

California State Auditor

B U R E A U O F S T A T E A U D I T S

The State's Offshore Contracting:

*Uncertainty Exists About Its Prevalence
and Effects*



January 2005
2004-115

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January 20, 2005

2004-115

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the Bureau of State Audits presents its audit report concerning service-related contracts and subcontracts for state-funded work that is being performed outside of the country. This report concludes that it is difficult to judge the prevalence and effects of offshore contracting (offshoring). Specifically, state agencies currently receive no guidance related to offshoring and are not required to track where their contracted services are being performed or report the extent to which services are being performed offshore. Because of the difficulty in identifying where subcontracted work is performed, determining with any certainty the amount of state funds spent on services performed offshore is a challenge.

Our survey of selected state agencies and campuses (entities) indicates that some state-funded services are being performed offshore. However, from our limited data, the State apparently has been spending little on services performed in foreign countries. Entities that we surveyed reported 185 contracts totaling \$638.9 million where at least some portion of the work has possibly been performed offshore. Asked to estimate the dollar amount of these offshored services, participants reported the amount was unknown for 76 of these contracts. For the remaining 109 contracts, totaling \$349 million, participants estimated that only \$9.7 million (2.8 percent) of the contracted services were performed offshore.

Finally, the offshore contracts we reviewed generally contain provisions to protect sensitive and confidential information from disclosure. It is essential for state entities to determine where subcontracted services are performed and who is performing the services. This knowledge will enable state entities to better ensure that all contracts and subcontracts include appropriate provisions to protect confidential information from disclosure and that all parties to the contract, including subcontractors, are aware of and comply with contract terms and conditions.

Respectfully submitted,

ELAINE M. HOWLE
State Auditor

CONTENTS

<i>Summary</i>	1
<i>Introduction</i>	5
<i>Audit Results</i>	
State Agencies Receive No Guidance on Offshore Contracting	13
The Extent of State Entities' Offshore Contracting Remains Unclear	13
Offshore Contracts Generally Contain Provisions Protecting Confidential Information	21
Legislative Attempts to Restrict Offshore Contracting Raise Serious Legal Concerns	23
Recommendation	28
<i>Appendix</i>	
Survey Results Offer No Certainty About the Prevalence of the State's Offshore Contracting	29
<i>Response to the Audit</i>	
State and Consumer Services Agency, Department of General Services	35
<i>California State Auditor's Comment on the Response From the State and Consumer Services Agency, Department of General Services</i>	39

SUMMARY

Audit Highlights . . .

Our review of the extent of the State's offshore contracting revealed the following:

- No current state laws or regulations address the use of offshore contracting, making it difficult to judge the effects and prevalence of offshore contracting.*
- Our analysis of the limited survey data suggests the State is spending little on services performed offshore:*
 - *Thirty-nine state entities responding to our survey reported 185 contracts totaling \$638.9 million where at least some portion of the work was possibly performed offshore.*
 - *For 109 of these contracts totaling \$349 million, respondents estimated that only \$9.7 million (2.8 percent) was for services performed offshore but could provide no estimate for the remaining 76 contracts.*
- The offshore contracts we reviewed generally contain provisions to protect sensitive and confidential information from disclosure.*
- Proposed legislation designed to place restrictions on and limit offshore contracting could face legal challenges or have unintended consequences.*

RESULTS IN BRIEF

Offshore contracting (offshoring) replaces services provided domestically with those performed outside the nation's borders. Although part of the U.S. economy for 30 years, the offshoring of jobs has recently expanded from manufacturing into services, especially skilled jobs such as software development. This loss of some well-paid jobs to other countries, the offshoring of food-stamp call centers, and an overseas threat to disclose confidential medical records have sparked public attention and led to proposed legislation restricting the practice. However, there still is a limited understanding of the extent and effects of offshoring, either by the private sector or by government.

Perhaps because offshoring has only recently emerged as a concern, the State has not developed policies and procedures requiring its agencies to track where contracted services are performed or the extent to which these services are performed offshore. Our survey of selected state agencies and campuses (entities) indicates that some state-funded services are being performed offshore, but the prevalence and effects of this practice are difficult to determine. However, from our limited data, the State apparently has been spending little on services performed in foreign countries. We surveyed the 35 state agencies with the largest dollar amount of contracts for certain services and the five University of California campuses with medical centers about their use of offshoring. These entities reported 185 contracts totaling \$638.9 million in which at least some portion of the work has possibly been performed offshore, with 55 percent of these contracts being for computer-related services, such as information technology consulting and software development and maintenance. Asked to estimate the dollar amount of these offshored services, participants reported that they did not know the amount for 76 of these contracts. For the remaining 109 contracts, totaling \$349 million, participants estimated that only \$9.7 million (2.8 percent) of the contracted services were performed offshore. The actual amount may be somewhat higher but is not likely to approach the total of the 185 contracts because survey respondents for the larger contracts estimated that relatively small amounts have been offshored. Survey results also indicate that state entities are inconsistent

in including contract provisions related to the subcontracting, delegation, or assignment of contract duties. Some entities do not require notification when contractors subcontract, assign, or delegate services, leaving the entities unaware of who is performing contracted services. Also, even when they receive notification that services have been subcontracted, the entities themselves cannot always determine exactly who is doing the specified work and where it is done.

Three other attempts to measure the extent of offshored government services also produced similarly limited results. The Department of General Services (General Services), a nonprofit corporate research company, and the U.S. Government Accountability Office all tried to estimate the extent of offshoring in either state or federal contracts but found a general lack of comprehensive data on this subject.

State and federal laws currently exist protecting an individual's confidential information, such as medical records, from disclosure. The offshore contracts we reviewed generally contain provisions to protect sensitive and confidential information from disclosure. To ensure that all parties to the contract, including subcontractors, are aware of and comply with the standard terms and conditions, state entities must know who will be performing the contracted services and where those services will be performed.

Finally, proposed legislation designed to place restrictions on and limit offshore contracting could face legal challenges and have unintended economic consequences. Over the last year, the federal government and 40 states, including California, have introduced or enacted legislation related to offshore contracting. These include laws that would prohibit all contracts in which work is performed offshore, provide preferences to state or local vendors, require that state contracts detail and report all services performed offshore, and require disclosure if contractors send sensitive or confidential information offshore. Although California legislators authored a number of bills in the last legislative session dealing with offshoring, the governor signed none into law; however, given the attention this issue is receiving, legislators may consider similar measures in the future. Existing research indicates that state efforts to restrict offshore contracting may violate constitutional provisions allowing the federal government to set uniform policies for the country as a whole in dealing with foreign nations. Also, restricting or limiting offshoring may invite retaliatory trade

sanctions against the United States. Before proposing measures to restrict offshoring, policymakers need to consider whether such actions are both legally sound in the United States and capable of withstanding international legal challenges.

RECOMMENDATION

If the Legislature wants information and data on offshoring of state services to be more readily available, it may consider granting General Services the authority to require contractors to disclose, as part of their bid on state work or during performance of the contract, details on any and all portions of the project that subcontractors or employees outside the United States will perform.

AGENCY COMMENTS

Our report contains a recommendation that we direct toward the Legislature. General Services indicates that it will be available to assist the Legislature and other interested parties in evaluating the proposed actions and will fully address any additional direction that is provided related to the control of offshoring. ■

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INTRODUCTION

BACKGROUND

Offshore contracting (offshoring) generally refers to the decision of a U.S. company or governmental entity to replace services provided domestically with those performed outside the nation’s borders. To achieve efficiency, business and governmental entities obtain services in various ways: providing the services in-house, contracting out for them domestically, or contracting out for them from offshore sources. The offshore sources can be either the entity’s own foreign-based affiliate or an unaffiliated foreign-based company, as shown in Table 1.

TABLE 1

Some Domestic and Offshore Options for Obtaining Services

	Domestic	Offshore
	Domestic In-House Production	Offshore In-House Production
In-House	Entity produces its products domestically without any outside contracts.	Entity uses services supplied by its own foreign-based affiliate.
	Domestic Outsourcing	Offshore Outsourcing
Outsourced	Entity uses services supplied by another domestically-based company.	Entity uses services supplied by an unaffiliated foreign-based company.

