

U10B00
Maryland Environmental Service

Operating Budget Data

(\$ in Thousands)

	<u>FY 02</u>	<u>FY 03</u>	<u>FY 04</u>	<u>FY 02-04</u> <u>Change</u>	<u>FY 05</u>	<u>FY 04-05</u> <u>Change</u>
Operations	\$58,193	\$77,170	\$78,751	\$20,558	\$60,453	-\$18,298
Contractual Services	12,362	13,629	16,247	3,885	11,819	-4,428
Grants	0	0	0	\$0	0	0
Adjusted Grand Total	\$70,555	\$90,799	\$94,998	\$24,443	\$72,272	-\$22,726
Nonbudgeted	70,555	90,799	94,998	24,443	72,272	-22,726
Total Nonbudgeted Funds	\$70,555	\$90,799	\$94,998	\$24,443	\$72,272	-\$22,726
Annual % Change		28.7%	4.6%		-23.9%	

- A number of Maryland Environmental Service (MES) projects are either scheduled for completion during the fiscal year, or the scope of work is not yet fully defined and they cannot be budgeted. These factors account for the projected decrease in the estimated fiscal 2005 budget. Some of the large projects winding down or scheduled for completion are Dundalk Marine Terminal, Boehml/Crownsville Tire Stockpile Clean-up, and Cox Creek construction.

Personnel Data

	<u>FY 02</u>	<u>FY 03</u>	<u>FY 04</u>	<u>FY 02-04</u> <u>Change</u>	<u>FY 05</u>	<u>FY 04-05</u> <u>Change</u>
Regular Positions	560.0	576.5	585.5	26	585.5	0.0
Contractual FTEs	0.0	0.0	0.0	0	0.0	0.0
Total Personnel	560.0	576.5	585.5	26	585.5	0.0

- MES does not anticipate a change in the number of positions between fiscal 2004 and 2005.

Note: Numbers may not sum to total due to rounding.

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Analysis in Brief

Issues

Crumb Rubber Manufacturing Operation Seeks Customers: In February 2003, MES initiated its biggest business venture to date: a whole scrap tire-to-crumb rubber manufacturing facility in Western Baltimore County. Like many start-up efforts to manufacture and sell products, MES is managing several financing and marketing challenges associated with this effort. **MES should be prepared to discuss how it is meeting the financing obligations associated with this facility; the latest expense and revenue estimates for the current and future year; and how it intends to better balance production and inventory levels with sales in the future.**

MES Feels Its Way Through FertileGRO's First Year: Sales of MES's FertileGRO organic fertilizer were slow during its first year, but fiscal 2004 sales are up and associated operating practices are being improved. **MES should be prepared to discuss the environmental benefits (i.e., tons of poultry litter removed from Maryland's Eastern Shore) of producing FertileGRO and establishing the broader bagging operation.**

Recommended Actions

1. Nonbudgeted.

Updates

MES Moves to Millersville: MES is a 50% partner in a new \$6.3 million office building in Millersville. The agency plans to move into this new, larger building in July 2004.

