



STATE OF NORTH CAROLINA

SPECIAL REVIEW

**NORTH CAROLINA DEPARTMENT OF ADMINISTRATION
DIVISION OF PURCHASE AND CONTRACT**

RALEIGH, NORTH CAROLINA

SEPTEMBER 2006

OFFICE OF THE STATE AUDITOR

LESLIE W. MERRITT, JR., CPA, CFP

STATE AUDITOR

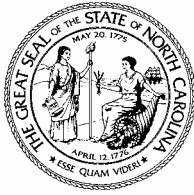
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AUDITOR'S TRANSMITTAL

The Honorable Michael F. Easley, Governor
The General Assembly of North Carolina
Mr. Britt Cobb, Secretary
North Carolina Department of Administration

Pursuant to General Statute §147-64.6(c)(16), we have completed a special review of allegations concerning a term contract administered under the North Carolina Department of Administration–Division of Purchase and Contract. The results of our review, along with recommendations for corrective action, are contained in this report.

Copies of this report have been provided to the Governor, the Attorney General and other appropriate officials in accordance with North Carolina General Statute §147-64.6(c)(12).

Leslie W. Merritt, Jr.

Leslie W. Merritt, Jr., CPA, CFP
State Auditor

September 5, 2006

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INTRODUCTION

The Office of the State Auditor received a number of allegations concerning a State of North Carolina term contract for tire retreading. The tire retreading contract was written and administered by the North Carolina Department of Administration–Division of Purchase and Contract. The allegations primarily concerned the contractor, White’s Tire Service, Inc., (the Contractor), and the procurement of retread tires for local school districts, which are referred to as Local Education Authorities (LEAs). Allegedly, the contractor violated provisions of the contract regarding charges for repairs, tire casing identification, and price adjustments.

To conduct a special review of these allegations, we performed the following procedures:

- Review of term contracts for retread tires;
- Examination of retread tire invoices to LEAs and the North Carolina Department of Transportation (NCDOT);
- Review of NCDOT *Report on Retread Tire Program*;
- Interviews with retread tire industry experts, contractors, North Carolina Department of Administration–Division of Purchase and Contract personnel, LEA personnel, and NCDOT personnel;
- Review of retread tire industry standard practice manuals;
- Observation of tire retread process at multiple locations.

This report presents the results of our special review. This review was conducted pursuant to North Carolina General Statute § 146-64.6(c)(16).

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BACKGROUND

Term Contracts for Tire Retreading

In 1976 the State of North Carolina recognized the economic benefit of repairing and recapping worn tires on school buses for Local Education Authorities (LEAs) and medium and large trucks for other state agencies by writing and administering tire retread term contracts under the North Carolina Department of Administration–Division of Purchase and Contract. For the initial contract, the state was divided into three geographical regions and the contract was awarded to two retailers. The original contract was awarded to White’s Tire Service, Inc., of Wilson for the eastern region and Leonard & Nicholson Royal Tire Service, Inc., of Charlotte for the central and western regions. This original contract was awarded for a period of two years.

The Division of Purchase and Contract awarded multiple tire retread term contracts over the past 30 years. The most recent tire retread contract was awarded in 2002 with an estimated annual dollar value of \$2,000,000. White’s Tire Service, Inc. (the Contractor) won the most recent contract to become the State’s sole provider for tire retreads on the term contract.

The current contract has a number of requirements for the contractor in providing retread tires to customers. Among the contractual requirements are casing identification methods, repairs allowed, and price lists. Each section is clearly defined and addressed in the contract. The present contract expires August 31, 2006¹ and there are no provisions for extending the contract beyond that date.

A new retread tire Invitation for Bids is being written by the Division of Purchase and Contract. A “Draft Only” version is available at the time of this report. A number of changes are being made to the proposed contract, some of which may address concerns raised in this report.

The Tire Retreading Process

The tire retread process consists of three parts: tire inspection, buffing, and application of new rubber. Each tire received is inspected to ensure the retread tire will be safe for future use. After inspection, accepted tires have the old tread mechanically removed by buffers and new rubber is applied through one of two tire retreading methods.

The precure, or “top cap,” method is the most commonly used method and the most widely available. The tread has been pre-cured with the tread pattern already molded into the rubber cap. This precured rubber cap is then applied to the buffed tire and the tire is heated for a time period to vulcanize the tread to the tire.

¹ The expiration of the present contract was extended to November 30, 2006.