Source: U.S. Government Accountability Office.

According to the U.S. Government Accountability Office (GAO), imported services include a wide range of functions, such as computer programming, payroll and accounting services, and customer call centers. When an entity replaces services it has previously performed in-house or acquired from a domestic supplier with imported services, those services and the domestic jobs associated with them are said to have been “offshored.” Offshoring has also been used to describe U.S. companies establishing offshore branches, moving domestic production and the related jobs to other countries. In either case, definitions of offshoring frequently define it in terms of the displacement of U.S. production and employment.

According to *Services Offshoring: Background and Implications for California*, a report by the Public Policy Institute of California (institute), offshoring has played an important part in the U.S. economy's evolution for the last 30 years. Recently, however, offshoring has expanded from manufacturing into services, particularly those provided by skilled workers. The institute sees two fundamental developments driving the current wave of offshoring: first, policy reforms and economic advances made by foreign countries; and second, the invention, commercial development, and rapid spread of information and communications technologies. Many developing countries—India, the Philippines, and China in particular—have successfully educated and trained large numbers of skilled workers in information technology (IT) while opening their economies to international trade and investment. Also, some of these countries, including India and the Philippines, have populations with strong English language ability. The combination of low wages, inexpensive and rapid international communication, and English ability has led many U.S. companies to conclude that the most cost-effective suppliers of certain services are overseas.

To counter this perceived increase of offshoring, policies and legislation are being developed to limit offshore contracting. However these measures could jeopardize U.S. obligations under international trade agreements, as we will discuss later. The United States participates in various trade organizations, including the World Trade Organization, that further the globalization of our nation's economy. The only international organization dealing with the global rules of trade between nations, the World Trade Organization has fostered various international agreements, including the Agreement on Government Procurement. The cornerstone of this agreement is nondiscrimination: Parties to the agreement are required to give the products, services, and suppliers of other parties to the agreement treatment that is "no less favorable" than they give to their own domestic products, services, and suppliers. The United States is also a member of the North American Free Trade Agreement—an agreement between the United States, Canada, and Mexico—that promotes conditions of fair competition, eliminates barriers to trade, and facilitates the movement of goods and services across member countries' borders.

OFFSHORING GAINS INCREASING PUBLIC ATTENTION

Recent concerns about individual privacy and the loss of jobs at home have focused policymakers and the general public on the issue of offshoring. At the forefront of privacy concerns is the shipment of medical records and other personal information

overseas for cheaper transcription and data entry services because U.S. laws against disclosing medical or other personal information may be unenforceable in some countries. Garnering headlines in October 2003, a medical transcriptionist in Pakistan threatened in an e-mail to staff at the University of California at San Francisco Medical Center (UCSF medical center) to expose patient records on the Internet unless they helped her get the money she was owed. Because the transcribing work involved a chain of three different subcontractors, the UCSF medical center had not known that the work would eventually find its way abroad.

Another concern focuses on some states' offshoring their food-stamp call centers, set up as part of the federally mandated replacement of paper food stamps with electronic benefit transfer (EBT) systems. According to a 2004 report¹ titled *Your Tax Dollars At Work . . . Offshore: How Foreign Outsourcing Firms Are Capturing State Government Contracts (Your Tax Dollars At Work . . . Offshore)*, the discovery that some of these telephone call centers were operating out of India and Mexico sparked the controversy of state government offshoring more than a year ago. This report concluded that the call centers for 42 states and the District of Columbia were operating offshore. Many state legislators, concerned that a safety net program for the U.S. unemployed and working poor was creating jobs offshore, reacted to the revelations by introducing bills aimed at restricting offshore outsourcing. Based on interviews with state procurement officials, the report noted that one state (New Jersey) had brought its call center back to the United States and five states (Arizona, Kansas, North Carolina, Oregon, and Wisconsin) were planning to do the same as a result of the controversy. As we will discuss later, the Health and Human Services Data Center contracted with J.P. Morgan Electronic Financial Services (J.P. Morgan) in 2001 to implement and operate the State's EBT system. J.P. Morgan in turn offshores some call center services to India and Mexico. The Department of Social Services, sponsor of the EBT contract, reported to us that \$892,000, or 0.32 percent, was for call center services performed offshore.

Offshoring has also gained attention from the displacement of U.S. jobs in the private sector, with concern about the layoffs of thousands of people in U.S. high tech, software, and service sector companies reported in various economic news sources. However, the number of jobs lost to offshoring differs from one source to another, primarily because reliable data is lacking and

¹ This report, written by Philip Mattera, and published by the nonprofit Corporate Research Project of Good Jobs First, was prepared on behalf of the Washington Alliance of Technology Workers, a local union chapter, based in the state of Washington, of the Communication Workers of America.

each researcher could be using different assumptions to develop estimates of such job losses. The California Labor Federation asserts that 15 percent of the nearly three million U.S. jobs lost since 2000 have reappeared overseas. A widely quoted source on offshoring, a 2002 study by Forrester Research Inc., a technology trend analysis firm, projected that companies would offshore 3.3 million white-collar U.S. jobs by 2015. Opponents argue that offshoring of jobs leads to increased U.S. unemployment, lower wages, and increased reliance on retraining, reeducation, and the development of new skills. Supporters argue that offshoring provides significant economic benefits because offshoring's improved efficiencies and cost savings often increase companies' profits. Additional capital then becomes available for new research, product development, and other business initiatives that will generate incremental U.S. employment growth. Supporters also reason that U.S. consumers benefit greatly from free markets, gaining access to goods and services at lower prices, which keeps inflation in check.

Although much debate focuses on offshoring in the private sector, less is known about the effects of offshoring in the public sector. As we will later describe, neither this report, the Department of General Services (General Services), nor a report by the GAO on the extent of offshoring in the federal and state governments has been able to accurately estimate the value of public offshore contracts.

GENERAL SERVICES DELEGATES AUTHORITY FOR CONTRACTING TO INDIVIDUAL STATE AGENCIES

General Services was created to provide state agencies with centralized services including planning, acquisition, construction and maintenance of state buildings and property; purchasing; printing; architectural services; administrative hearings; and accounting. General Services also acts as the State's contract and procurement oversight² department and performs the following functions:

- Approves state agency contracts.
- Provides assistance to agencies on contract problems.
- Oversees state contracting practices.

² State law specifically exempts state universities from this oversight.

- Improves the State's contracting system.
- Trains state personnel in contract requirements.

Competition is typically at the core of the process used for acquiring goods and services. State law and General Services policies generally require state agencies to conduct a competitive bidding process that allows vendors to submit price quotes or proposals for purchases of goods costing \$25,000 or more and for services valued at \$5,000 or more, with certain exceptions.

General Services delegates authority to individual state agencies to contract for IT goods and services, and for commodities. State agencies have authority to contract for non-IT services and use General Services' guidelines and procedures to independently determine and evaluate the need for contracts, the scope of the work, and the qualifications of contractors. In most cases, General Services reviews and approves contracts to ensure that the agencies followed all its procurement policies. However, as we later discuss, General Services policies and current state laws or regulations do not provide state agencies any guidelines on offshoring or on subcontracting portions of a contract offshore.

A general provision in state law, California Government Code, Section 19130, indirectly addresses offshoring of jobs. The provision prevents a state agency from contracting out for services when doing so would supplant the jobs of state civil service employees. Before contracting out for personal services, agencies must demonstrate that the proposed contract will result in actual cost savings to the State. Alternatively, agencies can demonstrate that the services contracted out are not available within civil service; cannot be performed satisfactorily by civil service employees; or are of such a highly specialized or technical nature that the necessary expert knowledge, experience, and ability are not available through the civil service system.

Since July 2003 General Services has maintained the State Contract Procurement Registration System (contract database), a database of state contracts that establishes a uniform reporting process for the purchase of goods and services costing more than \$5,000. A General Services management directive requires all state agencies to enter information about their contracts into the contract database. Authorized users may then extract contract reports by various categories including contract type, contracting method, contractor name, contract dates, and amounts.

