



Office of Mayor-Elect Lenny Curry

Fiscal Responsibility Sub-Committee Meeting

June 25, 2015

Jacksonville University

Davis College of Business

Public Policy Institute

2800 University Blvd, Room 171

IN ATTENDANCE:

Jay Demetree, Chair

Kelly Flanagan, Member

Jack Webb, Member

Peggy Sidman, OGC Representative

Greg Pease, SME

Chief Charles Moreland, Transition Team

GUESTS:

Devin Carter, COJ

Kirk Sherman, Council Auditor

Joe Orfano, JEA

Wendy Jones, Recorder

Chair Jay Demetree opened the meeting at 3:07 p.m. with no quorum present.

The Chair introduced Kirk Sherman, Council Auditor, who provided an explanation of Internal Services Charges. He provided all with an information sheet regarding pricing internal services from the Government Finance Officers Association. Currently the three (3) largest groups who bill internally are Fleet Management, Information Technologies and Office of General Council (OGC). OGC is the easiest to bill because they are a service with billable hours. The goal of the internal service accounts are to break even because they are not to be a profit center in the budget. There are considerable calculations done to make sure that the right costs are being loaded into the budget; however, they cannot be truly judged until the end of the fiscal year when the accounts are balanced. Capital items are loaded in and accounted for in these funds as the goal is to build up the cash reserves over the life of the item to be able to purchase a replacement item at the end of the life expectancy. OGC does bill outside agencies for their services.

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When trying to decide if an outside vendor would provide a cost savings on these types of funds, the City must be sure to compare apples to apples and include all levels of the service when going out during an RFP process. Public Buildings began internal billing 2 years ago. It must be noted that when there are changes to the billing methodology, adjustments must be made so that a true comparison between fiscal years can be done. With this done the Departments can defend their budgets when asked why costs are going up or down from year to year. It was asked what type of control system is in place regarding the internal services charges to which the answer is they must break even at the end of the year. Each of the departments that are billing (IT/OGC/PW/Fleet) has oversight of the billing process with the Chief Finance Officer and annually the Council Auditors reviewing the charges so that the billed departments are not overcharged.

The Chair expressed the need to prepare bullet points for the Committee's recommendations beginning next Tuesday.

Kirk Sherman was asked about the Banking fund. He said that it was easy to borrow money with this fund making it like a credit card instead of a mortgage. Legislation was introduced by the CIP Committee this week in City Council to pull the Banking Fund.

Meeting was adjourned at 4:01 p.m.



Office of Mayor-Elect Lenny Curry

AGENDA

Date: June 25, 2015

Time: 3:00 p.m.

Committee: Fiscal Responsibility Subcommittee Meeting

- | | | |
|-------------|--|--------------------------------------|
| I. | Review and Approval of Minutes 06.23.15 | Jay Demetree, Chair |
| II. | Presentation – Internal Service Charges | Kirk Sherman, Council Auditor |
| III. | New Business | Committee |
| IV. | Public Comments | |
| V. | Adjourn | |

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Fiscal Responsibility Sub-Committee

June 25, 2015

Name	Title	Signature
Mr. Jay Demetree	Chair	JOSEPH T. DEMETREE
Ms. Kelly Flanagan	Member	Kelly Flanagan
Mr. Hugh Greene	Member	
Mr. Andy Crawford	Member	
Mr. John Surface	Member	
Mr. Ron Townsend	Member	unable to attend
Ms. Cindy Stover	Member	
Mr. Aubrey Edge	Member	
Mr. Jack Webb	Member	Jack Webb
Ms. Peggy Sidman	OGC Representative	Peggy Sidman
Mr. Glenn Hansen	SME	Glenn Hansen
Mr. Greg Pease	SME	Greg Pease
Chief Charles Moreland	Transition Team	Charles Moreland
Guests / Visitors:		
KIRK SHESMAN	COUNCIL AUDITOR	Kirk Shesman
Joe Crigine	TEA	Joe Crigine
Devin Carter	COF	Devin Carter



GOVERNMENT SERVICES

Pricing Internal Services

Background. Internal services are those responsibilities a government provides to support its own internal operations. Common examples of internal services include information technology, payroll, motor pool, budgeting, legal, accounting, and human resources. Certain management objectives are served by creating a system to assign prices for the use of these internal services, which are then assessed to the departments that use the services. However, there is a cost to develop and maintain internal pricing systems. Governments must weigh the benefits of an internal services costing system against the cost and complexity of system design choices. Please note that this best practice is intended to apply to internal service charges regardless of whether it is accounted for in an internal service fund or as a general fund overhead allocation.

