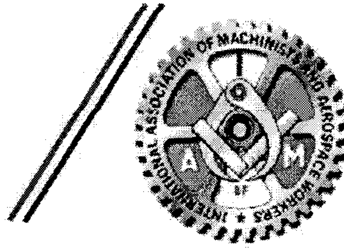
-----Original Message-----
From: Chaney Elaine
Sent: Friday, May 11, 2007 10:57 AM
To: contractor pensions
Subject: Comments on DOE Contractor Benefits Challenge

International
Association of
Machinists and
Aerospace Workers



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301/967-4500

OFFICE OF THE INTERNATIONAL PRESIDENT

May 11, 2007

Subj: Comment on Department of Energy Contractor Employee Pension and Medical Benefits Challenge

Ms. Stephanie Weakley
Director, Office of Procurement and Assistance Management
United States Department of Energy
1000 Independence Avenue, S.W.
Washington D.C. 20585

Dear Ms. Weakley,

Thank you for this opportunity to offer our deep concerns about the Department of Energy's contractor employee pension and medical benefits proposals. We would be very disturbed to see the resurrection of the policy proposal, first floated a year ago, that would discontinue reimbursement of contractor costs associated with defined benefit pension plans and certain medical benefits because of the great harm it would cause our members who work for DOE contractors.

The International Association of Machinists and Aerospace Workers, AFL-CIO ("IAM"), represents over 5,500 employees of DOE contractors under seventeen collective bargaining agreements at nine locations nationwide. These highly skilled employees play a critical role in the operation and development of our nation's energy resources. They also ensure that the environmental impacts of past energy investments are appropriately controlled. Every day on the job, our members apply their skills and attention to detail to operate safely in the face of extreme hazards. They are an essential part of the success of DOE's mission at its M&O sites.

DOE's policy proposal would do serious damage to the ability of DOE contractors to compete for and retain such highly skilled employees in the marketplace. In the rest of this letter, the IAM will set out broad policy concerns with the proposal. We will then turn to some specific problems. Lastly, we will offer some principles that we believe DOE should observe in its future consideration of this subject.

Broad Policy Concerns

DOE contractors, like all private sector employers, must compete for the skilled employees they need to carry out their business operations. For M&O contractors, this competition largely plays out in the collective bargaining process, where they negotiate at arms-length with unions such as the IAM over compensation packages that allow them to attract and retain qualified personnel. The fact that defined benefit (DB) pension plans and medical benefit plans for active and retired employees are a prominent feature of compensation packages among large, private sector employers that employ skilled workforces – including most DOE contractors – shows that these benefit structures satisfy the needs and preferences of both companies and workers. DOE's proposal would constitute substantial Federal intervention into these successful private-sector practices, and it would distort the marketplace to DOE's own disadvantage by making DOE contractors less able to compete for highly skilled employees.

Among DOE contractors, the IAM's collective bargaining agreements provide for a wide variety of retirement and medical benefits. Employees at some locations are covered by defined contribution (DC) retirement plans, at others they are covered by single employer DB pension plans or multi-employer DB plans. Many IAM-represented employees are covered by more than one retirement plan. Likewise, health benefits for IAM-represented employees of DOE contractors vary with respect to benefit design, employee cost-sharing, etc. Since these agreements are locally-bargained, they are able to reflect the particular needs and concerns of the local workforces, within the standards set by the Department for reasonableness and allowability. The Department's proposed policy would radically diminish the ability of DOE contractors to tailor benefit packages in collective bargaining, upsetting this carefully crafted pattern. By forcing all contractors to adopt benefit programs that offer different and unequal retirement and health benefits to members of the same workforce, the policy would generate substantial internal discord within the workforce.

We believe that the proposed policy, if implemented would not only prove counter-productive to DOE's mission, by eliminating the flexibility that private sector bargaining parties need to craft appropriate compensation structures, but it would also set damaging precedents for other areas of federal contracting and the private sector more broadly. It has only been eight months since Congress approved and President Bush signed the Pension Protection Act of 2006 into law. The stated goal of that sweeping pension reform was to strengthen private sector DB plans. The Department's proposed policy would directly contradict the will of Congress and the Administration in that regard.

Our members, along with the vast majority of U.S. workers, highly value guaranteed retirement benefits. As a public policy objective, the establishment and continuation of private sector DB pension plans has historically been promoted by the Federal government, in part, by permitting private contractors to receive reimbursement for the cost associated with maintaining such plans. DB plans are widely supported because they are particularly effective at providing benefits that allow workers to enjoy a measure of financial security in retirement. The Department's proposed policy, if implemented, would send an unmistakable message to the private sector workforce: "The Federal

government sees no value in DB pension plans for you." The Federal workforce rightly enjoys the security of a DB pension plan as part of their compensation package. Workers in the private sector should have the opportunity to enjoy a similar measure of security as those in public service.

Specific Problems with DOE's Policy Proposal

Aside from these broad objections to the Department's proposal, we have many specific concerns about the impacts this poorly designed policy would have within the DOE contractor workforce. In the interest of brevity, we focus here on four particular concerns.

- **Freezing out newly hired employees from DB pensions can drive up pension costs, rather than reducing them.** As any actuary knows, there are risks to depriving a DB pension plan of new entrants. As the age profile of a plan increases, the cost of funding benefits under the plan goes up as well. The Department's proposal to freeze out newly hired employees from DB plans, forcing them into DC plans, will drive benefit costs at contractors up, not down, contrary to DOE's stated concern.

- **Discriminatory treatment of hourly employees.** The Department's proposal appears to call for a blanket prohibition on plan amendments that "augment or potentially augment in any way" benefits in an existing DB pension plan. Such a prohibition would result in a decline in the real value of pension benefits for many hourly employees, with salaried employees of DOE contractors suffering no such reduction. The reason for this owes to the different structure of benefit formulas in some plans that cover hourly workers (so-called flat-dollar benefit plans), as compared with those that are more common for management and salaried personnel (final pay plans). In a final pay plan, retirement benefits automatically increase in line with salary increases, even without a plan amendment. Flat dollar plans, however, are periodically amended to ensure that pension benefits keep up with increases in the cost of living and pay. A blanket prohibition on plan amendments, over time, would steadily erode the adequacy of pension benefits for hourly employees, even as the real value of benefits for management and salaried personnel are maintained.

- **Other ways to address volatility concerns.** The rationale offered by the Department for freezing out new hires from defined benefit pension plans, is the "volatile funding" associated with DB plans. But pension experts understand that factors such as pension plan design and investment strategy can significantly impact funding volatility. By opting for the blunt instrument of cutting off reimbursement for DB pension costs for new hires, the proposed policy not only will have no effect on the funding volatility associated with existing benefit liabilities, it leaves unexplored other, less drastic alternatives for reducing volatility while still preserving defined benefits for employees.

- **Difference between Single-Employer and Multiemployer DB plans.** All DB plans are not created equal. In fact, multiemployer DB plans can function, for funding purposes, just like defined contribution plans, while still offering secure, known retirement benefits to employees. For instance, the IAM National Pension Fund's National Pension Plan, a multiemployer DB plan established for IAM members is sufficiently funded such that it has no withdrawal liability. Therefore, the only funding obligation a contributing employer has to the fund is the predictable hourly cost it has negotiated for in collective bargaining. This cost is defined and known in advance for the duration of the collective bargaining agreement.

Principles That Should Inform DOE's Further Deliberations

The materials that DOE has issued thus far have little detail or supporting documentation. The Department's proposals regarding health benefits are particularly vague and this lack of transparency is a source of deep concern to the IAM. While we disagree with the general policy direction as indicated in the policy proposal, it is difficult to make a detailed response in the absence of real data. As DOE proceeds, however, the IAM believes that the following principles should be observed.

- **DOE should observe neutrality between DB and DC pension plans.** As noted above, Congress recently passed the Pension Protection Act of 2006, and the President signed it into law. That Act set national policy regarding the continuation and strengthening of DB pension plans. DOE should not contravene Congress and the President by trying to force contractors to cut back on the benefits and use of DB plans in favor of DC plans.

- **DOE should allow private-sector competitive processes to work.** The labor pool for many highly skilled job classifications is aging rapidly, and competition among private-sector companies for skilled workers will grow more intense. DOE should not hobble its contractors by putting Federally-imposed constraints on their ability to offer competitive wage and benefit packages.

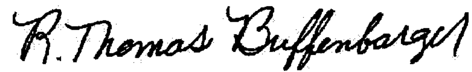
- **DOE should not intervene in the collective bargaining process.** In proposing restrictions on the benefits that its contractors can offer to employees, DOE would be putting its thumb on the scales of collective bargaining. But the essence of collective bargaining is that it is conducted at arms-length in a competitive environment. DOE should preserve that environment, not cut back on it.

In closing, we believe that the appropriate way to address issues of compensation is not through heavy-handed Federal policy, but rather, at the negotiating table. For it is only through arms-length bargaining, free from interference that employers and employees can resolve issues of mutual concern in a manner that balances all parties' considerations. We

hope that the Department will embrace this notion and avoid proposals that would inappropriately interfere with the collective bargaining process.

Once again, thank you for the opportunity to share our serious concerns about the Department's proposals on contractor employee pension and medical benefits.

Sincerely,



R. Thomas Buffenbarger
INTERNATIONAL PRESIDENT

RTB/ec

-----Original Message-----
From: Warin, Patricia
Sent: Friday, May 11, 2007 11:41 AM
To: contractor pensions

U.S. Chamber of Commerce

May 11, 2007

U.S. Department of Energy
Office of Procurement and Assistance Management
1000 Independence Avenue, SW
Washington, DC 20585

Re: **Request for Public Comment on Department of Energy Contractor Employee Pension and Medical Benefits Challenge**

Dear Sir/ Madam:

On behalf of the U.S. Chamber of Commerce, we submit this letter in response to the request for comments from the Department of Energy ("DOE") as posted in the Federal Register on March 27, 2007.[1] The U.S. Chamber of Commerce is the world's largest business federation representing more than three million businesses and organizations of every size, sector and region, with substantial membership in all 50 states. These comments have been developed with the input of member companies potentially affected by changes being considered by the DOE.

In April 2006, the DOE announced a new policy for reimbursements of allowable costs on certain contracts.[2] Under this policy, the DOE planned to continue to reimburse contractors for costs associated with current and retired employees' defined benefit pension and medical plans under existing contract requirements but would not reimburse these costs for new employees. Rather, the DOE intended to reimburse contractors only for the costs of defined contribution pension plans and market-based medical benefit plans. In response to the 2006 announcement, there was significant opposition from affected groups and Congress acted to prevent the DOE from carrying out the policy. In June 2006, before any Congressional action was completed, Secretary of Energy Samuel Bodman decided to delay implementation of the controversial policy change by one year.[3]

The Chamber appreciates DOE providing an opportunity to comment on the consideration of possible changes to policies concerning the reimbursement of pension and medical benefits. The ability to contract with DOE and the continued maintenance of the private retirement system is important to the Chamber and its members. Therefore, we are particularly pleased with the DOE's reconsideration of its earlier announcement

[1] 72 Fed. Reg. 14,266 (3/27/07).
[2] DOE N 351.1 (4/27/06).
[3] DOE N 251.66 (6/28/06).

that it would no longer reimburse contractors' defined benefit pension and medical costs for new employees. The Chamber views such a policy as a direct infringement upon employers' benefit decisions, sends the wrong message about defined benefit plans, and creates a significant barrier for companies to be able to compete for these DOE contracts. For reasons explained below, the Chamber urges the DOE to forego any further consideration of the policy expressed in 2006.

Refusing to Reimburse Defined Benefit Pension Costs Sends the Wrong Message. By stating that it no longer supports defined benefit pension costs, the DOE is effectively stating that it does not view these plans as beneficial or viable. For the past several years, Congress, the Administration, plan sponsors, trade associations, unions, and participant groups have worked on comprehensive reforms to the pension system. After much debate, the culmination of this extensive and exhaustive effort was the Pension Protection Act of 2006 ("PPA"). One of the biggest issues of debate surrounded defined benefit plans. Ultimately, all parties concluded that defined benefit plans were viable and set about implementing reforms to address employers' workforce concerns, participant rights, and funding concerns. If the DOE were to now state that it will no longer support defined benefit plans, it would be a rejection of the work done in the PPA and would send a discouraging message about defined benefit plans.

The effect of such a policy change would be to essentially force companies doing business with DOE to provide a smaller and less comprehensive benefits package to employees to remain viable to compete for new contracts or remain profitable on current ones. The federal government provides its employees a valuable and comprehensive benefits package and we believe that no government agency should force companies to provide fewer benefits.

The DOE Should Not Dictate Pension or Medical Benefits Policy for Private Employers. Employers that maintain pension and healthcare plans are already subject to the jurisdiction of several government agencies.[4] If each and every government agency were to dictate benefit policy, even indirectly, then these employers would be subject to the untenable burden of monitoring each government agency just to determine its compliance with the pension and healthcare policies and directives of each individual agency. At the very least, employers might not be able to provide uniform benefits to their workers. At the worst, other employers might find that they are not able to simultaneously comply with different directives from different agencies. To avoid conflicting directives, employers might decide it is easier to not offer pension or medical benefits at all. Certainly, this is not a result that should be encouraged by a government agency.

Non-reimbursement of Benefits Would Infringe upon Employers' Workforce Management Decisions. Employers who implement and maintain defined benefit plans are responding to the needs and concerns of their workforce. Companies are continuously looking for talented people and benefits are a vital part of the overall

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[4] ERISA plans are under the jurisdiction of the Department of Treasury and the Department of Labor. In addition, defined benefit plans are under the jurisdiction of the Pension Benefit Guaranty Corporation.

compensation plan. The specific types of plans companies provide as options to employees are voluntary and therefore employers would not implement them without a good business rationale. Companies need the flexibility to determine which plans are best for them to be able to compete in the global marketplace. Therefore, a proclamation by the DOE that it will no longer reimburse these business expenses would directly counter the business judgment and decision of contractors who have chosen to maintain defined benefit pension and traditional medical plans. Preventing reimbursement of these benefits will make such positions less attractive to talented workers and DOE should want the most talented workforce possible working for their contractors.

