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Report to the Chairman, Subcommittee on Environment, Energy, and Natural Resources, Committee on Government Operations, House of Representatives

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COST ACCOUNTING

Department of Energy's Management of Contractor Pension and Health Benefit Costs

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United States
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Accounting and Financial
Management Division

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August 29, 1990

The Honorable Mike Synar
Chairman, Subcommittee on
Environment, Energy, and
Natural Resources
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

The Department of Energy (DOE) is currently contracting with approximately 50 management and operating (M&O) contractors who operate DOE sites throughout the country. The Department fully reimburses all allowable costs incurred under these contracts. Allowable costs include those for pension and health benefits of approximately 130,000 contractor employees.

In light of concerns raised by a June 1987 report by the DOE Office of Inspector General (OIG), you requested that we review certain policies and practices of DOE and its contractors with regard to pension and retiree health plans. As agreed with representatives of your office, we reviewed (1) the funding of contractors' pension plans, (2) methods of segregating the pension cost of DOE work from that of other contractor work, (3) the payment of postcontract pension and retiree health benefit costs, and (4) DOE's management and audit of contractors' pension plans.

Results in Brief

We found that DOE has actively developed departmental policies on pensions and retiree health benefits to take advantage of the nature of M&O contracts. Nevertheless, we found that DOE is lacking formal policy in important areas. Presently, DOE has no policy on the level to which contractors should fund their pension plans. As a result, they are probably funded to a higher level than would otherwise be the case. Nor does DOE have adequate policy on settling its liability for pension costs and retiree health benefits when contracts expire.

Finally, the annual financial audits of the contractors' site-specific pension plans we reviewed were limited in scope and resulted in disclaimers of opinion. Thus, they limited DOE's management oversight and control over pension plan assets.

Background

Management and operating contractors' private sector pension plans are generally covered by the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code (IRC). These laws incorporate reporting requirements and set guidelines on minimum required contributions and maximum deductible contributions.

DOE's policy does not permit contractors to simply include their DOE site employees in companywide pension plans. Rather, the policy is to negotiate contractual requirements for site-specific plans or separate accounts. The purpose of these arrangements is to segregate the pension cost attributable to DOE work from that attributable to other work. One result of site-specific plans or separate accounts is that the total pension cost of employees who transfer to and from other contractor locations must be allocated by some method between the two locations.

When a contract is allowed to expire and a contractor leaves a DOE site, the workforce generally transfers to the successor contractor. Retired workers, however, sometimes remain with the former contractor. When that occurs, the parties must agree on how the contractor will be compensated for the health benefit and pension costs that the contractor will pay out in the future. This agreement can involve negotiations over difficult issues, such as the rate at which retiree medical costs will rise and the extent to which the contractor will increase pension benefits in response to future inflation.

DOE's primary control over a contractor's pension program is divided between two organizations: the field office responsible for monitoring the contractor and the headquarters Office of Industrial Relations (OIR). The field office is responsible for the award and administration of contracts. Field office managers have line responsibility and report directly to either the Under Secretary or to the Assistant Secretary for Nuclear Energy. OIR is responsible for establishing departmental policies on contractors' pension plans. In addition, DOE's OIG is responsible for auditing all aspects of the contractors' DOE operations. Additional background material is presented in appendix I.

Objectives, Scope, and Methodology

Our objectives were to examine the (1) funding of contractors' pension plans, (2) segregation of the pension cost of DOE work from that of other contractor work, (3) payment of postcontract pension and retiree health benefit costs, and (4) management and audit of contractors' pension plans.

To study funding of the plans, we interviewed DOE personnel at headquarters and in field offices, contractor personnel, and representatives of the DOE OIG. We also reviewed annual reports on contractors' pension plans (actuarial reports and reports to the Internal Revenue Service (IRS)) to determine the level to which plans were funded at the latest time for which information was available.

To ascertain how pension cost attributable to DOE work is segregated, we reviewed DOE's policies and practices requiring contractors to set up site-specific plans or separate accounts. We also reviewed the actual establishment of a site-specific plan at a DOE site.

To evaluate pension and health benefits paid out after contracts expire, we reviewed in detail a settlement that DOE negotiated with one contractor at contract expiration. We also reviewed DOE's policies regarding reimbursement of such costs.

To assess how DOE manages and audits contractors' pension programs, we reviewed management's written policies and identified the principal DOE organizational units, at headquarters and in the field, that develop and implement that policy. We reviewed DOE OIG audit reports on contractors' pension costs and reports by independent public accountants (IPAS) on pension plan financial statements. We also conducted interviews with DOE representatives in headquarters and in the field and with representatives of the DOE OIG.

Our review was conducted in accordance with generally accepted government auditing standards. Our work was done at DOE headquarters, where we dealt mainly with the OIR, and at seven DOE field offices and management and operating contractor sites. (Appendix II contains a more detailed discussion of our objectives, scope, and methodology.)

DOE Has Not Established a Funding Policy

DOE's contractors can make annual contributions in amounts between the minimum and maximum guidelines set by ERISA and the Internal Revenue Code. DOE presently sets no additional limits on the size of contractors' contributions to their pension plans. Thus, contractors are allowed to decide—within ERISA and Internal Revenue Code guidelines—how much of DOE's resources are invested in contractors' pension plans. As a result of a June 1987 OIG recommendation, DOE has proposed for comment a formal funding policy. At present, however, DOE is evaluating responses to the proposed policy.

