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STATE OF NEW YORK
OFFICE OF THE STATE COMPTROLLER

December 2, 2004

Mr. Anthony Coscia
Chairman
Port Authority of New York & New Jersey
225 Park Avenue South
New York, NY 10003-1604

Re: Contract for Temporary PATH Station
Report 2004-S-44

Dear Mr. Coscia:

According to the State Comptroller's authority as set forth in Section 7071 of McKinney's Unconsolidated Laws of New York, we audited the contract awarded by the Port Authority of New York and New Jersey (Authority) for the construction of the temporary PATH station and related work at the World Trade Center (Trade Center) site. Our audit covered the period November 1, 2001 through July 15, 2004.

A. Background

The Authority provides passenger rail service in the Port District through the Port Authority Trans-Hudson (PATH) railroad. The events surrounding the terrorist attack on the Trade Center on September 11, 2001 caused significant damage to the facilities providing PATH rail service between the Trade Center site in lower Manhattan and Jersey City, New Jersey. Restoring PATH service between these two locations became an immediate priority for Authority management.

On February 1, 2002, the governors of New York and New Jersey announced that the Authority had awarded a $300 million construction contract that would result in restored PATH service between the two locations. Under this contract, a new temporary PATH station would be constructed at the Trade Center site, the tunnels leading to the station would be repaired, and related repairs and upgrades would be made at the Exchange Place station in Jersey City, New Jersey. The contract was awarded to Yonkers, Tully, Pegno J.V. (Contractor), a joint venture of contractors from the New York City area.

The Authority set goals of re-establishing service to the Trade Center within 24 months, and re-establishing service to the Exchange Place station within 18 months, from the time of the contract award. Although the contract was awarded and the deadlines were established on February 1, 2002, control of the Trade Center site was not turned over to the Authority until July 1, 2002 because of clean-up and investigative activities. Nevertheless, PATH service was re-established within the

desired time frames: the Exchange Place station was re-opened on June 29, 2003 (within 17 months), and the temporary Trade Center station was opened on November 23, 2003 (within 22 months).

The $300 million construction contract stipulated that the Contractor would be compensated on a net cost basis. Specifically, the Contractor would be paid a flat fee and would be reimbursed for the net cost of the work, and the fee and the reimbursement together were not to exceed $300 million. The items eligible for reimbursement were described in the contract.

In July 2003, the contract was revised. The value of the contract was increased to $455 million (with an additional $5 million performance bonus), and the method of payment was converted to a guaranteed maximum payment (GMP) contract. GMP is a form of lump sum payment, in which an agreed upon maximum total is paid to a contractor for completing a defined scope of work, regardless of whether the contractor's costs exceed the maximum payment amount. However, if the contractor's total costs are less than the GMP amount, the savings are shared by the contractor and the contracting party. In this case, if the project is completed at a cost of $455 million or more, the Contractor will be paid $455 million (excluding any bonuses). If the project is completed at a cost of less than $455 million, the savings (the difference between the actual cost and $455 million) will be shared equally by the Authority and the Contractor.

B. Audit Scope, Objectives and Methodology

We audited the Authority's oversight of the construction contract for the restoration of PATH service between the two locations for the period November 1, 2001 through July 15, 2004. The objectives of our performance audit were to determine whether the increase in contract cost from $300 million to $455 million was legitimate, and whether Authority management followed proper procedures in awarding and monitoring the contract.

To accomplish our objectives, we interviewed Authority officials and reviewed applicable sections of federal laws. We reviewed Authority Board of Commissioners (Board) minutes relating to the authorization of the project, as well as documentation of Authority cost estimates for the project. In particular, we reviewed and analyzed the cost estimates that were used in converting the contract from a net cost basis of payment to a GMP basis of payment to determine when the conversions (contracts) occurred and whether they were properly supported. In addition, we reviewed Authority procurement documents identifying the steps that were followed in awarding the contracts, and we reviewed Authority policies and procedures associated with construction contracts in general.

We also reviewed the work papers of the Authority's internal audit unit to determine the extent of audit work done by the unit on this contract. In particular, we reviewed the work done by the unit in verifying the Contractor's costs and billings to the Authority, and we reviewed adjustments made by the unit to the Contractor's costs. We also evaluated the internal audit unit's compliance with professional auditing standards.