DOE Should Continue to Reimburse Costs for Defined Benefit Pension and Medical Plans. We understand that DOE has unique requirements with the large Management and Operating ("M&O") and site management contracts, but that does not signify the need for such a radical departure from current practices. As is well known, pension and medical benefits costs are increasing nationwide, but the government should not be in the position of encouraging the dissolution of such company plans. Reimbursement for pension and medical benefits costs are expressly allowable as defined in the Federal Acquisition Regulations and this approach of narrowing the scope of allowable costs will have detrimental affects on DOE's ability to attract qualified contractors.

The Chamber appreciates the DOE's request for comments on this issue of great concern to many of our members. Again, we strongly urge you to reject any policies that will negatively impact the ability of employers to provide benefits to their employees and compete for contracts. The private employee benefit system is not only a vital but also a voluntary system in which various concerns and interest must be balanced in order to adequately protect the medical and retirement security of millions of workers.

We sincerely appreciate your consideration of these comments.

Sincerely,

Randy K. Johnson
Vice President
Labor, Immigration & Employee Benefits
U.S. Chamber of Commerce

Aliya Wong
Director of Pension Policy
Labor, Immigration & Employee Benefits
U.S. Chamber of Commerce

-----Original Message-----
From: Codsia
Sent: Friday, May 11, 2007 12:00 PM
To: contractor pensions
Subject: DoE Contractor Employee Pension and Medical Benefits Challenge Comments

COUNCIL OF DEFENSE AND SPACE INDUSTRY ASSOCIATIONS
1000 Wilson Boulevard, Suite 1800
Arlington, Virginia 22209
www.codsia.org
703-243-2020

May 11, 2007

Secretary Samuel Bodman
U.S. Department of Energy
Office of Procurement and Assistance Management
1000 Independence Avenue, SW
Washington, DC 20585

Attn: Stephanie Weakley

Re: Request for Public Comment on Department of Energy Contractor Employee Pension and Medical Benefits Challenge
CODSIA Case No 04-07

Dear Secretary Bodman:

The undersigned members of the Council of Defense and Space Industry Associations ("CODSIA") appreciate the opportunity to respond to the request for comments from the Department of Energy ("DOE") published in the Federal Register on March 27, 2007.[1] Formed in 1964 by the industry associations with common interests in defense and space fields, CODSIA is currently comprised of seven associations representing thousands of member firms across the nation. Participation in CODSIA projects is strictly voluntary. A decision by any member association to abstain from participating in a particular activity is not necessarily an indication of dissent.

In April 2006, the DOE announced a new policy for reimbursements of allowable costs on certain contracts.[2] Under this policy, the DOE planned to continue to reimburse contractors for costs associated with current and retired employees' defined benefit pension and medical plans under existing contract requirements but would not reimburse these costs for new employees. Rather, for those new employees, the DOE intended to reimburse contractors only for the costs of defined contribution pension plans and market-based medical benefit plans. In response to the 2006 announcement, there was significant opposition from affected groups and Congress acted to prevent the DOE from carrying out the policy[3]. In June 2006, before any Congressional action was completed, you decided to delay implementation of the controversial policy change by one year.

We appreciate DOE providing an opportunity to comment on the possible changes to policies concerning the reimbursement of pension and medical benefits. The ability to contract with DOE and the continued maintenance of the private retirement

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[1] 72 Fed. Reg. 14,266 (3/27/07).
[2] Department of Energy Notice 351.1, Contractor Employee and Medical Benefits Policy
[3] House-Passed Fiscal Year 2007 Energy and Water Development Appropriations Act

system is important to CODSIA members. Therefore, we are particularly pleased with the DOE's reconsideration of its earlier announcement to no longer reimburse contractors' defined benefit pension and medical costs for new employees. We view such a policy as a direct infringement upon employers' recruitment efforts and benefits decisions, sends the wrong message about defined benefit plans, and creates a significant barrier for companies to be able to compete for these DOE contracts. For reasons explained below, we urge the DOE to forego any further consideration of the 2006 proposed change.

Refusing to Reimburse Defined Benefit Pension Costs Sends the Wrong Message. By stating that it no longer supports defined benefit pension costs, the DOE is effectively stating that it does not view these plans as beneficial or viable. For the past several years, Congress, the Administration, plan sponsors, trade associations, unions, and participant groups have worked on comprehensive reforms to the pension system. After much debate, the culmination of this extensive and exhaustive effort was the Pension Protection Act of 2006 ("PPA"). Ultimately, Congress and the President concluded that defined benefit plans were viable and addressed implementing reforms for employers' workforce concerns, participant rights, and funding concerns. If the DOE were to now state that it will no longer support defined benefit plans, it would be a rejection of the work done by Congress and the Executive Branch as reflected in the PPA and would send an inappropriate and chilling message about defined benefit plans.

The effect of such a policy change would be to essentially force companies doing business with DOE to provide a smaller and less comprehensive benefits package to employees to remain viable to compete for new contracts or remain profitable on current ones. The federal government provides its employees a valuable and comprehensive benefits package and we believe that no government agency should force companies to provide fewer benefits simply for the right to compete for federal business.

The DOE Should Not Dictate Pension or Medical Benefits Policy for Private Employers. Employers that maintain pension and healthcare plans are already subject to the jurisdiction of several government agencies.[4] If every government agency were to dictate contractor employee benefit policy, even indirectly, then these employers would be subject to the untenable burden of monitoring each government agency just to determine its compliance with the pension and healthcare policies and directives of each individual agency. At the very least, employers might not be able to provide uniform benefits to their workers. To avoid conflicting directives, employers might decide it is easier to not offer pension or medical benefits at all. Certainly, this is not a result that should be encouraged by the Federal government. At the worst, other employers might find that they are unable to simultaneously comply with different directives from different agencies. Furthermore, government contractors subject to the Cost Accounting Standards must ensure that they treat these benefits costs consistently and uniformly; inconsistent agency approaches also complicate company bidding and agency evaluations of these benefits costs.

[4] ERISA plans are under the jurisdiction of the Department of Treasury and the Department of Labor. In addition, defined benefit plans are under the jurisdiction of the Pension Benefit Guaranty Corporation.

Non-reimbursement of Benefits Would Infringe upon Employers' Workforce Management Decisions. Employers who implement and maintain defined benefit plans are responding to the needs and concerns of their workforce and competition in hiring. Companies are continuously looking for talented people, and benefits are a vital part of the overall compensation plan. The specific types of plans companies provide as options to employees are voluntary and employers would not implement them without a good business rationale. Companies need the flexibility to determine which plans are best for them to be able to compete in the global marketplace. Therefore, a proclamation by the DOE that it will no longer reimburse these business expenses would directly counter the business judgment and decision of contractors who have chosen to maintain defined benefit pension and traditional medical plans. Preventing reimbursement of these benefits will make such positions less attractive to talented workers and DOE should want the most talented workforce possible working for their contractors.

DOE Should Continue to Reimburse Costs for Defined Benefit Pension and Medical Plans. We understand that DOE has unique requirements and funding challenges with its large Management and Operating ("M&O") and site management contracts, but those do not justify such a radical departure from current practice. As is well known, pension and medical benefits costs are increasing nationwide, but the government's action should not encourage the dissolution of such company plans. Reimbursement for pension and medical benefits costs are expressly allowable by the Federal Acquisition Regulations and DOE's approach of narrowing the scope of allowable costs will have detrimental affects on DOE's ability to attract qualified contractors.

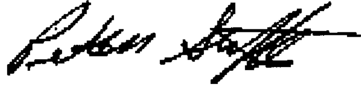
CODSIA appreciates DOE's request for comments on this issue of great concern to many of our members. Again, we strongly urge you to reject any policies that will negatively impact the ability of employers to provide benefits to their employees and compete for contracts. The private employee benefit system is not only a vital but also a voluntary system in which various concerns and interest must be balanced in order to adequately protect the medical and retirement security of workers.

If you need further information, please contact Chris Braddock at the U.S. Chamber of Commerce, who served as our project officer on this matter. He can be reached at 202-463-5891 or at cbraddock@uschamber.com.

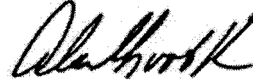
Sincerely,

Bruce Josten
Executive Vice President, Government Affairs
U. S. Chamber of Commerce

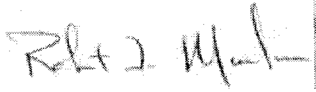
Dan Heinemeier
President, GEIA
Electronic Industries Alliance



Peter Steffes
Vice President, Government Policy
National Defense Industrial Association



Alan Chvotkin
Senior Vice President and Counsel
Professional Services Council



Robert T. Marlow
Vice President, Acquisition Policy
Aerospace Industries Association

Barry M. Cullen
President
Contract Services Association

-----Original Message-----
From: Fuerst, Don
Sent: Friday, May 11, 2007 1:03 PM
To: contractor pensions
Subject: Mercer Response to DOE Request for Comment

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May 11, 2007

Ms. Stephanie Weakley
Director, Office of Resource Management
US Department of Energy
1000 Independence Avenue, SW
Washington, DC 20585

Subject:
Request for Public Comment on Pension and Medical Benefits

Dear Stephanie:

We appreciate the opportunity to offer comments on the substantial financial challenges the Department of Energy (DOE) and your contractors face in managing the costs of pension and medical benefits. The undersigned collectively have worked with DOE laboratories and other sites for as many as twenty years. Our collective experience includes working with multiple contractors at locations including the Idaho Laboratory, the Oak Ridge Laboratory, the Pacific Northwest Laboratory, the Los Alamos Laboratory, the Lawrence Livermore Laboratory, the Sandia Laboratory, the Nevada Test Site, the Stanford Linear Accelerator, the Bettis Atomic Power Laboratory, the Pantex Plant, the Oak Ridge Y-12 Site, Oak Ridge Environmental Management, Idaho Clean Up Project, Paducah Remediation, Portsmouth Remediation, the Rocky Flats Closure Project and the Mound Environmental Closure Project.

At many of these locations we have helped design benefit programs and helped design financing plans for the programs. We have dealt with DOE regulations, Financial Accounting Standards, Federal legislation and Federal regulations. We have observed a wide variety of techniques and gained much insight into what is effective and what is not. We are writing to share these insights with you to help you formulate an effective policy regarding pension and medical benefits for all current and future employees of DOE contractors. We would like to make it clear that the opinions expressed herein are those of the undersigned and do not necessarily reflect the opinions of the DOE contractors who are or have been our clients. Furthermore, the examples are all based on information drawn from publicly available documents, not from any proprietary knowledge we gained from our client relationships.

In this comment letter we briefly discuss why implementing the provisions of Notice 351.1 would serve to increase contractor costs; we then propose several methods to stabilize pension and retiree medical costs and make them more predictable. These methods include changes in cost recognition, funding policy, investment policy and plan design.

Background

Financial security of future retirees is a concern for all Americans and is especially important for the DOE to help assure the ability to retain a highly skilled workforce in locations that are often lacking an indigenous skilled labor supply. Maintaining cost effective and efficient retirement plans is an integral part of a total rewards program. In fact, retirement plans are often an employee's **only** long-term financial incentive to stay with an organization.

DOE Notice 351.1 sought to assure reasonable costs, to moderate volatility of cost, to mitigate growth in cost, and to provide direction for dealing with post-closure obligations. Attaining these goals will work to the benefit of all stakeholders including contractors, employees, and the American taxpayers. However, we do not believe Notice 351.1 would accomplish these goals. Rather, the Notice would increase both short-term and long-term costs for contractors and would likely make the workforce less efficient, thus lessening the quality of work at the sites. We would like to point out how these costs would increase and then propose other ways in which the DOE can accomplish the laudable goals of the Notice.

Dual Programs = Higher Cost

The Notice would directly increase contractor expenses by mandating two-tier benefit structures that will increase administration and communication expense and require more complex and expensive discrimination testing. After several years, such a dual program is likely to fail discrimination testing. These additional costs of maintaining dual programs are likely to persist for 30 years or more.

The Notice would also directly increase contractor expense for the next several years because of the age profile of new hires. New employees are typically younger than the average employee in a workforce. Market-based defined contribution (DC) plans typically provide the same contribution level for all employees regardless of age. The cost of defined benefit (DB) pension plans is a function of age, with younger employees costing much less than older employees. This cost increase can be demonstrated by a simple example.

Suppose a contractor sponsors a DB pension plan with an average cost of 6% of pay for a workforce with an average age of 48. If the plan is closed to new hires and new hires are put in a DC plan that provides a 6% of pay contribution the contractor's cost will increase. The closed group of participants in the DB plan will age and the average cost will increase above 6%. New hires, who would have cost less than 6% of pay in the DB plan, will have a cost of 6% of pay in the DC plan. Cost for this contractor will continue to escalate above 6% for many years. If the new hires were placed instead in the DB plan, then the cost may have remained at 6% (particularly with the cost stabilization techniques we recommend below).

Indirect Costs

These direct cost increases are not the only reason the goals would not be attained. The Notice would indirectly increase contractor expenses because

1. Future employees will have less financial resources for retirement making it difficult to retire and causing many to continue working as their productivity declines.
2. Contractors will have less flexibility managing the workforce. Downsizing a workforce in slow economic times will be difficult because employees depending on DC plans will be less likely to leave a secure job if investments have declined. Contractors will not have the ability to offer early retirement incentives available through a traditional pension plan.
3. Recruiting experienced workers will be more difficult, particularly in remote geographic locations where many DOE sites are located. These are the very employees who place the greatest value on DB plans.

The Notice infringes on the ability of a contractor to develop the most effective human resource and benefits programs for their workers. Under current policy, contractors may design programs that attract and retain the types of employees they need. At many facilities that means highly skilled scientists who understand the value of retirement programs and who can easily obtain employment with other organizations that sponsor the type of programs that the Notice would prohibit.

Finally, the Notice would do little to moderate the volatility of reimbursement to Contractors. The vast majority of volatility for many years derives from existing liabilities for current employees and retirees, not future hires. Changing benefits for future hires would have no effect on these existing liabilities.

