

U10B00
Maryland Environmental Service

Operating Budget Data

(\$ in Thousands)

	FY 04 <u>Actual</u>	FY 05 <u>Working</u>	FY 06 <u>Allowance</u>	FY 05-06 <u>Change</u>	% Change <u>Prior Year</u>
Non-budgeted Fund	\$84,009	\$92,729	\$73,067	-\$19,662	-21.2%
Total Funds	\$84,009	\$92,729	\$73,067	-\$19,662	-21.2%
Adjusted Total	\$84,009	\$92,729	\$73,067	-\$19,662	-21.2%

- 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 2006 budget. Some of the large projects winding down or scheduled for completion are Dundalk Marine Terminal, Midshore Landfill Cell 4, scrap tire stockpile clean-up projects, and Cox Creek construction.

Personnel Data

	FY 04 <u>Actual</u>	FY 05 <u>Working</u>	FY 06 <u>Allowance</u>	FY 05-06 <u>Change</u>
Regular Positions	591.65	598.10	598.10	0.00
Contractual FTEs	0.00	0.00	0.00	0.00
Total Personnel	591.65	598.10	598.10	0.00

- MES does not anticipate a change in the number of positions between fiscal 2005 and 2006.

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

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Analysis in Brief

Issues

MES Cuts Its Losses and Ceases Production of FertileGRO: MES executive management recently made the decision to stop packaging and selling its organic fertilizer product FertileGRO. **MES should brief the committees on the total financial loss it sustained as a result of the development and production of FertileGRO, and how MES intends to use this experience to inform its other current and potential entrepreneurial projects.**

MES Crumb Rubber Facility Still Struggles: In February 2003 MES initiated its biggest business venture to date: a whole scrap tire-to-crumb rubber manufacturing facility in Western Baltimore County. While the facility is processing an increasing amount of crumb rubber, it is in poor financial health. MES initiated two major marketing efforts in 2004 to redirect its product focus and identify ways to increase the average price per pound of crumb rubber. **MES should be prepared to discuss how it is meeting the financing obligations associated with this facility, the project's latest expense and revenue estimates for the current and future year, and how long it intends to operate this facility at a financial loss.**

Recommended Actions

1. Nonbudgeted.

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Operating Budget Analysis

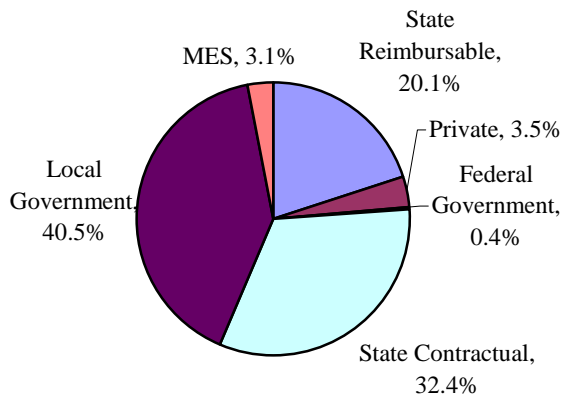
Program Description

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.

Exhibit 1 illustrates the agency's anticipated revenue sources for fiscal 2006. The agency expects to receive 93.4% of its revenue from fees charged to the State and other governments. This includes 40.5% for services provided to local governments, 52.5% for State reimbursable and contractual services, and 0.4% for services to the federal government. Services provided to the private sector account for 3.5% of the agency's total budget; and 3.1% of the projected revenues are from MES enterprises.

Exhibit 1
Fiscal 2006 Projected Revenue Sources
Total = \$73.1 Million



Source: Maryland Environmental Service

Performance Analysis: Managing for Results

Over the past year, MES adjusted its mission and vision statements and added several performance measures. The agency's new mission and vision statements are shown below.

