DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General
Office of Audit Services

Region VII
601 East 12th Street
Room 429
Kansas City, Missouri 64106

MAR 25 2009

Report Number: A-07-08-00283

Mr. Mark Stimpson
Vice President Medicare Northwest
2890 East Cottonwood Parkway
P.O. Box 30270
Salt Lake City, Utah 84130-0270

Dear Mr. Stimpson:

Enclosed is the U.S. Department of Health and Human Services (HHS), Office of Inspector General (OIG), final report entitled "Review of the Termination Claim for Postretirement Benefit Costs Made by The Regence Group for the Oregon Segment." We will forward a copy of this report to the HHS action official noted on the following page for review and any action deemed necessary.

The HHS action official will make final determination as to actions taken on all matters reported. We request that you respond to this official within 30 days from the date of this letter. Your response should present any comments or additional information that you believe may have a bearing on the final determination.

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If you have any questions or comments about this report, please do not hesitate to call me at (816) 426-3591, or contact Jenenne Tambke, Audit Manager, at (573) 893-8338, extension 21 or through e-mail at Jenenne.Tambke@oig.hhs.gov. Please refer to report number A-07-08-00283 in all correspondence.

Sincerely,

Patrick J. Cogley
Regional Inspector General
for Audit Services

Enclosure

Direct Reply to HHS Action Official:

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Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

REVIEW OF THE TERMINATION CLAIM FOR POSTRETIREMENT BENEFIT COSTS MADE BY THE REGENCE GROUP FOR THE OREGON SEGMENT

Daniel R. Levinson
Inspector General

March 2009
A-07-08-00283

Office of Inspector General

http://oig.hhs.gov

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OFFICE OF AUDIT SERVICES FINDINGS AND OPINIONS

The designation of financial or management practices as questionable, a recommendation for the disallowance of costs incurred or claimed, and any other conclusions and recommendations in this report represent the findings and opinions of OAS. Authorized officials of the HHS operating divisions will make final determination on these matters.

EXECUTIVE SUMMARY

BACKGROUND

The Regence Group (Regence) was formed on January 1, 1997, with the merger of Blue Cross Blue Shield of Oregon (Oregon), King County Medical Blue Shield, Pierce County Medical Bureau, and Medical Service Bureau of Idaho.

After the formation of Regence, it continued to administer the Oregon Medicare Part A operations under cost reimbursement contracts with the Centers for Medicare & Medicaid Services (CMS) until the contractual relationship was terminated effective November 30, 2005.

Prior to the formation of Regence, Oregon had a postretirement benefit (PRB) plan. Oregon established a Voluntary Employee Benefit Association (VEBA) trust in 1992 for the PRB plan and claimed PRB costs based on accrual accounting. Regence continued Oregon's established practice of funding the VEBA trust and claiming accrual costs until the contract termination. After the contract termination, Regence established an additional VEBA trust into which it deposited $452,106 for the PRB costs represented in the termination claim.

CMS reimburses a portion of its contractors' annual PRB costs. In claiming PRB costs, contractors must follow cost reimbursement principles contained in the Federal Acquisition Regulation (FAR) and applicable Cost Accounting Standards as required by their Medicare contracts.

OBJECTIVE

Our objective was to determine whether the PRB termination claim submitted by Regence for the Oregon segment was allowable for Medicare reimbursement.

SUMMARY OF FINDING

Regence's entire termination claim of $452,106 for the Oregon PRB costs was unallowable for Medicare reimbursement. The termination claim represented an unallowable accounting method with immediate recognition of the unamortized transition obligation, prior service costs, and gains and losses. None of these costs are allowable in accordance with the FAR and Statement of Financial Accounting Standards 106, and therefore the costs are unallowable for Medicare reimbursement.

RECOMMENDATION

We recommend that Regence withdraw its PRB termination claim of $452,106.

AUDITEE COMMENTS

In written comments on our draft report, Regence did not concur with our recommendation. Regence disagreed with the termination claim amount and submitted a revised claim, and it disagreed with the applicability of some of the criteria we used. Regence's comments are included in their entirety as the Appendix.

