



COMMONWEALTH OF PENNSYLVANIA
DEPARTMENT OF PUBLIC WELFARE
BUREAU OF FINANCIAL OPERATIONS
3rd Floor, Bertolino Building
Harrisburg, Pennsylvania 17105-2675

KEVIN M. FRIEL
DIRECTOR

TELEPHONE NUMBER
(717) 787-9200
FAX NUMBER
(717) 705-6334

January 11, 2008

Mr. Robert Powell, President
PA Child Care, LLC
10 Fox Run Road
Drums, Pennsylvania 18222

Dear Mr. Powell:

I am enclosing the final report of the PA Child Care, LLC (PACC) that was completed by this office. The comments submitted by PACC have been attached and are identified as Appendix B through D. The response submitted by Luzerne County Children and Youth Services (LCCYS) is also attached and is identified as appendix A. Your March 8, 2008 comments included a number of exhibits that could not be attached to this electronic file. The exhibits have been forwarded to LCCYS by mail and are available, to anyone who submits a request.

The report has been forwarded to the Department of Public Welfare's Office of Children, Youth and Families (OCYF) to begin the Department's resolution process concerning the report contents. The staff from the OCYF may be in contact with you to follow-up on the action taken to comply with the report's recommendations.

If you have any questions concerning this matter, please contact Tina Long, Audit Resolution Section, at (717) 705-2288.

Sincerely,

A handwritten signature in cursive script that reads "Kevin M. Friel".

Kevin Friel

cc: The Honorable Maryanne Petrilla
The Honorable Gregory Skrepenak
The Honorable Stephen Urban
Mr. Frank J. Castano
Mr. Gregory R. Zapalla, Esquire
Mr. Jonathan Vipond, Esquire
Mr. Geoffrey R. Johnson, Esquire



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January 11, 2008

Mr. Frank J. Castano, Director
Luzerne County Children and Youth Services
111 North Pennsylvania Boulevard, Suite 110
Wilkes Barre, Pennsylvania 18701-3697

Dear Mr. Castano:

I am enclosing the final report of the PA Child Care, LLC that was completed by this office. Your response has been labeled as Appendix A to the report. PA Child Care LLC has requested that all three of the responses they submitted be attached to the report. They are identified as Appendix B through D. Appendix B as submitted by PACC includes a number of exhibits which were too voluminous to attach to this electronic file. These exhibits have been forwarded to your attention by mail.

The report has been forwarded to the Department of Public Welfare's Office of Children, Youth and Families (OCYF) to begin the Department's resolution process concerning the report contents. The staff from the OCYF may be in contact with you to follow-up on the action taken to comply with the report's recommendations.

If you have any questions concerning this matter, please contact Tina Long, Audit Resolution Section, at (717) 705-2288.

Sincerely,

A handwritten signature in cursive script that reads "Kevin M. Friel".

Kevin Friel

cc: The Honorable Maryanne Petrilla
The Honorable Gregory Skrepenak
The Honorable Stephen Urban
Mr. Robert J. Powell, Esquire
Mr. Gregory R. Zapalla, Esquire
Mr. Jonathan Vipond, Esquire
Mr. Geoffrey R. Johnson, Esquire



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FAX NUMBER
(717) 705-6334

January 11, 2008

Mr. Richard Gold, Deputy Secretary
Office of Children, Youth, and Families
131 Health and Welfare Building
Harrisburg, Pennsylvania 17120

Dear Mr. Gold:

In response to a request from a previous Deputy Secretary for Children, Youth and Families, the Bureau of Financial Operations (BFO) conducted an audit of the PA Child Care, LLC (PACC). PACC was the primary provider of juvenile detention services in Luzerne County until January 1, 2005, when Luzerne County became the licensed entity to provide these services. The PACC audit was an extension of the statewide audit of all juvenile detention centers in the Commonwealth. The audit was included in the Department of Public Welfare (DPW) 2004-05 Annual Agency Audit Plan.

The mission of the BFO, accomplished through audit and review activities, is to assist DPW management to administer human service programs of the highest quality, at the lowest cost, with integrity.

Results in Brief

- **Reasonableness of Contract:** Based on the calendar year 2003 certified audit, PACC achieved a profit of \$1.2 million from revenues of \$4.3 million or a profit of 28 percent. Based on available data for calendar year 2004, PACC was projected to have a profit of \$1.9 million on revenues of \$5.6 million or 34 percent. In addition, based on the information provided to BFO as part of the audit, PACC daily rates exceeded actual costs by an average of \$85 for detention services and \$109 for treatment services. For detention services, the PACC per diem rates exceeded the average rate for the region by \$78.55 for Fiscal Year 2003-04 and \$85.26 for Fiscal Year 2004-05. The \$85.26 matches the average amount that the PACC detention rates exceeded actual costs. The PACC rates were 40% and 42% higher than the regional average for these two years. The BFO believes that the Department must evaluate this financial arrangement to determine if the contracting and claiming

Results in Brief (Continued)

process (described in more detail in the body of the audit) met state and federal contracting rules designed to ensure that profits are limited to what is “fair and reasonable” and that all costs billed for by Luzerne County were eligible costs.

- **Type of Lease:** Based on the information provided to BFO, the January 2005 lease arrangement between PACC and Luzerne County appears to be a capital lease. If the Department determines that the lease does in fact meet the definition of a capital lease, it must make appropriate changes to State Act 148 funding of that lease. If the lease is determined to be a capital lease, adjustments to return State and federal reimbursements would exceed \$1.6 million annually for the term of the lease.
- **Contract Terms:** The contract between PACC and Luzerne County includes several provisions not normally seen in similar arrangements throughout the Commonwealth. These contract terms may have contributed to inappropriate billings from PACC to Luzerne County and subsequent inappropriate billings to the Commonwealth and federal government. In all, BFO is questioning \$387,359 in costs submitted for reimbursement to the Commonwealth.
- **Billings to National School Lunch Program:** In seeking reimbursement for staff lunches, the U.S. Department’s of Agriculture National School Lunch Program was overbilled by \$11,472.51.

Executive Summary: Subsequent Events and Auditor’s Commentary

Upon release of the draft audit to the Luzerne County Children and Youth Program and PACC in February 2007, PACC provided a written response in March 2007. After reviewing the response, the Department informed the Luzerne County and PACC representatives that the DPW would make any changes appropriate to the draft as a result of an independent review.

Subsequently, a revised draft audit was issued on September 25, 2007. The DPW held several meetings with both Luzerne County and PACC. Upon review of the responses submitted from both Luzerne County and PACC, an auditor’s commentary was prepared and included in the report.

Omitted Documents and Information

In accordance with Government Auditing Standards we are required to report on information that was omitted from this report and the effect of the omission. PACC requested that certain financial documents be kept confidential and they are not included in the report but will be provided to the Office of Children, Youth and Families under separate cover.

AUDITOR'S COMMENTARY

The County asserts that the lease with PACC was its best and only option

The lease, in its present form, was not the sole and best option for the county as several other options existed including building of a county-owned facility and utilization of facilities in neighboring counties.

The County asserts that detention and secure residential costs were reduced as a result of the lease

The DPW was unable to validate this assertion. The DPW made requests to both Luzerne County and PACC to provide any detailed information in the form of cost schedules, contracts or other appropriate documents to verify this claim. Despite these requests, the DPW never received documentation supporting this assertion.

The County asserts that it is better to serve children close to home

Despite the position stated in its response, Luzerne County has utilized facilities both close to home and others that are at a distance. Of specific note, the County purchased in excess of one million dollars in services from a facility operated by PACC during FY 06-07, located in Butler County – more than 236 miles from Wilkes Barre despite the availability of facilities that are geographically much closer to Luzerne County.

PACC Responses

PACC Asserts that its Lease is Not a Capital Lease

The BFO believes that the analysis provided in the audit report is sufficient to show that the lease is in fact a capital lease. In addition, PACC's Chief Financial Officer stated that the lease was a capital lease in a meeting with the Department in October 2007.

PACC Disputes Amount of Profit for 2003 and 2004

Subsequent to the completion of fieldwork, PACC provided a pro-forma financial presentation for 2003 and a 2004 independent CPA audit. BFO found the amounts and classifications of certain costs in both documents to be either unreasonable or properly classified as profit or return to ownership.

PACC asserts that its Lease with the County has allowed the County to Realize Substantial Savings

As noted in the auditor's commentary on the Luzerne County response, neither PACC nor the County has provided any detailed information to support this assertion.

PACC Asserts That The County Did Not Fail to Negotiate its Contract

BFO has not been provided, nor has it uncovered, any evidence that the County completed the required cost analysis prior to entering into an agreement with PACC.

PACC Asserts That it Did Not Improperly Invoice For Both the Day of Admission and Discharge

The PACC agreement was unique from other County Juvenile Probation Purchase of Service Agreements and did not include standard language prohibiting payment for both the first day of care and the day of discharge.

Background

PACC is a Pennsylvania limited liability corporation with offices at 10 Fox Run Road in Drums, Pennsylvania. PACC owns a 48-bed juvenile detention facility located in Luzerne County at 701 Sathers Drive, Pittston Township, Pennsylvania. The facility provides services to alleged and adjudicated delinquent youths. The facility is licensed to provide 24 beds for secure juvenile detention services and 24 beds for secure treatment services. Subsequent to the leasing of the building to Luzerne County, PACC expanded the building size and the facility was licensed for a total of 60 beds in September 2005.

PACC started operations in February 2003. By April 2003, the program was fully operational. For the 12-month period ended June 30, 2004, the occupancy of the detention program was 92 percent of licensed capacity, and the occupancy for secure treatment was nearly 100 percent. PACC provided services under the terms and conditions of purchase of service agreements with various counties in the Commonwealth. Luzerne County accounted for 99 percent of the company's fee income for calendar 2003. For calendar 2003, the PACC had total income of \$4.3 million and earned \$1.2 million of net income/profit.

Effective January 1, 2003, PACC entered into a 24-month Juvenile Detention Facility Management Agreement with Northwestern Human Services of Pennsylvania, Inc. (NHS) to manage and operate the facility. NHS is a non-profit corporation located in Harrisburg, Pennsylvania. In addition to managing facilities, the NHS is licensed to directly provide child welfare services in the Commonwealth. The terms of the management agreement (Page 10, Item #6, "Managers Compensation") provided for annual compensation of \$396,000. Additionally, the agreement required NHS to provide all executive and direct service staff for which reimbursement from PACC was based on actual costs.

Effective January 1, 2005, Luzerne County became the licensed entity for the juvenile detention facility and assumed responsibility for operation of the detention and treatment programs. Luzerne County entered into an interim contract with NHS to

Background (Continued)

manage the facility. Luzerne County also entered into a 20-year lease agreement with PACC to lease the PACC facility. The terms of the lease require payments of \$2.3 million per year based on the existing 48-bed facility. The payments increase to \$2.9 million per year upon completion of a 12-bed addition. The 20-year minimum payments total \$58 million without consideration of the additional yearly rent based on the increase in the consumer price index.

Luzerne County receives reimbursement for children and youth services such as the detention and secure treatment services provided through the PACC facility from a variety of federal and state funding sources. These include the federal TANF and Title IV-E programs, and the Commonwealth Act 148 allocation. While most detention expenses are reimbursed 100 percent through TANF¹, secure treatment costs are reimbursed through a combination of Act 148 and County funds. Luzerne County, as operator of the PACC facility and a recipient of federal funds, is subject to adhere to federal and state fiscal policies. Specifically, these policies are addressed in:

- The Pennsylvania Code Title 55, Chapter 3170 regulations, Allowable Costs and Procedures for County Children and Youth.
- The Code of Federal Regulations, Title 45, Subtitle A, Part 92.
- The Office of Management and Budget Circular A-87, Cost Principles for State and Local Governments.

Objective, Scope and Methodology

The following objectives were developed for this audit and were discussed with PACC representatives at our November 3, 2004 entrance conference:

- To determine the actual cost of service to residents and determine if the costs were reasonable and consistent with applicable cost principles.
- To determine if the proposed juvenile detention facility lease between Luzerne County and PACC will be cost effective for Luzerne County.

The scope of our audit was limited as we were denied access to the source records pertaining to the PACC building costs and general and administrative expenses. PACC officials informed us that they considered these records to be proprietary. Because of this scope limitation, we were unable to satisfy ourselves as to the composition, reasonableness, and allowability of these expenses. In order to identify the actual cost of services, we accepted and relied upon the building and administrative costs included in the PACC calendar 2003 certified audit.

¹ Beginning January 1, 2006, detention services are no longer eligible for TANF funding.

Objective, Scope and Methodology (Continued)

As stated, our second objective was to determine if the proposed PACC lease would be cost effective to Luzerne County. The County agreed to lease the facility on November 17, 2004 prior to our review of the lease terms. As a result we limited our objective to a review of the allowability of rental costs for federal and state reimbursement.

The scope of our audit was also limited by litigation brought by PACC. On December 17, 2004, PACC, through their attorneys, filed a civil action in the Luzerne County Court of Common Pleas alleging the Luzerne County Controller and DPW staff had and will divulge trade secrets of PACC. This action resulted in the court granting a motion for sealing of records and a special injunctive order prohibiting communicating or disclosing trade secrets of PACC. Due to this action, we were not able to fully complete our audit procedures. For example, existing requests for documents were not satisfied, and our examination of certain documents such as the PACC lease was limited to review of a proposal and not the final signed and executed lease agreement. Additionally, we were not able to review and discuss the report findings and recommendations with PACC and Luzerne County officials prior to preparing this report.

Government auditing standards require that the BFO obtain an understanding of management controls that are relevant to the audit objectives described above. The applicable controls were examined to the extent necessary to provide reasonable assurance of compliance with generally accepted accounting principles. Based on the BFO understanding of the controls, no significant deficiencies came to our attention other than those described in this report.

In pursuing our objectives, we reviewed available fiscal/accounting records, audits, contracts, census reports, client data, and invoices and billings submitted to the County programs. We also reviewed the PACC operations and the financial impact on Luzerne County for compliance with DPW and federal regulations. In addition, we attended meetings and had discussions with representatives of PACC, NHS, and the Luzerne County Juvenile Probation Department. Our fieldwork was conducted intermittently between November 3, 2004 and December 3, 2004. Our work was conducted in accordance with generally accepted government auditing standards. This report, when presented in its final form, is available for public inspection.