BACKGROUND (CONCLUDED)

The mold cure method is a process similar to the new tire manufacturing process used by all tire manufacturers. New rubber is applied to the tread surface of the tire casing and the tire is then placed into a mold. The tread design is molded into the top section of rubber through the vulcanization process. The “bead to bead” mold cure process involves rubber being applied to the top and sides of the tire casing before the tire is placed into the mold. The tread and labeling information, which identifies the type and size of the tire, is molded into the tire.

FINDINGS AND RECOMMENDATIONS

1. THE CONTRACTOR PERFORMED AN UNUSUALLY HIGH PERCENTAGE OF SPOT REPAIRS UNDER THE PROVISIONS OF THE TIRE RETREAD CONTRACT.

The tire retread term contract allows the contractor to charge for spot repairs as allowed on the approved price list:

“Spot Repairs: Maximum 3 per tire for on-the-road type tires and maximum 12 per tire for off-the-road type tires. These are the maximum number that the contractor may charge for. If more are needed, those over the maximum shall be repaired at no charge. If less than the maximums are needed, only those repaired shall be charged and invoiced.”

The tire retreading process starts by buffing the tread area of the tire and removing the old tread. This process exposes damaged areas of the tire casing. Damaged areas require repair prior to applying new tread to the tire.

There are three basic types of repairs to the tread area of the tire:

1. Spot repairs which are needed when there is an injury to the tread area of more than 1/4” long and 1/16” deep;
2. Section repairs that are necessary when the damaged area includes damage to the belted section of the tire; and
3. Nail hole repairs which are needed when a nail or similar item punctures the tread or sidewall areas completely.

Spot repairs are performed using a “skive tool” to buff out the damaged area of the rubber in the tire casing. After inspection of the area is completed, new rubber is applied to the spot. This repair is required to ensure no air pockets are formed when the new rubber and tread are applied to the tire casing. If air pockets were to form, the tire tread may zipper and blow off the tire during vehicle use.

We reviewed a sample of invoices from the contractor to eight LEAs and one NCDOT division. For the sample reviewed, the Contractor performed retreads for 9,921 tires at a total cost of \$1,101,910.13. For the sample, 9,832 (99.1%) of the 9,921 tires retreaded were charged for the maximum number of spot repairs which amounted to \$340,280.05 or 30.8% of the total cost.

Interviews with other tire retread retailers and industry experts indicated that it is not routine to perform three spot repairs per tire for on-the-road tires. We also reviewed invoices from other retread retailers to North Carolina government entities. One retailer retreaded 92 tires for other LEAs but only 38 of those tires (41.3%) required any spot repairs. Of the 92 retreaded tires, only four (4.3%) required the maximum spot repairs. Thus, using the estimated annual dollar value of \$2,000,000 for the tire retreading term contract, and the above sample results, the contractor may have

FINDINGS AND RECOMMENDATIONS (CONTINUED)

overcharged local school districts and the NC Department of Transportation a minimum of \$361,592² per year by maximizing spot repair charges on almost every tire.

Since the contract allows the Contractor to receive payment for spot repairs up to a maximum per tire, an incentive exists for the Contractor to maximize spot repairs for each tire. Further, areas requiring spot repair are not visible prior to the buffing of the tire down to its casing. After the retread process is complete, the spot repairs are not visible. As a result, an agency may not be able to verify whether all charged spot repairs were performed or whether the repairs were even necessary.

Industry experts and other tire retread retailers said the industry standard was to not invoice the line-item fee for spot repairs. None of the other retailers we interviewed charged separately for these repairs. The manager of the Tire Retread Information Bureau (TRIB) said that separate charges for spot repairs are rare in the industry worldwide; rather, spot repairs are considered part of the cost of retreading a tire.

Contractor management said they have only charged for spot repairs actually completed and their inspection process revealed a high number of required repairs due to their focus on safety and quality. Contractor management believed all spot repairs were legitimate and a clear majority of tires required the maximum chargeable spot repairs or more per tire. Contractor management said they did not include a separate line-item charge for spot repairs on the State tire retread term contract from 1976 to 1995 even though they were making the repairs. Contractor management said they were losing money on the contract and were prepared to no longer bid on the contract until informed by a representative of the NC Department of Public Instruction that a contract provision allowed an additional charge for spot repairs. In addition, the owner said that the contract was only profitable once spot repairs could be charged and that “everyone knew we could charge for three spots per tire on this contract.” One of the LEA Transportation Directors recalled the contractor saying, “We charge for three spot repairs for each tire because we can.” In our opinion, the Contractor used the spot repair provisions of the tire retread contract to perform and charge for spot repairs that may not have been necessary.