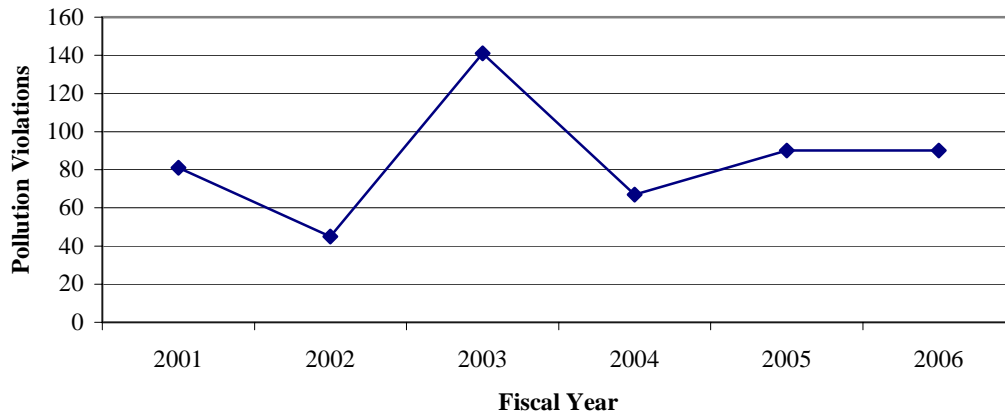
Mission Statement: To provide operational and technical services to protect and enhance the environment for the benefit of the people of Maryland.

Vision Statement: An innovative and leading edge solver of environmental problems, a responsible and successful manager of environmental operations, and a great place to work.

MES has experienced mixed performance results recently, as summarized in **Exhibits 2, 3, and 4**.

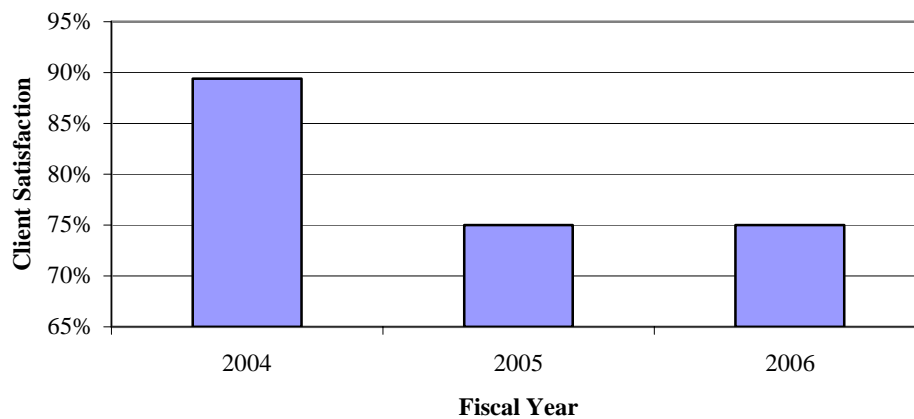
- While the number of pollution violations spiked in fiscal 2003 due to high rainfall and more rigorous permitting tests, violations stabilized in fiscal 2004 and are projected to remain steady at under 90 in fiscal 2005 and 2006.
- MES measured client satisfaction at nearly 90% in fiscal 2004 but projects a decrease in fiscal 2005 and 2006. **MES should explain why client satisfaction is likely to decrease in fiscal 2005 and 2006.**
- Increases in agency billable hours – a new performance measurement – are projected to continue in fiscal 2006.

Exhibit 2
Pollution Violations at MES Operated Wastewater Treatment Plants
Fiscal 2001 – 2006