We reviewed the OIG's June 1987 report in which it was reported that 20 contractors had—as of the beginning of fiscal year 1983—pension assets of $2 billion—about $600 million above the present value of accrued benefits. The report also stated that the contractors' total 1983 contributions of $222 million exceeded the minimum required by ERISA by $94 million.

During the course of our review, we compared plan assets and liabilities using more current data. We made two comparisons commonly used by actuaries in annual pension reports. In the first test, we examined eight plans operated by five contractors.[1] We compared the market value of assets with the present value of accrued benefits. We found that seven of the eight contractor pension plans had more assets than the present value of accrued benefits. The ratio of assets to the present value of accrued benefits ranged from 95 to 208 percent. Only one plan had a funded ratio less than 100 percent. Appendix III presents the complete results of this first test.

In our second test, we compared the actuarial value of plan assets and actuarial liabilities for seven of the eight plans mentioned above. The actuarial value of plan assets is a value produced by any of a variety of methods designed to smooth out short-run changes in the fair market values of plan assets. The actuarial liability is usually based on projected benefits, which are calculated assuming that participant service and pay increases will continue until an assumed retirement age. In four cases, plan assets exceeded actuarial liabilities; in the other three cases, plan assets were less than actuarial liabilities. Funded ratios varied from 83 to 157 percent.[2]

In the absence of a funding policy, DOE has not systematically determined how much of its resources to allocate to contractors' pension plans rather than to other programs. The resources allocated to contractors' pension plans are substantial and sometimes in excess of plan liabilities. Sandia's pension plans, for example, had assets of

[1]There were eight plans for five contractors because some contractors had separate plans for different classes of employees (for example, one plan for hourly-paid employees and one for salaried employees).

[2]Because of the complexity involved, we did not attempt to determine how much of the excess of plan assets over plan liabilities was caused by contributions above what would have been permitted had the proposed funding policy been in place. We acknowledge that some of the excess of plan assets over plan liabilities was caused by investment earnings greater than those that had been expected. A DOE actuary, however, confirmed our conclusion that plans' funded ratios would have been less had a funding policy been in place.

approximately $1 billion (at market value) as of January 1, 1988 (the latest date for which information was available). Plan assets were about 180 percent of the present value of accrued benefits and about 125 percent of the plans' actuarial liabilities. If DOE had played more of a role in determining contributions to these plans, it might have decided not to fund to such a level and could have used the resources for other purposes. Investments of DOE resources in such plans, however, do benefit the Department in that they earn market returns, which serve to reduce future plan contributions.

There may be potential problems associated with pension plans that are funded above plan liabilities. First, funding above plan liabilities may distort the pattern of pension costs charged to contractor programs, such as nuclear research, over the years. In earlier years, programs are overcharged. In later years, when no contributions are made, because plans have reached or exceeded the maximum tax-deductible level of funding, programs are undercharged.

Second, as noted in pension literature,[3] the fact that pension plans are funded above plan liabilities may invite participant pressure for benefit increases. When a plan is well funded, benefit increases appear to be more affordable because they can be financed—at least partially—from existing funds rather than from increased future contributions.

Third, funding levels higher than liabilities encourage the use of pension funds to finance health care costs, which, unlike pensions, have not been prefunded. Our review revealed a case in which Martin Marietta proposed using any excess funds in its site-specific pension plan to pay retiree health benefits in the event the contract was terminated with no successor contractor. A DOE official told us that DOE turned down Martin Marietta's proposal because it would have encouraged the contractor to fund its pension plan at a level higher than liabilities.

[3]See Dan M. McGill, Fundamentals of Private Pensions, 5th edition (Homewood, Illinois Richard D. Irwin, 1984), p. 370.

DOE Segregates Contractors' Pension Costs in One of Two Ways

DOE has an interest in ensuring that it reimburses contractors only for those benefits earned by contractor employees at DOE sites and not for the benefits earned by contractor employees at contractors' commercial operations. Otherwise, government funds might be subsidizing contractors' commercial operations.

DOE Order 3830.1, dated August 23, 1982, states that contracts should provide for site-specific plans or "separate accounting." In the event of contract expiration, these arrangements provide for the disposition of plan assets and liabilities.

We reviewed the characteristics of site-specific plans and separate accounting. Both are designed to ensure that assets attributable to DOE contributions are used to pay only the benefits earned on DOE contracts. Site-specific plans achieve this objective by legally segregating plan assets in a pension plan separate from the contractor's other plans. Site-specific plans also usually have separate brochures explaining benefits; separate actuarial reports of contributions, assets, and liabilities; and separate annual reports of financial and other information to the IRS and the Department of Labor.

Separate accounting differs in two significant ways from a site-specific plan. First, site employees continue as participants in the corporate plan. Second, assets are not legally segregated from those of the corporate plan. The contractor simply keeps a memorandum account of the assets attributable to DOE contributions. Since assets are not legally segregated from those of the corporate plan, a special contract clause governs refunds to the Department in the event the contract expires or the plan is terminated. The clause requires the contractor to use corporate funds to refund the net assets attributable to DOE contributions if such refunds cannot be made from the pension fund. Such refunds from pension funds may be prohibited by ERISA if the plan is funded below a certain point on an overall basis.

Of the seven sites we reviewed, five had site-specific plans. At one site, General Electric/Knolls, DOE was negotiating a site-specific plan during the course of our review. At another site, Westinghouse/Bettis, DOE completed negotiations of separate accounting shortly after the close of our review.