SCOPE AND METHODOLOGY

The Joint Legislative Audit Committee (audit committee) directed the Bureau of State Audits to examine the extent to which state-funded work is being contracted or subcontracted out of the country. Specifically, the audit committee asked us to review any General Services policies and procedures relevant to offshoring and directed us to survey selected state agencies to identify those that have, or are most likely to have, contracted for services offshore during the previous three fiscal years; the audit committee asked us to identify to the extent possible the types of services and the amounts spent on these contracts. Further, for a sample of those agencies identified as having contracts for services offshore, the audit committee asked us to review and evaluate the agencies' policies and procedures for offshoring, including how the agency protects against the disclosure of sensitive and confidential information.

We interviewed General Services staff to identify any General Services policies and procedures related to offshoring and to discuss its oversight role of the State's contracting practices in general. Also, to determine the implications of offshoring on current policy and legislation, we identified proposed California legislation, as well as that of the federal government and other states, related to offshoring. Chapter 657, Statutes of 2003, effective January 1, 2004, prohibits the State from contracting with any publicly held expatriate corporation, that is, a corporation based in the United States that has moved in name and on paper only to a tax-haven country and has no substantial business activities in the country of reincorporation. Because the provisions of this law are not related to our audit scope and do not fit our definition of offshoring, we did not perform any audit procedures related to it.

We also did not analyze how a state agency determines or evaluates the need for a contract, the scope of work, and the qualifications of contractors. Further, we compiled the survey results without validating any of the agencies' and campuses' responses to our survey, because the audit committee took formal action to reduce this portion of the audit's original scope. Finally, we did not explore the other side of the offshoring picture, the possibility that California workers may be performing services that other countries export, a practice often referred to as "inshoring."

To develop our written survey of offshoring, we reviewed several recent reports and studies on this subject, including documents from the audit committee's informational hearing on the offshore outsourcing of white-collar jobs and a report on offshore contracting in the public sector. This report, *Your Tax Dollars At Work . . . Offshore*, identifies 18 offshore outsourcing firms that are active in vying for contracts with state governments. Finally, we reviewed other entities' efforts to determine the prevalence of state-funded services being performed offshore; for example, General Services conducted a telephone survey in 2004 to determine the extent to which its own contracts were performed offshore. Also, in early 2004 the Governor's Executive Policy Office of the State of Washington conducted a survey of agencies, offices, and institutions to determine what contracts were being performed offshore.

To select our sample of survey participants, we analyzed data from the General Services contract database. Although the contract database, implemented in July 2003, does not give a complete picture of all statewide contracts during the past three fiscal years, we used it to give us a general idea of the state agencies with the largest dollar amounts of contracts for certain services. We extracted information on the number and dollar amounts of contracts for all listed state agencies for the following services: IT, IT consulting, non-IT consulting, non-IT services, and architecture and engineering. We selected the 35 state agencies that had the largest cumulative dollar total of contracts for these services. These 35 agencies encompass 98 percent of all state contracts for these services. Because of the potential for medical transcription services being performed offshore, we also surveyed the five University of California campuses with medical centers, bringing the number of survey participants to 40. We received and analyzed responses from 39 state agencies and campuses (entities), excusing one state department from participating in the survey because of extenuating circumstances.

In our survey, we asked participants to identify any known state-funded contracts and subcontracts for services performed abroad. For all other contracts, we questioned participants specifically about contracts for services exceeding \$50,000 that they had entered into or performed during fiscal years 2001–02, 2002–03, and 2003–04. For such contracts, we asked these entities questions such as whether contract provisions generally prohibit the contractor from subcontracting, assigning, or delegating any or all services; and if contract provisions do not prohibit these actions, we asked whether such actions require the contractor

to notify the entity. We then asked participants to indicate whether any of their contracts were for the following business services and activities, which the audit requester had identified as particularly susceptible to providing overseas workers with protected information: call centers, data entry and analysis, creation of computer databases, medical transcription or processing of medical records, insurance claims adjusting, tax preparation and collection activities, and other IT consulting activities. Next, if the participants identified contracts or subcontracts in which all or a portion of these services may have been provided outside the United States, we asked them to provide details of the contract. We also asked participants to report any contracts or subcontracts with the 18 offshore outsourcing firms identified in *Your Tax Dollars At Work . . . Offshore*.

Finally, we reviewed the description of services for each of the contracts that survey participants reported as having all or a portion of the services provided outside the United States to identify those contracts likely dealing with personal, sensitive, or confidential information. We contacted the administering entity for each to identify what policies and procedures it had in place to guard against the disclosure of such information. ■

AUDIT RESULTS

STATE AGENCIES RECEIVE NO GUIDANCE ON OFFSHORE CONTRACTING

State agencies currently receive no guidance related to offshore contracting (offshoring). Further, state agencies are not required to track where their contracted services are being performed or report the extent to which services are being performed offshore. As the State's contracting and procurement oversight agency, the Department of General Services (General Services) oversees state purchasing, approves contracts for services, and sets contracting policies for the State. To guide other state agencies in their contracting process, General Services provides the State Contracting Manual, which incorporates California law on state contracting, including policies, procedures, and guidelines. However, according to General Services, neither this manual nor any current state law or regulation specifically addresses the use of offshoring, the practice of subcontracting portions of a contract offshore, or the issue of determining where contracted services are performed. This lack of guidance can result in inconsistency in contract provisions among state agencies and makes it difficult to judge the effects and prevalence of offshoring.

THE EXTENT OF STATE ENTITIES' OFFSHORE CONTRACTING REMAINS UNCLEAR

Our survey consisted of the 35 state agencies that contracted out for the most services in terms of dollars, as well as the five University of California campuses with medical centers. We received and analyzed 39 surveys, excusing the Department of Forestry and Fire Protection from participating in our survey because of extenuating circumstances. However, our survey results give a limited understanding of the extent of these participants' offshore contracts because, as we mentioned earlier, state agencies are not currently required to collect or track data on state-funded services being performed offshore. Because of the difficulty in identifying where subcontracted work is performed, capturing with any certainty the amount of state funds spent on services performed offshore is a challenge. Also,

it is hard to predict the amount of money and resources the State would need to comprehensively compile such information. However, given the limitations of our research, the State seems to be spending little on offshore services. Detailed results of our survey appear in the Appendix.

Of those agencies and campuses (entities) that reported knowledge of offshore contracts, only some were able to provide estimates of either the percentage of work or dollar amount of the contract actually performed offshore, with other entities reporting that they could not identify the exact amounts or percentages of their contracts that were performed offshore. Many entities that did identify the amounts of state-funded offshore services reported that those services represented only a fraction of the contract. For example, the Health and Human Services Data Center (data center) contracts with J.P. Morgan Electronic Financial Services (J.P. Morgan) for design and implementation of its electronic benefit transfer (EBT) system, and J.P. Morgan handles inquiries from program participants through offshore call centers. However, these call centers represent less than 1 percent of the EBT system contract.

Further, entities are inconsistent in their contract provisions on subcontracting, delegating, or assigning contract duties, with about two-thirds of the survey respondents reporting that their contract provisions generally allow subcontracting and most of those reporting that contractors notify the entities when they subcontract work. However, determining who is performing the work and where it is being performed can be difficult if services are subcontracted.

Like us, General Services had difficulty trying to measure the extent of offshore work performed under its contracts. Also, a July 2004 report³ on offshore contracting in the public sector, titled *Your Tax Dollars At Work . . . Offshore: How Foreign Outsourcing Firms Are Capturing State Government Contracts (Your Tax Dollars At Work . . . Offshore)*, concluded that most state governments do not know where their contracted work is performed.

³ This report, written by Philip Mattera, and published by the nonprofit Corporate Research Project of Good Jobs First, was prepared on behalf of the Washington Alliance of Technology Workers, a local union chapter, based in the state of Washington, of the Communication Workers of America.