Results of Fieldwork**Issue No. 1 The Department Needs to Determine the Reasonableness of the Contract between PACC and Luzerne County, Contract Rates and Invoicing Practices**

Results of Fieldwork (Continued)

State and Federal Contracting Requirements

Services provided at PACC are reimbursed by the contracting county on a per diem basis. Per diems should be developed based upon historical data, including actual costs and occupancy data (if available) or upon budgeted costs and projected occupancy data when historical actual cost and occupancy data is not available. Once developed, the per diem should be scrutinized by the appropriate contracting office to ensure that the best possible rate is obtained. To do so, officials are responsible to conduct formal rate negotiations, as required by the standard found at Chapter 3170.83(b) of the Pennsylvania Code, which states that “the appropriate county authorities shall negotiate agreements with providers of services”. County officials are expected to act as “prudent buyers” and obtain the best possible rate for services. As such, these negotiations should result in reasonable and fair market prices.

Additionally, the Code of Federal Regulation, Title 45, Subtitle A, Part 92.36(f) (1) states, “Grantees and sub-grantees must perform a cost or price analysis in connection with every procurement action including contract modifications...A cost analysis will be necessary when adequate price competition is lacking...” Further, Part 92.36 (f) (2) requires, “grantees will negotiate profit as a separate element of the price for each contract in which there is no price competition and in all cases where cost analysis is performed.” The profit should be “fair and reasonable”. The BFO believes a profit not exceeding 10% could be considered fair and reasonable.

Since the PACC facility is the sole detention facility in Luzerne County, adequate price competition is lacking. As a result, the County should have performed a cost analysis of the PACC per diems. We were unable to verify if any negotiations of the per diem rates occurred and Luzerne County and PACC officials provided no evidence of price negotiations.

The BFO’s review of the financial records indicates that during calendar year 2003, PACC earned \$1.2 million profit on revenues of \$4.3 million (28 percent profit). During calendar year 2004, we projected the PACC profit to approximate \$1.9 million on revenues of approximately \$5.6 million (34 percent profit). These profits illustrate that the per diems paid by the County significantly exceeded the actual cost of service.

The CFR, Part 92.40 (a) requires monitoring by the grantor (Luzerne County), which would include a review and analysis of independent audit reports for the providers of service. Audits, when utilized effectively, provide an additional monitoring tool to ensure that costs appear fair and reasonable and that funds were spent in compliance with contract terms. PACC’s own independent audit report for the period ending December 31, 2003 similarly shows a \$1.2 million profit. The Department and the County officials responsible for reviewing the rates should consider PACC’s financial data from 2003 (and any available subsequent data) when making determinations regarding the reasonableness of the contract between Luzerne County and PACC.

Results of Fieldwork (Continued)

Daily Rates in Excess of Actual Costs

Excluding a start-up period, the PACC per diems charged to Luzerne County exceed actual costs by an average of \$85 per day for detention services and \$109 per day for treatment services. This has allowed PACC to generate a \$1.2 million profit for calendar year 2003 with a projected \$1.9 million profit for calendar year 2004.

According to PACC officials, the basis used to establish the per diems considered a market analysis of similar facilities and other factors such as risk and profit. The standard practice followed for other similar facilities, however, is to establish per diems based on historical actual cost and occupancy data.

The chart presented below shows the variance between the per diems included in the County contracts and actual costs incurred by PACC. The February through June 2003 period was a start-up period not representative of future periods. The compilation of the January through December 2004 actual per diems includes assumptions based on prior period data.²

| <u>DETENTION</u> | | | |
|-------------------------|------------------------|----------------------|------------------------|
| <u>Period</u> | <u>Per Diem</u> | <u>Actual</u> | <u>Variance</u> |
| Jan-June 03 | \$268 | \$239 | \$29 |
| July-Dec 03 | \$268 | \$186 | \$82 |
| Jan-June 04 | \$280 | \$196 | \$84 |
| July-Dec 04 | \$290 | \$200 | \$90 |

| <u>TREATMENT</u> | | | |
|-------------------------|------------------------|----------------------|------------------------|
| <u>Period</u> | <u>Per Diem</u> | <u>Actual</u> | <u>Variance</u> |
| Jan-June 03 | \$300 | \$243 | \$57 |
| July-Dec 03 | \$300 | \$187 | \$113 |
| Jan-June 04 | \$312 | \$207 | \$105 |
| July-Dec 04 | \$322 | \$213 | \$109 |

That notwithstanding, a comparison of the average detention per diem rates for Luzerne County and its surrounding counties shows that PACC per diem rates exceeded the average for this region by 40 percent in SFY03-04 and 42 percent in SFY04-05. Further, if per diem rates associated with PACC are excluded from Luzerne County per

² Our analysis entailed examining the actual costs incurred for the programs and the actual units of service provided. Documentation pertaining to the general and administrative expenses, including building costs was requested from PACC. However, PACC stated the information was "proprietary" and we were denied access to this documentation. As a result, the administrative and building costs included in the PACC calendar 2003 certified audit were used without review of the supporting documentation. The actual per diems listed in the above chart for calendar 2004 were developed based on the assumptions detailed in Exhibit A of this report.

Results of Fieldwork (Continued)

diem rates during SFY03-04, the average rate in Luzerne County falls from \$255.05 to \$178.53 – a rate that is consistent with the average for this region of \$187.79. Similarly, excluding per diem rates associated with PACC from Luzerne County, per diems in SFY04-05 reduces the average rate from \$281.49 to \$187.10, a rate consistent with the average of this region of \$195.29. The following tables of detention per diem rates demonstrate these differences.

| County | 2003-04 | 2004-05 |
|------------------------------------|----------------|----------------|
| Luzerne | 255.05 | 281.49 |
| Lackawanna | 152.73 | 226.53 |
| Monroe | 188.51 | 210.43 |
| Lehigh | 195.98 | 200.15 |
| Carbon | 189.85 | 210.48 |
| Schuylkill | 187.70 | 192.40 |
| Columbia | 180.31 | 188.51 |
| Sullivan | 160.57 | 167.00 |
| Northampton | 263.20 | 198.09 |
| Wyoming | 180.59 | 172.30 |
| Average | 195.45 | 204.74 |
| PACC Rate | 274.00 | 290.00 |
| % Difference PACC Rate vs. Average | 40 | 42 |

| | Luzerne County Average Rate w/ PACC Per Diems | Luzerne County Average Rate w/o PACC Per Diems | % Decrease Excluding Rates Associated with PACC |
|----------|---|--|---|
| SFY03-04 | 255.05 | 178.53 | 30% |
| SFY04-05 | 281.49 | 187.10 | 34% |

Based upon the above information, it is the BFO contention that the detention per diem rates included in the contracts between PACC and Luzerne County are not fair and reasonable.

Non-Allowable Costs

Costs in the amount of \$7,154 associated with a teacher providing education services during the period February through May 2003, were removed from consideration in our calculation of the 2003 detention per diem. Per Chapter 3170 regulations, education services are not included as a cost eligible for DPW financial participation. Additionally, our analysis identified direct care staff of the detention program who also worked in the education program who did not consistently report hours worked in each program. As a result we could not accurately allocate the cost of these two employees between the

Results of Fieldwork (Continued)

two programs and the costs remained with the detention program. The PACC assistant director acknowledged staff who work in both programs do not consistently record their hours worked in each program.

TANF Invoices Include Ineligible Medical Costs

Luzerne County billed and received TANF reimbursement for ineligible medical expenses incurred at the PACC facility. These medical expenses are associated with a contract between NHS and Prime Care Medical, Inc. for medical management and staffing services provided at PACC. The PACC per diems included in the Luzerne County agreements include medical costs. Per the County's TANF invoice, the entire per diem costs are being claimed for federal reimbursement. Our audit did not extend to identifying the amount of the ineligible medical costs.

The requirements of the U.S. Department of Health and Human Services, "Guide on Funding Services for Children and Families through the TANF Program", include a general prohibition, "...on expending federal TANF funds on medical services..." In addition, the OCYF Bulletin 3140-04-06, issued May 17, 2004, state, "Medical costs must be removed from the juvenile detention center per diem rate prior to billing to TANF." Since Luzerne County did not adhere to the applicable federal and Commonwealth regulations, they were incorrectly reimbursed for medical costs with federal monies.

Transfer of the Facility Operation to Luzerne County Will Require Reimbursement Based on Actual Costs

Effective January 1, 2005, Luzerne County entered into a lease agreement with PACC to lease the facility and assume responsibility for operation of the detention and treatment programs. As a County operated facility, the County is subject to the fiscal policies outlined in the Title 55, Chapter 3170 regulations, "Allowable Costs and Procedures for County Children and Youth Social Service Programs". Specifically, regulation 3170.11 (c) which identifies the sections of the 3170 regulations containing the policies for claiming DPW participation for services provided through County operated facilities. For these facilities, reimbursement is based on and cannot exceed actual costs.

It is the BFO's understanding that Luzerne County officials, as part of their negotiation of the financial terms of the PACC lease, anticipated the County would generate profits by selling empty beds to other counties. However, the 3170 regulations limit DPW financial participation for county operated facilities to the actual costs of the facility, which does not allow for profit. Any revenue from the sale of beds must be used to reduce the costs of the facility. Specifically, Chapter 3170.23 (d) (2) allows program funding of total eligible expenditures of a facility provided the cost of the service is

Results of Fieldwork (Continued)

reasonable and the cost when computed on a per diem basis does not exceed actual cost.

A decision by the County to sell empty beds to other Pennsylvania counties is subject to compliance with Chapter 3170.84 (a) (2) which would require the County to sell the beds based on the actual allowable costs incurred by the County as reported per the quarterly reports to the DPW. The OCYF may wish to grant a waiver of the Chapter 3170.84 requirement to allow the sale of unused beds to other counties at one rate throughout the year, provided the rate does not exceed actual costs. The rate agreed upon should as best possible represent actual allowable costs.

Recommendations

The BFO recommends that OCYF take all appropriate steps to ensure Luzerne County adheres to the Chapter 3170 regulations as required for county operated facilities.

The BFO recommends that the Department oversee completion of a cost analysis as required by the Code of Federal Regulation. The analysis should limit the allowance for profit to an amount that would not exceed 10% of revenue.

The BFO further recommends that the Luzerne County C&Y revise its federal and state funding claims for the period January 2003 through December 2004 to reflect the following:

- The findings and results of the cost analysis completed by the Department.
- Luzerne County C&Y should then determine if allowable TANF expenses were incurred during the same period for other TANF reimbursable services such as In-Home and Emergency Shelter program that were not funded with TANF funds due to the TANF allocation being exceeded. If this determination discloses that expenses were incurred, the County C&Y agency can substitute these expenses for the unallowable detention expenses, otherwise the associated federal funds must be returned.

The BFO also recommends the OCYF require Luzerne County to perform sub-recipient monitoring of all applicable grants and contracts. This would include effectively negotiating rates of all contracted providers utilizing a cost/price analysis and a "fair and reasonable" profit factor. The basis for the negotiations should be the standard computation using the actual cost of service divided by the days of service. Effectively negotiating rates would free up state and TANF funding, reducing the amount of County funds required to provide services.

The BFO also recommends the OCYF determine the most practical method for Luzerne County to report actual allowable costs for the TANF and Act 148 reimbursement going back to the January 2005 quarter. One method is for the County to complete a

Results of Fieldwork (Continued)

quarterly reconciliation to actual costs, which would result in a different per diem each quarter.

In the future, other counties would reimburse Luzerne County based upon an annual contracted per diem, which for existing programs would be developed using previous year actual costs and units of service. The income from this arrangement would be used to reduce the actual quarterly costs in the invoicing to DPW. Luzerne County could use a budgeted per diem based on anticipated costs and units until actual costs are available.

The BFO further recommends Luzerne County discontinue the practice of billing TANF for medical costs. This would result in the County reporting medical costs on the CY 348 for Act 148 reimbursement. The medical costs funded through Act 148 must be limited to those costs not reimbursable through MA or for MA ineligible placements.

The BFO finally recommends that Luzerne County instruct their contracted managing entity to accurately record the time and cost of direct care staff who also work in the education program.

Issue No. 2 The 2005 Lease Between PACC and Luzerne County Appears to be a Capital Lease

Effective January 1, 2005, Luzerne County entered into a 20-year lease agreement with PACC to lease the PACC juvenile care facility and assumed responsibility for operation of the detention and treatment programs. The terms of the lease require a minimum monthly rental of \$193,333.33 for the first year based on the existing 48-bed facility.

The first year payments total \$2.3 million. The minimum rent payments over the 20-year lease total \$46.4 million. The minimum payments could increase to \$58 million depending on the completion date of the proposed 12-bed expansion.

Luzerne County receives reimbursement for C&Y service expenditures through a variety of federal and state sources. Prior to January 1, 2006, most detention expenses are reimbursed 100 percent through the federal TANF program. The receipt of federal funds subjects the County to the requirements of the Code of Federal Regulations. As such, the PACC rental costs are subject to the limitations of OMB Circular A-87.

Requirements of OMB Circular A-87 Related to Rental Costs

A capital lease is a lease that transfers substantially all the benefits and risks inherent in the ownership of a property to the lessee. OMB A-87, Attachment B, Section 38(d) Rental Costs, states, "Rental costs under leases which are required to be treated as capital leases under GAAP are allowable only up to the amount that would be allowed had the government unit purchased the property on the date the lease agreement was

Results of Fieldwork (Continued)

executed. This amount would include expenses such as depreciation or use allowance, maintenance and insurance.”

Section 38(d) also identifies criteria for a capital lease. “The provisions of Financial Accounting Standards Board Statement 13 shall be used to determine whether a lease is a capital lease.” The lease would be classified as a capital lease if “the present value of the minimum lease payments at the beginning of the lease term is 90 percent or more of the fair value of the property at the inception of the lease.”