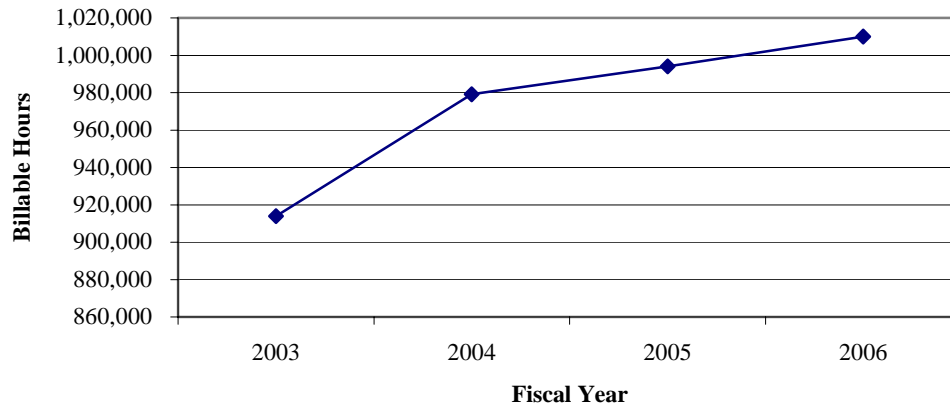
Source: Maryland Environmental Service

Exhibit 3
MES Client Satisfaction
Fiscal 2004 – 2006



Source: Maryland Environmental Service

Exhibit 4
MES Billable Hours
Fiscal 2003 – 2006



Source: Maryland Environmental Service

Fiscal 2005 Action

As a result of internal efforts to reduce costs, MES was able to contribute \$809,384 to the general fund for fiscal 2005. These funds represented unearned revenue from State projects. Unearned revenues occur when project cost estimates exceed actual project costs. As shown in **Exhibit 5**, MES has contributed unearned revenue to the State for the past two years – \$1,024,846 in fiscal 2004 and \$863,316 in fiscal 2003. MES does not foresee that this fiscal 2005 transfer will have an adverse impact. However, 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.

Exhibit 5
MES Unearned Revenue Contributions to the State

Fiscal 2003	\$863,316
Fiscal 2004	\$1,024,846
Fiscal 2005	\$809,384

Source: Maryland Environmental Service

Governor's Proposed Budget

The estimated fiscal 2006 budget for MES totals \$73.1 million. This represents a 21.2% decrease from the 2005 working budget. A decrease is typical, since it is difficult for MES to predict new business or changes in the scope of existing contracts. **Exhibit 6** summarizes the major State and local government project changes reflected in the agency's fiscal 2006 budget.

Exhibit 6
Governor's Proposed Budget
Maryland Environmental Service
(\$ in Thousands)

How Much It Grows:	Nonbudgeted	
	<u>Fund</u>	<u>Total</u>
2005 Working Appropriation	\$92,729	\$92,729
2006 Governor's Allowance	73,067	73,067
Contingent & Back of Bill Reductions	0	0
Adjusted Allowance	<u>73,067</u>	<u>73,067</u>
Amount Change	-\$19,662	-\$19,662
Percent Change	-21.2%	-21.2%

Where It Goes:

Local Government Projects

Western Acceptance Facility Upgrade – substantially complete in fiscal 2005	-\$2,694
Garrett County Landfill Cell 3 – scheduled for completion in fiscal 2005	-1,879
Midshore Landfill Cell 4 – construction nearing completion in fiscal 2006	-1,091

State Contractual Projects

Scrap Tire Projects – projects not yet defined	-3,756
Cox Creek – increased equipment purchased in fiscal 2005 and future work not defined	-3,615
Dundalk Marine Terminal – construction tapering off in fiscal 2006	-2,056
Maryland Port Administration – environmental planning and technical service projects not defined for fiscal 2006	-1,434
Beulah Landfill Closure – construction scheduled for completion in fiscal 2005	-823
Sandy Point State Park Water System – construction complete in fiscal 2005	-654
Western Maryland Parks Water and WWTPs – tapering off in fiscal 2006	-631
Maryland Correctional Institution – Hagerstown WWTP – scheduled for completion in fiscal 2006	-581
Deep Creek Water and WWTP – most activity scheduled for fiscal 2006	498
Jessup Water Towers – scheduled for completion in fiscal 2005	-492
Public School Playgrounds – scope of work not defined	-417
Other	-36
Total	-\$19,662

WWTP = wastewater treatment plants

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

Issues

1. MES Cuts Its Losses and Ceases Production of FertileGRO

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. To develop FertileGRO, MES purchased a pelletized chicken litter product from Perdue AgriRecycle in Seaford, Delaware, and transported it to a new MES bagging facility in Baltimore County. MES secured a \$720,000 loan and a \$380,000 State grant to finance this initiative. Through the sale of FertileGRO, MES sought to reduce nutrient runoff into the vulnerable waterways of the Chesapeake Bay.

MES executive management recently made the decision to stop packaging and selling FertileGRO. This decision was made for several reasons, including the following:

- **market** – The market was difficult to enter due in part to increasing competition with other organic fertilizers;
- **sales** – Product sales were covering only 35% of associated operating costs; and
- **trademark** – MES was not able to secure a trademark for the FertileGRO name.

Another key reason why MES ceased FertileGRO production was interest by a national lawn care company in widely marketing the product. MES believes that the resources and recognition that will be brought to the sale of this product will build on its initial efforts. Though the fertilizer product will have a new name and be marketed by others, MES advises that the environmental protection goals will remain the same.