DOE's goal in segregating pension costs attributable to its contracts appears to be sound. Legal segregation of plan assets from the assets of

other contractor plans ensures that they will be available to pay benefits earned on DOE contracts. In addition, pension costs and obligations are computed separately for each site-specific plan. Consequently, a separate plan for a DOE site helps ensure that pension cost reflects the age, length of service, and other characteristics of DOE contract employees and that actuarial assumptions reflect expected conditions at the DOE site.

Separate accounting has not been tested in a contract expiration. Consequently, we were unable to determine whether the special contract clause will work as well as legal segregation of assets, a characteristic of site-specific plans. Appendix IV presents further details of establishing both site-specific plans and separate accounting.

DOE Does Not Follow Its Policy on Employee Transfers

Once a site-specific plan or a separate account has been established, the total pension cost of an employee who transfers between the site plan and another contractor plan must be allocated between the two plans. Employee transfers can involve significant amounts. At one location, General Electric/Knolls, data were available that enabled us to compute the cumulative value of the pensions earned by employees who transferred over a 10-year period, 1976-1985. The cumulative value, at the end of that 10-year period, attributable to employees who transferred from General Electric's DOE facility to other contractor locations was about $9 million. The cumulative value attributable to employees who transferred from other contractor locations to General Electric's DOE facility was about $12 million.

DOE's pension order requires that an employee who transfers between plans receive a payment from each plan.[4] We found, however, that contractors were, with the approval of DOE, using another approach. Four of the seven contractors we reviewed transferred the liability for an employee's pension earned to date from the former plan to the employee's new plan. To offset the liability, an equal amount of assets was also transferred from the former plan to the new plan. This was true at Martin Marietta, General Electric/Knolls, Sandia, and Monsanto. OIR told us it now believes that transferring assets is preferable to a two-check policy. OIR also said it did not want to be limited by a policy because it wanted to negotiate transfers with contractors on a case-by-

[4]In practice, one plan may issue checks in the full amount of an employee's pension and be partially reimbursed by the other plan.

case basis. DOE's most recent draft of the order is silent on the issue of employee transfers.

DOE Policy Does Not Address All Postcontract Cost Issues

During contract performance, DOE's policy is to reimburse management and operating contractors on a pay-as-you-go basis for the cost of retiree health benefits and for any pension ad hoc cost-of-living adjustments (COLAS).[5] As a result, these costs generally are not funded or accrued over employees' working lives; rather, they are recognized and paid after retirement. Thus, when contracts expire, contractors have not yet been compensated for the cost of retiree health benefits and for any pension ad hoc COLAS that will be paid out in the future.

DOE's formal policy is to pay for a contractor's postcontract retiree health benefits if it has approved the plan in advance. DOE has also agreed to pay for postcontract ad hoc COLAS when it believes they are warranted, even though DOE's pension order is silent on the subject. For example, when Monsanto's contract to operate the Mound facility expired in 1988, DOE negotiated a lump sum settlement of $13.5 million for postcontract ad hoc COLAS. Before agreeing to that settlement, DOE advised us that it had satisfied itself that the contractor had a consistent record of granting ad hoc COLAS to its non-DOE retirees.

When contracts expire, DOE has three possible approaches to pay for postcontract retiree costs:

- agree with the contractor on a lump-sum settlement,
- continue to reimburse the contractor for costs on a pay-as-you-go basis, or
- transfer retirees to the successor contractor.

In one instance, DOE has agreed to a lump-sum settlement with a contractor. When DOE's Mound facility contract with Monsanto expired in September 1988, DOE negotiated lump-sum settlements of $40 million to cover retiree health benefits and $13.5 million to cover ad hoc COLAS. DOE has not used the second alternative—continued reimbursement on a pay-as-you-go basis—in recent years. It is an option, however, that DOE has agreed to in several contracts. The third alternative—transferring

[5]Ad hoc COLAs, which many companies grant from time to time to help compensate retirees for the rising cost of living, differ from COLAs that are automatically provided under the terms of a few pension plans.

retirees—was used when Martin Marietta succeeded Union Carbide at Oak Ridge in 1984.

DOE's formal policy on health benefits, DOE Order 3890.1, Contractor Insurance and Other Health Benefits Programs, provides that DOE will pay for postcontract retiree health costs and that it will do so by any reasonable method. It states, in paragraph 5.i. of chapter II, "Subsequent to contract termination or expiration, benefit continuation will be provided for those who earned such benefits, according to the approved benefit plans, on a funding basis most reasonable to the Department. Among acceptable arrangements for these provisions are paying a sum to the outgoing contractor to continue its liability, paying a third party such as an insurer, to guarantee benefit payments, or continuing the benefit payment obligation with the replacement contractor." A DOE official told us that no additional policy exists in other forms such as memoranda.

While DOE's present formal policy on contractors' pension programs (Order 3830.1, August 23, 1982) discusses the settlement of DOE's pension obligations when contracts expire, it is silent with respect to ad hoc COLAS. We were told that DOE's revised order, which is currently in process, will also likely be silent on postcontract ad hoc COLAS. Instead of having a formal policy, DOE prefers to address postcontract ad hoc COLAS on a case-by-case basis as they are claimed by contractors when contracts expire.

