Financial Statement Data

Maryland Environmental Service Financial Statement
Fiscal 2004-2006
($ in Thousands)

	Fiscal 2004	Fiscal 2005	Fiscal 2006	Change FY 05-06
Total Assets	$61,625	$61,512	$58,886	-$2,626
Total Liabilities	54,042	55,105	51,700	-3,405
Total Net Assets	**$7,583**	**$6,407**	**$7,186**	**$779**
Total Revenue	$66,132	$72,732	$78,937*	$6,205
Total Expenditures (includes non-operating)	68,676	73,908	78,158	4,250
Net Assets Change	**-$2,544**	**-$1,176**	**$779**	**$1,955**

*Includes $0.5 million tire grant.

- After two years of losses, the Maryland Environmental Service's (MES) reductions in net assets were reversed in fiscal 2006, bringing the change in net assets from -$1.2 million to $0.8 million.

- Growth in assets outpaced the growth in liabilities in fiscal 2006, resulting in a $0.8 million increase in total net assets.

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

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Analysis in Brief

Major Trends

Overall Business Increasing: Increased customer sales and decreased expenses boosted MES net assets by $779,000 between fiscal 2005 and 2006.

MES Product Revenues Slow: Revenue from MES products such as recycled rubber increased only $85,000 between fiscal 2005 and 2006 after increasing $671,000 between fiscal 2004 and 2005.

Issues

Plans Coming Together to Divest MES Tire Recycling Facility: The MES Tire Recycling Facility opened in Baltimore County in January 2003 and recycles passenger, light truck, and heavy truck tires into value-added, high quality crumb rubber and rubber mulch. While MES has sought to make this operation profitable, the facility is in extremely poor financial health. **The Department of Legislative Services recommends that MES apprise the budget committees of the status of the consultant's report on the Tire Recycling Facility and on the likelihood of recouping the $1.7 million grant anticipation note from the facility sale proceeds.**

Recommended Actions

1. Nonbudgeted.

Updates

Midshore Regional Solid Waste Facility to Be Reported as a Private Purpose Trust Fund: Midshore Regional Solid Waste Facility is the only regional solid waste facility in Maryland and serves Queen Anne's, Caroline, Talbot, and Kent counties through a Waste Disposal Service Agreement with MES. As part of the Midshore Regional Concept, each county takes turns operating the landfill for 20 years. MES decided that in order to meet the operating and ownership agreements relating to the four participating counties, Midshore should be reported as a private purpose trust fund for accounting purposes. As a result, financial restatements were made to account for the separation of Midshore from MES's asset accounting.

Insurance Procurement Pursued: MES currently participates in the State Self Insurance Pool. However, due to its nonbudgeted status, MES would have to pay back over three years the full amount of any losses it incurs, unlike most State agencies which would receive an appropriation for paying back the loss. Therefore, MES is pursuing preliminary conversations with the Treasurer's Office to obtain the authority to procure insurance coverage in addition to the State Self Insurance Pool.

Operating Budget Analysis

Program Description

The Maryland Environmental Service (MES) was created as a unit within the Department of Natural Resources (DNR) in 1970 to provide water supply, wastewater treatment, and waste management services to State agencies, local governments, and private entities. During the 1993 session, the General Assembly adopted legislation that created MES as an instrumentality of the State and a public corporation independent of DNR. The organization's primary goals are to improve the environment, work more safely, and provide excellent customer service and satisfaction. MES provides technical services including engineering, design, financing, construction, and operation of water supply and wastewater treatment facilities. MES also provides similar services in the area of hazardous and solid waste facility management, including sanitary landfills, incinerators, and resource recovery facilities. Additional services offered include sludge and dredged materials management, recycling and marketing of end products, and regulatory monitoring. As of June 30, 2006, MES operated and maintained 550 facilities of which 227 were State-owned facilities, such as the Poplar Island environmental restoration project, the Hart-Miller Island Dredged Material Containment Facility, and a regional yard-debris composting facility.

MES operates on a fee-for-service basis. Operating funds are generated from five sources: State agency contracts, local government contracts, federal government contracts, private contracts, and MES enterprises. In addition, MES receives State general obligation bond appropriations for capital improvements at State-owned facilities and may issue revenue bonds to finance local government projects. Revenues from State agency contracts derive from the operation and maintenance of State-owned water and wastewater treatment plants and from specific projects and services such as environmental cleanup or recycling program management. Revenues from local governments, the federal government, and the private sector derive from the operation and maintenance of water and wastewater treatment facilities and solid waste management services. MES enterprise revenues are generated by efforts such as recycled rubber products from a crumb rubber manufacturing facility, yard waste grinding and waste oil recovery.

