Office of Inspector General
Kristofer B. Sullivan, Inspector General

Audit Report No. 19I-1002 March 27, 2020
Florida East Coast Railway 2018 Fringe Rate

What We Did

The Florida Department of Transportation's Office of Inspector General reviewed the Florida East Coast Railway's (FEC) labor additive, material handling and supplies, and equipment (indirect) rates for calendar year 2018, to determine whether they are reasonable, based on allocable and allowable costs, and supported by transparent and understandable records.

What We Found

We **determined** the indirect rates submitted by FEC for use in billing railroad/highway projects are:

- for groups 2 and 3, reasonable, allocable, and allowable; and
- for group 4, reasonable and allocable, but not fully allowable.

The portion of the rate submission deemed unallowable relates to the bonus component of the group 4 (non-contract) labor rate, which increased by 20.8 percent. During a transition period between company owners, the new owner made a one-time decision to temporarily suspend the relationship between performance and bonus amounts for this group of employees. The decision contributed to the increase in bonus costs; however, to what extent cannot be exactly determined from available records.

What We Recommend

We recommend the Freight and Multimodal Operations (FMO) Office review and consider FEC's 2018 rate packet for approval, except for the bonus component of the group 4 (non-contract) labor rate.

Regarding this component, we recommend the FMO Office discuss possible solutions with FEC, which could include:

- Limiting the bonus component of the group 4 labor rate to 2017 rates; or
- Negotiating a lower increase amount based on a reasonable estimate of what bonus costs would have been without the one-time waiver of performance terms. (As stated in its official response to our report, FEC has already offered to lower the group 4 labor rate by 10 percent. See Appendix D.)

TABLE OF CONTENTS

BACKGROUND AND INTRODUCTION

The Florida East Coast Railway (FEC) is a Class II regional railroad that owns the 351-mile mainline track in Florida from Jacksonville to Miami. It is the exclusive rail provider for Port Miami, Port Everglades, and Port of Palm Beach. FEC connects to the national railway system in Jacksonville, allowing it to provide rail service in and out of Georgia, Tennessee, South Carolina, and North Carolina, into and out of Florida's east coast. Based in Jacksonville, FEC provides end-to-end intermodal and carload solutions to customers.[1]

On June 30, 2017, Fortress Investment Group finalized its sale of FEC, a privately held company, to Grupo Mexico, a publicly traded company listed on the Mexican Stock Exchange. Since FEC uses the calendar year as its fiscal year, this means the 2017 calendar year was evenly split between the old ownership and the new.

Criteria

The following regulations authorize the Florida Department of Transportation (Department) to pay labor surcharge and indirect cost rates, define allowable costs for purposes of inclusion in the rates, and set minimum standards for calculation methods and supporting records:

- Title 23, Part 140, Code of Federal Regulations (C.F.R.), Subpart I-Reimbursement for Railroad Work, Subsection .908(e)-Materials and Supplies;
- 23 C.F.R.140.910(a)-Equipment; and
- 23 C.F.R.140.906(b)(2)(ii)-Labor Costs.

Rate Utilization

FEC uses its indirect rates to bill for certain overhead costs related to rail/highway safety projects. Indirect rates are approved by the Department's Freight and Multimodal Operations (FMO) Office and the Federal Highway Administration (FHWA), and applied as follows:

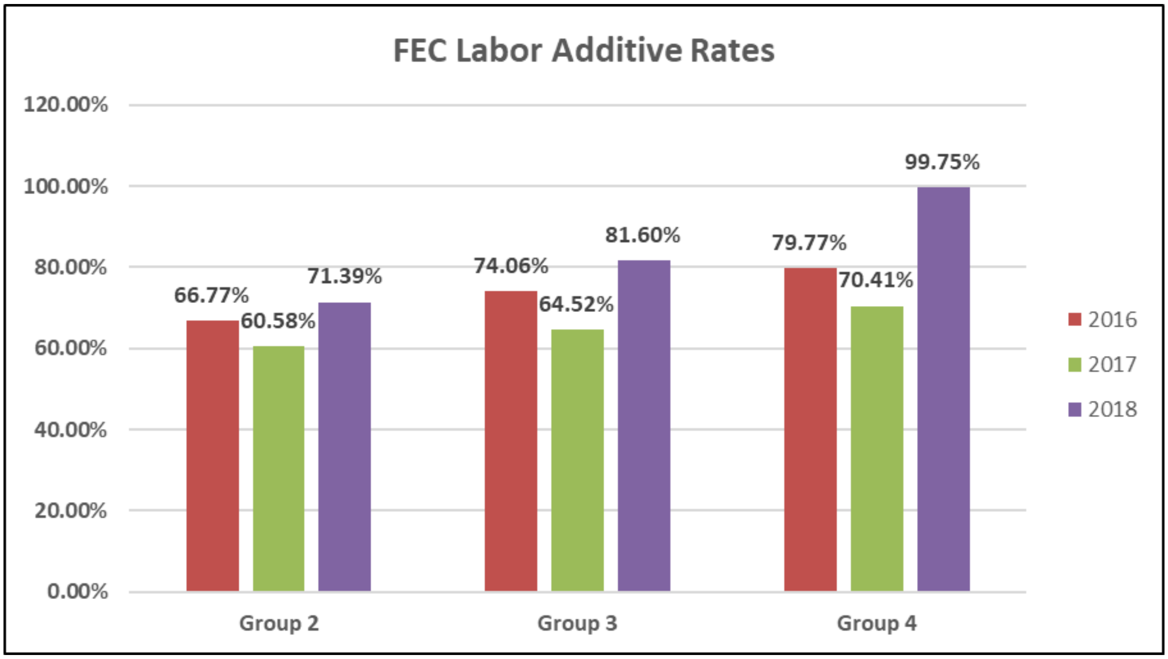
- For its hourly in-house labor charges, to recover costs associated with:
    - Workman's compensation, public liability, and property damage charged at the flat fee of 8 percent of direct labor costs in lieu of actual costs, per 23 C.F.R. 140.906(b)(2)(ii); and
    - Employee benefits and the employer-paid portion of payroll taxes. These components make up the balance of the total rate, which has ranged between 60 and 79 percent, depending on group and year;
- As an additional materials handling charge of 5 percent of the amounts billed for material and supplies issued from company stores and material yards in lieu of actual costs, per 23 C.F.R. 140.908(e); and
- As the industry rate for equipment costs based on the "Blue Book for Railroad Equipment," per 23 C.F.R. 140.910(a).

[1] "Who We Are", FEC website.

Rate Fluctuations

Indirect rates for 2018 are relatively higher than 2017's rates. See Figure 1.

Figure 1: FEC Historical Rate Trend



Source: Data from Appendix B and OIG Memo 18I-1002.

As shown in Figure 2, all labor types experienced increases in health and welfare costs of between 6 and 9 percent. Group 4 labor also experienced an increase in bonus costs of 20 percent. This increase is discussed in Finding 1.

Figure 2: 2017-2018 Rates Comparison

Comparison of 2017 and 2018 Rates	GROUP 2			GROUP 3			GROUP 4		
	2017	2018	Change	2017	2018	Change	2017	2018	Change
Sick Pay	0.11%	0.19%	0.08%	0.15%	0.23%	0.08%	1.58%	1.46%	-0.12%
Holiday & Vacation Pay	8.98%	9.10%	0.12%	9.96%	9.94%	-0.02%	9.80%	6.04%	-3.76%
Other Paid Absences	1.81%	1.54%	-0.27%	7.31%	10.87%	3.56%	4.65%	6.50%	1.85%
Bonuses	1.64%	3.58%	1.94%	0.94%	3.41%	2.47%	9.73%	30.54%	20.81%
Payroll Taxes	21.36%	22.49%	1.13%	22.46%	24.47%	2.01%	23.87%	28.42%	4.55%
Health and Welfare	18.68%	26.49%	7.81%	15.70%	24.68%	8.98%	12.78%	18.79%	6.01%
Property Damage Insurance	8.00%	8.00%	0.00%	8.00%	8.00%	0.00%	8.00%	8.00%	0.00%

Source: The OIG created this table from data submitted by FEC.