The Surveyed Entities Provided Limited Information About Offshore Contracts, but It Appears the State Probably Has Spent Little on Offshore Services

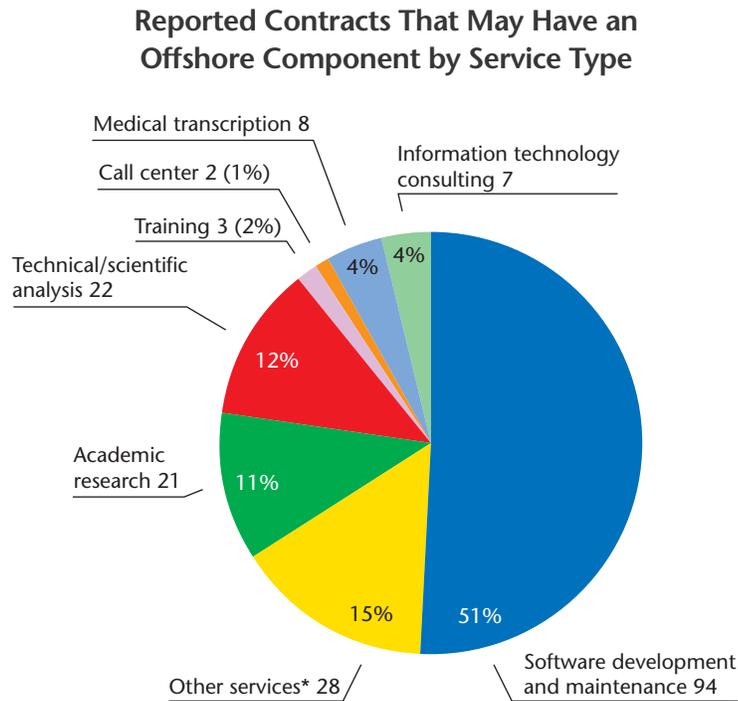
For those contracts where survey respondents could estimate the dollar amount of services provided offshore, the total amount is less than \$10 million.

About half of the entities we surveyed reported that during fiscal years 2001–02 through 2003–04 they had contracts in which all or a portion of the services may have been provided offshore. Further, survey respondents could estimate a dollar amount for only some of these contracts, with estimates of offshoring coming to less than \$10 million. Although this amount could be somewhat larger, our limited data indicates that the State has been spending relatively little on offshore services.

Of the 39 state entities responding to our survey, 19 reported that a total of 185 service contracts, worth about \$638.9 million, had portions in which the contract work may have been performed offshore. Because agencies are not required to track where contracted work is performed, many could not estimate the amount or the extent to which their contracted services were performed offshore. Thus, of the 185 contracts, survey participants could estimate a dollar amount or a percentage of the contract work performed outside the United States for only 109 (59 percent) of the contracts. The dollar amount of these 109 contracts is \$349 million, with a total of \$9.7 million estimated as performed offshore. For the remaining 76 contracts (41 percent), participants could not estimate the offshore portion of the contract total. For example, the Public Utilities Commission reported a \$22.8 million contract for call center services related to the Deaf and Disabled Telecommunications Program for which some work is likely performed offshore. However, the Public Utilities Commission could not provide us with an estimate of the amount performed outside the United States.

As shown in Figure 1 on the following page, more than half of the 185 reported contracts are for services related to software development and maintenance, areas that often represent a large part of reported offshoring activity. Another 15 percent of the contracts are for a variety of services not easily categorized, such as scanning and indexing legal documents; and 11 percent are for University of California contracts related to academic research, in which some or all of the work is performed offshore.

FIGURE 1



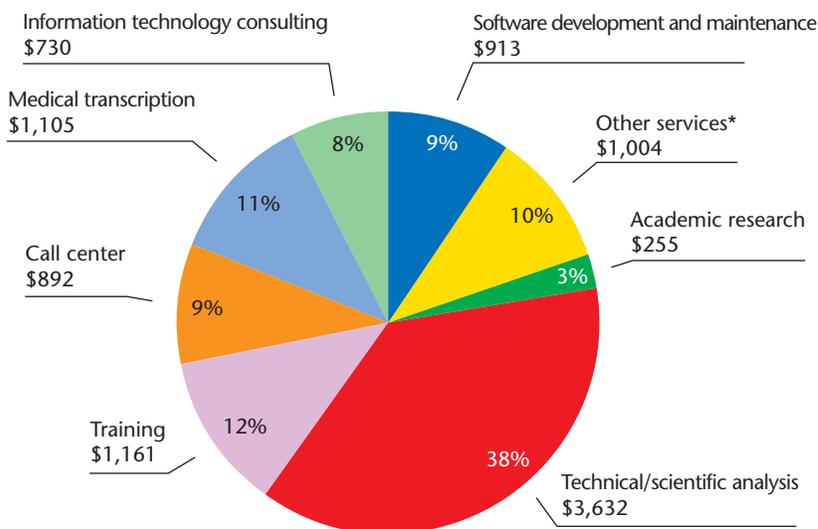
Source: Offshore contracting practices survey results.

* Other services include those not easily categorized, such as the scanning and indexing of legal documents, artwork projects, and the international recruitment of nurses.

Using a different subset of data from our survey results, Figure 2 represents dollar amounts of various service areas for the 109 contracts for which survey respondents could estimate an amount spent on offshoring. Figure 2 illustrates that of the estimated \$9.7 million of services reported as being performed offshore, the largest percentage (38 percent) was for technical or scientific analysis. For example, the Air Resources Board reported three offshore contracts totaling \$1 million for the contractor to provide chemical analysis on air samples and three offshore contracts between January 1999 and April 2005 totaling \$1.8 million for a contractor to operate and maintain air monitoring stations to collect data in Mexico along the California border. About \$1.6 million (17 percent) is for contracts related to information technology and software development, and \$892,000 is for call centers located offshore, a portion of a larger contract.

FIGURE 2

**Reported Offshore Contract Amounts by Service Type
(Dollars in Thousands)**



Source: Offshore contracting practices survey results.

* Other services include those not easily categorized, such as the scanning and indexing of legal documents, artwork projects, and the international recruitment of nurses.

Although our survey results indicate that a minimum of \$9.7 million in state funds was spent on services performed offshore, that number could possibly, but not likely, be much higher. We believe that the offshored contract dollar amount is a small proportion of the total of \$638.9 million for all 185 reported contracts with possible offshored components because the larger contracts have such small estimates of offshored amounts. For example, the total contract amount for the EBT system from J.P. Morgan is \$278.7 million, but it has a reported offshored component of only \$891,940, or 0.32 percent. Similarly, the Department of Health Services holds six contracts with Kaiser Permanente for a total of \$226.2 million, but the majority of that amount goes toward medical care for Medi-Cal recipients. Only a small portion of this contract is used for administration, of which an even smaller percentage is for software maintenance that is offshored. Even contracts with smaller dollar values may have only a small fraction of the services performed offshore. For example, General Services administered three contracts for software maintenance,

technical support, and help-desk services totaling \$444,335; but it reports that no more than 1 percent, or \$4,443, was offshored to provide help-desk support after normal business hours.

Eight participants reported that services were provided on-site at the agency or within the State for 33 of the 39 contracts they had with known offshore firms involved in the state government market.

Finally, as we discussed in the Introduction, we asked the survey participants to report any contracts or subcontracts they held with the 18 offshore firms identified as involved in the state government market in *Your Tax Dollars At Work . . . Offshore*. Eight state agencies reported 39 contracts with these firms, but only six of these contracts had a portion of the work performed offshore and are among the 185 contracts that survey respondents reported. These six are the contracts that the Department of Health Services holds with Kaiser Permanente, which subcontracted a small portion of the work to two of the offshore firms for software maintenance. According to the survey respondents, services for the remaining 33 contracts were performed either on-site at the agencies or within the State.