County Needs to Document Fair Value of PACC Property

Luzerne County needs to obtain and document the fair value of the PACC property in order to determine how much of the lease payments are eligible for reimbursement. Based on available information, it appears that the PACC lease meets the requirements of a capital lease. The present value of the \$46.4 million minimum lease payments for the 48-bed facility is \$26.6 million. The fair value of the property would have to exceed \$29.5 million before the lease could be classified as anything other than a capital lease. Considering the original cost basis of the property including furniture and equipment is \$8.9 million, as reported in the PACC independent CPA audit, it is unlikely fair value of the facility would exceed the \$29.5 million identified above.

County Needs to Document PACC Building Costs

Should the Department determine that the PACC lease does meet the definition of a capital lease, the County will need to obtain and document the actual building costs of the PACC facility in order to determine the rental costs eligible for federal reimbursement. Section 38(d) of OMB Circular A-87 allows rental costs “only up to the amount that would be allowed had the governmental unit purchased the property on the date the lease agreement was executed”.

Unallowable Rental Costs

The costs included in the PACC calendar 2003 independent CPA audit specifically related to the building are \$686,333. The \$686,333 is comprised of \$339,532 for depreciation and \$346,801 for interest.³ As such, the \$1,633,667 difference between the \$2,320,000 annual lease payments and the actual building costs of \$686,333 would be considered an unallowable cost under federal regulations. Based on the actual units of service provided by PACC for the 12-month period ended June 30, 2004, we project 16,862 units of detention and secure treatment services will be provided during calendar year 2005. The \$1,633,667 of unallowable rental costs divided by the 16,862 projected units results in \$96.88 of the daily per diem being unallowable for federal and state reimbursement.

³ The BFO was unable to determine if the depreciation and interest costs represented a full 12 months.

Results of Fieldwork (Continued)

State Funding of PACC Lease Rental Costs

The PACC rental costs determined unallowable under federal cost guidelines also appear to be unallowable for state reimbursement based on application of the Pennsylvania Code Title 55, Chapter 3170 regulations. These regulations define the costs allowable for reimbursement using Commonwealth Act 148 funds.

Specifically, 3170.11 states “the Department will participate financially in the payment of those expenditures which are necessary and justifiable for program operation.” “Expenditures made by the county children and youth program shall be reasonable to the extent that they are of the same nature as expenditures which would be made by a prudent buyer in the market place.” Additionally, the limitations of 3170.52(c) must be considered. This regulation applies to mortgaged real estate which is owned by a County and charged as a rent expense. Specifically, 3170.52(c)(1)(2) states rental charges “shall be the lesser of the fair rental value of the space or the actual cost of principal and interest”.

Based on the information provided, the BFO does not believe the \$2.3 million payment for annual rental costs meets the definition of “reasonable” as it significantly exceeds the \$686,333 cost of depreciation and interest.

Recommendations

Based on the above available information, the BFO concludes the PACC lease meets the requirements of a capital lease. This will require OCYF to make appropriate changes to State Act 148 funding of that lease and require Luzerne County to obtain and document the fair value and actual building costs of the PACC facility in order to determine the actual amount of reimbursable rent. The documentation used to determine allowable rental costs must be made available upon request for review by authorized representatives of the state and federal government.

Otherwise, in lieu of receipt of documentation, the OCYF should consider \$1,633,667 as the unallowable rental costs based on the original 48 bed facility. At the time, annual leases payments increase to 2.9 million based on the 12 bed addition, unallowable rent should be increased to \$2,042,093. The BFO also recommends that the federal TANF claims submitted by the County for detention services be adjusted to eliminate any unallowable rental costs.

Issue No. 3 Contract Provisions between Luzerne and PACC May Have Contributed to Potentially Inappropriate Billings from PACC

Results of Fieldwork (Continued)

Luzerne County Used A Non Standard Placement Agreement To Contract With PACC

The terms of the PACC placement agreement include significant differences from the standard purchase of service agreement used by the County for all other providers. The differences extend to payment terms, audit requirements, maintenance of records and insurance requirements. The use of the non-standard agreement for PACC has adversely affected the ability of the County and DPW to effectively review financial records and monitor the fiscal operations of PACC. The payment terms of the PACC agreement may have also contributed to inappropriate payments being made to PACC for billing of discharge days. Additionally, the modifications and/or exclusions in the PACC agreement does not provide full compliance with the requirements of Chapter 3170.93(e) – service contracts or agreements, which requires that purchased service contracts contain provisions for the maintenance and retention of accounting records, audit and inspection rights for the County and Department, and a budget and fiscal statement of how fees or costs were determined. The reason that a “custom” contract was used to formalize the agreement between PACC and Luzerne County could not be determined. According to Juvenile Probation Office officials, their office was not involved in review of and approval of the PACC placement agreement. As a result, we could not determine who would have reviewed the contract if a review was conducted.

Differences in PACC Placement Agreement and Standard Purchase of Service Agreement

The following are examples of differences between the PACC placement agreement and the standard purchase of service agreement used by the County.

- **Lack of Audit Rights**: The standard agreement used by the County provides four pages of comprehensive audit requirements. These requirements, in part, include audit rights and access to CPA audit workpapers by federal, state and local agencies, remedies for non-compliance with audit requirements, and preparation of a corrective action plan to address findings of non-compliance and internal control weaknesses. The PACC agreement is primarily limited to a general statement requiring compliance with federal and state audit requirements and financial reporting requirements. The PACC agreement does not include any of the specific requirements that are referenced above.

A request to meet with and have full access to the PACC audit firm workpapers was made by the BFO but denied by PACC. Having full access to the CPA workpapers as would be allowed per the terms of the County standard agreement would have provided the information necessary to understand the nature of certain costs including that of the certified audit. The workpapers could also provide resource for documentation of building and administrative and general expenses included in the PACC audit. The documentation for these expenses was denied by PACC as they considered the information to be proprietary.

Results of Fieldwork (Continued)

- **Non-Standard Payment Terms:** The PACC agreement and the County standard purchase of service agreement both include a payment term that allows payment for the “first and all subsequent days of care”. The standard agreement used to contract with NHS Youth Services includes a modification of this term with payment made for the “first and all subsequent days of care except the day of discharge”. Our review determined with the exception of PACC, the practice followed by the County C&Y and JPO offices for all other service providers is to make payment for only the day of admission and not the day of discharge.

For the period February 2003 through June 2004, the County Programs paid PACC \$287,608 for units representing the day of discharge. For the period July through December 2004, an additional \$117,028 was projected to be billed by and paid to PACC representing the day of discharge. The total payments for the day of discharge total \$404,636. The total was comprised of \$391,272 for detention services and \$13,364 for secure treatment services. Luzerne County's share of these payments was approximately \$400,590. For the period January 2003 through December 2004, Luzerne County included \$387,359 of expenditures representing the payment of detention discharge days on their federal TANF claims.

The payment for day of discharge does not appear to be consistent with several components of the Pennsylvania Code, Chapter 3170. Section 3170.11(b) which limits the Department's financial participation to “the payment of those expenditures which are necessary and justifiable for program operation” also advises that “expenditures made by the county children and youth program shall be reasonable to the extent that they are of the same nature as expenditures which would be made by a prudent buyer in the market place”. Additionally, Section 3170.85 states that the “appropriate county authorities are responsible to obtain the best possible rate for services by the county children and youth agency”. Additionally, general industry practice is to make payment for the day of admission but not the day of discharge. This is the practice followed by the Luzerne County C&Y and JPO for all service providers except for PACC.

Included in the discharge days are days related to the internal transfer of a juvenile from the PACC detention to the PACC treatment program. In these instances, juveniles located in the PACC detention facility were transferred by order of the judge to the secure treatment unit in the same facility. In these cases the PACC charges the County for both discharge from the detention program and the day of admission to the treatment program, even though it occurs on the same day. In this situation, Luzerne County reimbursed PACC \$568 for a single day of service (\$268 for detention services and \$300 for secure treatment).

Results of Fieldwork (Continued)

- **Lack of Insurance Coverage:** The standard purchase of service agreement has requirements for automobile and professional liability insurance coverage and maintenance and retention of records and reports. These requirements are not in the PACC agreement.

Recommendations

The BFO recommends the OCYF require Luzerne County to ensure the standard purchase of service agreement is used for all service providers. This will provide compliance with the requirements of Chapter 3170.93(e) – service contracts and allow federal, state, and local agencies full access to all financial and audit records needed in order to provide effective financial monitoring and oversight.

The BFO also recommends that the OCYF require Luzerne County to revise existing and/or future contracts to ensure a provider is only reimbursed for the usual and customary days of service, which would only be the day of admission.

The BFO further recommends the OCYF inform Luzerne County to revise its federal and state funding claims to reflect the following:

- The federal TANF claims for detention service costs should not include the \$387,359 representing the expenditures incurred for day of discharge.
- Luzerne County C&Y should then determine if allowable TANF expenses were incurred during the same period for other TANF reimbursable services such as In-Home and Emergency Shelter program that were not funded with TANF funds due to the TANF allocation being exceeded. If this determination discloses that expenses were incurred, the County C&Y agency can substitute these expenses for the unallowable detention expenses, otherwise the associated federal funds must be returned.

The BFO finally recommends that the OCYF initiate a review of the Fiscal Year 2003-04 and the Fiscal Year 2004-05 to ensure that state funds were not used to fund the \$400,590 of expenditures incurred for payment of day of discharge for both detention and secure treatment services. This amount includes payments of \$284,732 for the period February 2003 through June 2004, and \$115,858 for the period July-December 2004.

Results of Fieldwork (Continued)**Issue No. 4 The U.S. Department of Agriculture's National School Lunch Program Appears to have been Over-Billed by \$11,472.51**

While operating PACC's Juvenile Detention Center, NHS violated Federal Department of Agriculture (DOA) regulations by submitting and receiving reimbursement for staff meals. NHS over billed and received \$11,472.51 from the Pennsylvania Department of Education (PDE) for staff meals billed for the period March 1, 2003 through June 30, 2004. PACC financially benefited from the over billing. Since the PACC bills the county programs based on a fixed per diem, the additional food revenues resulted in a reduction to PACC operating costs and an increase to profit.

The National School Lunch Program is governed by DOA regulations. Regulation 7 CFR 210.2 defines reimbursement as "Federal cash assistance to schools for lunches meeting the requirements of 210.10 and served to eligible children". This regulation prohibits individuals other than eligible children from participating in the program. The PDE National School Lunch Program administrator provided confirmation that staff meals are ineligible for reimbursement.

Recommendations

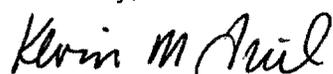
The BFO recommends the OCYF inform the NHS that staff meals are ineligible for reimbursement, and recommend the NHS stop the practice of billing for staff meals. The OCYF should also recommend NHS refund the PDE for the reimbursement received for staff meals billed for the PACC and for any other programs operated by the NHS for which staff meals were billed.

The BFO also recommends the NHS monthly reports of meals be prepared by calendar month instead of a four-week period to provide for a more accurate monthly claim and ensure all eligible meals are being claimed for reimbursement.

In accordance with BFO established procedures, please provide a response within 60 days to the Audit Resolution Section concerning actions to be taken to ensure the report recommendations are implemented.

Please contact Tina Long, Audit Resolution Section, at (717) 705-2288 if you have any questions concerning this matter.

Sincerely,



Kevin M. Friel

Attachment

cc: Mr. Robert Powell
Mr. Frank J. Castano
The Honorable Maryanne Petrilla
The Honorable Gregory Skrepenak
The Honorable Stephen Urban
Mr. Gregory R. Zapalla, Esquire
Mr. Jonathan Vipond, Esquire
Mr. Geoffrey R. Johnson, Esquire

EXHIBIT

Due to a scope impairment by PACC to restrict access to certain records considered “proprietary”, the following assumptions were used in compiling the January through December 2004 actual per diems detailed in Issue No. 2.

- For the period January through June 2004, the operating cost component is representative of actual costs posted in the PACC financial records. These costs were increased by four percent to establish the July through December 2004 costs.
- The administrative and building cost component is representative of the like expenses included in the PACC calendar 2003 certified audit, plus the projected 12-month costs of the new PACC business manager position established in late calendar 2003.
- The miscellaneous income used to establish the net actual costs was based on annualizing the income received from the National School Lunch Program and various school districts for the period July through December 2003 when the program was operating at near full capacity.
- The census data used to establish the per diems is based on actual billed units for January through June 2004, with July through December 2004 based on an average of units billed for the period July 2003 through June 2004.

SUBSEQUENT EVENTS AND AUDITOR'S COMMENTARY

The Department provided a copy of the draft audit to the Luzerne County Children and Youth Program and PACC in February 2007. PACC provided a written response in March 2007. After reviewing the response, the Department informed the Luzerne County and PACC representatives that the DPW would conduct a "cold reader" review of the draft audit by DPW personnel independent of those involved in the audit field work and report writing and make any changes appropriate to the draft as a result of the review.

When the review was completed, a revised draft audit was issued on September 25, 2007. In lieu of a formal audit exit conference, the Department held several meetings with both Luzerne County and PACC. The responses submitted from both Luzerne County and PACC have been attached and are incorporated in the final audit as appendices of this report. The BFO's review of the responses identified several areas that warrant clarification in the following auditor's commentary.

Omitted Documents and Information

In accordance with Government Auditing Standards we are required to report on information that was omitted from this report and the effect of the omission. PACC provided the BFO with a copy of pro-forma financial statements for 2003 and a certified audit of 2004 as part of their responses. PACC requested that the documents be kept confidential and they are not included in the report but will be provided to the Office of Children, Youth and Families under separate cover. The omitted documents adversely affect the reader's ability to understand how funds were expended and include information that is inconsistent with PACC's position or response to several audit findings.

AUDITOR'S COMMENTARY

Luzerne County Response

The County chose to not contest any of the audit findings directly and instead provided only a general response. Auditor's commentary regarding several issues raised in the County's response is provided below.

The County asserts that the lease with PACC was its best and only option

- The lease, in its present form, was not the sole and best option for the county as several other options existed. By way of example, the approximately \$2.9 million that the County pays to PACC in annual lease payments could have instead been used as debt service for the borrowing of enough funds to construct and furnish at least three detention facilities. Proceeding in this manner would have also allowed the County to own the facility instead of merely leasing it from PACC. In addition to constructing its own facility, there were several other options available to the County including the use of other facilities in neighboring counties.

