

INTERNAL SERVICE FUNDS OVERVIEW AND IMPACTS

INFRASTRUCTURE AND GENERAL GOVERNMENT APPROPRIATIONS SUBCOMMITTEE
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ISSUE BRIEF

Legislative Actions in the 2016 General Session Regarding Internal Service Fund Rates

Internal service funds (ISFs) proposed and the Legislature approved a number of rate changes during the 2016 General Session. The Legislature may – but is not obligated to – appropriate additional funding to customer agencies when it approves increased rates for ISFs.

The total projected incremental impact of rate changes for customer agencies was approximately \$4.1 million from all funds including about \$1.9 million from the General Fund (GF) and Education Fund (EF). The Legislature funded projected impacts from shifting the Department of Human Resource Management (DHRM) to an ISF, and it reduced funding for Worker's Compensation (\$1.9 million all sources/\$1 million GF/EF). Legislators did not fund the cost impacts for changes to other rates in the Department of Administrative Services (DAS) or Department of Technology Services (DTS). Consequently, agencies have been forced to either reprioritize internally or reduce consumption. ISFs have also explored charging rates that are lower than the rates authorized by the Legislature, but they may do so only if authorized by their rate committees (see [63A-1-114\(2\)\(c\)](#)) and the rate committees have not taken that action. Additionally, certain rate impacts are driven by actuarial analysis and are not flexible. Some agencies may be unable to absorb those mandatory costs. In such cases, supplemental appropriations may be necessary.

The Legislature may want to consider the following options regarding funding ISF rate impacts: (1) maintain the status quo, (2) appropriate approximately \$2.3 million ongoing from all funding sources including about \$1.0 million from GF/EF to fully cover the projected ISF incremental impacts, (3) fund the impacts of actuarially-calculated rate changes, (4) consider requests from individual customer agencies for additional funding to cover ISF impacts, or (5) reallocate funding across agencies. Each option has pros and cons that are explained in the concluding section of the report.

Background

An internal service fund is a state entity that provides goods or services to other government agencies on a cost-reimbursement basis. ISFs employ business practices to take advantage of economies of scale, to avoid duplication of effort, and to provide an accounting mechanism to identify costs of certain governmental services. There are two primary advantages to using internal service funds within government. First, ISFs charge customer agencies at rates set by the Legislature, and the price mechanism motivates customer agencies to find efficiencies in order to reduce expenses for ISF services so that operational budgets can be utilized elsewhere. Second, agencies can use federal and restricted funds to pay for ISF services rather than relying solely on General Fund appropriations.

The state's major ISFs are operated by the Department of Administrative Services, the Department of Human Resource Management, and the Department of Technology Services.

The **Department of Administrative Services** operates five ISFs:

- The *Division of Facilities Construction and Management* provides building maintenance, management, and preventative maintenance services to subscribers.
- The *Division of Finance* administers the Purchasing Card (P-Card) program and provides consolidated budget and accounting services for the Department of Administrative Services.

- The *Division of Fleet Operations* manages the state's vehicle fleet, fuel network, and statewide travel office.
- The *Division of Purchasing and General Services* provides procurement and contract services and mail, copying, printing, and state and federal surplus services.
- The *Division of Risk Management* provides liability, property, and auto physical damage insurance coverage to state agencies, school districts, charter schools, and institutions of higher education. In addition, Risk Management provides workers' compensation insurance coverage to state agencies.

The **Department of Human Resource Management** is the employer of human resource (HR) employees that are embedded in the state's executive agencies. The goal of having HR employees operate under DHRM is to improve control, coordination, and efficiency of HR functions.

The **Department of Technology Services** is the state's central service provider for information technology (IT) related activities, having consolidated all agency IT functions and employees to provide more efficient and effective use of IT resources statewide.

