United States General Accounting Office

GAO

Report to the Chairman, Subcommittee on Energy and Water Development, Committee on Appropriations, House of Representatives

April 2004

DEPARTMENT OF ENERGY

Certain Postretirement Benefits for Contractor Employees Are Unfunded and Program Oversight Could Be Improved

GAO-04-539

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GAO Accountability • Integrity • Reliability

Highlights

Highlights of GAO-04-539, a report to the Chairman, Subcommittee on Energy and Water Development, Committee on Appropriations, House of Representatives

Why GAO Did This Study

The Department of Energy (DOE), which carries out its national security, environmental cleanup, and research missions through extensive use of contractors, faces significant costs for postretirement health and pension benefits for contractor employees. Given DOE's long history of using contractors and the rising cost of postretirement benefits, you asked GAO to (1) analyze DOE's estimated financial obligation for postretirement health and pension benefits for contractor employees at the end of fiscal year 2003, (2) determine how DOE evaluates its contractor postretirement health and pension benefit programs and assesses the comparative levels of benefits offered by contractors, and (3) assess how DOE's oversight of these benefits could be enhanced.

What GAO Recommends

GAO recommends four executive actions: (1) institute systematic management review of pertinent data from each contractor location; (2) extend, as practical, DOE comparison study requirements to contractors not currently covered by them; (3) where the extension of the order is not practical, perform appropriate alternative procedures; and (4) incorporate into DOE's oversight a focus on the long-term costs and budgetary implications of decisions pertaining to each component of contractor benefit programs. In written comments on a draft of this report, DOE agreed with these recommendations.

www.gao.gov/cgi-bin/getrpt?GAO-04-539.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Robert Martin at (202) 512-6131 or martinr@gao.gov.

What GAO Found

As of September 30, 2003, DOE reported an estimated $13.4 billion in unfunded contractor postretirement health and pension benefits. This figure is an estimate of the present value of all benefits attributed to employee service before September 30, 2003, minus the fair market value of assets dedicated to the payment of retiree benefits. The unfunded balance has grown over the past 4 fiscal years as a result of the continuing accumulation of benefits, declining interest rates, and negative returns on pension assets. A significant portion of the unfunded balance relates to benefit programs at contractor sites that have already closed or will close once the work is complete.

DOE Order 350.1 generally provides that contractors periodically complete self-assessment studies comparing their benefits to professionally recognized measures. DOE uses these studies to make decisions about the level of contractor benefits. While the most recently completed comparison studies suggest that DOE has been successful in offering total contractor benefits that are comparable to those of selected competitors, the DOE Order 350.1 studies are not performed at a significant number of contractor locations, and alternative review procedures performed by DOE personnel are inconsistent from one contractor location to another; thus DOE's ability to evaluate the full range of programs is limited. In addition, GAO found that a number of the comparison studies did not conform to prescribed and recommended methodologies, calling into question the validity and comparability of the results.

Moreover, DOE's current focus on total benefits rather than individual benefit components in evaluating benefits does not fully recognize the differences in costs between deferred benefit programs, such as pension and postretirement health benefits, and other benefit components. This distinction is important because changes to pension and postretirement health benefits can have a significant impact on DOE's long-term costs and budgetary needs. For example, a 1 percent increase in a contractor employee's current year vacation benefits has less impact on DOE's long-term costs and budgetary needs than a 1 percent increase in postretirement pension or health benefits, which have a continuous and compounding effect as they are paid out in each year of retirement. Although reported total contractor benefits are comparable to selected competitors, the postretirement health benefits of DOE contractor employees at these sites averaged more than 44 percent greater than the average of the contractors' competitors, while defined benefit pension benefits averaged 29 percent greater.

The approval and monitoring of DOE contractor employee pension and postretirement health benefits is primarily the responsibility of DOE contracting officers, who administer contracts at individual contractor locations. Management does not systematically review information developed at individual contractor locations to identify best practices or areas where benefit comparisons do not adhere to agency requirements or guidance. Developing and disseminating this information agencywide would enhance DOE's oversight of contractor employee benefits and provide information needed to manage post-closure benefit costs.

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United States General Accounting Office
Washington, D.C. 20548

April 15, 2004

The Honorable David L. Hobson
Chairman, Subcommittee on Energy and Water Development
Committee on Appropriations
House of Representatives

Dear Mr. Chairman:

The Department of Energy (DOE) carries out its national security, environmental cleanup, and scientific and technological innovation missions through the extensive use of third-party contractors, including universities and private companies. These contractors, in many cases, incur costs for pension and postretirement health benefits that are reimbursed by DOE under the terms of their contracts. Contractor pension and postretirement health benefits represent significant costs for both research and environmental cleanup efforts. The current methodology used to fund these costs may result in the need for DOE to reimburse contractor benefit payments well after current operating contracts are terminated or cleanup sites are completed.

We, along with DOE's Office of Inspector General (IG), have issued several reports during recent years on the challenges DOE faces in the area of contract management and the extent of environmental cleanup costs.[1] Since 1990, we have included DOE's contract management, which is broadly defined to include contract administration and project management, as a high-risk area. Given DOE's long history of using contractors in its research and cleanup missions and the rising cost of providing employee postretirement health benefits, it is important that the management of short-term and long-term contractor employee benefits obligations ensures both the successful completion of cleanup and research objectives and the cost-effective use of government resources.

In this context, you requested that we review DOE's contractor employee benefits to (1) analyze the department's estimated financial obligation for

[1]U.S. General Accounting Office, *Major Management Challenges and Program Risks: Department of Energy*, GAO-03-100 (Washington, D.C.: January 2003), and *Contract Reform: DOE Has Made Progress, but Actions Needed to Ensure Initiatives Have Improved Results*, GAO-02-798 (Washington, D.C.: Sept. 13, 2002). U.S. Department of Energy, Office of Inspector General, *Management Challenges at the Department of Energy*, DOE/IG-0626 (Washington, D.C.: November 2003).

pension and postretirement health benefits for contractor employees at the end of fiscal year 2003, (2) determine how DOE evaluates its contractor pension and postretirement health benefit programs and assesses the comparative levels of benefits offered by its contractors, and (3) assess how DOE's oversight of these benefit programs could be enhanced.

We conducted our review from July 2003 through February 2004 at the Department of Energy headquarters in Washington, D.C., and the Defense Contract Audit Agency in Fort Belvoir, Virginia, in accordance with generally accepted government auditing standards. We requested written comments on a draft of this report from the Secretary of Energy. We also requested oral comments on applicable sections of a draft of this report from the Secretary of Defense. We incorporated those comments into our report as appropriate.

Results in Brief

As of September 30, 2003, DOE reported an estimated $13.4 billion in contractor pension and postretirement health benefits that remain unfunded. The unfunded balance, or funded status of these benefits, is an estimate of the present value of all benefits attributed to employee service rendered prior to September 30, 2003, less the fair market value of accumulated assets dedicated to the payment of retiree benefits.[2] The unfunded balance of these contractor benefits has significantly increased over the past 4 fiscal years due to the continuing accumulation of accrued benefits and adverse economic factors, such as declining interest rates and negative returns on pension assets. A significant portion of the unfunded balance relates to benefit programs at contractor sites where operations either have already been completed or will eventually be completed. The future administration and payment of pension and postretirement health retiree benefits following site completion creates a number of specific challenges for DOE.

DOE Order 350.1 provides that DOE's contractors should periodically compare their benefits to those of selected competitors or other professionally recognized measures. The most recently completed

[2]DOE calculates the funded status of its postretirement health and pension benefits in accordance with the accounting methodology and assumptions prescribed in Statement of Financial Accounting Standards (SFAS) No. 87, *Employers' Accounting for Pensions*, and SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, as issued by the Financial Accounting Standards Board (FASB).

comparison studies report that total contractor benefits are, on average, comparable to selected competitors. However, the self-assessment provisions of DOE Order 350.1 are not applicable to a significant number of contractor locations and benefit obligations. Also, our review of completed contractor studies reveals a number of cases of nonconformance with key DOE procedures, which raises questions about the validity of the results of the comparisons.

DOE's oversight of contractor postretirement health and pension benefits could be strengthened to provide for greater management review of contractor site information and incorporate a focus on the anticipated long-term duration of these benefit obligations. The absence of systematic management reviews of individual contractor site information hinders the agency's ability to conduct programwide oversight of contractor benefits and effectively evaluate post-closure benefit costs. Moreover, the lack of focus on long-term costs in periodic contractor benefit reviews does not fully recognize the difference in costs between deferred benefits programs, such as pension and postretirement health benefits, and other benefit components. This distinction is important because changes to deferred benefits have a continuous and compounding effect as they are paid out in each year of retirement.

