

**ACTIONS TAKEN TO RECOVER EXCESS
RESERVES FROM THE CENTRAL
ARTERY/TUNNEL PROJECT'S
OWNER CONTROLLED INSURANCE PROGRAM**

Federal Highway Administration

Report Number: IN-2002-095

Date Issued: July 22, 2002



Memorandum


**U.S. Department of
Transportation**

Office of the Secretary
of Transportation

Office of Inspector General

Subject: ACTION: Report on Actions Taken by the Federal
Highway Administration to Recover Excess
Reserves From the Central Artery/Tunnel Project's
Owner Controlled Insurance Program
Report No. IN-2002-095

Date: July 22, 2002

From: Alexis M. Stefani 
Assistant Inspector General for Auditing

Reply to JA-30
Attn of:

To: Federal Highway Administrator

In May 1999, we reported that the Central Artery/Tunnel Project (Project) had overfunded its owner controlled insurance program (OCIP) to develop excess insurance reserves to offset cost increases on the Project.¹ The Federal Highway Administration (FHWA) agreed to recover the excess reserves and implement a policy to prevent future occurrences. On September 30, 1999, Congress directed the Secretary to issue guidance to prevent other transportation projects from overfunding OCIPs.

Congress also directed the Inspector General "to monitor the implementation of FHWA's planned actions related to the Central Artery insurance program."² We reviewed how FHWA implemented its agreement to correct the problems previously reported and how it complied with direction from Congress. Our objective, scope, and methodology are in Exhibit A.

RESULTS IN BRIEF

Between 1992 and 1999, the Project had overfunded the OCIP by paying inflated premiums—90 percent of which were paid by the Federal Government—into an insurance program trust fund. The overfunding included overpayments of

¹ Report Number TR-1999-104, Overpayment of Premiums for the Central Artery Project's Owner Controlled Insurance Program, May 24, 1999.

² 106th Congress, House of Representatives Report 106-355, Conference Report to accompany H.R. 2084 and Joint Explanatory Statement of the Committee of Conference, September 30, 1999.

premiums, premiums based on expected high loss rates, and interest earned on the excess reserves. The Project partially reduced its insurance payments when it renegotiated the program in 1996. It also made some premium payments out of the trust in 1997. However, the payments were not fully reduced to reflect the amounts actually needed to fund the insurance program. In addition, the Project did not remove all excess funds from the trust fund. In response to our 1999 report, the Project agreed to use past overpayments we cited to pay its premiums in the next 2 policy years (November 1, 1999 through October 31, 2001).

This audit found the Project offset \$153 million (\$138 million Federal portion) in scheduled premium payments as agreed. In addition, both the Project and FHWA contracted for independent actuaries to estimate the actual liabilities of the OCIP. After receiving the report of its actuary, the Project removed an additional \$50 million in Federal funds from the OCIP trust fund and returned those funds to Massachusetts' Federal-aid account in 2001. However, when we began this audit we found that, although \$153 million in premiums were offset and \$50 million was removed, approximately \$133 million in excess Federal funds still remained in the trust fund. Further, we found that FHWA had not issued policy guidance as it agreed to do in response to our 1999 report, and as directed by Congress.

In September 2001, we brought this situation to the attention of the newly confirmed FHWA Administrator. As a result, on December 10, 2001, FHWA committed to advise the Project to remove an additional \$133 million of excess funds within 3 months and to complete an independent audit of the Project's insurance trust funds. Interest earned on the excess Federal funds that were improperly held in the trust will be identified and accounted for as Federal funding to the Project. (See Exhibit C.) The Administrator also issued interim OCIP policy guidance on January 8, 2002.

The Central Artery OCIP was used for investment purposes.

The Project established an OCIP in 1992. OCIPs can be used to reduce insurance costs. However, our May 1999 report found that the Project had overfunded the Central Artery OCIP. (See Exhibit B for the detailed background on the Project's OCIP and a description of prior audit coverage.) The overfunding occurred because the Project paid premiums which were set based on (1) a work plan that called for using large numbers of workers to complete the project by 2000, and (2) an expected high loss rate on the Project. Neither of these occurred, but the Project, with FHWA concurrence, did not reduce its insurance payments to reflect actual needs and did not remove excess funds that accumulated in the OCIP trust.

