
Office of Inspector General

***Overpayments of Premiums for
the Central Artery Project's
Owner Controlled Insurance Program***

Federal Highway Administration

Report Number: TR-1999-104

Date Issued: May 24, 1999

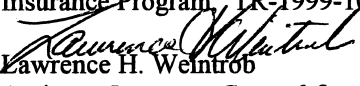




Memorandum

U.S. Department of
Transportation
Office of the Secretary
Of Transportation
Office of Inspector General

Subject: **ACTION: Report on Overpayments of Premiums** Date: May 24, 1999
for the Central Artery Project's Owner-Controlled
Insurance Program, TR-1999-104

From: 
Lawrence H. Weintrob Reply to: JA-30
Assistant Inspector General for Auditing Attn of:

To: Federal Highway Administrator

This report presents our interim findings on the Owner-Controlled Insurance Program (OCIP) established by the Massachusetts Highway Department for the Central Artery project. We conducted this audit in response to Congressional direction contained in House Report number 105-648. In that report, the Committee directed the Office of Inspector General "to continue to oversee the costs, funding, and schedule of the Central Artery project and to report periodically its results to the Committee."

Our objective in auditing the Central Artery OCIP was to determine whether the workers' compensation and general liability portions of the program were effective in reducing the overall cost of insurance for the project. In conducting our audit, we identified overpayments of Federal funds (including accrued interest) totaling \$150.0 million that warrant your immediate attention. This report addresses those overpayments. *We are recommending that the \$150 million be recovered and appropriately reallocated. If the Central Artery's holding of OCIP overpayments is allowed to stand, it may establish a precedent contrary to existing regulations' prohibition on the use of taxpayer money for investment purposes, and infrastructure programs around the country may start investing grant funds rather than using them for legitimate project expenses. This would clearly be a poor cash management practice for Federal funds.*

We have not completed our audit of the Central Artery OCIP. We expect to issue our final report on the Central Artery OCIP later in fiscal year 1999. The attached interim report should not be construed as reflective of OCIPs in general.

In examining the Central Artery OCIP, we conducted extensive outreach to insurance experts in the Federal government (U.S. Department of Labor), insurance industry (National Association of Insurance Commissioners), and academia (Rutgers

University). We discussed with them how OCIPs are generally structured, how risk is managed through insurance, and what other financial protections against loss (such as reserve funds) are generally considered prudent. More specifically, we also discussed the structure and operation of the Central Artery OCIP with these experts.

We found that the Massachusetts Highway Department overpaid workers' compensation premiums. The premiums are deposited by the insurance company into investment trust accounts owned by Massachusetts Highway Department. The OCIP arrangement is scheduled to continue through the year 2017, when the Massachusetts Highway Department anticipates collecting at least \$826 million from the trust accounts.¹ The arrangement is not consistent with Federal guidelines that allow grant recipients to use Federal funds only to pay allowable project costs, not for long-term investments.

In a March 26, 1999, response to our draft of this report, Federal Highway Administration (FHWA) officials disagreed that there have been overpayments. According to the FHWA Massachusetts Division Administrator, Massachusetts faces potential "mammoth" liabilities over and above the insurance coverage purchased. In addition, the FHWA Executive Director claimed all the funds in the insurance trusts are being used solely for insurance purposes, because the trusts have not reached a level that "collateralizes the State's potential exposure" to future claims and expenses. FHWA's speculation about the magnitude of risk is undocumented, and is fundamentally at odds with the opinions of independent insurance experts contained in risk assessments conducted for the project's insurance broker in 1991 and 1998. Furthermore, the Central Artery Finance Plan approved by FHWA is based on an expectation that \$826 million from the insurance trust funds will be returned to the State.

Claiming the funds are needed to pay future insurance liabilities while using these same funds as a credit against current costs is inherently inconsistent; project management cannot have it both ways. If FHWA and Massachusetts Highway Department officials believe that the Central Artery has such enormous liability risks, they should require the project to obtain appropriate insurance coverage. Furthermore, if FHWA and the Massachusetts Highway Department sincerely believe the funds are needed to cover future costs, they must not count on the \$826 million in future proceeds from the trusts to reduce the overall cost of the project, and must revise the Finance Plan to reflect the almost \$12 billion in expected project costs.

We are making three recommendations to FHWA regarding the Central Artery OCIP: First, recover the \$150.0 million (Federal share of \$166.7 million) in premium overpayments and interest earned related to payments made through 1997, as well as

¹ The March 1999 Project Management Monthly Report shows an additional \$209 million OCIP credit, bringing the combined credits to over \$1.0 billion.

any further overpayments and interest that have since accrued, and either apply the funds to current project costs or return the money to the U.S. Treasury. Second, on an annual basis, determine actual insurance requirements and ensure any overpayments involving Federal funds are recovered and applied to current costs or returned to the U.S. Treasury. And third, review the policy regarding reimbursement for insurance and establish guidelines to ensure any future overpayments of insurance premiums on highway projects are recovered and applied to current costs or returned to the U.S. Treasury.

We request that you provide written comments within 15 days. If you concur with our findings and recommendations, please indicate for each recommendation the specific actions taken or planned and the target dates for completion. If you do not concur, please provide your rationale. Furthermore, you may provide alternative courses of action that you believe would resolve the issues presented in this report.

If you have any questions, please contact me at x61992 or my Deputy Assistant Inspector General for Highways and Highway Safety, Patricia J. Thompson, at x60687.

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***Overpayments of Premiums for
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Owner-Controlled Insurance Program***

Federal Highway Administration

We conducted this audit of the Central Artery project's Owner-Controlled Insurance Program (OCIP) in response to Congressional direction contained in House Committee Report number 105-648. In that report, the Committee directed the Office of Inspector General "to continue to oversee the costs, funding, and schedule of the Central Artery project and to report periodically its results to the Committee." The objective of this audit was to determine whether the workers' compensation and general liability portions of the program were effective in reducing the overall cost of insurance for the project. (Attachment A.)

In auditing the Central Artery OCIP, we conducted extensive outreach to insurance experts in the Federal government (U.S. Department of Labor), insurance industry (National Association of Insurance Commissioners), and academia (Rutgers University). We discussed with them how OCIPs are generally structured, how risk is managed through insurance, and what other financial protections against loss (such as reserve funds) are generally considered prudent. More specifically, we also discussed the structure and operation of the Central Artery OCIP with these experts.

In the course of the audit, we identified significant overpayments of insurance premiums, which are the subject of this interim report. Due to the magnitude of the overpayments, we are issuing this interim report to facilitate timely management action. This report should not be construed as reflective of OCIPs in general. We have not completed our audit of the Central Artery OCIP. We plan to issue our final report on the Central Artery OCIP later in fiscal year 1999.

RESULTS-IN-BRIEF

The Massachusetts Highway Department has overpaid workers' compensation premiums, with 90 percent of the overpayments being made with Federal funds. These funds are held in trusts owned by the Massachusetts Highway Department. They are currently invested by a subsidiary of the insurance company in a portfolio that includes Walt Disney, Wal Mart, General Electric, and U.S. Treasury notes. The overpayments and accrued interest total at least \$166.7 million, of which \$150.0 million are Federal funds. We are recommending that these funds be recovered and appropriately reallocated. If the Central Artery's holding of OCIP overpayments is allowed to stand, it may establish a precedent contrary to existing regulations' prohibition on the use of taxpayer money for

investment purposes, and infrastructure programs around the country may start investing grant funds rather than using them for legitimate project expenses. This would clearly be a poor cash management practice for Federal funds.

The Central Artery's October 1998 annual Finance Plan projects that the excess funds generated by overpaid premiums will grow to \$826 million when the OCIP ends in the year 2017.¹ The Finance Plan uses the excess funds as a "credit" to offset current costs and reduce the cost of the project to \$10.8 billion, rather than almost \$12 billion.

In responding to a draft of this report, the Central Artery Project Director and FHWA Executive Director disagreed with our recommendation to recover the overpaid premiums, claiming that these funds (and the accrued interest) are needed to cover potential liabilities. Claiming the excess funds are needed to cover future liabilities, while at the same time citing these funds as a credit against ultimate project costs is inherently inconsistent; project management cannot have it both ways. If FHWA and Massachusetts Highway Department officials believe that the Central Artery has such enormous liability risks, they should require the project to obtain appropriate insurance coverage. Furthermore, if FHWA and the Massachusetts Highway Department sincerely believe the funds are needed to cover future costs, they must not count on the \$826 million in future proceeds from the trusts to reduce the overall cost of the project; and must revise the Finance Plan to reflect the almost \$12 billion in expected project costs.

Insurance Premiums Were Overpaid

Massachusetts Highway Department payment records show that, between 1992 and 1997, the project paid \$368.7 million in estimated premiums, of which 90 percent were paid for with Federal funds. Workers' compensation and general liability premiums accounted for \$335.4 million of the total premiums paid. These premiums were overpaid by \$132.7 million during the first 3 years because the estimated insurance premiums were set using a higher number of workers than were actually employed on the project. Premiums were underpaid slightly in subsequent years because the estimated premiums were lowered when the program was renewed in 1996.

