sponsorship arrangement with a beverage company.

On June 23, 2003, DOE, based on a request for proposals (RFP) issued in 2001, signed an interim authorization for Octagon to serve as DOE's agent for a vending machine marketing and administration program. On behalf of DOE, Octagon implemented a vendor selection process in July and August to select a beverage company for the school vending machine opportunity.

On September 9, 2003, DOE signed an interim agreement giving Snapple the exclusive right to sell water and 100 percent juice products in vending machines to be installed in the New York City public schools. The agreement guaranteed that Snapple would pay a minimum of $40.2 million to DOE between September 1, 2003 and August 31, 2008. Also on September 9, 2003, the New York City Marketing Development Corporation (MDC) signed a letter of intent with Snapple for the exclusive right to sell water, iced tea, and chocolate drink beverages in vending machines to be installed in City buildings. This agreement guaranteed that Snapple would pay a minimum of $126 million to the City between January 1, 2004 and December 31, 2008.

Audit Findings and Conclusions

The process that the Department of Education followed in awarding Snapple an exclusive vending machine opportunity in about 1,200 City schools was fundamentally flawed. For example, there were minimal solicitation efforts, an inadequate request for proposals package, and a defective bid evaluation and selection process. In addition, although DOE's process for choosing the marketing agent to implement the vendor selection process for the school vending machine opportunity was generally adequate from the announcement of the marketing RFP through to the selection of an agent, the process became questionable in that the ownership of the significant party of the selected marketing agent changed before it was authorized to work for DOE. Furthermore, Octagon, the agent subsequently authorized to handle the marketing of the vending machine opportunity, stands to realize exorbitant compensation for its services.

Audit Recommendations

To address these issues, we make 10 recommendations, among them that DOE should:

- Not pursue a school vending machine contract with Snapple in connection with the completed vendor selection process. Rather, DOE should conduct a new process for this opportunity that complies with its own *RFP* manual and ensures a fair and reasonable result.

- Ensure that any concession and sponsorship opportunities be handled through a well-structured request for proposals process in which there is: extensive public notification of potential bidders; an RFP package presenting detailed specifications and clear standards for evaluating the proposals; a pre-proposal conference to ensure that all bidders receive consistent information about the opportunity; and a written assessment of the competing proposals based on the evaluation standards identified in the RFP.

- Either reopen an RFP process or, at the very least, require a revised proposal before entering into an agreement with a company that has experienced a change of ownership after being selected through an RFP process. DOE should also prepare a written justification for entering into an agreement with such a company.

- Restructure and greatly reduce Octagon's compensation for its marketing and administration work on the school vending machine opportunity.

- Not award any new marketing assignments to Octagon in relation to the 2001 marketing RFP.

- Before hiring a marketing agent for similar work in the future, seriously consider the benefits of implementing the concession and sponsorship RFP process itself or of seeking the assistance of other City agencies.

Department of Education Response

On February 6, 2004, a draft response was sent to DOE officials with a request for comments. We received a response from DOE officials on February 24, 2004. In its response, DOE challenged many of the audit's findings and recommendations. We address the full scope of DOE's response in a section entitled "Discussion of DOE Response" that we present at the end of this report. The full text of DOE's response is included as an addendum to this report.

INTRODUCTION

Background

Over the years, the principals of many New York City public schools developed arrangements with a variety of independent companies to supply vending machines with an assortment of beverages. These arrangements led to concession payments by the independent companies to the individual schools that were used for a variety of purposes, such as to support extra-curricular activities. The Department of Education did not track the total amount of concession income the schools received through such arrangements.

In June 2003, DOE informed the schools that all existing vending machines selling beverages should be removed by the beginning of the 2003-2004 school year to allow for a centralized vending process. DOE centralized the vending process due to a new Chancellor regulation (Regulation A-812) on the nutritional content of the food and beverages being sold to students and the need for better controls over vending arrangements. In addition, DOE had an interest in establishing a concession and sponsorship arrangement with a beverage company.

On June 23, 2003, DOE, based on a request for proposals issued in 2001, signed an interim authorization for Octagon to serve as DOE's agent for a vending machine marketing and administration program. On behalf of DOE, Octagon implemented a vendor selection process in July and August to select a beverage company for the school vending machine opportunity.

On September 9, 2003, DOE signed an interim agreement giving Snapple the exclusive right to sell water and 100 percent juice products in vending machines to be installed in the New York City public schools. The agreement guaranteed that Snapple would pay a minimum of $40.2 million to DOE between September 1, 2003 and August 31, 2008. Also on September 9, 2003, the New York City Marketing Development Corporation signed a letter of intent with Snapple for the exclusive right to sell water, iced tea, and chocolate drink beverages in vending machines to be installed in City buildings. This agreement guaranteed that Snapple would pay a minimum of $126 million to the City between January 1, 2004 and December 31, 2008.

New York State Education Law authorizes the Schools Chancellor to establish DOE contract rules. As a result, DOE is not required to adhere to the New York City Procurement Policy Board (PPB) rules or the Franchise and Concession Review Committee (FCRC) rules other City agencies must follow. The Chancellor's rules are presented in DOE's *Standard Operating Procedures for Schools and FMCs* (Financial Management Centers) and in its *Procedures for Preparing Request for Proposals*.

Objectives

The objectives of this audit are to determine whether DOE followed appropriate processes in awarding a vending agreement to Snapple and in authorizing Octagon to serve as its marketing agent.

Scope and Methodology

The period covered by this audit is calendar years 2001 through 2003.

To gain an understanding of the processes by which DOE entered into a marketing agreement with Octagon and a vending agreement with Snapple, we reviewed relevant State laws, decisions issued by the State Education Commissioner (*Decision No. 14,489*) and the State Comptroller (*Opinion 92-5*), DOE's *Standard Operating Procedures for Schools and FMCs*, DOE's *Procedures for Preparing Request for Proposals,* and documentation relating to DOE's requests for proposals for the marketing and the vending machine agreements. This documentation included the RFPs, vendors' bids, DOE's evaluations of these bids, and related correspondence, including e-mail communications. We also interviewed numerous DOE and City officials, marketing agents (including Octagon), beverage companies (including Snapple), and vending machine companies. Based on our review of this information, we determined whether the selection processes for the marketing and vending agreements complied with DOE's *Procedures for Preparing Request for Proposals,* and whether the selection process for the vending agreement also complied with State Comptroller's *Opinion 92-5 and* State Education Commissioner's *Decision No. 14,489*. We also analyzed all the bids submitted by vendors in response to the marketing and vending opportunities, as well as DOE's evaluation of these bids. In addition, we analyzed Octagon's evaluation of the bids received in connection with the vending machine opportunity.

Independence Disclosure

Chapter 5, § 93, of the New York City Charter authorizes the Comptroller to

> "audit and investigate all matters relating to or affecting the finances of the city, including without limitation the performance of contracts and the receipt and expenditure of city funds."

Chapter 5, § 93, also states:

> "No contract or agreement executed pursuant to this charter or other law shall be implemented until (1) a copy has been filed with the comptroller, and (2) the comptroller has registered it."

The Comptroller has designated the Deputy Comptroller for Policy, Audit, Accountancy and Contracts as the executive responsible for overseeing the functions that fulfill these statutory requirements. These functions include the Bureaus of Audit and the Office of Contract Administration.

The Bureaus of Audit (which include the Bureau of Management Audit and the Bureau of Financial Audit) are responsible for conducting audits in accordance with Chapter 5, § 93, of the New York City Charter and the generally accepted government auditing standards (GAGAS) issued by the United States General Accounting Office. The Bureaus of Audit, which together serve as a separate and distinct component of the Comptroller's Office, have developed their own internal *Audit Policy and Instruction Manual* to ensure that all audits are conducted in accordance with GAGAS. The manual (which was recently revised in accordance with revisions to GAGAS) requires that each auditor annually recertify their awareness of and compliance with GAGAS independence requirements. This certification is intended to inform and remind our audit personnel of the extreme importance of both the fact and appearance of professional independence and the steps to be taken should a potential impairment become apparent.

The Office of Contract Administration is responsible for reviewing all contracts, contract amendments, leases, and concessions between City agencies and vendors to determine whether the agreement should be registered. The Comptroller publicly recommended that the Department of Education cancel the Snapple agreement on October 30, 2003 (prior to the initiation of this audit). The Office of Contract Administration was responsible for the review leading to that recommendation.

The United States General Accounting Office revised its government auditing standards in June 2003. In that revision, GAGAS § 3.03 states: "In all matters relating to the audit work, the audit organization and the individual auditor, whether government or public, should be free both in fact and appearance from personal, external, and organizational impairments to independence."

We have complied with the above standard in conducting this engagement. We wish to note that the Bureau of Management Audit had no involvement whatsoever in the review of the Snapple issue that was conducted by the Office of Contract Management, a separate unit of the Comptroller's Office that is independent of the Bureaus of Audit.

The Bureau of Management Audit and, more specifically, the audit professionals who conducted this engagement were not instructed by anyone in the Comptroller's Office to include or exclude any findings. Members of the audit team met with responsible City, DOE, and Octagon officials, as well as representatives of all of the beverage companies that bid on the vending opportunity, to obtain their perspectives on the process; carefully reviewed all of the documentation received from these officials and representatives; and followed all GAGAS standards in conducting this audit, including those relating to staff independence, staff qualifications, supervision, planning, audit documentation, evidence, and reporting.

This audit was conducted in accordance with generally accepted government auditing standards and included tests of records and other auditing procedures considered necessary. The audit was performed in accordance with the audit responsibilities of the City Comptroller as set forth in Chapter 5, § 93, of the New York City Charter.

Discussion of Audit Results

The matters covered in this report were discussed with DOE officials during and at the conclusion of this audit. A preliminary draft report was sent to DOE officials on January 23, 2004, and was discussed at an exit conference on February 4, 2004. We submitted a draft report to DOE officials on February 6, 2004, with a request for comments. We received a response from DOE officials on February 24, 2004. In its response, DOE challenged many of the audit's findings and recommendations. The full text of DOE's response is included as an addendum to this report. We review DOE's response in a section entitled "Discussion of DOE Response" that we present at the end of this report.

FINDINGS AND RECOMMENDATIONS

The process that the Department of Education followed in awarding Snapple an exclusive vending machine opportunity in approximately 1,200 City schools was fundamentally flawed. For example, there were minimal solicitation efforts, an inadequate request for proposals package, and a defective bid evaluation and selection process. In addition, although DOE's process for choosing the marketing agent to implement the selection process for the school vending machine opportunity was generally adequate from the announcement of the marketing RFP through to the selection of an agent, the process became questionable in that the ownership of the significant party of the selected marketing agent changed before it was authorized to work for DOE. Furthermore, Octagon, the agent subsequently authorized to handle the marketing of the vending machine opportunity, stands to realize exorbitant compensation for its services.

Department of Education Process for Awarding an Exclusive Vending Machine Opportunity Was Fundamentally Flawed

The DOE process for awarding an exclusive vending machine opportunity to the Snapple Beverage Group was fundamentally flawed. In addition, DOE failed to properly monitor the marketing agent it selected to implement the vendor selection process. Consequently, all aspects of the vendor selection process were substantially deficient in that:

- there were minimal solicitation efforts;
- there was an inadequate request for proposals package;
- there was no pre-proposal conference;
- there were inconsistent explanations to potential bidders about the scope of the opportunity; and
- there was a defective bid evaluation and selection process.

A properly managed vendor selection process requires extensive solicitation efforts, a comprehensive explanation of the opportunity in a request for proposals package, a pre-proposal conference, consistent explanations to potential bidders about the scope of the opportunity, and a well-documented and reasoned bid evaluation and selection process.

The Department of Education is not required to follow the City's PPB or FCRC rules. New York State Education Law authorizes the Chancellor to establish DOE contract rules. The Chancellor's rules are presented in DOE's *Standard Operating Procedures for Schools and FMCs* and in its *Procedures for Preparing Request for Proposals* (*RFP* manual). In addition, the State Comptroller issued an opinion in 1992 (*Opinion 92-5*) on the placement of privately owned vending machines on school property. This decision stated that although "the granting of a license or concession is not subject to the competitive bidding requirements of General

Municipal Law, . . . it is the duty of public officials to let out such contracts under terms which are fair and reasonable (emphasis added)." The decision further stated that "competition should be solicited by proposals or quotations prior to the granting of licenses or concessions." Further, in a November 13, 2003 letter to the New York City Comptroller, the City Law Department stated that legal opinions from the State Comptroller and State Education Commissioner advised that "school districts follow a request for proposal process to select a vending machine operator (emphasis added)."

However, DOE did not follow a request for proposal process. At the February 4, 2004 exit conference, DOE officials told us that this was a new and unique effort that did not require a request for proposals process because DOE was not procuring goods or services. The officials characterized the process as a solicitation of partnership offers. As a result, DOE officials said that its marketing agent did not need to follow the DOE *RFP* manual. Furthermore, DOE officials stated that their plan was to turn the responsibility for the process over to the marketing agent, which did not need written guidance on how to proceed. However, a private marketing agent, even one well versed in private sector marketing, needs close oversight when handling the marketing of a public sector opportunity. In awarding business opportunities, the public sector environment requires a heightened commitment to both the reality and perception of fairness that the private sector typically does not demand. Therefore, we concluded that DOE should have used its *RFP* manual to guide this process. We evaluated the vendor selection process in terms of the guidelines presented in the *RFP* manual.

Minimal Solicitation Efforts

Octagon made minimal efforts to solicit bids for this opportunity. A DOE official informed us that he instructed Octagon to contact as many beverage companies as possible for the purpose of soliciting bids. The DOE *RFP* manual states that "a well-planned solicitation effort should be undertaken to identify as many qualified vendors as possible." In addition to sending solicitation letters to these vendors, the manual states that the contract opportunity should be advertised in the *City Record* (a City government publication) and "in other newspapers and periodicals . . . [to] increase competition, broaden participation and target specific audiences." However, Octagon did not send any solicitation letters to possible vendors and did not advertise the school vending machine opportunity in any way. By telephone, Octagon contacted two beverage companies—Coca-Cola and PepsiCo. Coca-Cola ultimately decided not to place a bid. Pepsi placed a bid along with five other beverage companies—Veryfine, Apple & Eve, Nestle, Florida's Natural, and Snapple. None of these five companies was contacted by Octagon. All of these companies heard about the opportunity from beverage industry contacts, most of whom were local vending machine operators. Representatives of Apple & Eve told us that they only became aware of the opportunity on August 14, 2003, one week before the best and final offers (BAFOs) became due.

Inadequate Request for Proposals

Octagon's RFP for this opportunity was inadequate. The DOE *RFP* manual states that the RFP should contain "a complete description of the required service(s)" and provide "the established criteria that will form the basis for the evaluation and the requirements that must be met." The request for proposals package prepared by Octagon was not a clear explanation of the opportunity, but rather a bulleted outline for an oral presentation that provided general background information, listed sponsorship options, and supplied very limited data about the vending opportunity. A clear explanation of the opportunity would have presented detailed specifications and the criteria by which the proposals would be evaluated. For example, the package did not specify which beverages could be placed in the vending machines to be located in the student areas. Octagon informed beverage companies later that they should limit their bids to a combined fruit juice and water bid, a fruit juice only bid, or a water only bid.

As another example of the lack of clarity in the RFP package, after listing the numbers of existing vending machines in the student areas of high schools, middle schools, and elementary schools, which totaled 2,450 machines, and the number of vending machines in "faculty only" areas as 550, the next bulleted item read "2,500 – 3,000 total vending machines." Octagon and DOE officials claim that this range represented the maximum number of vending machines for juice and water products that the schools could accommodate. Octagon told us that they explained to the potential bidders that the range stated in the package was an upper limit because they wanted to leave room for additional vending machines for snacks and milk products. A senior DOE official, contradicting Octagon on this point, told us that the upper limit on the number of machines that the schools could accommodate was kept a secret during the bidding process so that it could be used to evaluate the bids.

Only one company (Veryfine) told us that it was informed that the 2,500-3,000 range represented a maximum number of machines that DOE would allow in the schools. All other companies (including Coca-Cola, which participated in the request for proposals process but declined to place a bid, and Snapple itself) told us that they did not realize that this represented an upper limit on the amount of machines that could be placed in the schools. Some thought that this range reflected an estimate of the opportunity. Snapple thought that the range represented a minimally acceptable amount. Another company actually indicated in its bid that it wanted to place 3,500 machines in the schools, clearly confused that the range indicated in the package was an upper limit.