Recommendation. GFOA recommends that governments follow these steps when considering an internal service pricing system:

1. Identify goals of internal service pricing;
2. Develop allocation strategy;
3. Define level of costing detail;
4. Determine cost of service;
5. Decide basis of allocation; and
6. Consider potential drawbacks.

Identify goals of internal service pricing. As a first step, GFOA recommends that governments identify the goals they hope to achieve through a pricing system for internal services. The goals will guide the design of the system. Potential goals for a pricing system include:

- Govern demand for a service. If the customers of an internal service are not charged based on their level of use they may have an incentive to over-use the service. Alternatively, charges may cause customers to limit their use of the service.
- Develop enterprise rate models. Government enterprises (e.g., a water utility) may use services provided by the general government. A pricing system could provide an input into the rate model used to calculate fees for the customers of the enterprise.
- Calculate indirect cost reimbursement for grants. Some grants may allow indirect costs to be reimbursed. An internal pricing system provides support for the reimbursement request.

- Provide input for full-costing model. A full costing model provides the total cost of a given service, which enables better informed budgeting and planning. The “full cost” of a program is equal to the direct cost of program plus the indirect costs. Internal service pricing is essential to calculating indirect costs.
- Promote discussion about the value of the service provided. Charging customer departments for use of a service will raise questions about the value received from the service and what the best service delivery model is (e.g., centralized, decentralized, outsourced, etc.). A pricing system can facilitate comparisons with alternative methods of service delivery, including outside providers.
- Examine value of a shared service model. Shared services are thought to deliver greater efficiency through economies of scale. A solid pricing model is important for determining if a shared service model is delivering on this promise.
- Promote competition in service delivery. Internal services could be run much like a private business, including service level agreements with customers and competition from outside providers (e.g., private firms). Accurate internal charges are essential for a level competitive field.¹
- Ability to customize service levels for different customers. A detailed rate model makes it easier to provide a higher level of service to a customer that demands it because they can be charged a higher fee.

Develop allocation strategy. After the goals have been identified, the organization must decide which internal services will be priced and allocated to user departments. To make this decision, it may be useful to differentiate between “market” services and those that have more of a policy or regulatory character.

- Market services are those where the user departments play the role of consumer. Examples of market services include IT, fleet, and perhaps facilities.
 - The charges for market services have application to goals like promoting competition in service delivery, governing demand, and/or examining the value of a shared service model. Charging user departments for regulatory/policy services could be necessary for goals like developing a full costing system or calculating indirect cost reimbursement for grants.
- Policy or regulatory services are used to establish organization-wide policies or ensure compliance with standards. Users of these services cannot be as easily described as “customers,” but more accurately as “regulated.” Examples of policy/regulatory services include budgeting, internal auditors, or a chief executive.

Define level of costing detail. Governments need to determine the level of detail associated with costing services.

- A low level of detail might define internal services at the department level (e.g., finance department, IT department). A low level of detail might be sufficient for a costing system with limited goals, such as developing enterprise rate models or obtaining reimbursement for indirect costs under a grant.

- A high level of detail would define services at the level of programs or other subunits (e.g., the various subdivisions of finance and IT cited earlier). A high level of detail might be needed for goals like governing the demand for service or promoting discussions about the value of a service.

In summary, a higher level of detail will lead to a more accurate costing system since the activities represented by the internal service categories will be more specified. However, more detail also leads to a more complex internal services pricing system. The government must decide if greater complexity (and its associated costs) will be worth the benefits.

Determine cost of service. With the internal services identified at either a high or low level of detail, the next step is to determine the cost of the service. The elements of the cost that should be considered include:

- **Direct costs.** Direct costs are the most essential cost element. This includes the service's personnel, materials, supplies, and contractors.
- **Interest costs from internal loans.** If the internal service takes loans from other parts of the government then a market interest rate may be applied.²
- **Services used from other support services.** A cost model can be designed such that the cost of the internal service reflects not only its direct costs, but also the indirect cost from other support services that it uses (e.g., an IT service uses payroll). This aspect of costing can be performed at varying levels of complexity – methods that fully reflect how each internal service uses the services of other internal providers can become much more complex than those that provide less precise estimates.³

Decide basis of allocation. With cost of the service decided, the bases for allocating costs from the internal service to customers must be decided. Table 1 provides examples of internal services and cost allocation bases. Below are general principles that should be observed when determining bases.