Audits performed by the insurance company showed the net estimated premiums exceeded appropriate premium amounts for 1992-1997 by over 39 percent, or \$129.8 million. The overpayments are being held in trusts owned by the Massachusetts Highway Department. Assuming interest at 6 percent compounded annually, the overpaid premiums and accrued interest now total \$166.7 million,

¹ The March 1999 Project Management Monthly Report shows an additional \$209 million OCIP credit, bringing the combined credits to over \$1.0 billion. We note that the project is scheduled to be completed in 2004, 13 years before receipt of the excess funds.

the Federal share of which is approximately \$150.0 million (Figure 1). Federal guidelines require the overpayments and interest to be immediately recovered and either used to pay current project costs or the Federal portion returned to the U.S. Treasury.²

Figure 1 – Overpayments of Central Artery Workers Compensation and General Liability Premiums (in millions)			
Premium Period	Estimated (Paid) Premium	Audited Premium	Overpayment
1992-93	\$66.6	\$22.0	\$ 44.6
1993-94	77.3	46.6	30.7
1994-95	105.3	47.9	57.4
1995-96	42.0	43.0	(1.0)
1996-97	44.2	46.1	(1.9)
Sub-Total	\$ 335.4	\$ 205.6	\$ 129.8
Investment Income Earned on Overpayments			\$ 36.9
Total Overpayments plus Earned Investment Income			\$166.7
90% Federal Share of Overpayments plus Earned Investment Income			\$150.0

In 1998, the Auditor of the Commonwealth of Massachusetts reported the overpayments and recommended that the excess be reclaimed and used to pay current project costs. Central Artery project management declined to implement the Auditor’s recommendation, stating “the trust fund now prudently anticipates the higher risks we face during the current peak construction period....” The Auditor replied that there was no need to fund potential losses over actuarial projections, since actuarially projected losses are recognized and funded as part of each program. The Auditor concluded, “[T]he funding of a contingency that is unlikely to materialize is not prudent use of project funds, especially in light of the favorable claims being experienced under both insurance programs.” Our review confirms the Auditor’s finding that premiums were overpaid.

FHWA and Massachusetts Highway Department Dispute OIG Findings

In their responses to a draft of this report, the FHWA Executive Director and Central Artery Project Director disagreed that there have been overpayments. The FHWA Executive Director stated the funds in the insurance trusts are being used solely for insurance purposes because the funds have not reached a level that “collateralizes the State’s potential exposure.” According to the FHWA Massachusetts Division Administrator, Massachusetts faces potential “mammoth” liabilities over and above the insurance coverage purchased. The Division Administrator went so far as to say the potential liabilities are so large that it would be impossible to overpay the insurance.

² OMB Circular A-87 “Cost Principles for State, Local and Indian Tribal Governments;” 23 CFR Part 140; the Cash Management Improvement Act of 1990; and 49 CFR Part 18.

Documented Risks Do Not Justify Overpayments

We found there are no documented risks that justify the overpayments. The Central Artery project's risks and estimated potential liability, in the event catastrophic accidents were caused by the project, were identified in a 1991 Risk Assessment conducted by the project's insurance broker in conjunction with a risk management and actuarial consultant. General liability insurance coverage of \$200 million was purchased based on the identified risks. Moreover, in a March 30, 1998 draft "Risk Assessment Report" conducted for the insurance broker, an independent insurance expert evaluated the currency of the 1991 assessment. The assessment found "the chances of a complete and total loss are infinitely small" and concluded, "On the whole, the 1991 Risk Assessment Report addressed the risks of loss with a reasonable methodology." The draft assessment states, however, that if officials still had concerns, the Central Artery could purchase an additional \$100 million of coverage (raising total coverage to \$300 million) through the end of peak construction in 2001. The cost of the additional coverage was estimated to be between \$750,000 and \$1 million. The premium cost to raise the coverage from \$200 million to \$300 million is low in comparison to the amount required for the initial \$200 million in coverage because (1) the amount paid for the initial coverage is not all "premium," but includes collateral for expected claims below the deductible, and (2) there is less risk that losses will mount to the higher levels of the additional coverage.

In January 1999, the insurance broker stated, "We are satisfied that the loss limit thresholds selected are appropriate and the continued emphasis on safety will keep losses well under control." The project has chosen not to purchase additional coverage.

We also found that the 1996 workers' compensation agreement, which includes the requirement for collateral to be held in the trusts, establishes procedures for adjusting the collateral annually and authorizes the Massachusetts Highway Department to recover any excess from the trusts. As of December 31, 1998, the OCIP trust accounts held \$264.6 million.³ This level of collateral is not required, a fact that is demonstrated by the Massachusetts Highway Department's use of \$22 million in excess trust monies to pay part of the premiums in subsequent policy years. Specifically, \$6 million was applied toward the 1995/1996 premium, and \$16 million was applied to the 1996/1997 premium. After recovery of the \$150.0 million Federal share of the overpayments, approximately \$114.6 million will remain in the trust.

³ The overpayments we are reporting resulted from an excess of "estimated" over "audited" premiums. Recovery of the Federal share of these overpayments will leave approximately \$114.6 million in the trusts, the amount that would have been reserved under the audited premiums. However, it appears the collateral included *within* the audited premium may also have been overpaid. Our review of the OCIP remains ongoing. Any excess collateral in the audited premium will be in addition to the \$166.7 million (\$150.0 million Federal share) in gross premium overpayments reported herein.

We conclude that, if the project runs a credible risk of liability for causing catastrophes beyond what was identified in the 1991 Risk Assessment, this has neither been documented nor disclosed to the public. Because the project has chosen not to purchase additional insurance coverage and has already used some excess funds to pay premiums, we are not persuaded by the argument that the overpayments are needed for insurance purposes.

Use of Grant Funds for Investment Not Authorized

Regarding the use of the trust funds credits, the Project Director of the Central Artery project stated that, when the \$826 million in credits are received in 2017, the funds will be used for highway construction projects in the State. The Project Director's statement directly contradicts FHWA's and his own position that there are no excess insurance payments, and their argument that the excess funds in the trusts are necessary to cover future losses on the Central Artery project.

Federal policies restrict recipients of Federal highway funds to using the money for project-related purposes, not for long-term investments. The accumulation of Federal funds in long-term investments to offset costs is inconsistent with Federal regulations, as well as OMB Circular A-87 and the Cash Management Improvement Act. Federal regulations require the overpayments, including any interest that has been generated on those funds, to be immediately applied to current project costs or the Federal share returned to the U.S. Treasury.

Recommendations

We recommend the FHWA:

1. Recover the \$150.0 million Federal share of the premium overpayments and interest earned related to payments made through 1997, as well as any further overpayments and interest that have since accrued, and either apply the funds to current project costs or return the money to the U.S. Treasury.
2. On an annual basis, determine actual insurance requirements and ensure any overpayments involving Federal funds are recovered and applied to current costs or returned to the U.S. Treasury.
3. Review its policy regarding reimbursement for insurance and establish guidelines to ensure any future overpayments of insurance premiums on highway projects are recovered and applied to current costs or returned to the U.S. Treasury.⁴

⁴ This is a reiteration of a recommendation from our April 1998 Report on the Central Artery/Ted Williams Tunnel project.

**Overpayments of Premiums for
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Owner-Controlled Insurance Program**

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Attachment A: Objectives, Scope, and Methodology

Attachment B: FHWA Comments to OIG Draft Report

SECTION I - BACKGROUND

The Central Artery project is the largest transportation infrastructure project in the nation. Planning for the project began in 1981. Construction of the project was authorized to begin in 1991 and is scheduled to be completed in 2004. The project will replace Boston's deteriorating, elevated Central Artery with a modern underground expressway, and will extend the Massachusetts Turnpike to Logan Airport through the new Ted Williams Tunnel under Boston Harbor. Federal government reimbursements to the Massachusetts Highway Department for the program range from 80 to 90 percent of the costs of the project.

It is standard practice on construction projects for contractors, subcontractors, engineering consultants, architects, construction managers and the owner to provide their own separate insurance. The cost of this insurance is one factor that contractors and others consider when determining the price of their bid proposals for project work.

An OCIP, also known as "wrap-up" or "blanket" insurance, is an alternative to traditional insurance management on construction projects. In a typical OCIP, the owner of a large construction project will purchase insurance that provides workers' compensation, general liability, and other coverage for themselves, as well as for the contractors and all other parties to the project. By purchasing all the insurance at once, the owner (or their insurance broker) can negotiate with underwriters to obtain better terms than could the individual project participants negotiating alone. For example, the owner may be able to obtain volume discounts; higher liability limits; coverage tailored to the specific risks of the project; cash flow plans that give the project credit for the insurer's investment income; and insurance for the duration of the project.

Using an OCIP can save money on large construction projects through lower bids from contractors, since insurance costs are not included in their bid price. This can lower the overall project cost if the OCIP costs less than the cumulative cost of insurance purchased separately by the participants. Projects employing an OCIP may also establish a central safety program with incentives for achieving a good safety record, which can result in further reductions in the insurance cost.