The County asserts that detention and secure residential costs were reduced as a result of the lease

- The Department made requests to both Luzerne County and PACC to provide any detailed information in the form of cost schedules, contracts or other appropriate documents to verify this claim. Despite these requests, the Department never received documentation supporting this assertion. The assertions of savings in the responses from both Luzerne County and PACC provide no detail to support the claim.

The County asserts that it is better to serve children close to home

- The Department agrees that it is best to place children as close to home as possible. The decision, however, must be made in conjunction with other factors such as the cost of those services and the availability of other feasible options.
- Despite the position stated in its response, Luzerne County has utilized facilities both close to home and others that are at a distance. Of specific note, the County purchased in excess of one million dollars in services during FY 06-07 from a facility operated by PACC, located in Butler County – more than 236 miles from Wilkes Barre, despite the availability of facilities that are geographically much closer to Luzerne County.

PACC Responses

PACC asserts that the audit is unbalanced and factually incorrect. To support this assertion, PACC provided the Department with some additional financial statements that purported to show additional costs that were not available to auditors during the Department's initial fieldwork.

After reviewing these documents, the BFO found PACC's position could not be credibly supported by the information provided. While BFO will not comment further at this time due to PACC's assertion that this information is proprietary and confidential, the Department believes that the BFO audit report accurately represents PACC's financial arrangement with the County.

Officials representing PACC provided the DPW with three separate responses as part of the audit process. Commentary related to these responses is provided below.

PACC Asserts that its Lease is Not a Capital Lease

- The BFO believes that the analysis provided in the audit report is sufficient to show that the lease is in fact a capital lease. This contention is somewhat surprising since PACC's Chief Financial Officer stated that the lease was a capital lease in a meeting with the Department in October 2007.

PACC Disputes Amount of Profit for 2003 and 2004

- The response asserts that “BFO made an early and undocumented determination that PACC made a profit of \$1.2 million and had additionally distributed dividends of \$2 million to members.” The response continues that BFO did not “have full information as to all of the detailed operating costs of PACC including debt service, administrative costs, insurance costs, taxes, maintenance costs, initial development costs, construction management costs, capitalized interest and other risk related costs incurred for the start-up of new facility in early 2003”.

Subsequent to the completion of fieldwork, PACC did provide the Department a pro-forma financial presentation for 2003 and a 2004 independent CPA audit. BFO found the amounts and classifications of certain costs in both documents to be inappropriate. The BFO believes these costs as presented were unreasonable and others should properly have been classified as profit or return to ownership. Due to PACCs request to keep these documents confidential, BFO will not comment further on these claims at this time.

PACC asserts that its Lease with the County has allowed the County to Realize Substantial Savings

- The Department was unable to validate this assertion. As noted in the auditor’s commentary on the Luzerne County response, neither PACC nor the County has provided any detailed information to support this assertion.

PACC Asserts That The County Did Not Fail to Negotiate its Contract

- BFO has not been provided nor has it uncovered any evidence that the County completed the required cost analysis prior to entering into an agreement with PACC and PACC has not provided any evidence other than its assertions that such a cost analysis was completed.

PACC Asserts That it Did Not Improperly Invoice For Both the Day of Admission and Discharge

- We agree that PACC’s billings were in accordance with their purchase of service agreement with the County. This agreement, however, was unique to PACC. A review of the standard Luzerne County Juvenile Probation Purchase of Service Agreement provides for payment of the per diem rates “for the first and all subsequent days of care except the day of discharge.” Neither the County nor PACC has provided a rationale for why the standard contract language was not used.

PACC is unaware of a standard purchase of service agreement

- While all other providers were required to utilize the County standard contract, County officials allowed PACC to develop their own contract. The PACC contract did not provide all of the requirements and safeguards of the standard contract and should have not been used.

Luzerne County
Response to Draft Report

LUZERNE COUNTY COMMISSIONERS
GREGORY A. SKREPENAK, CHAIRMAN
ROSE S. TUCKER
STEPHEN A. URBAN

JAMES P. BLAUM, ESQ.
County Solicitor



FRANK J. CASTANO
DIRECTOR

SAMUEL T. GUESTO, JR.
*County Manager for Legislation and
Chief Clerk*

LUZERNE COUNTY
CHILDREN AND YOUTH SERVICES

111 North Pennsylvania Boulevard Suite 110, Wilkes-Barre, PA 18701-3697
(570) 826-8710 · Fax Number: 570-821-7355
TDD (570) 825-1860

December 24, 2007

Mr. Kevin Friel, Director
Bureau of Financial Operations
PA Department of Public Welfare
3rd Floor Bertolino Building
P.O. Box 2675
Harrisburg, Pennsylvania 17105-2675

Dear Mr. Friel,

As per your request on December 10, 2007, this letter is to serve as a response to the draft audit relative to the lease between PA Child Care, LLC ("PACC") and Luzerne County (the "County") of the juvenile detention facility located in Pittston Township.

As you are aware, I was not the Director of Luzerne County Children and Youth Services at the time the County entered into the lease with PACC. Through my review with County officials, I have been informed that the lease with PACC was the best and perhaps the only option then available to keep the children close to their families to best promote and facilitate timely reunification.

Although the Bureau of Financial Operations ("BFO") has identified concerns regarding the lease, the County has shared with BFO during the numerous teleconferences that have occurred during the last three (3) months that, in the last three (3) fiscal years the County has reduced costs for juvenile detention and secure residential services. Moreover, it cannot be disputed, that placing Luzerne County juveniles in close proximity to their homes has been in the best interests of those children and their families due, in part, to the fact that it makes possible the implementation of treatment plans that can more easily include the participation of the juvenile's family members.

As was also discussed in the numerous conversations between the County and BFO, the overall costs of services at the subject facility is in many cases less than the costs that would be incurred if the County were forced to use facilities out of the area. As BFO is aware, this facility is utilized by other counties of this Commonwealth and,



as far as this County is aware, BFO has not questioned the costs being incurred by those counties in placing their juveniles at the facility. It is the County's understanding from its discussions with BFO that the crux of BFO's concerns is not with the overall costs being expended by the County or with recouping any funds expended to date but rather with the fact that part of the funds being expended goes toward the current lease with PACC. BFO has made it clear that the County could face reimbursement and funding implications that would total in the several millions of dollars if BFO's concerns with respect to this lease are not resolved to BFO's satisfaction.

In order to find a resolution to the draft audit, BFO provided the County with guidance and then directed the County to enter into negotiations with PACC. The result of the negotiations between PACC and the County produced the offer of a mutually agreeable termination of the lease. This was discussed during a conference call on December 10, 2007 between BFO and the County and, at that time, the proposed solution of terminating the lease was not accepted by BFO. As set forth above, the County believes that the lease has been beneficial to the County. However, despite the benefits that the County saw and continues to see in leasing this facility, the County would certainly terminate the lease as soon as BFO approves such an action in order to resolve this matter. Since the lease is the focus of BFO's concerns, the termination of the lease should fully and finally address all of the concerns outlined in the draft audit and the County respectfully requests that BFO give this proposed solution further consideration.

If the lease is terminated, the County is concerned about the limited availability to the County of detention services and the prospects of the Court having to make detention placements where juveniles of the County are scattered among numerous facilities, many of which will require transportation between the Court and facilities in far away locations. The concern, obviously, is that the potential transportation costs and labor costs (including overtime) will create a financial hardship on the County. While the County is willing to undertake any actions that BFO deems appropriate so as to resolve this audit, the County respectfully requests that BFO consider a possible scenario where the lease is terminated but where the County reserves twelve (12) spaces at the PACC facility on an ongoing basis for the Court's detention needs. This could be a relatively short term arrangement while the County explores the prospects of building its own detention facility. The County is simply concerned that, if and when the lease is terminated, the PACC facility will most likely be converted by PACC to a facility solely dedicated to secure residential services and that the County will be left with unsatisfactory detention options in remote locations while other counties of the Commonwealth enjoy the use of a facility that is located in this County.

It is the County's interest to find alternative placement options for all future children if and when the lease is terminated with PACC. It is also the County's interest to ensure that the children currently placed at the facility remain there until their discharge from the program so as not to disrupt their treatment. If the lease is terminated, the County will make every effort to find alternative placement options as close to Luzerne County as possible to best serve the needs of the children and their families. However, that goal would be much more likely to be attained if the County could secure the usage of a portion of the PACC facility for detention services. The County is looking for further guidance from BFO as to a course of action that will both satisfy BFO and spare the taxpayers and the County's court system from undue hardships that were at the front of mind of the County at the time it entered into this lease.

Your consideration of the foregoing is greatly appreciated. I have given careful attention to this matter and I will continue to work with BFO and County officials to find a resolution.

Sincerely,

A handwritten signature in black ink, appearing to read "F. J. Castano". The signature is fluid and cursive, with a long horizontal stroke at the end.

Frank J. Castano
Director
Luzerne County Children and Youth Services

CC: Commissioner Gregory Skrepenak
Commissioner Rose Tucker
Commissioner Stephen Urban
Commissioner Elect Maryanne Petrilla
Mr. Samuel Guesto
Mr. Samuel Diaz
Mr. Brian Bufalino
Mr. Joseph DeVizia
Honorable Mark Ciavarella
Mr. Larry Saba
Mr. John Johnson

**PA Child Care, LLC
Responses to Draft Report**

Exhibit B March 8, 2007

Exhibit C October 26, 2007

Exhibit D November 5, 2007

LAW OFFICES
SPRAGUE & SPRAGUE

SUITE 400
THE WELLINGTON BUILDING
135 S. 19TH STREET
PHILADELPHIA, PENNSYLVANIA 19103-4909
(215) 561-7681
TELECOPIER: (215) 561-6913
E-MAIL: LAWFIRM@SPRAGUEANDSPRAGUE.COM
OF COUNSEL
FRANCIS J. CATANIA

RICHARD A. SPRAGUE**
THOMAS A. SPRAGUE*†
GEOFFREY R. JOHNSON
CHARLES J. HARDY
JOSEPH R. PODRAZA, JR.*
THEODORE J. CHYLACK
STEPHEN R. KURENS*
MARK B. SHEPPARD
THOMAS E. GROSHENS
SHELDON L. ALBERT
RICHARD L. DESIPIO*
LAWRENCE R. WOHRLE*
LINDA A. FISHER

ROBERT C. DANIELS
SPECIAL COUNSEL

NEW JERSEY OFFICE
76 EUCLID AVENUE
HADDONFIELD, NJ 08033
(856) 216-1212
FAX (856) 354-2322

†MANAGING ATTORNEY
FOR NEW JERSEY

* ALSO MEMBER NJ BAR
* ALSO MEMBER NY BAR

March 8, 2007

VIA HAND DELIVERY

Ms. BethAnn Smetak
Acting Deputy Secretary
Office of Children, Youth & Families
Department of Public Welfare
131 Health & Welfare Building
Harrisburg, PA 17120

RE: Response to Bureau of Financial Operations "Draft" Audit Report
PA ChildCare, LLC, Dated February 6, 2007

Dear Ms. Smetack:

My client, PA ChildCare, LLC ("PACC"), is in receipt of a February 6, 2007 "draft" Audit Report prepared under the direction of John H. Bungo, Director of the Bureau of Financial Operations ("BFO") at the Department of Public Welfare ("Department"). We note that the original audit activities which resulted in this report occurred in October and November 2004 and that BFO work papers were released to the public, leading PACC to seek injunctive relief in the Court of Common Pleas of Luzerne County, which relief was granted. We also note subsequent efforts of PACC counsel to negotiate with the Department's counsel and the Office of the Attorney General an appropriate and balanced Audit Report to correct a multitude of inaccuracies in the original draft Audit Report and to provide additional documentation as to the fairness and benefit to Luzerne County of the development of a new juvenile detention facility for the county in 2003. I urge you, and the Secretary of Public Welfare, not to issue this Audit Report as presently drafted as it is replete with inaccurate factual statements, faulty financial analyses based on concededly-incomplete information and, therefore, unsupportable conclusions.

We are providing this response and analysis as allowed and requested in Mr. Bungo's February 6, 2007 letter as part of our ongoing efforts to resolve the questions raised by the BFO

Ms. BethAnn Smetak
Acting Deputy Secretary
March 8, 2007
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auditors and to present a fair and unbiased description of the contractual relationships between PACC and Luzerne County, first under a contract for secure juvenile treatment and detention services in 2003 and 2004, and then under a long term lease with Luzerne County for the facility as on January 1, 2005. The Audit Report should either be withheld completely in its present form or substantially and extensively amended as we have been endeavoring to do since late 2004. Accordingly, PACC now formally responds in writing to the February 6, 2007 "draft" Audit Report and herein states its detailed objections.

INTRODUCTION

As noted above, the saga of the audit process by BFO has been fraught with dispute and controversy from the outset. It is PACC's position that much of this conflict has resulted from mistaken stances taken at the outset of the process and the refusal to adjust those stances through negotiation. As the parties have grown rooted in steadfast and adverse positions, the ability to listen, the ability to communicate and to objectively reflect has been lost. Such a scenario usually results in the dedication of an inordinate amount of resources to conflict rather than resolving the initial misunderstanding. Former Israeli Army General Moshe Dayan once said "If you want to make peace, you don't talk to your friends, you talk to your enemies." The Greek philosopher Aristophanes stated: "A man can learn wisdom even from a foe." It is respectfully suggested that the issues separating the parties herein can be resolved if both sides heed this sage advice.

The matter at hand is the BFO "draft" Audit Report as to the operations of the juvenile detention facility in Pittston, Luzerne County. The Audit Report has from its earliest drafts erroneously described an operation generating excessive profits ultimately paid for by the taxpayers of Luzerne County, the Commonwealth of Pennsylvania and to an extent the United States of America as county, state and federal funds all support juvenile detention services.

From the time of the initial audit activities in the fall of 2004, PACC has cooperated with BFO personnel, but has steadfastly maintained that the information relied upon in the various versions of the Audit Report is incomplete, the analysis flawed and the conclusions unsupportable. The core dispute between the parties-- PACC and the Department -- concerns the incomplete nature of the financial analysis conducted by BFO. BFO in the Audit Report acknowledges that the "scope of our audit was limited," February 6, 2007 Audit Report at 3, and that, therefore, its conclusions are based on incomplete information, *id.*, an incomplete audit process, *id.* at 4, and an inability to determine the fair value of the PACC property. *Id.* at 11. There is substantial essential and relevant information that is absent from the Department's Audit Report -- information that both parties must agree to include if an accurate, properly analyzed and, most importantly, fair report is to be issued.