OFFICE OF INSPECTOR GENERAL RESPONSE

After reviewing Regence's comments, we changed the amount of the PRB termination claim in our finding and recommendation to reflect the revised termination claim submitted by Regence. Our finding and recommendation, as revised, are valid.

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INTRODUCTION

BACKGROUND

Medicare

The Regence Group (Regence) was formed on January 1, 1997, with the merger of Blue Cross Blue Shield of Oregon (Oregon), King County Medical Blue Shield, Pierce County Medical Bureau, and Medical Service Bureau of Idaho.

After the formation of Regence, it continued to administer the Oregon Medicare Part A operations under cost reimbursement contracts with the Centers for Medicare & Medicaid Services (CMS) until the contractual relationship was terminated effective November 30, 2005.

Prior to the formation of Regence, Oregon had a postretirement benefit (PRB) plan. Oregon established a Voluntary Employee Benefit Association (VEBA) trust in 1992 for the PRB plan and claimed PRB costs based on accrual accounting. Oregon determined an annual accrual amount for the plan as a whole and then allocated to cost objectives, including the Medicare contract(s). Regence continued Oregon's established practice of funding the VEBA trust and claiming accrual costs until the contract termination. After the contract termination, Regence established an additional VEBA trust into which it deposited $452,106 for the PRB costs represented in the termination claim.

CMS reimburses a portion of its contractors' annual PRB costs. In claiming PRB costs, contractors must follow cost reimbursement principles contained in the Federal Acquisition Regulation (FAR) and applicable Cost Accounting Standards as required by their Medicare contracts.

Federal Requirements

The FAR 31.205-6(o) sets forth the allowability requirements and applicable methods of accounting for PRB costs under a Government contract. PRB costs may include, but are not limited to, postretirement health care; life insurance provided outside a pension plan; and other welfare benefits such as tuition assistance, day care, legal services, and housing subsidies provided after retirement. PRBs do not cover retirement income and ancillary benefits, such as life insurance, that pension plans pay following employees' retirement.

In addition, the FAR 31.205-6(o) requires contractors to choose one of three accounting practices (pay-as-you-go, accrual accounting, or terminal funding) for measuring and assigning PRB costs to accounting periods. The Medicare contract, Appendix B, section II(A), requires that costs be estimated (budgeted), accumulated, and reported on a consistent basis.

For Government contract purposes, when a contractor elects to use accrual accounting to claim PRB costs the FAR requires the accrual to be funded and determined in accordance with generally accepted accounting principles. The Statement of Financial Accounting Standards

(SFAS) 106 governs how contractors report in their financial statements the accrued liability for PRBs for current and retired employees; SFAS 106 also sets forth specific guidance on the accrual methodology to be used.

The FAR 31.205-6(o)(2)(iii)(A) constrains SFAS by stating that the transition obligation that is in excess of the amount assignable under the delayed recognition methodology described in paragraphs 112 and 113 of the SFAS 106 is unallowable. The SFAS 106, paragraph 112, states:

> If delayed recognition is elected, the transition obligation or asset shall be amortized on a straight-line basis over the average remaining service period of active plan participants, except that (a) if the average remaining service period is less than 20 years, the employer may elect to use a 20-year period, and (b) if all or almost all of the plan participants are inactive, the employer shall use the average remaining life expectancy period of those plan participants.

SFAS generally provides for amortization of prior service costs (changes in the accrued liability) and gains and losses. It allows for accelerated recognition of gains and losses in accrued PRB costs only in accordance with the employer's established accounting practice, which must be consistently applied and disclosed.

OBJECTIVE, SCOPE, AND METHODOLOGY

Objective

Our objective was to determine whether the PRB termination claim submitted by Regence for the Oregon segment was allowable for Medicare reimbursement.

Scope

At the request of CMS, we audited the PRB termination claim of $452,106 submitted by Regence for the Oregon Medicare Part A contracts' PRB costs. Achieving our objective did not require that we review Regence's internal control structure. However, we reviewed the internal controls related to the PRB termination claim to determine whether the termination claim was allowable in accordance with the FAR and the Medicare contracts.