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Operating Budget Analysis

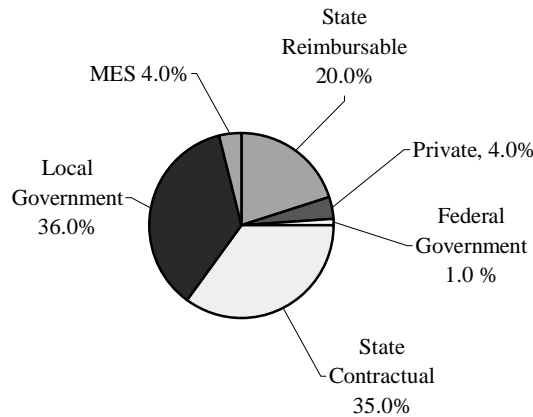
Program Description

The Maryland Environmental Service (MES) was created as a unit within the Department of Natural Resources (DNR) in 1970 to provide water supply, wastewater treatment, and waste management services to State agencies, local governments, and private entities. During the 1993 session, the General Assembly adopted legislation that created MES as an instrumentality of the State and a public corporation independent of DNR. The organization's primary goals are to improve the environment, work more safely, and provide excellent customer service and satisfaction. MES provides technical services including engineering, design, financing, construction, and operation of water supply and wastewater treatment facilities. MES also provides similar services in the area of hazardous and solid waste facility management, including sanitary landfills, incinerators, and resource recovery facilities. Additional services offered include sludge and dredged materials management, recycling and marketing of end products, and regulatory monitoring. Currently, MES operates over 200 water and wastewater treatment facilities, as well as the Poplar Island environmental restoration project, the Hart-Miller Island Dredged Material Containment Facility, and a regional yard-debris composting facility.

MES operates on a fee-for-service basis. Operating funds are generated from five sources: State agency contracts, local government contracts, federal government contracts, private contracts, and MES enterprises. In addition, MES receives State general obligation bond appropriations for capital improvements at State-owned facilities and issues revenue bonds to finance local government projects. Revenues from State agency contracts derive from the operation and maintenance of State-owned water and wastewater treatment plants and from specific projects and services such as environmental cleanup or recycling program management. Revenues from local governments, the federal government, and the private sector derive from the operation and maintenance of water and wastewater treatment facilities and solid waste management services. MES enterprise revenues are generated by efforts such as a crumb rubber manufacturing facility as well as a bagging operation.

Exhibit 1 illustrates the agency's anticipated revenue sources for fiscal 2005. The agency expects to receive 92% of its revenue from fees charged to the State and other governments. This includes 36% for services provided to other governments, 55% for State reimbursable and contractual services, and 1% for services to the federal government. Services provided to the private sector account for 4% of the agency's total budget; 4% of the projected revenues are from MES enterprises.

Exhibit 1
Fiscal 2005 Projected Revenue Sources
Total = \$72,271,646



Source: Maryland Environmental Service

Performance Analysis: Managing for Results

MES made several changes to its performance measures over the last year. Specifically, two goals were eliminated – “increase the efficiency of administrative procedures” and “retain clients and expand our business in accordance with our vision and mission statements.” These goals and associated performance measures were replaced by the goal “provide excellent customer service and satisfaction” as measured by an annual client satisfaction survey. Other changes included eliminating the Leafgro and compost sales performance measure and adding measures that track the amount of chicken litter fertilizer MES has bagged and the number of fishing reef sites established with reef ball structures.

MES has experienced mixed performance results recently, as summarized in **Exhibit 2**.

- Client satisfaction should remain steady at 75%.
- Employee accident leave is expected to remain level at .05%, after coming down from .29% in fiscal 2001.
- Collection of used oil dipped slightly in fiscal 2003 to 806,000 gallons but is expected to climb back up to 847,000 gallons in fiscal 2005.

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- While the number of corporate and State facility violations was extremely low in fiscal 2002 (45), the number shot up by 313% in fiscal 2003 to 141 violations. MES attributes this significant increase in violations to spring rainfall infiltrating plants and overwhelming systems, as well as increasingly rigorous and frequent permitting tests.

MES made a significant financial investment in its crumb rubber manufacturing facility and anticipates that it will make a major contribution to improving the environment by finding new uses for this product. However, MES has not developed a performance measure to show the impact of this product development and marketing initiative. **MES should be prepared to discuss why formal measures have not been included in the MFR to track the crumb rubber manufacturing initiative’s performance; why the Leafgro and compost sales performance measure was eliminated; and what efforts are being implemented to improve client satisfaction.**

**Exhibit 2
Program Measurement Data
Maryland Environmental Service
Fiscal 2001 – 2005**

	<u>Actual 2001</u>	<u>Actual 2002</u>	<u>Actual 2003</u>	<u>Est. 2004</u>	<u>Est. 2005</u>	<u>Ann. Chg. 01-03</u>	<u>Ann. Chg. 03-05</u>
Client Satisfaction	n/a	n/a	n/a	75%	75%	n/a	n/a
Accident leave as a percentage of total hours worked	0.29%	0.03%	0.05%	0.05%	0.05%	-58.5%	0.0%
Used oil collection (1,000 gallons)	799	840	806	826	847	0.4%	2.5%
Corporate and State facilities violations	81	45	141	75	75	31.9%	-27.1%

Source: Maryland Environmental Service

Fiscal 2004 Actions

Impact of Cost Containment

MES contributed \$1,024,846 to the general fund for fiscal 2004 in November 2003. These funds represented unearned revenue from State projects. Unearned revenues occur when project cost estimates exceed actual project costs. MES does not foresee that this transfer will have an adverse impact. By making this contribution to the general fund and decreasing its working capital, MES will be required to carefully monitor expenditures on projects with up front costs.