In written comments on a draft of this report, DOE noted that our findings were consistent with those of its own internal assessment and agreed with the report's four recommendations.

Background

DOE relies on contractor organizations to manage, operate, maintain, and provide support to its environmental cleanup and science and energy research at government-owned facilities. Contractors at environmental cleanup sites direct remediation efforts for radioactive and hazardous waste contamination generated during former nuclear weapons research and production activities. The eventual completion of cleanup activities at individual contractor locations without the existence of other ongoing operations, called site completion or site closure, generally leads to transition into long-term stewardship activities such as monitoring and surveillance requiring significantly fewer resources. Contractors at research sites complete a variety of ongoing research and development activities at national laboratories and universities.

Contractors at cleanup and research sites may sponsor and pay pension[3] and postretirement health[4] benefits, collectively called postretirement benefits, for employees providing service under DOE contracts in order to attract, motivate, and retain qualified individuals to assist the agency in carrying out its mission. Contractors administer postretirement benefits for these employees either by establishing separate benefit plans solely for these individuals or by arranging for their participation in existing corporate plans, where contractor employees at DOE sites and those contractor employees assigned to non-DOE work participate in the same benefit plans.

DOE reimburses contractor payments for employee compensation, including postretirement benefits as authorized by applicable regulations and each contractor's operating agreement. For example, the Federal Acquisition Regulation (FAR) establishes uniform policies and procedures for the acquisition of goods and services by executive agencies. The FAR cost principles include factors to be considered by an agency when determining whether a contractor-claimed cost is to be allowed and reimbursed by an agency. Generally, consideration of whether compensation costs incurred under a government contract with a commercial organization are allowable includes whether they are, among

[3]Employee pension benefits can include participation in defined benefit and defined contribution plans; however, we use the term pension benefits to refer to defined benefit pension benefits in this report. For information on the differences between defined benefit and defined contribution pension plans, please see U.S. General Accounting Office, *Answers to Key Questions About Private Pension Plans*, GAO-02-745SP (Washington, D.C.: Sept. 18, 2002), 8-11.

[4]In general, postretirement health benefits can include medical, disability, and life insurance coverage. However, the majority of DOE contractor postretirement costs are for retiree medical benefits; therefore, we refer to these benefits as postretirement health benefits in this report.

other things, reasonable,[5] allocable, and compliant with other applicable standards and the terms of the contract. For fiscal year 2003, DOE reimbursed approximately $431 million in contractor postretirement benefit contributions at 39 different DOE contractor sites.[6]

Contractor employees qualify for retiree benefits in pension and postretirement health plans differently, resulting in different methodologies for the payment of the two types of benefits. Pension benefits are determined using a formula based on employee salary and years of service as specified by contractor plan provisions. Employees accrue, or earn, future pension benefits throughout their period of service and are generally required to work for a certain period, called a vesting period, before they have a right to receive any accrued retirement benefits. DOE contractors that offer defined benefit pension plans are subject to the minimum funding standards established by the Employee Retirement and Income Security Act of 1974 (ERISA).[7] The ERISA requirements set minimum standards regarding how much contractors must set aside each year in order to provide for future defined benefit pension payments when they are due.

[5]The FAR provides that if the compensation costs are established pursuant to an "arms length" labor management agreement negotiated pursuant to the Federal Labor Relations Act or similar state statute and are otherwise allowable, they are reasonable unless, as applied to the work in performing government contracts, they are determined to be unwarranted based on criteria specified in the regulation. See 48 C.F.R. § 31.205-6(b)(1) (2003). In addition, the FAR provides that if employee compensation costs are not covered by labor-management agreements, the compensation for each employee or job class of employees must be reasonable for the work performed and is reasonable if the aggregate of each measurable and allowable element sums to a reasonable total. Factors that may be relevant to this determination include, but are not limited to, conformity with compensation practices of other firms: (1) of the same size, (2) in the same industry, (3) in the same geographic region, and (4) engaged in similar nongovernment work under comparable circumstances. See 48 C.F.R. § 31.205-6(b)(2).

[6]See app. I for a complete list of DOE contractor locations that had recorded financial accounting liabilities for contractor employee benefits as of September 30, 2003.

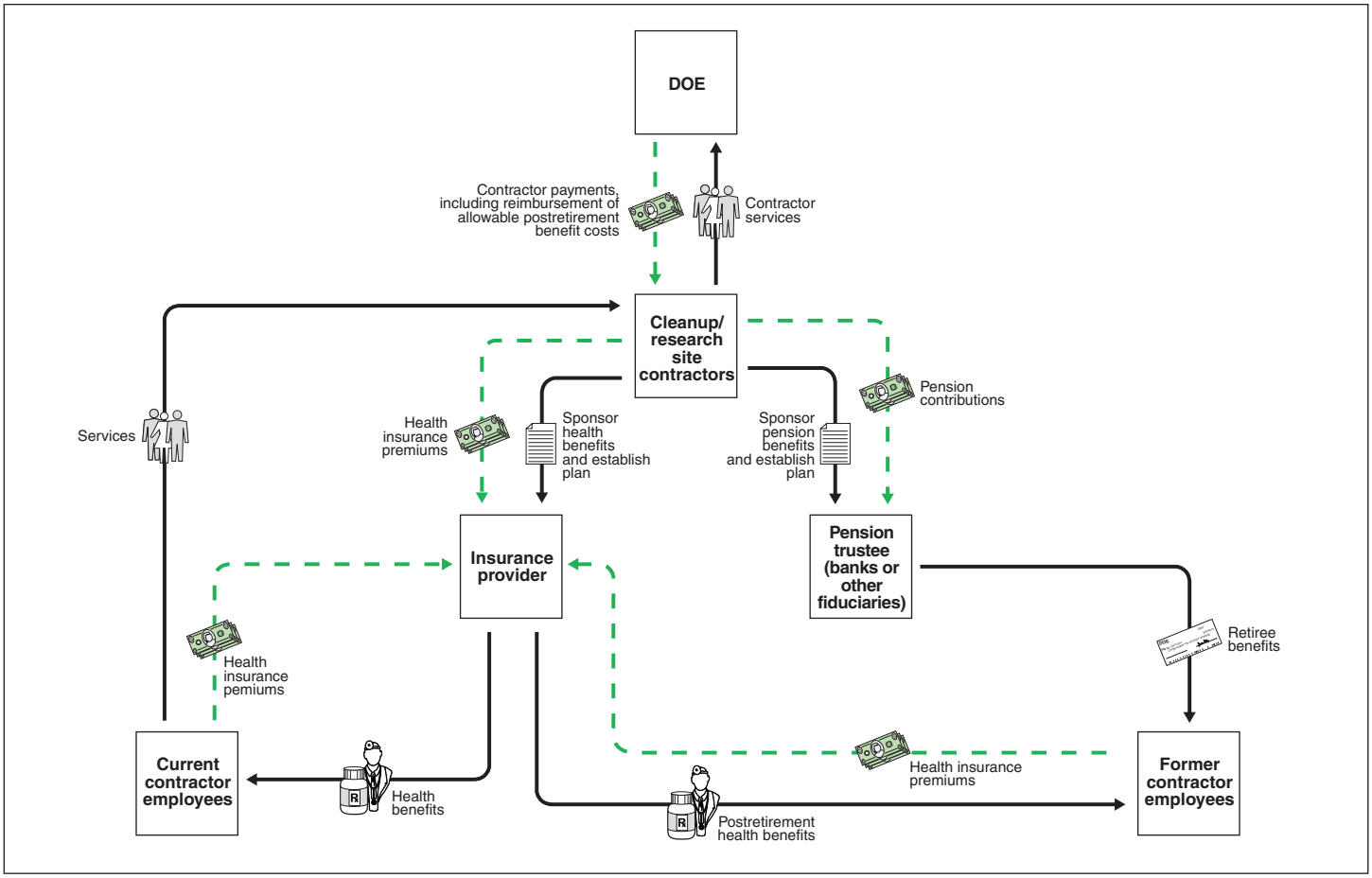
[7]Section 1013(a) of ERISA, Pub. L. No. 93-406, 88 Stat. 829, 914, added section 412 to the Internal Revenue Code of 1954, which appears at 26 U.S.C. § 412. Section 412 establishes minimum funding requirements for private sector defined benefit pension plans designed to ensure that these plans will have sufficient assets to pay the accrued benefits of participants upon retirement. The minimum funding rules generally require plan sponsors to contribute an annual amount to cover the following: (1) actuarial present value of benefits attributed by the pension benefit formula to services rendered during the plan year, (2) amortization of past service costs, and (3) amortization of increases in pension liabilities and experience losses. ERISA also establishes a maximum tax-deductible limit on the required contribution in 26 U.S.C. § 412(c)(7).