The contractual arrangements between DOE and the seven contractors we reviewed varied in their treatment of postcontract retiree costs in the event of contract expiration and replacement by a successor contractor. Du Pont's, Monsanto's, and General Electric/Knolls' contracts allow for settlements in terms of lump sums or, in the alternative, pay-as-you-go reimbursement. Two contracts, Martin Marietta's and Westinghouse/Hanford's, allow for transferring retirees to successor contractors. In the case of Westinghouse/Bettis and Sandia, contracts are silent with respect to postcontract retiree costs, and the treatment of these costs will be decided by the parties when the contracts expire.

DOE operates with the philosophy that it will reimburse contractors for the cost of all employee benefits earned under the contract, regardless of whether such benefits are paid during or after contract performance. Determining whether DOE should pay for postcontract retiree costs was not within the scope of our review. To gain a broader perspective of this

issue, we did, however, inquire of the Defense Contract Audit Agency,[6] as to how it had handled similar situations. The results of our inquiry and a brief analysis of the treatment of postcontract costs at an Army munitions plant are contained in appendix V.

In one case—the 1988 expiration of Monsanto's contract to operate the Mound facility—DOE has chosen the lump-sum payment approach for settling the liability it has assumed for postcontract retiree costs. Such lump-sum settlements for health benefits represent a potential risk for contractors because of uncertainties in estimating retirees' medical costs over the years when their claims will be paid. Because of the uncertainties, none of the approximately 10 insurance companies that DOE approached during its Monsanto negotiations expressed a willingness to provide such coverage in return for a single premium. The uncertainties involved in estimating a lump sum also pose difficulties for DOE in determining whether a given lump sum is a reasonable price to pay for having a contractor assume these liabilities.

Lump sums are estimates of the present value of the future benefits that will be paid out for retirees' health care. Certain difficulties arise when contractors make and DOE evaluates such estimates. Among these are the following:

- An assumption must be made as to the rate at which the retirees' health care costs will increase over the years during which the claims will be paid out. This assumption reflects such factors as medical care inflation, health care utilization, technological advances, and changes in the health status of the retirees and their covered dependents.
- Difficulties arise in reflecting future plan changes in calculations of lump sums. DOE is faced with the uncertainty of the contractor's future plan changes to contain escalating health care costs. Cost-cutting measures likely to affect retirees are increases in deductibles, co-payments, and/or premium contributions.[7] If the contractor pursues such cost-cutting measures in the future, DOE would not benefit from the ensuing cost savings.

Estimating lump sums for ad hoc COLAs presents even more uncertainty because the COLAs, by definition, may or may not be granted. If DOE

[6]The Defense Contract Audit Agency performs contract auditing for the Department of Defense.

[7]In a 1988 survey, Retiree Medical Benefits, The Washington Group on Health found that 69 percent of the 95 firms surveyed made these changes in the last 2 years prior to the survey or planned to make them within the next 2 years.

decides, based on a contractor's history, that they will be granted, DOE estimates the rise in the cost of living and the contractor's benefit increases in response to that rise. For example, a DOE official told us that the $13.5 million lump-sum settlement with Monsanto was based on an estimate that Monsanto would increase benefits annually by 3 percent. Since the 1960s, Monsanto has granted ad hoc COLAs that compensated retirees for about 40 percent of the increase in the Consumer Price Index. Estimating a 5-percent annual growth in the index, the Department attempted to negotiate a 2-percent annual increase in benefits. Because of trade-offs in other aspects of the negotiations closing out the contract, DOE agreed to a 3-percent annual increase in benefits.

DOE Management and Audit of Pension Plans Could Be Enhanced

Management of Contractors' Plans

DOE's management responsibility for M&O contractors' pension plans is divided between two organizations: DOE field offices that are responsible for the award and administration of contracts and OIR in headquarters.

Field office managers have line responsibility. They report to either the Under Secretary for Operations Offices or to the Assistant Secretary for Nuclear Energy. Field office managers are delegated the authority to serve as contracting officers, that is, those DOE representatives with legal authority to enter into binding contracts on behalf of the Department. Field office managers typically have an Industrial Relations staff, including a person who is responsible for reviewing pension reports received from the contractor and dealing with the contractor with respect to pension issues. That person, however, is not an actuary.

OIR in headquarters, on the other hand, is responsible for establishing departmental policies and procedures on contractors' pension programs. It derives its authority from DOE directives that require, for example, OIR approval of changes to contractual language governing pension plans. The OIR has two actuaries, who provide technical advice to field offices, review contractors' pension reports passed on to them from field offices, and assist in the negotiation of pension liabilities when contracts expire. The OIR is also responsible for improving policy. For example, it is currently rewriting the DOE pension order, which will, among other things,

set forth the new funding policy discussed earlier. The OIR is also responsible for implementing change to comply with DOE's pension policies. Establishing site-specific plans or separate accounting is an important example.

Establishing a site-specific plan or separate accounting illustrates the roles of field offices and the OIR. In both the cases we reviewed (General Electric/Knolls and Westinghouse/Bettis), the OIR notified the respective field office managers that current arrangements did not comply with DOE policy. This notification was timed to enable the field officer manager, in his or her role as contracting officer, to include pension issues in upcoming negotiations accompanying contract renewal. The contracting officer then negotiated new contractual language with the advice and approval of the OIR.

We observed that implementing change to contractual agreements is a time-consuming process. Among the delays we noted were the following:

- Negotiations for a site-specific plan at General Electric/Knolls began in April 1982. At the close of our review in December 1989, the value of the pensions owed to retirees still had not been negotiated. Over 7 years had elapsed.
- In December 1984, OIR told the responsible field office that current pension arrangements at Westinghouse/Bettis did not comply with DOE policy. The initial amount of assets assigned to the separate account was negotiated in January 1990. Five years had elapsed.
- In June 1987, the OIG recommended that DOE limit annual contributions to the minimum required by ERISA except in "extraordinary circumstances." In January 1988, the Department reached agreement with the OIG on a new funding policy. At the close of our review 2 years later, such an order had not been issued by DOE.