We did our audit according to Generally Accepted Government Auditing Standards. Such standards require that we plan and perform our audit to adequately assess Authority operations within our audit scope. Further, these standards require that we understand the Authority's internal control structure and compliance with those laws, rules and regulations that are relevant to the

operations included in our audit scope. An audit includes examining, on a test basis, evidence supporting transactions recorded in the accounting and operating records, and applying such other auditing procedures as we consider necessary in the circumstances. An audit also includes assessing the estimates, judgments and decisions made by management. We believe our audit provides a reasonable basis for our findings, conclusions and recommendations.

In addition to being the State Auditor, the Comptroller performs certain other constitutionally and statutorily mandated duties as the chief fiscal officer of New York State, several of which are performed by the Division of State Services. These include operating the State's accounting system; preparing the State financial statements; and approving State refunds and other payments. In addition, the Comptroller appoints members to certain boards, commissions and public authorities, some of whom have minority voting rights. These duties may be considered management functions for purposes of evaluating organizational independence under Generally Accepted Government Auditing Standards. In our opinion, these management functions do not affect our ability to conduct independent audits of program performance.

C. Results of Audit

Authority management restored PATH rail service between the Trade Center and Jersey City ahead of schedule. We found that the increase in contract cost from $300 million to $455 million was legitimate. The contract amount of $300 million was based on incomplete information, as complete information could not be obtained due to the initial difficulty of assessing the full extent of damage at the work site. The subsequent $155 million increase in costs was commensurate with the additional work that was identified when a thorough assessment of the work site could be performed. The increase in costs was also commensurate with the increase in risk that was accepted by the Contractor (under the revised contract, all cost overruns must be funded by the Contractor). The cost increase was also supported by Authority documentation, including cost estimates developed by Authority engineers.

We also found that the Authority complied, for the most part, with its procurement procedures in awarding the contract, and its lack of full compliance was attributable to the large scale and tight time frames of the project. We further found that the Authority has conducted appropriate ongoing monitoring of contract work. In particular, Authority engineers have performed on-site monitoring of labor, materials, and equipment, and the Authority's internal audit unit has verified Contractor costs and billings.

1. Cost Increase

To determine why the cost of the contract increased from the initial $300 million to $455 million, we met with Authority officials. The officials provided explanations for the cost increase and documentation to support their explanations. This documentation included detailed estimates of construction costs and proposals to the Board describing the reasons for the cost increase.

First, we found the amount of the initial contract ($300 million) was never considered sufficient for all the work that was to be performed under the contract (i.e., the construction of the temporary PATH station, the reconstruction and repair of the tracks and tunnels leading to the station, and the repair and upgrade work at the Exchange Place station). In an Authority project

proposal that was sent to the Board in November 2001 and approved by the Board in December 2001, the construction of the temporary PATH station alone was estimated to cost $395 million, with an additional $50 million for contingencies due to the uncertainties involving the Trade Center site.

Second, we found that the initial contract amount of $300 million was not based on a thorough assessment of the work site, because such an assessment could not be made within the tight time frames that were necessary to enable rail service to be restored quickly. Due to the vast destruction at the Trade Center site, the Authority's engineers could not be both quick and accurate in their assessments of the work that needed to be done. Thus, the initial contract amount of $300 million was developed without design documentation and was designed to get the work started quickly.

It should also be noted that the contract was initially awarded on a net cost basis, rather than a lump sum basis, because design documentation had not been developed. In a net cost contract, cost overruns are absorbed by the Authority; in a lump sum contract, cost overruns are absorbed by the contractor. The Authority prefers to bid contracts on a lump sum basis rather than a net cost basis, because the risks are distributed between the Authority and the contractor and the Authority is insulated against cost overruns. However, a lump sum contract is most effective when the scope of the work is clearly defined so potential bidders can submit complete and accurate bids. In the absence of design documentation, the scope of work in the initial contract could not be clearly defined.

After the Trade Center site was cleaned up, Authority engineers made a thorough assessment of the construction work that needed to done. The Authority then took steps to convert the contract to a lump sum basis of payment and thereby mitigate its exposure to the risks of cost overruns. The engineers then worked with the Contractor to convert the method of payment in the contract from net cost reimbursement to GMP. This was accomplished through 13 separate contracts that were negotiated between November 2002 and June 2003. In each contract, a certain portion of the work was defined in detail by Authority engineers, cost estimates were developed for the work by the engineers, and the Authority and the Contractor agreed to a specific price for that portion of the work.