Ms. BethAnn Smetak
Acting Deputy Secretary
March 8, 2007
Page 3

The parties agree that more information could impact the audit findings. The dispute as to the provision of such information by PACC arose out of the Department's expressed willingness and need to review such information as part of its audit process and PACC's expressed need to retain the confidentiality of such information as part of its proprietary internal business information. This inability of the parties to agree as to how to resolve this issue has escalated and complicated this process. PACC asserts that the Department through its Regional Office of Children, Youth and Families initiated inappropriate and baseless licensure enforcement proceedings to obtain such information and then permitted or did not prohibit certain BFO personnel from releasing information as to the preliminary audit findings to unauthorized third parties and ultimately to the press. PACC initiated trade secrets litigation in the Court of Common Pleas of Luzerne County against Departmental personnel involved in these actions in their individual capacities. PACC through counsel continued its efforts to provide the requisite information to the Department in a manner which would not compromise PACC's proprietary interests. Ultimately no agreement could be reached as to providing information in some protected fashion and negotiations ceased. The parties had sought to devise a means to secure the confidentiality of PACC's proprietary information and, absent such agreement as to protection, PACC was given the Hobson's Choice of disclosing its proprietary information or risking the publication of an inflammatory and flawed Audit Report.

PACC still seeks resolution of this dilemma by further negotiation with the Department.

HISTORY

A. Introduction and Background

Juvenile detention and treatment facilities in Pennsylvania, and particularly secure facilities for county services, are in short supply at a time when demand for such services is high and ever more important. In response to a specific need for such services in Luzerne County and a growing market emphasis on the provision of human services resources by private enterprise, PACC, a private, for-profit limited liability company ("LLC"), put its own capital at risk, negotiated through complex local and state regulatory barriers, and brought to market a state-of-the-art, model secure juvenile detention and treatment facility. The facility was promptly licensed by the Department in early 2003. The result was a new fully licensed and operational facility designed to accept for detention and treatment the *least desirable adjudicated delinquents* from Luzerne County and elsewhere.¹

It is important to recognize that PACC, and its sister corporation Western PA Child Care, LLC ("WPACC"), in developing new detention facility capacity in Pennsylvania have

¹PACC's recognized operational success as a secure juvenile detention and treatment facility has spawned a second facility serving a five county area in Western Pennsylvania, which facility enjoys similar operational success.

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endeavored to work harmoniously with the Department, and, in fact, has enjoyed a cordial relationship with respect to all licensing and regulatory matters. Indeed, PACC believes that the Department has encouraged its efforts and has commended the quality of its service delivery. PACC has therefore been distressed at the Department's perceived intransigence in not permitting reasonable resolution of the issues raised in the Audit Report and, without compromising the integrity of its proprietary business model and processes, seeks to end the dispute to the satisfaction of both parties and Luzerne County by demonstrating the fiscal and programmatic soundness of the negotiation process, the rates, and the remuneration to PACC in the context of the development of a completely new facility and the absence of viable competitive alternatives for detention services.

On December 31, 2002, the Court of Common Pleas of Luzerne County ordered the closing of the century-old Luzerne County Juvenile Detention Center ("Center"). The conditions at the Center included the following:

[R]odent [rats and other vermin] and cockroach infestation; roof leaks; inadequate physical disability accessibility; lack of facilities for physical examinations, classrooms and indoor physical education; and inadequate hot water, plumbing and ventilation. Due to a lack of air conditioning during the summer months, the windows had to be opened through which the detainees passed drugs and contraband. On December 6, 2002, President Judge Conahan, Juvenile Judge Ciavarella and other court officials held a meeting with Union officials regarding the closing of the Detention Center regarding the unsanitary conditions that threatened the health, safety and welfare of the juvenile detainees and increased the risk of liability.

See AFSCME District Council 87 v. Luzerne County, Case No. PERA-C-03-104-E, Final Order of the Pennsylvania Labor Relations Board, dated October 19, 2004, a copy of which is appended hereto as Exhibit "A." Conditions at the old Center were unquestionably dirty and dangerous, with those receiving services suffering abuse at the hands of other juveniles amid allegations that staff were indifferent to the health and safety of their charges. *See A.M. v. Luzerne County Juvenile Detention Center*, 372 F.3d 579 (3d Cir. 2004), a copy of which is appended hereto as Exhibit "B."

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B. The aging and dangerous Center was replaced by PACC's state-of-the-art facility.

Recognizing the need for new secure juvenile detention and treatment facilities in Luzerne County and elsewhere in Pennsylvania, two individuals, Robert Powell and Gregory Zappala, through their separate corporate entities, formed the limited liability company now known as PACC. Through the efforts of its two principals, PACC gained the necessary regulatory approvals, raised the necessary capital, and designed and constructed a state-of the art juvenile detention and treatment facility in Pittston, Luzerne County. The PACC facility featured licensed forty-eight (48) beds (later expanded to sixty (60) beds), health and medical facilities, educational facilities, psychiatric/therapy facilities, as well as recreational and social facilities. *See Exhibit "C" Photographs of PACC Luzerne County facility and description of services.* The PACC facility specializes in detention and treatment of the juveniles who are difficult to place in county facilities or other private facilities – juveniles requiring secure treatment and secure detention, as well as those requiring specialized treatment as sex offenders and "fire starters." Traditionally, juveniles requiring such specialized treatment must be transported to facilities hundreds, if not thousands of miles away – at a significantly higher cost to a county and ultimately the Commonwealth of Pennsylvania.

As noted above, the Department in early 2003 granted the PACC facility initial provisional and then full licensure. The PACC facility was inspected by Leonard Pocius, Northeast Regional Director of the Department's Office of Children Youth & Family and his staff. *See Exhibit "D" Deposition of Leonard Pocius at 22-30.* After such inspection, the Department issued PACC a provisional license for six months, and subsequently, after review, a full license. *Id.* at 30-31.

From the beginning of operations in February 2003, PACC contracted with Northwestern Health Services, Inc. ("Northwestern") to staff the PACC Center. Medical services were also contracted for with PrimeCare Medical, Inc. It is significant to note that the management contract between PACC and Northwestern was amended in January 2004 to shift the the accounting and billing functions to PACC.

As a newly formed and operating entity, PACC undertook to calculate a per diem for its secure detention and secure treatment services and to negotiate rates for services with Luzerne County. Two modalities were utilized to calculate the per diem. First, PACC, in its first year of operating a juvenile detention and treatment facility, asked Northwestern, the experienced operator that had been recommended by Mr. Pocius, to create a budget of the estimated expenses for the administration, management and operations of the Center. Northwestern submitted a budget (based on their own operation of a youth academy). PACC's principals cut a substantial amount of waste from that budget, and then, using an 80% occupancy rate, calculated its per diems. PACC's initial 80% occupancy rate is consistent that used by other facilities and PACC

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cited by way of relevant example the 80.6% occupancy utilized by another provider of these services, Northwestern, in calculating its per diem, as accepted in a parallel BFO Audit Report issued with respect to one of Northwestern's detention facilities. *See* Exhibit "E" Audit Report of Northwestern Academy Detention Program. PACC also reviewed per diem rates from comparable facilities throughout Pennsylvania and actual county per diem expenditures. Total projected operations costs were then divided by the number of available beds on a per diem.

In negotiating the original 2003 provider contract, PACC and Luzerne County reviewed actual juvenile detention payments in other counties for 2000, 2001 and 2002. PACC believes and asserts that the rates as negotiated were reasonable and not excessive and did not result in excessive profits to the provider.²

Although denied by Mr. Pocius, PACC principal Robert Powell asserts that he discussed with Mr. Pocius PACC's projected per diem rate at the time of the initial inspection as would be natural given Mr. Pocius position as Regional Director of OCYF. According to Mr. Powell, Mr. Pocius told Mr. Powell that he had no problem with the per diem. Additionally, PACC's per diems were disclosed to the Department as part of Luzerne County's budget for child welfare services for 2003.

PACC began accepting placements in February 2003 for detention, and then in March 2003 for treatment. Thereafter, and for the eleven months of operations in 2003, PACC's auditors prepared an internal financial statement that reflected the operational costs for the facility which did not include any actual and documented administrative, managerial and tax expenses incurred by the principals of PACC. The internal financial statement purported to reflect a "net income" to PACC of \$1,201,057. A copy of this financial statement was provided to the Department on August 9, 2004, without a full appreciation by BFO of its limited

²A critical conclusion of the Audit Report was that, under applicable Federal Regulations, PACC was required to use a "cost analysis" as opposed to a "price analysis" because "adequate price competition is lacking." Audit Report at 5. The Audit Report asserts: "Since the PACC facility is the sole detention facility in Luzerne County, adequate price competition is lacking. As a result the County should have performed a cost analysis of the PACC per diems." *Id.* This conclusion ignores the nature of the facility and the relevant market. By defining the relevant market as Luzerne County, the Audit Report overlooks relevant evidence and circumstances whereby Luzerne County had previously utilized facilities throughout the region, state and even in other states. The relevant market and benchmarks for calculating the proper payments for Luzerne County's detention and treatment services includes a myriad number of facilities and not just those within the geographical confines of the County. *See* Exhibit "F" Fee for Service Schedule for Luzerne County for 2003-2004 showing higher per diems paid for detention to Schaffner Youth Center (\$274.58/day) and treatment (Y.D.C. Loysville \$310.00/day; Y.D.C. New Castle Secure \$330.00/day; Allentown Secure \$330.00/day).

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examination and scope. PACC provided detention services at the facility through December 31, 2004.

In November 2004, PACC negotiated with and leased the PACC facility to Luzerne County. The lease is a twenty (20) year lease effective January 1, 2005, including rental payments of \$193,333 per month.

C. The Department's audit of PACC

In October 2004, the BFO announced that it would conduct an audit of PACC. Prior to the audit and based upon discovery in the Luzerne County proceedings, PACC learned that BFO Audit Director Thomas Crofcheck had communicated to various Department officials his conclusions, formed prior to the institution of the audit, that PACC had "earned a \$1.2 million profit on the sale of \$4 million in services. This is a 30% profit. In the same year PA Child Care gave members of the LLC distributions (dividends) of \$2 million." In a second E-mail, Crofcheck communicated the false statement that: "This facility has the highest per diem in the state." See Exhibit "G," E-mails from Thomas Crofcheck to Marilyn Eckley dated October 19, 2004 and October 21, 2004. Despite having already reached these unsubstantiated and incorrect conclusions prior to the audit, Mr. Crofcheck executed an Independence Statement as to the conduct of the audit. See Exhibit "H."

The intention to audit was communicated to PACC by letter dated October 26, 2004. The letter, as well as the Department's policies and practices, set forth the standard parameters of the audit, including the requirement of confidentiality during the audit process. See Exhibit "T", Letter of October 26, 2004. The October 26, 2004 BFO letter, which initiated the audit process, stated that the audit was being conducted pursuant to the provisions of 55 Pa. Code § 3170.106(a) and would begin with an Entrance Conference on November 3, 2004 at the PACC facility under review in Pittston, PA. The process for the conduct of the audit was then outlined as follows:

- the scope and objective of the review was to be discussed at the November 3, 2004 Entrance Conference;
- the review would be completed by December 1, 2004;
- onsite fieldwork by BFO auditors would commence immediately following the Entrance Conference and working space at the facility was requested for that purpose;
- a Closing Conference would occur with representatives of PACC at the conclusion of the onsite field work;

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- a confidential non-public draft audit report would be provided for review by representatives of PACC with an opportunity for a written response prior to any public distribution of the report;
- an Exit Conference could be requested and would be scheduled within forty (40) calendar days of receipt of the draft report by PACC;
- a written response would be requested and incorporated into any final report and such response would be provided in advance of any Exit Conference by a period of ten (10) days;
- the final public report, when distributed, would include consideration of the written responses and discussion at both the Closing and Exit Conferences.

During the course of the audit, PACC clearly and indisputably informed the BFO auditors that there was additional financial information reflecting costs and expenses not included in the 2003 financial statement referenced above. PACC requested its auditors and financial advisors to prepare additional information. On November 9, 2004, PACC's Chief Financial Officer Patrick Owens informed the BFO auditors that some requested information could not be disclosed because of its proprietary nature and its disclosure could jeopardize PACC's competitive market position. *See* Exhibit "J" BFO Meeting Summary. On that same day, PACC's principals met with the BFO auditors and reiterated Mr. Owens' concerns. Mr. Powell and Mr. Zappala, however, expressed their desire to cooperate and suggested a conference call with BFO supervisors "...to see if there is a way to accommodate BFO's needs without giving the competition access to proprietary information." *Id.*

Apparently, the BFO auditors gave no credence to PACC's efforts to devise a procedure whereby PACC's proprietary information could be communicated to the Department. To the contrary, two strategies coalesced to coerce PACC's disclosure. First, at the request of Mr. Crofcheck, on November 15, 2004, Mr. Pocius and the Regional Office of Children, Family & Youth sent a Licensing/Approval Inspection Summary indicating a failure in the context of the audit to supply unspecified information to BFO and commenced a license enforcement proceeding against PACC's license based on its alleged refusal to provide that information. *See* Exhibit "D" at 69-70. *See also* Exhibit "K" Letter of November 15, 2004 from Leonard J. Pocius to PACC commencing license enforcement proceeding. Mr. Crofcheck never advised Mr. Pocius that PACC had discussed providing information on a confidential basis to BFO and had requested a conference call to suggest a means to do so. *See* Exhibit "D" at 73. Prior to sending out the Licensing/Approval Inspection Summary requiring a response from PACC with ten (10) days, Mr. Pocius made no attempt to contact PACC. *See* Exhibit "D" at 83-84. PACC counsel did contact Mr. Pocius on November 22, 2004. Significantly, before PACC ever

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received a copy of the Licensing/Approval Inspection Summary, Mr. Crofcheck sent a copy of it to Luzerne County officials. See Exhibit "D" at 96-97. Mr. Pocius conceded that this disclosure was unfair. *Id.*

In addition, the Controller of Luzerne County, Stephen Flood, issued a subpoena to the Department for all records relating to the PACC audit. On November 19, 2004, Flood issued an subpoena directly to Mr. Crofcheck demanding the production of "[a]ll records and audits, including the most recent audit, pertaining to PACCare [sic], LLC, Juvenile Detention Center, Pittston Twp., Pennsylvania c/o Robert J. Powell Esq." The subpoena further demanded production of the documents on November 23, 2004 – just two business days after the subpoena was issued. As Mr. Crofcheck was supervising the Department audit of PACC's juvenile detention facility and pursuant to that audit, he had been given access to PACC's internal financial documents collected during the audit prior to that date. Similar subpoenas were issued to PACC and to various Luzerne County officials, all of whom challenged the blatantly illegal subpoenas by filing motions to quash in the Court of Common Pleas of Luzerne County. Mr. Crofcheck however rapidly complied with the subpoena and produced the documents on that date as chronicled in an article appearing in the November 24, 2004 edition of The Times Leader in Wilkes Barre. That article stated:

County Controller Steve Flood and his staff spent much of Tuesday reviewing more than 500 papers provided by the Department of Public Welfare in response to his subpoena issued last week.