Instead, the Project kept the excess funds invested in its insurance trust to earn additional income. The Project's 1999 Finance Plan showed that the balance of its insurance trust would exceed its insurance needs by \$826 million in 2017. At that

time, the money would be withdrawn and used for other transportation needs in the State. The Project showed the estimated future trust balance as an offset to current costs in its 1999 Finance Plan, thus keeping the publicly reported cost of the Project at just \$10.8 billion. In response to our objections, the use of a credit was discontinued in the October 2000 and October 2001 Finance Plans.

In response to our May 1999 report, FHWA agreed to (1) use part of the excess reserves to make premium payments for the next 2 policy years, (2) return remaining excess reserves to the Project, and (3) issue a policy to govern OCIPs on highway projects. In September 1999, Congress directed the Secretary to issue guidance ensuring that (1) the Federal share of insurance premium adjustments on all transportation projects is immediately applied to other Project costs or returned to the U.S. Treasury, and (2) insurance reserves are adjusted annually so that the balances do not exceed the amount reasonably needed to pay outstanding claims.³

After some delays, FHWA has issued an interim OCIP policy and directed the Project to remove all excess Federal funds from the OCIP trust.

The Project offset \$153 million (\$138 million Federal portion) in premium payments due for the policy years that began November 1, 1999 and November 1, 2000 and made two withdrawals of excess Federal funds totaling \$50 million and returned those funds to the State's Federal-aid account. However, approximately \$133 million of excess Federal funds remained in the Project's insurance trust.

As of July 31, 2001, the insurance trust still contained about \$231 million. On May 1, 2001, an independent actuarial study reported that the *estimated outstanding balance of claims incurred* on the Project through December 1999 totaled *at most* \$83 million. Based on the actuarially determined value of incurred claims (\$83 million), and the remaining trust balance (\$231 million), we concluded the trust balance exceeded the allowable amount by about \$148 million. Because about 90 percent of insurance payments were made with Federal funds, we estimate the Federal share of the excess reserves is approximately \$133 million.⁴ The Project intended to keep these excess reserve funds in the trust as advance payment of all *future* insurance costs through the end of the Project in 2005.

Advanced Federal payment of future costs on highway contracts, however, is prohibited. Federal laws and regulations limit Federal participation to a reimbursement of incurred costs, except in very limited circumstances not present

³ Conference Report on House Resolution 2084, Department of Transportation and Related Agencies Appropriation Act dated September 30, 1999.

⁴ An independent audit commissioned by the Project to confirm the OCIP trust balances and interest earned on the workers compensation reserve accounts was completed for the period ended June 30, 2001. A separate audit on the general liability accounts has not been completed.

here (for example, stockpiles of materials bought and stored on-site).⁵ Other laws that may apply are those that seek to prevent states from retaining Federal funds for investment purposes and those that prohibit false claims against the Federal Government.⁶

In addition, the Project negotiated new workers compensation and general liability insurance agreements with the insurance carrier that make it more difficult to recover premium overpayments. The renegotiated insurance agreements eliminate provisions in the original agreements that called for annual calculations of the balance of outstanding claims and adjustment of the reserves to keep the balance to the amount needed to pay claims. These procedures are required by Federal regulations.⁷ Rather than identifying and returning excess reserves or refunds of premium overpayments, the new agreements direct these refunds and overpayments to be kept in the trust. Thus, the new agreements restrict the return of excess reserves in violation of Office of Management and Budget (OMB) Circular A-87.

When we brought this situation to the attention of the newly appointed FHWA Administrator on September 27, 2001, she took prompt action to begin the process to take the Federal money out of the trust. As a result, on December 10, 2001, FHWA committed to advise the Project to remove an additional \$133 million of excess funds within 3 months and to complete an independent audit of the Project's insurance trust funds.⁸ Interest earned on the excess Federal funds that were improperly held in the trust will be identified and accounted for as Federal funding to the Project.

Also, on January 8, 2002, FHWA issued interim policy guidance to ensure OCIPs comply with Federal regulations. That policy was distributed to all FHWA state Division offices, and was posted on the FHWA Internet site. Regarding the noncompliance of the renegotiated OCIP agreements with OMB Circular A-87, rather than bringing the OCIP agreements into compliance, the Project plans to remove all Federal funds from the OCIP trust.

⁵ See Title 23 United States Code (U.S.C.) § 121 and 49 Code of Federal Regulations (C.F.R.) § 18.21(j).

⁶ See the Cash Management Improvement Act (Title 31 U.S.C. § 6503(f)) and the False Claims Act (Title 31 U.S.C. § 3729).

⁷ Office of Management and Budget Circular A-87, Cost Principles for State, Local, and Indian Tribal Governments, Attachment B, paragraph 25.d (3).