In the Central Artery OCIP, funds to cover the estimated claims and other expenses are deposited into the one of three investment trust accounts owned by the Massachusetts Highway Department. These are the Loss Fund Account, Aggregate Excess Loss Account, and Retained Earnings Account. The accounts are held at the State Street Bank in Boston, Massachusetts. The trust accounts are

managed by a subsidiary of the insurance company. Funds in the trust accounts are withdrawn as needed to pay insurance related costs. The insurance company is given a “security interest” in the funds in the trust accounts to ensure they are not withdrawn without the insurance company’s permission.

SECTION II - RESULTS

We initiated this audit to determine whether the Central Artery OCIP was effective in reducing insurance costs for the project. In the course of the audit, we found the overpayments detailed in this interim report. Due to the magnitude of the overpayments, we are issuing this interim report to facilitate timely management action. A draft of this report was provided to FHWA for comment. The results of our audit and FHWA’s response are provided below. A detailed discussion of the FHWA position and our analysis of FHWA official’s comments are included in Section IV of this report. Our audit of the overall OCIP remains ongoing.

A. Massachusetts Highway Department Overpaid Insurance Premiums

Between 1992 and 1997, the Massachusetts Highway Department paid Central Artery OCIP premiums totaling \$368.7 million. FHWA reimbursed the Massachusetts Highway Department \$331.5 million or 90% of that total. The workers’ compensation and general liability premiums accounted for \$335.4 million of the total premiums paid. However, according to internal audits by American International Group (AIG), the project insurer, premiums for workers’ compensation insurance were overpaid by \$129.8 million.¹

Premiums for workers’ compensation insurance are determined according to the number and type of workers insured.² Because premiums are paid in advance, initially they are based on projections of payroll and the number and types of workers expected to be employed (this is termed the “estimated premium”). After each annual policy period, audits are performed by the insurance company to establish the payroll and number and type of workers actually employed. The premiums are adjusted to reflect those actual numbers (this is termed the “audited premium”). The difference between the estimated premiums that were paid and the audited premium represents an overpayment or underpayment of insurance.

¹ There were \$132.7 million in overpayments during the first three years of the program (\$114.7 million in overpayments of workers’ compensation premiums and \$18.0 million in general liability premiums), but premium adjustments since 1996 reduced the overpayments to \$129.8 million and resulted in all excess funds in the trusts being attributable to worker’s compensation payments.

² The premiums paid by the Central Artery are intended to cover all insurance costs. They include not only the actual “premium” payments to the insurer, but an estimated amount to fund a reserve intended to pay claims below the deductible, administrative fees, and other related costs.

Overpayments occurred during the first 3 years because the payroll and worker estimates used to set the 1992 through 1995 OCIP premiums were based on an accelerated work schedule that called for more workers in order to complete the project by 1998. That work schedule was never implemented. Nevertheless, the estimated premiums for those years were not recalculated to reflect the revised schedule that was actually implemented. The revised schedule employs fewer workers and stretches construction to the year 2004. As a result, the annual premiums paid to the insurer exceeded the amount needed to pay insurance-related costs. Subsequent years premiums were slightly underpaid because the estimated insurance premiums were lowered when the program was renewed in 1996. Between 1992 and 1997, the net amount of overpayments totaled \$129.8 million. Including interest compounded annually, the overpayments total \$166.7 million. (Figure 1.) The Federal share of the overpayments and interest is \$150.0 million.

Figure 1 – Overpayment of Central Artery Premiums for Worker’s Compensation and General Liability (in millions)			
Premium Period	Estimated (Paid) Premium	Audited Premium	Overpayment
1992-93	\$66.6	\$22.0	\$ 44.6
1993-94	77.3	46.6	30.7
1994-95	105.3	47.9	57.4
1995-96	42.0	43.0	(1.0)
1996-97	44.2	46.1	(1.9)
Sub-Total	\$ 335.4	\$ 205.6	\$ 129.8
Investment Income Earned on Overpayments			\$ 36.9
Overpayments plus Earned Investment Income			\$166.7
90% Federal Share of Overpayments plus Earned Investment Income			\$150.0

In 1998, the Auditor of the Commonwealth of Massachusetts reported the overpayments and recommended that the excess be reclaimed and used to pay current project costs. Central Artery project management declined to implement the Auditor’s recommendation, stating “the trust fund now prudently anticipates the higher risks we face during the current peak construction period....” The Auditor replied that there was no need to fund potential losses over actuarial projections, since actuarially projected losses are recognized and funded as part of each program. The Auditor concluded, “[T]he funding of a contingency that is unlikely to materialize is not prudent use of project funds, especially in light of the favorable claims being experienced under both insurance programs.” Our audit reconfirms the Auditor’s finding that premiums were overpaid.

FHWA Comments on Overpayments

In discussions and correspondence regarding our draft of this report, FHWA officials stated that there have been no overpayments. According to the FHWA Executive Director: “To the extent that actual premium payments exceed audited premiums, any additional amounts are placed in the trusts with the goal of

reaching a level that collateralizes the State’s potential exposure. This level has not been reached.” The FHWA Massachusetts Division Administrator told us that the State faces potential “mammoth” liabilities under its general liability program over and above the insurance coverage purchased. The FHWA officials claimed all funds in the insurance trusts are therefore required and being used solely for insurance purposes because they “collateralize the State’s potential exposure.” In discussions about the proper level for collateralization, the Division Administrator indicated that these potential liabilities are so large that it would be impossible to overpay the insurance.

OIG Response

We disagree. The large balances in the trust funds are the result of overpayments of workers’ compensation premiums, not general liability premiums. Potential general liability risks, if any, are irrelevant to the workers’ compensation insurance. Further, the large risks hypothesized by FHWA are not supported by insurance program documents for either program.

Insurance experts have advised us that workers’ compensation risks are largely predictable. Since 1992, the Central Artery has incurred only \$50.1 million in workers’ compensation claims, none of which exceeded its \$1 million per claim deductible. According to insurance broker documents, as of December 15, 1998, \$32.4 million of those claims had already been paid, leaving \$17.7 million in outstanding claims. Collateral for claims incurred against future years’ policies will be included in the premiums to be paid in those years.

The 1996 workers’ compensation agreement includes procedures for adjusting collateral annually and specifically authorizes the Massachusetts Highway Department to recover any excess from the trusts. As of December 31, 1998, the OCIP trust accounts held \$264.6 million. This level of collateral is not required, a fact that is demonstrated by the Massachusetts Highway Department’s use of \$22 million in excess trust monies to pay part of the premiums in subsequent policy years. Specifically, \$6 million was applied toward the 1995/1996 premium, and \$16 million was applied to the 1996/1997 premium. We conclude the workers’ compensation claims history does not support the need for the \$264.6 million in reserves now held in the trust accounts.³

³ The overpayments we are reporting resulted from the excess of the “estimated” over “audited” premiums. Recovery of the \$150.0 million Federal share of the overpayments will leave approximately \$114.7 million in the trusts, the amount that would have been reserved under the audited premiums. However, it appears the collateral included *within* the audited premium may also have been overpaid. Our audit of the OCIP remains ongoing. Any excess collateral in the audited premium will be in addition to the \$166.7 million in gross premium overpayments reported herein.

Likewise, we also found no evidence of general liability risks such as FHWA officials hypothesized. According to the 1991 Risk Assessment conducted for the OCIP, the project faces a worst-case scenario of \$150 - \$300 million in liability from potential catastrophic accidents. A March 30, 1998 draft "Risk Assessment Report" evaluated the currency of the 1991 assessment and found "the chances of a complete and total loss are infinitely small." The report concluded, "On the whole, the 1991 Risk Assessment Report addressed the risks of loss with a reasonable methodology."

The 1998 draft assessment report recommended that, if officials still had concerns, the Central Artery purchase an additional \$100 million of general liability coverage (at an estimated total cost of \$750 thousand to \$1 million) to raise the total coverage to \$300 million through the end of peak construction in 2001. The premium cost to raise the coverage from \$200 million to \$300 million is low in comparison to the amount required for the initial \$200 million in coverage because (1) the amount paid for the initial coverage is not all "premium," but includes collateral for expected claims below the deductible, and (2) the cost of excess coverage is lower because there is less risk that losses will mount to higher levels. In January 1999, the project's insurance broker stated, "We are satisfied that the loss limit thresholds selected are appropriate and the continued emphasis on safety will keep losses well under control." The project has elected not to purchase any additional coverage.

Furthermore, there are no collateral requirements in the general liability program, and reserves against losses above the insurance limits are not needed because FHWA has agreed to reimburse these costs. General liability claims since 1992 have also been low - only \$26.1 million (of which \$6.3 million has already been paid), with no claim exceeding the \$2 million policy deductible. We conclude the assessments of general liability risk and the general liability claims history also do not support the need for the magnitude of reserves now being held in the trust accounts.

