November 16, 2007

Members of the Legislative Audit Committee:

In June 2007, the State Auditor’s Office received a June 15, 2007, report by the Texas Education Agency’s (TEA) Office of Inspector General entitled Final Report: Complaints Related to the Contracts and Procurement System of the Texas Education Agency. That report alleged that TEA’s Educational Initiatives Division “regularly and systematically manipulated the contract and grant processes,” identified “incidents wherein procedures were not followed or practices were vulnerable to manipulation,” and specified that “subcontracts were awarded with ties to TEA senior staff.”

After reviewing the report, the State Auditor’s Office’s Special Investigations Unit initiated an investigation. The purpose of our investigation was to determine whether the allegations in the Office of Inspector General report were the result of fraudulent activity and, if so, present a case for prosecution.

Based on witness interviews and document reviews conducted for this investigation, there is insufficient evidence to present this case to a prosecuting authority at this time. However, our investigation identified a number of instances in which it was a practice for regional education service centers (ESCs) to hire subcontractors on TEA projects based on recommendations by TEA staff and outside parties without conducting a competitive bidding process. This practice resulted in the appearance of less than arm’s-length transactions. If any additional information on these contracts becomes available that, in our judgment, warrants further action, the State Auditor’s Office will continue this investigation.

From July 2007 to October 2007, State Auditor’s Office staff conducted 21 interviews with TEA and non-TEA personnel. Our investigation focused on the following contracts, all of which were highlighted in the Office of Inspector General’s report and involved both TEA and ESCs:

- Contracts to evaluate TEA’s administrative hearings process.
- Contract related to the Commission for a College-Ready Texas.
- Contract related to State Funding Technical Assistance.
- Contracts related to the Gates Honor State Grant.

The information below summarizes the results of our investigation.

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**Arm’s-length Transactions**

Arm’s-length means “of or relating to dealings between two parties who are not related or not on close terms and who are presumed to have roughly equal bargaining power” (Black’s Law Dictionary, 8th Edition, 2004).

An arm’s-length transaction is a “transaction between two unrelated and unaffiliated parties” or “a transaction between two parties, however closely related they may be, conducted as if the parties were strangers, so that no conflict of interest arises” (Black’s Law Dictionary, 8th Edition, 2004).

Our investigation identified the appearance of less than arm’s-length transactions.
Contracts to Evaluate TEA’s Administrative Hearings Process

There was the appearance of less than arm’s-length transactions involving two subcontracts for evaluating TEA’s administrative hearings process over the course of two years. TEA contracted with Education Service Center XII in Waco (ESC XII-Waco) to facilitate and coordinate this evaluation. ESC XII-Waco did not comply with its own procurement policies when it subsequently subcontracted the work. ESC XII-Waco hired a subcontractor based on a recommendation from a public education consultant who was a member of the former TEA Commissioner’s transition team. The consultant also was the subcontractor’s former spouse.

For the period from September 2004 to August 2005, TEA and ESC XII-Waco entered into a contract to “facilitate and coordinate the strategic review of the Texas Education Agency and the State Board of Educator Certification hearings process and make recommendations to the Agencies to develop a sound hearing process by providing objective recommendations for possible improvement to the system.” A substantially similar contract was entered into for the period September 2005 to August 2006. The contracts provided for review of both the special education hearings process (federal) and the teacher termination and non-renewal hearings process (state).

Each of the two contracts between TEA and ESC XII-Waco was for a maximum of $100,000. Each of the two subcontracts between ESC XII-Waco and the subcontractor was for $100,000. TEA allocated federal funds from the Individuals with Disabilities Education Act (also known as the federal IDEA-B program) to pay ESC XII-Waco for services performed under the two subcontracts. The IDEA-B program provides funds to states for the education of children with disabilities. Since the contracts evaluated more than just the special education hearings process, TEA refunded the federal program with state General Revenue funds for work performed by the subcontractor related to the teacher termination and non-renewal hearings process.

It is important to note that TEA did not competitively bid its contracts with ESC XII-Waco because they were interlocal agreements with an ESC. Texas Education Code, Section 8.052, allows TEA to use ESCs to implement initiatives identified by the Legislature. Texas Education Code, Section 8.053, allows the ESCs to contract with a public or private entity for services. The decision to contract with ESCs resides with the members of TEA management, who originate projects. ESC XII-Waco’s procurement policy requires it to competitively bid these contracts. This policy is in place at the other 19 ESCs.

ESC XII-Waco management believed that the recommendation by the consultant to hire the subcontractor came from the TEA Commissioner and/or the TEA Chief Deputy Commissioner. However, ESC XII-Waco management did not contact the former TEA Commissioner or TEA Chief Deputy Commissioner to discuss the recommendation. In addition, TEA staff working in divisions that were affected by the evaluation of the administrative hearings process were not completely advised by TEA executive management regarding the evaluation’s purpose or results. None of the TEA staff whose divisions were affected by the outcome of the

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1 Except for references to the former TEA Commissioner, all references to job titles in this report are to job titles at the time the transactions occurred.
review was aware of the subcontractor’s second report until the release of the Office of Inspector General report.

The TEA Chief Deputy Commissioner asserted that TEA did not competitively bid the contracts for the evaluation of the administrative hearings process because it was concerned about appearing less than objective. He further stated that if TEA directly bid out the contracts itself, this might advertise to parties who would attempt to advocate the selection of certain contractors. To avoid this, he asserted TEA could obtain impartial recommendations in the evaluation by entering into a contract with ESC XII-Waco. Therefore, the TEA Chief Deputy Commissioner decided to have the project performed through ESC XII-Waco.