In another example of the RFP's lack of specificity, the RFP did not indicate the number of years that the company would be awarded the exclusive right to sell beverages in school vending machines. Bidders presented offers for different time periods, ranging from five to 10 years. This complicated the process of ranking the financial offers received.

In addition to concerns that the RFP was vague and confusing, it also appears in one important respect to have been poorly researched. The RFP developed by Octagon contained certain provisions that appear to be inconsistent with New York State education policy. In a State Education Commissioner's decision issued on November 30, 2000 (*Decision No. 14,489*), the Commissioner stated that "the Commissioner of Education has consistently sought to protect school children, who attend public schools by reason of the compulsory attendance law, from exploitation through the sale of commercial products." The Commissioner also stated that school boards, in considering concession agreements, should "carefully consider whether the commercial aspects of such contracts are acceptable influences on their students, and should thoughtfully negotiate and structure such agreements to minimize the potentially negative impact of such commercial influences on children." In that decision, the local school board was ordered not to distribute free products from the vendor to its students on school property.

However, Octagon's RFP package referred to the provision of "sampling rights at all general use facilities," such as cafeterias and gymnasiums; "six pages of advertising" in student planners to be distributed to all middle and high school students; and "725 outdoor [basketball] backboards . . . for sponsorship and corporate identity." The RFP package estimated that the student planners and the backboards would make 97.2 million corporate identity impressions on students over the course of one year. The package also offered logo placements in general use facilities for an additional 134.2 million corporate identity impressions per year. Coca-Cola told us that the plan for such an extensive display of commercial messages aimed at school children was "appalling." Snapple itself refused the student planner, backboard, and logo placement opportunities as part of this deal, selecting instead the options to sponsor athletic events and physical education programs.

In another indication that the RFP was faulty, Coca-Cola informed us that it found that specific information about the opportunity was so lacking that it notified Octagon on August 21, 2003 that it would not place a bid.

No Pre-proposal Conference

Octagon did not hold a pre-proposal conference. The DOE *RFP* manual states that a pre-proposal conference, while not mandatory, should be held if the "size, complexity and sensitivity" of the opportunity warrants. The size of this opportunity and the apparent bidder confusion over various aspects of it clearly suggest that a pre-proposal conference would have been appropriate. The *RFP* manual further states that "following the conference, all questions and answers should immediately be transcribed, put in written addendum form and mailed out to all potential proposer(s) known to have received the RFP."

In this case, the lack of both a pre-proposal conference and a post-conference letter providing questions and answers added confusion to the process. Each potential bidder met and communicated separately with Octagon, and many apparently developed different understandings about the opportunity. For example, even though the RFP package stated that vending machines selling other beverages, including soda, could be placed in teacher lounges, three of the five beverage companies that submitted losing bids informed us that Octagon told them to exclude the teacher lounge areas from their bids. Octagon told the other two companies to include the teacher lounge areas in their bids, which the companies did.[1]

[1] On September 9, 2003, DOE issued a formal request for bids (RFB) for an opportunity to provide beverage machines in teacher lounges. This opportunity, which involved no concession income and was to be awarded based on the lowest per unit price, was merely an extension of an existing contract by the DOE Office of Purchasing Management. However, the September 9, 2003 agreement between DOE and Snapple guaranteed that Snapple would be provided "a minimum of 500 exclusive cold beverage vending machine placements in faculty/employee lounges." DOE officials told us that these contradictory actions were simply a case of one DOE unit not knowing what another DOE unit was doing. DOE opened the sealed bids for the teacher lounge vending opportunity on October 2, 2003. However, on October 10, 2003, after DOE realized the mistake, it canceled the vending RFB for teacher lounges.

Defective Bid Evaluation and Selection Process

The bid evaluation and selection process for this opportunity was defective. Whereas the *RFP* manual states that those on the selection committee should complete rating sheets on the bids received and that a summary sheet showing each evaluator's scores should be prepared, none of this was done. In addition, DOE did not prepare either a written ranking of the proposals or a written justification of the selection of Snapple.

Based on discussions with Octagon, DOE, and MDC officials, one of the major reasons that Snapple was selected for this opportunity appears to be the perceived appeal of the Snapple brand to students. These officials did not present any market study to justify this perception. Since the selected company would have an exclusive opportunity to sell its beverages in the school vending machines, any actual student preference for one brand over another could be of less significance. In any event, the importance of any perceived appeal of the Snapple brand is clearly reduced by the fact that Snapple did not have a 100 percent fruit juice beverage at the time that it placed its bid, and it did not have a well-known water product. Other beverage companies that placed bids had a variety of well-established and market-tested 100 percent fruit juice and water products available for the schools. Snapple's new 100 percent juice products were introduced in the New York City schools in October 2003 without ever having been market tested elsewhere. In addition, Snapple offered only 12-ounce containers of fruit juices for the elementary, middle, and high schools; one of Snapple's competitors was able to offer a variety of container sizes that could be geared to children of different ages.

Another important reason for the selection of Snapple was the Citywide vending opportunity. It appears that by August 20, 2003, the City was seriously considering linking the DOE vending deal to a Citywide vending opportunity. Such a linkage would presumably favor larger companies, such as Pepsi, Nestle, or Snapple (as a subsidiary of Cadbury Schweppes), that could handle a larger deal and provide a wide range of beverages for non-student consumers. On August 20, 2003, the Deputy Chancellor for Finance and Administration e-mailed MDC (with a "cc" to the DOE General Counsel) that a meeting involving DOE, Octagon, and MDC on August 25, 2003, "would give you [MDC] a basis for evaluating a larger deal." Early on August 21, 2003, before the best and final offers were due, the DOE General Counsel responded to the Deputy Chancellor with a cautionary e-mail, stating that: "It's called a good deal for just DOE. Who cares about citywide if he gets a good deal for schools only?" In an August 22, 2003, e-mail from Octagon to DOE, Octagon stated that "if Pepsi wants city wide deal, let them guarantee the schools the maximum offer we got from other companies." A senior MDC official told us that Snapple was a better choice than Pepsi for the Citywide opportunity for non-carbonated beverages because it preserved the chance to issue an RFP for a Citywide carbonated beverages opportunity for which major beverage companies could compete. The official noted that Snapple could "live with Coke or Pepsi" as co-vendors for the Citywide vending opportunities, but it would be less likely that Coca-Cola and Pepsi would agree to serve as co-vendors.

The beverage companies' best and final offers[2] were required by August 21, 2003.[3] Snapple's financial offer was one of the lowest. As shown in Table I, Snapple's bid was the lowest combined juice and water bid placed by an individual company, was lower than three juice only bids, and was lower than three possible combinations of juice only and water only bids placed by different beverage companies. (As noted above, Octagon informed beverage companies that they had the option to submit a combined fruit juice and water bid, a fruit juice only bid, or a water only bid.) In comparison to the other bids received, Snapple provided a low annual guaranteed commission, and, unlike other vendors, it did not offer a placement fee for the privilege of placing its vending machines in the schools.

Table I
Comparison of Best and Final Offers (as of 8/21/03)

(1) Beverage Company*	(2) Beverage Category	(3) Number of Vending Machines	(4) Average Annual Guaranteed Commission	(5) Annual Guaranteed Sponsorship	(6) Annual Placement Fee	(7) Total Annual Guarantee as Determined by Comptroller's Office (Cols. 4+5+6)	(8) Total 5-Year Guarantee as Determined by Comptroller's Office (Col. 7 x 5 years)	(9) Total 5-Year Guarantee as Determined by Octagon
A	Juice & Water	2000	$ 5,800,000	$ 2,000,000	$ 80,000	$ 7,880,000	**$39,400,000**	**$ 39,400,000**
B	Juice	2050	$ 5,250,000	$ 2,000,000	$ 609,800	$ 7,859,800	**$39,299,000**	**$ 39,299,000**
C	Juice	1500	$ 5,308,800	$ 1,580,000	$ 750,000	$ 7,638,800	**$38,194,000**	**$ 30,000,000**
D	Juice & Water	3500	$ 5,140,000	$ 1,125,000	$ -	$ 6,265,000	**$31,325,000**	**$ 31,325,000**
E	Juice	2000	$ 4,800,000	$ 1,200,000	$ 80,000	$ 6,080,000	**$30,400,000**	**$ 30,400,000**
Snapple	Juice & Water	2500	$ 2,880,000	$ 3,000,000	$ -	$ 5,880,000	**$29,400,000**	**$ 33,000,000**
F	Water	1500	$ 1,500,000	$ 505,000	$ 245,000	$ 2,250,000	**$11,250,000**	**$ 15,000,000**
POSSIBLE COMBINATIONS OF JUICE ONLY AND WATER ONLY BIDS								
F & B	Juice & Water	3550	$ 6,750,000	$ 2,505,000	$ 854,800	$10,109,800	**$50,549,000**	**$ 54,299,000**
F & C	Juice & Water	3000	$ 6,808,800	$ 2,085,000	$ 995,000	$ 9,888,800	**$49,444,000**	**$ 45,000,000**
F & E	Juice & Water	3500	$ 6,300,000	$ 1,705,000	$ 325,000	$ 8,330,000	**$41,650,000**	**$ 45,400,000**

* One company placed two bids, one for juice only and another for juice and water.

As also shown in Table I, we determined that Octagon miscalculated three of the bids received, including the bids from beverage companies C and F, and the bid from Snapple. Snapple offered an annual guaranteed commission of $3.6 million for the second through the fifth years, but no guaranteed commission for the first year, for an average of $2.88 million per year over the five years. Octagon misinterpreted the bid as offering an annual guaranteed

[2] Each bid offered commission payments, which would be based on a percentage of sales, and sponsorship payments, which would support DOE athletic and physical fitness activities.

[3] The beverage companies provided preliminary offers at various stages of the process prior to the call for their best and final offers.

commission of $3.6 million for each of the five years. For beverage company C, Octagon, in its comparison of the BAFO bids received, used an earlier company bid rather than the company's best and final offer. For beverage company F, Octagon inappropriately included the $3.75 million value of the vending machines the company would install in the schools as part of the company's bid.

In an e-mail to DOE dated August 22, 2003, Octagon described Snapple's best and final offer as not being the highest. Octagon, DOE, New York City Marketing Development Corporation, and Law Department officials met on August 25, 2003, to discuss the received bids. On August 26, Octagon and MDC officials informed DOE that they recommended that Snapple be selected for the schools vending opportunity. Later that day, DOE informed Octagon that DOE concurred with these recommendations. On August 27, 2003, Octagon and MDC officials traveled to Snapple headquarters in White Plains, New York, to meet with Snapple officials. During this meeting, Octagon encouraged Snapple to improve its bid, presumably to exceed the bids provided by its competitors, and informed Snapple that it had been selected for the school vending opportunity. Octagon, MDC, and Snapple officials told us that after Octagon discussed the schools deal, the MDC official outlined a possible Citywide vending deal to Snapple that would be based on the schools deal.

As shown in Table II, Snapple's bid for the school vending opportunity rose from $29.4 million on August 21, 2003, to $40.2 million by the time post-BAFO negotiations were completed sometime between August 27, 2003, and September 9, 2003. Only Snapple was given the chance to engage in post-BAFO negotiations. The DOE *RFP* manual states that DOE "reserves the right to . . . re-open negotiations after the BAFO procedure, if it is in the [DOE's] best interest to do so." The manual explains that such negotiations should be held with those whose proposals "fall within a competitive range," or with the vendor who submitted "the overall best proposal or alternate." However, in this case, DOE engaged in post-BAFO negotiations with only one company, and this company had submitted one of the lowest offers. In addition, according to a senior MDC official, only Snapple was given the opportunity to also consider a Citywide deal.

Table II
Change in Snapple's Proposal

	Best and Final Offer as Determined by Comptroller's Office	**Best and Final Offer as Determined by Octagon**	**Terms of Interim Agreement**
Proposal Dates	August 21, 2003	August 21, 2003	September 9, 2003
Annual Guaranteed Sponsorship	$ 3.0 Million	$ 3.0 Million	$ 3.0 Million
Annual Guaranteed Minimum Commission			
Year 1	-	*$ 3.6 Million*	*$ 4.5 Million*
Year 2	*$ 3.6 Million*	*$ 3.6 Million*	*$ 4.5 Million*
Year 3	*$ 3.6 Million*	*$ 3.6 Million*	*$ 5.4 Million*
Year 4	*$ 3.6 Million*	*$ 3.6 Million*	*$ 5.4 Million*
Year 5	*$ 3.6 Million*	*$ 3.6 Million*	*$ 5.4 Million*
Average Annual Guaranteed Minimum Commission	$ 2.88 Million	$ 3.6 Million	$ 5.04 Million
Total Annual Guarantees	**$ 5.88 Million**	**$ 6.6 Million**	**$ 8.04 Million**
5-Year Guaranteed Sponsorship	$ 15.0 Million	$ 15.0 Million	$ 15.0 Million
5-Year Guaranteed Minimum Commission	$ 14.4 Million	$ 18.0 Million	$ 25.2 Million
Total 5-Year Guarantees	**$ 29.4 Million**	**$ 33.0 Million**	**$ 40.2 Million**

Even though the new $40.2 million offer beat all of the August 21st bids from individual companies, three possible combinations of juice only and water only bids placed by different companies, as shown in Table I above, would have led to total offers ranging from $41.7 to $50.5 million.

In terms of the number of vending machines that the companies would install in the schools, only one company, as previously noted, understood that the 2,500 to 3,000 range provided in the RFP represented the maximum amount that the schools could accommodate. Snapple thought this was the minimum amount. Consequently, other than Snapple, only the one company that understood the significance of this range met this standard. In addition, one of the possible combinations of two companies' bids (one for water only, the other for juice only) called for a total of 3,000 machines in the schools. DOE's position that it was appropriate to conceal the significance of this range to facilitate the evaluation of the received bids defies logic. DOE would have been better served by clearly explaining to the beverage companies any limits on the number of vending machines that could be installed in the schools. The companies would have adjusted their bids accordingly. Rejecting bids for failing to meet a standard that the bidders were not aware of, and very possibly would have been able to meet, only served to further limit competition for this opportunity.

No Contract in Place for over Six Months

Even though Snapple had been installing vending machines in the schools since September 2003, there was still no contract between DOE and Snapple until February 19, 2004. Neither the interim agreement signed on September 9, 2003, nor the February 19, 2004 contract has been sent to the Comptroller's Office for registration. The interim agreement itself left many questions unanswered. For example, the means by which Snapple would provide and service the vending machines was not addressed. Snapple chose to provide its own vending machines, rather than use local vending machine operators.[4] In addition, DOE's concern that the number of machines that can be installed through this opportunity not exceed 3,000 is not stipulated in the interim agreement. As noted above, Snapple informed us that it considered the 2,500-3,000 range noted in the RFP to represent a minimum, not a maximum number of machines. Also unexplained is the means for tracking and auditing beverage sales—the basis for Snapple's concession and sponsorship payments to DOE.

In addition, the cost of providing electricity or additional electric lines to service the machines is not addressed in the interim agreement. A recent vending machine and sponsorship RFP issued by the New York City Health and Hospitals Corporation (HHC) stipulated that "the chosen vendor shall pay to the Corporation a flat rate of $25.00 a month for each vending machine . . . to cover the Corporation's electric cost." If Snapple paid this amount for the minimum of 2,500 machines mentioned in the interim agreement, Snapple would need to pay an additional $750,000 per year to DOE. The interim agreement also contained no information about when principals could expect to receive money for their extra-curricular activities to replace the funds that were lost when existing relationships with local vending machine companies were terminated. Further, the prices that Snapple could charge for beverages after the 2003-2004 school year were not specified.

When DOE provided its written response to our draft report on February 24, 2004, it also provided us with a copy of its February 19, 2004 contract with Snapple. We discuss this contract in the "Discussion of DOE Response" section presented at the end of this report.

* * *

In light of all these concerns, we conclude that the fundamentally flawed DOE vendor selection process was neither fair nor reasonable, and did not ensure that the New York City schools received the best offer for the school vending opportunity. A better process could have led to additional and higher bids. A more careful review of the bids that were received could have led to a more lucrative deal for DOE and its schools. A process that is perceived to be fair would enhance public faith in the results and would very likely increase participation in future

[4] This adversely affected many local vending machine companies, several of which had longstanding relationships with a number of schools.