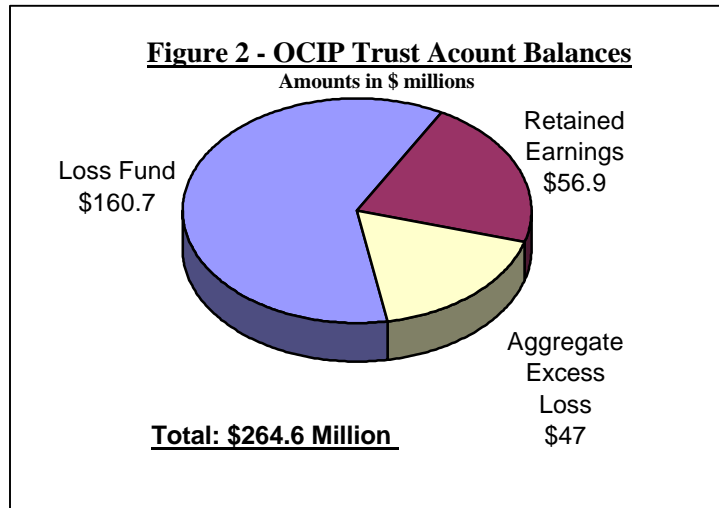
If the project runs a credible risk of causing catastrophes beyond what was identified in the 1991 Risk Assessment, this has neither been documented nor disclosed to the public. In our opinion, the entire remaining amount of the premium overpayments and accumulated interest, \$166.7 million, must be immediately applied to current project costs or the Federal share returned to the U.S. Treasury.

B. OCIP Premiums Used for Long-Term Investment

All the overpayments are held in one of three investment trust accounts. Claims, insurer expenses, and other OCIP-related costs are paid from the Loss Fund Account. The trust account funds are managed by AIG Capital Management

Corporation, a subsidiary of the insurance company, and invested in a portfolio of securities that includes Walt Disney, Wal Mart, General Electric, and U.S. Treasury notes.

Insurance company records show that, as of December 31, 1998, the OCIP trust accounts had accumulated premium payments and earned income amounting to \$264.6 million. (Figure 2.)



Under the original 1992 OCIP agreement, the income from the trust accounts was divided equally between the insurance company and the Massachusetts Highway Department. When the workers' compensation insurance agreement was renewed in 1996, the income distribution was changed. The investment income on the Loss Fund Account is still divided equally between the insurance company and the Massachusetts Highway Department.⁴ However, under the renewal agreement, the Massachusetts Highway Department now receives 100 percent of the income generated by the Aggregate Excess Loss and Retained Earnings Accounts.

The trust accounts are to continue until the end of the year 2017, more than 13 years after payment of the last premium and construction on the project is scheduled to be completed. At that time, the Massachusetts Highway Department estimates the value of the investments in its trust accounts will have grown to \$826 million. The anticipated "credit" is carried in the Central Artery's October 1998 Finance Plan as an offset against the ultimate cost of the project, keeping the apparent cost of the project at the artificially low figure of \$10.8 billion. We note that the March 1999 Project Manager's Monthly Report shows an additional \$209 million OCIP credit, bringing the total credit to \$1.04 billion. However, this additional credit is offset by \$209 million in cost increases, keeping the "net" cost of the project at \$10.8 billion.

FHWA Comments and OIG Response

In its response to our draft report, FHWA officials contended there is an opportunity for the project and public to reap a significant benefit when the OCIP is closed out in the year 2017. FHWA officials also stated they find this report

⁴ The insurance company's share of the income is paid to the company annually, while the Massachusetts Highway Department's share is deposited into the Retained Earning account, where it is reinvested and held.

inconsistent with our April 3, 1998 report. In that report, we questioned the likelihood of the then-projected \$827 million credit in 2017.

Our 1998 report looked at the funding and cost of the project. We did not audit how the insurance program operated. We maintain that it is inappropriate to take the full future value of *any* credit not scheduled to be received until 2017 as an offset against current project costs. Further, our 1998 report assumed the insurance program reserves were needed to cover documented liabilities. Hence, we questioned taking the full value of the “credit,” given that at least part of liabilities of such a magnitude should be expected to materialize. However, the results of our current audit have shown that, in fact, there are no documented risks of liability commensurate with the large level of reserves being generated.

In our discussions with insurance industry experts, they noted that the Central Artery OCIP financing differs from typical programs in an important aspect, that being the magnitude of the reserves being generated by the program. Consistent with Federal policies, in our opinion, the retention of Federal funds for investment purposes for up to 25 years is not a prudent use of funds. If the Central Artery’s holding of OCIP overpayments is allowed to stand, it will establish a precedent contrary to existing regulations’ prohibition on the use of taxpayer money for investment purposes, and infrastructure programs around the country may start investing grant funds rather than using them for legitimate project expenses. This would clearly be a poor cash management practice for Federal funds. OIG believes FHWA should be enforcing Federal policies that call for Federal funds to be used for current transportation needs. We reiterate an open recommendation from our 1998 report that FHWA review its policy regarding reimbursement for insurance and establish guidelines to ensure any future overpayments of insurance premiums on highway projects are recovered and applied to current costs or returned to the U.S. Treasury.

C. Long-Term Investment of Federal Funds Not Allowed

Federal regulations and guidelines do not allow Federal funds used to reimburse states for approved project costs, including insurance, to be used for long-term investments. The following guidelines establish how states may use Federal money granted to them for specific project purposes.

OMB Circular A-87. OMB Circular A-87 sets forth certain criteria for determining costs for Federal grants, contracts, and other agreements with State and local governments.⁵ Circular A-87 states, “...purchase discounts, rebates or allowances, recoveries or indemnities on losses, insurance refunds or rebates, and

⁵ DOT regulations (49 C.F.R. § 18.20(b)(5)) incorporate the A-87 standards.

adjustments of overpayments or erroneous charges...shall be credited to the Federal award either as a cost reduction or cash refund.”⁶ [Emphasis added.]

According to insurance company records, from 1992 through October 1997 the Massachusetts Highway Department paid \$335.4 million in workers’ compensation and general liability insurance premiums, including the overpayments of \$129.8 million reported herein. (Figure 1) Circular A-87 requires the overpayments and income generated on the overpayments be credited to the Federal award because they are not needed for insurance-related purposes. In policy years 1994-95 and 1996-97, \$22 million in overpayments were applied toward the OCIP premium. None of the remaining \$129.8 million in overpayments, or the interest of \$36.9 million we estimate has been earned on those funds, have been credited to the project as either a cost reduction or cash refund. The Federal share of the overpayments and interest is approximately \$150.0 million. As described above, the overpayments are being held in the trust accounts for up to 25 years (from the inception of the OCIP in 1992 until 2017.)

FHWA Comments and OIG Response

The FHWA Executive Director stated in his reply to our draft report that FHWA believes the OCIP is “in compliance” with Circular A-87 because “the trust exists solely for insurance purposes.”

We disagree. These funds are being used to generate income, as evidenced by the project’s continually claiming and budgeting for a large credit (\$826 million) in 2017. Project officials are not intending or planning to use the investment proceeds to cover insurance costs. In its November 18, 1996 approval of the OCIP renewal, FHWA recognized that funds were available for “transfers from insurance fund accounts for both immediate insurance needs and/or for other uses.” As the trust balances exceed insurance requirements and can be freely withdrawn by the project, they clearly constitute a refund, which the OMB Circular requires to be applied to current costs or to be returned.

23 C.F.R. Part 140, Reimbursement. These regulations state that Federal funds may be used to pay for group insurance premiums on the condition that the “costs for such benefits must be a liability [not an asset] of the [State Highway Agency].”⁷ In a June 27, 1995, letter, the Deputy Comptroller of the Commonwealth of Massachusetts told the U.S. Treasury that: “payments [to the OCIP] are technically assets held in trust for the Commonwealth....” OCIP payments classified as assets are not reimbursable liabilities.

⁶ OMB Circular A-87 (Section 25 - insurance and indemnification)

⁷ 23 C.F.R. § 140.711(b).

FHWA Comments and OIG Response

In response to the draft of this report, the FHWA Executive Director commented that 23 C.F.R. Part 140 Section 711 “relates to expenses of public employees and is not applicable to insurance coverage related to construction activities.” As paragraph 140.711(b) is the only FHWA guidance on insurance reimbursements, we looked to this regulation for insight on what constitutes an allowable cost versus an overpayment. The guidance in the paragraph is consistent with the standards of OMB Circular A-87 in requiring that insurance payments be liabilities to be eligible for reimbursement. Massachusetts has confirmed to the U.S. Treasury that the payments to the OCIP “are technically assets held in trust for the Commonwealth and as such do not meet the GAAP definition of an expenditure.” Notwithstanding the FHWA Executive Director’s disagreement, we note that he continues to concur with our open 1998 recommendation for additional guidelines in this area.

Cash Management Improvement Act (CMIA). The Cash Management Improvement Act prescribes rules and procedures for the transfer of funds between the Federal government and the states under Federal programs. Specifically, the CMIA states:

If a State receives refunds of funds disbursed by the State under a Federal program, the State shall return those refunds to the Federal executive agency administering the program or apply those refunds to reduce the amount of funds owed by the Federal Government to the State under such program. . . .⁸

On July 30, 1993, the Massachusetts Highway Department asked FHWA, “Does the proposed cash flow structure comply with the Federal Cash Management Improvement Act of 1990 and related regulations?” On August 28, 1993, FHWA replied:

Since the cash flow in the case of the Aggregate Excess Loss Fund involves a federal reimbursement for a[n] earlier state payment to AIG under the Insurance Contract, there should not be a period in which the state is holding federal funds awaiting payment to a state contractor. After payments are made to AIG by the state, none of the cash flow is returned to the state for holding pending reimbursement for project purposes. It is FHWA's opinion such an arrangement would not result in a violation of the Cash Management Improvement Act.