Cost versus Reimbursement

In the request for Public Comment, the DOE observes that reimbursements since FY 2000 have increased by 226% and that unfunded liabilities have increased by 68%. These increases, although significant and startling, are not representative of the true cost increases for the underlying plans.

Reimbursement for pension and retiree medical benefits is generally based on the actual contributions to pension plans and the actual medical benefits paid on behalf of retirees. These payments are not representative of the true cost of the plans or the time at which costs are actually incurred.

In FY2000 many of the contractor pension plans were fully funded, made no contribution to the plan, and had no unfunded liability. Some, but not all, of these contractors made contributions in FY2006 and have unfunded liabilities. The percentage increase for these plans is infinite and inappropriately inflates the percentages cited by the DOE.

Nevertheless, we are aware that costs have increased significantly over this time period and must be addressed. To implement effective policy, the costs must be measured properly. Accounting for pension and retiree medical benefits is evolving and the current standards are not adequate. We believe there are two costs associated with pension benefits that must be recognized separately – a **benefit cost** and a **financing cost**.

The benefit cost for a year includes the cost or present value of the additional benefits an employee earns by working during the year, also referred to as service cost. A present value must be used because the benefit will be paid to the employee many years in the future. The present value should be determined using a high quality fixed income interest rate and realistic assumptions about the longevity of the participant. Benefit cost determined in this manner is relatively stable, although it will change as interest rates change.

Benefit cost also includes the increase in liabilities associated with plan amendments – what the DOE refers to as benefit augmentations. This aspect of benefit cost can be very volatile but is under the control of the DOE and the contractor. Benefit augmentations do not take place without a conscious decision from the plan sponsor; thus they can be controlled.

Financing cost covers everything else. The financing cost includes the interest cost of increasing accrued liabilities offset by the investment income earned by any funds dedicated to the payment of these future obligations. Financing cost also includes gains and losses associated with changes in assumptions or demographic experience different than assumed. Financing cost is often quite volatile but techniques are available to substantially mitigate this volatility.

Pension plans should fund the benefit cost as it accrues and keep assets and liabilities in balance, thus minimizing financing cost. However, in practice the financing cost for some plans increased sharply in recent years as investments performed poorly. Yet in a few plans the assets still greatly exceed liabilities and the financing cost fully offsets the benefit cost.

Retiree medical plans introduce a further complication. These plans typically do not fund the benefit cost when it accrues. Instead, funding occurs when benefits are payable to the retiree. As a result, DOE reimbursement to the contractor occurs many years after the benefit cost is incurred and the lack of funding means there is no investment income to offset increasing liabilities. As a result the financing cost is highly volatile and the actual reimbursement does not correlate with the cost accrual.

Pension costs are substantially recognized and reimbursed during an employee's career with the goal that enough funds are available at retirement to provide all future benefits. This minimizes financing cost. On the other hand, retiree medical costs are not recognized and funded during an employee's career, but are usually deferred until the employee retires. This maximizes the financing cost and causes large unfunded liabilities. If retiree medical costs were properly recognized and funded during an employee's career, the resulting cost would be quite manageable.

Improving Cost Determination and Reimbursement Policy

The cost of pension plans is a function of benefit levels. If ongoing costs are too high, it simply means that benefits may be too generous, no matter what vehicle is used to deliver that benefit – a defined benefit plan or a defined contribution plan. High cost can be directly addressed by lowering prospective benefit levels – closing plans to new hires is not necessary and in fact can create morale issues due to staff inequality with two tiers of benefits (the "haves" and the "have nots").

Volatile costs and increasing reimbursements are not a function of benefit level, but a result of the need to fund unexpected pension deficits and medical benefit liabilities that were incurred many years ago. Unexpected pension deficits are caused by a variety of factors including rules that encouraged systematic understatement of costs, poorly conceived funding policies, investment policies that mismatch assets and liabilities, plan designs susceptible to financial volatility, and hidden and costly benefit subsidies. The DOE should require contractors to adopt and implement comprehensive policies to recognize pension costs properly and reduce volatility. This can be accomplished by addressing the causes of volatility directly. Abolishing plans for new hires will not eliminate this volatility.

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Predictability of costs can be improved, volatility lessened and growth slowed by aligning benefit cost with reimbursement. Recognizing the true cost of these benefit plans, funding the costs as they are incurred and taking certain steps to mitigate the volatility of financing cost will immediately and substantially improve predictability, lessen volatility and slow the growth of costs. This can reduce legacy costs in addition to the future cost of current employees and the cost of future hires.

Several areas need to be addressed to accomplish this goal: cost determination, funding policy, investment policy, and plan design. These are each addressed below.

Proper Determination of Cost

Pension costs may be understated because of aggressive and optimistic assumptions. Contractors are measured partly by their ability to control costs, resulting in an incentive to adopt optimistic assumptions that understate true pension costs. Many sites use interest assumptions that include an equity risk premium, but their costs do not reflect the risk inherent in such a high return assumption. Mortality assumptions are usually based on static tables that do not reflect improving longevity. Other demographic assumptions may underestimate the cost of benefits such as early retirement subsidies.

The DOE could address these issues in several ways:

1. Mandate the use of a high-quality, fixed-income yield curve to discount liabilities (this will be required by the Pension Protection Act).
2. Mandate the use of generational mortality tables that reflect longevity improvements and the likely longevity of a highly skilled and well-educated workforce.
3. Require contractors to substantiate all other assumptions, particularly medical trend, and avoid overly optimistic assumptions.
4. Require contractors to project costs at least five years into the future and build in financial incentives for contractors who meet these costs and penalties for those who do not.

Some of these changes (yield curve) will occur regardless of DOE policy, but more is required to eliminate the systematic understatement of cost and pension deficits leading to reimbursement volatility. Changes in reimbursement policy involve many complex issues, but such changes could be extraordinarily effective in producing better estimates of cost.

Funding Policy

Funding of pension plans at many sites is driven by minimum required contributions. Congress established minimum contribution policies to provide a degree of security to participants, not to produce stable predictable costs for plan sponsors. Minimum contribution requirements will always be likely to produce volatile contribution requirements.

Contractors should be required to develop rational funding policies that will produce stable and predictable contributions. Such policies are relatively easy to design, but require contributions greater than minimum legal requirements. The DOE must require these policies and be willing to reimburse for the necessary contributions to the plans as long as the plan benefit levels are reasonable and competitive – or, in DOE parlance, market-driven – within a total rewards context.

Accelerated Closure at Rocky Flats

We would like to point out examples of funding policies that lead to volatility. First, the Rocky Flats Closure Project, considered by many to be an enormous success for the DOE. The closure was completed 60 years ahead of the original schedule and $30 billion under the original estimate. Yet the project has close to $1 billion of unfunded pension and retiree medical liabilities. How did this happen?

When the closure project began in 1995 the pension plan, but not the retiree medical plan, was well funded. In subsequent years the contractor had predictable and stable appropriation of funds. Incentives existed to accomplish the closure as quickly as possible. Although pension costs and retiree medical costs were incurred in the late 1990s, only the absolute minimum contributions were made, generally the required medical benefits to retirees and no contributions to the pension fund. Instead, available funds were used to accelerate the closure. Pension deficits might not have developed if the investment returns of the late 1990s would have persisted. But the bear market of 2000-02 and a policy of deferring contributions inevitably created unfunded pension liabilities. The absence of any advance funding of retiree medical benefits also guaranteed large unfunded liabilities at closure when many additional employees retired.

The completion of this closure is a great accomplishment. But it had costs that were not properly recognized. The current existence of large unfunded liabilities is not because pension plans and retiree medical plans are inherently volatile and costly, but because decisions were made to fund the acceleration of the closure rather than the pension and medical liabilities. In retrospect, these were likely very good decisions, but the resulting unfunded liabilities should not be used as a reason to eliminate benefits for future employees of DOE contractors.

Current Overfunded Plans

The second example is several of the laboratories that still have overfunded pension plans (Oak Ridge, Sandia, Los Alamos, and perhaps others). Each of these sites is currently incurring benefit cost for pensions benefits, but they are not contributing to the pension plan because of the overfunded status. As these plans incur more liabilities, they will eventually exhaust the surplus that currently exists. When this happens, there will be a sharp upward spike in the reimbursement cost and there might be a sharp increase in unfunded liability.

Sponsors should be contributing a portion of the benefit cost to these overfunded plans each year. By contributing a portion of this cost they could prolong the existence of a plan surplus and lessen the increase of contribution requirements when the plans ultimately emerge from full funding. The recent legislative changes of the Pension Protection Act make it much easier for a plan sponsor to make contributions to a plan that is fully funded. The DOE should require contractors to take advantage of this opportunity to lessen the volatility of the contributions to these plans.

A Stable Funding Policy

One laboratory had a funding policy in the 1980s and early 90s of contributing 4% of compensation to the pension plan each year. This was the approximate benefit cost or service cost of the plan. In years of good experience, this was more than the minimum requirement. In years of poor experience, the cushion established in the good years allowed the sponsor to maintain the stable contribution. Contributions and reimbursements were always easy to predict and budget.

This changed in the mid 1990s when the plan became overfunded due to excellent investment results. The 4% budgeted contribution exceeded the maximum deductible contribution and no contribution was made. This persisted for several years and no pension contribution was budgeted or reimbursed. By 2001, the surplus was exhausted but contributions of 4% were not reinstated, at least partially because it would have been a sudden increase in costs. When contributions were first legally required in 2003, the required minimum was well above 4% of compensation.

Had this site been able to continue making 4% contributions throughout the late 1990s, the sharply higher contributions of 2003-6 would not have been required. The plan's funded status would have been strong. The good news is that the changes in the tax code made by the Pension Protection Act will now allow this site to make 4% contributions even if such conditions develop again. Stable contribution policies can be developed and sustained for many years.

Retiree Medical Funding

Retiree medical plans are a prime example of poorly conceived funding policy. In most cases the policy is to never fund in advance, but to fund when the benefit is payable to the retiree. This is many years after the real obligation or cost has been incurred. The real cost is incurred when the participant earns the right to future benefits, not when the benefit must be paid.

Retiree medical plans do not have required funding rules comparable to pensions, but they can be effectively funded when the cost is incurred by using 401(h) accounts and Voluntary Employee Benefit Associations (VEBAs). The Pension Protection Act also expands the ability of a plan sponsor to transfer pension surplus to a 401(h) account to fund medical benefits. Contractors should be required to establish these accounts and fund them to the maximum extent allowable under current laws.

Unfunded retiree medical liabilities constitute the majority of the DOE's future obligations. Funding these costs when employees earn the right to these benefits provides better cost recognition, matches expenses with the appropriate revenues or services provided by employees, and ultimately lowers the cost of these benefits through the investment income earned by the invested funds. Rather than defer reimbursement to future periods, the DOE should require contractors to fund these benefits to the maximum extent allowed by the law as the employees earn the right to the benefits. The cost of these benefits, if accrued properly during the working career, will be far less than the ultimate cost if funding is deferred until employees retire.

The existing legacy liabilities are a problem of insufficient cost recognition in the past. This problem cannot be solved by denying these benefits to future employees. The costs for future employees can be properly recognized and funded, and are not excessive. The problem of legacy liabilities is substantial and will remain even if future employees are denied benefits.

Enlightened funding policies for both pension and retiree medical programs can produce stable and predictable reimbursement costs for the DOE and your contractors. The DOE should require all contractors to develop funding policies that match contributions to the period in which benefits are earned. Such funding and reimbursement should continue even when plans have a modest surplus.

Investment Policy

Net investment income is a major component of financing cost. If assets and liabilities grow at the same rate, financing cost is more likely to be stable and predictable.

The liabilities of most pension plans grow relatively consistently, varying only with changing interest rates. When interest rates are stable, liabilities grow at stable and predictable rates. When interest rates decline, liabilities grow more rapidly. Conversely, when interest rates rise, liabilities grow more slowly and might even decline.

Most pension plans are invested in diversified portfolios that include large exposure to equity investments. While a diversified portfolio is likely to produce higher long-term returns, it also results in volatile returns that do not correlate well with the growth of liabilities, resulting in volatile financing costs. To avoid contribution volatility, a diversified portfolio needs a stronger funding policy and higher asset levels to avoid unfunded liabilities during poor investment markets. Such policies can be developed and may lower long-term cost but will also require contributions at times when the plan may appear fully funded.

Alternatively, pension portfolios can be invested in duration matched assets assuring that interest rate changes and volatile markets will not produce unfunded liabilities. This technique, often referred to as liability driven investing, has gained much academic support and has proven effective at reducing the volatility of pension costs.

Closing or freezing pension plans does not remove the need for an effective investment policy. The requirement that the plan provide benefits already earned means that these plans will still contain substantial assets and liabilities many years into the future. Volatility in contributions, expense, and balance sheet entries can still exist unless prudent funding and investment policies are implemented.

Most if not all contractors have written investment policies in place for their pension plans. These policies should be required to include supplemental information describing how the investment policies integrate with the funding policy, including an assessment of the likely resulting volatility of funding requirements.

Plan Design

The long-term cost of any retirement plan (defined benefit or defined contribution) is dictated by the richness of the benefits. Two factors are important in understanding and controlling the richness of a pension plan.

- *Base pension design/formula* - this formula should fit the workforce, be within reasonable long-term budgets and be based on realistic economic and demographic assumptions
- *Hidden pension subsidies* – hidden pension subsidies should be aggressively eliminated. They often escalate costs dramatically, and are not valued dollar for dollar by participants

Base Pension Design/Formula

Defined benefit plans are sometimes perceived to be more expensive than defined contribution plans. This perception is flawed because the benefit levels of the plans are usually not comparable. A DB plan that costs more than a DC plan is likely to provide much higher benefits. If a DB plan and a DC plan have the same long-term cost, the DB plan is likely to provide better retirement benefits although the DC plan will provide better termination benefits for short term employees. The better retirement benefits of the DB plan are directly the result of certain cost efficiencies, primarily the pooling of the longevity risk that creates value and provides lifetime benefits at a much lower cost than DC plans, and the lower cost of vesting for employees who do not work a full career.