RFPs for similar ventures. Therefore, considering the substantially deficient vendor selection process for this opportunity, DOE should discontinue its contract negotiations with Snapple and conduct a new process that complies with the *RFP* manual and ensures a fair and reasonable result.

Recommendations

1. The Department of Education should not pursue a school vending machine contract with Snapple in connection with the completed vendor selection process. Rather, DOE should conduct a new process for this opportunity that complies with the *RFP* manual and ensures a fair and reasonable result.

DOE Response: "We decline to follow the recommendation that the Department should not pursue a school vending machine contract with Snapple. The process used to solicit offers for a marketing partnership with a beverage company was a fair and open process designed to obtain competitive proposals and resulted in a fair and reasonable agreement."

Auditors' Comments: The fundamentally flawed selection process that DOE allowed Octagon to follow was neither fair nor open. There were minimal solicitation efforts, an inadequate request for proposals package, and a defective bid evaluation and selection process. Since we made this recommendation in the draft report, DOE has signed a contract with Snapple. We believe that DOE should cancel its school vending machine contract with Snapple and conduct a new process for this opportunity that complies with the *RFP* manual and ensures a fair and reasonable result.

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2. The Department of Education should ensure that any concession and sponsorship opportunities be handled through a well-structured request for proposals process in which there is: extensive public notification of potential bidders; an RFP package presenting detailed specifications and clear standards for evaluating the proposals; a pre-proposal conference to ensure that all bidders receive consistent information about the opportunity; and a written assessment of the competing proposals based on the evaluation standards identified in the RFP.

DOE Response: "We decline to follow the recommendation that any concession and sponsorship opportunities be handled through a request for proposal process. Because this was not a purchase agreement, Octagon was not obligated to follow the RFP procedures outlined in the Department's Standard Operating Procedures Manual. The RFP by which Octagon was retained did not require it to use such a process. The process to select Snapple was fair and reasonable. The agreement with Snapple creates unprecedented incremental revenue to the Department. We also disagree with this recommendation to the extent it seeks to mandate a strict, formulaic process to enter into concession and sponsorship opportunities. The Department will continue to assure that any process for entry into such opportunities is an open and fair process and achieves fair and reasonable compensation for the Department."

Auditors' Comments: Even though Octagon was not obligated to follow a formal RFP process, DOE should have established a procedure for its marketing agent to follow to ensure that the public interest was protected. Without any guidelines, Octagon, a private sector marketing agent, was given wide latitude to create its own process. This is a concern because, in awarding business opportunities, the public sector environment requires a heightened commitment to both the reality and perception of fairness that the private sector typically does not demand. In addition, a well-structured process could have led to more and better bids, and a more lucrative deal for DOE and its schools.

RFP Process for Selecting Marketing Agent Was Generally Adequate, But Became Questionable When Ownership of the Significant Party of the Selected Vendor Changed Prior to Interim Authorization

DOE's process for choosing the marketing agent to implement the vendor selection process for the school vending machine opportunity was generally adequate from the announcement of the marketing RFP through to the selection of an agent, but became questionable in that the ownership of the significant party of the selected marketing agent changed before it was authorized to work for DOE. DOE failed to require the new owner either to revise the selected agent's proposal or to make an oral presentation explaining how the new organization would meet its responsibilities.

In 2001, the Department of Education (then known as the Board of Education) issued a request for proposals seeking a vendor that would serve as its marketing agent for the schools. The process for selecting the marketing agent generally complied with the *RFP* manual. DOE prepared a standard RFP and advertised the opportunity in several newspapers, such as the *City Record*, the *New York Times*, and the *Wall Street Journal*. DOE also solicited bids from 274 vendors. In addition, DOE conducted a pre-proposal conference and then distributed a letter providing answers to questions asked at the conference. Further, a DOE committee evaluated the proposals and prepared a written justification of its selection.

DOE received three bids as of the required submission date of December 15, 2001. DOE officials have told us that one of the bids was quickly rejected because it was clearly not responsive to the RFP. Although the DOE *RFP* manual indicates that bid evaluation documentation should be kept for six years from the date of the contract award, DOE was unable to provide us with copies of this bid or of DOE's evaluation of it. The two responsive vendors—Growth Through Sports Marketing (GTS) and the Public Enterprise Group (PEG)—subsequently made presentations to a DOE selection committee in January 2002. The committee selected GTS for the marketing opportunity, concluding that its proposal had a more expansive view of the schools' marketing potential.

DOE officials informed us that the marketing opportunity was put on hold for much of calendar year 2002 for a number of reasons. These reasons included the fact that during this period, State legislation transformed the Board of Education into the Department of Education over which the Mayor was given greatly enhanced authority; the Mayor appointed a new Schools

Chancellor; and DOE moved its headquarters offices from 110 Livingston Street in Brooklyn to 52 Chambers Street in Manhattan. On January 29, 2003, the marketing opportunity was rejuvenated when the Chancellor approved a request for authorization for DOE to "enter into a systemwide agreement with Growth Through Sports Marketing, LLC, for alternative revenue generation from corporate sponsorship [of] public school athletic league events."

However, by January 2003, GTS was no longer in business. DOE officials informed us that GTS had been a joint venture of Bober Associates, Edelman (a public relations firm), and Newtek Capital (a venture capital firm) that was established to respond to the DOE RFP. In July 2002, Bober Associates, the significant party of GTS, was purchased by Octagon, a sports and event marketing company owned by the Interpublic Group, a large international advertising and marketing communications business. Despite this change of ownership, DOE did not reopen the RFP, require a revised proposal from Octagon, or prepare any written justification for negotiating an agreement with Octagon. On June 23, 2003, DOE signed an interim authorization for Octagon to serve as its agent for "a vending machine marketing and administration program."

At the February 4, 2004 exit conference, DOE provided us with the contract it signed with Octagon on January 29, 2004. Prior to the signing of this contract, Octagon had served as the DOE marketing agent for over seven months without a detailed written agreement. We are concerned that DOE has not submitted either the June 23, 2003 interim authorization or the January 29, 2004 contract to the Comptroller's Office for registration.

DOE officials told us that they did not conduct a background check or a review of Octagon on the City vendor database, Vendex, before the contract was signed. Although this is consistent with the provisions of the *RFP* manual, we believe that such reviews should have been performed before DOE sent the interim authorization letter to Octagon on June 23, 2003, especially since Octagon officially began to work for DOE upon receipt of this letter.

Recommendations

3. DOE should either reopen an RFP process or, at the very least, require a revised proposal before entering into an agreement with a company that has experienced a change of ownership after being selected through an RFP process. DOE should also prepare a written justification for entering into an agreement with such a company.

DOE Response: "We disagree with the recommendation that the Department should reopen the RFP process that resulted in the selection of a marketing agent. Our initial decision to use Growth Through Sports was based on the human capital value provided by its principal, David Bober, which subsequently was purchased by Octagon. Since the essence of the proposal did not change with the transfer of ownership no revisions were legally necessary. The Department received verification of the purchase of Bober Associates, Inc. by Octagon prior to execution of the contract with Octagon. We also disagree with this recommendation insofar as the Comptroller recommends that this RFP process should have been reopened or the Department should have required a new proposal where there was a change in ownership. We decline at this time to address the hypothetical situation of a future RFP where there is a change in ownership. The decision of whether an RFP should be reopened depends on the particular facts presented."

Auditors' Comments: At the very least, DOE should have required Octagon to submit a revised proposal before entering into an agreement with it. DOE should have required that Octagon, in the revised proposal, explain its organization and its plans to manage its DOE marketing efforts. In addition, when DOE states that it received a verification of the purchase of Bober Associates' assets by Octagon prior to the execution of the contract, we believe that DOE is missing an important point. The fact that Bober Associates was acquired by Octagon does not, in and of itself, give Octagon any legal rights in relation to the property interests of GTS, which, after all, was DOE's selected vendor.

4. DOE should maintain copies of all the bids that it receives and of its evaluations of these bids for at least six years from the date of the contract award.

DOE Response: "We agree with the recommendation that for any formal bid or RFP processes the DOE should – and in fact has and will continue to – retain copies for appropriate time periods."

Auditors' Comments: DOE's response would make it appear that it retained copies of all of the bids submitted in response to the marketing RFP. However, DOE did not provide us with a copy of one of the three bids it received. We can only conclude that DOE failed to maintain a copy of this bid as required.

5. DOE should complete a background check and a Vendex review prior to signing an agreement or a contract.

DOE Response: "We agree with the recommendation that DOE should – and in fact has and will continue to – perform background checks and Vendex reviews when appropriate for its contracts."

Auditors' Comments: DOE's response would make it appear that it performed a Vendex review before DOE sent the interim authorization letter to Octagon on June 23, 2003. However, DOE officials told us during the audit that they did not conduct a Vendex review of Octagon before the contract was signed.

6. DOE should forward the Octagon contract to the Comptroller's Office for registration.

DOE Response: "We disagree with the recommendation that DOE should forward the Octagon contract to the Comptroller for registration, because the Department is not obligated to submit such contracts for registration."

Auditors' Comments: Since DOE acknowledges that the selection of Octagon resulted from a formal RFP process, DOE should have followed its own *RFP* manual, which states that “all contracts, regardless of their value, must be sent to and be approved by the City’s Corporation Counsel and Comptroller’s Office.” In addition, while State law has pre-empted New York City procurement rules, State law does not address the issue of registration. It would be sound public policy for DOE contracts to be submitted for registration. The submission of contracts to the Comptroller’s Office helps, among other things, to ensure that contractor integrity is properly reviewed.

Octagon Stands to Realize Exorbitant Compensation for Its Marketing Services to DOE

Octagon stands to realize exorbitant compensation for its services as the DOE marketing agent for the school vending machine and sponsorship opportunity.

The Chancellor’s January 2003 approval of the request for authorization for DOE to enter into a systemwide marketing agreement indicated that the marketing agent would receive 25 to 35 percent of the revenue generated by its marketing efforts for DOE; the commission percentage would increase as DOE’s revenue increased. The Chancellor’s approval of the request for authorization appears to be based on the marketing agent’s March 27, 2002 financial proposal, which is presented in Table III below.

Table III

Marketing Agent’s Financial Proposal

DOE Revenue Amount	% of Revenue to DOE	% of Revenue to Marketing Agent
$0 - $10,000,000	75%	25%
$10,000,001 - $20,000,000	72%	28%
$20,000,001 - $50,000,000	69%	31%
$50,000,001 – Above	65%	35%

In contrast, the Public Enterprise Group, in its bid, offered to receive only 15 percent of the revenue it generated. PEG informed us that it believes that a marketing agent that receives a higher commission percentage at higher revenue levels would be receiving excessive profits. A senior MDC official stated that such an arrangement would be unusual and inconsistent with customary market practices.

In 2002, PEG served as the marketing agent for an $18.4 million, 10-year soft drink and snack vending contract between the New York City Health and Hospitals Corporation and PepsiCo. PEG informed us that for the HHC contract, it scouted every significant HHC facility to identify vending opportunities, prepared a report of its findings, developed a detailed request for proposals, conducted a pre-proposal conference to answer the questions of potential bidders, and provided guided tours of HHC facilities for potential bidders.

As indicated above, Octagon's work on the DOE vending agreement did not involve any of these steps. The work done by Octagon could readily have been accomplished by DOE's Office of Contract Management at a substantially reduced cost. Octagon engaged in minimal solicitation efforts, conducted minimal research on the opportunity (the survey report on the vending machines that were already in the schools was prepared by DOE and not by Octagon), prepared a very general document on the opportunity for potential bidders that included marketing opportunities that appear to be contrary to State education policy, and did not conduct a pre-proposal conference.

DOE officials told us that Octagon will also be involved in monitoring Snapple's implementation of the school vending program. However, when we asked DOE and Octagon in December 2003 for the names of the schools in which Snapple had installed vending machines and the number of machines installed in each of these schools, we were told that they did not have such a list and suggested that we ask Snapple for it. When we asked Octagon how it planned to track and audit the sale of Snapple beverages in the schools, it indicated that it would review monthly revenue reports from Snapple for anomalies. Currently, only Snapple has access to counters in the machines that indicate the number of beverages sold. Without DOE having access to these counters, it will not be able to ensure the accuracy of Snapple's sales information upon which DOE's share of the revenue will be based.

DOE clearly failed to monitor Octagon's implementation of the request for proposal process. DOE allowed gross shortcomings in the process and now appears prepared to provide exorbitant compensation to Octagon. Based on the marketing agent's March 27, 2002 financial proposal (see Table III above), Octagon was slated to receive at least $11.6 million for its minimal work, as shown in Table IV below.

Table IV
Marketing Agent's Compensation

DOE Revenue	Octagon's Commission Rate	Amount To Be Received By Octagon
First $10 million	25%	$2.5 million
Second $10 million	28%	$2.8 million
Additional $20.2 million	31%	$6.3 million
Total		**$11.6 million**

In a troubling development, DOE's January 29, 2004 contract with Octagon actually increased Octagon's compensation to about **$15.3 million**. This amount is based on compensation provisions in the contract that provides Octagon with 15 percent of gross sales, rather than a percentage of DOE revenue, and 18 percent of DOE's sponsorship income. The five-year guaranteed commission payment of $25.2 million to DOE (as shown in Table II above) was based on a commission rate of 30 percent of gross sales.[5] But now, by DOE giving Octagon

[5] Snapple agreed to provide DOE with 30 percent of a minimum of $84 million (for a commission payment of $25.2 million) based on anticipated sales over five years of at least 84 million beverage units at $1 per unit. The $25.2 million commission payment is a guaranteed minimum payment that will not be affected by the number of

15 percent of gross sales, DOE's actual commission rate is reduced by half, from 30 percent to 15 percent of gross sales. DOE has therefore agreed to provide up to half of its $25.2 million in guaranteed commission income (or $12.6 million) to Octagon. By DOE giving 18 percent of its five-year guaranteed sponsorship income of $15 million to Octagon (as shown in Table II above), DOE has agreed to provide an additional $2.7 million to Octagon. Without this staggering total expense of about $15.3 million, DOE would have been able to provide either more funds to the schools or lower-cost beverages to the students.

Raising further concerns about payments to Octagon, City and MDC officials have stated that Octagon will be provided additional compensation relative to the Citywide deal. This additional compensation appears to be unwarranted, as Octagon, according to a senior MDC official, had an extremely limited role in the Citywide deal. Octagon claims that it provided MDC with some advice on how the Citywide deal could be structured. However, MDC did not either formally or informally procure Octagon's services. City officials argue that Octagon is entitled to some compensation for the Citywide deal because it structured the school vending opportunity upon which the Citywide deal was, to some extent, based. We disagree. In structuring the school vending deal, Octagon was acting as an agent for, and providing a service to, DOE. The structure of the school vending opportunity was thus owned by DOE and therefore available for other City use without compensation to Octagon.

An additional concern here is that Octagon provides marketing services to Cadbury, which is owned by Snapple's parent company, Cadbury Schweppes. Cadbury Schweppes clearly benefits from the DOE and Citywide vending opportunities through its ownership of Snapple and through the opportunity to sell Cadbury Schweppes products, such as RC Cola and Diet Rite Cola, in the minimum of 500 vending machines that will be placed in teacher lounges. DOE's written agreement with Snapple, signed on September 9, 2003, states that the vending machines in the teacher lounges "can carry any products of Snapple or its Affiliates." This expanded opportunity to sell Cadbury Schweppes products could help enhance Octagon's business relationship with Cadbury. In light of this potential conflict of interest, DOE should have strictly limited Octagon's role on marketing the vending opportunity and even more closely monitored the marketing services that Octagon provided.

Recommendations

7. The Department of Education should restructure and greatly reduce Octagon's compensation for its marketing and administration work on the school vending machine opportunity.

DOE Response: "The recommendation that the Octagon compensation should be restructured and reduced has already been implemented in that the final Octagon contract provides a vastly reduced commission to Octagon. Octagon's compensation is fair and reasonable for the work performed. Octagon performed extensive services in connection with the process to obtain a marketing partner, and is obligated to perform extensive contract administration services under its agreement with the Department."

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units Snapple actually sells. However, if Snapple sells more units, Snapple's commission payment to DOE would exceed the minimum payment of $25.2 million by an amount equal to 30 percent of Snapple's additional sales.