We performed the audit work in the Region VII field office located in Jefferson City, Missouri.

Methodology

In performing our review, we used information presented in Regence's Termination Cost Voucher, which included support provided by Regence's consulting actuaries. We evaluated Regence's PRB claim in relation to applicable laws and regulations to determine whether Regence complied with regulatory requirements.

We performed this review in conjunction with our audit of the PRB costs claimed for Medicare reimbursement for the Oregon PRB costs (A-07-08-00282). The PRB costs allowable for Medicare reimbursement from fiscal year 1992 through the contract termination for the Oregon PRB were determined during that review.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our finding and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our finding and conclusions based on our audit objective.

FINDING AND RECOMMENDATION

UNALLOWABLE TERMINATION CLAIM

Regence's entire termination claim of $452,106 for the Oregon PRB costs was unallowable for Medicare reimbursement. The termination claim represented an unallowable accounting method with immediate recognition of the unamortized transition obligation, prior service costs, and gains and losses. None of these costs are allowable in accordance with the FAR and SFAS 106, and therefore the costs are unallowable for Medicare reimbursement.

Regence's contractual relationship under Medicare was terminated on November 30, 2005. Prior to terminating its Medicare contract, Regence's normal practice for Government contracting purposes was to claim PRB costs using accrual accounting with recognition of the transition obligation, prior service costs, and gains and losses on an amortized basis. Using this methodology, Regence was reimbursed for funded accrued PRB costs totaling $580,734 incurred through the contract termination date.[1] However, Regence claimed an additional $452,106 of PRB costs which, contrary to Federal requirements, represented an immediate recognition of the unamortized transition obligation, prior service costs, and gains and losses.

The FAR does not allow for the immediate recognition of the transition obligation. Furthermore, the FAR requires that the accrual costs be calculated in accordance with generally accepted accounting principles (SFAS 106 for PRB costs). SFAS 106 requires that a systematic method of amortization be applied on a consistent basis. Regence's established amortization method was to amortize the gains and losses and prior service costs over the average future service. As a result, Regence's change to an immediate recognition of the unamortized transition obligation, prior service costs, and gains and losses was unallowable.

Therefore, Regence claimed reimbursement for costs that were not in compliance with the FAR and SFAS 106.

[1]"Review of Postretirement Benefit Costs Claimed for Medicare Reimbursement by The Regence Group – Oregon for Fiscal Years 1992 Through 2005" (A-7-08-00282), November 20, 2008.

RECOMMENDATION

We recommend that Regence withdraw its PRB termination claim of $452,106.

AUDITEE COMMENTS

In written comments on our draft report, Regence did not concur with our recommendation. Regence disagreed with the termination claim amount and submitted a revised claim, and it disagreed with the applicability of some of the criteria we used.

A summary of Regence's comments follows:

- Regence did not agree with the amount of PRB termination costs that, according to our draft report, Regence had submitted for the Oregon segment. Regence stated that our draft report had relied on an estimated amount provided by Regence's actuarial consulting firm "in a letter dated November 14, 2005." After the termination date of the Medicare contract, Regence's actuarial consulting firm "recalculated the termination liability and updated their estimate in 2006 based on actual termination data." Accordingly, the actual amount claimed was $452,106, not $113,831 as stated in our draft report.

- Regence did not agree with the application of the FAR requirements in regard to the transition obligation: ". . . the purpose of the FAR certainly was not to prevent contractors from *ever* receiving reimbursement of the full transition obligation . . ." Regence further indicated that it was seeking reimbursement for the remaining unamortized transition obligation as a segment closing adjustment. Regence said that "This type of segment-closing adjustment is also consistent with and warranted under the principles of Cost Accounting Standards 412, 413, and 416."

- Regence also stated that ". . . Regence's funded PRB costs should be reimbursed pursuant to FAR 31.205-42(b), because these are costs that cannot be discontinued immediately after the effective date of contract termination."

Regence's comments are included in their entirety as the Appendix.