Performance Analysis: Managing for Results

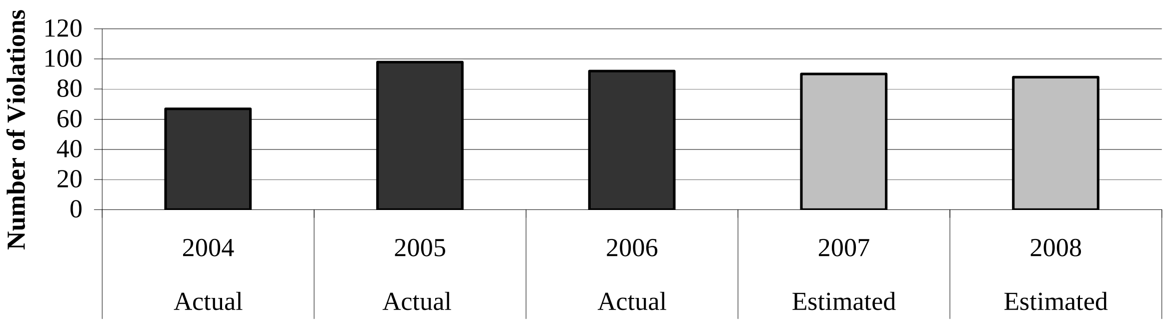
MES's mission and vision statements are shown below.

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

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

MES's performance measures relate to three goals. The first goal is to improve the environment through MES's activities. One output for this goal is the number of corporate and State National Pollutant Discharge Elimination System (NPDES) violations. **Exhibit 1** shows that MES's fiscal 2006 performance improved over that of fiscal 2005 and that future year estimates project a continuing improvement.

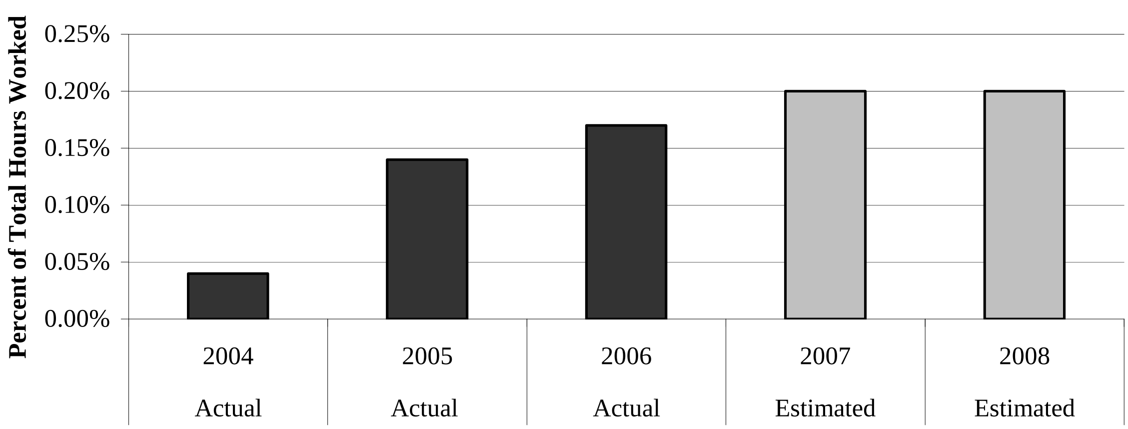
Exhibit 1
Number of Corporate and State NPDES Violations
Fiscal 2004-2008



Source: Governor's Budget Books, Fiscal 2007-2008

MES also has a second goal of working more safely. One outcome related to this goal is accident leave as a percent of total hours worked. While low, MES's accident leave did increase as a percent of total hours worked between fiscal 2004 and 2006 as shown in **Exhibit 2**.