Previous Efforts to Determine the Prevalence of Offshoring Also Yielded Limited Results

Three other organizations that tried to determine the prevalence of services contracted offshore also produced limited results. In response to a February 2004 legislative directive, General Services provided documentation detailing all the internal contracts it entered into that had work performed out of state or out of the country. Initially, General Services did not know which, if any, of its own contracts were performed offshore, so it had to ask all of its contractors where services were performed. General Services found that when contractors' specified work was performed offshore, the degree of offshore work was not always apparent. According to General Services, such data is extremely difficult to gather because the State currently has no requirement for state agencies to collect and track any offshore information. Also, agencies are not required to include provisions for contractors to notify the State regarding portions of the work performed offshore.

Your Tax Dollars At Work . . . Offshore claims that most states cannot estimate the total amount or value of state contract offshoring because most state governments do not know where service work they contract out is performed. This report also observes that "state officials know whether work is done onsite at the offices of the agency that commissioned it, or offsite, but 'offsite' could mean the other side of town or the other side of the world." It goes on to say that because subcontracting is so

A report by a nonprofit center concluded that most state governments do not know where their contracted-out services are performed.

common, states are often unaware of the exact identity and location of the company that is ultimately performing the work. In some instances, states award contracts to U.S. firms and assume that they will do the work domestically, but then the company subcontracts to an offshore firm. Finally, the report describes how some companies appear to be domestic but are not. A contractor's U.S. mailing address may be only the marketing office of an offshore company or the company may exist officially in the United States but do most of its work at offshore locations.

Moreover, Congress directed the U.S. Government Accountability Office (GAO) to determine what the existing data reveals about the extent of offshoring in the federal and state governments. The GAO concluded that although there are anecdotal accounts of state governments using offshore contracts, no comprehensive data or studies of the extent to which state governments use these contracts are available.

Contract Provisions Related to Subcontracting Are Not Consistent Among Entities

Our survey results show that state entities are inconsistent about including contract provisions related to subcontracting, delegating, or assigning contract duties. Also, because contractors often subcontract services, entities may have trouble determining exactly where that work is being performed. According to General Services, state agencies cannot determine which of their contracts have offshore components because contractors often subcontract out portions of the work.

We asked survey participants if their general contract provisions prohibit any or all of the contracted services to be subcontracted, assigned, or delegated. Eleven of the 39 entities responding reported that they generally prohibit any or all services from being subcontracted, assigned, or delegated. Another 24 responded that their contract provisions generally do allow for services to be subcontracted, and the remaining four entities did not respond to the question. Of the 24 entities that generally allow for subcontracting, four reported that their contracts generally do not require the contractor to notify the agency when subcontracting services. However, when entities do not require such notification, they are unaware of who is providing the services, making it difficult to effectively manage the contract. The 20 entities that do require such notification can still find it difficult to determine

Entities that do not require notice when contracted work is subcontracted or assigned are left unaware of who is providing the services.

who is performing the work and where it is being performed. As we discuss in a later section, entities that receive notification when services are subcontracted need to determine where the services are being performed. If the services are to be performed offshore, entities should ensure that all parties to the contract are aware of and comply with the contract's terms and conditions, especially those protecting sensitive and confidential information from disclosure.

Some Medical Transcription and Data Center Services Are Among the State's Contracted Services Performed Offshore

The State contracts for a wide range of services, some of which may be ultimately performed offshore, including medical transcription work, call centers, software maintenance, and database creation. Two state contracts reported in our survey illustrate that some medical transcription and call center services have been offshored. As we will later discuss, the contracts for such offshored services generally contain provisions protecting confidential information.

As a part of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996, Congress mandated that all states implement an EBT system to replace traditional paper food stamps. Many states, including California, also use this system to allow participants access to other safety net programs using debit cards. The EBT system stores benefits in a central computer database that cardholders can access electronically at point-of-sale terminals (for example, a debit card reader at a grocery store), automated teller machines, and other devices for electronic fund transfer, using a reusable magnetic-stripe plastic card, much like a debit card. To fulfill the federal requirement, the data center entered into a \$278.7 million contract with J.P. Morgan to design, develop, and implement California's EBT system as well as provide ongoing maintenance and operational support. As the EBT project's sponsor, the Department of Social Services (Social Services) entered into an interagency agreement with the data center to provide contract management services. To support the State's EBT system, J.P. Morgan operates offshore call centers that handle inquiries from program participants. According to both Social Services and the data center, J.P. Morgan operates its automated response unit in Florida and only those clients who need to speak to a customer service representative will be transferred to the offshore call centers, including locations in India and Mexico. Social Services stated that the call centers' services represented 0.32 percent, or

\$891,840, of the EBT system contract. J.P. Morgan employees who take calls have access to confidential information related to recipients of welfare and other benefits.

In another example of offshore contract work, the University of California at San Francisco Medical Center (UCSF medical center) contracted out medical transcription services. During fiscal years 2001–02 through 2003–04, the UCSF medical center entered into six contracts with Scribe International, Inc. (Scribe) to provide medical transcription services for a total of \$395,000. The information processed under these contracts is highly confidential, and both state and federal law contain a number of important restrictions on its disclosure. Scribe’s services enabled UCSF medical center staff to call a toll-free telephone number and dictate medical information directly over the phone. Scribe then routed the dictated voice recording to transcription partners worldwide and delivered the complete transcript back to the UCSF medical center within 24 hours for a standard service rate. Beginning in fiscal year 2004–05, Scribe offered the UCSF medical center the option of having its transcription work performed within the United States for a standard service rate or offshored at a discounted price; the UCSF medical center opted to have all transcription services performed within the United States.

OFFSHORE CONTRACTS GENERALLY CONTAIN PROVISIONS PROTECTING CONFIDENTIAL INFORMATION

The offshore contracts we reviewed generally contain provisions to protect sensitive and confidential information from disclosure. To ensure that all parties to the contract, including subcontractors, are aware of and comply with these standard terms and conditions, state entities must know who will be performing its contracted services and where those services will be performed.

For 11 of the 185 contracts with a portion of the work performed offshore, the contractor has access to confidential information.

Current state and federal laws protect an individual’s confidential information, such as medical records, from disclosure. Of the 185 contracts that state entities reported as having at least some portion of work performed offshore, we identified 11 contracts in which the contractor has access to confidential information. Of these 11 contracts, six are between the UCSF medical center and Scribe; two are for transcription services between the UCSF medical center and another company; and one is the EBT contract between the data center and J.P. Morgan. The remaining two include a contract between the Department of Justice and Merrill Corporation for a Web browser-based repository for case documents and a contract between the Public Utilities Commission

All 11 contracts, where the contractor has access to confidential information, contain general terms that prohibit the contracted parties from disclosing sensitive and confidential information, and some specifically describe the contractor's responsibility in protecting this information.

and Nordia, Inc., for a deaf and disabled telecommunications relay service. All 11 of these contracts contain, at a minimum, general terms that prohibit the contracted parties from disclosing sensitive and confidential information. Some of these contracts also contain language that specifically describes the contractor's responsibility in protecting this information.

Beginning in November 2002, the UCSF medical center amended its contracts with Scribe to clearly define the term "protected health information" and specify the responsibilities of the contractor under the federal Health Insurance Portability and Accountability Act of 1996.⁴ Similarly, the EBT contract between the data center and J.P. Morgan requires that the contractor have written policies governing access to and duplication and dissemination of all confidential information. The contract further states that the contractor and all subcontractors shall at all times comply with security standards, practices, and procedures that are equal to or exceed those of the State. The contracts with both Scribe and J.P. Morgan also contain language that requires the contractors to report to the State any breach of sensitive and confidential information. As recourse, in the event this information is disclosed, the EBT contract allows for injunctive relief—a court order forcing the vendor to immediately cease the actions resulting in the breach of the confidential information. Nine of the 11 contracts allow the State to terminate the contract if the entities consider the contractor to be in material breach of the terms and conditions, including those protecting sensitive and confidential information. The contract between J.P. Morgan and the State also expressly provides that disputes arising under the contract will be resolved in a California court. Finally, nine of the 11 contracts include a provision dictating that the governing law of the contract shall be the laws of the State.⁵

General Services requires state contracts to include standard terms and conditions that subject the contract to the laws of California, including those related to confidential information, and that impose liability on the contractor for all actions arising out of the contracts. General Services believes this language holds the contractor accountable for complying with the laws of the

⁴ Also known as HIPAA, this federal law provides limited protection for working Americans and their families in obtaining health care coverage and sets penalties for unauthorized disclosure of individually identifiable health information.