DB plans can become too expensive if the benefits are too generous. The DOE has in place a mechanism to control excessively generous benefits. The relative value study required by DOE Directive 350.1 is effective at identifying excessively generous benefits, although we would suggest that the 5% parameter may be too restraining. Some contractors may be more effective at retaining a stable workforce with benefits that are more generous and base pay packages that are somewhat lower. We suggest that the 5% parameter should be increased if a contractor can demonstrate that total compensation (direct pay plus benefits) is within the 5% constraint.

Hidden Subsidies

Hidden pension subsidies can dramatically escalate plan costs and should be aggressively eliminated. Early retirement subsidies can be especially costly, and can significantly increase the magnitude and volatility of pension costs. Retirement patterns that seem predictable in normal times may change suddenly during an economic downturn or when a site experiences a significant strategic shift. Early retirement subsidies should be significantly restricted or eliminated in future pension plans and the cost of subsidizing retirements at a particular time should be explicitly recognized at the appropriate time, for example, as part of a site closure or restructuring.

Other automatic subsidies that can lead to employee windfalls include – plant shutdown benefits (other than ad hoc at DOE discretion as necessary), disability (that overlaps with other disability benefits), and form of payment subsidies such as lump sum distributions.

The DOE should ensure all such hidden subsidies are identified, recognized in pension liabilities and then aggressively eliminated to the extent allowed under pension law.

New Plan Designs that Lessen Volatility

New pension plan designs can eliminate the financial volatility of pension costs and still provide the higher long-term return expected from diversified investment portfolios. Variable annuity plans can provide the participant the security of a lifetime income with the potential for inflation protection and at the same time provide the plan sponsor with stable, predictable costs. With asset driven liabilities, variable annuity plans can eliminate over 90% of the volatility associated with fixed benefit pension plans.

These variable annuity designs are not new, but recent thinking has led to design improvements that make the plans more attractive to sponsors and employees. We believe these new designs place risk where that risk is most easily managed – mortality risk with the sponsor and investment risk with the employee – while still providing the attraction and retention characteristics of traditional pension plans

We have had the opportunity to present variable benefit plans to several DOE contractor conferences and contractors have expressed enthusiasm for the idea. They recognize that these plans can deliver the benefits workers need and the cost stability sought by the DOE. An acknowledgement by the DOE that costs for these plans are reimbursable would accelerate their adoption and the stabilization of pension costs.

Retiree Medical Design

A primary cause of volatility in retiree medical plans is the uncertainty of medical trend. This component of volatility can be eliminated by adopting plans that reimburse retirees for a specific dollar amount toward the premium and require the retiree to pay the balance of the medical premium. While these plan designs generally are less attractive to the retiree, they are still much better than no plan at all. A defined dollar benefit can provide the contractors and DOE with stable predictable costs.

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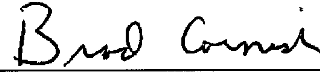
May 11, 2007
Ms. Stephanie Weakley
US Department of Energy

Summary

The DOE has correctly identified the volatility of reimbursements for pension and retiree medical benefits and the design of these programs as serious business issues. However, abolishing plans will exacerbate problems as contractors will have increased costs, may be unable to retain workers and may have more difficulty managing the turnover of the workforce. Intermediate solutions exist that will mitigate volatility and provide valued retirement benefits to workers.

Donald E Fuerst, FSA
Worldwide Partner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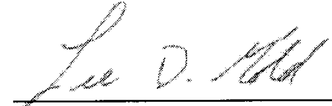
Principal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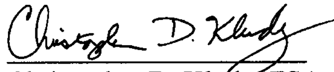
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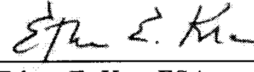
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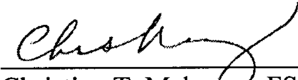
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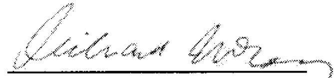
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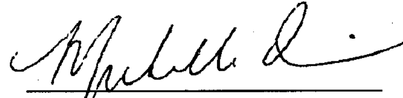
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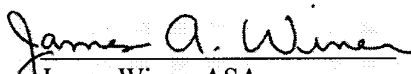
James Winer, ASA
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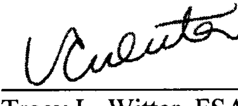
Tracy L. Witter, FSA
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-----Original Message-----
From: Warin, Patricia
Sent: Friday, May 11, 2007 1:50 PM
To: contractor pensions
Subject: Submission of Group Comments

May 11, 2007

U.S. Department of Energy
Office of Procurement and Assistance Management
1000 Independence Avenue, SW
Washington, DC 20585

Re: **Request for Public Comment on Department of Energy Contractor Employee Pension and Medical Benefits Challenge**

Dear Sir/ Madam:

The undersigned organizations submit this letter in response to the request for comments from the Department of Energy ("DOE") as posted in the Federal Register on March 27, 2007.[1] We represent plan sponsors, service providers and plan professionals in the employer-provided defined benefit pension plan system. As such, we believe that the defined benefit plan system should be supported and oppose policies that negatively impact the ability of employers to establish and maintain defined benefit pension plans. We appreciate the opportunity to share our thoughts with the DOE and urge the agency to forego any further consideration of policies that discourage the maintenance of defined benefit plans.

In April 2006, the DOE announced a new policy for reimbursements of allowable costs on certain contracts.[2] Under this policy, the DOE planned to continue to reimburse contractors for costs associated with current and retired employees' defined benefit pension and medical plans under existing contract requirements but would not reimburse these costs for new employees. Rather, the DOE intended to reimburse contractors only for the costs of defined contribution pension plans and market-based medical benefit plans. In response to the 2006 announcement, there was significant opposition from affected groups and Congress acted to prevent the DOE from carrying out the policy. In June 2006, before any Congressional action was completed, Secretary of Energy Samuel Bodman decided to delay implementation of the controversial policy change by one year.[3] For the reasons stated below, we believe that this policy should be permanently rejected.

Refusing to Reimburse Defined Benefit Pension Costs Contradicts the Intent of Recent Pension Reforms. The undersigned organizations have spent the past several years working with Congress, the Administration, and other interested parties to implement comprehensive pension reform. After much debate, the culmination of this extensive and exhaustive effort was the Pension Protection Act of 2006 ("PPA"). One of the biggest issues of debate surrounded defined benefit pension plans and their continued feasibility. Ultimately, all parties concluded that defined benefit plans were viable and set about implementing reforms to address employers' workforce concerns, participant

[1] 72 Fed. Reg. 14,266 (3/27/07).
[2] DOE N 351.1 (4/27/06).
[3] DOE N 251.66 (6/28/06).

rights, and funding concerns. By stating that it no longer supports defined benefit pension plan designs, the DOE would be effectively stating that it does not view these plans as beneficial or viable. Such a statement would be inconsistent with the intent behind the PPA and would undermine both the work done in the PPA to support the continuation of the defined benefit plan system and the voluntary nature of the system.

The DOE Should Not Dictate Pension Policy for Private Employers. Employers that maintain pension plans are already subject to the jurisdiction of several government agencies.[4] If each and every government agency were to dictate benefit policy, even indirectly, then these employers would be subject to the untenable burden of monitoring each government agency just to determine its compliance with the pension and healthcare policies and directives of each individual agency. At the very least, employers might not be able to provide uniform benefits to their workers. At the worst, employers might find that they are not able to simultaneously comply with different directives from different agencies. To avoid conflicting directives, employers might decide it is easier to not offer pension benefits at all. Certainly, this is not a result that should be encouraged by a government agency.

In conclusion, the DOE's April announcement essentially forces companies doing business with the Department to shape their retirement plans to meet contractual requirements rather than selecting the benefits program that fits with their workforce and business needs and is in contradiction to the voluntary nature of the retirement system. In addition, the DOE would be sending the wrong message about the government's support of the private defined benefit system. Consequently, we urge the DOE to permanently reject its earlier proposal. We believe that DOE should not reject defined benefit plans. Instead, DOE should rely on the judgment of the plan sponsor who knows the workforce to determine what kind or kinds of plans are best for its employees.

Sincerely,

American Benefits Council
American Society of Pension Professionals & Actuaries
Business Roundtable
The ERISA Industry Committee
Financial Executives International's Committee on Benefits Finance
The Financial Services Roundtable
HR Policy Association
The National Association of Manufacturers
Society for Human Resource Management
U.S. Chamber of Commerce

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[4] ERISA plans are under the jurisdiction of the Department of Treasury and the Department of Labor. In addition, defined benefit plans are under the jurisdiction of the Pension Benefit Guaranty Corporation.

-----Original Message-----
From: Deanna Johnson
Sent: Friday, May 11, 2007 2:59 PM
To: contractor pensions
Subject: American Benefits Council Comment Letter on Contractor Pension and Medical Benefits Cost Challenges

May 11, 2007

Submitted Electronically

Ms. Stephanie Weakley
Director, Office of Resource Management
Department of Energy
1000 Independence Avenue, S.W.
Washington, D.C. 20585

Re: Request for Public Comments on Department of Energy Contractor Pension and Medical Benefits Cost Challenges

Dear Ms. Weakley:

The American Benefits Council (the "Council") appreciates the opportunity to offer comments regarding the challenges faced by the Department of Energy ("DOE") regarding the increasing costs associated with contractor employee pension and medical benefits.[1] As a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees, the Council is acutely aware of the challenges faced by employers in both the private and public sector with respect to accrued pension liabilities and the high costs of medical coverage today. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.

The following is a summary of the Council's comments and recommendations:

- DOE policy should focus on curtailing actual costs not benefit design and should continue to allow employers to design the benefits programs offered to new employees.
- Defined benefit plans play an integral role in helping employees prepare for retirement and should be supported by DOE policy.
- A government agency's decision to preclude the use of defined benefit plans for future hires would set a dangerous policy precedent and would be inconsistent with the recent collective efforts of Congress, the Administration, and employers to amend federal laws to strengthen the defined benefit plan system.

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[1] 72 Fed. Reg. 14266 (March 27, 2007).

- The cost data presented in the Federal Register is not representative of the actual cost increase for DOE with respect to pension plan benefits.

- Mandating the use of defined contribution plan participation for future hires will likely increase costs in the short-term and fails to address the cost volatility attributable to current defined benefit plan participation.

- Although defined benefit plans are subject to a certain degree of cost volatility (*i.e.*, interest rate risk, investment return risk, mortality risk), this volatility could be reduced through the alteration of plan features and future benefit accruals and the use of more effective funding and asset management policies.

1. **DOE policy should focus on curtailing actual costs not benefit design and should continue to allow employers to design the benefits programs offered to new employees.**

The Council understands DOE's concerns regarding its increasing costs attributable to contractor pension and medical benefits for employees. The issue of pension liabilities and high medical coverage costs are issues currently being confronted by our members. The Council believes precluding future participation in defined benefit plans, however, is unlikely to achieve DOE's intended goal of constraining future cost increases. Instead of focusing on limiting benefit plan *design*, the Council urges DOE to focus instead on implementing comprehensive and effective policies that focus on reducing or otherwise constraining actual pension and medical plan benefit *costs*.

Under current DOE rules, contractors are free to design their compensation and benefit programs as they deem necessary to attract and retain a qualified workforce; this includes the ability to offer defined benefit plan coverage for new hires. The current rules make good policy sense because employers, not the federal government, are in the best position to know the benefits that are most desired by current and future employees and likely to contribute to effective recruitment, increased job tenure, and enhanced productivity. Some contractors may find moving to an exclusively defined contribution approach works very well for their workforce; other contractors may have workforces well-suited to a defined benefit plan approach. As is well documented, the defined benefit plan system has been in decline for many years and the rate of decline has accelerated in recent years. Yet despite this decline and other competitive pressures, many companies remain committed to the defined benefit plan system because of how well it serves both the company and its employees. It would be counterproductive and inappropriate for the federal government to push those companies out of the defined benefit plan system.

Notice 351.1, if implemented, would establish a dangerous policy precedent because it would interject the federal government into benefit plan design and circumscribe an employer's ability to best determine benefit design in order to attract and retain a qualified workforce. Although DOE is operating in many ways like an employer with respect to its Management and Operating ("M&O") contracts, DOE is first and foremost a federal

agency. In this regard, a ban on defined benefit plans would be strikingly inconsistent with the sweeping pension reform recently enacted based on an Administrative proposal. That reform was intended to strengthen the defined benefit plan system so that workers can receive guaranteed benefits for life. It would be inappropriate for a part of the Administration to then announce a ban on the very type of plan that the Administration set out to strengthen. Moreover, the legislation confirmed the national commitment to an open marketplace for different types of retirement plans, including hybrid plans. The federal government should not now send signals favoring one type of plan over another, but rather should show consistent and united support for all aspects of the voluntary private retirement plan system (including the provision of guaranteed benefits to workers) and for employers' ability to choose the type of plan best suited to their workforces.

The inappropriateness of an agency ban on defined benefit plans can be further illustrated by the possibility that another agency could potentially establish a conflicting policy, which could put contractors serving both agencies in an untenable position. This further underscores the need for the federal government to be united in permitting contractors to choose the types of plans best suited to their workforces.

The ability of DOE contractors to choose among benefit plan options for their new employees, including defined benefit plans, is also very important to ensure that DOE contractors remain able to compete in the marketplace for the best qualified workers. As DOE's request in the Federal Register dated March 27, 2007, expressly acknowledges, "[t]he Department of Energy relies on contractors to manage and operate its specialized scientific, engineering, production and clean-up sites and facilities." Additionally, many of the DOE facilities are in remote geographic locations, which in many instances may make it more difficult for DOE contractors to recruit and retain experienced workers. Accordingly, DOE contractors must be permitted to design their benefits in order to attract and retain an effective and qualified workforce. To handcuff DOE contractors by precluding future defined benefit plan participation is to ignore the realities of the marketplace and to place DOE contractors at a significant disadvantage in recruiting and retaining a skilled workforce.

2. Defined benefit plans play an integral role in helping employees prepare for retirement and should be supported by DOE policy.