Neither of the two contracts between TEA and ESC XII-Waco reflected dates on which the contracts were signed by either party. Records from both TEA and ESC XII-Waco show that the subcontractor ESC XII-Waco hired began work prior to when TEA entered into its contracts with ESC XII-Waco for the project. TEA records show that TEA entered into the contracts with ESC XII-Waco in December 2004 and December 2005. However, ESC XII-Waco records indicate that it entered into subcontracts with the subcontractor in September 2004 and September 2005.

The subcontractor drafted the scope of work for the subcontracts. ESC XII-Waco acted as the fiscal agent for the project and received no administrative fees from TEA for facilitating the subcontracts. The subcontractor contacted the ESC XII-Waco Associate Executive Director for Administrative and Business Services by phone and e-mail prior to initiation of each subcontract. The subcontractor provided ESC XII-Waco with a description of work to be performed and a timeline of when the work was to be completed. The subcontractor mailed and faxed invoices to ESC XII-Waco for payment.

The subcontractor presented two reports to the TEA Chief Deputy Commissioner in August 2005 and August 2006 concerning recommendations for improvements in the administrative hearings process and the implementation of those recommendations into TEA policies and procedures. The subcontractor was not required to provide reports to ESC XII-Waco; instead, both subcontracts stated that the reports were to be delivered directly to the TEA Chief Deputy Commissioner.

**Contract Related to the Commission for a College-Ready Texas**

There was the appearance of a less than arm’s-length transaction involving this contract. The contract was related to a $750,000 grant and $750,000 in-kind match from TEA to carry out statutory functions required under House Bill 1 (79th Legislature, 3rd Called Session). These funds were to be used to establish and implement the Commission for a College-Ready Texas (CCRT), an organization designed to assist state leaders in improving college readiness programs by aligning high school curriculum with college standards.

TEA did not competitively bid this contract because it was an agreement with an ESC. The Executive Director of Education Service Center XIII in Austin (ESC XIII-Austin) stated that he asked the previously mentioned public education consultant, who was known to be a member of the TEA Commissioner’s transition team, who he wanted on the project. The consultant recommended several individuals to the ESC XIII-Austin Executive Director to work on this project. These individuals were subsequently hired by ESC XIII-Austin.
ESC XIII-Austin did not follow its procurement policies when it entered into subcontracts with the individuals who conducted this project. ESC XIII-Austin said it managed the subcontract and was the fiscal agent on the project. The project was overseen by the CCRT and TEA staff.

**Contract Related to State Funding Technical Assistance**

There was the appearance of a less than arm’s-length transaction involving this contract to provide TEA advisory and technical assistance in the areas of school finance, fiscal analysis, state funding programs, financial modeling, and projections of fiscal impact. The contract was for $130,000.

TEA did not competitively bid this contract because it was an interlocal agreement with an ESC. The TEA Chief Operating Officer requested that ESC XIII-Austin hire a TEA employee who had recently retired. ESC XIII-Austin did not follow its procurement policies when it entered into a subcontract with the former TEA employee. ESC XIII-Austin entered into a contract with TEA. ESC XIII-Austin said it was the fiscal agent on the project. The subcontractor was supervised by TEA executive staff.

TEA provided the subcontractor with office space, the use of a computer and a telephone, and general office supplies. None of these resources was included in the contract between TEA and ESC XIII-Austin.

**Contracts Related to the Gates Honor State Grant**

There was the appearance of less than arm’s-length transactions involving these contracts to work on communicating information to high school dropouts, parents, and teachers. The first subcontract was for $101,500 and the second subcontract was for $73,500.

TEA did not competitively bid these contracts because they were interlocal agreements with an ESC. TEA executive staff requested that ESC XIII-Austin subcontract with the former TEA Commissioner’s speech writer to work on this project. The subcontractor’s work included creating brochures and establishing a Web site. The work the subcontractor conducted was part of a larger project funded by a grant awarded to TEA.

ESC XIII-Austin entered into two contacts with TEA. ESC XIII-Austin said it was the fiscal agent on the project. The subcontractor entered into two subcontracts with ESC XIII-Austin. The subcontractor remitted invoices to ESC XIII-Austin. The subcontractor was supervised by TEA policy staff. ESC XIII-Austin did not follow its procurement policies when it entered into these subcontracts.

During the first subcontract, the subcontractor worked from home. For the second subcontract, because of the nature of the project and the need to interact with staff, TEA provided the subcontractor with office space, the use of a computer and a telephone, and general office supplies. The second subcontract included timelines and deadlines for work performed but did not include the subcontractor’s use of TEA resources.

The subcontractor left the project during the second subcontract, resulting in the end of that subcontract.
Recommendations

The results of our investigation indicate there is a need to strengthen controls over contracting and subcontracting at both TEA and ESCs. Therefore, we recommend that the Legislature consider the following:

- Require competitive bidding for all consulting and professional services contracts that exceed $25,000 and that are entered into by TEA.
- Require competitive bidding for all consulting and professional services contracts that exceed $25,000 and that are entered into by ESCs.
- Require that all proposed contracts between TEA and an ESC be competitively bid or, if not, that the intent to contract and final contracts be posted in the Texas Register.
- Strengthen the independence of ESC executive directors.
- When TEA enters into contracts with ESCs, require full disclosure by TEA staff of professional or personal relationships that may create a conflict of interest. For example, require a statement of independence by the individual with responsibility to approve a contract, regardless of the amount of the contract.
- Establish requirements regarding contracts between TEA and ESCs, including enforcing a requirement for a signature with a date on all contracts.

If you have any questions, please contact me at (512) 936-9500.

Sincerely,

John Keel, CPA, CFE
State Auditor

cc: The Honorable Rick Perry, Governor
    Members of the State Board of Education
    Mr. Robert Scott, Commissioner, Texas Education Agency