We also observed two instances of delay in resolving other issues. It took the OIR 21 months to approve new multiple employer plans at the Hanford site, and more than 3 years had elapsed before DOE was able to negotiate contractual language with Martin Marietta governing contract terminations.

Undue delay in resolving issues being negotiated increases the risk that the problem that the negotiations were intended to prevent will occur. For example, the longer the delay in negotiating a site-specific plan, the greater the risk that the contractor will allow its contract to expire without such a plan.

Audit Coverage

Management and operating contractors' pension programs receive audit coverage in two ways. First, the OIG is responsible for auditing contractors' pension programs as part of its review of contractors' operations and costs. The OIG performs this task by means of audits that specifically deal with pension issues and by annual audits designed to test the reliability of contractors' cost representations. Appendix VI discusses the OIG's audit coverage of contractors' pension cost.

Private sector pension plans, such as those operated by the contractors we reviewed, are generally subject to annual financial audits by IPAS. Financial statements, including the auditor's report, usually become part of the annual report filed with the IRS. The IRS then provides a copy to the Department of Labor.

ERISA allows plan administrators[8] to exclude assets that are held by regulated financial institutions, such as banks and insurance companies, from the scope of IPA audits. Instead of examining the financial institution's records, the auditor can, by regulation, accept the institution's certification that the statement of assets received by the plan is accurate. As a result, significant amounts of plan assets are not audited by plan auditors. The Department of Labor's Inspector General recently found that nearly half the IPA audits it reviewed had such a scope limitation.[9]

We found that all seven of the audits performed on site-specific plans resulted in disclaimers of opinion because of such scope limitations.[10]

The Department of Labor has proposed amending ERISA to repeal the limited scope exemption. Although we have not evaluated the specific

[8]The plan administrator is generally either the plan sponsor or a designated person or committee charged with responsibility for operating all aspects of the plan, including the management of its assets.

[9]Changes Are Needed in the ERISA Audit Process to Increase Protections for Employee Benefit Plan Participants, Report No. 09-90-001-12-001 (Nov. 9, 1989).

[10]The other two site-specific plans were those of General Electric/Knolls and Du Pont. The new site-specific plan at General Electric/Knolls had not prepared a separate annual report as of the close of our review in December 1989. Du Pont's Savannah River employees were participants in Du Pont's companywide plan. At the outset of the contract in 1950, the government and Du Pont entered into a special arrangement covering the funding and reimbursement of pension cost attributable to those employees. We were told by a Du Pont official that because DOE guarantees that the benefits of those employees will be paid, Du Pont excludes plan assets and liabilities attributable to Savannah River employees from its annual report. Consequently, no financial audit was performed of the Savannah River portion of the Du Pont pension plan.

details of the proposal, we agree that full-scope audits should be required for employee benefit plans.[11]

Neither DOE's pension policy nor DOE contracts address the issue of plan financial audits. As a result, decisions on audit scope are made solely by contractors, in their capacity as plan administrators, even though DOE reimburses all contributions to a plan and plan assets will be used to pay benefits earned on DOE contracts.

Conclusions

DOE has not systematically determined how much of its resources to allocate to contractors' pension plans. In these times of budgetary constraints, it would serve DOE well to have more input into these decisions. In addition, the lack of a funding policy increases the likelihood that contractors' pension plans will be funded at levels higher than liabilities because there is no DOE cap on contractor contributions.

DOE's failure to follow its policy with respect to employee transfers detracts from the policy's overall credibility. Seeing an aspect of policy simply disregarded by OIR—the headquarters group responsible for formulating pension policy—could reduce the importance of adhering to other aspects of the policy in the eyes of DOE field office personnel and contractors.

DOE has only limited policy on postcontract retiree health benefits and no policy on postcontract ad hoc COLAS. Policy does not set forth criteria for determining whether a proposed lump sum represents a reasonable price to pay in return for a contractor assuming liability for postcontract retiree health benefits or ad hoc COLAS.

DOE has limited oversight control over pension fund assets because of scope limitations on audits conducted by independent IPAS. Neither DOE's pension policy nor DOE contracts address the issue of plan financial audits. Decisions on limited-scope audits are made solely by contractors even when DOE reimburses all contributions to a plan and plan assets will be used to pay benefits earned on DOE contracts. In view of the large amounts of plan assets, full-scope audits are worthwhile to provide DOE greater assurance that its financial interests in those assets are being protected.

[11] Federal Government's Oversight of Pension and Welfare Plans (GAO/T-HRD-90-37, June 13, 1990).

Recommendations

We recommend that the Secretary of Energy direct the Office of Industrial Relations to

- Ensure that the revised DOE pension order includes a formal funding policy, encourages plan administrators to choose full-scope audits of site-specific pension plans, and addresses issues related to employee transfers and postcontract ad hoc COLAS.
- Develop additional policy and procedures on settling postcontract retiree health benefits which set forth the criteria for deciding at contract expiration which approach—lump-sum settlement, continued pay-as-you-go reimbursement, or transfer of employees to the successor contractor—should be used.
- Evaluate the resolution process for pension issues and accelerate the resolution of those that are long-standing.