Exhibit 2
Accident Leave as a Percent of Total Hours Worked
Fiscal 2004-2008

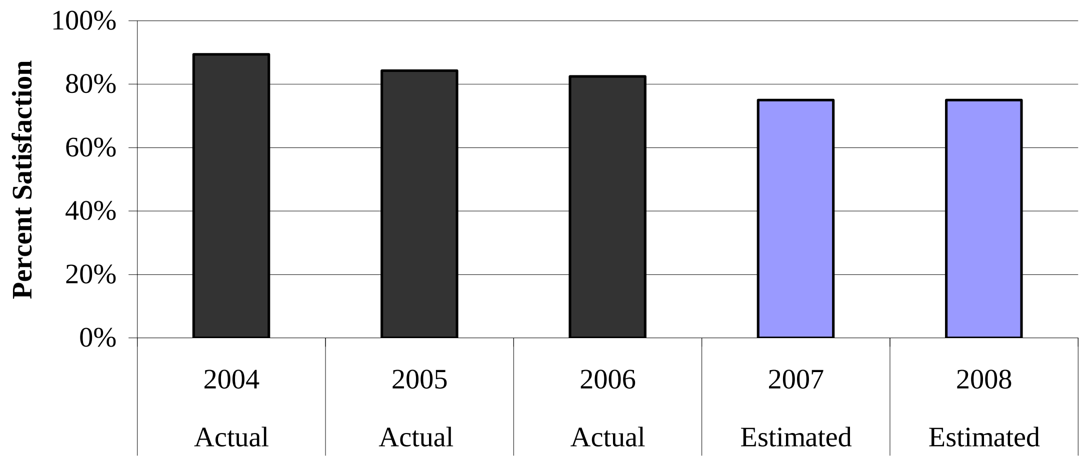


Note: Fiscal 2007 and 2008 estimates are for less than 0.20%.

Source: Governor's Budget Books, Fiscal 2007-2008

Providing excellent customer service and satisfaction is MES's third goal. It is measured by client satisfaction rate, as shown in **Exhibit 3**. Performance has also moved in the wrong direction for this measure. In fiscal 2004, MES had an 89% client satisfaction rate, which decreases to the fiscal 2007 and 2008 estimates of greater than 75%.

Exhibit 3
Client Satisfaction Rate
Fiscal 2004-2008



Note: Fiscal 2007 and 2008 estimates are for greater than 75%.

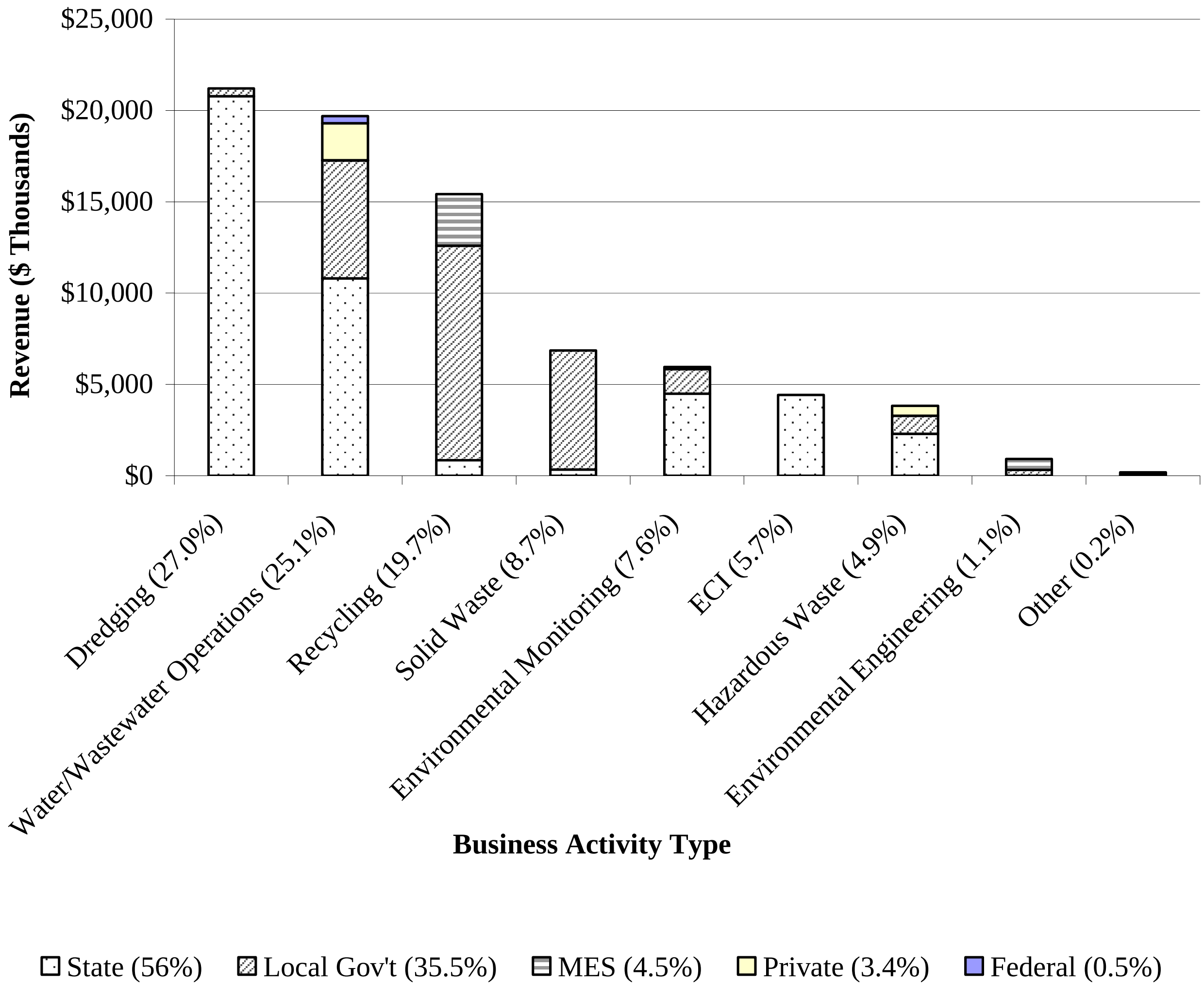
Source: Governor's Budget Books, Fiscal 2007-2008