OFFICE OF INSPECTOR GENERAL RESPONSE

After reviewing Regence's comments, we changed the amount of the PRB termination claim in our finding and recommendation to reflect the revised termination claim submitted by Regence. Our finding and recommendation, as revised, are valid.

With respect to Regence's more specific comments:

- Regence presented to us the termination voucher dated April 26, 2006, as the PRB termination claim submitted to CMS. Regence did not provide us with the revised termination voucher, nor were we aware of this revised termination voucher until we received Regence's comments on our draft report. After receiving Regence's comments, we obtained the additional documentation from Regence regarding the revision in the PRB termination claim amount. We determined that Regence submitted a revised termination claim on August 6, 2008, which included the revised PRB termination claim amount of $452,106. We have revised our finding and recommendation to reflect this change.

- Regence stated that it did not agree with the application of the FAR in regard to treatment of the transition obligation. FAR 31.205-6(o)(2)(iii)(A), which addresses the allowability of the transition obligation, requires that the transition obligation be amortized over a straight line basis. Regence elected to amortize the transition obligation over a 20 year period. Furthermore, Regence stated that CAS 412, 413, and 416 allow for a segment closing of PRB costs. We agree that CAS 412 and 413 contain a provision to compute the difference between the actuarial liability for the segment and the market value of the assets allocated to the segment as a result of a segment closing; however, CAS 412 and 413 apply specifically to pension plans. The Regence PRB plan is not a pension plan but rather a retiree insurance program which is governed by CAS 416. CAS 416 does not have a provision for this type of an adjustment if a segment ends. Instead, it requires that the cost of the retiree insurance program be ratably spread over the average future years of service of the active employees, but does not include any immediate recognition provision.

- Regence also stated that the PRB costs could not be discontinued immediately; therefore, it should be reimbursed for those termination costs. However, the termination clause within Regence's PRB plan document states, "The Company intends this Plan to be permanent, but may terminate this Plan or any component plan at any time." Therefore, Regence could terminate the plan at its discretion with no liability due to the employees.

APPENDIX

MAILING ADDRESS
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Salt Lake City, Utah 84130-0270

Regence

Regence BlueCross BlueShield of Utah is an Independent Licensee of the Blue Cross and Blue Shield Association

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January 19, 2009

Patrick J. Cogley
Regional Inspector General for Audit Services
601 East 12th Street
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Kansas City, Missouri 64106

Re: Response to Audit Report A-07-08-00283, "Review of the Termination Claim for Postretirement Benefit Costs Made by The Regence Group for the Oregon Segment"

Dear Mr. Cogley:

Thank you for the opportunity to respond to the above-referenced draft audit report. In that draft audit report, the Office of Inspector General made the following finding and recommendation:

> Regence's entire termination claim of $113,831 for the Oregon PRB costs was unallowable for Medicare reimbursement. The termination claim represented an unallowable accounting method with immediate recognition of the unamortized transition obligation, prior service costs, and gains and losses. None of these costs are allowable in accordance with the FAR and Statement of Financial Accounting Standards 106, and therefore the costs are unallowable for Medicare reimbursement.

We do not concur with the recommendation for the reasons stated below.

Post-retirement benefit (PRB) costs are among the reimbursable costs that contractors incur in administering the Medicare program. As your Office noted in audit report A-07-08-00282, Regence's claimed PRB costs during fiscal years 1992 through 2005 met the FAR requirements because they were (1) measured and assigned in accordance with generally accepted accounting principles such as FAS 106; (2) calculated in accordance with generally accepted actuarial principles and practices; and (3) funded through VEBA trust deposits or liquidated through direct payments to plan beneficiaries.

The PRB costs addressed in Regence's termination voucher have different elements however, for which additional separate reasons exist in support of their reimbursement. The two components of PRB costs for which Regence seeks recovery are (1) transition obligation costs that were not yet amortized at the time of termination under the delayed recognition methodology required by the FAR, and/or (2) continuing PRB costs that are reimbursable under the FAR termination cost principle.