Revised January 2019

RESULTS OF REVIEW

To assess reasonableness, allocability, allowability, transparency, and understandability of the indirect rates submission packet, we evaluated the costs associated with the rates (Appendix B) and compared current to prior year's submission (Appendix C). However, we noted a 20.8 percent increment in the group 4 rate during 2018's submission, which required further analysis as explained below.

Assessment of the risk of miscalculation of FEC's submitted rates[2] continues to be low for the following reasons:[3]

- FEC's rate calculation methodology has not changed since 2014 (other than the exclusion of the extraordinary transactions related to the Grupo Mexico buyout in 2017).
- FEC's rates are inherently conservative, since it only charges for the portion of allowable indirect costs directly attributable to the fringe costs of labor, and not for general administrative costs.
- FEC relies heavily on third-party contractors for project completion and passes hiring costs to the Department without any markup. As a result, FEC's in-house labor (direct) costs represent a small percentage of total costs, and indirect costs represent an even smaller percentage.
- Although the FEC staff members responsible for performing the 2018 rate calculations are not the same as those responsible for prior submissions, a walkthrough of procedures and additional research indicate the new staff has a thorough understanding of the process.

Finding 1 – Allowable Costs

We **determined** the rates submitted by FEC are:

- for groups 2 and 3, reasonable, allocable, and allowable; and
- for group 4, reasonable and allocable, but not fully allowable.

The portion of the rate submission deemed unallowable relates to a 20.8 percent increase in the bonus component of the group 4 labor rate.

48 C.F.R. 31.205-6 states:

> (f) Bonuses and incentive compensation. (1) Bonuses and incentive compensation are allowable provided the –

[2] Reference: Appendix B: 2018 Labor Additive Surcharge Rates
[3] Additional details may be found in OIG Attestation Reports 16I-1001 dated October 20, 2016 (regarding 2014 rate), 17I-1002 dated June 23, 2017 (regarding 2016 rate), and 18I-9002 dated June 27, 2018 (regarding 2017 rate).

(i) Awards are paid or accrued under an agreement entered into in good faith between the contractor and the employees before the services are rendered or pursuant to an established plan or policy followed by the contractor so consistently as to imply, in effect, an agreement to make such payment; and
(ii) Basis for the award is supported.

Historically, FEC has paid out incentive bonuses to eligible cost groups as follows:

- Group 2 contract employees received incentive bonuses based on attendance;
- Group 3 contract employees received incentive bonuses based on attendance; and
- Group 4 non-contract employees received incentive bonuses capped at a predetermined percentage of their annual salaries based on performance evaluations.

Group 4 bonus amounts earned in 2017 were paid in 2018 and included as part of the 2018 rate calculation. During the transition between owners, Grupo Mexico made a one-time decision to suspend the relationship between performance and bonus amounts for the six-month period of July through December 2017. The decision, which was neither documented nor publicized to FEC's employees in advance, simplified distribution of the set-aside for bonuses defined by the terms of FEC's sale.

Grupo Mexico's decision to temporarily suspend the connection between performance and bonus amounts contributed to the 20.8 percent increase in Group 4 bonus costs; to what extent it contributed to the increase cannot be exactly determined due to the absence of computerized performance records during a changeover between computer systems after the buyout. FEC has indicated the administrative burden of retroactively compiling performance scores from paper records to recalculate bonus amounts would be administratively burdensome.