DLS recommends that MES discuss why the accident leave as a percent of total hours worked has increased and why the client satisfaction rate has decreased, as well as what measures it plans to adopt to reverse these trends.

MES's Fiscal 2006 Financial Position

MES breaks down its revenue by business type activity and by fund source. **Exhibit 4** provides a fiscal 2006 revenue overview; percentages of the total are listed following each business type activity and fund source.

Exhibit 4
Revenue and Percent of Total by Business and Source
Fiscal 2006



Source: Maryland Environmental Service

Income Deficit Reduced

MES's reductions in net assets were reversed in fiscal 2006 by a combination of increases in revenue from environmental dredging and restoration ($4.4 million) and water/wastewater operations ($2.2 million) and decreases in expenses for land, structure, and equipment ($1.9 million) and contractual services ($1.3 million). Revenue by business type activity is shown in **Exhibit 5** and expenses by object are shown in **Exhibit 6**.

Exhibit 5
Revenues by Business Type Activity
Fiscal 2004-2006
($ in Thousands)

Business Type Activity	**Fiscal 2004**	**Fiscal 2005**	**Fiscal 2006**	**Change FY 05-06**
Environmental Dredging and Restoration	$16,225	$16,850	$21,202	$4,352
Water/Wastewater Operations	15,207	17,495	19,692	2,197
Recycling	14,288	14,968	15,420	452
Environmental Monitoring	4,497	5,522	5,957	435
Solid Waste Management	5,727	7,281	7,447	166
Energy Co-Generation	4,459	4,431	4,431	0
Other	279	259	185	-74
Environmental Engineering	2,533	957	245	-712
Hazardous Waste Treatment	2,917	4,967	3,833	-1,134
Total Revenues by Business Type Activity	**$66,132**	**$72,730**	**$78,412**	**$5,682**

Source: Maryland Environmental Service

Exhibit 6
Operating Expenses
Fiscal 2004-2006
($ in Thousands)

	Fiscal 2004	**Fiscal 2005**	**Fiscal 2006**	**Change FY 05-06**
Salaries and benefits	$23,323	$24,277	$28,502	$4,225
Materials and supplies	7,783	8,828	10,536	1,708
Repairs and maintenance	2,593	3,001	3,729	728
Technical fees	2,989	3,576	3,991	415
General and administrative	6,972	7,101	7,493	392
Utilities	2,006	1,987	2,233	246
Depreciation	853	744	875	131
Other	711	758	129	-629
Contractual Services	11,834	12,946	11,647	-1,299
Land, structures and equipment	9,612	10,335	8,408	-1,927
Total Operating Expenses	**$68,676**	**$73,553**	**$77,543**	**$3,990**