Auditors' Comments: While Octagon's compensation was restructured between the January 29, 2003 request for authorization and the January 29, 2004 contract, Octagon still stands to gain exorbitant compensation for its services. If the contract is not amended to clarify that Octagon will receive 15 percent of DOE's commission revenue rather than 15 percent of gross sales, Octagon stands to realize about $15.3 million. DOE claims that the contract will be so amended (see page 14 of the addendum). Even if the contract is amended as DOE claims, Octagon will still be in a position to realize at least $7.6 million for its services. This is still excessive considering Octagon's minimal work on the DOE vending opportunity. Therefore, we strongly urge DOE to re-examine and further reduce Octagon's compensation for its work on the school vending machine opportunity. In addition, this compensation issue could have been avoided had an adequate contract been negotiated and executed prior to the commencement of work on June 23, 2003.

8. The Department of Education should not award any new marketing assignments to Octagon in relation to the 2001 marketing RFP.

DOE Response: "As to whether new marketing assignments should be made to Octagon, should the Department consider seeking additional marketing partners, it will evaluate whether to continue to use Octagon's services for this purpose. Each marketing partnership has and always will be assigned in a fair and reasonable fashion."

Auditors' Comments: Because the vendor selection process that Octagon followed was fundamentally flawed, and because the compensation rate for Octagon is exorbitant, we maintain that DOE should not award any new marketing assignments to Octagon in relation to the 2001 RFP.

9. Before hiring a marketing agent for similar work in the future, DOE should seriously consider the benefits of implementing the concession and sponsorship RFP process itself or of seeking the assistance of other City agencies.

DOE Response: "With respect to the recommendation that DOE should consider seeking the assistance of other City agencies before hiring a marketing agent for similar work in the future, the Department always performs a "make or buy" analysis prior to proceeding with partnerships."

Auditors' Comments: DOE's response would make it appear that it prepared a "make or buy" analysis that concluded that an outside vendor was needed to handle the marketing of the vending machine and sponsorship opportunity. However, DOE did not provide us with a copy of such an analysis.

10. Whenever a marketing agent working for DOE has a potential conflict of interest, DOE should strictly limit the marketing agent's role and even more closely monitor the marketing agent's services.

DOE Response: "With respect to the recommendation that DOE should limit a marketing agent's role when there is a potential conflict of interest, there were no conflicts of interest associated with this process. In the event that a conflict is presented in the future, the Department will ensure that appropriate oversight is given."

Auditors' Comments: As stated in the report, a potential conflict of interest did exist with Octagon because it serves as Cadbury's marketing agent and Cadbury is owned by Snapple's parent company, Cadbury Schweppes. Moreover, the September 9, 2003 agreement between DOE and Snapple allows Cadbury Schweppes the opportunity to place any of its beverage products in the faculty lounges. Therefore, in light of this potential conflict of interest, DOE should have more strictly limited Octagon's role on marketing the vending opportunity and more closely monitored Octagon's services.

Discussion of DOE Response

In its response, DOE challenged many of the audit's findings and recommendations. Unfortunately, in addition to presenting some legitimate differences of opinion concerning our conclusions, DOE chose to include in its response numerous falsehoods, misrepresentations, obfuscations, and contradictions about our findings. We address the full scope of the DOE response below. Our discussion first reviews DOE's general observations on the report and then addresses its specific comments on our findings.

DOE's General Observations on this Report

In its general observations on this report, DOE claims that "as a legal and auditing matter the audit report is wrong in assuming that the Department and Octagon, Inc. were required to use a formal Request for Proposal procurement process." DOE further states that "this misconception permeates the entire draft and thus leads to manifestly inaccurate conclusions." DOE attaches a February 23, 2004 letter from the City Law Department that DOE claims "explain(s) that the competitive selection process followed by [DOE] was lawful in all respects and that the laws and rules applicable to public procurements relied upon by [the Comptroller's Office] throughout the audit are inapplicable to the selection of a beverage licensee by [DOE]." In addition, the Department stated that "the report's incorrect analysis was perhaps preordained by your office's public announcement in October 2003, prior to the commencement of the audit, that the deal with Snapple failed to follow procedural requirements and should be cancelled. This biased, pre-determined approach to an audit is itself inconsistent with the unbiased approach that the Comptroller is expected to employ by GAGAS audit principles." The DOE response also states that "the audit report fails to recognize that as a result of the extraordinary beneficial arrangement entered into with Snapple, the Department, operating under severe time restraints, not only was able to remove non-nutritious beverages from the New York City public schools, but will receive over $40 million of revenue."

DOE's and the Law Department's responses represent a misreading of our draft report and an unwillingness to seriously address the audit issues the report raises. Stressing their position that there was no statutory mandate to follow a formal request for proposal process in selecting a beverage company for the school vending machine opportunity, DOE and the Law Department do not address the audit issues that DOE failed to establish a vendor selection process for its marketing agent to follow or to adequately monitor the marketing agent's efforts.

Our draft report never stated that there was a statutory mandate to follow a formal RFP process. Our draft report stated that DOE did not need to follow the City's PPB or FCRC rules and that New York State Education Law authorized the Chancellor to establish DOE's contract rules. It quoted a State Comptroller's decision on the placement of privately owned vending machines on school property as stating that "the granting of a license or concession is not subject to the competitive bidding requirements of General Municipal Law." The draft report further quoted the State Comptroller's decision as stating that, despite the inapplicability of the competitive bidding requirements of General Municipal Law, "competition should be solicited by proposals or quotations prior to the granting of licenses or concessions." We also quoted a Law Department letter to the Comptroller that referred to the State Comptroller's decision about the need for school districts to follow a request for proposals process to select a vending machine operator. In addition, the primary thrust of the draft report was that DOE should have provided written guidance to its private marketing agent on how to implement the vendor selection process to ensure a fair and reasonable result. Ignoring this context, DOE and the Law Department emphasized part of one sentence in the draft report, which read "the City Law Department acknowledged that school districts must follow a request for proposal process" and which has been changed in the final report to read "the City Law Department stated that legal opinions from the State Comptroller and State Education Commissioner advised that school districts follow a request for proposal process." They deliberately misinterpreted and exaggerated the significance of this one statement in order to place themselves in a position to forcefully and at great length argue against a stance that the audit report never took. More significantly, DOE continues to ignore two fundamental points.

First, DOE ignores that the Law Department, in its February 23, 2004 letter attached to the DOE response, restates what it wrote in a November 13, 2003 letter to the New York City Comptroller and DOE that the State Comptroller and the State Education Commissioner have advised in legal opinions "that school districts <u>follow a request for proposal process</u> to select a vending machine operator (emphasis added)." This is consistent with an earlier (October 14, 2003) Law Department letter on this matter to the New York City Comptroller and DOE. In that correspondence, the Law Department states that "in the absence of a formal mandated process, the courts recognize that public bodies such as the DOE have <u>the legal responsibility to employ a procedure</u> calculated to result in an arrangement that protects the public interest (emphasis added)." As discussed in the report, the selection process followed by Octagon on behalf of DOE did not meet this standard.

Second, DOE ignores the basic point of the audit that by not providing Octagon with any written standards whatsoever to guide the selection process, it was allowing a private marketing agent to establish its own process that might not be consistent with the public interest. As we state in the report, in awarding business opportunities, the public sector environment requires a heightened commitment to both the reality and perception of fairness that the private sector typically does not demand. In this case, while the sponsorship and concession income that DOE's agreement with Snapple will obtain for the schools is commendable, the fundamentally flawed selection process that DOE allowed Octagon to follow failed to guarantee a process that was fair for the beverage companies that bid on this opportunity. Since DOE provided no written standards or procedures to Octagon to guide the process, we evaluated the selection process based on the guidelines presented in DOE's own *RFP* manual.

We take particular exception to DOE's baseless charge that the audit had a "biased, pre-determined approach" that was inconsistent with GAGAS. The Bureaus of Audit of the Comptroller's Office have always taken exceptional measures to ensure that our audit work complies with GAGAS. Our ability to do so has been consistently acknowledged in the external, independent peer reviews that have been conducted of our audit organization every three years in accordance with GAGAS. The Institute of Internal Auditors (IIA) conducted the most recent review of our work in 2001. In its report dated November 30, 2001, IIA concluded that "the Bureaus of Audit generally conform to the Government Auditing Standards (1999 Version). This means that policies and procedures and an auditing charter existed which were judged to be in accordance with the GAGAS."

The United States General Accounting Office has revised its government auditing standards since 1999. The most recent revision was issued in June 2003. In that revision, GAGAS § 3.03 states: "In all matters relating to the audit work, the audit organization and the individual auditor, whether government or public, should be free both in fact and appearance from personal, external, and organizational impairments to independence."

We have complied with the above standard in conducting this engagement. As disclosed in the Scope and Methodology section of this report (Independence Disclosure), the New York City Charter authorizes the Comptroller to "audit and investigate all matters relating to or affecting the finances of the city, including without limitation the performance of contracts and the receipt and expenditure of city funds." The New York City Charter also states, "No contract or agreement executed pursuant to this charter or other law shall be implemented until (1) a copy has been filed with the comptroller and (2) the comptroller has registered it."

The Comptroller has designated the Deputy Comptroller for Policy, Audit, Accountancy and Contracts as the executive responsible for overseeing the functions that fulfill these statutory requirements. These functions include the Bureaus of Audit and the Office of Contract Administration.

The Bureaus of Audit (which include the Bureau of Management Audit and the Bureau of Financial Audit) are responsible for conducting audits in accordance with Chapter 5, § 93, of the New York City Charter and the generally accepted government auditing standards issued by the United States General Accounting Office. The Bureaus of Audit, which together serve as a separate and distinct component of the Comptroller's Office, have developed their own internal *Audit Policy and Instruction Manual* to ensure that all audits are conducted in accordance with GAGAS. The manual (which was recently revised in accordance with revisions to GAGAS) requires that each auditor annually recertify their awareness of and compliance with GAGAS independence requirements. This certification is intended to inform and remind our audit personnel of the extreme importance of both the fact and appearance of professional independence and the steps to be taken should a potential impairment become apparent.

The Office of Contract Administration, a separate unit of the Comptroller's Office that is independent of the Bureaus of Audit, is responsible for reviewing all contracts, contract amendments, leases, and concessions between City agencies and vendors to determine whether the agreement should be registered. The Comptroller publicly recommended that the Department of Education cancel the Snapple agreement on October 30, 2003 (prior to the initiation of this audit). The Office of Contract Administration was responsible for the review leading to that recommendation.

We wish to note that the Bureau of Management Audit (one of the two Bureaus of Audit of the Comptroller's Office) had no involvement whatsoever in the review of the Snapple issue that was conducted by the Office of Contract Management.

The Bureau of Management Audit and, more specifically, the audit professionals who conducted this engagement were not instructed by anyone in the Comptroller's Office to include or exclude any findings. Members of the audit team met with responsible City, DOE, and Octagon officials, as well as representatives of all of the beverage companies that bid on the vending opportunity, to obtain their perspectives on the process; carefully reviewed all of the documentation received from these officials and representatives; and followed all GAGAS standards in conducting this audit, including those relating to staff independence, staff qualifications, supervision, planning, audit documentation, evidence, and reporting.

DOE's Specific Observations on this Report

DOE's specific comments on the audit's findings are presented and discussed below.

Department of Education Process for Awarding An Exclusive Vending Machine Opportunity Was Fundamentally Flawed

In response to our finding that Octagon made minimal solicitation efforts in that it only directly contacted two beverage companies, DOE argues that Octagon also "contacted other beverage and snack vendors, who subsequently decided not to submit offers. Further, at least ten vendors, including all the other major beverage companies (with the exception of Apple and Eve) contacted Octagon within two weeks of the Department's execution of the letter of intent with Octagon, even before the presentation was prepared and while Octagon was in the process of identifying companies that could satisfy the Department's nutritional requirements."

First, we asked Octagon to identify all of the companies that it directly contacted. Octagon was unable to identify any companies that it contacted other than Pepsi and Coca-Cola. In addition, while DOE asserts that all the other major beverage companies (except Apple & Eve) contacted Octagon within two weeks after the June 23, 2003 letter of intent (known as the interim authorization letter) to Octagon, two other beverage companies that placed bids (in addition to Apple & Eve) informed us that they contacted Octagon between three and four weeks after this date. Apple & Eve contacted Octagon more than seven weeks after the June 23, 2003 interim authorization. These delays were significant in that the entire process, from the date of the interim authorization letter to August 21, 2003, when the best and final offers were due, was only two months.

In response to our finding that Octagon had prepared an inadequate request for proposals, DOE agrees that "some vendors apparently have stated that they were confused about certain terms in the presentation materials." However, DOE goes on to state that "the audit does not contain any evidence that reveals any source for this confusion in actions of the Department or of Octagon." This is erroneous. As we stated in the draft report, we contacted every beverage company that placed a bid or, in the case of Coca-Cola, formally declined to submit a bid, to determine their understanding of the number of machines that could be placed in the schools through this opportunity. As we discuss in the report, the beverage companies had a variety of conflicting understandings on this matter. As for the source of the confusion, DOE need look no further than to its marketing agent to whom it had delegated, without a contract, the responsibility to clearly explain the opportunity to potential bidders.

In addition, DOE contradicts itself when its states that "there was no upper limit" on the number of machines that could be placed in the schools. Later in its response, DOE states that when our audit notes that "three other possible combinations of juice only and water only bids would have resulted in higher total commissions (and presumably should have been the selected deal)," the audit "does not consider the fact that each of these combinations would have required 3000 or more vending machines in schools to produce the projected commissions." This clearly implies that there was an upper limit in the range of 3,000 machines. Furthermore, by not clearly explaining to the potential bidders the importance of the number of machines that the schools could accommodate, Octagon unnecessarily complicated the bid comparison process because beverage companies would be making financial offers relating to different numbers of machines.

DOE further states that "the Snapple partnership requires only 2500 machines to achieve the described financial benefits." However, DOE's contract with Snapple, dated February 19, 2004, and provided to us on February 24, 2004, refers to DOE making available 2,000 vending locations in student areas and allowing the vendor to place 500 machines in teacher lounge vending locations. If Snapple is allowed to place more than one machine per vending location in the student areas, Snapple will be exceeding the 2,500 machine placements discussed in the September 2003 agreement and may even exceed the 3,000 machines that DOE implied was an upper limit. As we noted in the draft report, Snapple itself was confused about the number of machines that would be allowed in the schools. Snapple told us that they assumed that 2,500 machines was the minimum number of machines that they would be allowed to place in the schools.

In response to our finding that the request for proposals was poorly researched in that it appeared to be inconsistent with New York State education policy by providing the winning beverage company the option of making up to 231.4 million corporate identity impressions per year on students, DOE states that "Snapple did not elect any of the more direct options, such as placement of advertisements in student planners. Thus, rather than speculate on hypothetical marketing opportunities that were not selected, this audit should confine its analysis solely to the actual offer and agreement with Snapple." This misses the point of the finding. We indicated in the draft report that Snapple rejected this option. The point is that an additional reason that the request for proposals was inadequate is that it presented an option to potential bidders that appears to be inconsistent with State education policy.

DOE quotes the relevant State Education Commissioner decision as follows: "It is also unreasonable to find that no athletic equipment or other equipment used on school premises may ever, under any circumstances, exhibit any private logo or corporate name. The criteria to be applied in examining each circumstance are the nature and degree of the commercial content; the appropriateness of each use will turn on the specific facts presented." We neither stated nor implied that the State Education Commissioner had prohibited the placement of corporate logos or names in the schools. In fact, the section of the decision that we quoted in the draft report states that school boards should "carefully consider whether the commercial aspects of such contracts are acceptable influences on their students." In addition, the quoted State Education Commissioner's reference to the nature <u>and the degree</u> of the commercial content being the determining factors in examining such circumstances only reinforces our concern about the appropriateness of offering the winning beverage company the option of making up to 231.4 million corporate identity impressions on students each year.

In response to our finding concerning <u>the lack of a pre-proposal conference</u>, DOE states that "the report criticizes the process for its lack of a pre-proposal conference, although such a conference is not even required for a Request for Proposals. Individual meetings with the vendors were designed to encourage competition by allowing vendors to ask questions without the risk of disclosure to competitors." DOE neglects to state that our draft report notes that the *RFP* manual does not require a pre-proposal conference. However, the manual does state that a pre-proposal conference should be held if the "size, complexity and sensitivity" of the opportunity warrants. We believe that the size of this opportunity and the apparent bidder confusion over various aspects of it clearly suggest that a pre-proposal conference would have been appropriate. The DOE argument that a pre-proposal meeting was not held because vendors would refrain from asking questions for fear of disclosing information to competitors inappropriately suggests that vendors would have been unable to phrase questions about the vending and sponsorship opportunity without revealing company secrets.