Recommendation

We recommend the FMO Office review and consider FEC's 2018 rate packet for approval, except for the bonus component of the Group 4 labor rate. However, we also observe the Group 4 labor rate is rarely applied in practice. Therefore, we recommend the FMO Office discuss possible solutions with FEC, which could include:

- Limiting the bonus component of the Group 4 labor rate to 2017 rates; or
- Negotiating a lower increase amount based on a reasonable estimate of what bonus costs would have been without the one-time waiver of performance terms.

Observation 1 – Indirect Rate Development Manual

We observed the indirect rate development manual submitted with the indirect packet lacks descriptive steps of the rate development process.

We suggest the FMO Office request FEC create a more comprehensive indirect rate development manual to better understand FEC's rate development procedures. A complete set of written procedures would help FEC train new employees as well as communicate more easily with its stakeholders.

APPENDIX A – Purpose, Scope, and Methodology

The **purpose** of this engagement was to determine whether FEC's calendar year 2018 indirect rates are:

- reasonable, allocable, and based on allowable costs; and
- supported by transparent and understandable records.

The **scope** of this audit consisted of the proposed 2018 indirect rates submitted by FEC and associated records and supporting documentation.

The **methodology** included:

- reviewing relevant regulations:
  - 23 C.F.R. 140.908(e)-Materials and Supplies
  - 23 C.F.R. 140.910(a)-Equipment
  - 23 C.F.R. 140.906(b)(2)(ii)-Labor Costs
- reviewing FEC's rate preparation procedures;
- identifying and reviewing account classification differences between 2017 and 2018;
- re-performing rate calculations;
- performing comparative analysis on 2017 and 2018 rate data; and
- interviewing key management staff and reviewing selected workpapers prepared internally by FEC.

APPENDIX B – 2018 Labor Additive Surcharge Rates

Group II – Maintenance of Roadway, Equipment, and Signal Employees

Sick Pay	0.19%
Holiday & Vacation Pay	9.10%
Other Paid Absences	1.54%
Bonuses	3.58%
Payroll Taxes	22.49%
Health and Welfare	26.49%
Workman's Compensation (W/C), Public Liability & Property Damage Insurance	8.00%
Total	71.39%

Group III – Transportation Employees

Sick Pay	0.23%
Holiday & Vacation Pay	9.94%
Other Paid Absences	10.87%
Bonuses	3.41%
Payroll Taxes	24.47%
Health and Welfare	24.68%
Workman's Compensation (W/C), Public Liability & Property Damage Insurance	8.00%
Total	81.60%

Group IV – General and Administrative Employees

Sick Pay	1.46%
Holiday & Vacation Pay	6.04%
Other Paid Absences	6.50%
Bonuses	30.54%
Payroll Taxes	28.42%
Health and Welfare	18.79%
Workman's Compensation (W/C), Public Liability & Property Damage Insurance	8.00%
Total	99.75%

Source: OIG compiled this table utilizing data provided by FEC.

APPENDIX C – Comparison of 2017 and 2018 Rates

Group II - Maintenance of Roadway, Equipment, and Signal Employees	2017 Audited	2018 Submitted	Change
Sick Pay	0.11%	0.19%	0.08%
Holiday & Vacation Pay	8.98%	9.10%	0.12%
Other Paid Absences	1.81%	1.54%	-0.27%
Bonuses	1.64%	3.58%	1.94%
Payroll Taxes	21.36%	22.49%	1.13%
Health and Welfare	18.68%	26.49%	7.81%
W/C, Public Liability & Property Damage Insurance	8.00%	8.00%	0.00%
Total	60.58%	71.39%	10.81%

Group III – Transportation Employees	2017 Audited	2018 Submitted	Change
Sick Pay	0.15%	0.23%	0.08%
Holiday & Vacation Pay	9.96%	9.94%	-0.02%
Other Paid Absences	7.31%	10.87%	3.56%
Bonuses	0.94%	3.41%	2.47%
Payroll Taxes	22.46%	24.47%	2.01%
Health and Welfare	15.70%	24.68%	8.98%
W/C, Public Liability & Property Damage Insurance	8.00%	8.00%	0.00%
Total	64.52%	81.60%	17.08%