In contrast to contributions for pension benefits, there are no legal requirements to fund postretirement health benefits in advance for payments to retirees. Therefore, DOE contractors generally pay for postretirement health plans on a pay-as-you-go[8] basis. Retired contractor employees are usually entitled to participate in contractor health plans after they complete a period of service immediately prior to their retirement. However, unlike pension benefits, the future amount of postretirement health benefits earned by a contractor employee cannot be expressly defined at the employee's retirement date. This is due, in part, to the potential for future contractor changes in benefit provisions, such as retiree contributions, copayments, and coverage limitations, or cancellation of postretirement health coverage.

Figure 1 summarizes the previously discussed relationships between DOE, contractors, third-party administrators, and contractor employees in the payment, sponsorship, and delivery of postretirement benefits.

[8]Under a pay-as-you-go method, DOE only reimburses contractors for the funds needed to meet the premium costs of current retirees' benefits. This method can be contrasted with an accrual basis funding method, which funds estimated amounts of future payments needed to cover benefits earned during the current period. According to DOE officials, one DOE contractor does fund postretirement health benefits on an accrual-funding basis, as defined and allowed by applicable regulations.

Figure 1: Relationship between DOE, Contractors, Third-Party Administrators, and Contractor Employees



Source: Developed by GAO based on discussions with DOE officials.

Consistent with the long-term nature of DOE research and cleanup activities, it is DOE's policy to provide for the continuation of postretirement benefit plans when there are changes in individual contractors due to contract competitions. Typically, these scenarios would not result in the need for the cancellation and re-creation of these benefit plans. Although future contractor employee benefits earned may change as a result of contract negotiations, DOE attempts to continue the existing benefit plan with the new contractor as the sponsor, or offer comparable benefits in a successor contractor benefit plan during changes in contractors. Under this scenario, prior contractor retirees continue

receiving benefits from the new plan sponsor and current employees continue to accrue benefits according to existing plan provisions.

It is also DOE's policy to facilitate the continuation of postretirement benefits following the completion of activities at environmental cleanup sites. DOE officials stated that an agency review of contracts, benefit plan documents, and labor agreements determined that contractor postretirement plans set forth the terms of an exchange between the contractor and contractor employees.[9] In exchange for current services, contractors provide benefits after retirement (i.e., monthly pension payments and payments toward postretirement health insurance premiums) as defined by the terms of the postretirement benefit plans. DOE officials also stated that the continuation of pension and postretirement health benefits is necessary to reward former contractor employees for prior service at cleanup sites and to attract and retain future contractors and contractor employees to work at remaining cleanup sites.

The completion of all contractor activities at environmental cleanup sites generally results in either the termination of the prime contract or a significant reduction in the scope of the outstanding contract. These contract changes at site closure differ from a change in contractor at an ongoing site because retirees who earned postretirement benefits under the terms of prior contracts are left without an active contractor to administer future benefit payments. It is DOE's policy in these situations that future postretirement benefits earned by contractor employees may be satisfied by the outgoing contractor in one of two ways. Under the first option, the contractor can request reimbursement from DOE for the immediate settlement of outstanding benefit obligations, such as through the purchase of insurance contracts. Under the second option, the contractor may facilitate the continuation of the current benefit program and seek DOE reimbursement as postretirement benefit payments are made to retirees. The outgoing contractor can achieve the latter option through continuing to sponsor current postretirement benefit plans or through the transfer of plan administration to another party. This report refers to those benefits due and paid after site closure as post-closure benefits.

[9]This exchange is consistent with the provisions of SFAS No. 87, *Employers' Accounting for Pensions*, and SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*.

In 1996, DOE issued Order 350.1 to establish responsibilities, requirements, and further cost allowability criteria for the management and oversight of contractor compensation programs.[10] The order provides that contracting officers are largely responsible for the review and approval of allowable contractor compensation costs. It also details procedures for the management and oversight of postretirement benefits, such as the approval of new postretirement benefit plans, the approval of changes made to existing plans, and required procedures during contract and postretirement benefit plan terminations. The department's Contractor Human Resources Management Division (CHRM) is responsible for providing contracting officers with policies and procedures for managing contractor postretirement benefits costs under the provisions of DOE Order 350.1. DOE's Office of Procurement Assistance Management (OPAM) establishes overall performance objectives for contractor compensation programs and approves changes to pension and postretirement health benefit plans in excess of contracting officer authorization limits. The National Nuclear Security Administration (NNSA) assumes these responsibilities at current naval reactor sites and assists in the review of contractor compensation programs at other NNSA-designated locations.

DOE Order 350.1 requires contractors to complete a recurring evaluation of their employee benefit programs,[11] including pension and postretirement health plans, against the benefit programs of labor competitors in the private sector or other professionally recognized measures.

These provisions are completed to aid contracting officers in assessing contractor benefit costs against the reasonableness standards of the FAR. Specifically, DOE Order 350.1 states that contractors may use either the results from (1) a benefit value study or (2) the annual U.S. Chamber of Commerce Employee Benefit Study, collectively called comparison studies in this report, to perform an appropriate evaluation of their benefit programs.

[10]Compensation programs and costs discussed in DOE Order 350.1 include employee salaries, other cash and noncash compensation, and employee benefits programs.

[11]Contractor benefit programs, or contractor benefits, as used in this report, includes all major nonstatutory benefit programs offered by the contractor, such as postretirement health and pension benefits. Contractor benefits, as used in this report, exclude statutory benefits, such as Social Security benefits, and contractor employee compensation, which are evaluated separately by DOE.

Benefit value studies are intended to measure the relative worth of a contractor's benefit programs to its employees. This is done through the calculation of a replacement value[12] for the benefits offered in the contractor's benefit program. Replacement values that may differ among employees, such as the use and extent of current employee health benefits, are calculated through the use of a hypothetical group of employees. This methodology allows comparisons between the provisions of benefit programs with different demographics, turnover and retirement rates, and benefit election patterns. As such, replacement values are also calculated for selected labor market competitors of the contractor and compared to the contractor replacement values. DOE contractors engage benefits consulting companies to assist with the benefit value studies and work with contracting officers to approve the methodologies used.

Replacement values are found for each benefit component evaluated in the study and used to develop an overall benefit index program for that contractor. The final product of the benefit value study, called the net benefit value index, compares the relative value of the contractor's employer-paid benefits to the employer-paid value of the average labor competitor's benefits, represented by an index of 100. Therefore, a contractor with a net benefit value index of 107.0 offers benefits to its employees with a replacement value that is 7 percent above the average of the contractor's labor competitors. As mentioned, the benefit value studies also create separate indexes for major individual benefit components, such as pension benefits and vacation time.

The U.S. Chamber of Commerce Employee Benefit Study, or Chamber of Commerce cost study, provides a comparison of the annual employee benefit contributions and payments made by the contractor with the average contributions and payments of a survey population. The U.S. Chamber of Commerce Employee Benefit Study is an annual polling of domestic employers conducted by the U.S. Chamber of Commerce's Statistics and Research Center and sponsored by American International Group, Inc. The survey publishes information on average employer benefit contributions and payments per full-time employee made during the preceding year and the percentage of total employer payroll spent on employee benefits.

[12]Replacement value, in this context, indicates the amount of money an employee would need to spend or invest in order to duplicate the benefits provided by the employer.

Scope and Methodology

To analyze the agency's estimated financial liability for contractor employee pension and postretirement health obligations, we

- obtained audited financial reports and disclosures on contractor employee postretirement benefit obligations for fiscal years 1999 through 2003,
- interviewed DOE officials from the Office of Finance and Accounting Policy and CHRM regarding the character of obligations at DOE research and cleanup sites,
- reviewed actuarial computations of DOE contractor benefit obligations to determine how obligations at cleanup sites were adjusted for expected site closure dates, and
- interviewed DOE officials from the Office of Finance and Accounting Policy and the Office of General Counsel regarding the agency's liability with respect to contractor post-closure benefits.

The calculation of financial liabilities for postretirement benefits earned by contractor employees involves the use of significant economic and demographic assumptions under the guidance of Statement of Financial Accounting Standards (SFAS) No. 87, *Employers' Accounting for Pensions*, and SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*. It was not our intent to assess, nor did we independently assess, the reasonableness of the assumptions used in the financial calculations or the accuracy of contractor data used in the calculations. For fiscal years 1999 through 2003, DOE's financial statements, including estimates of contractor postretirement benefits, were audited by either independent public accountants or its IG. For each of these years, the auditing entity determined that DOE's financial statements presented fairly, in all material respects, the financial position of the agency.