⁵ The remaining two contracts are administered by the University of California. The University of California requires standard terms and provisions, including the governing law of the contract, to be part of each contract. Although the other University of California contracts we reviewed included these provisions, these two contracts, which have since been terminated, did not.

State. However, it is important that all parties to the contract, including all subcontractors, either domestic or offshore, are aware of these standard terms and conditions and comply with them. As discussed earlier, because contractors often subcontract services, entities may have trouble determining exactly where that work is being performed. For example, respondents indicated that they did not know the amount or portion of the work that may have been performed offshore for 76 of their contracts. Although it did not appear that any of these contracts dealt with confidential information, it is essential for state entities to determine where subcontracted services are performed and who is performing the services. This knowledge will enable state entities to better ensure that all contracts and subcontracts include appropriate provisions to protect confidential information from disclosure and that all parties to the contract are aware of and comply with standard contract terms and conditions.

LEGISLATIVE ATTEMPTS TO RESTRICT OFFSHORE CONTRACTING RAISE SERIOUS LEGAL CONCERNS

Proposed Offshoring Legislation Is Typically Aimed at Accomplishing One or More of the Following Objectives

Prevention—prohibits contracts in which all or a portion of the work will be performed offshore.

Preferences—provides preferences to local bidders or to vendors who employ state or local employees.

Reporting—requires that state contracts detail all services that will be performed offshore.

Protection—requires disclosure if the contractor sends sensitive or confidential information offshore, such as medical records.

The federal government and 40 states, including California, have proposed or adopted legislation to restrict offshore contracting. Proposed legislation is typically aimed at accomplishing one or more of the purposes described in the text box. However, such restrictions are likely to face both legal challenges and economic consequences. States' efforts to restrict offshore contracting may violate constitutional provisions allowing the federal government to set uniform policies for the country as a whole in dealing with foreign nations. Also, restricting or limiting offshoring may invite retaliation in the form of trade sanctions against the United States.

The Federal Government and Various States Have Attempted to Pass Legislation Restricting Offshoring

At the federal level, Public Law 108-199 of January 2004 requires that any activity or function of a federal agency that is contracted out may not be performed at a location outside the United States. Additionally, Congress proposed legislation limiting the distribution of federal funds for state contracts performed offshore. Despite the federal government's efforts to legislate offshore contracting, the individual states do not necessarily enjoy the same latitude, because a state's attempt to legislate offshoring

None of California's 11 proposed bills on offshore contracting have become law: The governor vetoed six, and five did not pass out of the Legislature.

can improperly encroach on the federal power over foreign affairs. Although a few states have passed bills to restrict offshoring, none of California's 11 proposed bills on this practice have become law: The governor vetoed six, and five did not pass out of the Legislature.

According to the National Foundation for American Policy, a nonprofit organization, 40 states have introduced legislation related to offshore contracting. Four of the 40 states have passed laws, and one has passed a resolution related to offshoring state-funded contracts. In 2004 Indiana, North Carolina, and Tennessee enacted bills giving preferences to contractors who hire U.S. citizens or residents or who use products or services manufactured in the United States. Furthermore, Colorado enacted a bill in June 2004 permitting state departments to contract for services offshore provided that (1) the contract will not reduce the quality of services offered, (2) the contract contains safeguards to ensure the confidentiality and right to privacy of Colorado residents' medical and other personal information, and (3) the contractor discloses to the department the portion of the services that will be performed outside the United States. Finally, in April 2004 Alabama passed a joint resolution strongly encouraging its local, county, and state governments to use Alabama businesses and professionals when procuring professional services.

As detailed in Table 2, California legislators introduced 11 bills during the 2003–04 legislative session dealing with issues related to offshore contracting. Three bills were aimed at preventing state-funded contracts from being performed by workers outside the United States. The governor vetoed two of these bills at the end of the last legislative session, stating that Assembly Bill (AB) 1829 would be detrimental to California's economy and the creation of new jobs in the State and that Senate Bill (SB) 888 would result in higher prices for services without increasing homeland security. In vetoing AB 1829, the governor also said that the "wrong way to expand economic opportunity is to restrict trade, invite retaliation, or violate the U.S. Constitution and our foreign trade agreements." Rather, he said, "the best approach to create and enhance job growth in California is to provide a competitive business environment." The third bill in this group did not pass out of the Legislature. Another bill, AB 990, which would have provided preferences to bidders who employ California workers, also did not pass out of the Legislature.

TABLE 2

**The State’s Proposed Legislation Related to Offshore Contracting
2003–04 Legislative Session**

Bill Number	Objective	Description of Proposed Legislation	Status
AB 1829	Prevention	Prohibits state agencies and local governments from contracting for services unless the contractor or subcontractor certifies that the contract, or any subcontract, would be performed solely by workers in the United States.	Passed by the Legislature but vetoed by the governor
SB 888	Prevention	Prohibits the performance of any work involving information essential to homeland security at a worksite located outside the United States unless the expertise necessary to perform the work was not available within the United States.	Passed by the Legislature but vetoed by the governor
SB 1452	Prevention	Prohibits the State from contracting for services with any individual or entity that employs persons or subcontractors outside of the United States in order to perform and complete that state contract.	Introduced but did not pass out of the Legislature
AB 990	Preferences	Gives preference to bidders that employ California workers over bidders that do not employ California workers when awarding public contracts.	Introduced but did not pass out of the Legislature
AB 2449	Reporting	Requires that any vendor awarded a state contract for services, in excess of \$100,000, disclose an estimate of all portions of the project that will be performed by subcontractors or employees located outside of the United States.	Introduced but did not pass out of the Legislature
AB 2715	Reporting	Requires a person or entity conducting business in California that contracts with a customer sales call center or a customer service telephone bank to include a provision in the contract requiring a customer service employee to disclose his or her location upon the request of the California resident.	Passed by the Legislature but vetoed by the governor
AB 3021	Reporting	Requires an employer with more than 250 employees to report the number of its employees within California, outside of California but within the United States, and outside of the United States.	Passed by the Legislature but vetoed by the governor
SB 1453	Reporting	Requires employers to give 60-days notice before ordering a mass layoff, relocation, or termination; and to include in their notices to affected employees and specified government agencies, the number of employees laid off, relocated, or terminated because of offshoring.	Introduced but did not pass out of the Legislature
AB 2163	Protection	Requires any person or entity hired by a provider of health care for the purpose of transcribing medical records to disclose to the health care provider all contractors or subcontractors that the person or entity uses to perform that function and to disclose whether any of the medical records will be sent offshore.	Introduced but did not pass out of the Legislature
SB 1451	Protection	Prohibits a person who is otherwise not subject to the provisions of privacy law from sharing or disclosing protected information in a manner that would be prohibited by privacy law.	Passed by the Legislature but vetoed by the governor
SB 1492	Protection	Prohibits a health care business from transmitting individually identifiable health information to a site outside the United States, unless specified notice and authorization requirements are satisfied.	Passed by the Legislature but vetoed by the governor

Source: California Legislative Data Center.

Four bills were aimed at enhanced reporting requirements for contract work performed offshore. The governor vetoed AB 2715, stating that the bill was unnecessary and its underlying

policy had “no discernible public benefit;” he also vetoed AB 3021, stating that it would add “burdensome requirements” on California businesses. The remaining two bills in this group did not pass out of the Legislature.

Finally, legislators introduced three bills aimed at protecting sensitive or confidential information. The governor vetoed SB 1451, stating that the measure was well intentioned and he would consider signing a similar measure in the future, but that the bill had an ambiguity that could be interpreted to conflict with the California Financial Information Privacy Act. In addition, he vetoed SB 1492, stating that it was unnecessary because existing laws prohibit the sharing of an individual’s medical information. The remaining bill in this group did not pass out of the Legislature.