Finances and Oversight

Finances. Unlike traditional state agencies, Utah budgetary procedures do not require expenses to be equal to or less than revenues for internal service funds. Instead, ISFs are allowed retained earnings, either positive or negative, that are analogous to profits and losses in the private sector. The Legislature monitors retained earnings balances and may transfer excesses to the General Fund or reduce rates to customer agencies in order to reduce retained earnings. Federal guidelines limit the amount of retained earnings to be between 30 and 60 days of operational costs, depending on the service. ISFs that collect more than federal limits must rebate a portion of the excess to the federal government. On the other hand, subject to certain limitations, ISFs may borrow from the General Fund to eliminate negative working capital or to acquire capital assets.

Oversight – rate committees. For an upcoming fiscal year, each ISF estimates usage of its services by customer agencies and the costs of providing those services. Using this and other information, the ISF calculates “break even” rates. The ISF then recommends to a rate committee that it be allowed to charge the calculated rates for the upcoming fiscal year. A rate committee provides the first level of oversight for an ISF as the committee either forwards the ISF's recommended rates to the Governor's office and Legislature or it modifies the recommendations before sending them on.

Prior to FY 2017, an ISF's rate committee included at least one representative from the ISF. Recognizing the inherent conflict of interest of allowing the ISFs to vote on approval of their own recommended rates, the 2016 Legislature passed [S.B. 52](#), “Rate Committee Modifications,” that prohibited ISFs from being represented on their own rate committees. Beginning in FY 2017, the rate committees for DAS, DHRM, and DTS each have seven members – at least six members are representatives of customer agencies and at most one member may be from the Governor's Office of Management and Budget, the Division of Finance, or the other two ISF agencies.

Oversight – legislative approval. Section [63J-1-410](#) of the Utah Code requires that before an ISF bills another agency for services, the Legislature must approve the ISF's rates and fees, number of full-time permanent and full-time equivalent contract employees, capital outlay, and estimated revenues. The Legislature authorizes rates and fees in an annual bill titled, “State Agency Fees and Internal Service Fund Rate Authorization and Appropriations” (ISF bill) (see, for example, [H.B. 8](#), 2016 General Session (G.S.)), and it also may appropriate funds to agencies in the ISF bill to pay for incremental impacts associated with changes in rates and fees. The other components that must be approved by the Legislature are typically included in the base budget bills for the Infrastructure and General Government Appropriations

Subcommittee (DAS and DTS) (see, for example, [S.B. 6](#), 2016 G.S.) and the Retirement and Independent Entities Appropriations Subcommittee (DHRM) (see, for example, [S.B. 5](#), 2016 G.S.).

The Office of the Legislative Fiscal Analyst prepares draft base budget bills and a draft ISF bill prior to each general session and the drafts are available for legislators to review for several weeks before they come to the chambers for votes. In the early weeks of each general session, LFA staff also present to appropriations subcommittees the differences between rates authorized for the current fiscal year and rates in the draft ISF bill for the upcoming fiscal year.

Impacts of Rates and Fees

The 2016 Legislature approved the following changes for ISFs:

- DAS – rate adjustments for facilities serviced by the Division of Facilities Construction and Management and new labor rates for DFCM services that are not included in standard service agreements;
- DAS – a new rate for online non-vehicle sales conducted through the Division of Purchasing and General Services;
- DAS – adjustments in property and actuarially-calculated liability insurance rates charged to individual agencies by the Division of Risk Management and a decrease in the Workers' Compensation rate;
- DAS – increases in two rates within the Consolidated Budget and Accounting Section;
- DHRM – the shift of Administration, Policy, and Information Technology programs from the appropriated line item to the internal service fund, an increase in the HR services fee, and implementation of a new core HR fee;
- DTS – increases in a number of fees in order to fund compensation increases for employees; and
- DTS – new rates for Google Vault, File Share, and Back-up Storage and authorization to charge tiered rates for labor and rack space instead of single rates for those services.