In response to our conclusion that a pre-proposal conference could have prevented the apparent confusion among vendors as to whether the vending opportunity included teacher lounge areas, DOE states that "the objective evidence belies this claim, since every proposal included vending machines in teachers' lounges." This statement is false. As we stated in the draft report, even though the RFP package stated that the vending opportunity included teacher lounge areas, three of the five beverage companies that submitted losing bids informed us that Octagon told them to exclude the teacher lounge areas from their bids. As a result, the three beverage companies told us that they did not include the teacher lounge areas in their offers. Our review of these three beverage companies' best and final offers showed that the guaranteed offers made either no reference to, or excluded the placement of, vending machines in teacher lounge areas.

In response to our finding that DOE and Octagon employed a <u>defective bid evaluation and selection process</u>, DOE states that "contrary to the statement in the report that a market analysis was not presented, Octagon possessed such market information and, in its analysis of the pros and cons of each of the proposals, included information about the marketability of the various products." As we stated in our draft report, neither DOE nor Octagon presented us with any market study to justify its perception that the Snapple brand had considerable appeal to students. They still have not provided such a study. Octagon's "analysis" of the marketability to which DOE refers only consists of a presentation of the market information that the beverage companies themselves provided to Octagon. More fundamentally, since Snapple did not have a 100 percent fruit juice beverage or a well-known water product at the time that it placed its bid, DOE had no assurance that students would respond more favorably to these products than to the established and market-tested products Snapple's competitors were offering. DOE also states that "had Florida Natural's proposal been potentially the most lucrative, it would have been imprudent for the Department not to consider whether young people drink orange juice." We assume that DOE meant that it would have been imprudent not to consider whether young people drink the Florida's Natural orange juice and note that the Florida's Natural proposal stated that the company would also have been able to provide other types of fruit juices, such as apple, grape, and kiwi strawberry juices.

In response to the evidence that we present in the report that suggests that the Citywide opportunity influenced the results of the DOE selection process, DOE states that "the audit . . . leaps to the conclusion that the 'fact' that New York City intended to enter into a partnership with Snapple for Citywide vending was the reason for the Department's selection of Snapple. The audit report wrongly states that 'the City was seriously considering linking the Department's vending deal to a Citywide vending opportunity.' As has been repeatedly publicly stated, including statements made under oath, there was no specific Citywide deal for beverages contemplated at the time that the Department competition was created or prior to the Department's selection of Snapple. Therefore, the audit report is simply wrong when it states that the alleged 'linking' was an 'important reason' for the Department's selection of Snapple. The possibility that the New York City Marketing Development Corporation (MDC), on behalf of the City, might at some point seek to enter into a Citywide agreement did not confine the Department's evaluation of the competitors for the Department opportunity." DOE further states that MDC "did not have any role in the Department's process prior to the August 25, 2003 presentation by Octagon, and did not influence the Department to choose a company in a manner inconsistent with the Department's own interests. . . . The spirit of MDC's offer was one of helping, i.e., the assistance that MDC could provide to the Department."

We will not repeat the evidence that we present on this issue in the report (in the section entitled "Defective Bid Evaluation and Selection Process"). We continue to believe this evidence strongly suggests that the two opportunities were linked during the negotiating phase of the process. We will add, however, that MDC, in its written request for the Franchise and Concession Review Committee's approval of its Citywide concession agreement with Snapple, stated that "after the DOE selected Snapple to be the exclusive vendor of 100% juices and bottled water, NYC Marketing assisted the DOE in negotiating an even better agreement, one that raised the guaranteed minimum and provided the DOE with advanced payment." This statement clearly demonstrates MDC's direct involvement in the post-selection negotiations on the DOE deal, which, as we show in the report, began on the same day (August 27, 2003) that MDC presented the possibility of a Citywide deal to Snapple. Engaging in post-best-and-final-offer negotiations in an effort to obtain a better deal is commendable. The concern here, again, is that even though Snapple made one of the lowest best and final offers, only Snapple was given the chance to improve its offer on the DOE opportunity, and, according to a senior MDC official, only Snapple was given the chance to bid on the Citywide opportunity.

In terms of our comparison of the financial offers of the six competing beverage companies, DOE states that "the audit omits the first year guarantee of $3.6 million included in the Snapple offer, making the total 5 year guarantee $33 million, as determined by Octagon, rather than the Comptroller's number of $29.4 million. Although the Comptroller asserts that there was no first year guarantee included in the Snapple offer, the first year guarantee was in fact included in the Snapple deal, as Octagon, in its presentation to the Department, confirmed based on communications with Snapple." This statement plainly demonstrates the inappropriately casual nature of the entire selection process. Snapple's written best and final offer only provides an annual guaranteed commission of $3.6 million for the second through the fifth years. Neither DOE nor Octagon has provided us with a copy of any correspondence or e-mail communication received from Snapple that added a guaranteed commission for the first year. Based on this, we can only conclude that if Snapple did communicate with Octagon after submitting its best and final offer, it did so only through a telephone call and not through any written communication of this significant change prior to its being selected for the DOE opportunity. DOE further states that "Snapple's initial proposal, as properly analyzed by the Department, was among the best financial offers in terms of minimum guarantees." This is simply false. Even if Snapple's best and final offer was modified through subsequent communication to $33 million, this offer, as can be seen in Table I above, was still less than those of three of the other five companies.

On a related point, DOE states that "we also note that the analysis of Beverage Company C in the report is inaccurate. The 5 year guarantee should be $34 million." DOE is mistaken. A careful review of the offer shows that beverage company C's five-year guarantee was $38,194,000, as we show in Table I of this report. DOE fails to indicate which aspect of our analysis of this offer it questions. Octagon itself, in the comparison of offers that it presented at the August 25, 2003 vendor selection meeting held at DOE, erroneously indicated that beverage company C's five-year guarantee was $30 million.

DOE also argues that at higher sales levels, Snapple's offer is clearly superior to all of the other offers. DOE states that Snapple's offer "had superior upside potential to increase in value as the program became more successful. . . . Snapple offered a $3 per case bonus in sponsorship if sales exceeded one million cases. . . . At 1 million cases, the value of the Snapple partnership exceeds all other possible partnerships except one. At 1.5 million cases, the Snapple partnership exceeds all other possible partnerships." DOE presents a table in its response (see page 9 of the addendum) that it claims demonstrates this. DOE does not explain how it calculated the amounts it presents in this table. (Please note that the beverage company letters that it uses in this table do not correspond to the beverage company letters we use in our report.)

First of all, we believe that <u>guaranteed</u> commissions, sponsorships, and placement fees are substantially more significant factors than potential income that materializes only if sales exceed one million cases per year. As stated in the audit report, three possible combinations of guaranteed juice only and water only bids exceeded Snapple's September 9, 2003 guarantee of

$40.2 million over five years. Considering that DOE did not provide us with any market data suggesting what the level of sales would likely be, and considering that many principals, especially in the elementary schools, may decide not to allow any vending machines to be installed in their schools, sales exceeding one million cases per year or reaching 1.5 million cases per year may relate more to wishful thinking than to reality.

Secondly, we determined that at the sales level of one million cases per year, one juice only and three combinations of juice only and water only offers beat Snapple's final offer; that at 1.5 million cases per year, one juice only offer and one combination offer beat Snapple's final offer; and that at two million cases per year, one juice only offer beat Snapple's final offer, as shown in Table V below.

Table V

Comparison of Offers at Escalating Levels of Sales

Millions of Cases Sold Each Year*	Beverage Company	Annual Guaranteed DOE Revenue	Additional DOE Revenue at Indicated Level of Sales	Total Annual DOE Revenue	Total 5-Year DOE Revenue
1.0	F&B	$10,109,800	$ 2,100,000	$ 12,209,800	$ 61,049,000
1.0	F&C	$ 9,888,800	$ 2,100,000	$ 11,988,800	$ 59,944,000
1.0	B	$ 7,859,800	$ 3,751,600	$ 11,611,400	$ 58,057,000
1.0	F&E	$ 8,330,000	$ 2,100,000	$ 10,430,000	$ 52,150,000
1.0	**Snapple**	**$ 8,040,000**	**$ 2,160,000**	**$ 10,200,000**	**$ 51,000,000**
1.5	B	$ 7,859,800	$ 8,502,400	$ 16,362,200	$ 81,811,000
1.5	F&B	$10,109,800	$ 5,401,200	$ 15,511,000	$ 77,555,000
1.5	**Snapple**	**$ 8,040,000**	**$ 7,260,000**	**$ 15,300,000**	**$ 76,500,000**
2.0	B	$ 7,859,800	$ 13,440,700	$ 21,300,500	$106,502,500
2.0	**Snapple**	**$ 8,040,000**	**$ 12,360,000**	**$ 20,400,000**	**$102,000,000**

* In analyzing combination juice only and water only bids from two different beverage companies, we assigned half of the cases sold to each company.

DOE also states that it had to "consider the clear administrative efficiencies obtained by dealing with only one beverage manufacturer to manage vending machines in schools. A business judgment could be made that one beverage machine was preferable to two, particularly where there is a possibility in the future of food vending machines in the schools as well." If this was DOE's judgment, why did Octagon tell the beverage companies that it was fine to submit a juice only or a water only bid? In addition, why was DOE willing to sacrifice millions of dollars in revenue simply to make Octagon's job of monitoring the vending machine program a little easier?

In response to the finding presented in our February 6, 2004 draft report that although Snapple had been installing vending machines in the schools since September 2003, there was still <u>no contract in place</u>, DOE provided us with a copy of its February 19, 2004 contract with Snapple on February 24, 2004, the date of the DOE response to the draft report. The contract addresses some of the items that we noted in our draft report had not been covered by DOE's interim agreement with Snapple signed on September 9, 2003. However, the contract still does not address the additional electricity costs of the vending machines or the maximum number of vending machines that can be placed in student areas. In fact, the contract confuses the matter further by committing DOE to providing a minimum of 2,000 "vending locations" in the student areas rather than the minimum of 2,000 "vending machine placements" noted in the interim agreement.

Of more significant concern, the February 19, 2004 contract extends the agreement for another year without a comparable increase in the guaranteed payments that will be required of Snapple. The contract transforms the five-year $40.2 million agreement into a six-year $47.4 million agreement. The $47.4 million amount is an optimistic figure that assumes that the 1,350 student accessible vending locations in place as of January 31, 2004 increased to 2,000 student accessible vending locations as of February 29, 2004, and thereby maximized Snapple's guaranteed sales commission payment to DOE during the first year of the new contract. Thus, under the most optimistic scenario, Snapple's average minimum payment to DOE will decrease slightly from about $8.0 million per year to about $7.9 million per year.

RFP Process for Selecting Marketing Agent Was Generally Adequate, But Became Questionable When Ownership of the Significant Party of the Selected Vendor Changed Prior to Interim Authorization

In response to our finding that the RFP process for selecting a marketing agent became questionable when the ownership of the significant party of the selected vendor changed prior to the interim authorization, DOE states that "the report erroneously concludes that the marketing opportunity was simply reopened in January 2003 without any consideration of the change of ownership. The report concludes that the Department, instead of continuing negotiations and entering into an agreement with Octagon, should instead have reopened the solicitation process when Bober Associates, Inc. was acquired by Octagon. In fact, in July 2002, the Department was advised of the sale of Bober Associates to Octagon. The Department received assurances that David Bober, the key employee identified in the GTS RFP, was a key employee with Octagon. The critical piece to the success of the project, and the reason for selecting GTS initially, was the expertise that David Bober could provide. Octagon moreover replaced the capital and non-monetary contributions previously contemplated to be provided by GTS with even more ample resources at the Department's disposal. Prior to execution of the contract, the Department received written proof of the purchase of all of the assets of Bober Associates, Inc. by Octagon. This is a standard contract assignment transaction routinely engaged in by City agencies and the Department."

DOE is once again inaccurate both in terms of the relevant facts and our discussion of these facts in the audit report. While DOE claims that it considered the change of ownership issue in January 2003, the fact is that on January 29, 2003 the Chancellor approved a request for authorization to "enter into a systemwide agreement with Growth Through Sports Marketing, LLC [GTS]" even though GTS was no longer in business and Bober Associates, one of the three companies comprising the GTS joint venture, had been purchased by Octagon. In addition, although DOE states that the audit report concludes that DOE should have reopened the solicitation process when Octagon purchased Bober Associates, the draft report only referred to this as one of two appropriate responses to the change of ownership. The report states that DOE should have either reopened the process or required a revised proposal from the new owner. The report also states that DOE should have prepared a written justification for entering into an agreement with Octagon. In its response to the audit report, DOE provides the first written explanation of its decision to allow Octagon to replace GTS. On a related matter, when DOE states that it received a written proof of purchase of Bober Associates' assets by Octagon prior to the execution of the contract, we believe that DOE is missing an important point. The fact that Bober Associates was acquired by Octagon does not, in and of itself, give Octagon any rights in relation to the property interests of GTS, which, after all, was DOE's selected vendor.

Octagon Stands to Realize Exorbitant Compensation for Its Marketing Services to DOE

In response to our finding that DOE plans to provide exorbitant compensation to Octagon for its marketing services relating to the school vending machine opportunity, DOE states that "the Comptroller's analysis of the commission to be paid to Octagon relies on the original response to the RFP and a misreading of the executed contract. The contract between the Department of Education and Octagon, just signed, substantially reduces the commissions that will be received by Octagon for the performance of services from the amount in the Request for Proposals. The Comptroller misreads the provision of the contract when it states that Octagon will receive 15 percent of gross sales. The contract contemplates payment to Octagon of 15 percent of the amount received by the Department, in essence, 4.5% of the Snapple sales. . . . In any event, to eliminate public confusion occasioned by the Comptroller's continuing insistence on inaccurately portraying the Octagon arrangement, the parties are amending the contract to make this more clearly explicit. In addition, it is notable that the Department has negotiated a provision allowing for termination for convenience at the end of the first year of the contract. The percentages paid thereafter are further reduced, should the Department exercise its right to terminate the Octagon contract."

DOE here presents a blatant falsehood. DOE states that "the Comptroller misreads the provision of the contract when it states that Octagon will receive 15 percent of gross sales." However, the contract reads as follows: Octagon "<u>shall receive</u> as payment for activity undertaken pursuant to this contract a commission of (fifteen percent) <u>15% of the gross sales</u> made through vending machines placed on BOE real property as a result of this contract (emphasis added)." Then, in a logic that defies reason, DOE states that due to the Comptroller's "continuing insistence on inaccurately portraying the Octagon arrangement, the parties are amending the contract." If the audit were inaccurate on this point, the contract would not need to be amended. If DOE does amend the contract as it claims in its response, then we estimate that Octagon stands to realize at least $7.6 million through this contract. If Octagon is terminated without cause after one year, we estimate that Octagon stands to receive at least $4.7 million; and if Octagon is terminated for cause, we estimate that it stands to receive at least $1.9 million. As we observe in the report, MDC will also pay Octagon through MDC's Citywide deal with Snapple. A senior MDC official testified before the FCRC and told us that part of this compensation is an effort on the part of MDC to ease some of the financial burden of DOE's agreement with Octagon.

In relation to our finding that Octagon provided minimal work for this compensation, DOE states that "the audit errs in its evaluation of the services provided by Octagon under the contract." Throughout its response, DOE claims that Octagon provided valuable marketing services to DOE on this vending opportunity. DOE states that Octagon "brought to the process extensive knowledge of the industry. . . . Octagon's expertise and understanding of the market informed its analysis of the pros and cons of each offer." DOE also states that "the audit erroneously concludes that Octagon engaged in no market analysis."

Throughout our audit report, we describe the minimal work performed by Octagon in relation to its potential compensation. We stand by that assessment. The draft report did not state, as DOE alleges, that Octagon did not conduct any market analysis, only that Octagon had not presented us with a market study. DOE states that the market analysis that Octagon conducted was presented in the marketing agent's August 25, 2003 evaluation of the offers received. Based on this statement, we now conclude that Octagon actually did not conduct any market analysis because the market research information provided in this evaluation only presented market data that were included in the beverage companies' proposals submitted to Octagon.