To determine how DOE evaluates its contractor postretirement benefit programs and compares the benefits offered by DOE contractors with private industry benchmarks, we

- reviewed DOE Order 350.1 and other agency policy and procedure guidance related to the completion of contractor comparison studies,

- interviewed DOE officials from CHRM to determine procedures used to assess the quality of the contractor comparison studies,

- obtained and analyzed the most recent comparison studies completed by DOE contractors for all locations subject to the valuation provisions of DOE Order 350.1, and

- reviewed the most recent comparison studies for all locations subject to the DOE Order 350.1 valuation provisions for compliance with DOE policies and procedures.

We reviewed contractor comparison studies for compliance with key controls in DOE's policies and procedures, designed to provide reasonable assurance over the validity of the study results, including (1) timely completion and inclusion of major benefit components; (2) presence of recommended certifications to attest to the accuracy, relevance, and consistency of the data used in the study; (3) development of benchmark information through the selection of labor competitors and the use of up-to-date data for the competitors selected; and (4) calculation of desired (either required or recommended) performance measures. We summarized the results of these procedures in this report and communicated the detailed results of our testing to DOE officials. It was not our intent to verify, nor would we have been able to independently verify, the accuracy of actuarial calculations, assumptions, or competitor data used in the comparison studies due to the proprietary nature of benefits consulting firm databases used to conduct the studies. However, we confirmed that DOE requirements regarding the completion of these studies by national consulting groups with annual consulting revenues in excess of $5 million were met for all benefit value studies reviewed. We also did not independently assess the validity of the data supplied by DOE contractors for use in the comparison studies.

To assess DOE's oversight of its contractors' pension and postretirement health benefit programs, we

- reviewed the FAR and other applicable standards related to allowable pension and postretirement health costs under contracts with commercial organizations;

- determined applicable internal control procedures for DOE's contractor benefits program using our *Standards for Internal Control in the*

Federal Government[13] and *Internal Control Management and Evaluation Tool;*[14]

- reviewed related DOE policy and procedure guidance and interviewed DOE officials regarding procedures for overseeing contractor benefit programs in existence through the end of fiscal year 2003; and

- reviewed contractor locations subject to the provisions of DOE Order 350.1 for compliance with DOE policies and procedures related to the review of changes to contractor postretirement benefit programs.

In addition, we reviewed contractor operations and the oversight of contractor postretirement benefit programs at several federal agencies to determine whether contractor benefit programs at these agencies were comparable to those at DOE. We determined that the oversight of contractor benefit programs at the Department of Defense (DOD) was comparable, in some respects, to oversight at DOE and interviewed DOD officials to gain an understanding of that agency's procedures and the differences between DOE and DOD contractor operations.

Reported Unfunded Balances for Contractor Postretirement Benefits Are Significant, and Amounts for Post-Closure Benefits Are Increasing

In DOE's fiscal year 2003 Performance and Accountability Report, the agency reported that the present value of estimated contractor postretirement and pension benefits that were unfunded as of

[13]U.S. General Accounting Office, *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1 (Washington, D.C.: November 1999).

[14]U.S. General Accounting Office, *Internal Control Management and Evaluation Tool*, GAO-01-1008G (Washington, D.C.: August 2001).

September 30, 2003, totaled $13.4 billion.[15] The unfunded balance of these deferred benefits has increased significantly over the past 4 fiscal years due to various operating and economic factors. An increasing portion of the future unfunded balance will relate to estimated pension and postretirement health obligations at completed or near-completed environmental cleanup sites. The expected magnitude of these benefits at site closure will require DOE to meet significant future budgetary and administrative challenges to facilitate the future payment of these benefits.

DOE Estimates That the Present Value of Unfunded Contractor Postretirement Benefits as of September 30, 2003, Is $13.4 Billion

DOE reimburses allowable contractor costs for employee postretirement benefits and records estimates of these future benefit payments in its financial accounting statements.[16] The agency reported an estimated present value of $13.4 billion for pension and postretirement health benefits that have been earned by contractor employees under current postretirement benefit plan provisions but were unfunded as of September 30, 2003. This figure, also called the funded status, is an actuarial[17] estimate of future postretirement benefits attributed to contractor employee service rendered prior to the measurement date less the fair market value of accumulated assets dedicated to the payment of the obligation.

The calculation of financial accounting estimates involves the use of significant actuarial, demographic, and economic assumptions, including, among other things, future interest rates, health care cost trends, salary

[15]The unfunded balance of $13.4 billion differs from the financial liability of $9.8 billion presented in the Consolidated Balance Sheet of DOE's fiscal year 2003 Performance and Accountability Report. The unfunded balance of $13.4 billion equals the financial liability of $9.8 billion plus $3.6 billion in net losses incurred but not required to be recorded until future periods and other adjustments as prescribed by SFAS No. 87, *Employers' Accounting for Pensions*, and SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*.

[16]DOE calculates liabilities for contractor pension and postretirement health benefits according to the methodology established by FASB, which promulgates accounting rules for private sector enterprises. DOE's costs under its commercial contracts include the reimbursement of annual contractor employee benefits, and therefore DOE records these obligations as if it were the plan sponsor.

[17]Actuarial calculations for postretirement benefits involve the determination of the value, as of a specified date, of a series of future amounts payable, adjusted to reflect the time value of money (through discounts for interest) and the probability of payment (for example, by means of decrements for events such as death, disability, or withdrawal from a plan) between the specified date and the expected date of payment.

increases, and life expectancies of eligible retirees (and their survivors). Also, the estimation is inherently difficult because benefits earned by current contractor employees are deferred until retirement and the actual payment of these benefits may not occur for decades.

Funded Status of Contractor Postretirement Benefits Has Deteriorated Significantly since 1999

The combined funded status for contractor pension and postretirement health benefits has changed from a $3.6 billion overfunded position in 1999 to a $13.4 billion unfunded position in 2003. There are several significant reasons for this deterioration in funded status over the last 4 fiscal years, including negative pension asset returns, declining discount rates[18] over the past 3 fiscal years, and increasing trends in estimated postretirement health care costs. Table 1 summarizes the funded status for pension and postretirement health benefits for the last 5 fiscal year-ends as reported by DOE.

Table 1: Reported Funded Status for DOE Contractor Pension and Postretirement Health Benefits at the End of Fiscal Years 1999 through 2003

Dollars in billions

Fiscal year-end	Pension funded status	Postretirement health funded status	Total funded status
2003	($3.7)	($9.7)	**($13.4)**
2002	($1.0)	($8.3)	**($9.3)**
2001	$5.1[a]	($6.8)	**($1.6)**
2000	$10.2	($5.4)	**$4.8**
1999	$8.2	($4.6)	**$3.6**

Source: DOE.

Notes: Information from DOE Performance and Accountability Reports for fiscal years 1999 through 2003. Numbers may not add to total due to rounding. DOE's financial statements for the covered fiscal years were audited and received unqualified audit opinions.

[a]A positive funded status indicates an excess of the fair value of dedicated assets over estimated benefit obligations.

[18]Financial liabilities for postretirement health and pension obligations are estimated using the present value of future expected benefit payments. When assigning postretirement benefit costs to more than one financial statement period, interest costs are incurred due to the passage of time. The rate used to calculate the interest costs, and therefore adjust outstanding obligations for the time value of money, is called the discount rate. Decreases in the discount rate result in increases in annual financial statement benefits costs.

In general, deterioration in the funded status of postretirement health benefits can be attributed to the excess of future benefits earned by current contractor employees, known as service costs, plus interest costs on outstanding obligations over the payments made to retirees to satisfy previously earned benefits. Postretirement health benefit service costs plus interest costs have ranged from 2.3 times to 2.5 times the payments to retirees made in each of the past 5 fiscal years. The significant increases in recent retiree health benefit costs, decreases in discount rates, and continuing accrual of postretirement benefits in existing contractor plans all affect the service and interest costs of contractor postretirement health plans, although we did not determine to what extent each of these individual factors affected the total funded status.

Annual changes in the funded status of pension plans, unlike changes in the funded status of postretirement health plans, can be significantly affected by returns on dedicated pension assets. Contributions to pension plans are generally held in trust for the payment of benefits to participants and their beneficiaries. Plan trustees, usually banks or trust companies, make investment decisions for the plan with these assets. Contractor pension assets have, on average, experienced negative returns from 7 percent to 8 percent in each of the past 5 fiscal years. Negative asset returns decrease the fair market value of accumulated pension assets and therefore significantly contribute to changes in the funded status of pension benefits.