Source: Maryland Environmental Service

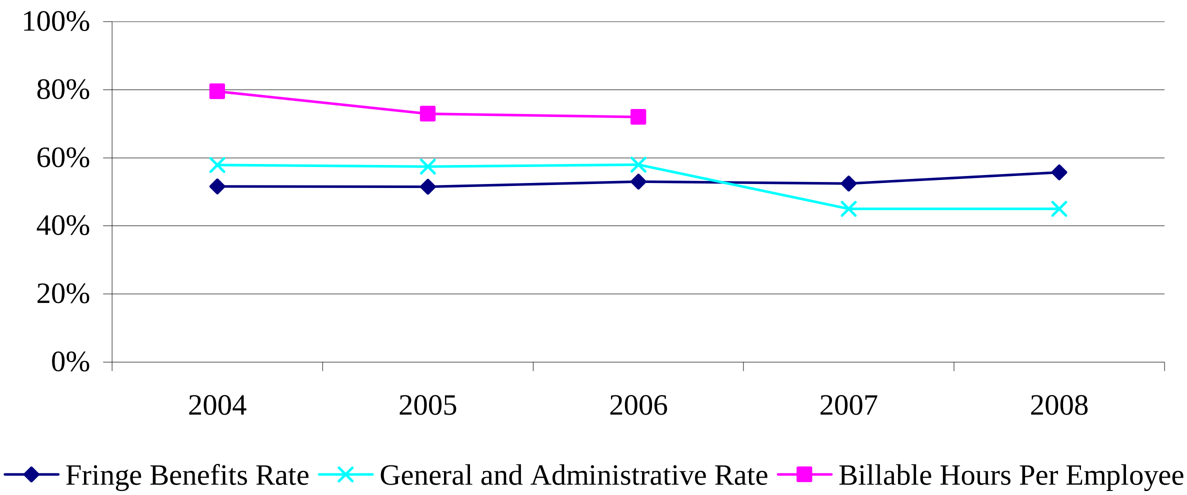
Types of MES Operations

MES's business type activities can be viewed generally as fee-for-service, but more specifically as net revenue generating activities and cost recovery activities. Net revenue generating activities include MES's recycled rubber products. The majority of MES's activities are cost recovery, though, which means that ideally revenues for the projects equal the expenses.

Three Rates That Indirectly Measure Financial Performance

MES has chosen labor sales as the focus of its business plan, and in order for it to cover all of its administrative and non-billable personnel costs, it must charge its customers two rates: one for employee fringe benefits and the other for general and administrative (overhead). It is MES's intent to expand business and increase internal efficiency such that its overhead rate is spread out over its return-customer base and its expenses are reduced. As a result, MES will be able to reward its customers for return service by reducing its overhead rate. In the meantime, MES's products are intended to provide a little cushion for the rest of the budget and allow for the reduction in the overhead rate. **Exhibit 7** shows the fringe benefits, general and administrative, and billable hours per employee rates (where billable hours per employee is defined as the total number of billable hours in a year divided by the total number of employees and then divided by 2,080 work-hours per year to get a percentage). For fiscal 2007 and 2008, the general and administrative rate is a base of approximately 45%. On top of this base rate is added a general and administrative rate for each business activity type for a fiscal 2007 range of 47.36 to 57.43% and a fiscal 2008 range of 50.34 to 58.36%.

Exhibit 7
MES Financial Indicator Rates
Fiscal 2004-2008



Source: Maryland Environmental Service

Overall, the general and administrative rate is decreasing which is a good sign. In contrast, the fringe benefits rate is increasing, which makes sense in terms of rising health care costs and other fringe benefits proportionally tied to salary but hurts MES's bottom line. The billable hours per employee rate is decreasing during the time period shown. According to MES, this may be the result of adding 50 new positions in fiscal 2006 (many of them late in the year) to handle more projects. In addition, MES stated that positions were added for compliance and safety which are not directly billable; these positions would be covered by the general and administrative rate applied to positions that are billable. In order to be successful, MES needs to find a balance between the number of projects it takes on, its general and administrative rate, and the incremental cost of adding administrative and non-billable positions.