Regence's Medicare employees had worked tirelessly over the past forty years to ensure proper administration of the program on the government's behalf, and as a result, many have earned the right to post-retirement benefits. Regence, in partnership with CMS, has worked hard to ensure that these employees would receive these PRBs, especially during a time when so many Americans are in danger of losing their benefits.

To this end, prior to 1992, Regence accounted for and funded PRBs on a "pay-as-you-go" ("PAYGo") basis, which was consistent with standard industry practice. In the early 1990s, however, the Financial Accounting Standards Board (FASB) issued the Statement of Financial Accounting Standard 106 (FAS 106), requiring companies to accrue for and report PRB liability in their financial statements. Thus, as the draft audit report correctly notes, from fiscal year 1992 through the end of the contract, Regence accounted for the costs of PRBs on an accrual basis instead of on a "pay-as-you-go" basis.

Like most businesses that had followed the standard industry practice of accounting for PRB costs on a "pay-as-you-go" basis, Regence was faced with the problem of how to account for the enormous shortfalls presented by the full accrual of the PRB obligations to retired and still-active employees. FAS 106 offered two alternative methods of accounting for this so-called "transition obligation": (1) an "immediate recognition" of the full amount of the shortfall in the first fiscal year in which FAS 106 became effective, or (2) a "delayed recognition" of this amount over the average remaining service period of active employees.

For government contract cost accounting purposes, however, FAR 31.205-6(o)(2)(iii)(A) required contractors to use the "delayed recognition" methodology described in paragraphs 112 and 113 of FAS 106. 56 *Fed. Reg.* 41738 (August 22, 1991) (issuing interim rule that inserted delayed recognition requirement and amended recent final rule, which added new PRB subparagraph (o) effective July 25, 1991). Consistent with this rule, Regence amortized its FAS 106 transition obligation over 20 years.

But fourteen years later – before the expiration of the 20-year delayed recognition period – Regence's Medicare contract was terminated. Regence served the Medicare programfor forty years and accrued PRB liability for its Medicare program employees for a substantial portion of that period. Regence followed the requirements of FAS 106 and the FAR. Had Regence continued to administer the Medicare program under a cost reimbursement contract for the entire transition period required by the regulations, Regence's entire PRB "transition obligation" would have been fully amortized and funded by 2012.

Now, according to the flawed reasoning in the OIG draft audit report, Regence's remaining transition obligation costs, which were incurred during the life of the Medicare contract, could *never* be allowable under *any* accounting methodology. This was not the intent of the FAR in requiring the "delayed recognition" accounting methodology to be applied over the "immediate recognition" methodology. Because so many contractors were changing from PAYGo accounting to accrual accounting of PRB liability after the release of FAS 106 in the early 1990s, presumably CMS would not have been able to reimburse the full transition obligation claims from all of these contractors in the same year (1992). Thus, delayed recognition was chosen over immediate recognition. While the intent might have been to prevent a massive reimbursement request from multiple contractors all in the same year, the purpose of the FAR certainly was not to prevent contractors from *ever* receiving reimbursement of the full transition obligation, which had been accrued and funded pursuant to the Medicare contract.

This is not a situation where Regence is attempting to circumvent the FAR by applying the FAS 106 "immediate recognition" method of accounting. The full 20-year amortization period for "delayed recognition" was made an impossibility by the termination of the contract. Thus, this represents a unique circumstance – and in such exceptional circumstances, the termination cost principle provides a remedy. Accordingly, as discussed further below, Regence's remaining PRB costs should be deemed allowable.

First, FAS 106 requires the amortization of the transition obligation to be accelerated under certain circumstances, for example, when years of future service are eliminated or when a settlement occurs. The termination of Regence's Parts A and B contracts eliminated future service years and a FAS 106 curtailment applies here, requiring immediate recognition of the remaining transition obligation amount. This does not change the accounting methodology to "immediate recognition," but rather it simply represents an exceptional circumstance (contract termination) within the delayed recognition methodology framework, which Regence has consistently applied to its Medicare contracts since 1992. Thus, Regence seeks reimbursement for its remaining, funded PRB costs, including the remaining proportionate share of the unrecognized transition obligation. This type of segment-closing adjustment is also consistent with and warranted under the principles of Cost Accounting Standards 412, 413 and 416.