⁸ 31 U.S.C. 6503(f)

FHWA's opinion was based on information provided by the Massachusetts Highway Department that indicated the premiums were paid to and held by the insurance company as a vendor. However, the Chief Counsel for the Central Artery later expressed concerns about having the funds in the possession of the insurance company where creditors or regulators might seize them. Subsequently, in February 1996, the Massachusetts Highway Department and the insurance company entered into a series of agreements, *which were made retroactive to November 1, 1992*, in which the funds were transferred from the insurance company into the trust accounts. The owner of the trust accounts is the Massachusetts Highway Department. Consequently, the basis for FHWA's opinion that the arrangement did not violate the CMIA (i.e., that "none of the cash flow is returned to the state") was changed. FHWA acknowledged to us that the Agreements are "not the mechanisms which have ultimately controlled the trust fund account levels, as the program has developed." We further note that, in neither their original request nor in other correspondence related to their request for an opinion from FHWA, did the Massachusetts Highway Department make any reference to the fact that the funds were to remain invested in the trust accounts for up to 25 years.⁹

The deposit of the premiums into the trust accounts owned by the Massachusetts Highway Department constitutes a refund, and the premiums and any income earned on those funds are subject to the CMIA. Therefore, the overpayments and interest at the applicable Treasury rate must be returned to the U.S. Treasury or applied to the cost of the project.

FHWA Comments and OIG Response

In his response, the FHWA Executive Director disagreed that holding of the overpayments until 2017 violates the CMIA. He maintains the trust agreement is in compliance with the CMIA, because the "trust and contributions are always used for insurance purposes." We have found that the premiums paid exceeded insurance requirements and the OCIP agreement specifically entitles the Massachusetts Highway Department to withdraw the excess funds from the trusts. Therefore, the deposit of the excess premiums into the trust accounts constitutes a refund to the Massachusetts Highway Department and the excess and any income earned on those funds are subject to the CMIA. Furthermore, FHWA's argument that the funds are always used for insurance purposes is undercut by the Central Artery Project Director's confirmation that Massachusetts intends to use the

⁹ In a 1993 case specifically on the retention of interest on Federal reimbursements in a workers' compensation account, the U.S. Court of Appeals concluded that Congress "would have been shocked by the thought that a state could keep millions of dollars of interest on federal funds placed in such accounts." The Court also stated that the CMIA was intended to "save the Federal Government considerable amounts of interest costs" not to give states a huge interest windfall. Commonwealth of Pennsylvania Office of the Budget v. Department of Health and Human Services, 996 F.2d 1505 (3rd Cir. 1993) certiorari denied 114S.Ct.599.

“credit” for Title 23 surface transportation projects when it is received in 2017. FHWA should immediately require the project to comply with the CMIA and apply the overpayments to the cost of the project, or return the Federal portion and any interest at the applicable Treasury rate to the U.S. Treasury.

49 C.F.R. Part 18, Subpart C, Post-Award Requirements – Financial Administration. These Department of Transportation regulations encourage program income in order to reduce program costs.¹⁰ Program income, rebates, refunds, contract settlements, audit recoveries and interest earned on those funds are to be disbursed before requesting additional cash payments.¹¹ Because the OCIP premiums are deposited into the trust accounts owned by the Massachusetts Highway Department, they constitute a refund, and must be disbursed before additional Federal funds are expended on the project.

FHWA Comments and OIG Response

Regarding 49 C.F.R. Part 18, the FHWA Executive Director stated that the OCIP complies with these regulations because he maintains that all of the funds are to be used, at some point, for insurance purposes. Again, the argument that the funds are always used for insurance purposes is undercut by the Central Artery Project Director’s statement that Massachusetts intends to use the “credit” for Title 23 surface transportation projects when it is received in 2017. As detailed above, OIG maintains that the amounts in the trust fund exceed insurance requirements and can be withdrawn by the Massachusetts Highway Department. Therefore, this regulation requires all of the excess to be used before additional Federal funds are expended on the project.

SECTION III –RECOMMENDATIONS

Payments for the Central Artery OCIP have far exceeded what is needed for reimbursement of insurance. Federal regulations prohibit holding of the overpayments in an investment account for 25 years. In its November 18, 1996 approval of the renewal of the OCIP, FHWA recognized the potential for “transfers from insurance fund accounts for both immediate insurance needs and/or for other uses.” The recovery of those overpayments is overdue. We recommend that the FHWA:

1. Recover the \$150.0 million Federal share of the premium overpayments and interest earned related to payments made through 1997, as well as any further

¹⁰ 49 C.F.R. § 18.25

¹¹ 49 C.F.R. § 18.21(f)

overpayments and interest that have since accrued, and either apply the funds to current project costs or return the money to the U.S. Treasury.

2. On an annual basis, determine actual insurance requirements and ensure any overpayments involving Federal funds are recovered and applied to current costs or returned to the U.S. Treasury.
3. Review its policy regarding reimbursement for insurance and establish guidelines to ensure any future overpayments of insurance premiums on highway projects are recovered and applied to current costs or returned to the U.S. Treasury.¹²

SECTION IV – MANAGEMENT COMMENTS AND OIG RESPONSE

On March 29, 1999, the FHWA Executive Director provided written comments in response to our draft report. In addition, the Central Artery Project Director wrote to the Inspector General on March 26, 1999. The FHWA Executive Director and Central Artery Project Director disagreed with our report, in large part because they maintained there have been no overpayments to the OCIP. We considered all comments provided and made revisions, as appropriate. All of our revisions were minor; the substance of our draft report is unchanged. The specific objections raised by the FHWA Executive Director and our responses regarding the overpayments, regulatory guidance, the appropriateness of long-term investments of Federal funds are incorporated into the body of the report, and are discussed in detail below.

A. Comments on Overpayments

The primary argument in the FHWA Executive Director’s response to our draft report is that all funds in the trust accounts are required for insurance purposes. According to the Executive Director, there have been no overpayments because the monies in the trust accounts are less than required to “collateralize” the state’s potential liability exposure. He maintains: “To the extent that actual premium payments exceed audited premiums, any additional amounts are placed in the trusts with the goal of reaching a level that collateralizes the State’s potential exposure. This level has not been reached.” In discussions regarding our draft of this report, the FHWA Massachusetts Division Administrator stated that the State faces potential “mammoth” liabilities under its general liability program over and above the potential losses over the insurance coverage purchased. According to the Division Administrator, these potential liabilities are so large that it would be

¹² This reiterates a recommendation in our April 1998 Report on the Central Artery project.

impossible to overpay the insurance. The FHWA Executive Director's response also indicated he believes that the funds in the trust accounts cannot be removed under the terms of the agreement.

We disagree. The Executive Director's position that the Central Artery's OCIP is not sufficiently "collateralized" is unsupported by OCIP insurance documents. The risks on the OCIP were examined and identified in the 1991 Risk Assessment for the OCIP conducted by the insurance broker (Sheppard, Riley, and Coughlin) in conjunction with a risk management and actuarial consultant (Tillinghast). According to that Risk Assessment, the project faces a worst-case scenario of \$150 - \$300 million in liability from potential catastrophic accidents.

The Executive Director's response implies there are potential liabilities beyond those identified in the Risk Assessment, and the overpayments must be retained for up to a quarter of a century as a reserve in case of catastrophic losses over the amount of coverage purchased. However, we found no evidence of any additional independent risk assessment that would support claims of increased potential risk. A March 30, 1998, draft "Risk Assessment Report" evaluated the currency of the 1991 assessment and found "the chances of a complete and total loss are infinitely small." The report concluded, "On the whole, the 1991 Risk Assessment Report addressed the risks of loss with a reasonable methodology," but recommended the Central Artery purchase an additional \$100 million of coverage (at an estimated cost of \$750 thousand to \$1 million) to raise the total coverage to \$300 million. If the project runs a credible risk of causing catastrophes beyond those identified in the 1991 Risk Assessment, this has not been documented or disclosed to the public.

We found the \$200 million of general liability coverage purchased under the OCIP is reasonably consistent with the estimates of \$150 - \$300 million in potential catastrophic losses identified in the 1991 Risk Assessment. The project has elected not to follow the advice in the 1998 draft Risk Assessment report to raise the coverage to \$300 million. In fact, in January 1999, the insurance broker who conducted the 1991 Risk Assessment declared the insurance coverage adequate, saying, "We are satisfied that the loss limit thresholds selected are appropriate and the continued emphasis on safety will keep losses well under control."

Furthermore, the project does not need reserves against losses above the insurance limits because FHWA has agreed to reimburse these costs. Specifically, FHWA's October 1992 approval of the workers' compensation and general liability insurance program stated, "In the unlikely event that claims are settled in excess of the policy limits, FHWA will make a participation determination on a case-by-case basis." The likelihood of a settlement surpassing the general liability policy limits is small, because, as noted in the draft 1998 Risk Assessment Report, the State has statutory immunity against losses over \$100,000 per claim.