In reaching agreement on a price for each portion of the work, the Authority and the Contractor followed certain procedures that have been developed by the Authority for such negotiations. These procedures provide assurance the negotiated price is consistent with the Authority's cost estimates. We examined documentation relating to these negotiations and determined that the procedures were in fact followed, and the price agreed upon for each of the 13 phases was consistent with the Authority's cost estimates.

The 13 contracts had a value of $101.8 million. In addition, the Contractor was paid for some work on a net cost basis, as stipulated in the original contract, because contract work began in 2002 but conversion to the GMP payment method was not completed until June 2003. As a result, in

the final contract the total cost was increased to $455 million (with a provision for a $5 million performance bonus). The $455 million took into consideration payments already made under the original contract, fees paid to the contractor, as well as the amounts of the 13 contracts previously agreed to.

As of March 31, 2004, Authority officials reported that the actual costs on the Contractor's books was $473.9 million. Thus, while there is no opportunity for the Authority to share in any savings, the Contractor is responsible for all costs in excess of $455 million.

2. Contract Award and Monitoring

We found the Authority complied, for the most part, with its procurement procedures. While the contract was not offered for public bid as required by Authority procedures, it was competitively bid. We also found the Authority has monitored the contract and construction activities on a regular basis and continues to do so through on-site engineers and its internal audit unit.

The contract was not publicly bid because of the large scale and tight time frames of the project. Instead, the Chief Engineer's Office in the Authority developed criteria that could be used to identify companies that could handle the project. The Authority used the criteria to identify four companies that appeared capable of performing the work, and asked the four companies to submit competitive bids. Because so much work had to be completed within such tight time frames, the four companies created two separate joint ventures for the purpose of bidding on the contract, and each joint venture submitted its own bid (the bids for the initial net cost contract represented the fees the contractors would charge the Authority). The two bids were opened publicly by the Authority, and the contract was awarded to the low bid of $16.7 million, which was lower than the Authority's bid estimate. The second bid was $23.8 million.

Once the contract was awarded, the Authority monitored the contract on an ongoing basis. For example, Authority engineers monitor the cost of labor, purchases, and equipment at the construction sites. These engineers must approve all purchases, timesheets and equipment. Other Authority engineers perform desk reviews to determine whether the required approvals have been obtained.

In addition, the Authority's internal audit unit has verified a substantial portion of the Contractor's costs and billings. According to Authority records, the internal auditors began reviewing billings in June 2002. Moreover, in August 2003, right after the final conversion phase, the internal audit unit verified costs recorded in the Contractor's books. As of March 31, 2004, the unit had tested about $126.6 million of transactions, which accounted for almost 27 percent of the total costs recorded on the Contractor's books, and had identified about $11 million in adjustments to these costs. The internal audit unit will continue to monitor costs until the project is complete.

We provided draft copies of the matters contained in this report to Authority officials for their review and comment. We considered their comments in preparing this report. A complete copy of the Authority's response is included as Appendix A.

Major contributors to the report include Al Kee, Ed Durocher, Brian Krawiecki, Vicki

Wilkins, Amanda Strait and Marticia Madory.

We wish to thank the management and staff of the Port Authority of New York and New Jersey for the courtesies and cooperation extended to our auditors during this audit.

Yours truly,

David R. Hancox
Audit Director

cc: Robert Barnes, DOB

A. Paul Blanco
Chief Financial Officer

November 10, 2004

Mr. David R. Hancox
State Audit Bureau Director
Office of the State Comptroller
State of New York
110 State Street
Albany, N. Y. 12236

RE: Office of the State Comptroller - Report 2004-S-44 (Draft): Contract for Temporary PATH Station at the World Trade Center site

Dear Mr. Hancox:

We have reviewed the working draft of the subject audit report, which you forwarded to us on October 12, 2004. We are pleased to note that the audit concluded that The Port Authority of New York and New Jersey followed proper procedures in awarding the contract for the construction of the temporary PATH station at the World Trade Center site, that the amount of the contract was reasonable relative to the work, and that appropriate monitoring of contract work and reviews of contractor billings have taken place.

The Port Authority places great emphasis on the integrity of its processes and adherence to the guidelines and checks and balances which exist to ensure such integrity; and no less emphasis was placed by the Port Authority on the temporary PATH station project, size of project and completion deadlines notwithstanding.

We appreciate your staff's efforts and professionalism in conducting this review and look forward to receiving the final audit report closing out this review.

Sincerely,

A. Paul Blanco
Chief Financial Officer

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Appendix A