MES should brief the committees on the total financial loss it sustained as a result of the development and production of FertileGRO, and how MES intends to use this experience to inform its other current and potential entrepreneurial projects.

2. MES Crumb Rubber Facility Still Struggles

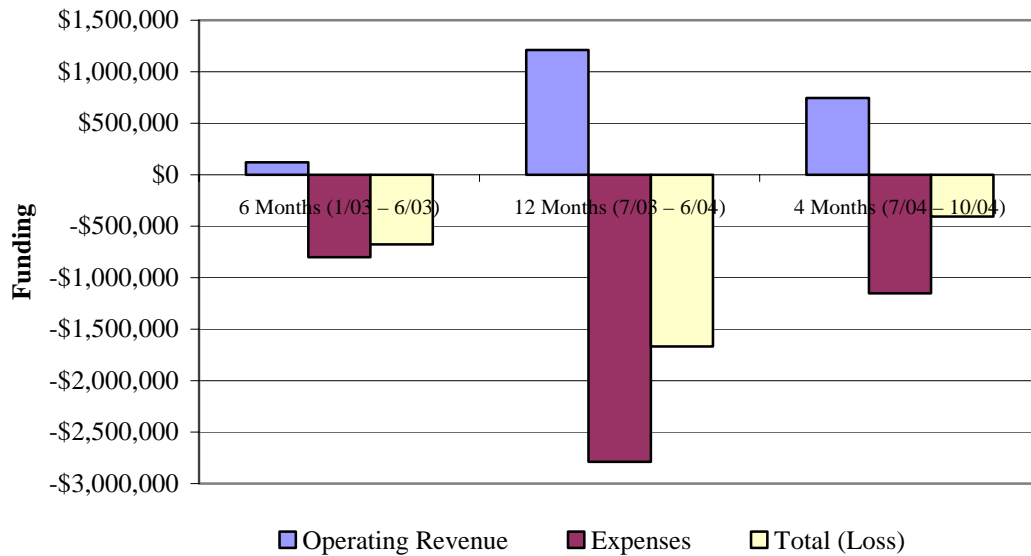
Background

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 at least 1.5 million scrap tires – approximately 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, and ground cover. This operation is wholly owned by MES at an initial investment of \$5.5 million and currently employs 14 production staff.

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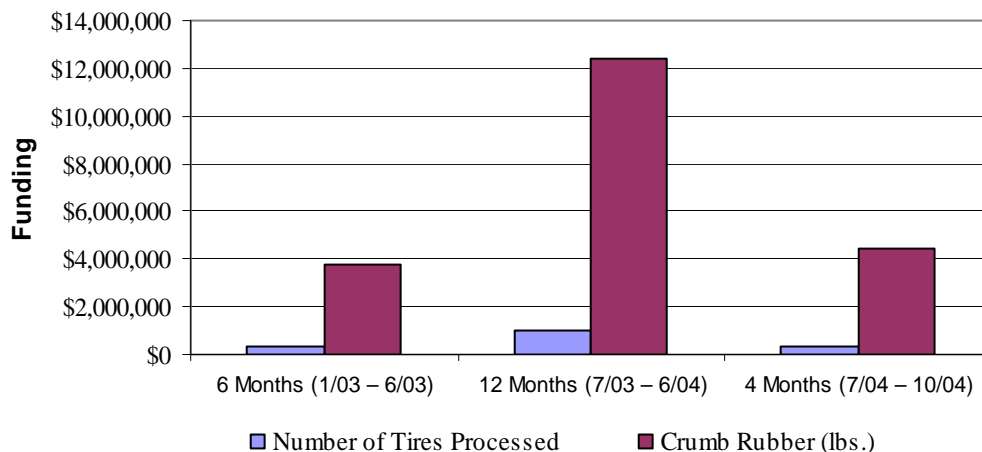
While the facility is processing an increasing amount of crumb rubber, it is in poor financial health. The establishment of this venture is taking longer than MES anticipated. As shown in **Exhibits 7** and **8**, crumb rubber production has increased, but revenues are still not covering associated production and capital debt service costs. Lower than anticipated operating revenues have placed considerable strain on MES’s cash flow. However, MES advises that it is currently able to absorb these costs and meet its financing obligations. In December 2004 the MES Board of Directors approved the purchase of \$180,000 in additional equipment that should nearly double the facility’s capacity. MES reports that it is currently negotiating a contract with a private label company to purchase the additional capacity product.