However, because of current DOE policies, neither the current unfunded position nor the significant recent changes in funded status results in a requirement for contractors, or DOE, to make any additional annual postretirement benefit contributions. DOE Order 350.1 provides that in general, annual contractor contributions for pension benefits shall not exceed the minimum contribution required by ERISA. The order also provides that postretirement health benefits are paid using a pay-as-you-go method unless otherwise required by state or federal statute. See table 2 for pension contributions and postretirement health payments reimbursed by DOE over the last 5 fiscal years.

Table 2: DOE Reimbursements for Contractor Pension Contributions and Postretirement Health Payments for Fiscal Years 1999 through 2003

Dollars in millions

Fiscal year-end	Pension contributions	Postretirement health payments	Total contributions and payments
2003	$167	$264	**$431**
2002	$75	$243	**$318**
2001	$43	$226	**$269**
2000	$58	$205	**$263**
1999	$61	$181	**$242**

Source: DOE.

Note: Information from DOE Performance and Accountability Reports for fiscal years 1999 through 2003.

However, certain contractors may face higher short-term pension contributions because minimum contributions calculated under ERISA rules factor in both current service costs and outstanding obligations.[19] In any case, the reported $13.4 billion unfunded balance will, eventually, require additional contributions, investment gains, or favorable benefit experience[20] within existing pension and postretirement health plans in order to satisfy future benefits when they come due.

Post-Closure Benefit Obligations Will Increase with Continuing Environmental Site Closures

While DOE fiscal year 2003 reimbursements of postretirement benefits to contractors administering benefits following site closure totaled only approximately $6 million, future amounts will significantly increase with continuing environmental site closures. DOE has indicated that the agency is scheduled to close several environmental cleanup sites within the next few years. Contractor employee postretirement benefits at these sites had total unfunded balances in excess of $1.5 billion as of September 30, 2003.

[19]26 U.S.C. § 412.

[20]Favorable benefit experience can be defined as differences between estimates of benefits earned to date by current and retired employees and the actual postretirement benefits paid to those employees in the future. Favorable benefit experience may also include the negotiated settlement of benefit obligations with contractors for amounts less than the estimated accounting obligations as measured by FASB standards.

DOE Order 350.1 provides that when operations at a DOE facility are terminated and no further work is to be completed, pension and postretirement health benefit continuation will be provided for those contractor employees who earned retirement benefits in these plans. Consistent with DOE Order 350.1, contract language at anticipated closure sites (such as Fernald and Rocky Flats) indicates that the DOE contracting officer will designate and communicate the method of benefit continuation within the final 6 months of the contract and may direct any of a number of potential means of doing so, including, but not limited to, (1) termination and settlement of the plans in accordance with relevant laws and regulations, (2) continuation of the plans on a pay-as-you-go basis under a separate contract with the contractor, or (3) transfer of plan responsibilities to another contractor or third party.

In conjunction with a site closure, the contractor may submit a claim, called a settlement proposal, for the final calculation of estimated postretirement benefits earned by contractor employees. The reimbursement of these costs would allow the contractor, generally through the purchase of insurance contracts, to complete the payment of future pension and postretirement health benefits without further DOE reimbursement. The ability of DOE to honor these claims largely depends on DOE's available financial resources compared to the total settlement costs[21] involved in the satisfaction of outstanding postretirement benefits.

According to DOE officials, DOE has recently considered several options to avoid postretirement benefit settlements because the reimbursement of contractors for the purchase of annuity contracts and future health benefit payments involves significant costs above the calculated settlement amount. Because of the budgetary resources required to settle postretirement benefits at completed cleanup sites, DOE officials anticipate continuing the annual reimbursement of benefit payments by extending contracts with cleanup site contractors in some cases, solely to administer the benefits, thereby preserving the contractor relationship as the plan sponsor. The continuation of these benefits creates specific challenges for DOE, including the following:

[21]The total settlement costs for each contractor pension plan consist of the unfunded benefit obligation at the contract termination date, the reimbursement of excise taxes paid by the contractor to terminate the plan, and any additional costs or fees associated with the purchase of insurance contracts to satisfy future payments to employees. Contractor benefit plans that are overfunded at the settlement date could result in the reversion of excess funds to DOE after all costs are paid to satisfy the estimated benefit obligations.

- DOE currently attempts to pass the administrative responsibilities for the continuation of post-closure employee benefits to existing contractors. However, as the number of contractors with existing cleanup operations diminishes with additional site closures, DOE must either continue relationships with former contractors, many of which were created only to facilitate a site closure, or transfer responsibilities to another party.

- Even though contractor postretirement benefits are earned during previous employment periods, DOE will require continuing appropriations in order to reimburse contractors for the payment of postretirement benefits to former contractor retirees and other beneficiaries. DOE officials estimate that the post-closure obligations may extend through 2075.

- The continuation of postretirement benefits through another contractor or a third party requires DOE to pay for the allowable administrative expenses of these activities.

- The continuation of postretirement benefits requires DOE to monitor and evaluate the ongoing contractor reimbursement for post-closure benefit payments and any changes in those benefit programs made by the contractor.

In response to these challenges, DOE announced plans in 2003 to establish an Office of Legacy Management to address the long-term management of former cleanup site contractor obligations. According to agency officials, a key mission of the Office of Legacy Management is to ensure the quality of service and continuity of former contractor employees' pension and medical benefits. The office is planning a comprehensive approach to fulfill the agency's pension and postretirement health obligations at current and future closure sites.

Evaluation of Contractor Benefits Could Be Improved

DOE Order 350.1 generally requires that contractors periodically complete self-assessments of major nonstatutory benefit programs against professionally recognized measures. The most recent contractor comparison studies report average contractor benefits are 0.2 percent below the value of selected labor competitors. However, a significant number of contractor locations are not subject to the valuation provisions of DOE Order 350.1, or otherwise do not complete them. In cases where DOE Order 350.1 does not apply, alternative procedures are performed by

DOE personnel; however, the procedures are inconsistent among contractor locations and are limited at completed, or near-completed, cleanup sites. We also found the comparison studies that were completed under DOE Order 350.1 often did not conform to existing DOE policies and recommended procedures.

Evaluation Studies Report Contractor Benefits Are Comparable to Those Offered by Selected Competitors

Each DOE contractor subject to the self-assessment provisions of DOE Order 350.1 is to periodically complete a comparison study evaluating its benefit programs against external benchmarks. This evaluation of contractor benefits may take the form of either a benefit value study, which measures relative replacement cost of employer-paid benefits against the benefits offered by a group of selected labor competitors, or a cost study, which measures the annual relative per capita benefit cost against companies surveyed by U.S Chamber of Commerce. The results of the comparison studies allow DOE contracting officers to measure the competitiveness of contractor benefit programs in the labor market and to assess contractor benefit program costs for reasonableness under applicable regulations and contract provisions. Table 3 summarizes the reported results from the most recent contractor comparison studies completed.

Table 3: Summary Statistics for DOE Order 350.1 Benefit Value and Cost Comparison Studies (Results Compared to an Average Comparator Index of 100.0)

Comparison study measures	Total benefits index
Average	99.8
Maximum	148.0
Minimum	71.0
Number of sites with an index above 105[a]	5
Number of sites with an index from 90 to 110	16

Source: GAO analysis.

Notes: Summarizes most recent contractor benefit value and Chamber of Commerce cost studies submitted by 21 DOE contractors. Generally, DOE benefit value study indexes should not be used to compare benefit program values between contractor sites because each study uses different comparator firms, each study completes the study as of a different date, and assumptions and methodologies may vary among contractor locations. However, the comparison study results are useful as performance indicators of how contractor benefits compare to a similarly determined value, the average benefit value of a selected set of labor competitors.

[a]DOE's goal is for the reported contractor benefit value to be no higher than 105 (or 5 percent higher than the average value of the contractor competitors at each location).

The reported results of the contractor comparison studies suggest that DOE has been fairly successful in achieving its goal of limiting the total value of contractor benefits to no more 5 percent higher than the average total value of the contractor's labor competitors at each location. As shown in table 3, only 5 of 21 studies have a benefits value of more than 105 and the average contractor benefits value is 0.2 percent below the employer-paid benefits level of selected study competitors. The reported results range from 29 percent below competitor averages to 48 percent above those averages; however, at 16 of 21 contractor locations, the reported benefits value falls from 90 to 110, or 10 percent below to 10 percent above labor competitor averages. As discussed later in this report, contractor nonconformance with DOE guidance on the completion of these studies raises questions about the validity of the comparison study results.