As agreed with your office, we did not obtain written comments on a draft of this report. However, we did discuss its contents with responsible agency officials and incorporated their views where appropriate.

We are sending copies of the report to the Secretary of Energy, the Director of the Office of Management and Budget, the Inspector General of the Department of Energy, and other interested parties. Copies will also be made available to others upon request.

Please contact me at (202) 275-9489 if you or your staff have any questions regarding the contents of this report. Major contributors to this report are listed in appendix VII.

Sincerely yours,

Rein Abel
Director, Cost and
Regulatory Accounting

Contents

Section	Page
Letter	1
Appendix I Background Information	18
Appendix II Additional Details on Our Objectives, Scope, and Methodology	20
Appendix III Ratio of Plan Assets to Present Value of Accrued Benefits	24
Appendix IV Setting Up a Site-Specific Plan or Separate Accounting	25
Appendix V Differing Positions on Paying for Postcontract Costs	26
Appendix VI DOE OIG Audit Coverage of Contractors' Pension Costs	28

Appendix VII
Major Contributors to This Report 29

Abbreviations

AICPA	American Institute of Certified Public Accountants
COLA	cost-of-living adjustment
DCAA	Defense Contract Audit Agency
DOD	Department of Defense
DOE	Department of Energy
ERISA	Employee Retirement Income Security Act
IPA	Independent Public Accountant
IRC	Internal Revenue Code
IRS	Internal Revenue Service
M&O	management and operating
OIG	Office of Inspector General
OIR	Office of Industrial Relations
PVAB	present value of accrued benefits

Background Information

The Department of Energy, which is responsible for the government's atomic energy defense activities and other energy programs, accomplishes much of its mission by contracting with over 50 management and operating contractors. These contractors operate DOE sites under cost-reimbursable[1] contracts. They employ about 130,000 employees.

The concept underlying management and operating contracts was developed by the Army's Manhattan Engineer District, a forerunner of DOE. During World War II, the District contracted with major industrial companies and research institutions to develop government-owned facilities for the development and production of the atomic bomb. The idea was to engage private enterprise as a partner in accomplishing a federal mission.

Today, management and operating contractors operate, for example, facilities that research, develop, and test nuclear weapons; produce nuclear materials and weapons; and provide repositories for radioactive wastes. They also design naval nuclear reactors, run the Strategic Petroleum Reserve and the naval petroleum reserves, and perform basic physics research.

Management and operating contracts generally have the following characteristics:

- The contractors use DOE-owned facilities.
- Contractors perform work that is separate from the remainder of their business.
- DOE agrees to pay the contractors' allowable costs and usually a fee. Allowable costs include pension and health care costs.
- Contracts usually are extended for long periods. Many contractors that began operations in the 1940s or early 1950s are either still working for DOE or have recently left.
- When the contracts expire, current workers generally stay on the job and transfer to the successor contractor. For workers retired from the site, however, DOE and the contractor must agree on how health benefits and cost-of-living pension adjustments will be paid in the future.

The contractors included in our review have defined benefit pension plans, under which they promise to pay specified benefits, such as a

[1]Management and operating contractors pay for allowable costs from funds advanced to them by DOE. Technically, therefore, DOE is not "reimbursing" costs paid out of contractor funds. To avoid the awkwardness of having to explain that, when we refer to contract costs being paid for by DOE, we use the terms "reimbursable" and "reimbursement."

percentage of the final average pay for each year of service. Such plans are generally covered by the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code, which include minimum funding and other requirements. For instance, the assets accumulated to pay a plan's benefits must be legally separated from the contractor's other assets.

Additional Details on Our Objectives, Scope, and Methodology

The objective of our work was to assess DOE's management of its management and operating contractors' pension programs. In response to the Subcommittee's request, as modified in meetings with Subcommittee staff, we addressed four issues:

- Funding. Our specific objectives were to examine DOE's funding policy for contractors' pension plans and to determine funding levels for those plans.
- DOE's segregation of contractors' pension cost attributable to its contracts from that attributable to contractors' other work. In this area, we wanted to examine how DOE ensures that the cost of pension benefits earned on DOE work is segregated from the cost of pension benefits earned at other contractor locations.
- DOE's payment of postcontract pension and health benefit costs. Our objective was to evaluate how DOE reimburses contractors for health and pension benefits paid out after contracts expire.
- DOE's methods of managing and auditing contractors' pension programs. Here we wanted to assess how DOE oversees and audits contractors' pension programs.

Our work was done at DOE headquarters, where we dealt mainly with OIR, and at selected DOE field offices and management and operating contractor sites. Factors affecting the selection of field offices and contractors were the size of the contractor's pension plan, geographical location, and the presence of issues of interest to the Subcommittee.

Of a total of approximately 50 management and operating contractors, we reviewed the following 7 contractors and their field offices:

- Martin Marietta Energy Systems, Inc., in Oak Ridge, Tennessee, operates several facilities in Oak Ridge. The cognizant DOE field office is the Oak Ridge Operations Office. Martin Marietta was selected partly because we wanted to review the process by which it had replaced Union Carbide, whose contract had expired in 1984.
- E.I. du Pont de Nemours and Company operated the Savannah River Plant near Aiken, South Carolina, through March 31, 1989. DOE's Savannah River Operations Office is responsible for the plant. We selected Du Pont partly because of the contract expiration issue.
- General Electric Company operates the Knolls Atomic Power Laboratory near Schenectady, New York. DOE's Schenectady Naval Reactors Office oversees the laboratory. We selected General Electric/Knolls partly because it was in the process of establishing a site-specific plan.