Group IV – General and Administrative Employees	2017 Audited	2018 Submitted	Change
Sick Pay	1.58%	1.46%	-0.12%
Holiday & Vacation Pay	9.80%	6.04%	-3.76%
Other Paid Absences	4.65%	6.50%	1.85%
Bonuses	9.73%	30.54%	20.81%
Payroll Taxes	23.87%	28.42%	4.55%
Health and Welfare	12.78%	18.79%	6.01%
W/C, Public Liability & Property Damage Insurance	8.00%	8.00%	0.00%
Total	70.41%	99.75%	29.34%

Source: OIG compiled this table utilizing data provided by FEC.

APPENDIX D – Affected Entity Response

Florida East Coast
RAILWAY
FECRWY.COM

Jacksonville, FL
February 6, 2020

Dear Ms. Shepherd:

I enjoyed speaking with you today concerning the Group 4 rate change for calendar year 2018. As discussed, FEC is proposing a ten (10) percent increase for this Group. Please forward to any decision makers with our regards for their consideration.

If for any reason this increase is not approved, please let me know as soon as possible, as it is FEC'S desire to conclude this matter as soon as possible.

Finally, I appreciate the help and guidance you have afforded me as we work through this issue.

Kindest regards.

X

Dani Brandenburg
AVP, Accounting & Finance

APPENDIX E – Management Response

On March 17, 2020, the Department's Freight and Multimodal Operations Office contacted the OIG to indicate it is pursuing additional discussions with FEC.

DISTRIBUTION

Responsible Manager:

Gerard O'Rourke, Administrator, Freight, Logistics & Passenger Operations
Rickey Fitzgerald, Manager, Freight and Multimodal Operations

Affected Entity:

Daniela Brandenburg, Assistant Vice President, Florida East Coast Railway
Melissa Kier, Controller, Florida East Coast Railway
Sonia Mamara, AP/Payroll Manager, Florida East Coast Railway
Michelle Genovar, Manager of Human Resources, Florida East Coast Railway

Internal Distribution:

Kevin J. Thibault, P.E., Secretary, Department of Transportation
Torey L. Alston, Chief of Staff
Courtney Drummond, P.E., Assistant Secretary for Engineering and Operations
Stacy Miller, P.E., Assistant Secretary for Finance and Administration
Tom Byron, P.E., Assistant Secretary for Strategic Development

External Distribution:

Melinda Miguel, Chief Inspector General, Executive Office of the Governor
Sherrill Norman, Auditor General, State of Florida
Jamie Christian, Florida Division Administrator, Federal Highway Administration
Ralph Yoder, Executive Director, Florida Transportation Commission

PROJECT TEAM

Engagement was conducted by:
Scott Armstrong, Auditor in Charge

Under the supervision of:
Luis Camejo, Senior Audit Supervisor
Nancy Shepherd, Deputy Audit Director for Intermodal
Joseph W. Gilboy, Director of Audit

Approved by:
Kristofer B. Sullivan, Inspector General

STATEMENT OF ACCORDANCE

The Department's mission is to provide a safe transportation system that ensures the mobility of people and goods, enhances economic prosperity, and preserves the quality of our environment and communities.

The Office of Inspector General's mission is to promote integrity, accountability, and process improvement in the Department of Transportation by providing objective, fact-based assessments to the DOT team.

This work product was prepared pursuant to section 20.055, Florida Statutes, in accordance with the Association of Inspectors General *Principles and Standards for Offices of Inspector General*, and conforms with The Institute of Internal Auditors' *International Standards for the Professional Practice of Internal Auditing*.

Please address inquiries regarding this report to the Department's Office of Inspector General at (850) 410-5800.