In relation to our finding that Octagon's role in monitoring the vending machine program was not clear, DOE states that "the final contract identifies and describes the responsibilities that rest with Octagon." While the January 29, 2004 contract finally sets forth these responsibilities, our concern is that several months elapsed from the first installation of vending machines by Snapple in September 2003 to the time that DOE delineated the program monitoring services that it would require from Octagon.

In relation to our finding that Octagon's business relationship with Cadbury, which is owned by Snapple's parent company, Cadbury Schweppes, created a potential conflict of interest, DOE states that "there is simply no basis for the conclusion that such a potential conflict exists. Octagon's work for Cadbury is done in the United Kingdom, by a separately incorporated branch of Octagon, and focuses on confections, not beverages. Octagon's work for the Department was undertaken by its New York offices by a completely separate management team and involving a completely separate product. . . . Finally, as demonstrated above, the Department was actively involved in the solicitation process and, ultimately, made the decision to select Snapple, thereby avoiding the possibility that even a non-existent conflict of interest would affect the final decision." We continue to believe that the possible enhancement of Octagon's business relationship with Cadbury, through the expanded opportunity to sell Cadbury Schweppes products in the schools as a result of the Snapple deal, created a situation in which DOE should have been much more closely involved in monitoring Octagon's work. Our audit report demonstrates the very limited level of such monitoring by DOE.

THE NEW YORK CITY DEPARTMENT OF EDUCATION
JOEL I. KLEIN, *Chancellor*

OFFICE OF THE DEPUTY CHANCELLOR
Kathleen Grimm, Deputy Chancellor for Finance and Administration
52 Chambers Street, Room 320 • New York, New York 10007
(212) 374-0209 (Voice) (212) 374-5588 (Facsimile)

February 24, 2004

Greg Brooks
Deputy Comptroller
Policy, Audits, Accountancy and Contracts
The City of New York
Office of the Comptroller
1 Centre Street
New York, NY 10007

Re: Audit Report on the Process by which the Department of Education Awarded a Vending Machine License to the Snapple Beverage Group, ME04-123A

Dear Mr. Brooks:

The Department of Education ("Department") submits the annexed response to your Draft Audit Number ME04-123A.

Sincerely,

Kathleen Grimm
Deputy Chancellor for Finance and Administration

Cc: Joel I. Klein
LaVerne Srinivasan
Chad Vignola
Bruce Feig
Marty Oestreicher
Steve Allinger
Richard Stewart

Response to Audit Report on the Process by which the Department of Education Awarded a Vending Machine License to the Snapple Beverage Group, ME04-123A

The Department of Education ("Department") submits this response to your Draft Audit Number ME04-123A. The audit report suffers from two fundamental flaws.

- First, as a legal and auditing matter the audit report is wrong in assuming that the Department and Octagon, Inc. were required to use a formal Request for Proposal procurement process. State Comptroller opinions make this clear, as do previous Department contracts, including one entered into when the Comptroller himself was president of the former Board of Education.

- Second, as a factual and economic matter the audit report fails to recognize that as a result of the extraordinary beneficial arrangement entered into with Snapple, the Department, operating under severe time restraints, not only was able to remove non-nutritious beverages from the New York City public schools, but will receive over $40 million of revenue.

Introduction

The audit report suffers from the fundamental misconception that the Department and Octagon, Inc. ("Octagon") were required to use a formal "Request for Proposal" ("RFP") procurement process to locate a marketing partner for the Department. This misconception permeates the entire draft and thus leads to manifestly inaccurate conclusions. Rather than evaluate what the Department did to locate a business partner, the report focuses on a putative failure to follow rules that the Department neither needed nor attempted to follow. This misunderstanding of the relevant legal rules has also engendered evident methodological failings in the audit analysis. For example, the audit does not correctly value the potential financial benefits of the transaction with Snapple. Instead, in an attempt to construct a basis for criticizing an agreement that serves the interests of the Department and the students, it focuses on formulaic calculations that misstate the business opportunity. The report's incorrect analysis was perhaps preordained by your office's public announcement in October 2003, prior to the commencement of the audit, that the deal with Snapple failed to follow procedural requirements and should be cancelled. This biased, pre-determined approach to an audit is itself inconsistent with the unbiased approach that the Comptroller is expected to employ by GAGAS audit principles.

As has been explained at length to Comptroller's staff, and explained in detailed legal memoranda by the Corporation Counsel who under the Charter provides legal guidance to the Comptroller, an RFP is neither required nor necessarily warranted in the context where a school district seeks to create a beneficial marketing relationship with a private partner. Instead, as both the State Education Department and the New York State Comptroller have explained, the school district need only use a process intended to solicit "fair and reasonable" offers. A review of the report and an analysis of the Snapple deal demonstrate that the Department has done more than that: we have secured a multi-year deal generating more than $40 million in revenues – $ 15 million of which is sponsorship monies over and above concession revenues – a huge sum that will be put to the benefit of hundreds of thousands of school children in desperate need of athletic and other health initiatives. Moreover, the process secured this tremendous investment in our children's health in a very short time frame to ensure that by the start of the 2003-2004 school year, there would be available 100 percent fruit juice and water machines to replace cola and other non-nutritious soft drink vending machines that had already been removed from our schools. The RFP process touted by the Comptroller would not have allowed this remarkable success.

In this response we will demonstrate that the Department has obtained a beneficial arrangement for the provision of beverage vending machines and sponsorship in the New York City public schools through an open competition that was fair to all proposers. We include and incorporate in our response a letter received from the Corporation Counsel explaining that the competitive selection process followed by the Department was lawful in all respects and that the laws and rules applicable to public procurements relied upon by your office throughout the audit are inapplicable to the selection of a beverage licensee by the Department. We will describe how the Department, with the assistance of the internationally-recognized marketing consultant Octagon, obtained the submission of seven proposals, each of which proposed to guarantee substantial payments to the Department for the benefits of its sports and physical education programs.

We will show that the selection of Snapple was not, as your audit repeatedly claims, "fundamentally flawed". To the contrary: the use of Octagon to solicit offers for a business partnership arrangement resulted in a deal that was far greater than the legally required "fair and reasonable," and that was obtained through a competitive process that was designed to and did obtain multiple substantial offers from which a selection was made.

<u>The Snapple Partnership Offers Opportunity for Substantial Revenue to the Department</u>

Octagon was retained to assist the Department to locate a business partner to bring in additional revenues to the Department to benefit physical education and school athletic programs. As a result of Octagon's marketing expertise, six different beverage companies submitted a total of seven offers for sponsorship arrangements based upon exclusivity in vending 100 percent juice and water beverages. Each company submitted proposals that guaranteed substantial revenue to the Department in the form of commissions on sales and sponsorship payments to the Department. Six of the seven offers would have guaranteed the Department in excess of $29 million over a five year period.

It was from this wealth of options that the Department evaluated and selected Snapple as its partner. Most significant to the Snapple selection decision was the fact that the Snapple proposal offered the Department the greatest potential for financial reward. The initial Snapple offer included a five year guarantee of $33 million, including a first year guarantee of $3.6 million, and a minimum sponsorship amount of $3 million annually. As a consequence, the Snapple offer included a net margin of 43% on sales ($7.20 commission plus $3.00 sponsorship = $10.20 per case). This margin was the highest margin of all the offers received. In addition, the Snapple offer included a $3 per case bonus for every case sold over one million cases, a bonus not included in any of the other offers. With this bonus, the 43 percent margin remains the same as sales increase, whereas the margin for the other vendors decreased as sales increase. Once the Department actually selected Snapple, Snapple increased its minimum guarantee 22 percent from $33 million over five years to $40.2 million.

The report fails to acknowledge that the Department could consider various factors when making its business judgment. Instead, the report, focusing on an analysis of the minimum guaranteed revenues (p. 11), asserts that the Snapple "financial offer was one of the lowest." Not only is this "minimum guarantee" approach to the selection decision overly simplistic, but the audit's factual finding about the value of the Snapple minimum guarantee is incorrect. The audit (at page 12) omits the first year guarantee of $3.6 million included in the Snapple offer, making the total 5 year guarantee $33 million, as determined by Octagon, rather than the Comptroller's number of $29.4 million.[1] Although the Comptroller asserts that there was no first year guarantee included in the Snapple offer, the first year guarantee was in fact included in the Snapple deal, as Octagon, in its presentation to the Department, confirmed based on its communications with Snapple. The audit's mistaken claim that the initial Snapple proposal was much less valuable to the Department than it actually was forms the basis (discussed below) for the later implication that Snapple was afforded an unfair opportunity to improve its standing against its competitors.

The Competition Was Fair and Open

1. The Competitive Process That Was Required to be Followed

The letter of the Corporation Counsel attached to this response establishes that, contrary to the basic underlying assumption in the entire audit, a procurement RFP is neither legally required nor even necessarily an appropriate process to follow in securing the vending machine program license business opportunity. The Corporation Counsel, referencing court decisions and Opinions of the State Comptroller, advises that the Department's responsibility was not that it had to follow an RFP process, but rather it had to receive fair and reasonable compensation from the licensee. The letter repeats the conclusion, reached in Corporation Counsel letters addressed to the Comptroller before the audit began, that it is advisable to use a competitive process to select a licensee, as a competition is an effective way to ensure a fair and reasonable return. This is exactly what the Department did.

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[1] We also note that the analysis of Beverage Company C in the report is inaccurate. The 5 year guarantee should be $34 million.

2. <u>A Competitive Process was Followed</u>

Your office was given access to and reviewed the Request for Proposals pursuant to which Octagon was ultimately retained to act as a marketing agent. Likewise, the Comptroller was provided with a copy of the letter of intent signed with Octagon in June, 2003, and the Octagon contract that was executed on February 4, 2004. These documents evidence that Octagon was not retained to, nor did it simply, seek a company to place vending machines in the New York City public schools. Rather, Octagon was retained to identify a partnership arrangement with an outside corporate sponsor, which could include a vending machine component. The marketing agent was expected to use its expertise to solicit and obtain a beneficial business partnership deal. Octagon fulfilled this requirement, and, as described above, the deal selected by the Department meets the requirement that the terms be "fair and reasonable."

The audit highlights instances where Octagon did not follow the formal procurement processes contained in the Department's Standard Operating Procedures Manual (SOPM). In attempting to describe the process that was undertaken to locate a business partner, the audit omits any of the details of the work undertaken by Octagon, choosing instead to paint this as a process in which Octagon performed limited services.

Because this was never intended to be a Request for Bids or Request for Proposals, as defined in the SOPM, but was intended to explore the possibilities for sponsorship and partnership arrangements with a vendor, the presentation materials provided information to the vendors, but did not mandate any particular terms. Octagon was required to develop materials and a presentation that would convince vendors to make a substantial investment of capital. It was necessary to compile information about potential opportunities in an understandable way. Although the audit simply concludes that the Department could have developed its own request for proposal and followed the Request for Proposal process designed for procurement of professional services, this overlooks the task that was presented. Octagon needed to create an opportunity that would encourage companies to make an investment beyond the traditional vending machine model by offering a new and creative program, in the absence of a sales history, and within the very narrow beverage category of 100% fruit juice and water. The receipt of seven beverage offers bespeaks the quality of the materials prepared by Octagon and the value of its interactions with multiple vendors. By comparison, when the Department issued its publicly-advertised RFP for a marketing agent two years previous, only two eligible proposals were submitted, even though the Department sent notification of the RFP to over 270 potential proposers, and advertised extensively in trade journals.[2]

The materials that Octagon prepared and presented to potential partners offered various options that flexibly could have been part of a proposal submitted by the partner. The Department deliberately wanted an open and flexible process to obtain a full range of ideas for opportunities that would maximize the financial benefit to the Department. Using a formulaic Request for Proposal package would have inhibited the possibility of

[2] The other two "proposals" that were submitted failed to satisfy the minimum terms required by the RFP. For example, one of the two proposals simply offered the opportunity to sell telephone cards.

creative input from potential sponsors. Key senior officials at the Department provided information to Octagon, met with Octagon officials to discuss the nature of the presentation materials, reviewed and approved the presentation material, were present at many of the meetings with potential sponsors, reviewed and discussed proposals and questions that had been raised and analyzed financial and operational considerations. The Department made the final selection among the offers, after reviewing the proposals and the analysis provided by Octagon.[3]

3. <u>The Potential Vendors for the Beverage Arrangement</u>

Among the purported flaws in the solicitation process highlighted in the audit report are that Octagon only contacted two potential vendors, neither of which was Snapple. This is factually wrong and, in the end, irrelevant. Octagon contacted other beverage and snack vendors, who subsequently decided not to submit offers. Further, at least ten vendors, including all the other major beverage companies (with the exception of Apple and Eve) contacted Octagon within two weeks of the Department's execution of the letter of intent with Octagon, even before the presentation was prepared and while Octagon was in the process of identifying companies that could satisfy the Department's nutritional requirements.[4] Ultimately, Octagon interacted with over twenty different companies and received seven beverage offers and three snack food offers.

The audit erroneously concludes that Octagon engaged in no market analysis. Octagon, and, in particular, its Senior Vice President David Bober, had expertise in the market. Indeed, it is our understanding that, in his interview, Mr. Bober confirmed to Comptroller's staff that Octagon engaged in market analysis. The continued inclusion of this substantive factual inaccuracy and others in the draft audit report that have been brought to staff's attention at the exit interview underscores our concerns about the evident bias in the report.

Because the Department was committed to ensuring compliance with federal and state requirements restricting sale of soda and candy in schools prior to the end of the lunch periods and its own regulation banning the sale of such food and drink in schools altogether, Octagon was required to be familiar both with the Department's nutritional requirements and the nutritional components of the products offered by the different vending companies with whom it met. Bober and Octagon staff met with Department of Education employees to understand the arrangements pursuant to which vending

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3 Indeed, the process followed by Octagon is more than that done by the Comptroller when he was the President of the Board of Education and approved the process for soliciting school bus advertisements. That resolution and contract approved by the Comptroller did not require our private sector agent to publish in the public record the opportunity to advertise on the sides of buses: the vendor was directed to solicit advertisers and, like here, merely had a financial incentive to maximize revenues. Each year, the Board was presented with the results of this advertising revenue initiative. In fact, here, the Department did far more by having the described competitive solicitation process. In either case, as it was during the Comptroller's tenure on the Board of Education, it also here was a perfectly legal and legitimate way to promote business opportunities by the Department.

4 The audit fails to state that Octagon, as part of its research into whether potential vendors could meet the Department's requirements, contacted other companies with respect to snack food.

machines were currently in schools, the new nutrition regulations and requirements, and what ideas were available to offer to vendors, in addition to vending machines. Octagon also brought to the process extensive knowledge of the industry. Octagon had already worked with many of the companies with whom Octagon and the Department subsequently met. Octagon's expertise and understanding of the market informed its analysis of the pros and cons of each offer.

4. The Information Available to the Vendors

The same slide presentation was used for each of the vendors with whom Octagon met. Part of the documents provided to the Comptroller's office included samples of the presentation materials, as well as email between Octagon and the various companies, setting up meetings for presentation and responding to follow up questions. The report criticizes the process for its lack of a pre-proposal conference, although such a conference is not even required for a Request for Proposals.[5] Individual meetings with the vendors were designed to encourage competition by allowing vendors to ask questions without the risk of disclosure to competitors.

Some vendors apparently have stated that they were confused about certain terms in the presentation materials. The audit does not contain any evidence that reveals any source for this confusion in actions of the Department or of Octagon. To the contrary. Bober explained to the Comptroller's staff that the presentation materials were designed to present what opportunities existed within the Department. Vendors were not restricted to any particular number of machines, either as a maximum or minimum. The Department disputes the statement at page 8 of your audit that it or Octagon said to any proposer that the number in the materials was a maximum. There was no upper limit. Nor was there a minimum. The Department and Octagon quite consciously did not set numerical boundaries. Vendors were invited to submit their offers which would reflect their judgment as to the number of machines required for them to reach their proposed level of financial support. The Department's analysis of the viability of the offers included consideration of the number of machines needed to meet the vendor's guarantees.

The audit further states (p. 9-10) that there was confusion about whether proposals could include vending machines for teacher's lounges. The objective evidence belies this claim, since every proposal included vending machines in teachers' lounges. Indeed, all of the written evidence about the status of the teacher's lounges, such as the two emails provided to your office, confirm that a proposal could include teacher's lounges. Fundamentally missing from the audit is the recognition that proposers could design the package as they saw best able to maximize revenues. For that reason, the presentation materials did not contain a limit about the number of years of exclusivity.