Exhibit 7
Crumb Rubber Facility — Statement of Operations



Source: Maryland Environmental Service

Exhibit 8 Crumb Rubber Facility Production



Source: Maryland Environmental Service

Marketing Maneuvers

MES initiated two major marketing efforts in 2004 to redirect its product focus and identify ways to increase the average price per pound of crumb rubber. First, significant resources were directed at developing a business relationship with a leading company in the sports athletic surfacing area. These efforts resulted in the sale of 4.4 million pounds of crumb rubber in fiscal 2004 and 4.2 million pounds of crumb rubber in the first four months of fiscal 2005. The second major marketing effort involved developing a strategy to sell colored crumb rubber to wholesale and retail customers as a mulch product. This product, called TreadSpread, was introduced in April 2004 and is being targeted as a landscape and playground product.

By moving into sports athletic surfacing and initiating TreadSpread, MES tapped into the higher value markets it needs to make this operation a success. However, there is a continued need to make the production process more flexible in order to manufacture a wider array of high-value products and develop a larger customer base. The management team now in charge of day-to-day operations and tire products marketing has been fully in place for about six months. MES hopes to cut its losses in half this year and to move toward profitability in fiscal 2006.

MES should be prepared to discuss how it is meeting the financing obligations associated with this facility, the project’s latest expense and revenue estimates for the current and future year, and how long it intends to operate this facility at a financial loss.

Recommended Actions

1. Nonbudgeted.

Current and Prior Year Budgets

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

	Nonbudgeted <u>Fund</u>	<u>Total</u>
Fiscal 2004		
Estimated Budget	\$65,266	\$65,266
Change	18,743	18,743
Actual Expenditures	\$84,009	\$84,009
Fiscal 2005		
Estimated Budget	\$72,272	\$72,272
Change	20,457	20,457
Working Budget	\$92,729	\$92,729

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

Fiscal 2004 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 2005 Budget Changes

Similar to fiscal 2004 changes, the \$20.5 million fiscal 2005 increase is due to new contracts and conservative budget forecasting practices. The majority of the additional revenue is the result of potential projects becoming defined.

Audit Findings

Audit Period for Last Audit:	October 12, 1999 – September 24, 2002
Issue Date:	March 2003
Number of Findings:	3
Number of Repeat Findings:	1
% of Repeat Findings:	50%
Rating: (if applicable)	

Finding 1: The amounts MES billed State agencies for overhead and fringe benefit expenses related to certain reimbursable projects exceeded its actual costs by approximately \$220,000 for a three-year period.

Finding 2: Certain collections MES received were not sufficiently controlled and non-cash credit adjustments to the accounts receivable records were not reviewed by supervisory personnel.

Finding 3: **MES did not fully use the security features of the State’s Financial Management Information System to establish proper internal control over certain disbursement transactions.**

* Bold denotes item repeated in full or part from preceding audit report.

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

<u>Object/Fund</u>	<u>FY04 Actual</u>	<u>FY05 Working Appropriation</u>	<u>FY06 Allowance</u>	<u>FY05 - FY06 Amount Change</u>	<u>Percent Change</u>
Positions					
01 Regular	591.65	598.10	598.10	0	0%
Total Positions	591.65	598.10	598.10	0	0%
Objects					
01 Salaries and Wages	\$ 30,300,598	\$ 33,072,626	\$ 33,874,114	\$ 801,488	2.4%
02 Technical & Spec Fees	4,543,601	4,021,139	2,442,106	-1,579,033	-39.3%
03 Communication	472,792	479,807	461,428	-18,379	-3.8%
04 Travel	170,681	219,961	196,636	-23,325	-10.6%
06 Fuel & Utilities	2,314,762	2,333,787	2,362,992	29,205	1.3%
07 Motor Vehicles	2,842,412	2,592,924	2,547,373	-45,551	-1.8%
08 Contractual Services	14,537,955	16,347,871	11,856,347	-4,491,524	-27.5%
09 Supplies & Materials	8,336,777	6,619,946	6,124,478	-495,468	-7.5%
10 Equip – Replacement	753,227	1,792,529	1,884,820	92,291	5.1%
11 Equip – Additional	1,615,914	2,327,300	1,795,416	-531,884	-22.9%
13 Fixed Charges	4,833,861	5,271,902	5,308,888	36,986	0.7%
14 Land & Structures	13,286,118	17,649,240	4,212,509	-13,436,731	-76.1%
Total Objects	\$ 84,008,698	\$ 92,729,032	\$ 73,067,107	-\$ 19,661,925	-21.2%
Funds					
07 Nonbudgeted Fund	\$ 84,008,698	\$ 92,729,032	\$ 73,067,107	-\$ 19,661,925	-21.2%
Total Funds	\$ 84,008,698	\$ 92,729,032	\$ 73,067,107	-\$ 19,661,925	-21.2%