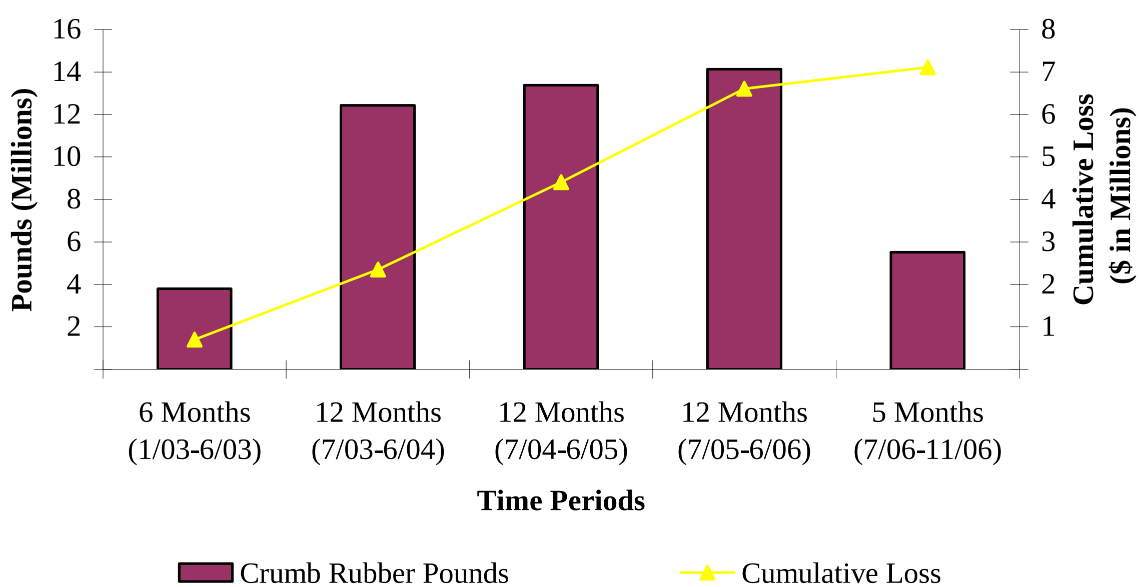
Issues

1. Plans Coming Together to Divest MES Tire Recycling Facility

The MES Tire Recycling Facility opened in Baltimore County in January 2003 and recycles passenger, light truck, and heavy truck tires into value-added, high quality crumb rubber and rubber mulch. This facility recycles over 900,000 scrap tires annually, which is just under 20% of the total scrap tires processed in Maryland. While MES has sought to make this operation profitable, the facility is in extremely poor financial health. Lower than anticipated revenues are not covering associated production and capital debt service expenses, placing a strain on MES's cash flow.

Exhibit 8 summarizes the pounds of rubber processed and the cumulative loss for the facility. The facility has lost a cumulative $7.1 million over four years of operations. MES advises that the facility's financial problems are due to high operating costs caused by operating at less than design specification, higher than anticipated fixed costs, and inadequate storage capacity. One explanation for why the operating costs are higher than anticipated is the failure to account for the heavily subsidized nature of the prototype crumb tire facility observed in Italy.

Exhibit 8
Rubber Tire Facility Processing and Cumulative Loss
Fiscal 2003-2007



Source: Maryland Environmental Service

MES Proposal

Given the lack of financial viability of the facility, MES is proposing to divest itself of the facility and to address the remaining debt owed. This includes:

- ***Sale of the Facility Assets:*** MES has contracted with the consulting firm of Clifton Gunderson to assess the value of the facility and equipment for sale. A report was expected late in calendar 2006, but as of January 19, 2007, MES had to reschedule a meeting with the consultant and so the report may not be available until the end of January 2007. MES hopes to initiate sale of the facility shortly after receiving the report. Continued operation of the facility has been recommended by MES to maximize the potential sale value to prospective bidders and to further MES's goal of increasing recycling capacity in Maryland by selling the plant to a recycling business; and

- ***Repayment of Remaining Debt:*** The facility was originally financed with a loan from a financial institution secured by the facility and equipment. MES indicates that it has paid down the majority of the loan, with the balance to come from the Maryland Department of the Environment's Used Tire Cleanup and Recycling Fund. Upon the $1.1 million payment in fiscal 2007 through Amendment 030-07, MES intends to refinance the remaining $1.7 million through a Grant Anticipation Note (GAN) that would no longer be secured by the facility and, therefore, would permit its sale. MES anticipates receiving $1.7 million from MDE's Used Tire Fund in fiscal 2009. MES plans to retire the GAN using this $1.7 million Used Tire Fund payment.

DLS recommends that MES apprise the budget committees of the status of the consultant's report on the Tire Recycling Facility and on the likelihood of recouping the $1.7 million grant anticipation note from the facility sale proceeds.