A Significant Number of Contractors Do Not Complete DOE Order 350.1 Comparison Studies

A significant number of DOE contractors, and the postretirement benefits they offer, are not subject to the comparison study provisions of DOE Order 350.1. Contractors with postretirement benefits (1) offered in corporate plans,[22] (2) reimbursed under support contracts,[23] and (3) provided for employees at naval reactor sites are exempted from the requirements. In addition, the studies were not performed at six contractor sites that were closed, or nearing completion.

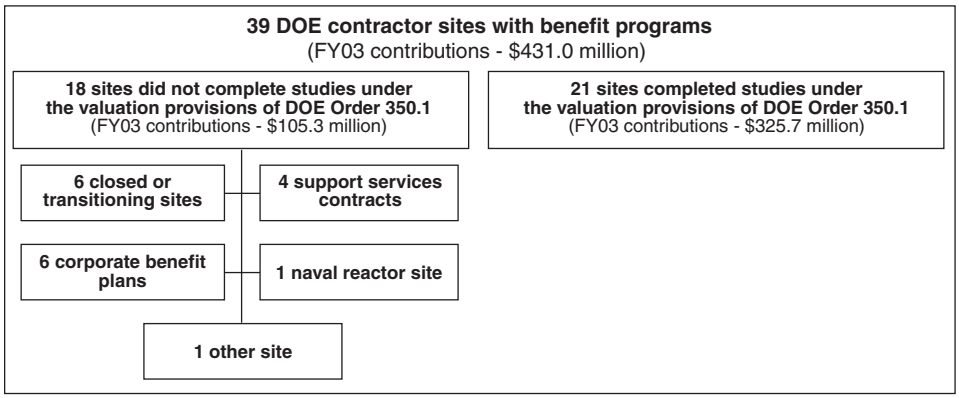
DOE reimbursements of postretirement benefits at sites at which comparison studies were not completed accounted for $105 million of the $431 million, or 24 percent, in total contractor contributions made for contractor postretirement benefit programs in fiscal year 2003. Figure 2 illustrates DOE reimbursements for postretirement benefits made for fiscal year 2003 according to whether the contractor location is subject to the

[22]The term "corporate plan" is used within DOE Order 350.1 to indicate the participation of DOE contractor employees in a contractor's companywide benefits program. Contractors providing corporate plan benefits are subject to the provisions of DOE Order 350.1; however, they are specifically exempted from the comparison study requirements.

[23]Although the majority of DOE contracts at environmental cleanup and research sites are for primary cleanup and research missions, called management and operating contracts, some contracts at these sites are support services contracts. Support services refer to those activities that are not fundamental to the environmental cleanup and research operations, including facilities management, security, and health services. These contracts are generally smaller in size and scope and were separated from larger management and operating contracts in order to provide opportunities for smaller businesses.

comparison study provisions and the reasons DOE officials provided for their exclusion.

Figure 2: DOE Reimbursements for Postretirement Benefits Sorted by the Applicability of DOE Order 350.1 Comparison Studies



Source: GAO analysis.

Note: Based on information provided by DOE and data in its fiscal year 2003 audited financial statements.

DOE officials complete alternative monitoring procedures at some locations where DOE Order 350.1 comparison studies are not required or otherwise completed. Examples of these procedures include reviews of benefit payment invoices, comparisons to other DOE contractor programs, and review of annual actuarial calculations. CHRM also periodically completes valuation and cost reviews at various contractor sites. CHRM procedures include reviews of contractors' actual incurred costs for benefits and wages; actuarial valuation and accounting reports; and various annual pension plan reviews, such as salary replacement, plan investment, and cash flow requirement analysis.

However, at completed or near-completed cleanup sites we found that DOE officials did not complete comparison studies and completed limited alternative procedures to assess the reasonableness of continuing pension and postretirement health payments at these locations. According to DOE officials, significant reasons for the absence of comparison studies for post-closure benefits include the lack of resources to perform the studies at former contractor sites that are nearing completion and the fact that three DOE sites were closed before the provisions of DOE Order 350.1 became applicable. Reimbursements at these locations in fiscal year 2003 totaled

$31 million and, as previously mentioned, the postretirement benefits paid at closed locations are anticipated to increase as additional closure sites are completed.

Nonconformance with DOE Guidance Raises Questions about the Validity of Comparison Study Results

DOE Order 350.1 requires certain processes and procedures for completing the previously discussed comparison studies. In addition, DOE's *Value Study Desk Manual*[24] describes recommended methodologies for the completion of a benefit value study. Collectively, the procedures and methodology outlined in DOE Order 350.1 and the *Value Study Desk Manual* are intended to provide reasonable assurance that the comparison studies result in valid, reliable, and comparable information regarding the benefits offered by DOE contractors. To assess the studies completed by DOE contractors, we selected 12 significant provisions from DOE Order 350.1 and the *Value Study Desk Manual* and reviewed the most recently completed contractor studies for conformance with these provisions. Our review encompassed all 21 contractor sites subject to the comparison study provisions of DOE Order 350.1 (18 completed benefit value studies and 3 completed Chamber of Commerce cost studies).

Based on our review of the studies performed at contractor sites subject to the valuation provisions of DOE Order 350.1 and the *Value Study Desk Manual*, we found one or more instances of nonconformance with required or recommended comparison study procedures at 18 of the 21 contractor sites. In summary, we found instances of nonconformance with guidance in the following areas:

- Contractors did not follow applicable provisions for selecting and documenting comparators used in the development of a benefit value index (11 of 18[25] sites completing benefit value studies).

[24]The *Value Study Desk Manual* was prepared for DOE by Buck Consultants, Inc., and issued in February 1999. The manual is distributed to all DOE contracting officers and contains recommended procedures for completing DOE benefit value studies. Policies and procedures for the completion of both the benefit value studies and the Chamber of Commerce cost studies are also found in DOE Order 350.1.

[25]These tests were conducted for 18 of the 21 contractor sites because the *Value Study Desk Manual* recommended procedure to obtain contractor and actuarial certifications and maintain documentation for comparator companies outside of the contractor's industry are not applicable to the 3 contractor sites that completed Chamber of Commerce cost studies.

- Contractors did not use the recommended methodologies to calculate the results of the comparison study (10 of 21 sites completing benefit value or cost studies).

- Contracting officers did not obtain recommended certifications from contractors and actuarial consultants to verify data used in the benefit value studies (16 of 18[26] sites completing benefit value studies).

Since the results of the benefit value comparison studies are sensitive to the selection of a comparator group, DOE Order 350.1 and the *Value Study Desk Manual* provide that the comparator group include at least 15 participants, only 20 percent of which can be other DOE contractor sites that compete for professional level staff. Our review determined that 11 out of 18 contractors did not properly select comparator firms or maintain documentation on comparators in accordance with recommended procedures in the *Value Study Desk Manual*.[27] Although DOE policies also require contracting officers to review and approve the contractor comparator group prior to the completion of the benefit value study, several contractors were not in compliance with this agency procedure because they did not provide the specific documentation recommended by the *Value Study Desk Manual*. This situation may result in inconsistent criteria selection for comparators among contractor studies.

DOE Order 350.1 requires contractor comparison studies to generate appropriate comparison statistics. The *Value Study Desk Manual* recommends that benefit value studies calculate the contractor's total employer-paid net benefit value using a comparison to the average total (e.g., the mean) net benefit value for the comparator group. DOE Order 350.1 requires Chamber of Commerce cost studies to calculate the contractor's actual per capita benefits cost per employee compared to the most recently published survey from the same benefit year. Our review found that 10 out of the 21 contractor sites did not calculate the desired performance measure as required or recommended by DOE guidance. In several cases, we found that the contractor total benefit value index was computed based on the median, not the mean, of competitor replacement

[26]See footnote 25.

[27]The *Value Study Desk Manual* recommends that all companies selected as comparators for the benefit value study should compete for professional staff in the same "industry" or the contractor should provide documentation that they have gained or lost professional staff to the comparator firm within recent years.

values. We also found that separate performance measures were presented for employee groups with tiered benefits without any indication of the total cost distribution between the groups. The failure to calculate consistent comparison study results makes it difficult for agency officials to compare results among sites and correctly determine whether corrective action plans are required.