Flood said he and his staff will work through the Thanksgiving holiday so they can prepare an audit highlighting their findings, hopefully for release next week.

D. The Luzerne County litigation

In December 2004, PACC brought an action in the Court of Common Pleas of Luzerne County seeking relief under the Uniform Trade Secrets Act, 12 Pa.C.S. § 5301 *et seq.*, and requesting, *inter alia*, special, preliminary and permanent injunctive relief, as well as compensatory and exemplary damages, attorneys fees, costs and other relief deemed appropriate by the Court. The action expressly pleaded the wrongful misappropriation of the trade secrets of PACC by Mr. Flood, Mr. Crofcheck and Mr. Pocius. As expressly pleaded in the Complaint, PACC asserted that Mr. Flood, as the Controller of Luzerne County, and Mr. Crofcheck and Mr. Pocius, though employees of the Department of Public Welfare, *in their individual capacities*, and acting individually and in concert, obtained and publicly disseminated PACC's internal, confidential and proprietary trade secret information. Prior to the commencement of litigation, Mr. Flood, through use of his subpoena power which PACC asserts was blatantly improper, and

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with the apparent cooperation of Mr. Crofcheck, had obtained documents which contained confidential and proprietary trade secrets of PACC and broadcast his intent to disclose this information publicly. Moreover, after receiving notice of the pendency of the court action as well as the subsequent issuance of the injunctive order prohibiting disclosure of PACC's trade secrets, Mr. Flood turned over the documents and information illegally subpoenaed from Crofcheck to *The Times Leader*. After the improper release of the information, PACC refused to provide additional information to the Department.

PACC sought and obtained a Special Temporary Injunction prohibiting those defendants "from taking any action, directly or indirectly, to acquire, maintain, communicate or disclose any trade secret of PACC pending further Order of this Court." On December 23, 2004, the parties agreed to continue the Special Injunction in full force and effect. That injunction remains in effect.

Mr. Flood's dissemination of PACC's internal and confidential documents in violation of the Special Injunction is the subject of a contempt proceeding in the Luzerne County Court.

In the Luzerne County proceedings on December 23, 2004, Mr. Flood produced, pursuant to subpoenas issued by counsel for PACC, copies of the documents containing PACC's proprietary information that he obtained from Mr. Crofcheck. These documents, or a significant portion of these documents, had been willfully disclosed by Mr. Flood to reporters from *The Times Leader*, and contain not only the confidential and proprietary "trade secret" information of PACC, but also contain internal records of PACC containing census information on the juveniles admitted to the facility, including the names of, and other identifying information about those juveniles, and whether the juveniles were in detention or in treatment. Thus, there is a substantial basis to assert that Mr. Crofcheck and Mr. Flood permitted the disclosure of not only the trade secrets of PACC, but also confidential information about juvenile detainees and delinquents as to which the juveniles have significant privacy interests and confidentiality rights under the Juvenile Act.

Despite the prohibition on further disclosure, Messrs. Crofcheck and Pocius and their counsel, in the context of an appeal from a challenge to the jurisdiction of the Luzerne County court, publicly filed with the Supreme Court of Pennsylvania an appendix which included the referenced confidential materials belonging to PACC and the names and status of juveniles in detention and/or treatment.

It is of notable significance to PACC's position, as to the content and findings in the Audit Report and the appropriateness of the contract negotiation process and payments under the contract, that, during the course of discovery in the Luzerne County litigation, Mr. Crofcheck

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testified under oath that he agreed PACC was entitled to reasonable profits and to deduct administrative expenses in the calculation of net income, to wit:

Q. Apart from the operation of the center, would you agree that there are legitimate costs involved in the management of the company operating the center that are attributable to—or reasonable in considering the per diem?

A. Yes, there are.

Q. What kind of costs would those include?

A. They would be—you're talking about management costs, correct?

Q. Management costs.

A. All right. Chief financial officer's salary, clerical costs. There—there could be an amortization of space, like, from this office (The Powell Law Group, PC), okay, utilities, whatever's—costs associated with this office, a percentage could be associated, if this is the office of Pa Child Care. There—there could be initial costs of the audit—certified audit, financial advise, legal advice There are many expenses that would be considered as legitimate expenses of running an operation like Pa Child Care.

Q. How about the—some compensation for Mr. Powell and Mr. Zappala for their efforts in creating, implementing, and overseeing the operation of Pa Child Care?

A. That would be an eligible expense or an expense considered appropriate for PA Child Care.

Deposition of Thomas P. Crofcheck, Page 43, line 21– Page 44, Line 22. A copy of this testimony is appended hereto as Exhibit "L."

E. The circumstances surrounding the issuance of the Audit Report

In March 2005, the Department issued an initial "draft" Audit Report regarding the audit of PACC (which version is the predecessor to the February 6, 2007 "draft" Audit Report). The March 2005 "draft" Audit Report did not emanate directly from BFO for the Department to PACC which is standard practice. To the contrary, it was transmitted to counsel for PACC through counsel for Messrs. Crofcheck and Pocius in the Luzerne County litigation. In May 2004, PACC's counsel sent a comprehensive response *inter alia* objecting to the procedural irregularities in the issuance of that draft report and detailing the erroneous conclusions,

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regulatory and statutory misinterpretations and the blatant prejudicial nature of that report in terms of PACC's compliance with applicable law and its reputation in the provider community.

Thereafter, in seeking to supplement and correct the unfair, incomplete and faulty information, analysis and conclusions contained in the March 2005 version of the Audit Report, and having obtained the critical concession by Mr. Crofcheck as to PACC's right to have its management and administrative costs considered, PACC once again attempted to explore a mutually acceptable and protected means to provide additional material information to the Department. PACC expressed its desire to have the information maintained by the Department confidentially in light of the repeated public disclosures of PACC's internal information that had already occurred by Mr. Flood's improper subpoena, in the Luzerne County newspapers, and in unsealed pleadings filed with the Supreme Court of Pennsylvania that were obtained and reported again by the Luzerne County newspapers. Despite repeated meetings among PACC and Department's counsel at which various proposals were exchanged, no agreement could be reached. PACC continued its efforts at resolution until the issuance of the revised Audit Report by the Department on February 6, 2007.

SUMMARY OF RESPONSES TO AUDIT FINDINGS

Luzerne County fairly and effectively negotiated with PACC in 2003 a reasonable set of per diem rates for secure juvenile treatment and detention services considering its need for such services and based upon comparable rates in other counties

PACC as a new enterprise calculated its offered per diem rates on cost projections and reasonable occupancy projections and earned reasonable returns based upon its overall risk assumption, largely based on nearly 100% occupancy, not 80% as projected

The January 2005 capital lease is not a capital lease, as the Audit Report grossly understates the value of the underlying assets

PACC billed Luzerne County for all days on which any individuals was in detention including the day of admission and the day of discharge consistent with the terms of its prior contracts and not contrary to any stated or unstated policy or regulation of the Department of Luzerne County

PACC and Luzerne County entered into a provider agreement which is consistent with Departmental regulations as to the terms of such provider contracts

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RESPONSE AND ANALYSIS

1. **The County did not fail to negotiate the per diem rates for services and the utilization of a price analysis, in conjunction with a cost analysis, was proper.**

Luzerne County has the responsibility to arrange and provide for certain child welfare services under the provisions of the County Code at 16 P.S. § 101 et seq., with specific reference to those responsibilities at Section 2168. Further, Luzerne County is required to procure such services pursuant to the contracting process set forth in the Department's regulations for child welfare services at 55 Pa. Code § 3170.1 et seq. Section 3170.94 sets forth that each county shall follow the procurement and bidding standards prescribed by the appropriate county code. Luzerne County chose to procure child welfare services by negotiation with PACC and conducted those negotiations in conformity with 55 Pa. Code § 3170.85, which mandates that "...the appropriate county authorities are responsible for obtaining the best possible rate for purchase of services by the county children and youth agency."

The Department reimburses counties in terms of maximum amounts as set forth at 55 Pa Code § 3170.84. One of the benchmarks of such maximum rates and reimbursement is the rate "...charged another government agency which purchases the same services from the provider agency." Luzerne County and PACC referenced rates charged by other counties for similar services and indeed relied upon Department calculations and reports in reviewing a range of rates. See Exhibit "E." It is particularly significant that PACC charges less than competing facilities operated by the Department. See Exhibit "M" BFO worksheet on comparison per diems showing facilities charging higher per diems than PACC.

Although the regulations require counties to negotiate, the negotiations, as any negotiations are governed by the practical laws of supply and demand. Luzerne County was in need of immediate access to secure juvenile detention and treatment services and looked to other counties for fair and reasonable rates in the absence of alternative vendors for such services. In fact, an audit survey undertaken by BFO for the Department when it audited Northwestern, another provider of these services in other locations in Pennsylvania, supports this reference to rates in other counties. See Exhibit "E." In the Northwestern audit, BFO contacted juvenile probation offices in Monroe, Schuylkill, Lebanon, Northumberland and Perry Counties to understand and benchmark the rate development process. In response to the question to these counties – "Do you negotiate rates with the detention centers or request line item budgets so you are aware of the costs that are included in the line item rate?" -- , the counties' response was "The counties do not negotiate rates and generally feel powerless regarding such negotiations." Rates are based upon what a willing vendor believes to be reasonable and what other counties are paying.

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PACC reasonably projected its own expected costs of services as a new facility and the calculated risk in assuming the responsibility for juvenile detention services which had previously been provided directly by Luzerne County. PACC and Luzerne County reviewed actual juvenile detention payments in twenty-five (25) counties for 2000, 2001 and 2002 and reasonably increased those rates for inflation by 4% annually. The calculated per diem rates for the three (3) counties which paid the highest rates were Montgomery, Bucks and Philadelphia Counties which exceeded \$303 for 2003 and \$315 for 2004. The rates negotiated between Luzerne County and PA Child Care for 2003 as set forth in the agreement for that year were \$268 per day for juvenile detention services and \$300 per day for secure treatment services. For 2004, those rates were increased to \$290 per day for juvenile detention services and \$322 per day for secure treatment services. These rates are consistent with "market" rates and the methodology established for appropriate and maximum levels of Departmental reimbursement at 55 Pa. Code § 3170.84. The rates as negotiated were reasonable and not excessive and did not result in excessive profits to the provider.

Despite the lack of alternative vendors upon whom to exercise bargaining power, Luzerne County did effectively negotiate and agreed upon the rates lower than those charged in other similar large counties, including Bucks, Philadelphia and Montgomery, and indeed, far less than the rates charged by the Department for placement in one of their Youth Development Camps. Essentially, the rates negotiated by PACC with Luzerne County are within the range of rates charged to other similar counties and by the Department at one or more of its own detention facilities.

2. PACC did not make an excessive profit and its per diem rates were appropriately calculated.

Even before the audit had commenced as documented by the Department's internal memoranda and email cited above and disclosed in the related litigation in Luzerne County, BFO personnel had apparently made an early and undocumented determination that PACC had made a profit of \$1.2 million and had additionally distributed dividends of \$2 million to members. BFO personnel also erroneously concluded that PACC charges the highest per diem in the state. These premature conclusions are completely without factual support and offend the concept of fairness and evenhandedness inherent in the audit process. The \$1.2 million "net income" appeared on a preliminary copy of the financial statement for PACC as to 2003 is appended hereto as Exhibit "N" and does provide a full accounting of PACC's true revenue for that year.

PACC as an LLC is owned by two (2) separate corporate entities in equal shares. The "net income" of \$1.2 million dollars referenced is not, according to any reasonable economic or tax analysis, the final "profit" of the entity. BFO did not have full information as to all of the

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detailed operating costs of PACC, including debt service, administrative costs, insurance costs, taxes, maintenance costs, initial development costs, construction management costs, capitalized interest and other risk related costs incurred for the start-up of this new facility in early 2003. To calculate the actual profit or loss to the corporate owners of PACC, all operational expenditures incurred in the management, supervision, financing and operation incurred by each corporate owner must be subtracted from their share of gross profit. **The result of this calculation is the before tax profit or loss of each entity.**

Both at the time of the audit, in November 2004, and more recently, PACC asked for an opportunity to share with the Department the relevant information regarding operational expenditures incurred in the management, supervision, financing and operation, which would demonstrate the inaccuracy of the Department's conclusions regarding alleged profit. These responsive efforts were derailed by the Department's licensure enforcement actions in November, 2004, and by the improper disclosures to the press by individuals employed by the Department of sensitive internal financial information regarding PACC. PACC has provided to its counsel an independent auditor's report as a supplement to prior audits for 2003 denominated "Supplemental Information" which sets forth additional relevant information regarding operational expenditures incurred in the management, supervision, financing and operation, and shows general and administrative expenses for that year reducing the net income of PACC by approximately \$1 million. A copy of that supplemental report with "Supplementary Information" for 2003 is attached hereto in a sealed confidential envelope as Exhibit "O."

The Department's assertions regarding profit are also contrary to the testimony of their own auditor, Mr. Crofcheck, who acknowledged that the type of expenses reflected in the Supplementary Information are allowable and proper in calculating actual income. See Testimony of Crofcheck quoted herein *supra*.