RECOMMENDATION

The Department of Administration–Division of Purchase and Contract should eliminate the separate line-item charge for spot repairs in future tire retread contracts. Any costs for spot repairs should be included in the bid price for each tire size to eliminate the incentive to charge for additional spot repairs. The Division should also review and continue to monitor the contractor’s performance at other LEAs and DOT divisions. The Division should carefully evaluate the awarding of future contracts in view of the issues identified in this finding.

² (\$2,000,000 x 30.8% x 58.7% (tires not requiring spot repairs))

2. THE CONTRACTOR VIOLATED CONTRACTUAL PROVISIONS RELATING TO PRICE ADJUSTMENTS.

North Carolina standard General Contract Terms and Conditions include a section on price adjustments for term contracts. The terms and conditions state:

“Any price changes, downward or upward, which might be permitted during the contract period must be general, either by reason of market change or on the part of the contractor to other customers.”

Further, the terms and conditions specify that notification of price adjustments *“must be given to the Division of Purchase and Contract, in writing, concerning any proposed price adjustments.”*

From the beginning of the current contract, September 1, 2002, the Contractor’s invoices included one line-item for tire retreads and a separate line-item for spot repairs. Each line-item showed the unit price per the contract. In April 2005, Contractor management met with several LEA transportation directors that were using the State tire retread term contract. The transportation directors expressed concern about the expense for spot repairs and how much of their tire budgets were consumed by this expense. The Contractor advised the transportation directors that it would change the way the spot repairs were invoiced. However, only a small number of LEA transportation directors knew the change was made.

In May 2005, the Contractor dropped the invoice line-item charge for each spot repair. Instead, the invoices showed a single charge for each tire that included the total cost of retread and the spot repair which caused an effective increase in the contract price for retreading tires. For example, the 11R22.5 size tire showed a price increase of 44% from the contract price of \$81.19 to a new price of \$117.40. The invoice change was made for LEAs only; the invoices for NCDOT still included a separate line-item for spot repairs.

The Director of the Department of Administration–Division of Purchase and Contract (P&C) was not notified of this change by the Contractor. The Director said P&C was unaware of the price change until our inquiry. The Director agreed the price change was in violation of the General Terms and Conditions of the contract. The Contractor subsequently returned to the original billing practice in May 2006 so that future billings reflect the unit cost for retread and spot repairs separately.

RECOMMENDATION

The Contractor should comply with all contract provisions including the General Contract Terms and Conditions. For any price changes, the Contractor should properly notify the Department of Administration–Division of Purchase and Contract and provide the reason for the change. The Contractor should charge for spot repairs separately as provided under the contract. At all times, the price invoiced should reflect the approved price under the current contract.

3. THE CONTRACTOR VIOLATED CONTRACT REQUIREMENTS REGARDING ITEMIZED PICK-UP LISTS.

The tire retread term contract requires:

“When picking up the casing(s), the contractor’s representative shall identify each casing to assure return of the exact tire(s) to the rightful agency. A copy of the list identifying the casing(s) shall be left with the agency. The tire shall be on the same casing picked up by the contractor.”

All tires are manufactured with numbers on each tire that identify the specific tire. The tires are also marked with load ratings and other markings that identify the tires and ensure the rightful owner is in possession of a specific tire.

The tire pick-up sheet used by the Contractor only identified the quantity of each size of tire picked up from the customer. The sheet did not identify each tire specifically as required by the contract. For example, the listing could show 75 11R22.5 type tires were picked up from a location. However, that listing does not include any identifiers to ensure the same tires are later returned to the agency.

Several of the school transportation directors interviewed said they did not receive an itemized listing of each casing picked up by the Contractor. Two transportation directors said they received the wrong tires back after being retreaded. One county stated they received H load rated (16 ply sidewall and 6,610 lbs capacity) tires although their county only uses G load rated (14 ply sidewall and 6,040 lbs capacity) tires and another county said they received G load rated tires when they only use H load rated tires. The lack of identifying numbers on the pick-up sheets contributed to this mistake. If the tire casings were properly identified for each tire on the pick-up sheet, the agency could compare tires received to the sheet at the time of drop off. Contractor management said their representatives marked the customer number on the inside of the tires when picked up. This number remains on the tire throughout the retread process. However, this system did not work as intended in the above instances.