In addition to the role that defined benefit plans play in the recruitment and retention of skilled workers, defined benefit plans are, for many employees, an integral part of a comprehensive retirement planning strategy. In conjunction with defined contribution plans, defined benefit plans can help ensure that employees have an adequate and accessible source of retirement income. Moreover, for many employees, the guaranteed retirement income stream from a defined benefit plan (for example, in the case of a benefit payable as a single life annuity) provides important financial security and allows individuals to better plan for their retirement. This is especially so given that defined benefit plan participants are generally insulated from mortality and investment risk. Given the important role that defined benefit plans play in helping American

workers prepare for retirement for themselves and their families, federal policies should reinforce the continued use of defined benefit plans by employers.

3. **The cost data presented in the Federal Register is not representative of the actual cost increase for DOE with respect to pension plan benefits.**

In its March 27, 2007 request, DOE states that reimbursements have increased by 226% percent since the close of fiscal year 2000. The Council believes this statistic may be somewhat misleading because fiscal year 2000 is used as the starting point for DOE's cost comparison. Based on DOE's Performance and Accountability Reports, it appears that as of fiscal year 2000, the vast majority of contractors had pension plans that were funded at or above 100% of current liabilities. Thus, few, if any, pension plans required contributions in 2000 by DOE contractors (subject to reimbursement from DOE as an allowable cost). Comparing current year costs to those faced in 2000, when DOE's pension costs were near zero, provides little guidance regarding the actual cost increase for DOE. This is because any increase in comparison to a near-zero baseline number is likely to result in a very large percentage increase. In fact, had the contractors been funding their plans in 2000 and the years thereafter to reflect additional benefit accruals under their plans (regardless of the plan's status as fully funded), the percentage increase would likely be much lower than the stated 226%. Moreover, a much more problematic issue for DOE in curbing future cost increases pertains to those contractor costs attributable to accrued but unfunded health liabilities.

4. **Mandating the use of defined contribution plan participation for future hires will likely increase costs in the short-term and fails to address the cost volatility attributable to current defined benefit plan participation.**

Notice 351.1 provides that DOE will not reimburse costs attributable to defined benefit plan coverage of future hires. The practical effect of this new rule, if implemented, is that DOE contractors will be forced to look to defined contribution plans as the sole mechanism for helping their future employees save for retirement. Although intended to reduce costs for DOE, the proposed rule likely would increase costs at least in the short-term for both contractors and DOE. This is due in large part to the age profile of new employees, which is typically younger than the age profile of the average employee in the workforce. Defined contribution plans typically provide for the same contribution amount regardless of an employee's age. This is in marked contrast to traditional defined benefit plans where the cost of the benefit accrual increases with age, with younger employees costing much less than older employees (because of the longer time horizon to normal retirement age under a defined benefit plan). Thus, the practical effect of DOE's proposed rule in the short-term is that costs for both contractors and DOE are likely to increase.

Regardless of whether DOE contractors sponsor defined benefit or defined contribution plans, actual benefit costs will not decrease unless contractors establish defined contribution plans with benefits that are less generous than those provided under

their current defined benefit plans. Thus, the better approach for DOE in establishing new rules would be to focus more on actual benefit levels and less on employer plan choice.

In addition to the likely short-term increase in costs under the proposed rule of Notice 351.1, unless and until DOE addresses the cost volatility associated with current defined benefit plan participants, DOE and its contractors are likely to confront long-term cost volatility associated with unpredictable and significant upward spikes in funding liabilities and benefit costs.

5. <u>Cost volatility can be reduced.</u>

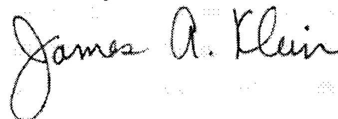
The Council is not unaware of the cost volatility that is typically associated with the sponsorship of a defined benefit plan. This volatility is often related to the uncertainty regarding mortality rates, interest rates, retirement rates, and investment return, among others. Nevertheless, the Council believes that the cost volatility can in fact be reduced by altering certain plan features and future benefit accruals and by implementing more effective funding and asset management policies. For example, investment strategies can be modified to reduce volatility. Actuarial assumptions, such as mortality tables and retirement rates, can also be scrutinized to reduce the risk of unexpected increases in costs. Funding patterns can be reexamined to ensure a steady flow of contributions. Accordingly, we urge DOE to work with our members that have expertise in this area to discuss appropriate tools to address the real cost issues confronting DOE. We are not recommending that DOE develop mandates regarding funding, investments, and assumptions. Any type of one-size-fits-all mandate would not be appropriate in light of the variety of plans and workforces. But the dialogue could be helpful in identifying further areas to explore in the effort to control costs.

We are not suggesting that there are simple answers. But we are suggesting that there are tools available to reduce the volatility associated with defined benefit plans. The Council believes that for some employers the challenges posed by volatility are offset by the value they are able to still receive by continuing to sponsor defined benefit pension plans for their employees.

* * *

The Council appreciates the opportunity to share with you our comments and recommendations.

Sincerely,



James A. Klein
President

-----Original Message-----
From: Jeannine Markoe Raymond
Sent: Friday, May 11, 2007 4:12 PM
To: contractor pensions
Subject: Request for Public Comment on Department of Energy Contractor Employee Pension and Medical Benefits Challenge

National Conference of State Legislatures (NCSL)
National Association of Counties (NACo)
United States Conference of Mayors (USCM)
National League of Cities (NLC)
International City/County Management Association (ICMA)
National Association of State Auditors Comptrollers and Treasurers (NASACT)
Government Finance Officers Association (GFOA)
Council of Institutional Investors (CII)
National Association of State Retirement Administrators (NASRA)
National Council on Teacher Retirement (NCTR)
National Institute on Retirement Security (NIRS)
National Conference on Public Employee Retirement Systems (NCPERS)
National Association of Government Defined Contribution Administrators (NAGDCA)
International Public Management Association for Human Resources (IPMA-HR)
American Federation of State, County and Municipal Employees (AFSCME)
American Federation of Teachers (AFT)
Fraternal Order of Police (FOP)
International Association of Fire Fighters (IAFF)
National Association of Police Organizations (NAPO)
National Education Association (NEA)

May 11, 2007

VIA ELECTRONIC MAIL

U.S. Department of Energy
Office of Procurement and Assistance Management
1000 Independence Avenue, SW
Washington, DC 20585
contractorpensions@hq.doe.gov

Re: **Request for Public Comment on Department of Energy Contractor Employee Pension and Medical Benefits Challenge**

Dear Sir/ Madam:

On behalf of the 20 national organizations listed above – representing state and local governments, public employee unions, public retirement systems, and over 20 million public employees, retirees, and beneficiaries – we are writing in response to the Request for Public Comment on the Department of Energy Contractor Employee Pension and Medical Benefits Challenge. Specifically, we wish to register our objections to a proposed policy as outlined in DOE Notice 351.1 that would deny reimbursement of contractor costs associated with defined benefit (DB) pension plans for new employees. **We urge the agency to cease consideration of this proposal.**

The proposal is simply bad public policy. It is irresponsible for an agency of the Federal government to limit the type of benefits a public or private contractor may provide its employees. This is particularly true for the DB model that has proven invaluable in the management of human resources as well as one of the most efficient means of providing retirement security. Encouraging those that contract with the DOE to terminate their DB plans or close them to new hires has the very real possibility of increasing transition costs, employee turnover and training expenses at a time when many government agencies and private employers are attempting to retain institutional knowledge.

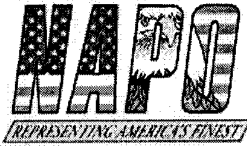
These losses will not only affect DOE and its private contractors, but also many State and local agencies that contract with the Department. State and local governments would be required to take on the administrative burdens and transition costs associated with freezing existing DB plans and operating new DC plans for future employees associated with the performance of such work. This additionally sets a very dangerous precedent with regard to other intergovernmental agency contracts and Federal-State shared programs.

In the State and local government workforce—two-thirds of which is employed in education, public safety, corrections and the judiciary—such a policy could undermine an important and successful workforce management tool used to attract and retain qualified, experienced and trained personnel in positions critical to the continuous and reliable delivery of vital public services. It also removes a cost-effective means for delivering survivor and disability benefits particularly important in many high risk public sector jobs.

Furthermore, to have employees who will be receiving very different retirement benefits working alongside one another at the same job – particularly highly technical or hazardous work such as that encountered in connection with many DOE and other Federal contracts – could have a significant adverse impact on employee morale and, accordingly, employee productivity and work quality. When national security could be at stake, Federal policies should focus on attracting the most qualified workers, not creating barriers that could serve to effectively discourage the use of some of the best experts available.

We strongly urge that this policy be rejected. Please contact our association representatives if you have any questions or require further information.

-----Original Message-----
From: Andrea Mournighan
Sent: Friday, May 11, 2007 4:36 PM
To: contractor pensions
Subject: Re: Request for Public Comment on DOE Contractor Employee Pension and Medical Benefits Challenge



NATIONAL ASSOCIATION OF POLICE ORGANIZATIONS, INC.

Representing America's Finest

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Executive Secretary
Southwest Florida Police Benevolent Association

NATIONAL HEADQUARTERS

WILLIAM J. JOHNSON
Executive Director

May 11, 2007

VIA ELECTRONIC MAIL

United States Department of Energy
Office of Procurement and Assistance Management
1000 Independence Avenue, S.W.
Washington, D.C. 20585
contractorpensions@hq.doe.gov

Re: Request for Public Comment on Department of Energy Contractor Employee Pension and Medical Benefits Challenge

Dear Sir or Madam:

On behalf of the National Association of Police Organizations (NAPO), representing over 2,000 state and local law enforcement units and associations from across the United States, I am writing in response to the Request for Public Comment on the Department of Energy (DOE) Contractor Employee Pension and Medical Benefits Challenge. Specifically, I wish to voice our strong opposition to any changes to the current program that would deny reimbursement of contractor costs associated with defined benefit (DB) pension plans for new employees, as proposed in DOE Notice 351.1 (April 2006).

There are several reasons for NAPO's opposition to the proposed policy. First, it is NAPO's belief, as a matter of public policy, that it is outside the purview of the DOE or any government entity what the contractor does with the money it is paid pursuant to an agreed-upon contract, as long as it is not illegal. The DOE should not restrict a contractor's decision to use any part of its contracted earnings for the service it is providing to fund a DB plan, or any type of employee benefit for that matter. The only concern for the DOE should be whether the contractor is effectively providing the services as agreed to in the contract.

Second, the DOE's proposal would effectively force public and private entities who desire to continue contracting with the Department to use defined contribution (DC) plans as their only retirement plan for all future employees associated with the performance of such work. A major consequence of this shift would be the loss of an important recruiting tool for public employers – mainly the DB model. Public employers often find it necessary or simply expedient to provide ample benefits to its employees because they find that is the best way to attract and retain the most qualified, experienced and trained personnel.

For instance, survivor and disability benefits, staples of public sector DB plans, are particularly important to public employees due to the high risk associated with many jobs. Such retirement benefits for survivors or workers who become disabled, if provided through private insurance – which would be required if individual retirement accounts were the only pension benefit available – would be much more expensive and potentially less comprehensive as a result.

The loss of such benefits as a tool to recruit new employees not only would hamper the contractor's ability to hire and retain the best people, but it would also lessen the competitiveness of their business. It would foreclose federal taxpayers from utilizing the best available people simply because those persons have fled to private sector employers that have freely decided to provide a competitive package.

Lastly, there is no legitimate economic rationale for the change. The provision of DB plans by DOE contractors is not an additional cost to the Department. However, the termination or freezing of contractor DB plans would increase transition costs, employee turnover and training expenses at a time when many government agencies and public employers are attempting to retain institutional knowledge.

The DOE's April 2006 proposal threatens to undermine the financial stability of Federal contractors' existing DB pension plans, as well as restrict the ability of employers to fashion retirement plans that best address their unique needs and those of their workforce. Finally, it would lessen the competitiveness of government contractors with the private sector in attracting the best employees critical to the continuous and reliable delivery of vital public services.

NAPO strongly urges that this policy be rejected. Please feel free to contact me at (202) 842-4420 if you have any questions or require further information.

Sincerely,

William J. Johnson
Executive Director

-----Original Message-----
From: Ocaya, Judy (Irvine) Sent: Friday, May 11, 2007 4:57 PM
To: contractor pensions
Subject: Request for Public Comment on Department of Energy Contractor Employee Pension and Medical Benefits Challenge

Watson Wyatt & Company

Suite 1400
950 Seventeenth Street
Denver, CO 80202-2831

Telephone 303 298 7878
Fax 303 623 5633

May 11, 2007

Ms. Stephanie Weakley
Director, Office of Resource Management
U.S. Department of Energy
1000 Independence Avenue, S.W.
Washington, D.C. 20585

Re: Request for Public Comment on Department of Energy Contractor Employee Pension and Medical Benefits Challenge

Dear Ms. Weakley:

This letter contains our comments and recommendations in response to the request by the Department of Energy (DOE) as posted in the *Federal Register* on March 27, 2007.[1] Watson Wyatt Worldwide is a global human capital and financial management consulting firm specializing in employee benefits, human capital strategies and technology solutions. Founded in 1878 as an actuarial consulting firm, Watson Wyatt combines human capital and financial expertise to deliver business solutions that drive shareholder value. Watson Wyatt has more than 6,000 associates in 88 offices in 30 countries and corporate offices in Arlington, Virginia, and Reigate, England.

Our main comments and recommendations are highlighted below.

The DOE's suspended policy, DOE N 351.1, bypasses the appropriate legislative process for national policies on retirement plans, conflicts with long-standing public policy supporting employer-sponsored pension plans and goes beyond the DOE's purview.

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[1] *Federal Register*: March 27, 2007 (Volume 72, Number 58), pp. 14266-14267.

- Congress regularly revises pension laws in order to balance the interests of sponsors, plan participants and taxpayers. With DOE N 351.1, the DOE will effectively set a national benefit policy that bypasses the legislative process and preemptively puts an end to a specific type of retirement plan — in this case, defined benefit (DB) pension plans — for DOE contractors.