Moreover, the referenced BFO audit of Northwestern supports the handling of initial gross one year profits of approximately \$1.2 Million Dollars for Northwestern's operation of a similar, yet smaller, juvenile detention center before deducting certain expenses. The BFO auditors subtracted significant administrative expenses from that initial "profit" so as to calculate net profit based on the verbal representations of the Chief Financial Officer of the audited entity. The result was then an acceptable and accurate audit in the Department's opinion. The report was supplied to Mr. Crofcheck who was aware of that result. A copy of the BFO audit of Northwestern is appended hereto as Exhibit "E."

In terms of total revenues from Luzerne County in a given year, the actual number of service days billed to Luzerne County by PACC were established by the actual high need for services, a factor not in any way controllable or influenced by PACC. At the time of negotiation with Luzerne County, PACC could not predict what the occupancy of the facility would be and included some revenue protection with respect to the circumstance whereby the facility would

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not be full, using an 80% occupancy figure. The negotiations were arms length and fair and based upon reasonable rates derived from the actual costs and risks assumed by PACC and per diem rates paid for other comparable services in other Pennsylvania counties.

The conclusion advanced in the Audit Report as to a possible disallowance in terms of federal TANF claims and any possible repayment of funds is therefore based on unfounded speculation. Instead PACC asserts that the per diem rates were fairly negotiated but demand for the services was higher than anticipated -- the facility was full. The circumstance that Luzerne County exceeded its Departmental allocation for child welfare services in FY 2003-2004 by \$2,772,801 was not based upon any failure of the rate negotiation process, but rather on that high service demand in Luzerne County driven by placements from the juvenile courts under the provisions of the Juvenile Act as set forth at 42 Pa. C.S.A. § 6301 et seq. PACC agrees that it is the responsibility of Luzerne County to be a prudent buyer and to monitor all contracts for appropriate compliance with applicable regulations and appropriate reimbursement from the Department and other funding sources. There is no question that Luzerne County exceeded its Departmental allocation for these programs but such costs are attributable to the demand for services and not to inappropriate rates charged by PACC.

3. The Audit Report's treatment of the capital lease issue is based on speculation

The Audit Report asserts that the payments under the January 2005 twenty year lease, which was a speculative and prospective conclusion by BFO in November 2004, at the time of the audit survey, drive a further conclusion that the lease payments amount to the transfer of substantially all of the benefits and risks inherent in the ownership of the property to the lessee so as to characterize the lease as a "capital lease." Further, the Audit Report asserts that the Department under the provisions of 55 PA Code Section 3170.11 requires "prudent buyer" principles to apply and limits reimbursement under Section 3170.52 by requiring allowances only for the lesser of fair market value or actual costs regardless of the nature of the lease as capital or otherwise. BFO admits that it could not calculate actual costs of depreciation and interest for 2003 or 2004 so as to apply those costs as adjusted for 2005 and going forward under the lease. The record does not contain evidence of those costs or of fair market or rental value in any sense.

PACC asserts that a just determination of present market value includes not only the initial property acquisition but all of the development costs, construction management fees, taxes, insurance, capitalized interest, and other expenses related to the establishment of the facility. PACC asserts that the lease is not a capital lease as the present value of the facility even at the start of the lease in 2005 is significantly higher than the total then-present value of the

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cumulative lease payments by Luzerne County for twenty years. As to the more significant question as to the fairness and reasonableness of the lease payments, PACC asserts that such payments are consistent with "prudent buyer" principles and with the relevant market place for such facilities, recognizing that the Pittston facility is a unique "state of the art" juvenile detention facility. PACC is however not only ready and able to demonstrate the reasonableness of the lease payments in terms of the valuation of the underlying leased asset and to work with the Department and with Luzerne County to demonstrate appropriate market value on which the lease negotiations were based to support the conclusion that this lease is fair and prudent, PACC is also willing to examine with the Department alternative methods for fair market valuation which take into account the actual costs to develop and the operating value of the facility at the time of the lease in 2005 and going forward to support fair lease payments to the mutual satisfaction of the parties and to satisfy the provisions of 55 PA Code Section 3170.52.

4. PACC did not improperly invoice for both the day of admission and the day of discharge and therefore overcharge Luzerne County by \$400,590.

The Audit Report concludes that PACC should not have been paid a per diem rate for the day of discharge of a youth or adolescent at the facility or when a juvenile was transferred within the facility from juvenile detention to secure treatment. BFO cites no regulation to support its conclusion that it is "general industry practice to make payment for the day of admission but not [for] the day of discharge." To the contrary, it has been the confirmed practice of Luzerne County as evidenced by discussions with Paul McGarry as Director of Probation Services for the county, and in the Department's own workpapers, that there is no policy or requirement with respect to not paying for services on the discharge date. Such conclusion is further confirmed by email correspondence and other documentation from within BFO as to the absence of any such regulation or Departmental policy directive. Therefore, absent a specific contractual provision or other regulatory limitation, Luzerne County continued its past practice of allowing payments for such days. The BFO recommendation that Luzerne County revise such language in future contracts may be considered and Luzerne County may in its discretion make such modifications.

PACC's contracts with Luzerne County and other counties explicitly permit PACC to charge for day of admission and every day thereafter. The documents produced by the Department demonstrate efforts to find some basis to disallow payment for the documented day of discharge despite the clear terms of the contracts and the absence of a prohibition on such practices in any cited regulation. See Exhibit "P." Ultimately the Department relies on the language at 55 PA Code §§ 3170.11(b) and 3170.85 to the general effect the Department will participate only in the payment of those expenditures which are necessary and justifiable for program operations and that are in the same nature as expenditures which would be made by a prudent buyer in the marketplace.

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Review of the documentation provided by Mr. Crofcheck in the Luzerne County litigation shows that tremendous effort was exerted to find some authority that prohibited PACC billing for the first day and every day thereafter. None was ever found. Indeed, PACC's own research discloses no authority that prohibits billing in this manner.

Significantly, the documentation provided by Mr. Crofcheck in the Luzerne County litigation discloses that Mr. McGarry as Luzerne County's Director of Probation has disclosed directly to BFO, in the strongest terms possible that, not only has Luzerne County routinely paid other facilities, including those in Lackawanna County, for the date of discharge, but Luzerne County itself has billed other counties who sent their juveniles to Luzerne County for date of discharge and received payment. *See Exhibit "Q."* Clearly, PACC's practice is not improper or unusual as it comports with Luzerne County's own practice both as a provider and user of juvenile detention and treatment services. Luzerne County was following its own prior contracting practices and included explicit language in the PACC contract as a prudent and consistent buyer of services.

5. Response to Issue No. 5: Luzerne County used a non-standard placement agreement to contract with PA Child Care.

PACC is unaware of any "standard purchase of service agreement" for the purchase of child welfare services by Luzerne County or by other counties. The requirements for any provider contract are set forth at 55 Pa. Code § 3170.93. At subsection (e) is an enumerated list of the terms which must be included in such agreements, to wit: (1) the signature of the chairperson of the county commissioners, or a duly authorized representative, and an authorized person for the service provider; (2) the names and addresses of the contracting parties; (3) the effective date and term of the contract; (4) the contracted amount or unit price and payment schedule; (5) provisions for contract modification amendments or terminations; (6) prohibitions against reassignment without county permission; (7) a work statement; (8) required reports for the county and the Department; (9) maintenance and retention of required records, documents, and accounting books; (10) audit rights for the county and the Department; (11) procurement of liability insurance; (12) client-confidentiality and right of privacy provisions; (13) units of service to be provided and their definitions; and (14) provisions as to non-discrimination. In each of the PACC contracts for 2003 and 2004 which are essentially identical, these provisions are contained in the contract as follows:

1. Full signatures on the signature page
2. Names and addresses of the parties in the initial paragraph

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3. Effective dates and term of the contract in the initial paragraph and at Section V
4. Payment provisions at Section X
5. Provision for modification at Section XVII
6. Prohibition against reassignment at Section XVI
7. Work statement at Sections I, II, III, VI, VII, VII and IX
8. Required reports at Section XI
9. Audit rights at Section XII, specifically referencing the fact the PACC shall comply with all federal and state audit requirements
10. Liability insurance at Section XII
11. Client confidentiality and rights of privacy at Section I(a) relating generally to the laws and regulations governing the delivery and funding of child welfare services in Pennsylvania
12. Units of service are defined at Section X
13. Non-discrimination provisions at Section XII.

The contracts as written are in full conformity with the regulatory provisions for such contracts cited above.

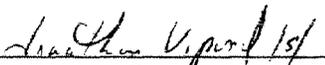
Ms. BethAnn Smetak
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In sum, PACC negotiated fairly with Luzerne County, established rates based upon recognized county benchmarks, complied with applicable regulations as to the substance of such negotiations and the contract terms and supplied services to the satisfaction of the county. PACC stands ready to yet devise mutually agreeable and protected methods of supplying additional financial information to support its assertions and with Luzerne County and the Department to examine the ongoing lease. We look forward to meeting with you promptly to address these concerns and to avoid the release of the Audit Report in this unacceptable form.

Sincerely,

BUCHANAN INGERSOLL & ROONEY, PC

SPRAGUE & SPRAGUE

BY: 
JONATHAN VIPOND

213 MARKET STREET, 3D FLOOR
HARRISBURG, PA 17101

BY: 
RICHARD A. SPRAGUE
GEOFFREY R. JOHNSON
SUITE 400, THE WELLINGTON BUILDING
135 SOUTH 19TH STREET
PHILADELPHIA, PA 19103

ATTORNEYS FOR APPELLANT
PA CHILDCARE, LLC

cc: Howard Ulan, Esquire (via hand delivery)
Timothy Keating, Esquire (via hand delivery)
James B. Blaum, Esquire (via federal express)

LAW OFFICES
SPRAGUE & SPRAGUE

SUITE 400
THE WELLINGTON BUILDING
135 S. 16TH STREET
PHILADELPHIA, PENNSYLVANIA 19103-4912
(215) 561-7681
TELECOPIER: (215) 561-6913
E-MAIL: LAW@SPRAGUEANDSPRAGUE.COM
OF COUNSEL
FRANCIS L. CATANIA

NEW JERSEY OFFICE
76 EUCLID AVENUE
HADDONFIELD, NJ 08033
(856) 216-1212
FAX (856) 354-2322
† MANAGING ATTORNEY
FOR NEW JERSEY

RICHARD A. SPRAGUE**
THOMAS A. SPRAGUE**
GEOFFREY R. JOHNSON
CHARLES I. HARDY
JOSEPH R. PODRAZA, JR.
THEODORE J. CHYLACK
STEPHEN R. KURENS*
MARK B. SHEPPARD
THOMAS B. CROSHENS
SHELDON L. ALBERT
LAWRENCE R. WOEMBLE*

* ALSO MEMBER NJ BAR
** ALSO MEMBER NY BAR

October 26, 2007

VIA TELEFACSIMILE AND FIRST CLASS MAIL

Allen Warshaw, Esquire
Chief Counsel
Pennsylvania Department of
Public Welfare
Health & Welfare Building, 3rd Floor West
Harrisburg, PA 17120

RE: Draft Audit of PA Childcare, LLC

Dear Mr. Warshaw:

At the conclusion of our meeting on Tuesday, October 23, 2007, you requested that I provide you with a proposed schedule of action items demonstrating efforts to advance the resolution of outstanding issues in order to bring this audit process to a prompt conclusion. Since then I have had the opportunity to discuss the matter further with PACC's CFO, Patrick Owens, as well as PACC's principals. Additionally, PACC has consulted further with its accountants. Based on those discussions, I would propose the following:

1. Additional Support for PACC Administrative Expenses

For the first time at our meeting on October 23, 2007 you requested an opinion from PACC's accountants verifying the validity of our Administrative Expenses. We are prepared to produce for inspection information in that regard at a meeting with you and Messrs. Friel and Dallas.

Our request for a meeting and/or extension is certainly reasonable in light of the history of this matter, and in particular, since PACC only learned of the heightened standards and scrutiny being applied to PACC which was again evident at our meeting of October 23, 2007.

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Allen Warshaw, Esquire
Chief Counsel
October 26, 2007
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I will not recount the problems that arose with the previous Audit Team as those facts are set forth in PACC's March 8, 2007 letter to BethAnn Smetak (Section C, at pages 7-9). As is evident from that discussion, PACC was prepared to document its internal expenses in November, 2004. Instead, PACC's private and confidential proprietary information was leaked to the press with the assistance of Department employees, and the principals of PACC were not given the same opportunity as their competitors, i.e. Northwestern Human Services, to support claimed administrative expenses, as more particularly described later herein.

In the above-referenced letter, as a demonstration of its good faith and in an effort to resolve the issue regarding PACC's calculation of its *per diem*, PACC submitted a confidential supplementary report from its auditors regarding PACC's administrative expenses. The Department, after a period exceeding six months, issued its Revised Draft Audit on September 25, 2007. Without any explanation whatsoever, the Department rejected all administrative expenses of PACC.

It was not until our meeting of October 19, 2007 that Messrs. Friel and Dallas informed PACC that the Department required additional documentation of the expenses set forth in the confidential supplementary report. We requested that Messrs. Dallas and/or Friel provide specifics as to the requisite supporting information. Their response was that the schedules of allocated expenses and documentation regarding Messr. Powell and Zappala's rates and hours would suffice to finally put this issue to rest.

Once again, in the spirit of cooperation, PACC immediately scheduled a follow up meeting to produce PACC's administrative expense detail as requested. When we met on October 23, 2007, Mr. Vipond and I were accompanied by Mr. Owens who produced and explained in detail schedules showing precisely how PACC's administrative expenses were calculated. Further, those expenses were tied to ledger entries, financial statements and tax returns. The Department's response was shocking in that the bar was raised again and, for the first time, we were informed that the only documentation acceptable to the Department was a certification from PACC's auditors as to the administrative expenses.

We question why the Department, having received the supplementary report from PACC's auditors in March 2007, did not contact PACC and request additional information for over seven months if it believed the supplementary report was insufficient. We also reasonably question why the Department continues in its disparate treatment of PACC - i.e., accepting the undocumented verbal representations of Northwestern's CFO, while rejecting a written report of PACC's auditors and the supplemental documentation provided by PACC's CFO. Any audit is supposed to be done using the same rules, yet the Department continues to ignore this fact. This disparate treatment has not been lost on my client.