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MES's audited financial statements for the fiscal year ended June 30, 2003, are attached as **Appendix 3** and **Appendix 4**. These statements illustrate that MES is in a positive financial position.

Governor's Proposed Budget

The estimated fiscal 2005 budget for MES totals \$72.3 million. This represents a 24% decrease from the 2004 working budget. A decrease is typical, since it is difficult for MES to predict new business or changes in the scope of existing contracts. However, the significant size of this decrease illustrates the potential impact that reduced State agency contracting may have on MES operations. **Exhibit 3** summarizes the major changes in the agency's budget for fiscal 2005.

Exhibit 3
Governor's Proposed Budget
Maryland Environmental Service
(\$ in Thousands)

	<u>FY 03</u>	<u>FY 04</u>	<u>FY 05</u>	<u>FY 04-05</u>	<u>FY 04-05</u>
	<u>Actual</u>	<u>Approp.</u>	<u>Allowance</u>	<u>Change</u>	<u>% Change</u>
Nonbudgeted	\$90,799	\$94,998	\$72,272	-\$22,726	-23.9%
Total Nonbudgeted	\$90,799	\$94,998	\$72,272	-\$22,726	-23.9%

Where It Goes:

Personnel Expenses

Estimated performance based compensation \$348

State Contracts

Maryland Port Administration (MPA) Site 92 Monitoring – Scope of work not defined.....	-1,209
MPA Environmental Planning and Technical Services – Scope of work not defined.....	-1,133
Eastern Correctional Institution Co-Generation Facility – Design phase and necessary repairs tapering off	-1,136
Western Acceptance Facility Upgrade – Scheduled for completion in fiscal 2005.....	-1,660
Boehml/Crownsville Tire Stockpile Cleanup – Scheduled for completion in fiscal 2005.....	-1,105
BWI Airport – Projects completed	-729
Scrap Tire Recycling – Scope of work not defined for fiscal 2005	-1,016
Cox Creek Construction – Scheduled for completion in fiscal 2005.....	-5,837
Dundalk Marine Terminal – Construction phase tapering off.....	-3,411
Springfield Hospital Infrastructure – Water system scheduled for completion in fiscal 2004.....	-1,172
Beulah Landfill Closure – Scheduled for completion in fiscal 2004	-781
Reichs Ford Landfill Closure – Scheduled for completion in fiscal 2004	-832
Rosewood Hospital Infrastructure – Scheduled for completion in fiscal 2005	-740
MD Correctional Institution Hagerstown Wastewater Treatment Plant – Scheduled for completion in fiscal 2004.....	-480
Jessup Water Distribution System – Construction phase tapering off	-400
Other	-1,433
Total	-\$22,726

Note: Numbers may not sum to total due to rounding.

Issues

1. Crumb Rubber Manufacturing Operation Seeks Customers

In February 2003, MES initiated its biggest business venture to date: a whole scrap tire-to-crumb rubber manufacturing facility in Western Baltimore County. MES's goal is to convert 1.5 million scrap tires – 30% of those generated annually in the State – per year into high quality crumb rubber. The facility converts tires retrieved from tire companies, solid waste facilities, and junk yards into tiny nuggets of pure rubber, called crumb rubber, which is then sold to manufacturers. Manufacturers use this crumb rubber to make both consumer and industrial products, such as mats, sports field turf, fence posts, insulation, and sound barriers. This operation is wholly owned by MES at an investment of \$5.5 million and currently employs 14 production staff.

Like many start-up efforts to manufacture and sell products, MES is managing several financing and marketing challenges associated with this effort.