Legislation Against Offshoring Is Likely to Face Legal Challenges and Economic Consequences

Over the last year, 40 states have introduced more than 100 bills aimed at restricting offshore contracting. As our earlier discussion indicates, many of the state legislative proposals designed to curb the practice of offshore contracting have attempted to accomplish this goal by restricting where contracted services could be performed. Before proposing measures to restrict offshoring, policy-makers should consider whether such actions violate the U.S. Constitution and can withstand international legal challenges. Also, international concerns are significant because much of the legislation proposed by the various states could invite retaliation, such as trade sanctions, by other nations. In some cases, these state legislative proposals would have required the services performed under contract to be performed in the United States, while in other cases the legislative proposals would have given preference to local (or in-state) bidders. Although the latter type of restriction does not directly prohibit services from being performed offshore, it does so indirectly. In addition, some legislative proposals would have required that work under the contract be performed only by persons authorized to work in the United States.

These state legislative proposals raise significant legal concerns. First, any state legislative proposal that requires work to be performed exclusively in the United States may effectively regulate commerce between a state and a foreign country by prohibiting work from being performed in a foreign country. Under the U.S. Constitution, only the federal government may

Over the last year, 40 states have introduced more than 100 bills aimed at restricting offshore contracting.

Any state legislation that regulates foreign commerce may be subject to legal challenge because individual states lack the authority to regulate in this area.

regulate foreign commerce. Consequently, any state legislation that regulates foreign commerce may be subject to legal challenge because individual states lack the authority to regulate in this area.

Second, when state legislation allows contracts to be awarded by giving preferential treatment to local or in-state contractors rather than out-of-state contractors, this practice may violate the commerce clause of the U.S. Constitution, which generally prohibits states from restricting interstate commerce. These laws may also violate the privileges and immunities clause of the U.S. Constitution, which prohibits the laws of one state from discriminating against the citizens of another state. For example, the U.S. Supreme Court has held that Alaska could not limit jobs on its oil pipelines to state residents based on this constitutional provision. Such legislation may also be challenged as interfering with an individual's right to travel freely from one state to another in order to find work.

In addition to the potential legal obstacles that state legislation may face based on the U.S. Constitution, federal attempts to restrict offshore contracting must also be in accord with the various requirements contained in international treaties that the United States has signed. Some commentators have noted that the federal legislation mentioned earlier may be subject to legal challenge on the grounds that it conflicts with the World Trade Agreement. In an August 2004 report, *Services Offshoring: Background and Implications for California*, the Public Policy Institute of California (institute) argues that legislation aimed at limiting state contracts performed offshore may "run afoul of" the Agreement on Government Procurement under the World Trade Organization and a similar provision in the North American Free Trade Agreement (NAFTA). The institute states that if the World Trade Organization or NAFTA finds that this legislation violates the Agreement on Government Procurement, countries that have been discriminated against may be entitled to retaliate by issuing trade sanctions against the United States. Such sanctions would cost U.S. jobs by putting U.S. companies at a competitive disadvantage abroad. Further, the institute concludes that "although countries are not likely to retaliate if only California limits offshoring, California is part of a broader state-level movement, and a large portion of the California workforce either depends on foreign trade or works for foreign-owned companies." Policymakers thus have to weigh the gains and losses: If they restrict offshoring, they keep certain California jobs but may lose export markets and jobs from foreign-owned companies; however, if they leave offshoring alone, they maintain those export markets and jobs from abroad but lose certain California jobs.

RECOMMENDATION

If the Legislature desires information and data on offshoring of state services to be more readily available, it may consider granting General Services the authority to require contractors to disclose, as part of their bid on state work or during performance of the contract, details on any and all portions of the project that subcontractors or employees outside the United States will perform.

We conducted this review under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted government auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,



ELAINE M. HOWLE
State Auditor

Date: January 20, 2005

Staff: Nancy C. Woodward, CPA, Audit Principal
Rob Hughes
Sheryl Liu-Philo, CPA
Sang Park

APPENDIX

Survey Results Offer No Certainty About the Prevalence of the State's Offshore Contracting

To determine the extent of state-funded services being provided offshore, we conducted a written survey of 40 state entities, including the 35 agencies with the largest dollar amount of contracts for certain services and the five University of California campuses with medical centers. We received and analyzed 39 surveys, excusing the Department of Forestry and Fire Protection (Forestry) from responding because flooding in its contracting unit made its records temporarily unavailable. However, according to Forestry, its contracted services are generally performed within the State, and the nature of its services provide little, if any, opportunity for contracted services to be performed offshore. Both the Department of Social Services (Social Services) and the Health and Human Services Data Center (data center) reported a contract with J.P. Morgan Electronic Financial Services to provide cash and food-stamp benefits to eligible participants. Social Services is the contract's sponsor, and the data center administers the contract. We counted this as one contract and included it with the data center. Further, the Department of Health Services provided us with separate responses from two of its divisions. We report these separately in this Appendix.

Table A.1 on the following pages summarizes the results of our survey. The 39 state agencies and campuses that responded to our survey reported a total of 185 service contracts totaling \$638.9 million that possibly have an offshore component. Of these 185 contracts, survey participants estimated a dollar amount or percentage of the contract work performed outside the United States for 109 (59 percent) contracts. For the remaining 76 contracts, participants could not provide us with an estimate of the dollar amount or percentage of contract work performed offshore.

Table A.2 on page 32 details the 109 service contracts, totaling \$349 million, with a known offshore component. Of this total, \$9.7 million (2.8 percent) was estimated to have been performed offshore.

Finally, Table A.3 on page 33 details the remaining 76 service contracts, totaling \$289.9 million, that possibly have an offshore component; however, participants reported the dollar amount as unknown.

TABLE A.1

Summary of Results: Survey of Offshore Contracting Practices

	Entity	Number of Reported Contracts With Possible Offshore Amounts	Total Dollar Value of the Contracts With Possible Offshore Amounts	Number of Contracts in Which Offshore Amount Is Unknown	Number of Reported Contracts With Known Offshore Amounts	Estimated Value of Known Offshore Portion of Contracts
1	Air Resources Board	14	\$ 3,148,807	—	14	\$3,117,407
2	Board of Equalization	0	—	—	—	—
3	California Bay-Delta Authority	2	56,000	—	2	16,800
4	California Children and Families Commission	0	—	—	—	—
5	California Highway Patrol	0	—	—	—	—
6	Department of Alcohol and Drug Programs	0	—	—	—	—
7	Department of Child Support Services	0	—	—	—	—
8	Department of Conservation	0	—	—	—	—
9	Department of Consumer Affairs	1	1,139,000	—	1	1,139,000
10	Department of Developmental Services	0	—	—	—	—
11	Department of General Services	4	550,350	1	3	4,443
12a	Department of Health Services: Medi-Cal Managed Care Division	6	226,239,107	6	—	Unknown
12b	Department of Health Services: Prevention Services Division	1	660,219	—	1	132,044
13	Department of Justice	6	1,023,000	—	6	740,890
14	Department of Mental Health	0	—	—	—	—
15	Department of Motor Vehicles	31	1,296,498	27	4	4,228
16	Department of Parks and Recreation	0	—	—	—	—
17	Department of Rehabilitation	0	—	—	—	—
18	Department of Social Services	0	—	—	—	—
19	Department of the Youth Authority	0	—	—	—	—
20	Department of Toxic Substances Control	0	—	—	—	—
21	Department of Transportation	3	9,386,434	—	3	74,280

22	Department of Veterans Affairs	0	—	—	—	—	—	—
23	Department of Water Resources	0	—	—	—	—	—	—
24	Employment Development Department	0	—	—	—	—	—	—
25	Franchise Tax Board	0	—	—	—	—	—	—
26	Health and Human Services Data Center	10	\$278,799,552	9	1	—	—	\$ 891,840
27	Integrated Waste Management Board	0	—	—	—	—	—	—
28	Managed Risk Medical Insurance Board	0	—	—	—	—	—	—
29	Prison Industry Authority	0	—	—	—	—	—	—
30	Public Utilities Commission	1	22,764,003	1	—	—	—	Unknown
31	Secretary of State	1	25,284,656	1	—	—	—	Unknown
32	State Energy Resources Conservation and Development Commission	1	50,000,000	—	1	—	—	230,000
33	State Treasurer's Office	2	6,234,461	2	—	—	—	Unknown
34	Stephen P. Teale Data Center	11	2,392,616	8	3	—	—	371,997
35	University of California, Davis	46	5,618,532	17	29	—	—	289,296
36	University of California, Irvine	0	—	—	—	—	—	—
37	University of California, Los Angeles	1	445,132	—	1	—	—	222,566
38	University of California, San Diego	4	13,500	—	4	—	—	13,500
39	University of California, San Francisco	40	3,883,624	4	36	—	—	2,442,975
	Totals	185	\$638,935,491	76	109	—	—	\$9,691,266

Source: Offshore contracting practices survey results.