Second, Regence's funded PRB costs should be reimbursed pursuant to FAR 31.205-42(b), because these are costs that cannot be discontinued immediately after the effective date of contract termination. Regence's termination of its Medicare contracts is a change in circumstance that obviously affects the equation implicit in FAR 31.205-(6)(o), which is that postretirement benefits will ultimately be reimbursed over time. As noted, the termination cost principle at FAR 31.205-42 recognizes that terminations are exceptional circumstances that alter reimbursement calculations, including the acceleration of future obligations and even accounting changes such as the reclassification of indirect costs as direct. Accordingly, what Regence has done in this Termination setting is wholly consistent with the operation of FAR 31.205-6(o), which is simply to seek reimbursement of postretirement benefits fairly earned, actually funded, and accrued.

Finally, as noted above, neither the intent of the FAR nor the principles of fundamental fairness and equity are served by disallowing these accrued and funded PRB costs.

I. CMS Should Reimburse Regence For Its Remaining Transition Costs Pursuant to FAS 106 and Consistent with CAS Principles in 412, 413 and 416

A. FAS 106

The draft audit report claims that Regence's reimbursement request for its remaining transition obligation costs is not in compliance with the principles identified in FAS 106. We respectfully disagree. FAS 106 requires the amortization of the transition obligation to be accelerated under certain circumstances. The termination of the Medicare contract is such a circumstance, because it has the effect of eliminating approximately seven years of future service over which the remaining transition obligation amount would have been recognized and reimbursed. Your Office previously wrote, in this regard, "SFAS 106 requires that when years of future service are eliminated by an early retirement window, a proportionate share of the unrecognized transition obligation be immediately recognized and offset with a corresponding gain or loss." Department of Health and Human Services (HHS), Office of Inspector General (OIG) Report, *Review of Postretirement Benefit Costs Claimed by Pennsylvania Blue Shield*, at 4 (June 6, 2005). FAR 31.205-6(o)(2)(iii) requires contractors using the accrual basis to measure and assign PRB costs in accordance with generally accepted accounting principles, such as FAS 106, and thus, a proportionate share of the unrecognized transition obligation should be recognized immediately, pursuant to FAS 106 and the FAR.

This process is consistent with accounting for the transition obligation using the delayed recognition methodology in paragraph 112 of FAS 106 as well. As discussed above, in order for PRB costs calculated under the accrual basis to be allowable, FAR 31.205-6(o)(2)(iii)(A) requires any transition obligation to be calculated in accordance with the delayed recognition methodology described in paragraphs 112 and 113 of FAS 106. Paragraph 112 of FAS 106 states that "the transition obligation or asset shall be amortized on a straight-line basis over the average remaining service period of active plan participants . . . ."

Even with delayed recognition methodology accounting, however, there are times when the amortization period should be accelerated or the remaining transition obligation should be immediately recognized. For example, Paragraph 112 of FAS 106 requires the amortization of the transition obligation to be accelerated if the cumulative benefit payments subsequent to the transition date exceed the cumulative PRB cost accrued subsequent to the transition date. The measurement of cumulative benefit payments made subsequent to the transition date includes settlements payments, for example, like the purchase of "long-term nonparticipating insurance contracts for the accumulated postretirement benefit obligation for some or all of the plan participants." FAS 106, ¶ 90 and ¶ 112. Moreover, a curtailment has occurred here, requiring immediate recognition of the remaining transition obligation. FAS 106, ¶¶ 96-99.

Thus, consistent with FAS principles, the amortization period for Regence's remaining transition obligation that was incurred under Regence's long-term Medicare contract is properly accelerated and recognized as a termination cost.