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[5] Nor is it even clear that there would have been a value to a pre-proposal conference. Despite extensive advertising and outreach, only five vendors attended the pre-proposal conference for the RFP to locate a marketing agent.

5. <u>The Flexibility in the Proposals that might be Offered</u>

Although the Snapple deal contains only a sponsorship and vending machine provision, the audit criticizes the Octagon presentation to proposers for containing a menu of possibilities, some of which a school district might later consider inappropriate to the school setting. The audit misleadingly cites only limited portions of the a decision of the State Commissioner of Education, Appeal of Citizens for Responsible Fiscal and Educational Policy No, 14,489, Education Reporter 11-30-00, at 315, to claim that the Octagon package was not adequately researched. That decision in fact recognizes that "it is also unreasonable to find that no athletic equipment or other equipment used on school premises may ever, under any circumstances, exhibit any private logo or corporate name." <u>Id</u>. at 326. The decision continues: "The criteria to be applied in examining each circumstance are the nature and degree of the commercial content; the appropriateness of each use will turn on the specific facts presented." <u>Id</u>.

The State Commissioner's decision recognizes that the actual commercial activity must be evaluated in determining its propriety. Indeed, the Commissioner declined, in the case before it, to address the propriety of the proposed commercial activity in the absence of a description of the items in the field kit at issue. (<u>Id</u>. at 327) Similarly here, no sponsor selected all the various options contained in the Octagon package. Instead, for example, Snapple offered a sponsorship component, with far less exposure than the 134.2 million opportunities discussed in the package. By these sponsorship funds, Snapple will support innovative sports programs in the middle schools, expand the school-based summer recreation program for inner-city children, add over 60 sport teams and nearly 1,000 athletes to our high school sports league, and provide direct financial support for high school sports programs. Snapple did not elect any of the more direct options, such as placement of advertisements in student planners. Thus, rather than speculate on hypothetical marketing opportunities that were not selected, this audit should confine its analysis solely to the actual offer and agreement with Snapple.

Moreover, this business opportunity is not unlike others the Department has executed in the past. Indeed, when the Comptroller himself was President of the former Board of Education, the Department initiated similar public-private partnerships such as the innovative and uniformly-praised *Take-the-Field* program which has, to date, renovated over thirty athletic fields in exchange for naming these fields after private individuals and entities. These naming opportunities, as the Comptroller well knows, were not selected through an RFP process and nor would our students be using these athletic fields today without these business ventures. Similarly, the Department entered into a contract with a vendor to serve (like Octagon in this context) as our agent for soliciting advertising on the sides of school buses. In any event, consistent with the approach directed by the State Education Commissioner, the audit should have evaluated the actual deal, not speculated upon the solicitation materials.

Snapple Was Fairly Selected

As noted above, Snapple's initial proposal, as properly analyzed by the Department, was among the best financial offers in terms of minimum guarantees. More importantly it had superior upside potential to increase in value as the program became more successful. Almost all proposers offered 30 percent commission on vending sales. The critical financial differentiator was in the sponsorship commitments. Snapple offered the highest pure sponsorship dollars, $3 million, regardless of sales. In addition, Snapple offered a $3 per case bonus in sponsorship if sales exceeded one million cases. For the other vendors, however, if sales went over their guarantee, the percent margin to the Department would decrease, thereby reducing the net payment per case given to the Department. By contrast, if sales of Snapple exceed one million cases, the net margin remains at 43 percent, resulting in higher income to the Department and its schools.

As the chart below demonstrates, as the number of cases increases, the value of the Snapple deal compared to the other six offers continues to increase. At 1 million cases, the value of the Snapple partnership exceeds all other possible partnerships except one.[6] At 1.5 million cases, the Snapple partnership exceeds all other possible partnerships.

Beverage Companies	500K Cases	1MM Cases	1.5MM Cases	2MM Cases	Min Spons/yr
A (water)	$4,600,000	$8,200,000	$11,800,000	$15,400,000	$1,000,000
B (juice)	$6,080,000	$8,400,000	$12,000,000	$15,600,000	$1,280,000
C (both)	$7,880,000	$9,200,000	$12,800,000	$16,400,000	$2,080,000
D (juice)	$6,808,800	$9,470,000	$13,830,000	$18,190,000	$1,500,000
E (both)	$6,265,000	$7,125,000	$10,125,000	$13,125,000	$1,125,000
F (juice)	$7,859,800	$10,609,800	$14,734,800	$19,047,300	$2,609,800
Snapple	$6,600,000	$10,200,000	$15,300,000	$20,400,000	$3,000,000

This differential existed even prior to the post-decision negotiations with Snapple, at which Snapple improved its offer, by reducing the length of time of the contract from seven years to five years, and increased its guarantee for years 2 through 5 from 500,000 to 750,000 cases. As a result of these negotiations, Snapple increased its minimum guarantee for a five-year contract to $40.2 million.[7]

In an attempt to show that the Snapple deal was inferior, the audit analyzes vending programs using combinations of machines from several proposers (see page 14). Octagon conducted a similar analysis of the final offers for the Department. The audit analysis, however, fails to account for obvious business judgments that the Department

[6] This does not include the possible combinations of two vending companies, since no vending company submitted an offer that included a second company.

[7] The final negotiated contract, reflected in the final contract signed with Snapple on February 19, 2004, changes these figures slightly by increasing guarantees over a six year period to reflect phased, program rollout. A copy of this contract is included for your information (but not for registration).

had to make to select a beverage company. The statement on page 14 of the audit that three other possible combinations of juice only and water only bids would have resulted in higher total commissions (and presumably should have been the selected deal) does not consider the fact that each of these combinations would have required 3000 or more vending machines in schools to produce the projected commissions. By contrast, the Snapple partnership requires only 2500 machines to achieve the described financial benefits. The Department had to take into account the number of machines in the offers and consider the clear administrative efficiencies obtained by dealing with only one beverage manufacturer to manage vending machines in schools. A business judgment could be made that one beverage machine was preferable to two, particularly where there is a possibility in the future of food vending machines in the schools as well.

Snapple Improved Its Offer After It was Selected

The audit also fails to recognize that on August 26, 2003 the Department made a decision to enter into a sponsorship and vending machine arrangement with Snapple. Only then did Octagon and the Department engage in additional negotiations with Snapple to improve the terms of the agreement. This factual omission leads the audit (at page 12) to erroneously claim that Snapple was unfairly given the opportunity, in meetings held following this date, to improve its bid, "presumably to exceed the bids provided by its competitors." This analysis misunderstands the process and the fact that the Department had already made a decision to do business with Snapple. The August 27th meeting was typical of contract negotiations, in which the Department attempts to improve the deal. There was no reason to return to the other vending companies at this point, as the Department had already determined that Snapple offered the best opportunity. The improved deal simply validates that decision. Indeed, in the separate procurement realm to which the audit report keeps inaptly referring, the Department ***always*** seeks to negotiate and improve business deals after vendor selection, particularly in the RFP context.

In sum, each vendor who submitted an offer was given the opportunity to submit a best and final offer by August 21, 2003. Although the audit recognizes this earlier round of negotiations, it is inaccurate in its characterization of the later negotiations with Snapple.

The Audit Makes Unsupported and Mistaken Surmises About the Selection Decision

1. The Audit Results were Reached by the Comptroller Before the Audit was Begun

In October 2003, before this audit was commenced and before your office had even reviewed any of the underlying materials pertinent to the deal, the Comptroller announced publicly that the process by which Snapple was engaged failed to follow public procurement rules and should be cancelled. Given this announcement, it is hardly surprising that the audit reaches the same conclusion, despite the ample documentation and information supplied by the Department during the audit process. The information we have provided demonstrates that the Department's open process was intended to and did obtain competition and resulted in a fair and reasonable deal. The audit response is to minimize the work done by Octagon and to conclude, through a misreading of legal authorities, that the formulaic RFP process should have been used.[8]

2. <u>The Department's Selection of Snapple Was Unrelated to the City's Decision to Enter an Agreement with Snapple</u>

We have already addressed the financial aspects of the Snapple deal, to demonstrate the substantial value offered to the Department. The audit, however, overlooks this analysis, and, surmising incorrectly that Snapple's proposal was inferior, leaps to the conclusion that the "fact" that New York City intended to enter into a partnership with Snapple for Citywide vending was the reason for the Department's selection of Snapple. The audit report wrongly states that "the City was seriously considering linking the Department's vending deal to a Citywide vending opportunity" (p. 10). As has been repeatedly publicly stated, including statements made under oath, there was no specific Citywide deal for beverages contemplated at the time that the Department competition was created or prior to the Department's selection of Snapple. Therefore, the audit report is simply wrong when it states that the alleged "linking" was an "important reason" for the Department's selection of Snapple (p. 10). The possibility that the New York City Marketing Development Corporation (MDC), on behalf of the City, might at some point seek to enter into a Citywide agreement did not confine the Department's evaluation of the competitors for the Department opportunity.

The e-mails cited by the audit report do not support a contrary conclusion (pp. 10-11). They do show, however, that MDC had an interest, as indeed it should, in the interests of the City as a whole. The audit report fails to recognize that, in the summer of 2003, MDC—a new entity—was meeting with many City agencies and companies to create and describe its general mission. While MDC had, in a non-specific way, explored the possible parameters of a marketing partnership with a beverage company (among many other types of agreements in many other product categories) throughout the summer of 2003, and had communicated its general interest to the Department in helping with marketing and sponsorship matters, it did not have any role in the Department's process prior to the August 25, 2003 presentation by Octagon, and did not influence the Department to choose a company in a manner inconsistent with the Department's own interests. To the contrary, rather than seeking to steer the Department to Snapple (or another "larger compan[y]" (p. 10)), MDC offered to provide the Department with help on any of three approaches: (a) a Citywide deal, if it were appropriate; (b) a "vending only" relationship (as opposed to one that also involved marketing); or (c) a deal along the lines of the one that the Department ultimately entered into with Snapple, although

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[8] In a further confusion, the draft repeatedly uses the term "bid" when describing the offers from the various vendors. This could lead to a misconception that Octagon was required to engaged in "competitive bidding" in order to engage a vendor to supply beverage vending machines and beverages, and that the Department was required to select the responsible bidder who offered the highest minimum guarantee. Even the Comptroller concedes that competitive bidding requirements are inapplicable. However, much of its analysis of the value of the Snapple proposal is in essence a calculation of the "lowest responsible bidder."

only for a two-year term. The spirit of MDC's offer was one of helping, i.e., the assistance that MDC could provide to the Department. This offer was in the e-mail to which the Deputy Chancellor for Finance and Administration responded on August 20, 2003 (one of the e-mails cited by the audit report). Taken in context, it is clear that the Deputy Chancellor was simply reacting to MDC's offer to help. Neither this e-mail, nor any of the others, provides any reason to conclude that the Administration, or MDC, was directing the Department to do anything but make the best deal for the Department.

3. The Relevance of the Snapple Appeal to Students

The report also notes that a "major reason" for the selection of Snapple was the perceived appeal of Snapple to students, and claims that no market study was presented to justify this conclusion. The report further notes that at the time of the deal, Snapple did not have a 100 percent fruit juice beverage. (p. 10)

Neither Department officials nor Octagon stated that Snapple's perceived appeal was a "major reason." It was one factor among others that led to the decision to select Snapple. As described above, the Snapple proposal offered the greatest upside to the Department. In evaluating a solicitation for vending machines, which rely on student and employee purchases to bring in revenue, Octagon and the Department would have been remiss were they not to have considered all the information about Snapple's market share and appeal to young people. Contrary to the statement in the report (at 10) that a market analysis was not presented, Octagon possessed such market information and, in its analysis of the pros and cons of each of the proposals, included information about the marketability of the various products. Snapple was identified as the number 1 seller of non-carbonated soft drinks in the relevant age group in the New York City metropolitan area. This is a reasonable and responsible analysis. For example, had Florida Natural's proposal been potentially the most lucrative, it would have been imprudent for the Department not to consider whether young people drink orange juice. Since commissions form the basis for the Department's receipt of a large portion of the money, the best deal on paper cannot be achieved without consideration of whether the market will purchase the product. Moreover, although 100% Juiced had not yet been brought to market, Snapple had prior experience in 100 percent juices, through other juice companies that were a part of the Snapple Beverage Group, including Mott's, Nantucket Nectars, and Mystic, and had tested its new products in focus group settings.

The audit suggests that the fact that the sponsor would have an "exclusive opportunity" to sell its beverages negates any obligation to consider the marketability of the product. (page 10) Such a conclusion is simply wrong. Students in middle, junior, and high schools often have the right to leave the school premises during the school day. In many New York City schools, students have easy access to corner delis, at which they can purchase beverages. Particularly because the machines could not sell soda, it certainly was relevant to consider whether students would want to purchase the products in the machine.

Further, the statements on page 10 of the audit disclose a lack of understanding of basic marketing principles. Octagon used its expertise to inform the Department of the significant role of brand recognition. The fact that its new product, 100% Juiced, had not been test marketed in New York City was not a reason not to select Snapple. According to Octagon, the Department's marketing expert, Snapple's own brand recognition would translate into sales of its new product.

4. The DOE/Snapple Contract

The last issue raised by the audit with respect to Snapple is the absence of a contract. The audit contends that the absence of a contract leads to unanswered questions, including for example, the responsibility for the extra electrical expense to run vending machines. It compares the existing interim agreement with the contract to which Health and Hospitals Corporation is a party. On Thursday, February 19, 2004, the Department and Snapple executed a contract. The contract addresses applicable business terms.

The actual details of the process used to select Snapple for a partnership arrangement pursuant to which it obtained sponsorship rights and would place and stock vending machines in schools assured the Department that it would obtain a fair arrangement that afforded significant financial opportunities. This was not an agreement to purchase goods or services, but rather a private business opportunity the Department was making available to possible licensees; hence, the process used by Octagon was not only perfectly legal and appropriate but also ensured public accountability and secured an exceptionally lucrative and beneficial arrangement for the Department. Over $40 million in guaranteed revenues – while meeting one of the most stringent school nutrition standards in the country – is plainly a "beneficial" arrangement.

The Octagon Contract

The second portion of the audit addresses the agreement with Octagon to act as a marketing agent for the Department. The audit has no criticism of the RFP used by the Department. Significantly, the RFP did not restrict the marketing agent to use the SOPM for its solicitation of marketing partners for the Department. The only criticism of the RFP process rests on the Department's decision to enter into an agreement with Octagon when a company known as Growth Through Sports, Inc. (GTS) had submitted the underlying response to the RFP and been selected by the Department.[9] The report erroneously concludes that the marketing opportunity was simply reopened in January 2003 without any consideration of the change in ownership. (p. 13) The report concludes that the Department, instead of continuing negotiations and entering into an agreement with Octagon, should instead have reopened the solicitation process when Bober Associates, Inc. was acquired by Octagon., In fact, in July 2002, the Department was advised of the sale of Bober Associates to Octagon. The Department received assurances that David Bober, the key employee identified in the GTS RFP, was a key employee with Octagon. The critical piece to the success of the project, and the reason for selecting

[9] The Department has provided copies of all proposals received to the Comptroller.

GTS initially, was the expertise that David Bober could provide. Octagon moreover replaced the capital and non-monetary contributions previously contemplated to be provided by GTS with even more ample resources at the Department's disposal. Prior to execution of the contract, the Department received written proof of the purchase of all of the assets of Bober Associates, Inc. by Octagon. This is a standard contract assignment transaction routinely engaged in by City agencies and the Department.

Upon execution of the contract, the Department is undertaking the required Vendex review of Octagon. The contract executed with Octagon is conditioned on Vendex review.