- The policy of the federal government toward whether employers should sponsor and employees should benefit from DB pension plans should be coordinated and consistent. The administration in 2005 proposed, Congress passed and the President in 2006 signed landmark legislation reforming the funding and other important rules pertaining to DB pension plans. This was done to make participants' benefits more secure, and to establish a stable and more supportive environment for the sponsorship of these plans than existed under prior law. This legislation was the culmination of several years of study and discussions among the administration, Congress, plan sponsors, employee groups and various policy experts. It has been the long-standing policy of the federal government to support American workers' retirement security through guaranteed pensions. It is inappropriate for the DOE to put itself outside of this policy consensus to unilaterally impose a viewpoint that is prejudicial toward DB plans.

- It is inappropriate for the DOE or other government agencies to so directly manage benefit plan *design* of its contractor workforces. Rather, the agencies should manage benefit plan *costs* through the contracting process. The concern should focus on the overall level of costs for compensation and benefits, rather than on the specific components of compensation and benefits. The agencies should not penalize or micromanage contractor companies that choose DB versus defined contribution (DC) plans or, more broadly, greater benefits and perhaps lower cash pay. Contractors may indeed have good human resource management reasons for these choices, such as offering certain plan designs that have been shown to reduce long-term costs and turnover, and increase productivity.

The costs cited in the* Federal Register *indicate some staggering historical increases and suggest that the future is quite bleak. But there is no evidence that historical cost increases are representative of future increases.

- The DOE discloses in the *Federal Register* that its contributions have increased by 226 percent since the end of fiscal year 2000 (FY2000). This statistic reflects both pension and postretirement medical benefits (referred to as PRB). The "Department of Energy Contractor Employee Pension and Medical Benefits Briefing — March 2007"[2] notes the following contributions to contractors' pension and PRB plans:

Amounts in millions	FY2000	FY2006	Percentage Increase Over 6-Year Period
• Pension	$58	$530	814%
• PRB	$205	$328	60%
• Total	$263	$858	226%

Bigger pension contributions drove the overall 226 percent increase, but the snapshot above is unrepresentative. In FY2000, contractors' pension plans held a net asset surplus.[3] It is likely that, at the time, many of their plans were fully funded and required little or no contributions; in other words, the DOE was enjoying contribution holidays.

To use FY2000 as a baseline — a year in which many contractor plans required minimal contributions — is misleading; any increase in contributions, when measured against small or near-zero amounts, would naturally appear as an alarming escalation. Future (after FY2006) increases in the DOE's contributions are likely to be much lower.

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[2] See "Additional Background Information" at http://management.energy.gov/request_for_comments.htm

[3] See the Department of Energy's Performance & Accountability Reports

We note that, while the DOE has disclosed historical costs, it did not disclose projected costs, i.e., the cost challenges ahead.

- Deteriorating assets are another reason for higher contributions in recent years. From FY2000 to FY2003, assets for DOE contractors' pension plans lost $3.8 billion in value (declining from $23.2 billion to $19.4 billion). Despite this large loss, the old pension law required only $0.3 billion in contributions during this period. From FY2005 to FY2006, the DOE's pension contributions increased almost 200 percent, from $271 million to $530 million under old pension law.[4] This increase could be the result of several factors, such as plans coming out of full funding in FY2006. In other words, contributions were required in FY2006 but not in FY2005. In addition, some requirements under the old pension law, such as the additional funding charge/deficit reduction contribution, triggered sudden spikes in contributions, particularly for companies whose contributions had been the minimum required amounts. By contrast, the new pension law provides for more rational, consistent funding of DB plans.

- The DOE disclosed in the *Federal Register* that its benefits-related financial statement liability has increased by 68 percent since FY2000. However, the DOE's financial statement liability has been relatively stable in more recent years. The department's financial statement liability for pensions was $2.2 billion in FY2006, $2.6 billion in FY2005 and $1.9 billion in FY2004. Its financial statement liability for postretirement medical benefits was $9.7 billion in FY2006, $9.0 billion in FY2005 and $8.5 billion in FY2004.[4]

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[4] See the "Department of Energy Contractor Employee Pension and Medical Benefits Briefing – March 2007."

- In the Request for Comments, the DOE states the following:

  ... the volatility and unpredictability of contractor benefit cost reimbursements will continue to make it difficult for the Department to plan and execute budgets. The Pension Protection Act of 2006 generally accelerates required contributions to defined benefit pension plans and is expected to increase the amount that the DOE reimburses contractors for pension benefits over the next 5 to 7 years.

  Under the Pension Protection Act of 2006 (PPA), there could be some acceleration of contributions for some — although certainly not all — plans. Also, while many in our industry initially expected the PPA to increase the volatility of pension contributions, our latest research indicates that, on the contrary, the PPA will alleviate the overall volatility of required contributions.[5]

Contractors' postretirement medical plans loom as a much bigger cost-management challenge for the DOE than pension plans. Yet DOE N. 351.1 imposes a draconian policy on retirement plan design (i.e., mandating DC plans instead of allowing employers to choose the right plan for their workforce), and largely ignores the existing unfunded liabilities for postretirement medical benefits.

- Unfunded postretirement medical benefits pose a greater cost-control challenge to the DOE than pension plans. The DOE's Performance & Accountability Reports disclose the following data about the pension benefits and PRBs for DOE contractor plans.

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[5] See Mark Warshawsky, "The New Pension Law and Defined Benefit Plans: A Surprisingly Good Match," *Journal of Pension Benefits*, forthcoming, Summer 2007.

Amounts in billions	Funded Status Pension	PRB
FY2000		
▪ Accumulated benefit obligation (at 8% discount rate)	11.3	5.5
▪ Assets	23.2	0.1
▪ Surplus/(Deficit)	11.9	(5.4)
FY2006		
▪ Accumulated benefit obligation (at 5.75% discount rate)	24.9	11.5
▪ Assets	24.1	0.2
▪ Surplus/(Deficit)	(0.8)	(11.3)

The accumulated benefit obligation (ABO) is the actuarial present value of benefits attributed to employee service rendered before the measurement date. This is essentially the liability that would remain if the plans were to stop accruing benefits. Moreover, for pension plans, this is essentially the sponsor's funding target and therefore its cash flow cost basis, which the new pension law has put in place to assure the security of plan participants' benefits.

Note that *the DOE's ABO for pension plans is almost 100 percent funded,*[6] while the PRBs are virtually unfunded. Moreover, these aggregate statistics likely combine well-funded plans with underfunded plans.

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[6] If, consistent with current financial accounting standards, increases in pension benefits due to future compensation increases are taken into account, the pension surplus was $10.1 billion for FY2000 and the pension deficit was $4.5 billion for FY2006. Note, however, that not all types of DB pension plans need to reflect additional liabilities to account for future compensation increases; this treatment affects primarily the "final pay" plans (in which benefits are defined in terms of the employee's years of pay just before termination). If financial accounting standards are deemed to be an important consideration, then this particular issue can be addressed through changes in the details of plan design and/or a prudent funding policy that anticipates salary progression. We note that the financial accounting standards for pension and other post-retirement benefit plans are currently under redeliberations and there is a distinct possibility of changes in the measurements of these plans for purposes of financial statements.

The ABO is measured at discount rates that reflect the rates at which the pension benefits could be effectively settled at the time of measurement. The lower the discount rate is, the higher the measurement of the ABO and therefore the lower the funded status. As shown above, the DOE's ABOs have more than doubled since FY2000. The increase in ABOs is not entirely due to accruing benefits during this period; declining discount rates between FY2000 and FY2006 were also a significant factor.

Discount rates, however, change in predictable ways over the business cycle. In financial economics terms, they are mean-reverting; as markets react to the steady tightening and firmness of Federal Reserve monetary policy as the economy strengthens, interest rates, and hence discount rates, generally rise. For example, from September 30, 2005, to September 30, 2006, the average discount rate used by large companies rose from 5.52 percent to 5.87 percent.[7] Similarly, the DOE's discount rate rose from 5.25 percent to 5.75 percent in the same period.

- The unfunded PRB obligation will need to be addressed. Pay-as-you-go funding may not be the best approach for several reasons. First, this approach leaves the DOE exposed to balance sheet changes and limits its ability to manage cash flow. In addition, benefit payments will drag on in diminishing amounts for 50-plus years for current participants alone. Over time, prefunding these obligations would be cheaper than continuing to finance them on a pay-as-you-go basis.

- Pension reforms implemented by the PPA will limit the DOE's exposure to large unfunded pension liabilities in the future. In effect, Congress and the White House have implemented hedges against large future DOE unfunded pension liabilities. With respect to postretirement medical benefits, the DOE should consider instituting a reimbursement policy that covers prudent prefunding of retiree medical obligations, subject to appropriately defined financial constraints.

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[7] Source: Watson Wyatt's database of publicly available information for FORTUNE 1000 companies to facilitate analyses of their pension and other postretirement benefit plans, and the relationship of these plans to overall corporate financials.

Mandating DC plans instead of DB plans for future hires can increase both near-term and long-term costs. This change would not reduce cost volatility for many years, perhaps even decades.

- Under DOE N 351.1, there will be no reimbursements for DB plan coverage of future hires. The DOE is essentially requiring contractors to sponsor only DC plans for their future hires.

  But providing a DC plan instead of a DB plan will not necessarily lower costs. In fact, both near-term and long-term costs could increase. For DOE contractors that sponsor well-funded plans, costs could increase immediately, as establishing new DC plans for new hires could require a larger cash outlay than enrolling them in existing DB plans.

  Whether DOE contractors sponsor DB plans or DC plans, the costs won't decrease unless the new plans provide lower benefits than the existing DB plans.

- Research has shown that investments in DC plans consistently underperform investments in DB plans by 100 basis points or more. So in order to provide the same benefit levels to workers over time, sponsors of DC plans must make larger contributions than sponsors of DB plans.[8]

  Plan type and plan design should reflect the desired workforce. It is reasonable to presume that DOE contractors, and indeed the DOE itself, desire a stable, long-term workforce for reasons of both national security and worker productivity. Research has consistently shown that turnover is lower and retirement patterns more stable for workers with DB plans than for workers with DC plans only.[9] DB plans enable

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[8] See Alicia Munnell and others, "Investment Returns: Defined Benefit vs. 401(k) Plans," Center for Retirement Research at Boston College, *Issue Brief*, September 2006.

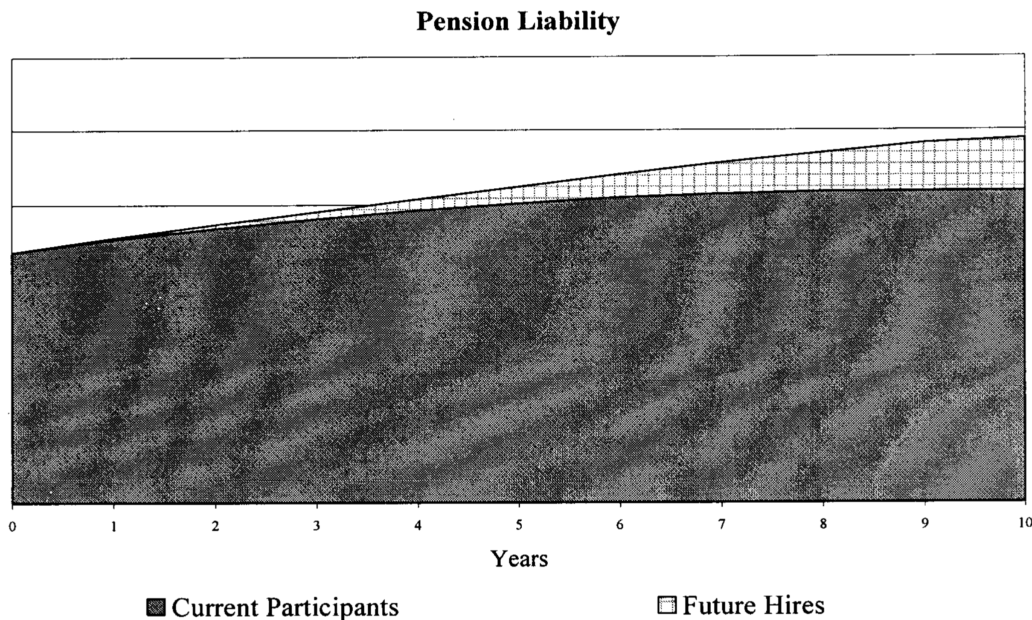
[9] See Sylvester J. Schieber, "Pension Aspirations and Realizations: A Perspective on Yesterday, Today and Tomorrow," http://www.watsonwyatt.com/research/whitepapers/wprender.asp?id=2006-US-0103.

sponsors to respond more flexibly to changing workforce needs by allowing early retirement windows and phased retirement opportunities, and attracting highly experienced, mid-career workers.

To enable plan sponsors to manage workforce attraction, retention and retirement on an orderly basis, contractors and consequently the DOE may end up having to spend more on benefits and compensation in a DC-only environment.

- Freezing benefit accruals in underfunded DB plans for new workers will not significantly reduce the DOE's costs for quite some time.

Pension Liability



The figure above illustrates a typical distribution of liabilities between current participants and future hires for a mature pension plan. As shown, most of the liability is for current participants. Given the relative proportions of the liabilities for current participants versus future hires, simply changing the plan type for future hires will not significantly reduce costs. Significant reductions in levels of cost and cost volatility

will take many years, perhaps even decades. Other measures would be more effective, such as those mentioned below.

The DOE should reconsider disallowing lump sum distributions of future accruals, as this will eliminate an option that could mitigate the DOE's cost challenges.

- Under DOE N 351.1., lump sum distributions of future accruals will not be allowed.

  However, in some situations, lump sum distributions may be advantageous to the employees, the employers and the DOE. The PPA levels the playing field between lump sum and life annuity distributions, which is likely to make lump sum payouts somewhat less popular with participants and more affordable for employers.

- Given the right plan design, lump sum distributions can be an effective tool in mitigating ongoing cost volatility for the DOE. To the extent that pension obligations are a source of cost volatility, settling the obligations reduces volatility at the source. One way of settling plan obligations is through annuity buyouts, which can be expensive if not done at the right time or under the right circumstances. Another way to settle pension obligations is with lump sum distributions to participants, which eliminate the ongoing cost volatility associated with those participants.