B. Cost Accounting Standards

In addition, the segment-closing adjustment sought here by Regence would be consistent with and warranted under the principles of Cost Accounting Standards (CAS) 412, 413 and 416. In a 1996 memorandum regarding PRBs, the HCFA Pension Actuarial Office, Office of the Actuary, stated that, for contractors using the accrual accounting as opposed to the pay-as-you-go accounting, "the treatment of funded PRBs under provisions of CAS 412 and 413 when the PRBs are an integral part of a pension plan, and the treatment of funding under CAS 416 are similar and would result in similar allocable contract costs." Memorandum, Response to Draft Report CIN A-07-96-0 1177 entitled *Post Retirement Benefit Costs Claimed by Blue Cross Blue Shield of Michigan*, Ronald L. Solomon, HCFA Office of the Actuary (Aug. 22, 1996) at 3.[1]

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[1] The government has insisted on a reversionary right to any over-funding of PRBs, just as it has with pensions. FAR 31.205-6(o)(5) states in this regard that the "Government shall receive an equitable share of any amount of previously funded PRB costs which revert or inure to the contractor." To permit the government to recover excess funding, but not to share in the responsibility for the obligation, is directly contrary to principles of fundamental fairness. In the analogous section regarding pension costs, the government must share in the responsibility for funding as well. *Cf., General Motors Corp. v. United States*, 66 Fed. Cl. 153 (2005).

For a contractor using accrual accounting and prefunding insurance coverage for retired persons, CAS 416-50(a)(1)(v)(c) requires that the "amount added to the reserve or fund in any cost accounting period must not be greater than an amount which would be required to apportion the cost of the insurance coverage fairly over the working lives of the active employees in the plan." Here the working lives of the active employees ended prior to their retirement with the termination of the contracts. Thus, CAS 416 supports a segment closing adjustment that reflects the immediate recognition of the remaining transition obligation.

The remaining PRB obligation is a cost that may be assigned to the termination package, assuming it also is pre-funded at the same time. Because Regence has funded the requested remaining PRB obligation using the accrual basis under the FAR, an adjustment for the funded PRB costs that is similar to the adjustments made for funded pension plans similarly would be appropriate.

II. CMS Should Reimburse Regence For Its Remaining, Funded PRB Costs, Including the Remaining Transition Obligation, Pursuant to FAR 31.205-42.

As noted, a one-time segment closing adjustment for PRB costs is appropriate under the circumstances presented here. Regence incurred PRB costs and liabilities under the Medicare contracts, and if the contracts had not been terminated, CMS would have fully reimbursed Regence for these PRB costs. "[T]he overall purpose of a termination for convenience settlement is to fairly compensate the contractor and to make the contractor whole for the costs incurred in connection with the terminated work." *Nicon, Inc. v. United States*, 331 F.3d 878, 885 (Fed. Cir. 2003) (vacating lower court's decision for government and concluding that contractor may recover unabsorbed overhead costs as part of its termination for convenience settlement). Pursuant to FAR 31.205-42(b), "costs which cannot be discontinued immediately after the effective date of termination are generally allowable." Regence's future PRB payments cannot be discontinued immediately because Regence already has incurred the liability for these accrued costs during the Medicare contract periods.

This kind of segment closing adjustment is equitable as a termination cost under the circumstances because Regence's eligible Medicare employees have earned these benefits and Regence has funded future PRB payments on an irrevocable basis. Thus, there is no danger that the funded PRB costs will revert back to Regence; the funding will only benefit the Medicare employees who have earned the future benefits through their service during the Medicare contracts. A Cost Accounting Standards Board Staff Discussion Paper on post-retirement benefits stated:

> When a segment closes, any adjustment amount measured for post-retirement benefit plans is to be reported to the parties for consideration when negotiating the overall settlement of costs and credits associated with the segment closing. The parties are expected to negotiate an agreement on the treatment of any post-retirement benefit segment closing adjustment and the CAS 9904.413-50(c)(12) pension adjustment that is equitable based on the facts and circumstances of the particular segment closing.

Cost Accounting Standards Board Staff Discussion Paper On Post-Retirement Benefits, Mr. Eric Shipley, Project Director, 61 *Fed. Reg.* 49534 (Sept. 20, 1996).