Notwithstanding these issues, PACC believes it can produce for inspection documentation that should be more than acceptable under any reasonable requirement of the Department as to the

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Allen Warshaw, Esquire
 Chief Counsel
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bona fides of its administrative expenses. PACC will within the next two weeks obtain additional documentation from its accountants. In light of all of the above, PACC requests a meeting at the Department's earliest convenience, to produce the same for inspection. This request is certainly reasonable in light of all the circumstances.

2. Discussions regarding Renegotiation of the Lease with Luzerne County

The County has represented to PACC and the Department that it is extremely happy with the lease. In fact, at our meeting of October 23, 2007, County Manager Sam Guesto informed the Department that the lease has resulted in substantial savings to the County and the Commonwealth for juvenile detention. Simply stated, the lease has done exactly what the County anticipated it would – it has been a win-win for the County and the State taxpayers. The following is a recap of those savings:

| | County Funds | State Reimbursements |
|------|-----------------------|-----------------------|
| 2004 | \$15,600,000 | \$5,600,000 |
| 2005 | 12,700,000 | |
| 2006 | 11,100,000 | |
| 2007 | 9,430,000 (projected) | 3,970,000 (projected) |

Luzerne County now charges a \$302 per diem for detention at its facility which is a mere 15 minutes from the Courthouse where these juveniles appear in Court. As shown by the chart attached as Exhibit "A," which incorporates the latest rates from institutions responding to a survey conducted by J.D.C.A.P., factoring in transportation and personnel costs, the per diem cost to send Luzerne County juveniles to the other institutions ranges from \$326.46 per juvenile per day to \$501.13 per juvenile per day. Simply stated, the best use of taxpayer dollars has been and is the PACC facility.

As stated, PACC is more than willing to open discussions with Luzerne County regarding the lease for the juvenile detention facility to address the capital lease issue.

Two alternatives present themselves: (1) an amendment of the lease *ab initio* to adjust the term of the lease to a term that renders the lease an operational lease rather than a capital lease, and (2) discussions regarding the terms for terminating the lease.

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Page 4

A. REDUCTION OF LEASE TERM

Accepting for the purposes of argument that the lease is a capital lease, a conclusion which PACC steadfastly disputes, it must be recognized that when the parties entered into the agreement, neither considered whether the lease was a capital lease or an operational lease. The County wanted to have a long term solution to containing its costs for juvenile detention and treatment and PACC was willing to accommodate that interest. PACC is perfectly willing to discuss adjusting the term of the lease and has been advised that a term adjustment should most certainly put to rest the disputed claim that the lease is a capital lease.

B. LEASE TERMINATION

It is odd, to say the least, that the Department would want to interfere with a lease that has resulted in significant cost savings to the taxpayers of the Commonwealth and Luzerne County. If the Department wishes to shoulder that responsibility and explain to those same taxpayers why their tax burden will now increase, that is your decision. We are committed to publicly communicating this to the County and the taxpayers if this is the Department's preferred method for resolution.

Assuming arguendo that PACC would agree to terminate the Lease, which would require a mutual termination from the County, which neither party has agreed to, minimally, PACC would require an authorized representative of the Commonwealth to execute a Hold Harmless Agreement to release PACC of any liability from the County and/or taxpayer(s).

C. CONCLUSION

While PACC is willing to discuss either of these alternatives, we are not are willing to negotiate per diem rates that we are know are justified. PACC is confident that after reviewing the additional documentation regarding PACC's administrative expenses, the Department will agree that they are fair and reasonable.

PACC would propose that any discussions regarding the lease also take place at the aforementioned meeting.

3. Outstanding Issues

PACC would also like to meet and discuss further the "market analysis" performed by Mr. Friel in the Revised Draft Audit Report. In particular, Mr. Friel performed a putative analysis of the difference in per diem rates for detention in which he concludes PACC charged an unreasonably high rate. The problem with this analysis is he did not perform a similar analysis for treatment (a/k/a long term residential). Had Mr. Friel performed such an analysis, he would have found only an \$18 difference between PACC's per diem and the average per diem of other providers providing juvenile treatment services to Luzerne County, a difference that is easily justified in light of the fact that

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Allen Warshaw, Esquire
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Page 5

PACC and its principals must pay federal and state income tax on income earned.

Lastly, PACC would like to discuss with Mr. Friel the source of his information on the detention rates charged by surrounding counties as found in the chart on page 7 of his Revised Draft Audit. It has been our experience that Auditors disclose the sources for their information. Additionally, we would like to know whether the Department he performed a comparative analysis of the per diem rates paid for treatment in the counties offered as a comparison.

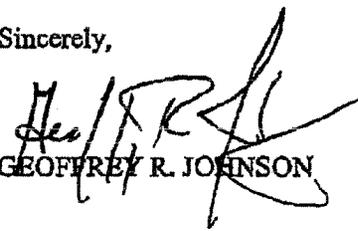
In closing, PACC believes that the time schedule proposed to continue discussions is fair and reasonable and we hope to meet with you at your earliest convenience.

In the event that the department is unwilling to meet, PACC will require additional time to prepare its response to the Revised Draft Audit Report. We would request an additional week from the October 27, 2007 deadline stated by Mr. Dallas, so that our written response would be due Monday, November 5, 2007.

Jonathan Vipond, counsel for PACC, joins in this request.

Thank you for your consideration.

Sincerely,



GEOFFREY R. JOHNSON

GRJ/mw
Encl.

cc: Jonathan Vipond, Esquire
Robert J. Powell, Esquire
Gregory R. Zappala, Esquire

| County | Per Diem Cost (\$20 per Staff) | Transportation Costs (.485 per mile) | Other Costs | Day 1 Total Cost | Day 2-5 Cost @ Per Diem | Day 6 Total Cost | Average Per Diem Cost | Annual Cost Per Bed | Annual Cost 24 Bed | LCJC Annual Cost 24 Bed @ 302 | Additional Cost to Luzerne Cty. |
|---------------|--------------------------------|--------------------------------------|-------------|------------------|-------------------------|------------------|-----------------------|---------------------|--------------------|-------------------------------|---------------------------------|
| Bucks | 408.85 | 46.84 | 30 | 685.69 | 1,635.40 | 685.69 | 601.13 | 182,912 | 4,389,888 | 2,645,520 | 1,744,368 |
| Dauphin | 328.66 | 61.40 | 30 | 610.06 | 1,314.64 | 610.06 | 422.46 | 154,190 | 3,700,750 | 2,645,520 | 1,055,230 |
| Montgomery | 278.70 | 46.30 | 30 | 657.00 | 1,114.80 | 657.00 | 371.47 | 135,505 | 3,254,037 | 2,645,520 | 608,517 |
| Westmoreland | 253.15 | 116.56 | 30 | 799.71 | 1,012.60 | 799.71 | 436.34 | 158,897 | 3,813,535 | 2,645,520 | 1,168,015 |
| York | 280.96 | 63.50 | 30 | 614.46 | 1,124.84 | 614.46 | 392.13 | 143,126 | 3,435,019 | 2,645,520 | 789,499 |
| Lancaster | 281.19 | 55.48 | 30 | 610.67 | 1,124.76 | 610.67 | 391.02 | 142,121 | 3,425,307 | 2,645,520 | 779,787 |
| CAYC | 219.30 | 75.08 | 30 | 594.38 | 877.20 | 594.38 | 346.99 | 124,482 | 2,907,096 | 2,645,520 | 341,576 |
| Allentown | 206.95 | 127.38 | 30 | 794.33 | 827.80 | 794.33 | 392.74 | 143,351 | 3,440,419 | 2,645,520 | 794,899 |
| Centre County | 215.00 | 64.39 | 30 | 549.39 | 860.00 | 549.39 | 326.46 | 119,159 | 2,859,815 | 2,645,520 | 214,295 |
| Delaware | 317.91 | 54.89 | 30 | 622.80 | 1,271.64 | 622.80 | 419.54 | 153,132 | 3,676,177 | 2,645,520 | 1,029,657 |
| Philadelphia | 361.94 | 55.04 | 30 | 686.98 | 1,447.76 | 686.98 | 463.62 | 169,221 | 4,081,305 | 2,645,520 | 1,435,785 |

LAW OFFICES
SPRAGUE & SPRAGUE

SUITE 400
THE WELLINGTON BUILDING
135 S. 19TH STREET
PHILADELPHIA, PENNSYLVANIA 19103-4912
(215) 561-7681
TELECOPIER: (215) 561-6913
E-MAIL: LAWFIRM@SPRAGUEANDSPRAGUE.COM
OF COUNSEL
FRANCIS J. CATANIA

NEW JERSEY OFFICE
76 EUCLID AVENUE
HADDONFIELD, NJ 08033
(856) 216-1212
FAX (856) 354-2322

†MANAGING ATTORNEY
FOR NEW JERSEY

RICHARD A. SPRAGUE *
THOMAS A. SPRAGUE **
GEOFFREY R. JOHNSON
CHARLES J. HARDY
JOSEPH R. PODRAZA, JR. *
THEODORE J. CHYLACK
STEPHEN R. KURENS *
MARK B. SHEPPARD
THOMAS E. GROSHENS
SHELDON L. ALBERT
LAWRENCE R. WOEHRLER *

* ALSO MEMBER NJ BAR
** ALSO MEMBER NY BAR

November 5, 2007

VIA E-MAIL AND FIRST CLASS MAIL

Allen Warshaw, Esquire
Chief Counsel
Pennsylvania Department of
Public Welfare
Health & Welfare Building, 3rd Floor West
Harrisburg, PA 17120

RE: Draft Audit of PA ChildCare, LLC

Dear Mr. Warshaw:

In response to your letter of October 26, 2007, implicitly denying PA ChildCare, LLC's request for a meeting and granting it only until November 5, 2007 to respond to the Revised Draft Audit, PA ChildCare, LLC responds as follows:

1. PA ChildCare, LLC incorporates herein its March 8, 2007 response to the prior Draft Audit, including all of the exhibits thereto, as though set forth fully herein.
2. PA ChildCare, LLC incorporates herein the facts and arguments stated in my letter to you, dated October 26, 2007, including the exhibit thereto, as though set forth fully herein.
3. PA ChildCare, LLC incorporates herein the information and calculations regarding PA ChildCare, LLC's 2003 administrative expenses communicated to you and Kevin Friel by PA ChildCare, LLC Chief Financial Officer Patrick Owens at our meeting of October 23, 2006.

Allen Warshaw, Esquire
Chief Counsel
November 5, 2007
Page 2

4. PA ChildCare, LLC submits confidentially and under seal the 2004 Audited Financial Statements of PA ChildCare, LLC which includes the audited administrative expenses for 2004. This audited financial statement directly contradicts the Department's Revised Draft Audit at page 1 ("Based on available data for calendar year 2004, PACC was projected to have a profit of \$1.9 million on revenues of \$5.6 million or 34 percent"), at page 6 ("This has allowed PACC to generate . . . a projected \$1.9 million profit for calendar year 2004"), and the "assumptions" in Exhibit A to the Revised Draft Audit. Further, the 2004 audited financial statement supports the propriety of PA ChildCare, LLC's administrative expenses for 2003 which were determined through the same methodologies.

5. PA ChildCare, LLC takes exception to the Department's refusal to provide additional time for PA ChildCare, LLC to obtain additional documentation from its auditors regarding the acknowledgment, acceptance and approval of the procedures for calculation of its administrative expenses for 2003. Those procedures were the same procedures utilized and accepted in PA Childcare, LLC's audited 2004 financial statements.

6. PA ChildCare, LLC takes exception to the arbitrary and capricious actions and decisions of the Department in (1) treating PA ChildCare, LLC differently than its competitor Northwestern Human Services, (2) failing to give PA ChildCare, LLC adequate and timely notice of its objections to the additional financial documentation submitted on March 8, 2007, and (3) failing to give PA ChildCare, LLC sufficient opportunity to provide additional information after the Department's notice of its objections.

7. PA ChildCare, LLC takes exception to the arbitrary and capricious actions and decisions of the Department in rejecting PA ChildCare, LLC proffered administrative expenses for 2003 on the putative basis that it could only accept "audited" results while at the same time basing its own conclusions on the Department's "assumptions" about PA ChildCare, LLC's 2004 financials. Additionally, PA Childcare, LLC takes exception to the arbitrary and capricious actions and decisions of the Department in speculating as to PA ChildCare, LLC's 2004 financial results despite having never requested PA ChildCare, LLC to provide audited financials for 2004.

8. PA ChildCare, LLC takes exception to the arbitrary and capricious actions and decisions of the Department in using its audit to attempt to force PA ChildCare, LLC, a privately-held, for-profit corporation to sell its facility to Luzerne County.

9. PA ChildCare, LLC further wishes to supplement the record with the fact that the Department rejected a proposed agreement between PA ChildCare, LLC and Luzerne County to (1) amend the lease to an eight year term effective 1/1/08 to 12/31/15, thereby removing any question as to the whether the lease is a capital lease, (2) reduce by 12% the annual current gross

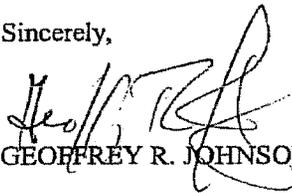
SPRAGUE & SPRAGUE

Allen Warshaw, Esquire
Chief Counsel
November 5, 2007
Page 3

rent, and (3) work in good faith toward a sale in the short term of the facility utilizing the existing lease provision at Section 34 of the lease which specifically relates to County purchases of real estate.

I would appreciate your making this additional information available to Mr. Friel for inclusion in his audit. Thank you for your attention to this matter.

Sincerely,



Handwritten signature of Geoffrey R. Johnson in black ink, appearing as a stylized cursive script.

GEORFREY R. JOHNSON

GRJ/mw
Encl. (Confidential and Under Seal)

cc: Jonathan Vipond, Esquire (via e-mail and first class mail)
Robert J. Powell, Esquire (via e-mail and first class mail)
Gregory R. Zappala, Esquire (via e-mail and first class mail)