The Executive Director's contention that the overpayments are needed as collateral is also contradicted by the insurance agreement. The only collateral requirements under the OCIP are established in the workers' compensation insurance policy and Large Deductible Agreement. Collateral is not required under the general liability policy. The insurance company is prohibited from applying any additional collateral requirements by the Massachusetts Commissioner of Insurance's October 1992 approval of the OCIP, which specified that given the "proposed arrangements to secure payments of claims against the Project, neither the Project nor any secured under the Program shall be required to post a letter of credit [i.e., collateral] to secure reimbursement of payments within the deductible."

The collateral required under the workers' compensation agreement is funded as a part of the audited premium. Therefore, any excess collateral identified by our further audit will be additional to the gross overpayments of \$166.7 million that resulted from the excess of the estimated premiums over the audited premiums. The insurance agreement includes a provision ("Section XIII") that directs the Massachusetts Highway Department and insurance company to annually determine the appropriate amount needed as collateral against expected claims. The provision also establishes procedures for adjusting the collateral annually based on the calculation, and specifically authorizes the Massachusetts Highway Department to recover any excess from the trusts.

The Massachusetts Highway Department reported to us that they have never made the required calculations. Instead, they claim that, despite the provisions of the agreement to the contrary -- and without providing any written documentation of any alternative agreements -- it was the parties "intention" that the collateral only be adjusted upon termination of the insurance program. Our audit of the collateral requirements established under the agreement remains ongoing.

We reject the Massachusetts Highway Department's "interpretation" of the agreement. There are other procedures in the agreement to govern dissolution of the trusts upon termination of the program. Section XIII calls for annual calculations of collateral and the return of excess collateral during the life of the program. No prudent business would enter into an agreement that does not allow excess payments to be returned for up to 25 years. In commenting on the Massachusetts Highway Department's response, FHWA agreed that the agreement does call for a calculation on a yearly basis, but noted that the agreement provisions are not the mechanisms that control the collateral levels "as the program has developed." This is a cause for concern, as any "understandings" not included in the insurance agreement are improper and are unenforceable per the provisions of the agreement (Large Deductible Agreement, Section XXI).

We conclude that the clear language of the agreement allows the Massachusetts Highway Department to recover the excess funds in the trusts, but it has chosen not to do so. Instead, it has kept the excess funds invested in its trust accounts to earn interest for use as an offset against current cost increases.

As of December 31, 1998, the OCIP trust accounts held \$264.6 million, far in excess of the amount required to fund the insurance program. The overpayments are not collateral, a fact that is demonstrated by the Massachusetts Highway Department's use of \$22 million of excess trust monies to pay part of the premiums in subsequent policy years. Specifically, \$6 million was applied toward the 1995/1996 premium, and \$16 million was applied to the 1996/1997 premium. The Massachusetts Highway Department has chosen to leave the funds in the trust accounts as an investment. In our opinion, the Federal share of the remaining overpayments and accumulated interest, \$150.0 million, must be used to pay current project costs or returned to the U.S. Treasury.

B. Comments on Statutory and Regulatory Guidance

The FHWA Executive Director disagreed with OIG's determination that Federal regulations and guidance prohibit holding of the excess balances in the trust accounts until 2017. This disagreement was based on the presumption that there are no excess balances.

OMB Circular A-87. In reply to our draft report, the Executive Director stated:

As we have explained to [OIG], the circular does not neatly address a program structured such as the CA/T OCIP program. While this program is clearly vendor provided insurance, it is more nearly analogous to self insurance and follows the trust guidelines as stated in Circular A-87. Proceeds do not leave the system, always being retained to reimburse the deductibles or for other insurance purposes. The premium adjustments that are placed in the trusts are not counted as insurance refunds that would or could leave the program. Rather, they stay in the system to meet the project goal of collateralizing the trusts. We recognize that the program is not defined in the strict sense as 'self insurance'. However, it functions more nearly as that type of program than as a traditional insurance policy. Nevertheless, the program still meets the requirements of vendor provided insurance as described in the circular when it is recognized that the trust exists solely for insurance purposes. Therefore, we believe that the program is in full compliance with the provisions of Circular A-87.

As shown above, we believe the trust fund balances are far in excess of insurance requirements and can be freely withdrawn by the project. Under OMB Circular A-87 Section 4, "insurance refunds or rebates, and adjustments of overpayments" must be credited to the Federal award either as a cost reduction or cash refund, as appropriate. Furthermore, to avoid excessive reserve balances, Section 25 of the Circular limits premiums to current value of expected losses. The excess balances in the trust accounts are overpayments that are being retained to "collateralize the trust," not only above the current value of expected losses, but above the level of

documented overall risk. Once the excess funds were placed into the Massachusetts Highway Department's accounts and were available for use, they constitute a refund which must "be credited against insurance costs in the year the refund is received."

Cash Management Improvement Act. The FHWA Executive Director also disagreed that holding of the overpayments until 2017 violates the Cash Management Improvement Act (CMIA). He maintained the trust agreement is in compliance with the CMIA because the "trust and contributions are always used for insurance purposes." As shown above, we believe the amounts in the trust funds owned by the Massachusetts Highway Department exceed the insurance requirements identified in the insurance agreements and the project's own Risk Assessment. The OCIP agreement specifically entitles the Massachusetts Highway Department to withdraw excess funds from the trusts. As we stated previously, the deposit of the excess premiums into the trust accounts owned by the Massachusetts Highway Department constitutes a refund, and the excess and interest at applicable Treasury rates are subject to the CMIA.

On February 18, 1999, we discussed the results of this audit with representatives from the U.S. Department of Treasury's Financial Management Services Division. According to those officials, the Central Artery's OCIP would be inconsistent with the CMIA if the overpayments are deemed to be a refund. In our opinion, because the monies are deposited into the Massachusetts Highway Department's trust accounts, and the state is entitled to freely withdraw any excess funds, the overpayments have been "refunded." Therefore, the CMIA requires the overpayments and interest at applicable Treasury rates to be returned to the U.S. Treasury or applied to the cost of the project.

23 C.F.R. Part 140. Regarding 23 C.F.R. Part 140 Section 711, the FHWA Executive Director commented that this section "relates to expenses of public employees and is not applicable to insurance coverage related to construction activities." As paragraph 140.711(b) is the only FHWA guidance on insurance reimbursements, we looked to this regulation for insight on what constitutes an allowable cost versus an overpayment. The guidance in the paragraph is consistent with the standards of OMB Circular A-87 in requiring that insurance payments be liabilities to be eligible for reimbursement. Massachusetts has confirmed to the U.S. Treasury that the payments to the OCIP "are technically assets held in trust for the Commonwealth and as such do not meet the GAAP definition of an expenditure." Notwithstanding the FHWA Executive Director's disagreement, we note that he continued to concur with our open recommendation for additional guidelines in this area.

49 C.F.R. Part 18. Regarding 49 C.F.R. Part 18, the FHWA Executive Director stated that the OCIP complies with these regulations because he maintains that all of the funds are to be used, at some point, for insurance purposes. However, under the regulations, program income, rebates, refunds, contract settlements, audit recoveries and interest earned on those funds are to be disbursed before requesting additional cash payments. The amounts in the trust accounts owned by the Massachusetts Highway Department exceed the insurance requirements, and the Large Deductible Agreement specifically entitles the Massachusetts Highway Department to withdraw the excess funds from the trusts. In our opinion, this regulation requires all of the excess to be used before additional Federal funds are expended on the project.

C. Comments on Long-Term Investment of Federal Funds

In his response, the FHWA Executive Director contended there is an opportunity for the project and public to reap a significant benefit when the OCIP is closed out in 2017. Federal policy calls for Federal funds to be used for current transportation needs. Consistent with this policy, in our opinion, the retention of Federal funds for investment purposes for up to 25 years is not an allowable or prudent use of funds.

D. Other FHWA Comments

1. In his response, the FHWA Executive Director characterized OIG's position as being that the Central Artery project is overinsured. That is incorrect. The central concern addressed in our report is not overinsurance, but overpayment of insurance premiums for investment purposes.
2. The FHWA Executive Director stated he finds this report inconsistent with our April 3, 1998, report. In our 1998 report, we questioned the likelihood of the then projected \$827 million credit in 2017. That report looked at the funding and cost of the project. We did not audit how the insurance program operated. We maintain that it is inappropriate to take the full value of any credit not scheduled to be received until 2017 as an offset against current project costs. As the FHWA Executive Director stated in the comments to this report, there is only the "likelihood of a credit when the program is eventually closed out." The credit may be less than the full amount, or nothing.

Further, our 1998 report assumed the insurance program payments were based on valid potential liabilities. Hence, we questioned taking the full value of the "credit," given that at least part of liabilities of such a magnitude should be expected to materialize. However, the results of our current audit have shown that, in fact, there are no documented risks of liability commensurate with the large level of reserves being generated. In our discussions with insurance

industry experts, they noted that the financing of the Central Artery OCIP differs from typical programs in an important aspect, that being the magnitude of the reserves being generated by the program. Consistent with Federal policies, the retention of Federal funds for investment purposes for up to 25 years is not an allowable or prudent use of funds. OIG believes FHWA should be enforcing Federal policies that call for Federal funds to be used for current transportation needs.