Concerns about cost levels and cost volatility can be addressed without having to change or mandate plan type. These issues can be managed just as effectively by adjusting plan features and future benefit levels, and implementing more effective funding policies and asset management policies.

- Aside from the risks imposed by an uncertain regulatory environment, pension plans inherently carry inflation risk, interest rate risk, investment risk, mortality risk and incentive risk[10]. Although all these risks affect cost levels and cost volatility, they can

[10] Incentive risk: the long-term ramification of outdated early retirement incentives.

be minimized to acceptable levels.[11] To reduce their pension risks, contractors can redesign their existing plans and adopt effective funding and asset management policies.

- It should be noted that a funding policy based on contributing only the minimum required amount is generally not the optimal risk-reduction strategy for managing overall pension costs and cost volatility.

- In its April 2004 report, "Certain Postretirement Benefits for Contractor Employees Are Unfunded and Program Oversight Could Be Improved," the U.S. General Accounting Office (GAO)[12] noted the following for FY1999 thru FY2003:

  Contractor pension assets have, on average, experienced negative returns from 7 percent to 8 percent in each of the past 5 fiscal years.

  These results are well below median returns on corporate pension funds,[13] indicating that contractors need to pay particular attention to asset management and governance. Traditionally, pension funds have more of an *asset-focus* towards setting investment policy. Now more and more pension funds are using *liability-driven* investment techniques to help close the gap between their assets and liabilities. Setting a pension fund's investment policy and strategy with a closer eye on its liabilities, combined with a review of funding/contribution policy, is a step in the right direction.

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[11] See Sylvester J. Schieber, "Pension Aspirations and Realizations: A Perspective on Yesterday, Today and Tomorrow," http://www.watsonwyatt.com/research/whitepapers/wprender.asp?id=2006-US-0103.

[12] U.S. Government Accountability Office.

[13] Based on the Northern Trust Universe for corporate pension plan returns.

The DOE should continue to allow contractors the flexibility to design and manage their plans in ways that best address both the contractors' and their employees' needs, and balance those needs with the DOE's financial constraints. The DOE could achieve its cost management objectives and limit its exposure to large unfunded future liabilities by requiring contractors to adhere to stricter financial controls, rather than overriding contractors' ability to design compensation programs that are appropriate for their workforce.

- We believe that the contractors, not the DOE, are in the better position to explore various avenues to mitigate and better manage the costs of their benefit plans. The DOE should define acceptable cost levels and require contractors to demonstrate their efforts and progress toward mitigating the cost challenges.

  There are myriad strategic alternatives contractors can employ to accomplish cost objectives, and, given the diversity of workforces used by contractors, conventional wisdom would argue that a one-size-fits-all benefits design policy simply will not work.

- The DOE should revisit its contractor reimbursement policy. Does the current policy allow contractors to use suboptimal financial strategies in managing their benefit programs? Does the DOE make use of effective incentives to encourage contractors to rein in both the cost and the volatility of their benefit programs? Does the DOE require contractors to project their pension and PRB costs and monitor contractors' efforts to mitigate forecasted cost increases?

  Does the DOE require its contractors to operate within formal plan governance structures and monitor the effectiveness of those structures? An effective plan governance structure should include:

  (a) People: for delegating decision-making authority to the right people and committees, and clarifying roles and responsibilities;

(b) Policies: to document objectives and guidelines, ranging from investment manager search and selection, to administration and communication policies; and

(c) Performance measures: for benchmarking performance and services against predetermined criteria.

Effective plan governance can reduce funding costs by improving investment performance; it can also decrease administrative costs through greater efficiencies and better management.

- The DOE hires contractors to manage facilities rather than managing facilities on its own. This approach enables the DOE to focus on selecting a contractor who will best execute the particular contract. It is the contractor's responsibility to meet various performance and financial objectives by marshalling its resources and applying its business acumen. The DOE entrusts many aspects of facility operation to the contractor; it is inconsistent with a contracting relationship to implement a policy that singles out one aspect of facility management — employee benefits plan design — for direct DOE regulation.

  The DOE's efforts would be better focused on ensuring that contractors are subject to appropriate financial operating objectives, rather than telling contractors how to achieve those financial objectives.

We appreciate the opportunity to submit these comments and recommendations.

Sincerely,

Gene Wickes
Global Practice Director - Benefits Consulting Group

-----Original Message-----
From: Jeffrey C. Morris
Sent: Friday, May 11, 2007 5:00 PM
To: contractor pensions
Subject: Comment from LLNL on contractor pensions and medical benefits

To: Ingrid Kolb, Director, DOE Office of Management
From: Jeffrey C. Morris, Counterintelligence Awareness Communications Coordinator, Lawrence Livermore National Laboratory
Subject: Comments and recommendations on how DOE can address the challenge it faces due to increasing costs and liabilities associated with contractor employee pension and medical benefits
cc: Senator Diane Feinstein; Senator Barbara Boxer; Representative Ellen Tauscher; Representative Gerald McNerney; Bill O'Connell, SPSE/UPTE; Steven Aftergood, Federation of American Scientists; AARP

Date: May 11, 2007

I am writing in response to your request for comments and/or recommendations on:

HOW CAN DOE ADDRESS THE CHALLENGE IT FACES DUE TO INCREASING COSTS AND LIABILITIES ASSOCIATED WITH CONTRACTOR EMPLOYEE AND RETIREE PENSION AND MEDICAL BENEFITS?

Two simple answers:

1. Through the taxing authority of the U.S. government. DOE, like other U.S. government organizations, is funded through the taxing authority of the U.S. government. Unlike private sector organizations, neither the U.S. government nor DOE depend on increasing profits on an annual basis to satisfy corporate shareholders and board members' expectations to maintain profitability and stock or bond ratings. DOE does not have to compete in the global marketplace, as many corporations do.

Corporations may declare bankruptcy, restructure, sell out, or go out of business, turning over their pension liabilities to the Pension Benefit Guaranty Corporation, which historically has paid pennies on the dollar to annuitants. DOE, as a government agency, does not have the pressures or a corporation, nor does it have the option of turning its liabilities over to the PBGC.

It is obvious that by turning over its facilities to private, limited liability corporations, DOE intends to mask its obligations as a U.S. government entity. Congress and the Bush Administration mandated that DOE Complex facilities be privatized. Nevertheless, the responsibility to fund contractor and retiree pension and medical benefits continues to rest with the U.S. government, i.e., DOE and Congress.

2. Employee pension and medical benefits are included in contractor operating funds. Funding for contractor employee pension and medical benefits are part and parcel of a contractor's obligations and rightly are paid from the operating funds DOE pays its contractor organizations. The amounts DOE pays limited liability corporations to manage Los Alamos National Security Limited Liability Corporation (the former Los Alamos National Laboratory) and will soon begin paying to Lawrence Livermore National Security LLC (currently Lawrence Livermore National Laboratory) for example, are

many times the amount it paid the University of California alone to operate the laboratories.

Note that improved security, the stated objective of privatizing the national laboratories, has not materialized as LANS LLC (with UC as a lead participant) replaced UC as the exclusive operating contractor. While security challenges at Lawrence Livermore National Laboratory have been nowhere as significant as they have been at Los Alamos, LLNL will soon be privatized as well and will become Lawrence Livermore National Security LLC on October 1, 2007.

It could be concluded that security was not the real issue and that other issues such as lucrative operating contracts and shares of the University of California Retirement Plan lay at the heart of the initiative to privatize these institutions.

Comments:

1. The question should more appropriately be "How can DOE afford to pay the exorbitant management fees and state franchise taxes it incurs by privatizing its facilities?" How can DOE say that funding pension and benefits for DOE contractor employees and retirees presents a problem or challenge when the Administration and Congress have been so eager to quadruple contractor management fees (from approximately $10 million to $40 million a year at the new LLNS LLC) and incur state franchise tax liabilities (estimated at $140 million per year at LLNS LLC) by converting public institutions to private?

> **Isn't privatizing DOE facilities, then asking how you can afford to pay pension and medical benefits, rather like trading your Toyota for a Hummer, then saying you can't afford to feed your family when SUV payments, taxes, insurance, and gas are so expensive?**

2. Privatization created huge, unnecessary liabilities, including new, underfunded pension programs. A significant portion of the liabilities to which you refer are the millions of dollars needed to fund new pension programs as the result of converting DOE government owned contractor operated facilities (GOCOs) from public institutions to private. Los Alamos National Security LLC, for example, started out underfunded by a reported $54 million. Such contributions would have been unnecessary had the pension dollars for employees transferring to the new employers' pension plans remained in the existing systems (within the University of California Retirement System, example).

Multiply these site-specific problems by the "45 contractor defined benefit pension plans, 37 contractor defined contribution pension plans, 23 contractor life insurance plans, and approximately 260 contractor medical plans" that you mention, and it's easy to see that privatization has generated tremendous expenses.

These expenses were not unforeseen. One consequence that can be foreseen, however, is a private contractor's inclination to cut or eliminate benefits for retirees who have never worked for that company.

3. The "shareholders" in DOE are the people who have invested their lives in careers serving the nation in DOE/ERDA/AEC facilities. Many of these people were recruited as "the best and the brightest." I know, because I wrote some of the recruiting campaigns. These people could have gone to work in private industry or for themselves and quite possibly made much more money (as some who have left their DOE contractor positions have done). They could have tied their careers to any number of benefit and pension plans. Instead, they chose to do work that led to the end of the Cold War. They developed many military, civilian, and dual-use technologies that have maintained the national security and that have benefited the U.S. population in general through cleaner and more efficient sources of energy. Their developments have benefited and even created industries and, in doing so, have contributed to the nation's economic strength. Thousands of support personnel contributed to those successes.

4. DOE's "commitment" apparently is to drastically limit or terminate benefits for retirees. Your request in several places uses the words "committed" and "commitment." DOE and site contractors made commitments to employees of its facilities when it hired them. These people were promised pensions and retiree medical benefits upon qualifying for retirement (although the University of California, for one, has backpedaled on its commitment to provide retiree lifetime medical benefits).

I would like to believe that DOE is committed to recognizing pension benefits already accrued as well as medical, dental, and legal insurance benefits in retirement that employees have earned. Evidence of such a commitment is DOE's contributions to the new LANS LLC pension fund.

However, your request for recommendations and comments casts doubt on DOE's commitment to ensure continued funding of pensions and medical benefits for retirees. And then there's DOE Notice N351.1.

5. DOE Notice N 351.1 indicates the intent to discontinue pensions and medical benefits for retirees. Although DOE Notice N 351.1 has been suspended, it is a clear indication of intent and a harbinger of things to come. For example:

- The notice repeatedly uses the phrase, "shall not approve" (reimbursement of costs).
- It raises the specter of site closures, which is of particular concern considering the possibility of creating a new site or sites for the Reliable Replacement Warhead (RRW). Page 2 states, "...site closure has become an achievable goal at a number of locations, both in the near and mid-term...Contractor and Departmental liabilities for disposition of pension and retire medical benefit plans associated with these closure sites has become a concern for DOE, closure Contractors, and closure Contractors' current and retired employees."

- The Notice is an invitation to contractor organizations to discontinue medical plans. Page 5, for example, states, "Department elements are not authorized, either orally or in writing, to compromise a Contractor's right to unilaterally change, suspend, or terminate any medical plan, coverage or contribution at any time."

6. "Mitigation" translates to dereliction of duty, and ethical failure to honor commitments. DOE Notice N 351.1 goes on to say, "In response, many private sector organizations across a broad spectrum of industries and businesses have taken actions to mitigate cost volatility and liability growth in their DB [Defined Benefits] pension plans."

That is correct. Corporations such as United Airlines and IBM have declared bankruptcy, restructured, sold out, or gone out of business, eliminated their Defined Benefit plans, and turned over pension obligations to the PBGC, effectively cutting pensions to small fractions of their value and leaving retirees to fend for themselves.

DOE is not a private sector organization. If this is the example that DOE would wish to emulate, that paints a frightening picture for the future of everyone in the DOE Complex.

7. UC is already playing a shell game with retiree medical benefits. UC recruited a workforce through several decades by offering pensions and lifetime medical benefits (literally, the percentage of premiums to be paid based on the Regents' annual decision — which has to my knowledge always been 100 percent). Some time later, UC changed this policy to eliminate medical benefits in retirement for those who chose a lump sum distribution rather than a pension. They also required, and still require, that a person separating from UC retire within 120 days or forfeit retiree medical coverage (and unused sick leave as well). The current line from UC Benefits is "We never promised retiree medical benefits." Yes, they did, in order to recruit an elite workforce.

8. Shifting the buck(s) The burden will fall upon taxpayers whether: (a) the DOE accepts responsibility for ensuring the pensions and medical benefits of DOE and NNSA contractor retirees; (b) the burden is shifted to the PBGC (the fiscally fashionable thing to do these days); or (c) DOE and NNSA contractor retirees are left to become wards of social welfare programs.

> **DOE can either step up to the plate, or abrogate its responsibility and transfer that responsibility to Congress, which will decide which social programs will be responsible for supporting the 100,000 retirees, dependents, and beneficiaries to whom you refer.**

9. Expect "the best and the brightest" to fight for their pension and medical benefits. At LLNL, whose UC contract will expire September 30, 2007, employees and retirees are concerned that their pensions may not be paid in the event UCRP or the new LLNS LLC pension plan performance declines, is mismanaged, or catastrophes such as the Enron disaster of 2001 occur. They are concerned that DOE may not reimburse

contractors for pension expenses in such cases. They are concerned that UC, the LLC, and DOE will not pay their medical premiums in retirement. Are they to become wards of the Medicare system, wards of the state welfare system? These concerns are compounded by the realization that the institutions in which they invested their entire careers, or significant portions of their careers, were or are being converted to private, for-profit LLCs.

10. These are the people who hold the keys to national security. I ask that you not lose sight of the fact that the people whose livelihoods are being held in your hands hold the keys to U.S. national security. These are the people who designed, developed, refined, and maintained the U.S. nuclear arsenal as well as some conventional weapons. A few remain who worked on the atomic weapons that ended World War II and who developed the fusion weapons that maintained a strategic balance, and hence prevented nuclear war throughout the latter part of the Twentieth Century and into the Twenty-first. Others developed nuclear power that propels today's military vessels and that has provided cheap, clean energy to the U.S. population for decades. Still others are working on a reliable nuclear stockpile and energy sources for the future. Most of these people have been vetted repeatedly in the process of obtaining and maintaining their security clearances while doing the work most crucial to the U.S. national security. Their commitment to their country has been proven repeatedly throughout their working lives.