Moreover, with respect to segment closing adjustments for pension costs, the United States Court of Federal Claims explained in *General Motors Corp. v. United States*, 66 Fed. Cl. 153 (2005),

> The CAS 413 adjustment is not a "normal" pension cost or an "annual" pension cost. Rather, the calculation under CAS 413 results in an adjustment to those prior pension cost determinations. For this reason, the CAS 413 segment-closing adjustment operates independently of the contractor's obligation to properly allocate pension costs on an annual basis.

Therefore, the court rejected the government's argument that the contractor was bound by the funding requirements in FAR 31.205-6(j)(2)(i)[2], which contains identical language to that in FAR 31.205-6(o)(3)[3] regarding the requirement to fund costs by the time set for filing the federal tax return. Thus, the remaining, but funded, PRB costs are analogous to the pension costs claimed in *General Motors*, which supports CMS' reimbursement of these costs. Regence's recovery of an adjustment amount that compensates for the pre-funded post-retirement benefits would be equitable under the

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2 FAR 31.205-6(j)(2)(i) states that, to be allowable, pension costs assigned to the current accounting period must be funded "by the time set for filing the Federal income tax return or any extension thereof . . . ."

3 FAR 31.205-6(o)(3) similarly states that, to be allowable, PRB costs assigned to the current accounting period "must be funded by the time set for filing the Federal income tax return or any extension thereof . . . ."

circumstances presented here and wholly consistent with the rationale of the *General Motors* case.

III. <u>Reimbursement Of Regence's PRB Costs Is Proper Under The Medicare Contracts Pursuant To Principles of Fundamental Fairness and Equity.</u>

A failure to reimburse Regence for the costs of the funded PRB obligations, some of which were earned by Regence's employees during the years before the PRB cost principle was even written in 1991, would amount to a material failure by CMS to live up to its bargain with Regence under the Medicare contracts. Permitting Regence to incur such a loss without reimbursement would be in violation of the fundamental principle of the Medicare contracts that Regence shall incur neither profit *nor loss* resulting from its administration of the Medicare program.

In addition, a failure to pay Regence its accumulated and fully-funded PRB obligation would effectively permit CMS to receive a "windfall" under the contract, just as Regence would incur a loss. As the Army Contract Adjustment Board noted in the *Uniroyal* decision, in the context of contracts that were not predicated on an express provision about "neither profit nor loss," "It cannot be said that either party envisioned such an outcome when they entered into the agreement to have Uniroyal operate [the ammunition plant] on a cost reimbursement basis." *See Application of Uniroyal Chemical Company, Inc.*, ACAB No. 1245, 4 ECR ¶ 85 (Fed. Pubs.) (Oct. 4, 1996) ("*Uniroyal*") at 7. Principles of equity and fairness mandate the cost-reimbursement requested here.

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Lastly, we note that Regence's certified claim for Oregon PRB costs is actually in the amount of $452,106, not $113,831. The draft audit relies on an earlier estimate provided by Regence's actuaries (Towers Perrin) in a letter dated November 14, 2005. Based on this information, Regence funded the $1,555,538 termination liability prior to the end of the CMS contracts. Of that amount, $1,441,707 was attributed to the Utah contract and $113,831 to the Oregon contract. After the termination date Towers Perrin recalculated the termination liability and updated their estimate in 2006 based on actual termination data. The total liability increased to $1,810,558 with $1,358,482 attributable to the Utah contract and $452,106 attributable to the Oregon contract. Regence provided the updated Towers Perrin report to CMS in April 2006 as part of the termination voucher. Regence then fully funded the difference between the estimates, and filed a certified claim dated August 6, 2008 with CMS, which included the $1,810,558 for PRB termination costs. <u>See</u> Attachment A. Thus, Regence respectfully requests that the draft audit report be amended to reflect Regence's actual costs and the amount requested in the certified claim.

Thank you for your time and attention to this matter. Please do not hesitate to contact me at (801) 333-2000 to discuss this response.

Sincerely,

Mark Stimpson
Vice President of Medicare