Financing Challenges

As of December 31, 2003, MES outlays associated with this project totaled approximately \$5.5 million. Of this total outlay, \$823,000 is from MES bank accounts, and \$4,680,000 is being financed through SunTrust Leasing. The semiannual debt service payments are \$345,746. This lease financing agreement is backed by the full faith and credit of MES and has a taxable interest rate of 5.18%.

Revenues from the first year of operations are significantly less than estimated. In January 2003, project revenue estimates for fiscal 2003 and 2004 were \$1.2 million and \$4.0 million respectively. As **Exhibit 4** indicates, operating revenues for the first ten months of operation are approximately 50% below estimates and covered only approximately 34% of the associated operational expenses, excluding the capital debt service payment mentioned above. MES advises that lower than anticipated operating revenue has placed considerable strain on its cash flow. However, currently MES is able to meet financing obligations, and revenues picked up during the later half of 2003.

Exhibit 4
Crumb Rubber Facility Statement of Operations

	<u>1/1/03 - 6/30/03</u>	<u>7/1/03 - 10/31/03</u>	<u>Total</u>
Operating Revenue	\$122,502	\$493,280	\$615,782
Expenses	(799,784)	(1,010,099)	(1,809,883)
Total	(\$677,282)	(\$516,819)	(\$1,194,101)

Source: Maryland Environmental Service

Sales Challenges

Entering the market for crumb rubber has been a significant challenge for MES. As **Exhibit 5** illustrates, MES has developed a strong supply of tires and inventory of crumb rubber. However, sales have been lackluster as the ending inventory amounts below suggest. Recently, some of the largest customers have been Recovery Technologies Group (2,351,333 pounds), Edge Rubber (1,354,941 pounds), and Sportex (813,139 pounds). Sportex used the crumb rubber to make the artificial turf used at the M & T Bank Raven's football stadium in Baltimore.

Exhibit 5 Crumb Rubber Sales

	<u>1/1/03 - 6/30/03</u>	<u>7/1/03 - 10/31/03</u>	<u>Total</u>
Scrap Tires (tons)*	3,771.5	3,786.5	7,557
Crumb Rubber Sold (lbs)	1,257,660	5,042,687	6,300,347
Ending Inventory (lbs)	2,541,160	2,434,932	2,434,932

*Scrap tires are expressed in PTE's (passenger tire equivalents, 100 per ton)

Source: Maryland Environmental Service

MES has initiated several efforts to cultivate new customers and significantly increase sales volume, including:

- relocating the key crumb rubber marketing position from the tire facility to the Annapolis headquarters office to allow fulltime concentration on marketing efforts;
- hiring an outside consultant to generate leads for potential new customers;
- targeting specific trade shows that complement the facility's production capabilities; and
- revamping the pricing structure to be more competitive and to secure the long-term contracts necessary to build a core business.

Overall, MES has recognized the need to make the production process more flexible in order to manufacture a wider array of products. Specifically, MES is interested in moving into higher value markets such as highway construction and expanding its sports fields/athletic surfacing products. Also, MES plans to investigate the benefits of producing a 3/8" crumb rubber product for colored mulch and playgrounds.

MES should be prepared to discuss how it is meeting the financing obligations associated with this facility; the latest expense and revenue estimates for the current and future year; and how it intends to better balance production and inventory levels with sales in the future.

2. MES Feels Its Way Through FertileGRO's First Year

In January 2002, MES debuted an organic fertilizer product under the trademark name of FertileGRO Brand and began to sell it in 40-pound bags for consumer distribution. FertileGRO is sold to the landscape industry and homeowners in the Mid-Atlantic region. To finance the FertileGRO effort, MES secured a \$720,000 loan and a \$380,000 State grant. In addition, a portion of the \$823,000 in MES capital that funded the crumb rubber facility was used to build the bagging operation's infrastructure.