The *Value Study Desk Manual* also recommends that the assigned contracting officers obtain certifications from both the contractor and the benefits consulting group performing the comparison studies to verify the accuracy, consistency, and validity of comparisons completed. The certifications are key controls over the quality of the studies. For example, they would alert contracting officers if the contractor was to change comparator firms or valuation methodologies and assumptions or was unable to obtain up-to-date competitor benefit data. Our review determined that 16 out of 18 contractors that completed a benefit value study did not submit the contractor and actuarial certifications at the completion of the study. The absence of these certifications can result in the improper interpretation of the comparison study results by contracting officers.

Increased Management Review Would Help DOE Oversee Its Contractor Employee Benefits Program

DOE could enhance its oversight of contractor employee benefits and address the challenges posed by the future administration of significant post-closure benefits by providing for greater management review of information developed at individual contractor sites and incorporating a focus on the long-term nature of pension and postretirement health benefits. The limited review of post-closure benefit payments completed by contracting officers at closed sites may make the continued decentralization of benefit program monitoring impractical. Also, the 70-year anticipated duration for some DOE reimbursements of contractor employee pension and postretirement health costs earned to date needs additional consideration in DOE's evaluations of contractor benefit costs.

DOE contracting officers are primarily responsible for determining the allowability of DOE contractor employee benefit costs and administering the benefits. Accordingly, DOE's current monitoring and risk assessment process is largely performed by contracting officers who are responsible for reviewing benefit programs at one contractor site. Contracting officers have the ability to seek technical advice and policy support from various DOE resources, including CHRM, OPAM, and NNSA. DOE also maintains a Memorandum of Understanding with DOD agency offices to provide audit services. These management offices offer, as needed or requested, various

issue- or location-specific monitoring activities; however, they do not routinely review the results of the monitoring and risk assessment activities of the contracting officers. Thus, agencywide information regarding nonconformance with guidelines for contractor employee benefit program assessments is not routinely analyzed by management so that corrective actions can be taken. Similarly, best practices are not routinely identified at individual contractor sites and propagated across the agency.

Also, dissimilarities in benefit programs between contractor locations can lead to adverse situations for the contractor benefits program as a whole. DOE recently approved proposals submitted by contractor employee groups at two DOE sites to enhance each group's pension benefits so they would be comparable with the pension benefits at another DOE site. The agency approved these benefit enhancements largely based on the argument that doing so would retain skilled staff, even though the most recent contractor benefit value studies indicated that these sites already had pension and postretirement health benefit replacement values exceeding average labor competitor programs.

The fact that some sites have closed, and others are nearing completion, also suggests the need for more management attention to program reviews. We found that contracting officers at several closed, or near-completed, environmental sites did not perform comparison studies under the provisions of DOE Order 350.1 or complete other substantive monitoring procedures. The failure to do so was attributed to a lack of resources. We believe that transitioning these monitoring and risk assessment procedures to a management level that will still exist after site closure would better position DOE to address future challenges. Systematic monitoring reviews and risk assessments will be necessary for post-closure benefits since DOE officials contend that (1) current contractor pension and postretirement health plan provisions allow for changes in postretirement benefits subsequent to the site closure and (2) post-closure benefit payments remain subject to compliance with DOE's guidance for comparison studies and applicable regulations, such as the cost reasonableness provisions of the FAR.

Although the agency resources required to monitor DOD's contractor benefits program are significantly greater than those needed at DOE,[28] the organizational structure at DOD provides an example of an oversight group used to assist in compliance reviews and risk assessment at all contractor locations. DOD provides contracting officers significant operational support from the Defense Contract Audit Agency (DCAA) and the Defense Contract Management Agency (DCMA). The two agencies provide a consistent source of routine review and analysis of detailed benefit and cost information outside of individual contractor locations. This group is thus able to gain broad knowledge of contractor issues and decisions to apply a more consistent definition of reasonableness to the evaluation of contractor benefit costs. DOD also has formal guidance within the agency's supplement to the FAR,[29] which lists occurrences in postretirement health or pension programs that indicate heightened risk and should lead a contracting officer to request a separate in-depth evaluation of the policies, practices, and costs of a contractor benefit component that is performed jointly by DCAA and DCMA staff.

DOE's evaluation of total benefits in the benefit value study rather than a review of the individual benefit components does not fully address the differences in costs between deferred benefit programs, such as pension and postretirement health benefits, and other benefit components. A management focus on the long-term impacts of contractor benefit program decisions may provide improved information for decision makers in DOE and Congress. This information is important because decisions on changes to pension and postretirement health benefits can have a significant impact on DOE's long-term budgetary needs. For example, a 1 percent increase in a contractor employee's current year vacation benefits has less impact on DOE's long-term costs and budgetary needs than a 1 percent increase in postretirement pension or health benefits, which have a continuous and compounding effect as they are paid out in each year of retirement. Nevertheless, DOE contracting officers decide whether corrective action

[28]DOD generally maintains a shorter duration of individual contractor operations and contractor employees usually participate in existing corporate plans and are not separated from non-DOD contract operations. This results in an increased need to review the allocation of employee costs, including benefit costs, between DOD and non-DOD contracts. See app. II for further comparisons between DOE and DOD contractor benefit reimbursement programs.

[29]Federal agencies subject to the FAR provisions may supplement the regulations through separately issued requirements for agency contractors. Both DOE and DOD have issued agency supplements to the FAR.

plans are needed largely based on the review of the total benefit value index, which does not take into account the differences between the total cost of pension and postretirement health benefits and other benefit components. These cost differences may be significant because pension and postretirement health benefits can require DOE reimbursement long after an employee retires.

As shown in table 4, the benefit value indexes for contractors' pension and postretirement health benefits are significantly different from the total benefits indexes shown in table 3. Both the pension and postretirement health benefit indexes have larger programwide averages, larger index ranges, and more contractors with benefit indexes outside of DOE's target range of 5 percent above the average of selected competitors. For example, postretirement health benefits average more than 44 percent greater than the average of the DOE contractors' competitors, while defined benefit pensions average 29 percent greater.

Table 4: Summary Statistics for Total Benefits, Defined Benefit Pension Benefits, and Postretirement Health Benefits in DOE Contractor Value Studies (Results Compared to an Average Comparator Index of 100.0)

Comparison study measures	Total benefits index	Defined benefit pension index	Postretirement health index
Average	99.8	129.0	144.8
Maximum	148.0	261.2	737.0
Minimum	71.0	75.0	18.6
Number of sites with an index above 105	5	11	9
Number of sites with an index from 90 to 110	16	2	2

Source: GAO analysis.

Note: Summarizes the most recent contractor benefit value studies submitted by DOE contractors.

In addition, DOE's review of current pension contributions and postretirement health payments through the Chamber of Commerce cost studies completed by three contractor sites is not consistent with the long-term nature of pension and postretirement health benefits. This inconsistency is largely due to the fact that annual employer contributions for pension and health benefits generally do not equal the estimated amount of postretirement benefits earned by current employees that year, also called the annual service cost of benefits. For example, DOE

reimbursed $430 million in costs to its contractors for pension and health plan contributions in fiscal year 2003; however, the reported fiscal year 2003 service cost of those plans was $872 million.[30]

It is DOE's policy to evaluate contractor requests for changes to existing pension and postretirement health plans by reviewing total benefit values and annual contributions, rather than total costs. DOE Order 350.1 requires contractors to submit proposed changes to contractor postretirement benefit programs with information on the impact of the changes on existing comparison studies and anticipated changes in cost. However, the order does not differentiate the annual contractor contribution cost from the total future cost of the changes. For example, the determination to accept proposed changes by one contractor noted that the increase in pension liabilities caused by the changes would not result in additional short-term reimbursements by DOE due to the positive funded status of the plan. Furthermore, our review of changes made to contractor postretirement benefit plans during fiscal year 2002 revealed that 3 out of 11 contractors that submitted changes to DOE for approval did not include either the effect of the plan changes on comparison study results or an estimate of savings or costs.

Conclusions

The satisfaction of postretirement contractor benefits earned under current and prior contracts with the government will require significant amounts of budgetary and administrative resources to pay and monitor the payment of these benefits long after current research contracts and cleanup sites are terminated. Because DOE has excluded certain contractor locations from a requirement to complete periodic benefit valuation studies, it cannot apply a consistent evaluation of costs for all benefit programs. Within programs required to complete comparison studies, instances of contractor nonconformance with policies and guidance make the results difficult to interpret and use in making management decisions regarding the level of program benefits. The challenges associated with administering post-closure benefits and a lack of focus on the long-term nature of postretirement pension and health

[30]These differences in annual postretirement benefit payments and service costs can occur because the number of current employees earning benefits and the cost of those benefits in any given year may not equal the number of retirees receiving postretirement benefits and the cost of those benefits. Differences can also occur because pension contribution amounts required under ERISA may not equal the estimated benefits earned by employees.

benefit obligations exacerbate these problems. Formal management reviews that attempt to identify and correct areas of nonconformance, propagate best practices agencywide, and focus on long-term budgetary needs could improve DOE's oversight of the contractor employee postretirement benefits program.