- Westinghouse Electric Corporation operates the Bettis Atomic Power Laboratory near Pittsburgh. The DOE Pittsburgh Naval Reactors Office is responsible for the laboratory.
- Sandia Corporation, an AT&T subsidiary, operates the Sandia National Laboratories in Albuquerque, which is overseen by DOE's Albuquerque Operations Office.
- Monsanto Research Corporation operated the Mound facility in Miamisburg, Ohio, until September 1988. Monsanto was replaced by EG&G Inc., which formed a wholly-owned subsidiary to run the Mound facility. DOE's Albuquerque Operations Office and Dayton Area Office have oversight responsibilities. We selected Monsanto/Mound partly because we wanted to review the settlement made at contract expiration for retiree health benefits and ad hoc COLAS.
- Westinghouse Hanford Company is responsible for certain activities at the Hanford site near Richland, Washington. The DOE field office is the Richland Operations Office.

Funding Issues

To study funding issues, we interviewed DOE personnel at headquarters and in field offices, contractor personnel, and representatives of the DOE OIG. We also reviewed annual reports on contractors' pension plans (actuarial reports and reports to IRS) to determine the level to which plans were funded at the latest time for which information was available. To test plans' funded status, we extracted information for two tests commonly used by plan actuaries in annual pension reports. For one test, we compared the market value of assets with the present value of accrued benefits.[1] For the other test, we compared the actuarial value of assets with the plan's actuarial liability.[2] We also identified some of the potential problems of funding plans above plan liabilities.

Cost Segregation

To ascertain how pension cost attributable to DOE work is segregated, we reviewed DOE's policies and practices dealing with commingled pension cost. Commingled pension cost is a problem when contractors—like DOE's M&O contractors—have one division doing government work and other divisions doing commercial work. The contracting agency must

[1] The present value of accrued benefits is a liability measure based on participants' current years of service and earnings.

[2] The actuarial value of assets is any asset measure that is designed to stabilize the market value of assets for actuarial purposes, for example, a moving average of year-end market values for the past several years. For most methods used to calculate plan costs and obligations, the actuarial liability is based on projected benefits, which are calculated assuming that participant service and pay increases will continue until an assumed retirement age.

ensure that the pension cost generated by its work is adequately segregated from the pension cost generated by commercial work.

We also reviewed the establishment of a site-specific plan at General Electric/Knolls, which DOE had sought in order to achieve more accurate cost segregation. We interviewed contractor personnel and DOE headquarters and field personnel. We reviewed correspondence between the company and DOE to identify the issues that arose and how they were resolved. We reviewed the contractual provisions dealing with the new plan that the parties had agreed to. We also examined a statistical sample of personnel records to find out the extent to which retirees had worked at General Electric locations other than the Knolls site. (The extent of non-Knolls service performed by retirees was a factor in determining the amount of compensation General Electric should receive in assuming liability for these retirees.)

Postcontract Costs

To evaluate how pension and health benefits are reimbursed after contracts expire, we reviewed DOE's policies and practices dealing with costs that continue after contracts expire. The principal continuing costs relate to retired workers since active workers generally transfer to the successor contractor. The principal costs involved are pension benefits and health care costs that will be paid out after contract expiration. We reviewed DOE's settlement with Monsanto in which it agreed to pay Monsanto $40 million for health benefits and $51.5 million for pension benefits that will be paid out in the future. Of the $51.5 million in pension benefits, $13.5 million was for future ad hoc cost-of-living adjustments. We interviewed contractor and DOE headquarters and field personnel. We reviewed the contract between DOE and Monsanto to determine what the parties had agreed to with respect to postcontract costs. We also reviewed correspondence between DOE and Monsanto to identify issues and to determine how they were resolved. We reviewed the calculation of the $40 million lump sum and the factors on which it was based. We also identified alternatives other than lump-sum settlements that are available for settling postcontract costs. We reviewed the use of one such alternative—transferring retirees to the successor contractor—at Martin Marietta/Oak Ridge.

Management and Audit

To assess how DOE manages and audits contractors' pension programs, we reviewed management's written policies and identified the principal DOE organizational units, at headquarters and in the field, that develop

and implement that policy. We also conducted interviews with DOE representatives in headquarters and in the field and with representatives of the DOE OIG. We identified the types of audit coverage to which contractors' pension programs are subject. We reviewed audit reports and interviewed OIG representatives at headquarters, the Eastern Regional Audit Office in Oak Ridge, and the Western Regional Audit Office in Albuquerque.

Our review was conducted from August 1987 through December 1989. We did our audit work in accordance with generally accepted government auditing standards.

Ratio of Plan Assets to Present Value of Accrued Benefits

Dollars in thousands

Plans[a]	Valuation date[b]	Assets at market value	Present value of accrued benefits (PVAB)	Assets in excess of PVAB	Funded ratio (assets/ PVAB) (percent)
Du Pont	3/31/89	$1,252,100	$791,530[c]	$460,570	158
EG&G/Mound					
Hourly Paid Employees' Plan	1/1/90	12,139	8,074	4,065	150
Salaried Employees' Plan	1/1/90	71,519	47,254	24,265	151
Martin Marietta	1/1/89	1,408,000	868,100	539,900	162
Sandia					
Retirement Income Plan	12/31/87	822,856	478,355	344,501	172
Pension Security Plan	12/31/87	241,149	115,783	125,366	208
Westinghouse/Hanford Multiple Employer Plans					
Operations & Engineering Plan	1/1/89	221,999	234,429	(12,430)	95
Represented Employees' Plan	1/1/89	74,762	69,075	5,687	108

[a]We did not include in the table two contractors we reviewed—General Electric/Knolls and Westinghouse/Bettis—because the purpose of the table is to show the effect of DOE's policies (or lack thereof) on plans' funded status. Until recently those two contractors had companywide plans. Consequently, the funded status of the new site-specific plan (for General Electric/Knolls) and the new separate account (for Westinghouse/Bettis) was determined by the companies' funding policies, not DOE's.