We reviewed the tire inventory pick-up sheets used by other tire retread contractors. We found the other contractors listed each tire by number, load rating, and speed rating. Those listings ensure each customer receives its own tires after retreading.

RECOMMENDATION

The Contractor should immediately develop an inventory pick-up sheet that identifies each tire that is picked up for retreading. The revised pick-up sheet should include the tire numbers specific to each tire as well as load ratings and speed ratings specific to each tire. Upon dropping off tires, the Contractor and the customer should verify that each tire received matches those picked up by the Contractor.

RESPONSE FROM THE NORTH CAROLINA DEPARTMENT OF ADMINISTRATION



**North Carolina
Department of Administration**

Michael F. Easley, Governor

Britt Cobb, Secretary

August 30, 2006

The Honorable Leslie W. Merritt, Jr., CPA, CFP
State Auditor
2 South Salisbury Street
20601 Mail Service Center
Raleigh, North Carolina 27699-0601

Dear Mr. Merritt:

Attached please find our response to the Special Review of the term contract for tire retreading administered by the Division of Purchase and Contract.

We appreciate the opportunity to address these concerns and thank you for the conscientious work of your staff members on this review.

Please contact me if you need additional information.

Sincerely,

A handwritten signature in cursive script that reads "Britt Cobb".

Britt Cobb

cc: Governor Michael F. Easley
Mike Mangum, State Purchasing Officer

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**Response to Special Review of the North Carolina Department of Administration
Division of Purchase and Contract
August 2006**

The report makes three recommendations, which are listed below.
Following each recommendation is our response.

1. **Recommendation:** The Department of Administration – Division of Purchase and Contract should eliminate the separate line-item charge for spot repairs in future tire retread contracts. Any costs for spot repairs should be included in the bid price for each tire size to eliminate the incentive to charge for additional spot repairs. The Division should also review and continue to monitor the Contractor's performance at other LEAs and DOT divisions. The Division should carefully evaluate the awarding of future contracts in view of the issues identified in this finding.

Response: The Division of Purchase and Contract has interviewed the two major users of the term contract for tire retreading: the Department of Public Instruction which represents the individual Local Education Agencies (LEA) and the North Carolina Department of Transportation (NCDOT). A sufficient number of LEAs desired to eliminate the separate line-item charge for spot repairs. However, NCDOT believes it is more economical to pay the contractor for each spot repair and specifically requested that the Division not eliminate the separate line-item charge for spot repairs. While the Division of Purchase and Contract respects the State Auditor's recommendation that all customers pay for both a retread and spot repairs in one unit cost, the Division must also value the requests of its customers. In an effort to balance the competing requests of its customers, the new Invitation for Bids (IFB) eliminates the separate line-item charge for spot repairs for LEAs. The Division of Purchase and Contract will continue to carefully review and monitor the Contractor's performance and compliance on spot repairs.

2. **Recommendation:** The Contractor should comply with all contract provisions including the General Contract Terms and Conditions. For any price changes, the Contractor should properly notify the Department of Administration – Division of Purchase and Contract and provide the reason for the change. The Contractor should charge for spot repairs separately as provided under the contract. At all times, the price invoiced should reflect the approved price under the current contract.

Response: In the price change instance cited in the report, the actual price of the tire and the associated spot repairs did not change. Instead, the method of invoicing changed. This gave the appearance of a price change. At least one LEA made a direct request to the contractor, without notice to the Division of Purchase and Contract, for "simplified billing." Our understanding was that the LEA simply did not want the spot repair charges appearing as a separate line item. Unfortunately, the Contractor obliged, and this led to the appearance of an unauthorized price change. The Division of Purchase and Contract discussed this matter with the contractor several months ago, and the matter was immediately rectified. We do agree that this Contractor, if successful on future bid solicitations, may need to be monitored closely to prevent a similar situation from recurring.

3. **Recommendation:** The Contractor should immediately develop an inventory pick-up sheet that identifies each tire that is picked up for retreading. The revised pick-up sheet should include the tire numbers specific to each tire as well as load ratings and speed ratings specific to each tire. Upon dropping off tires, the Contractor and the customer should verify that each tire received matches those picked up by the Contractor.

Response: We agree with this recommendation. We have become aware of concern by some users that casing tracking by the current contractor is deficient. The contract administrator will discuss this with the current contractor, and in addition, the pending IFB has strengthened the provision dealing with the requirement for the contractor's casing tracking system.

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ORDERING INFORMATION

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