3. We accept the FHWA Executive Director's comments regarding \$30.1 million in discrepancies that we listed in a draft of this report. The discrepancies arose because the actual payments made by the Massachusetts Highway Department are not documented in the insurance company's audits. Instead, the insurance company audits list the estimated premiums the Highway Department was supposed to pay. FHWA provided additional documentation to demonstrate that the payments were less than the estimated premium in 2 years, because previous overpayments were applied to subsequent policy years. Therefore, we removed the discussion of discrepancies from the report. However, we note the use of some previous overpayments demonstrates that excess funds are available for recoupment. We maintain that all of remaining overpayments and interest, \$166.7 million, should be used to pay project costs or the Federal portion returned to the U.S. Treasury.
4. The FHWA Executive Director's comments regarding "caps" on workers' compensation relate to discussions between OIG and FHWA officials on the extent of potential workers' compensation liability, which were not included in the draft of this report. The Executive Director commented that at least one portion of workers' compensation benefits has not been capped. Section 36 of the Massachusetts Workers' Compensation law limited 15 categories of benefits to an amount calculated using the State average weekly wage multiplied by a defined number of weeks. OIG had pointed out that these limitations have had a substantial effect in reducing payments for claims across the state, and made it highly unlikely that the Central Artery OCIP will ever provide any significant coverage of the State's liability. This was confirmed when the Massachusetts Department of Industrial Accidents, the State agency charged with overseeing workers' compensation, reported to us that, since 1992, only 2 workers' compensation cases in the entire State have exceeded \$1 million, the deductible on the OCIP. (Neither of these cases involved the Central Artery). The Department of Industrial Accidents has also reported that the legislative and regulatory limitations have led to a 50.9% reduction in workers' compensation premiums in Massachusetts since 1991.

After reviewing comments provided by the FHWA Executive Director, we reiterate that the conclusions of our draft report were correct as stated. Payments for the OCIP have far exceeded the amount needed to fund the insurance program.

As stated by the FHWA Executive Director: “At the point that the trust is funded to a level higher than is needed for insurance purposes, then [OIG’s] point can be made that the proceeds are no longer insurance, per se.” That point has been reached. FHWA should require the Massachusetts Highway Department to either use the \$150.0 million Federal share of the \$166.7 million in excess funds accumulated in the OCIP trust accounts to pay current project costs, or return the Federal share to the U.S. Treasury.

OBJECTIVES, SCOPE, AND METHODOLOGY

OBJECTIVES

We audited the Central Artery project's Owner-Controlled Insurance Program (OCIP) pursuant to Congressional direction in House Committee Report 105-648 (accompanying H.R.4328, Department of Transportation and Related Agencies Appropriations Bill, 1999), which stated:

The Committee directs the department's Inspector General to continue to oversee the costs, funding, and schedule of the Central Artery project and to report periodically its results to the Committee.

The objective of this audit was to determine whether the workers' compensation and general liability portions of the OCIP were effective in reducing the overall cost of insurance for the project. In conducting our audit, we identified the overpayments that are the subject of this report. In accordance with Government Auditing Standards, we are reporting these overpayments now to allow program officials to undertake needed corrective action immediately. Our overall audit of OCIP effectiveness remains on-going.

SCOPE

This scope of this report is limited to the workers' compensation and general liability portions of the Central Artery OCIP. There are other insurances that, along with the workers' compensation and general liability, comprise the OCIP. These include Employment Practices, Airport Contractor's, Railroad Protective Liability, and Project Professional Liability insurance. However, the cost of the workers' compensation and general liability insurance constitutes over 91 percent of the total cost of the OCIP. Therefore, our audit was limited to these two elements of the program.

In June 1996 FHWA issued a report that, among other things, recommended that the project or its consultants implement procedures to ensure that the insurance company's, AIG's, payroll audits are accurate. We did not conduct a reliability assessment of AIG's audit results because the project and its insurance broker, Sheppard, Riley, and Coughlin (SRC), have yet to fully implement procedures in response to the FHWA's recommendations.

METHODOLOGY

We evaluated supporting documentation from FHWA, the Commonwealth of Massachusetts, the Central Artery project, AIG, and SRC. Specifically, we reviewed premium payment schedules, AIG's payroll audit reports for 1992 through 1997, insurance company estimates of projected losses, insurance documents including the policies, the workers' compensation Large Deductible Agreement, the trust agreement, correspondence between FHWA and the Massachusetts Highway Department contemporaneous to the establishment of the program, and other pertinent documents.

We met with the Auditor of the Commonwealth of Massachusetts who extended to us the courtesy of reviewing work papers from their audit of the OCIP.

To determine insurance industry standard practice concerning OCIPs and workers' compensation insurance programs, we contacted insurance institutes, consultants, government insurance related contacts, and insurance educators. In addition, we reviewed literature on insurance industry practices. Through these contacts, we determined the standard insurance industry practice for establishing OCIPs, identifying risk, funding collateral for projected liabilities, and managing reserves. The significant contacts we made included:

- Department of Labor
Office of Workers' Compensation Programs
- National Association of Insurance Commissioners
Washington, DC, and Kansas City offices
- John Burton, Dean,
Rutgers University
- John Lewis, Esq.
Outside Attorney Familiar with Bechtel and AIG OCIPs

The literature we reviewed on insurance industry practices included:

Workers' Comp for Employers: Taking Control, James Walsh; Merritt Publishing 1994.

Comp Control – The Secrets of Reducing Workers' Compensation Costs, Edward I. Priz; Oasis Press, 1995.

The Buyer's Guide to Business Insurance, Don Bury and Larry Heischman; Oasis Press, 1994.

Slash Your Workers' Comp Costs, Thomas Lundberg and Lynn Tylczak; American Management Association, 1997.

Dictionary of Insurance Terms, Harvey W. Rubin, Ph.D, CLU, CPCU; Barrons, 1995.

We also discussed the structure of the OCIP with officials from the US Treasury's Financial Management and Internal Revenue Services, as well as the Securities and Exchange Commission.

Our audit was performed over the period from October 1998 to March 1999, and was performed in accordance with the Government Auditing Standards prescribed by the Comptroller General of the United States.

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U.S. Department
of Transportation
**Federal Highway
Administration**

ATTACHMENT B

Memorandum

Subject: FHWA Comments to OIG Draft Report, "Audit of Central Artery Project Owner-Controlled Insurance Program" Date: March 29, 1999

From: Anthony R. Kane  Executive Director Reply to Attn. of: HAIM

To: Lawrence H. Weintrob
Assistant Inspector General for Auditing (JA-1)

The FHWA provided draft comments to your office on March 26, 1999, in response to your draft Audit Report which was received on March 4, 1999, on the Central Artery Project Owner-Controlled Insurance Program (OCIP). This is to advise that the draft comments will serve as the FHWA's final comments.

In addition, the FHWA encourages the OIG to continue its efforts regarding the original objective of the review; that is, whether the workers compensation and general liability portions of the OCIP were effective in reducing the overall cost of insurance for the project. The FHWA believes that this technique is important and worthy of further exploration.



U.S. Department
of Transportation
**Federal Highway
Administration**

Memorandum

ATTACHMENT B

Subject: **DRAFT** FHWA Comments to (undated) OIG Draft Report,
"Audit of Central Artery Project Owner-Controlled
Insurance Program"

Date: March 26, 1999

From: *A.R. Kane*
Anthony R. Kane
Executive Director

Reply to
Attn. of: **HAIM**

To: Lawrence H. Weintrob
Assistant Inspector General for Auditing (JA-1)

The following are FHWA's draft comments to your Audit Report on the Central Artery Project Owner-Controlled Insurance Program. Our comments respond to this draft and planned changes you have advised us of in meetings and conference calls as specifically addressed below. Vince Schimmoller, Program Manager, Office of Infrastructure, spoke to Pat Thompson today and agreed to furnish these draft comments with the understanding that FHWA could modify our response on Monday, March 29.

The FHWA is very concerned about the OIG's position on the Central Artery/Tunnel (CA/T) Project Owner Controlled Insurance Program (OCIP). Although the FHWA and Project staff have tried to provide an accurate synopsis of the program, it appears from your draft report and subsequent discussions that a significant level of misunderstanding still exists. There obviously is a different understanding about the fundamental purpose and structure of the CA/T Project's insurance program. We believe there is some agreement on the elimination of a number of inaccuracies in the first draft of your report. Except as noted, our comments reflect our position based upon the review of that earlier draft. We feel that further collaboration with your staff, prior to the issuance of a final report, could resolve the issues still remaining.

As an overview, your report seems to be saying that the CA/T Project is over-insured. We strongly disagree for the reasons that follow. Our primary concern is that this largest highway project in the history of the United States should not risk a loss of the billions of dollars that have been invested and will be invested.