[b]The latest date as of which funding information was available.

[c]Includes the present value of future ad hoc COLAs at 3 percent per year.

Setting Up a Site-Specific Plan or Separate Accounting

Developing a site-specific plan at an incumbent contractor entails the following tasks:

- DOE must negotiate with a contractor concerned about the ramifications of any change in the status quo.
- Employee morale must be maintained. Neither the contractor nor DOE wants the employees to feel they will receive lower benefits under the site-specific plan.
- Administrative tasks must be accomplished. New plan documents and brochures must be prepared, the approval of unions and the contractor's board of directors must be obtained, and information required by the Internal Revenue Code and ERISA must be filed.
- The beginning asset balance must be established. This is the amount to be transferred from the corporate plan to the site plan—a matter of obvious concern to both DOE and the contractor. The parties must determine the amount of assets that would have been in the plan if assets attributable to DOE's contributions over the years had always been separately identified. Ideally, that means reconstructing, for every year from the contract's inception to the present, the amounts of (1) departmental contributions, (2) earnings on those contributions, and (3) payments to site retirees.
- Decisions must be made about employees who have retired after working at the DOE site. Should retirees remain with the corporate plan or be transferred to the new site-specific plan? If they remain with the corporate plan, it must be compensated for the liability it is assuming.

Many of the administrative tasks necessary to set up a site-specific plan are unnecessary for separate accounting. Nevertheless, the most sensitive task—negotiating a beginning asset balance—must also be performed under separate accounting.

Differing Positions on Paying for Postcontract Costs

DOE's practice is to pay the costs of retiree health benefits paid after contracts expire and (when warranted) ad hoc COLAs granted after contracts expire. Its operating philosophy is to reimburse contractors for the cost of all employee benefits earned under the contract, regardless of whether such benefits are paid during or after contract performance.

The Defense Contract Audit Agency (DCAA), however, has recommended that the Army not pay for the postcontract retiree health benefit costs of Remington Arms, a contractor that operated the Lake City Army Ammunition Plant from the mid-1940s until the contract expired in 1985. Remington Arms retained retirees from the plant in its corporate health plan and has claimed $60 million for future retiree health benefits. The claim was based on, among other things, its interpretation of the cost accounting standards incorporated in its contract. The Army contracting officer had not, at the close of our review in December 1989, made a final decision on paying these costs.

The Army contract is similar to a DOE management and operating contract in several respects:

- Both call for the operation of government-owned facilities.
- Both involve work that is separate from other contractor business.
- In both cases, all allowable costs are paid by the government.
- Both involve long-term relationships with contractors.

DCAA took the position that the applicable cost accounting standards incorporated in the Remington Arms contract did not permit the contractor to change its practice of recognizing retiree health benefit costs on a pay-as-you-go basis. Under the pay-as-you-go concept, the government is responsible for the cost of benefits paid only during the contract term.

DCAA also took the position that the Army could not reimburse Remington Arms for postcontract ad hoc COLAs—for which Remington Arms claimed a $21 million lump sum. DCAA's position was based on a cost accounting standard incorporated into the Remington Arms contract. The standard requires that pension cost "be based on the provisions of existing plans." Consequently, the estimated cost of ad hoc COLAs that have not yet been granted are excluded. In addition, further support can be found for not recognizing postcontract ad hoc COLAs:

- The Financial Accounting Standards Board has concluded that it is reasonable to assume that pension benefit increases granted to

retirees—like those granted to active employees—are intended to benefit an employer's operations in the future rather than in the past.

- Contributions to pension plans for future ad hoc benefit increases are not deductible for tax purposes.

The Remington Arms case illustrates some of the issues that must be addressed by any departmental policy on postcontract retiree costs. DOD and DOE each has the authority to adopt the policy it believes most appropriate.

DOE OIG Audit Coverage of Contractors' Pension Costs

From December 1986 through December 1989, the OIG made seven audits specifically dealing with contractor pension issues. One of those audits—the June 1987 review of 20 contractors, which prompted the Subcommittee's request for this review—covered various aspects of contractors' pension plans, including funding policy and contract clauses dealing with contract expirations. The review was made by an IPA under the OIG's guidance. The remaining six audits, which were made by the OIG or by IPAS, had more limited scopes. For example, the OIG audited (1) Martin Marietta's adoption of its predecessor's pension plan for the Oak Ridge site and (2) the asset balance determined during negotiations for the General Electric/Pinellas site-specific plan.

In addition, IPAS hired and guided by the OIG made annual financial and compliance audits. Such audits are designed to express an opinion on the contractors' financial statements and provide only a limited review of pension costs. An OIG official told us that these audits were recently discontinued and would be replaced by cyclical audits of contractor functions, such as employee relations, purchasing, and security. The policy change was not yet in place at the sites we reviewed.

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