11. How might they react to betrayal? I can tell you as someone who as worked in the counterintelligence field at LLNL for the past seven years that the two strongest motivations for Americans betraying their country are MONEY and DISGRUNTLEMENT. That is according to a study conducted by the Defense Personnel Security Research Center in Monterey, CA, of 150 cases of U.S. citizens who committed espionage against their country since the beginning of the Cold War. (See http://rf-web.tamu.edu/security/SECGUIDE/Treason/Numbers.htm).

The study shows that insiders, not foreign agents, pose the greatest threats to loss of classified information.

"Only a trusted and checked-out person could really betray his country, and unfortunately the FBI hadn't learned to look inside a person's brain and heart." So wrote Tom Clancy in *Rainbow Six*.

> **How those trusted and checked-out people who hold the keys to the national security secrets may react when they feel in their brains and hearts that their country has betrayed them remains to be seen.**

12. The paradox is that DOE would pay them if they went to Russia. Following the collapse of the Soviet Union, the U.S. provided tens of millions of dollars to prevent large numbers of weapons scientists, engineers, and technicians in Former Soviet Union weapons complex facilities from transferring their expertise and nuclear materials to nations unfriendly to the U.S. or to terrorist groups, and to secure nuclear materials from

theft. This was done through a number of programs, including: Material Protection, Control & Accounting (MPC&A); International Policy, Initiatives for Proliferation Protection (IPPP); Nuclear Cities Initiative (NCI); International Science and Technology Center (ISTC); Science and Technology Center of the Ukraine (STCU); and Highly Enriched Uranium (HEU).

> **How ironic it would be if the people who worked so diligently to prevent the loss of nuclear expertise and materials from the Former Soviet Union would themselves be denied livelihoods and health care in their retirement years by the U.S. government, which has provided for former Soviet scientists and other Soviet nuclear workers for many years.**

Conclusion

The question for DOE and the Congress to address is not how they can afford to pay retirement benefits and retiree health insurance costs for contractor employees. The question is how can they afford not to?

-----Original Message-----
From: Rebecca Davis
Sent: Friday, May 11, 2007 5:55 PM
To: contractor pensions
Subject: pension Rights center comments on contractor employee pensions

PENSION RIGHTS CENTER

1350 CONNECTICUT AVENUE, NW, SUITE 206 WASHINGTON, DC 20036-1739
TEL: 202-296-3776 FAX: 202-833-2472
WWW.PENSIONRIGHTS.ORG

May 11, 2007

Stephanie Weakley, Director
Office of Resource Management
U.S. Department of Energy
1000 Independence Avenue, SW
Washington, DC 20585

Re: Department of Energy Contractor Employee Pension and Medical Benefits Challenge

Dear Ms. Weakley:

We are writing in response to the Department of Energy's (DOE) request for comments relating to its proposal to discontinue reimbursement to contractors for defined benefit pension costs for new employees. The Pension Rights Center is a nonprofit consumer organization that has been working since 1976 to protect and promote the retirement security of American workers, retirees and their families. We appreciate the opportunity to comment on the pension aspects of the proposal.

We are concerned that the DOE proposal will adversely impact both the retirement security of thousands of employees of DOE contractors and the ability of DOE contractors to attract and retain the highly skilled workers they need to fulfill their contract obligations. It will also impair employers' ability to structure their compensation policies as they see fit.

Traditional defined benefit plans are a highly efficient way of delivering adequate and secure lifetime monthly pensions to employees at all income levels. They are particularly appropriate for a company that seeks to attract and retain the kinds of highly-trained experienced employees essential to fulfilling DOE contract requirements. Currently, more than 20 million workers are earning benefits under these plans. Many of these are employees of DOE contractors.

Although 401(k) savings plans may be appropriate for certain workforces, they do not provide the same level of adequacy or security as traditional defined benefit plans. One government survey shows that half of all workers with 401(k) plans have less than $15,000 in their accounts. For older employees, the median account balance is $23,000. Another government survey that focuses on households and includes IRAs (often rollovers from defined benefit plans), shows median account balances of $32,500, and even among older households, median account balances of only $83,000. While these account balances will increase in the future, even increased amounts will provide much lower retirement benefits than most defined benefit plans.

DOE's concern about the expenditure of taxpayer money is commendable. However, refusing to reimburse costs for defined benefit plans will not necessarily reduce overall costs to taxpayers since DOE contractors are likely to have to increase salaries to compensate for the lack of adequate pensions. Moreover, American taxpayers understand the value of retirement security

and are interested in securing the best value for their tax dollars. From an adequacy and security perspective, defined benefit plans provide a much higher return on taxpayer dollars.

Taxpayers are also concerned about their own retirement security. The fact that the DOE itself and the rest of the federal government sponsor defined benefit pension plans demonstrates to the private workforce the value of defined benefit plans. As a model employer, the government influences the working standards, such as wages, benefits and working conditions, for employees in the private workforce, benefiting all workers and taxpayers.

Finally, the DOE proposal is at odds with the voluntary nature of the nation's private retirement system, which allows employers to choose whether to adopt a plan and decide what form that plan should take. The proposal would have the effect of forcing DOE contractors to forgo their defined benefit pension plans and replace them with 401(k) savings plans. This would send a message to all private employers that the federal government does not value defined benefit plans, and would run counter to the goal of the Pension Protection Act of 2006, signed into law less than a year ago, to encourage the continuation of defined benefit plans by requiring improved funding.

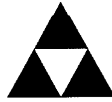
In closing, we ask that the DOE continue to reimburse its contractors' costs for defined benefit plans.

Respectfully Submitted,

Rebecca A. Davis
Staff Attorney

Karen W. Ferguson
Director

-----Original Message-----
From: Samuel Genson
Sent: Thursday, May 10, 2007 6:16 PM
To: contractor pensions
Subject: American Academy of Actuaries response to DOE's request for comment



AMERICAN ACADEMY *of* ACTUARIES

Ms. Stephanie Weakley
Director, Office of Resource Management
U.S. Department of Energy
1000 Independence Avenue SW
Washington, D.C. 20585

May 10, 2007

Subject: Request for Public Comment on Pension and Medical Benefits

Dear Ms. Weakley:

The Pension Committee of the American Academy of Actuaries[1] appreciates the opportunity to offer comments on the issues faced by the Department of Energy (DOE) and its contractors in managing the costs of "pension and medical benefits." We understand the DOE's need to control cost, and we acknowledge the recent increases in DOE costs. However, we are concerned that the issues facing the DOE in these matters are being obscured. As such, we ask that you consider the following:

Plan Design

The long-term cost of any retirement plan is a function of the level of the benefits, not whether it is a defined benefit (DB) or a defined contribution (DC) plan.

Defined benefit plans are sometimes perceived as more expensive than defined contribution plans. This is a flawed perception because the benefit levels of the plans are usually not comparable. A DB plan that costs more than a DC plan is likely to provide much higher benefits. If a DB plan and a DC plan have the same long-term cost, the DB plan is likely to provide better retirement benefits, although the DC plan may provide better termination benefits for short-term employees. The better retirement benefits of the DB plan are the result of certain cost efficiencies, primarily the pooling of the longevity risk that creates value and provides lifetime benefits at a much lower cost than DC plans, and the higher investment returns typically obtained by professional defined benefit plan

[1] The American Academy of Actuaries is a national organization formed in 1965 to bring together, in a single entity, actuaries of all specializations within the United States. A major purpose of the Academy is to act as a public information organization for the profession. Academy committees, task forces and work groups regularly prepare testimony and provide information to Congress and senior federal policy-makers, comment on proposed federal and state regulations, and work closely with the National Association of Insurance Commissioners and state officials on issues related to insurance, pensions and other forms of risk financing. The Academy establishes qualification standards for the actuarial profession in the United States and supports two independent boards. The Actuarial Standards Board promulgates standards of practice for the profession, and the Actuarial Board for Counseling and Discipline helps to ensure high standards of professional conduct are met. The Academy also supports the Joint Committee for the Code of Professional Conduct, which develops standards of conduct for the U.S. actuarial profession

asset managers investing large amounts compared to the average defined contribution plan participant[2].

We agree that the contractor's cost of the retirement program should be market competitive. A plan's competitiveness should be evaluated based on long-term anticipated costs. In addition, given an acceptable cost level, the design of the plan, should still be determined by the contractor.

We understand that assessing the long-term cost of a defined benefit plan is not always clear. When the plan's actual experience falls short of the actuarial assumptions used during the procurement process, the actual plan costs will increase over what was initially projected—sometimes dramatically so. We note that the DOE has qualified actuaries who are capable of assessing whether the assumptions are reasonable, and assisting in determining comparability of pension design between competing bidders. We suggest that instead of restricting plan design, DOE should instead require review of actuarial assumptions, particularly those relating to:

- Investment return;
- Current mortality rates and expected improvements in mortality;
- Anticipated salary increases; and
- Early retirement.

For retiree medical benefits accruals, we suggest review of claim-cost assumptions, including trend rates and aging factors

Definition of Cost

The DOE has observed that reimbursements since FY 2000 have increased by 226 percent. However, we note that the costs in FY 2000 probably understated the true costs of the plans, and are thus an inappropriate starting point for comparing costs. In addition, the period chosen is unlike any other in DB funding history, due to a severe market crash, falling interest rates, and problems in the minimum funding rules (e.g., the deficit reduction contribution rules, which have been fixed). In any other period there would have been much different results.

Under the DOE's policy, sponsor contributions to the plan and DOE reimbursements to the sponsor are both based on minimum funding requirements, which can vary above and below the true long-term cost of the plan. DOE could use alternative approaches to determine reimbursements that would better reflect the true cost of the plan and be less volatile. For example, reimbursements to 100 percent funded plans could be set at the value of benefits earned each year (a relatively consistent amount) rather than the

[2] Furthermore, if a DB plan sponsor is considering a DC plan in order to provide more benefits to young, mobile employees (and less benefits to older employees), there are other options that can be explored that take advantage of the higher investment returns within DB plans. For example, cash balance DB plans can provide the same benefits as a self-funded DC plan, but at a lower expected cost due to the investment efficiencies discussed earlier.

minimum contributions. We would be pleased to work with the DOE in developing other acceptable approaches.

Volatility

In addition to overall cost levels, DOE has expressed concern about the volatility of those costs. Given the needs of government, which include the need to budget, we understand that DOE may seek measures that will control volatility. Use of stable, reasonably conservative actuarial assumptions as previously described will help control volatility, as will adoption of a reimbursement policy more stable than minimum contributions. In addition, a substantial portion of the perceived volatility arises from insufficient asset/liability matching. To address this, the DOE could consider requiring contractors to utilize strategies (e.g., equity linked benefits or interest sensitive investments) that can largely eliminate this volatility. Also, in some specific situations, contractors may be able to control volatility through restructuring certain benefit provisions.

We believe that sound policy requires that the DOE specify the outcomes they need (e.g., limited volatility and cost) rather than try to define the products (i.e., type of plan) that may or may not accomplish DOE's goals.

Practical Issues

The preceding parts of this letter described some of what we believe to be the theoretical underpinnings of an appropriate pension reimbursement policy. Furthermore, forcing contractors to adopt a defined contribution plan for new employees has practical problems as well, including the following:

- Defined contribution plans generally focus a greater proportion of the benefit dollar on younger, short-service employees. By using defined contribution plans for new employees, contractors will either have to increase overall costs (obviously not what the DOE wants) or significantly decrease retiree benefits.
- It is widely known that DOE contractors are faced with the challenge of attracting and retaining experienced employees in high-skill positions. Defined benefit plans are an effective attraction and retention tool for those types of employees. Eliminating defined benefit plans may force contractors to increase pay to replace the attraction/retention advantages, thus resulting in higher costs to the DOE, even if the replacement DC plan is cost neutral.
- Administering two plans is more expensive than administering one. The dual administration costs, including the need to avoid IRS plan discrimination issues, continue for many years.
- A dual plan structure results in employees working side by side with different benefit plans. This can easily lead to morale problems, which result in lower productivity or higher turnover, both of which again would create cost issues for DOE.
- Because volatility is tied to benefits already earned, changing benefits for future service will likely have a very minimal effect on volatility over the next decade or

more. The other items mentioned in this letter would be much better at controlling volatility.

- Workforce management is more difficult under DC plans. Instead of the relatively consistent patterns of retirement one sees with a DB plan, employees in DC plans will be more apt to retire in droves when the stock market is doing exceptionally well and may not opt to retire at all when the stock market is doing poorly. If the contractor's business needs do not match this pattern, significant payroll/training cost inefficiencies can occur. DB plans also improve workforce management by allowing employers to create retirement incentives/disincentives. This is not similarly possible with DC plans, particularly with the many employees who have not contributed enough to the 401(k) arrangements.

Summary

Volatility and levels of pension cost are significant business issues. However, prohibiting certain plans will not control volatility, but will exacerbate problems as contractors will have increased costs, may be unable to retain workers and may have more difficulty managing the turnover of their workforce. Solutions can be developed that will meet the needs of the DOE, contractors, and their employees.

The DOE could examine how it defines reimbursable costs, and consider requiring contractors to maintain plans that control the growth and volatility of pension and retiree medical costs by using appropriate funding policy, investment policy, and plan design. Financial incentives and penalties could be incorporated into contracts to support these policies.

We appreciate this opportunity to share our concerns on the issues the DOE faces with contractor costs related to pensions. We would appreciate the opportunity to meet with you in order to answer any questions you may have or to discuss any of the concerns expressed within this letter. If you have any specific questions or would like more information, please contact Samuel Genson, the American Academy of Actuaries' pension policy analyst, at 202-223-8196. Thank you for your consideration of this matter.

Sincerely,

James F. Verlautz, FSA, EA, MAAA, FCA
Chairperson, Pension Committee
American Academy of Actuaries