Note: The fiscal 2005 appropriation does not include deficiencies, and the fiscal 2006 allowance does not reflect contingent reductions.

Statement of Revenues, Expenses, and Changes in Net Assets
For the Years Ended June 30, 2004 and 2003
(\$ in Thousands)

	<u>2004</u>	<u>2003</u>
Operating Revenues		
Charges for services	\$71,151	\$74,672
Operating Expenses		
Salaries and benefits	24,142	22,935
Contractual services	13,100	12,763
Technical fees	3,021	4,047
Utilities	2,032	2,060
Repairs and maintenance	2,731	2,345
Materials and supplies	7,869	6,202
Land, structures, and equipment	10,430	13,659
Depreciation	1,930	1,924
General and administrative	7,268	7,100
Other	725	707
Total Operating Expenses	\$73,248	\$73,742
Operating income (loss)	-2,097	930
Nonoperating Revenues (Expenses)		
Interest income	284	444
Interest expense	-1,692	-1,724
Gain (loss) sale of equipment, net	21	-36
Nonoperating expenses, net	-1,387	-1,316
Income (loss) before contributions	-3,484	-386
Capital Grants	361	1,424
Change in Net Assets	-3,123	1,038
Net Assets, Beginning of Year	10,706	9,668
Net Assets, End of Year	\$7,583	\$10,706

Source: Clifton Gunderson LLP

Statement of Cash Flows
For the Years Ended June 30, 2004 and 2003
(\$ in Thousands)

	<u>2004</u>	<u>2003</u>
Cash Flows from Operating Activities		
Receipts from customers	\$70,010	\$74,984
Payments to suppliers	-48,215	-46,033
Payments to employees	-25,213	-22,748
Other receipts from project participants	2,342	4,812
Other receipts or (payments)	<u>1,240</u>	<u>238</u>
Net cash provided by operating activities	164	11,253
Cash Flows from Capital and Related Financing Activities		
Proceeds from capital debt	375	721
Capital grants	361	1,424
Purchases of capital assets	-2,576	-7,766
Direct financing lease principal payments received	1,432	1,658
Principal paid on capital debt	-3,537	-3,590
Interest paid on capital debt	-1,667	-1,687
Other receipts	<u>85</u>	<u>31</u>
Net cash used in capital and related financing activities	-5,527	-9,209
Cash Flows from Investing Activities		
Purchases of investments	-63,280	-57,592
Sales and maturities of investments	67,816	55,933
Interest and dividends	<u>462</u>	<u>444</u>
Net cash provided (used) in investing activities	<u>4,998</u>	<u>-1,215</u>
Net increase (decrease) in cash and cash equivalents	-365	829
Cash and Cash Equivalents — Beginning of the Year	1,115	286
Cash and Cash Equivalents — End of the Year	\$750	\$1,115
Reconciliation of Operating Income to Net Cash Provided by Operating Activities:		
Operating income (loss)	-\$2,097	\$930
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation expense	2,481	2,150
Change in assets and liabilities:		
Receivables, net	-2,209	391
Other assets and inventory	1,393	-1,319
Accounts and other payables	-2,661	2,811
Due to/from project participants	2,866	5,473
Accrued workers compensation and landfill closure	<u>391</u>	<u>817</u>
Net cash provided by operating activities	\$164	\$11,253

Source: Clifton Gunderson LLP