By way of background on the OCIP, it is important to note that what was estimated to be a \$200 million savings when the "go-forward" decision was made to use the program is now estimated to be a significantly larger savings due to the unique structure of the insurance program. These savings, and the eventual credits that may occur when the program is closed, are very much within a "closed system" where the proceeds all benefit the Federal-aid Project. The unique structure of the OCIP provides an innovative way to underwrite the significant risks associated with such a large undertaking as the CA/T Project, while also providing a significant opportunity for the public at large to benefit from the likelihood of a credit when the program is eventually closed out. These benefits are very different from the Pennsylvania court case cited in your report where the proceeds

AUDITOR'S NOTE: FHWA did not revise this draft reply. 1

were diverted from the system to go to general purpose use.

It is extremely confusing to see that this year's report from the OIG is so dramatically different from the report issued less than a year ago by the same staff reviewing basically the same numbers. Quoting the OIG's April 3, 1998 "Report on the Central Artery/Ted Williams Tunnel Project":

"...Because this insurance refund is dependent on many variable factors, the amount of refund, if any, is uncertain...."

The design and early construction phases of this Project are not necessarily the type of activities that result in significant injuries, accidents, and claims. The expectation that there will be excess premium payments and interest earnings is at least partially premised on "claims to date." However, current claim costs do not necessarily reflect what can be expected during the heavy construction remaining on the Project. Much of the remaining construction on the Project requires underground tunneling involving work in confined areas, with poor lighting and ventilation, and with heavy equipment operating overhead. Such work conditions typically increase the risk of job-related injuries and claims. In addition, the construction will take place in densely populated urban areas, where potential damage to adjacent buildings also increases the risk of claims."

GAO also shared similar concerns about the level of risk associated with the CA/T Project.

These statements made eleven months ago contributed to the continuing concern about whether the assumptions made for the program were conservative enough. There was a clear lack of confidence expressed in those reports regarding whether the favorable loss ratios could be sustained. The CA/T Project has been entrusted with the responsibility of ensuring the safety of the public and workforce, a trust that the Project does not take lightly. While the issue of determining a proper level of insurance for the CA/T Project is a valid concern and worthy of additional study, we do not believe that it should appear as a citation in an OIG report. The State has a responsibility to provide insurance coverage for the inherent risks associated with heavy construction in an urban area. The CA/T Project's approach, which the FHWA has concurred in, has been to provide for a safe level of reserves to ensure the long-term success of the program. As the project has evolved, the State has worked to make incremental and reasonable changes to the insurance program to maximize the benefits of the Project's current excellent safety record while ensuring that appropriate insurance coverage remains. The nature of these adjustments has been conservative, as it should be, to ensure that collateralized trusts are there if and when they are needed.

Examples of the program adjustments that have already been implemented include:

1. Increased contractor deductible limits for general liability.
2. Secured exemption from Division of Industrial Accidents assessments.
3. Reduced fixed fees to the insurer, American International Group, Inc. (AIG)
4. Reduced risk transfer charges paid to AIG.
5. Modified the trust arrangements to protect the trust reserves from outside entities.
6. Modified investment guidelines to allow improved rates of return.

7. Reduced the amount of investment returns that are shared with AIG.
8. Lowered the maximum premium limits.
9. Implemented drug testing program.

The central premise of your draft report is that the CA/T Project has used the trust mechanism to produce income far beyond that needed for insurance purposes. We disagree. One hundred percent of the funds residing in the OCIP trust accounts are there for insurance purposes only. The agreement with AIG requires the Project to have available collateral assets to serve to reimburse AIG for the State deductible share after AIG has paid a claim. You term certain monies in the trust accounts as "overpayments". Again, we do not agree. To the extent that actual premium payments exceed audited premiums, any additional amounts are placed in the trust with the goal of reaching a level that collateralizes the State's potential exposure. This level has not yet been reached. FHWA and the State have had, and will continue to have, discussions regarding a reasonable level of funding for these trusts. Withdrawing funds at the level recommended in your draft report (and as you reported verbally on March 25, 1999 that you are lowering in the final report) would not provide adequate reserves to cover the potential exposure of the State.

At the point that the trust is funded to a level higher than is needed for insurance purposes, then your point can be made that the proceeds are no longer insurance, per se. The decision on this appropriate level of insurance for a project such as this is very subjective. There are numerous "correct" answers, but the ultimate test that FHWA has used in reviewing the State's program is one of reasonableness in application. The State has acted in good faith in setting up the OCIP, coordinating and receiving approvals from FHWA and the U.S. Treasury on issues such as the Cash Management Improvement Act (CMIA) throughout the early history of the project. FHWA has concluded that the State's approach for providing for potential insurance exposures is reasonable.

Regarding your contention that workers compensation (WC) has "capped" exposure, we believe after our discussions that you agree at least one part of WC is not statutorily capped. As for predicting the maximum potential WC liability, and for that matter for general liability, we can not comment on the specifics of your proposal because they were not included in the draft report. While you have in our discussion called them actuarial numbers, and imply they might be the only correct ones, we would have to see the assumptions used to generate the numbers before we can assess your position. We would be glad to meet with you and the State to discuss your method versus the State's method. In the interim, if you are correct, the money is still in the trust. If the State is right and did not have the coverage they now have, they would in essence have to go find the funds.

You have cited several instances where you claim the Project's program does not comply with Federal requirements:

1. OMB Circular A-87: As we have explained to your staff, the circular clearly does not neatly address a program structured such as the CA/T OCIP program. While this program is clearly vendor provided insurance, it is more nearly analogous to self insurance and follows the trust guidelines as stated in Circular A-87. Proceeds do not leave the system, always being retained to reimburse the deductibles or for other insurance purposes. The premium adjustments that are placed in the trusts are not counted as insurance refunds that would or

could leave the program. Rather, they stay in the system to meet the project goal of collateralizing the trust. We recognize that the program is not defined in the strict sense as "self-insurance". However, it functions more nearly as that type of program rather than as a traditional insurance policy. Nevertheless, the program still meets the requirements of vendor-provided insurance as described in the circular when it is recognized that the trust exists solely for insurance purposes. Therefore, we believe that the program is in full compliance with the provision of Circular A-87.

2. Cash Management Improvement Act: The trust arrangement has been coordinated with the U.S. Treasury and with FHWA. The 1993 finding by FHWA and the subsequent coordination with Treasury maintained that the trust arrangement is in compliance with CMIA. The trust contributions and interest are always used for insurance purposes. At the point that they no longer serve an insurance purpose, they would be credited back to the Federal-aid project for Title 23 purposes.
3. 23 CFR, Part 140: Section 711 of 23 CFR Part 140 relates to expenses of public employees and is not applicable to insurance coverage related to construction activities.
4. 49 CFR, Part 18: The sections you cite imply that the proceeds of the trusts are not being used for insurance purposes prior to requesting additional Federal funding. Dollars are allocated first to pay premiums, with additional dollars over and above the audited premium eventually flowing to collateralize the insurance trust for deductible reimbursements, a term of the insurance contract with AIG. For these reasons we believe that the program complies with the requirements of 49 CFR, Part 18.

Given the fact that FHWA considers the funds and generated interest as an integral part of the insurance program, we do not concur that federal funds cannot participate in these costs. Insurance is clearly an eligible project cost, and the FHWA will allow federal participation only to that amount that allows the trust to collateralize the State's liability. Since that level has not yet been reached, no removal of federal funds from the trust is required at this time. At the point that funds in the trust exceed the levels collateralizing the State's exposure, FHWA will require prompt crediting back to federal accounts. At that point, should the State believe that additional funds are needed in these trusts, such contributions would be non-federal.

Prudent management of these trusts is expected; therefore, the interest generated is not only allowable, it is encouraged (and helps the trust to reach collateralized levels earlier). Since the interest is never diverted from the accounts, recognizing the effects of interest generation on "total cost" is appropriate. We note that interest and principal over and above the fully collateralized level cannot be federally funded for the reasons stated by the OIG. Whatever level is determined appropriate for the trust, associated costs and credits will be counted as part of overall project cost.

Regarding your earlier determination that there are \$30.1 million in "discrepancies" between MHD's and AIG's records related to premium payments, we have provided you with additional information which clarifies this issue. It is now our understanding based on discussions with your office that you now agree there are no discrepancies, either reconciled or unreconciled, between MHD's and AIG's

records regarding actual payments. We understand from our telephone conversation with your staff on March 25, 1999 that all references to any accounting "discrepancies" have been removed from the report based upon the material that was provided to you.

Specific comments regarding OIG's recommendations follow:

1. **Do Not Concur:** FHWA does not agree that the State has "overpaid" the trusts since the funds that exceeded the audited premium have been placed in the trust specifically for insurance purposes. When and if those funds do not serve an insurance purpose, they will be promptly re-credited to the Federal-aid account.
2. **Concur:** FHWA concurs that the establishment of additional guidelines would be helpful and provide clarity to the field.
3. **Do Not Concur:** FHWA has provided you with additional information which clarifies this issue. It is now our understanding based on discussions with your office that you now agree there are no discrepancies, either reconciled or unreconciled, between MHD's and AIG's records regarding actual payments and that this finding will be dropped in the final report.

In closing, we urge you to coordinate further with us prior to releasing a report that may seriously hinder the application of an innovative and appropriate tool in the management of costs for large projects. If the project becomes under-insured, it is in essence the State's responsibility to cover this. We believe that the approach employed by the State in the CAT OCIP program is "good public policy" and provides significant benefits to the public.