To develop FertileGRO, MES is purchasing a pelletized chicken litter product from Perdue AgriRecycle in Seaford, Delaware. Perdue AgriRecycle is a joint venture between Perdue Farms Inc., one of the country's largest poultry companies, and AgriRecycle, a company that developed litter-pelletizing technology. To bag the FertileGRO product, MES developed and equipped a regional bagging facility next to its crumb rubber manufacturing operation. The operation currently bags FertileGRO as well as other products, such as Pure Barnyard's poultry litter fertilizer called "Cockadoodle DOO" and a corn waste product that is used to replace chemical herbicides.

Through the sale of FertileGRO, MES is seeking to reduce nutrient runoff into the vulnerable waterways of the Chesapeake Bay. As shown in **Exhibit 6**, MES plans to substantially increase its bagging and marketing of fertilizer made from chicken litter. Increasing production will help reduce the solid waste burden on Eastern Shore counties.

Exhibit 6 Fertilizer Bagged (Tons)

2002 Actual	2003 Actual	2004 Estimated	2005 Estimated
n/a	179	1,000	1,500

Source: Maryland Environmental Service

FertileGRO sales for fiscal 2003 totaled only \$71,299, largely due to the extremely wet fall season. However, sales appear to be gaining momentum, as there was \$23,400 in sales the first four months of fiscal 2004 (July-October 2003). To encourage continued growth, MES hired a FertileGRO Manager dedicated to expanding MES efforts to market recycled organics products. MES also intends to adjust some of its operational practices. For example, there was a higher inventory of the product than desired over the past year. In the future, MES plans to better manage the inventory by bagging the product closer to actual orders received instead of forecasting sales.

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MES should be prepared to discuss the environmental benefits (i.e., tons of poultry litter removed from Maryland's Eastern Shore) of producing FertileGRO and establishing the broader bagging operation.

Recommended Actions

1. Nonbudgeted.

Updates

1. MES Moves to Millersville

MES is a 50% partner in a joint venture formed for the purpose of developing an office building that will serve as its new headquarters. The cost of the new building is estimated at \$6.3 million, with each partner contributing approximately \$500,000, and the remaining \$5.3 million being financed over the next 20 years. MES plans to move into the 45,233 square foot two-story building in July 2004. MES may exercise a purchase option after ten years.

Current and Prior Year Budgets

Current and Prior Year Budgets Maryland Environmental Service (\$ in Thousands)

	Nonbudgeted <u>Fund</u>	<u>Total</u>
Fiscal 2003		
Estimated Budget	\$74,062	\$74,062
Change	16,737	16,737
Actual Expenditures	\$90,799	\$90,799
Fiscal 2004		
Estimated Budget	\$65,266	\$65,266
Change	29,732	29,732
Working Budget	\$94,998	\$94,998

Note: Numbers may not sum to total due to rounding.

Fiscal 2003 Budget Changes

The significant difference between the estimated budget and actual expenditures is largely the result of new contracts and conservative budget forecasting practices. When developing its budget, MES assumed several projects would not go forward because the project scope of work was not finalized.

Fiscal 2004 Budget Changes

Similar to fiscal 2003 changes, the \$29.7 million fiscal 2004 increase is due to new contracts and conservative budget forecasting practices. While the majority of the additional revenue is the result of potential projects becoming defined, MES has entered into numerous unanticipated contracts with entities such as the City of Frostburg, the Maryland Aviation Administration, and Baltimore County.