The Commission to be Paid to Octagon

The Comptroller's analysis of the commission to be paid to Octagon relies on the original response to the RFP and a misreading of the executed contract. The contract between the Department of Education and Octagon, just signed, substantially reduces the commissions that will be received by Octagon for the performance of services from the amount in the Request for Proposals.[10] The Comptroller misreads the provision of the contract when it states that Octagon will receive 15 percent of gross sales. The contract contemplates payment to Octagon of 15 percent of the amount received by the Department, in essence, 4.5% of the Snapple sales. Indeed, the first payment of moneys from Snapple in January, 2004, consisted of payment of 25.5 percent of Snapple's sales to the Department, and 4.5 percent to Octagon. This objective fact confirming that the commission to Octagon decreased was explained to the Comptroller's staff during the audit process. The continued inclusion of this incorrect factual assertion in the draft audit report (and use of inflammatory accusations of "an outrageous development" [p. 20]) in the face of objective facts demonstrating the inaccuracy of the audit report's assertion, again raises serious questions about improper bias in the audit's findings. In any event, to eliminate public confusion occasioned by the Comptroller's continuing insistence on inaccurately portraying the Octagon arrangement, the parties are amending the contract to make this more clearly explicit. In addition, it is notable that the Department has negotiated a provision allowing for termination for convenience at the end of the first year of the contract. The percentages paid thereafter are further reduced, should the Department exercise its right to terminate the Octagon contract.

The report relies on the information contained in the initial request for proposals to conclude Octagon will be paid excessive amounts for its marketing services. The Comptroller's determination to criticize the process is evident in reference to the opinion of Public Enterprise Group (PEG) that a commission higher than 15 percent would be excessive. (p. 19) Fifteen percent was the rate contained in the PEG proposal submitted in response to the marketing RFP. Had the Department followed PEG's opinion, the GTS proposal would not have been selected initially, despite the fact that subsequent negotiations reduced the commission on sales to this exact percentage. Rather than

10 The report makes reference to the separate agreement that the City is entering into with Octagon. The City independently engaged Octagon to act as a marketing consultant, with terms independent of the terms of the Department's agreement with Octagon.

simply focus on the commission rates, however, the Department evaluated the services that each proposer offered and determined that the services offered by GTS, which exceeded simply locating and monitoring vending machine companies, served the purposes of the Department better than the narrow PEG proposal. Because this was an RFP process, the Department was not obligated to select the lowest responsible bidder. Rather, it could and did opt for the company that offered the ability to solicit and locate vendors who would do more than simply place vending machines in schools.

The audit errs in its evaluation of the services provided by Octagon under the contract. We have already delineated the services that Octagon provided in locating a marketing partner. While the audit minimizes these services and compares this process to the activities undertaken by PEG for HHC, including visiting every significant HHC facility to identify vending opportunities, this activity was not feasible. The letter of intent with Octagon was not executed until July 2003. The Department had a goal of having vending machines with nutritionally acceptable products available for the start of school at the beginning of September. This goal was critical because schools had already been instructed to have their existing vending machines removed from their schools. Since schools use the vending machine revenues to support school programs, the Department did not want any delay in entering into an arrangement with a system-wide vendor. In light of the tight timeframe, there was not time to conduct visits to the 1200 buildings used by the Department of Education.

The report also states that the role of Octagon in monitoring the program is not clear – for example, at the time of the audit, Octagon could not identify the number of machines that had been installed, purportedly had no plan for auditing sales other than reviewing Snapple revenue reports, and lacked access to counters in the machines. However, your office was provided a copy of the Octagon contract, which details Octagon's obligations. Under the terms of the contract, Octagon has and will be required to provide substantial services. The final contract identifies and describes the responsibilities that rest with Octagon. Among other things, Octagon is required to collect sales data, and provide audit and accounting services. Section 3.8 requires Octagon to ensure the effective operation of a 24-hour a day telephone line for the ordering of new machines and reporting of problems. Octagon must assign a full-time employee to work exclusively on managing this contract. Octagon is required to manage the installation of vending machines (section 3.13). Octagon is required to oversee Snapple's maintenance of the machines (3.15). It simply is premature to critique the monitoring of the installation of machines and sales of Snapple in the New York City public schools. When the interviews were conducted, the interim agreement with Snapple had only been in effect for three months. Machines were and are still being installed. Octagon and the Department have only just received the first reports about sales. Moreover, Octagon has incentives to monitor and audit the sales reports (insofar as the report appears to suggest that Snapple will undercount its sales to avoid paying the full share due to the Department). Octagon's commission is largely based on the sales of Snapple. As sales increase, its compensation also increases. The very commissions that the preliminary report criticizes in fact assure accuracy in monitoring by Octagon in its oversight role.

Finally, the report criticizes the Department for failing to implement controls to address the potential for a conflict of interest because Octagon provides marketing services to Cadbury, which is owned by Snapple's parent company, Cadbury Schweppes. There is simply no basis for the conclusion that such a potential conflict exists. Octagon's work for Cadbury is done in the United Kingdom, by a separately incorporated branch of Octagon, and focuses on confections, not beverages. Octagon's work for the Department was undertaken by its New York offices by a completely separate management team and involving a completely separate product. On behalf of its clients, Octagon has negotiated endorsement deals with other beverage companies, at least one of which submitted an offer and another that chose not to. Indeed, Octagon was seen as an even more valuable marketing partner to the Department than GTS precisely due to its connections to many beverage and food companies. There is nothing in the process undertaken to locate a sponsoring partner that warrants a concern that Octagon was driven by its relationship with Schweppes, or any other beverage company. Finally, as demonstrated above, the Department was actively involved in the solicitation process and, ultimately, made the decision to select Snapple, thereby avoiding the possibility that even a non-existent conflict of interest would affect the final decision.

Conclusion

- The Department's program to put in place a beverage vending and marketing partner has been extremely successful, resulting in substantial revenue to the Department. The importance of this transaction to the vendor community combined with the unprecedented nature of the undertaking has unfortunately led disappointed proposers to be unjustifiably critical of the process through which our partner was selected.

- The audit, which should have been a vehicle to consider and evaluate those criticisms objectively, began instead with a predetermined conclusion that the process was flawed.

- A central premise of the audit is the incorrect assumption that this program involved a purchase of professional services from the marketing partner by the Department. This legal conclusion is incorrect, as the State Education Commissioner and State Attorney General's opinions make manifest.

- This error is compounded by the audit's adoption of a "minimum guarantee" analysis of the proposals received from the vendors, and the use of this analysis to make accusations that an "inferior" Snapple proposal was unfairly given preference over the competition to address a citywide concern that played no part in the Department's decision.

Response to Recommendations

1. We decline to follow the recommendation that the Department should not pursue a school vending machine contract with Snapple. The process used to solicit offers for a marketing partnership with a beverage company was a fair and open process designed to obtain competitive proposals and resulted in a fair and reasonable agreement.

2. We decline to follow the recommendation that any concession and sponsorship opportunities be handled through a request for proposal process. Because this was not a purchase agreement, Octagon was not obligated to follow the RFP procedures outlined in the Department's Standard Operating Procedures Manual. The RFP by which Octagon was retained did not require it to use such a process. The process to select Snapple was fair and reasonable. The agreement with Snapple creates unprecedented incremental revenue to the Department. We also disagree with this recommendation to the extent it seeks to mandate a strict, formulaic process to enter into concession and sponsorship opportunities. The Department will continue to assure that any process for entry into such opportunities is an open and fair process and achieves fair and reasonable compensation for the Department.

3. We disagree with the recommendation that the Department should reopen the RFP process that resulted in the selection of a marketing agent. Our initial decision to use Growth Through Sports was based on the human capital value provided by its principal, David Bober, which subsequently was purchased by Octagon. Since the essence of the proposal did not change with the transfer of ownership no revisions were legally necessary. The Department received verification of the purchase of Bober Associates, Inc. by Octagon prior to execution of the contract with Octagon. We also disagree with this recommendation insofar as the Comptroller recommends that this RFP process should have been reopened or the Department should have required a new proposal where there was a change in ownership. We decline at this time to address the hypothetical situation of a future RFP where there is a change in ownership. The decision of whether an RFP should be reopened depends on the particular facts presented.

4. We agree with the recommendation that for any formal bid or RFP processes the DOE should – and in fact has and will continue to – retain copies for appropriate time periods.

5. We agree with the recommendation that DOE should – and in fact has and will continue to – perform background checks and Vendex reviews when appropriate for its contracts.

6. We disagree with the recommendation that DOE should forward the Octagon contract to the Comptroller for registration, because the Department is not obligated to submit such contracts for registration

7. The recommendation that the Octagon compensation should be restructured and reduced has already been implemented in that the final Octagon contract provides a

vastly reduced commission to Octagon. Octagon's compensation is fair and reasonable for the worked performed. Octagon performed extensive services in connection with the process to obtain a marketing partner, and is obligated to perform extensive contract administration services under its agreement with the Department.

8. As to whether new marketing assignments should be made to Octagon, should the Department consider seeking additional marketing partners, it will evaluate whether to continue to use Octagon's services for this purpose. Each marketing partnership has and always will be assigned in a fair and reasonable fashion.

9. With respect to the recommendation that DOE should consider seeking the assistance of other City agencies before hiring a marketing agent for similar work in the future, the Department always performs a "make or buy" analysis prior to proceeding with partnerships.

10. With respect to the recommendation that DOE should limit a marketing agent's role when there is a potential conflict of interest, there were no conflicts of interest associated with this process. In the event that a conflict is presented in the future, the Department will ensure that appropriate oversight is given.

THE CITY OF NEW YORK
LAW DEPARTMENT
100 CHURCH STREET
NEW YORK, N.Y. 10007-2601

MICHAEL A. CARDOZO
Corporation Counsel

February 23, 2004

Joel I. Klein
Chancellor
New York City Department of Education
52 Chambers Street
New York, New York 10007

Re: Comptroller Audit of Vending Machine License

Dear Chancellor Klein:

I write in response to your request that this office comment on an audit report prepared by the New York City Comptroller examining the process followed by the Department of Education (DOE) in awarding a vending machine license to the Snapple Beverage Group. You ask in particular whether we agree with the Comptroller's apparent legal position that the DOE agreement with Snapple is a procurement contract. The central point of the Comptroller audit is that DOE failed to follow its own Request for Proposal procedures governing procurement contracts in the award of this vending license. As we explain below, and as explained to the Comptroller previously, the vending opportunity which culminated in the Snapple agreement was **not** a procurement contract, and the audit is wrong in concluding that DOE failed to follow its own procedures in awarding that contract to Snapple.

In letters dated October 14, 2003 and November 13, 2003 this office advised the Comptroller concerning the proper legal analysis of the DOE vending machine program. Our October 14 letter states that the license program is the type of transaction that when undertaken by an agency subject to the City Charter's concession procedures must be secured through the concession process set out in Chapter 14 of the Charter and the rules of the Franchise and Concession Review Committee. That letter went on to explain that since DOE operates under the Education Law it is not governed by Chapter 14 of the Charter. We concluded that since there was no formal mandated process for the award of vending machine licenses, the DOE's legal responsibility was to "employ a procedure calculated to result in an arrangement that protects the public interest". Our November 13 letter stated that the Comptroller's continued assertion of "serious breaches of the fundamental aspects of standard public bidding" was incorrect. We noted that the State Comptroller and State Education Commissioner have each opined that vending machine agreements are not subject to competitive bidding laws. We state in that letter that "[t]hese officials have advised instead that school districts follow a request for proposal process to select a vending machine operator. This flexible mechanism is most likely to result in an appropriate compensation payment to the district."

As detailed below, we continue to advise that DOE, having determined to develop a vending machine license program, was under the legal obligation to obtain an agreement in the public interest and, in the absence of a formal process for concluding such an arrangement, properly devised a competitive process to achieve that goal. Since the vending machine program was not a procurement contract DOE was **not** required to follow its procurement contract processes. We are very troubled that the audit report completely misrepresents our correspondence with the Comptroller on this matter. The audit twists our November 13 paraphrase of a recommendation for competition given by state officials, quoted above, into a legal mandate for use of the DOE formal procurement process. The audit's statement that the procedure followed by the DOE was "[c]ontrary to the Law Department's position on this matter" is wrong, and ignores the circumstance that the Law Department letters were written to explain and defend the legality of the competitive process that had been followed by the DOE.

The procurement actions of the DOE are governed by the Education Law and Article 5-A of the General Municipal Law, entitled "Public Contracts". Section 103 of the GML covers the award of public works and goods purchase contracts through a competitive sealed bid process. Section 104-b of the GML governs the award of all "goods and services" contracts that are not covered by 103, and is intended "to facilitate the acquisition of goods and services of maximum quality at the lowest possible cost under the circumstances" by means other than competitive sealed bidding, including Requests for Proposals, and, where appropriate, sole source purchases without competition. The DOE's "Procedures for Preparing Requests for Proposals", which the audit would apply to the vending machine license program, were explicitly developed for use when engaging a person or entity to perform professional services for the DOE, such as staff development contracts, curriculum development contracts and services offered by cultural institutions and arts organizations, as required by the GML procurement article. These are precisely the sort of professional service purchase contracts that, when procured by the City, are awarded pursuant to Chapter 13 of the City Charter and the rules of the Procurement Policy Board. Nothing in the language, context or judicial interpretation of Article 5-A of the GML suggests application of that law to the type of transaction here undertaken by the DOE, in which the DOE is making its real property available to a private entity to conduct its business for a fee. When the Courts have been asked to address similar programs, they have expressed the understanding that such arrangements are licenses, not procurements. See, Citiwide News, Inc. v. New York City Transit Authority 62 N.Y.2nd 464 (1984); B.C.I. Industrial Catering, Inc. v. Town of Huntington, 250 A.D. 2nd 674 (2nd Dept., 1998).

The audit report's essential characterization of the DOE vending machine program is at fundamental variance with our legal conclusion. We agree, however, that State Comptroller Opinion 92-5, which is relied upon by the auditors for their erroneous conclusion that formal procurement procedures should have been used by the DOE for this program, contains a useful discussion of the law governing such transactions. However, in relying on this advisory legal opinion, the auditors misread it. That Opinion's statement that "it is the duty of public officials to let out such contracts under terms that are fair and reasonable" (- citing as authority the case of Blank v. Browne, 217 App Div 624 (2nd Dept., 1926)) is the basis for the position taken in our letter of October 14 that it is the obligation of the DOE to obtain a financially favorable agreement "in the public interest". In the Blank case, the plaintiff alleged that an arrangement the Parks commissioner had made with the operator of a parking field at Coney Island was, among other things, financially improvident. The Commissioner defended on the basis that the arrangement was "fair and reasonable". The inference the audit would have the reader draw - that the State Comptroller was addressing the process of awarding a license, rather than the financial terms of the license itself - is not supported by the State Comptroller Opinion. In fact, it is refuted by the authority cited by the Opinion itself. There is not the slightest support for audit's further contention that the State Comptroller has ruled that in particular the formal procurement provisions of the GML apply to license programs. Such a ruling cannot be found in the statement that "it is the duty of public officials to let out such contracts under terms that are fair and reasonable."

The next sentence in the State Comptroller's opinion, "[i]n order to assure that municipalities properly fulfill this duty [to obtain a "fair and reasonable" compensation], competition should be solicited by proposals or quotations prior to the granting of licenses or concessions (see Opn No. 88-60, supra, 1982 Opns St Comp. No. 82-237, p. 298; cf. General Municipal Law 104-b)", is the basis for our favorable reference in the November 13 letter to the advice of state officials favoring competition of license agreements as "most likely to result in an appropriate compensation payment to the district". The audit turns this reasonable advice into an apparent legal mandate by using a partial quote from our November 13 letter. Our letter states "[t]hese officials have advised instead that school officials follow a request for proposal process". In the audit this is described as an acknowledgement "that school districts must 'follow a request for proposal process to select a vending machine operator (emphasis added).'" Here again, having turned advice into a legal command, the audit twists the "command" for competition into a requirement to use the formal procurement competition process that had been developed for quite different undertakings. Neither our November 13 letter nor the State Comptroller ever said this. It is worth noting that GML 104-b, the final authority cited by the State Comptroller in the sentence quoted above, is introduced by the cf. form of legal notation. This signifies that the State Comptroller understood that as a procurement law GML 104-b does not directly control the award of vending machine licenses, but simply acknowledged that the procurement law may contain guidance that is useful to consider.

In sum, DOE, in its efforts to develop a vending machine program, was not engaged in the conduct of a procurement governed by its "Procedures for Preparing Requests for Proposals" or any other pre-established formal process. Thus, the fundamental criticism in the Comptroller's audit that the DOE acted in violation of its own rules is clearly mistaken. We trust that this letter will assist the DOE in responding to the Comptroller that the competition undertaken by the DOE was consistent with the written advice of the State Education

Commissioner, the State Comptroller and of this office, and in establishing that DOE's actions were not only legal, but very much "in the public interest".

Sincerely yours,

Michael A. Cardozo