TABLE A.2

Summary of Survey Participants Reporting Contracts With Known Offshore Amounts

	Entity	Number of Reported Contracts With Known Offshore Amounts	Total Dollar Value of the Contracts With Known Offshore Amounts	Estimated Value of Known Offshore Portion of Contracts
1	Air Resources Board	14	\$ 3,148,807	\$3,117,407
2	California Bay-Delta Authority	2	56,000	16,800
3	Department of Consumer Affairs	1	1,139,000	1,139,000
4	Department of General Services	3	444,335	4,443
5	Department of Health Services: Prevention Services Division	1	660,219	132,044
6	Department of Justice	6	1,023,000	740,890
7	Department of Motor Vehicles	4	4,228	4,228
8	Department of Transportation	3	9,386,434	74,280
9	Health and Human Services Data Center	1	278,700,000	891,840
10	State Energy Resources Conservation and Development Commission	1	50,000,000	230,000
11	Stephen P. Teale Data Center	3	371,997	371,997
12	University of California, Davis	29	289,296	289,296
13	University of California, Los Angeles	1	445,132	222,566
14	University of California, San Diego	4	13,500	13,500
15	University of California, San Francisco	36	3,389,455	2,442,975
	Totals	109	\$349,071,403	\$9,691,266

Source: Offshore contracting practices survey results.

TABLE A.3**Summary of Survey Participants Reporting Contracts
in Which Offshore Amount Is Unknown**

	Entity	Number of Contracts in Which Offshore Amount Is Unknown	Total Dollar Value of the Contracts in Which Offshore Amount Is Unknown
1	Department of General Services	1	\$ 106,015
2	Department of Health Services: Medi-Cal Managed Care Division	6	226,239,107
3	Department of Motor Vehicles	27	1,292,270
4	Health and Human Services Data Center	9	99,552
5	Public Utilities Commission	1	22,764,003
6	Secretary of State	1	25,284,656
7	State Treasurer's Office	2	6,234,461
8	Stephen P. Teale Data Center	8	2,020,619
9	University of California, Davis	17	5,329,236
10	University of California, San Francisco	4	494,168
	Totals	76	\$289,864,087

Source: Offshore contracting practices survey results.

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Agency's comments provided as text only.

State and Consumer Services Agency
Office of the Secretary
915 Capitol Mall, Suite 200
Sacramento, CA 95814

January 7, 2005

Elaine Howle, State Auditor*
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, CA 95814

Dear Ms. Howle:

Enclosed is our response prepared by the Department of General Services to the Bureau of State Audits' Report No. 2004-115 entitled, *The State's Offshore Contracting: Uncertainty Exists About Its Prevalence and Effects*. A copy of the response is also included on the enclosed diskette.

If you have any questions or need additional information, please contact me at (916) 653-4090.

Sincerely,

(Signed by: Fred Aguiar)

Fred Aguiar, Secretary
Enclosures

* California State Auditor's comment appears on page 39.

State and Consumer Services Agency
Department of General Services
Executive Office

January 7, 2005

Fred Aguiar, Secretary
State and Consumer Services Agency
915 Capitol Mall, Room 200
Sacramento, CA 95814

Response to Bureau of State Audits' Report No. 2004-115 – “The State’s Offshore Contracting: Uncertainty Exists About Its Prevalence and Effects”

The Department of General Services (DGS) has reviewed the Bureau of State Audits' (BSA) Report No. 2004-115 and provides the following comments. The report addresses the State of California's offshore contracting practices and includes information on the state's service contracting program that is overseen by the DGS. During its audit the BSA obtained information from the DGS on various areas including: the department's contract oversight responsibilities; any statewide policies and procedures relevant to offshore contracting; and, the results of a DGS' survey of its own contracts for any offshored services that was conducted based on a Legislative request. Further, the DGS was one of the 40 state entities that were surveyed by the BSA to obtain information on contracts that were entered into within the last three fiscal years that included an offshore component.

The BSA accurately reports that current state laws, regulations and policies do not specifically address the use of offshore contracting, the practice of subcontracting portions of a contract offshore, or determining where contracted services are performed. Therefore, comprehensive data on this subject is not readily available.

In its report, the BSA raises concerns with the state's ability to legally protect sensitive and confidential information from disclosure when this information is communicated to workers in a foreign country. The state has a long-standing and firm commitment to adequately protecting this type of information regardless if the information is handled by contractors within California, in another state or in a foreign country. Toward this end, additional action was recently taken to further strengthen the state's policies and procedures over the protection of its information resources that are accessed by contractors, including confidential information contained in the state's automated files and databases. Specifically, on November 16, 2004, the Department of Finance issued Budget Letter 04-35. This document required that each state agency immediately establish additional policies and procedures for preserving the integrity and security of each automated file or database, including the use of written agreements with non-state entities to cover, at a minimum, the following:

- Appropriate levels of confidentiality for the data, based on data classification;
- Standards for transmission and storage of the data, if applicable;
- Agreement to comply with all state policy and law regarding the use of information resources and data;
- Signed confidentiality statements;
- Agreement to apply security patches and upgrades, and keep virus software up-to-date on systems on which the data may be used; and,
- Agreement to notify the state agency data owners promptly if a security incident involving the data occurs.

The DGS' Office of Legal Services is in the early stages of drafting standard contract language to implement the new policies. This language will be required to be agreed to by all contracted vendors, consultants and researchers before they are allowed access to state data.

It should be noted that, although based on limited information, the DGS believes that it spends very little on offshore services within its own contracting program. As indicated in the BSA's report, in response to the BSA's survey request and the criteria contained in that request, the DGS identified only four contracts with a likely offshore service component. For three of these contracts totaling \$444,335, the DGS estimated the offshore component as no more than one percent, or \$4,443. The department could not readily estimate the offshore component of the other contract that totaled \$106,015.

The BSA's report addresses two recommendations to the Legislature. The DGS' contracting and legal personnel are available to assist the Legislature and other interested parties in evaluating the proposed actions.

The DGS remains firmly committed to effectively and efficiently overseeing the state's contracting program. As part of its continuing efforts to improve this process, the DGS will fully address any additional direction that is provided related to the control of offshore contracting.

If you need further information or assistance on this issue, please call me at 376-5012.

(Signed by: Ron Joseph)

Ron Joseph
Director

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COMMENT

California State Auditor's Comment on the Response From the State and Consumer Services Agency, Department of General Services

To provide clarity and perspective, we are commenting on the response to our audit report from the State and Consumer Services Agency, Department of General Services (General Services). The number below corresponds to the number we placed in the margin of General Services' response.

- After the agency response period, we modified a section of our audit report and eliminated one of the audit recommendations.

cc: Members of the Legislature
Office of the Lieutenant Governor
Milton Marks Commission on California State
Government Organization and Economy
Department of Finance
Attorney General
State Controller
State Treasurer
Legislative Analyst
Senate Office of Research
California Research Bureau
Capitol Press