Recommendations for Executive Action

GAO recommends that the Secretary of Energy take the following four executive actions:

1. Institute systematic management review of pertinent data from each contractor location to enhance the consistency of benefit program evaluations and reduce the instances of nonconformance with the requirements of DOE Order 350.1 and other recommended procedures. The intent of the management review would be to correct areas of nonconformance, identify best practices, and disseminate this information across the agency.

2. Extend the comparison study requirements of DOE Order 350.1, to the extent practical, to all contractor locations with benefit obligations to provide better information about programwide contractor employee benefit costs.

3. In cases where the extension of the order is not practical, develop and perform appropriate alternative procedures to provide similar information.

4. Incorporate into DOE's oversight process a focus on the long-term costs and budgetary implications of decisions pertaining to each component of contractor benefit programs, especially pension and postretirement health benefits, that have budgetary requirements beyond the current year. This would augment the current consideration of total annual benefit costs.

Agency Comments and Our Evaluation

We requested and received from DOE written comments on a draft of this report, which are reprinted in appendix III. In its comment letter, DOE noted that our findings were consistent with those of its own internal assessment and agreed with the report's four recommendations. DOE also provided us with technical comments, which we have incorporated as appropriate.

Additionally, we requested oral comments from DOD on applicable report excerpts. DOD did not have any comments on the report.

We are sending copies of this report to appropriate House and Senate committees; the Secretary of Energy; and the Director of the Office of Management and Budget. We will also make copies available to others upon request. The report is also available at no charge on GAO's Web site at http://www.gao.gov. If you have any questions about this report, please contact me at (202) 512-6131. You may reach me by e-mail at martinr@gao.gov. Contributors to this report are listed in appendix IV.

Sincerely yours,

Robert E. Martin
Acting Director
Financial Management and Assurance

DOE Contractor Locations with Pension and Postretirement Health Liabilities as of September 30, 2003

Contractor site

Ames Laboratory
Argonne National Laboratory
Bettis Atomic Power Laboratory
Brookhaven National Laboratory
Civilian Radioactive Waste Management Program (Yucca Mountain Project)
Fermi National Accelerator Laboratory
Fernald Environmental Management Project
General Electric Vallecitos Nuclear Center
Grand Junction Sites
Hanford Site
Hanford Site – Hanford Environmental Health Foundation
Idaho National Engineering and Environmental Laboratory
Kansas City Plant
Knolls Atomic Power Laboratory
Lawrence Berkeley National Laboratory
Lawrence Livermore National Laboratory
Los Alamos National Laboratory
Miamisburg Environmental Management Project (Mound Plant)
National Renewable Energy Laboratory
Nevada Test Site/Naval Petroleum Reserves[1]
Nevada Test Site – Security Services
Oak Ridge / Paducah and Portsmouth Gaseous Diffusion Plants
Oak Ridge Y-12 Site
Oak Ridge Associated Universities / Oak Ridge Institute for Science and Education
Oak Ridge National Laboratory
Oak Ridge – Security Services
Pacific Northwest National Laboratory
Pantex Plant
Pinellas Plant
Portsmouth Gaseous Diffusion Plant[2]
Princeton Plasma Physics Laboratory

[1]DOE operations sites that include more than one contractor have been counted as one location for purposes of this report when the contractor benefits for multiple contractors are included in the same DOE Order 350.1 comparison study.

[2]The obligation for postretirement benefits at this contractor site was liquidated through a negotiated settlement in February 2004.

Rocky Flats Environmental Technology Site / Rocky Flats Security Services[3]
Sandia National Laboratory
Savannah River Site
Savannah River Site – Security Services
Stanford Linear Accelerator Center
Thomas Jefferson National Accelerator Facility
Waste Isolation Pilot Plant
West Valley Demonstration Project

[3]See footnote 1.

Comparison of DOE and DOD Contractor Benefit Programs

Both DOE and DOD manage a large number of individual contracts and contractor operations. Both agencies also allow for the reimbursement of annual pension and postretirement health costs and have agency contracting officers who are responsible for reviewing these costs for compliance with applicable regulations. However, as shown in table 5, there are some underlying program differences that have an impact on the way the two agencies manage their contractor benefits.

Table 5: Comparison of DOE and DOD Contractor Benefit Programs

Program area	DOE	DOD
Ownership of operations facilities	Employees receiving benefits are at government-owned facilities.	Majority of employees receiving benefits are at contractor-owned facilities.
Duration of contractor / site mission	Long-term relationships, for example, completion of environmental cleanup tasks and ongoing research missions.	Mostly short-term relationships, for example, construction of military equipment.
Separation of operation employee benefits from other contractor employee programs	Majority of plans are for DOE contract benefits only; corporate plans require separate benefits calculations for reporting purposes.	Employees continue to participate in existing contractor corporate plans.
Involvement in contractor establishment and changes to existing contractor employee benefit programs	Contracting officers are involved in the initial approvals of contractor benefit programs and subsequent changes to those programs.	Contractor is usually free to structure and make changes to plans, but resulting costs are subject to review for allowability.
Segregation of operation contractor employees from other contractor operations	DOE contractor employees generally do not split time between DOE and non-DOE work.	DOD contractor employees often work on DOD and other contracts concurrently.
Extent of post-closure benefit obligations and applicability of Cost Accounting Standards (CAS)[a]	DOE policies allow for contractor continuance of benefit programs for employees who earned benefits under former contracts.[b]	DOD generally settles obligations according to CAS provisions after the contractor ceases to perform under the contract.

Source: GAO analysis of DOE and DOD data.

[a]Section 26 of the Office of Federal Procurement Policy Act, as amended, 41 U.S.C. § 422 (2000), requires certain contractors and subcontractors to comply with CAS, as issued by the Cost Accounting Standards Board. These standards are mandatory for use by all executive agencies and by contractors in estimating, accumulating, and reporting costs in connection with negotiated prime contract and subcontract procurements with the government in excess of $500,000, other than contracts or subcontracts that have been exempted by regulations.

[b]According to a DOE official, compliance with CAS standards related to accounting for pension costs is not mandatory under DOE management and operating or support services contracts.

Comments from the Department of Energy

Department of Energy
Washington, DC 20585

APR 0 5 2004

Mr. Jeffrey C. Steinhoff
Managing Director
Financial Management and Assurance
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Steinhoff:

We appreciate the General Accounting Office (GAO) comprehensive review of the Department of Energy (DOE) financial obligations for postretirement health and pension benefits for contractor employees and the assessment of how Departmental oversight of these benefit programs could be enhanced. Contractor pension and postretirement health benefits represent significant costs under DOE major facility management contracts but, unlike pension benefits, there are no tax favorable vehicles to prefund retiree medical benefits. In addition, medical cost inflation has continued to increase, causing enduring cost escalation in otherwise reasonable contractor medical benefit plans.

While we agree with the four GAO recommendations, we have enclosed detailed comments on your draft report, *Certain Postretirement Benefits for Contractor Employees are Unfunded and Program Oversight Could Be Improved (GAO-04-539).* Our comments either clarify the Department's position or note factual errors. We are please to note that the GAO findings were consistent with the conclusions of a DOE internal assessment which was completed in September 2003, and that the GAO recommendations appear to support the corrective actions already underway as part of the Fiscal Year 2004 Balanced Scorecard Performance Assessment Program.

The DOE internal assessment identified Department oversight of Contractor Human Resource costs as a significant area of concern. The DOE conclusion that "...appropriate oversight of contractor compensation cost, long term pension, and retiree medical liabilities is necessary for programmatic financial planning..." mirrors the GAO concerns for long-term liabilities associated with post closure pension and health benefits.

We believe that completion of these management initiatives will result in more consistent implementation of DOE contractor compensation and benefit acquisition policy. The Department would be pleased to provide any additional information that is desired in this matter.

Sincerely,

James T. Campbell

James T. Campbell
Acting Director, Office of Management, Budget
and Evaluation/Acting Chief Financial Officer

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GAO Contact and Staff Acknowledgments

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Robert E. Martin, (202) 512-6131

Acknowledgments

In addition to the individual named above, Sharon Byrd, Richard Cambosos, Lisa Crye, Frederick Evans, Darren Goode, Roger Thomas, and Scott Wrightson made key contributions to this report.

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