The total projected impact of a rate or fee to an agency equals the legislatively authorized rate or fee amount multiplied by the projected quantity of service. In practice, impacts are assumed to be ongoing and agencies receive the bulk of funding for ISF impacts in base budget bills that include the prior year's ongoing appropriations. The Legislature may – but is not obligated to – provide additional funding to agencies to cover incremental impacts that result from increased rates or fees.

The 2016 Legislature authorized the FY 2017 rates and fees as recommended by the ISF agencies. The Legislature appropriated a total of \$1,876,000 from all funding sources including \$971,700 from the General and Education Funds to agencies to cover changes in DHRM's rate structure. In conjunction with the overall funding, the Legislature also reduced the direct General Fund appropriation to DHRM by \$2,571,900. It also reduced funding to agencies to pay for Workers' Compensation premiums by a total of \$1,790,600 with \$804,100 of that reduction being from the General Fund. The Legislature did not appropriate additional funding for approximately \$2.3 million from all funding sources (about \$1.0 million from GF/EF) in projected impacts for the other ISFs operated by the Departments of Administrative Services and Technology Services. Instead customer agencies are motivated to find savings in their budgets to cover increased ISF rates or to reduce their usage of ISF services. ISFs are also motivated to reduce their costs as they may realize revenues that are lower than anticipated.

Options Regarding ISF Incremental Impacts

Option 1 – maintain the status quo. As described above, the Legislature appropriated funding in FY 2017 for the shift in DHRM's rate structure and it reduced funding for Worker's Compensation premiums. The benefit of this option is that customer agencies are adjusting to the consequent budget changes and to changes in other ISF rates that will affect their budgets in FY 2017. A drawback to this option is that customer agencies are affected differently by changes in ISF rates as some rely more heavily on ISF services than others and some agencies receive a greater portion of funding from fixed sources such as federal funds that may not increase when ISF rates increase.

Option 2 – appropriate to fully cover projected ISF impacts. The 2017 Legislature could appropriate supplemental funds for FY 2017 to fully cover projected ISF impacts. This option would put customer agencies on equal footing by adjusting their budgets in accordance with their projected usage of ISF services. However, this option would eliminate the incentive for customer agencies to find efficiencies in their operations regarding the quantity of services they receive from ISFs.

Option 3 – fund the impacts of actuarially-calculated rate changes. Liability rates charged by the Division of Risk Management are calculated actuarially. Due to federal rules regarding fair assessment of charges, the division must charge the calculated rates (or equally scaled rates) to all agencies or the federal government could seek reimbursement from the State. Federal rules would not allow the division to charge rates that deviate from the actuarially-determined rates based on the amount of funding each agency received. This option would avoid issues with the federal rules while still maintaining the incentive for customer agencies to find efficiencies in their operations.

Option 4 – consider requests from individual customer agencies. At their discretion, customer agencies in conjunction with the Governor's Office of Management and Budget (GOMB) could go through the standard budget process to request additional funding to cover the incremental ISF impacts. This option would provide a level of oversight within the executive branch as GOMB would balance the needs of agencies and the governor's priorities within existing budget constraints. It would also allow the Legislature to consider on a case-by-case basis whether providing additional funding to an agency is prudent.

Option 5 – reallocate funding across agencies. Another option the Legislature may want to consider is to reallocate funding across agencies, but to leave total funding unchanged. This option would more closely align agency budgets with projected expenses for ISF services without affecting the overall state budget. This option may cause challenges for those agencies that would have funding reduced, particularly as the fiscal year would be half way completed at the time the funding reduction would occur; and it would provide more latitude to those agencies that would have funding increase.

The Executive Appropriations Committee (EAC) asks that the Infrastructure and General Government Appropriations Subcommittee consider the issue, and that prior to the 2017 General Session the subcommittee reports a recommended course of action to EAC. EAC has also requested that going forward each ISF build an assumed compensation adjustment in to its proposed rates; although the adjustment may not equal what the Legislature funds in a particular year, on average the ISFs should be able to fund adjustments for their employees with relatively minor ebbs and flows in retained earnings.