Recommended Actions

1. Nonbudgeted.

Updates

1. Midshore Regional Solid Waste Facility to Be Reported as a Private Purpose Trust Fund

Midshore Regional Solid Waste Facility is the only regional solid waste facility in Maryland and serves Queen Anne's, Caroline, Talbot, and Kent counties through a Waste Disposal Service Agreement with MES. As part of the Midshore Regional Concept, each county takes turns operating the landfill for 20 years. MES decided that in order to meet the operating and ownership agreements relating to the four participating counties, Midshore should be reported as a private purpose trust fund for accounting purposes. As a result, financial restatements were made to account for the separation of Midshore from MES's asset accounting.

In addition to having a collaborative operating and ownership agreements, the landfill also has large financial responsibilities in the near future. July 2007 will mark the need for a fourth and final cell at Midshore. The contract for constructing the cell was awarded in August 2006 and is estimated to cost $3.2 million. This final cell will allow Midshore to operate until December 31, 2010, at which time Midshore I will need to be closed at a cost of approximately $11.0 million and Midshore II will open for operation.

2. Insurance Procurement Pursued

MES currently participates in the State Self Insurance Pool. However, due to its nonbudgeted status, MES would have to pay back over three years the full amount of any losses it incurs, unlike most State agencies which would receive an appropriation for paying back the loss. Therefore, MES is pursuing preliminary conversations with the Treasurer's Office to obtain the authority to procure insurance coverage in addition to the State Self Insurance Pool. MES has reserves of $944,000 for equipment and $364,000 for business research and development/contingencies which MES does not believe will cover the $60 million in original cost for its depreciable assets.

Appendix 1

Audit Findings

Audit Period for Last Audit:	September 25, 2002 – January 31, 2006
Issue Date:	July 2006
Number of Findings:	2
Number of Repeat Findings:	1
% of Repeat Findings:	50%
Rating: (if applicable)	n/a

Finding 1: MES retained interest earned on State agency project fund advances and did not disclose the earnings in annual budget submissions. However, there are no State policies concerning this for MES to follow.

Finding 2: **MES did not use available State Financial Management Information Systems security features for independent on-line approval of critical disbursement transactions.**

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

Object/Fund Difference Report
Maryland Environmental Service

Object/Fund	FY06 Actual	FY07 Working Appropriation	FY08 Allowance	FY07-FY08 Amount Change	Percent Change
Positions					
01 Regular	675.70	631.27	681.64	50.37	8.0%
Total Positions	**675.70**	**631.27**	**681.64**	**50.37**	**8.0%**
Objects					
01 Salaries and Wages	$ 35,466,108	$ 38,431,152	$ 41,102,665	$ 2,671,513	7.0%
02 Technical and Spec Fees	5,075,090	6,105,586	6,343,560	237,974	3.9%
03 Communication	538,269	481,916	565,915	83,999	17.4%
04 Travel	190,834	255,950	315,170	59,220	23.1%
06 Fuel and Utilities	2,638,017	2,559,842	3,049,284	489,442	19.1%
07 Motor Vehicles	4,197,301	3,041,429	4,574,979	1,533,550	50.4%
08 Contractual Services	13,043,813	17,865,553	15,629,395	-2,236,158	-12.5%
09 Supplies and Materials	11,247,129	7,102,743	8,230,794	1,128,051	15.9%
10 Equip – Replacement	1,514,324	1,875,355	2,343,211	467,856	24.9%
11 Equip – Additional	2,019,987	1,954,756	2,210,452	255,696	13.1%
13 Fixed Charges	4,355,831	5,660,145	3,824,616	-1,835,529	-32.4%
14 Land and Structures	13,015,940	23,149,370	14,363,072	-8,786,298	-38.0%
Total Objects	**$ 93,302,643**	**$ 108,483,797**	**$ 102,553,113**	**-$ 5,930,684**	**-5.5%**
Funds					
07 Nonbudgeted Fund	$ 93,302,643	$ 108,483,797	$ 102,553,113	-$ 5,930,684	-5.5%
Total Funds	**$ 93,302,643**	**$ 108,483,797**	**$ 102,553,113**	**-$ 5,930,684**	**-5.5%**

Note: The fiscal 2007 appropriation does not include deficiencies, and the fiscal 2008 allowance does not reflect contingent reductions.