**Object/Fund Difference Report
Maryland Environmental Service**

<u>Object/Fund</u>	<u>FY03 Actual</u>	<u>FY04 Working Appropriation</u>	<u>FY05 Allowance</u>	<u>FY04 - FY05 Amount Change</u>	<u>Percent Change</u>
Positions					
01 Regular	576.50	585.50	585.50	0	0%
Total Positions	576.50	585.50	585.50	0	0%
Objects					
01 Salaries and Wages	\$ 28,812,373	\$ 31,874,517	\$ 32,222,372	\$ 347,855	1.1%
02 Technical & Spec Fees	5,174,351	5,653,905	2,561,388	-3,092,517	-54.7%
03 Communication	477,465	447,957	430,495	-17,462	-3.9%
04 Travel	170,828	204,684	138,277	-66,407	-32.4%
06 Fuel & Utilities	2,223,591	2,664,683	2,401,856	-262,827	-9.9%
07 Motor Vehicles	2,478,994	2,423,327	2,263,441	-159,886	-6.6%
08 Contractual Services	13,629,213	16,246,943	11,819,176	-4,427,767	-27.3%
09 Supplies & Materials	6,859,787	7,761,273	6,761,037	-1,000,236	-12.9%
10 Equip - Replacement	3,142,038	1,031,956	1,151,482	119,526	11.6%
11 Equip - Additional	7,980,001	1,672,560	1,376,851	-295,709	-17.7%
13 Fixed Charges	4,419,661	5,277,822	5,307,808	29,986	0.6%
14 Land & Structures	15,431,025	19,738,678	5,837,463	-13,901,215	-70.4%
Total Objects	\$ 90,799,327	\$ 94,998,305	\$ 72,271,646	-\$ 22,726,659	-23.9%
Funds					
07 Nonbudgeted Fund	\$ 90,799,327	\$ 94,998,305	\$ 72,271,646	-\$ 22,726,659	-23.9%
Total Funds	\$ 90,799,327	\$ 94,998,305	\$ 72,271,646	-\$ 22,726,659	-23.9%

Note: Fiscal 2004 appropriations and fiscal 2005 allowance do not include deficiencies, cost containment, and contingent reductions.

Statement of Revenues, Expenses and Changes in Net Assets
Years Ended June 30, 2002 and 2003
(\$ in Thousands)

	<u>2002</u>	<u>2003</u>
<i>Operating revenues:</i>		
Charges for services	\$67,788	\$74,672
<i>Operating expenses:</i>		
Salaries and benefits	20,191	22,935
Contractual services	11,786	12,763
Technical fees	4,686	4,047
Utilities	2,011	2,060
Repairs and maintenance	2,058	2,345
Materials and supplies	5,141	6,202
Land, structures and equipment	10,564	13,659
Depreciation	2,028	1,924
General and administrative	6,851	7,100
Other	962	707
Total operating expenses	\$66,278	\$73,742
Operating income	1,510	930
<i>Nonoperating revenues (expenses):</i>		
Interest income	678	444
Gain (loss) sale of equipment, net	21	-36
Interest expense	-1,780	-1,724
Nonoperating expenses, net	-1,081	-1,316
Income (loss) before contributions	429	-386
Capital grants	72	1,424
Change in net assets	501	1,038
Net assets, beginning of year	9,167	9,668
Net assets, end of year	\$9,668	\$10,706

Source: KPMG LLP

Statement of Cash Flows
Years Ended June 30, 2002 and 2003
(\$ in Thousands)

	<u>2002</u>	<u>2003</u>
Cash Flows from Operating Activities		
Receipts from customers	\$63,860	\$74,984
Payments to suppliers	-40,315	-46,059
Payments to employees	-20,003	-22,748
Other receipts (payments) net	<u>1,574</u>	<u>5,051</u>
Net cash provided by operating activities	5,116	11,228
Cash Flows from Capital and Related Financing Activities		
Proceeds from capital debt	5,391	721
Capital grants	72	1,424
Purchase of capital assets	-1,563	-7,766
Direct financing lease principal payments received	897	1,658
Principal paid on capital debt	-3,288	-3,590
Interest paid on capital debt	-1,715	-1,661
Other receipts (payments) net	<u>-642</u>	<u>31</u>
Net cash used by capital and related financing activities	-848	-9,183
Cash Flows from Investing Activities		
Purchases of investments	-64,831	-57,592
Sales and maturities of investments	59,439	55,933
Interest and dividends	<u>678</u>	<u>444</u>
Net cash used by investing activities	<u>-4,714</u>	<u>-1,215</u>
Net decrease in cash and cash equivalents	-446	830
Cash and cash equivalents – beginning of the year	732	286
Cash and cash equivalents – end of the year	286	1,116
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	1,510	930
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation expense	2,220	2,150
Change in assets and liabilities:		
Receivables, net	-3,421	391
Other assets	-407	-1,116
Accounts and other payables	3,740	2,786
Due to/from project participants	<u>1,474</u>	<u>6,086</u>
Net cash provided by operating activities	\$5,116	\$11,227

Source: KPMG LLP