- **Cause-and-effect relationship.** Costs should be allocated based on usage or causal factors relating to costs incurred by service provider. See Table 1 for examples of how cost bases for internal services can be related to the usage of various internal services.
- **Benefit received.** The basis for allocation should bear a relationship to the benefit the customer receives from the service. For example, while "miles driven" might be a good barometer of the benefit that police patrol receives from its vehicles, "hours used" might be a better measure for public works.
- **Fairness.** The method of cost allocation that will be used must be seen as fair and legitimate by the users of the costing system. The fee should be charged equitably based on use and other considerations.⁴ Users must understand how the costs are calculated and should have a role in determining how the price system will be structured.⁵
- **Legal constraints.** State laws may place constraints on how charges are developed. For example, if the charge for providing a service exceeds the true cost of the service, it could be construed as a tax under the law. Also, federal regulations on grants may place limits on internal charges against grant programs.⁶

Table 1 - Examples of Internal Services Cost Allocation Bases

Internal Service	Allocation Basis
Payroll processing	Number of employees, number of checks
Budgeting	Labor hours, size of budget
Insurance	Number of employees, experience
Legal services	Direct labor hours
Office space / rent	Square feet of space occupied
Procurement services	Number of P.O.s, dollar volumes, direct labor
Vehicle costs	Miles driven, hours used
Information technology	Number of devices, server time, number of calls to help desk, direct labor hours

A government might also consider the accounting mechanism for the internal charge. An internal service fund provides the most detailed accounting, but also entails the most administrative effort. If the goals of the internal charge are modest (e.g., not charging back to federal grants, full cost recovery is not a goal), then it may be easier to simply recognize the charge as a general revenue in the general fund (or some other fund as may be appropriate to the circumstances).

Governments should also regularly review their internal charge rates against actual experience for appropriate adjustments. Governments should also develop guidelines to determine what will happen to excess funds should an internal charge generate cost recovery proceeds in excess of actual costs.

Consider potential drawbacks of internal costing systems. Finally, governments should be aware of the drawbacks of internal costing systems below and should consider mitigating strategies.

- Diminished trust between providers and customers. A charge system could create a suspicion among customers about how charges are developed and/or administered, especially if the basis of the charges is not adequately communicated to customers.
- Subverting processes or not using shared services. If customers perceive charges to be too high or unfair, they may respond by developing their own service capabilities. This can lead to duplication of resources and wasted effort.
- Acrimony and debate over the charge system. Even if users do not subvert the system, a costing system that is viewed negatively by users could

generate a great deal of debate and discussion - energy that could be better spent on other pursuits.

- Costs exceed the benefits of the system. A precise internal costing system can be relatively complex. Complexity entails cost, such as training managers to use cost information. Whether this complexity and cost is worth it should be seriously considered in light of the goals for the system and system design choices.
- Unmet expectations. Managers can become frustrated with the system if they do not understand what it can and cannot accomplish. For example, if internal charges cause users to lower their consumption of a service they may see their per unit cost rise as the fixed cost of service is now allocated over a lower volume.

Notes.

- 1 However, it should be noted that comparing internal charges to a potential external service provider's proposed fee cannot be the basis for a sound outsourcing decision because the external provider's proposed cost must be compared to the internal costs the government will avoid (i.e., no longer have to incur) by using the external provider (known as "avoidable costs"). For example, there may be overhead costs included in an internal charge that will not be eliminated (avoided) by using an external provider.
- 2 If used, the interest rate should be consistent with any governing laws/regulations.
- 3 For example, "single step allocations" are the least complex, but is less precise, while "reciprocal allocations" are more precise, but much more complex. For a complete explanation of these methods please consult R. Gregory Michel, *Cost Analysis and Activity-Based Costing for Government*. (Chicago, Illinois: GFOA) 2004
- 4 For example, the customer may provide value back to the internal service in some way that justifies a lower charge.
- 5 IT governance systems are an example of a means for giving customer departments input into rate modeling decisions. See GFOA's publication *IT Budgeting and Decision Making* (2009).
- 6 For example, the Federal Office of Management and Budget circular A-87 outlines standards for determining costs which can be charged to Federal grants and reimbursement contracts.