⁸ The audit results will be subject to review by the Office of Inspector General.

RECOMMENDATIONS

We recommend that the Federal Highway Administrator:

1. Ensure the Project completes the withdrawal of \$133 million in excess Federal reserves held in the OCIP trust and either applies the funds to other allowable project costs or returns the money to the State's Federal-aid account.
2. Require the Project to complete the ongoing independent audit of the Central Artery OCIP trust accounts to verify the account balances and interest earned. To ensure the audit complied with Government Auditing Standards, the audit results will be subject to review by the Office of Inspector General (OIG).
3. Cease Federal participation in the OCIP unless workers compensation and general liability agreements are revised to be consistent with Federal regulations and the interim policy.
4. Issue a final OCIP policy within 30 days or make the interim policy permanent.

MANAGEMENT COMMENTS AND OIG RESPONSE

Responding to a draft of this report, both FHWA and the Project disagreed with the report's findings that the OCIP program had accumulated excess reserves. However, they both agreed to implement the report's recommendations. Although FHWA agreed to implement an OCIP policy as we recommend, it stated that it needs more time to consider a final policy and it did not establish a timeframe to issue a final policy. In our opinion, further delay is unwarranted because an interim policy that adequately reflects key Federal requirements is in place, over 3 years have passed since the problems were brought to FHWA's attention, and Congress directed FHWA to implement OCIP policy guidance. (Management's comments and our response are discussed in detail on page 15.)

FINDING AND RECOMMENDATIONS

The Project Reduced Excess Federal Reserves by \$188 Million

In response to our 1999 audit report, the Project took two actions to reduce excess reserves. First, the Project used \$153 million (\$138 million Federal portion) in past overpayments and interest to offset current premiums due. Second, the Project withdrew \$50 million from the trust and returned the funds to the State's Federal-aid account.

For the period August 1999 to August 2001, the Project reported that \$153 million in trust funds were used to offset insurance premiums for the policy years ending October 31, 2000 and October 31, 2001. The \$153 million includes approximately \$112 million in workers compensation insurance premiums and \$41 million in general liability insurance premiums, as shown in Table 1.

Table 1 – Workers Compensation and General Liability Premiums Paid From Trust Fund (\$ in Millions)

<u>Date</u>		<u>Workers Compensation</u>	<u>General Liability</u>	<u>Total</u>
Aug	1999	\$ 12.28	\$ 0.00	\$ 12.28
Dec	1999	\$ 13.18	\$ 0.00	\$ 13.18
Feb	2000	\$ 13.18	\$ 0.00	\$ 13.18
May	2000	\$ 13.18	\$ 6.89	\$ 20.07
Aug	2000	\$ 13.18	\$ 0.00	\$ 13.18
Dec	2000	\$ 11.67	\$ 8.60	\$ 20.27
Feb	2001	\$ 11.67	\$ 8.60	\$ 20.27
May	2001	\$ 11.67	\$ 8.60	\$ 20.27
Aug	2001	\$ 11.67	\$ 8.60	\$ 20.27
Total		\$111.68	\$41.29	\$152.97

In addition to the \$153 million in offset payments, the Project withdrew \$50 million from the trust and returned the funds to the State's Federal-aid account. The \$50 million was removed in two withdrawals of \$25 million each, in February and May 2001. The total of fund offsets and withdrawals was \$203 million (\$188 million Federal share).

The Project Continues To Retain at Least \$133 Million in Excess Federal Funds in the OCIP Trust

Although FHWA has recovered a portion of the excess reserves, the Project continues to hold a surplus of at least \$148 million, the Federal share of which is \$133 million. This unnecessarily increases the Federal obligations and allows the

Project and the insurance carrier, American International Group (AIG), to continue using excess Federal funds for investment purposes.

Excess reserves generated through overpayment of premiums. The workers compensation reserves on the Project were higher than necessary for two reasons. First, the estimates used to set the premiums were based on a work schedule that anticipated using a large number of workers to complete the Project by 2000. Workers compensation premiums are set, in part, based on the number of workers employed. The anticipated work schedule never materialized, and the Project actually employed far fewer workers than originally estimated in calculating the premiums. Consequently, the premiums paid were higher than necessary for the number of workers employed.

Second, from the beginning of the program, losses experienced by the Project were significantly less than anticipated. In addition to the number and type of workers, insurance premiums are based in part on the loss experience of the insured. The Central Artery OCIP agreements are a blend of purchased coverage and self-insurance. Part of the premiums are put into the trust reserves to pay the expected claims under the self-insured part of the program.

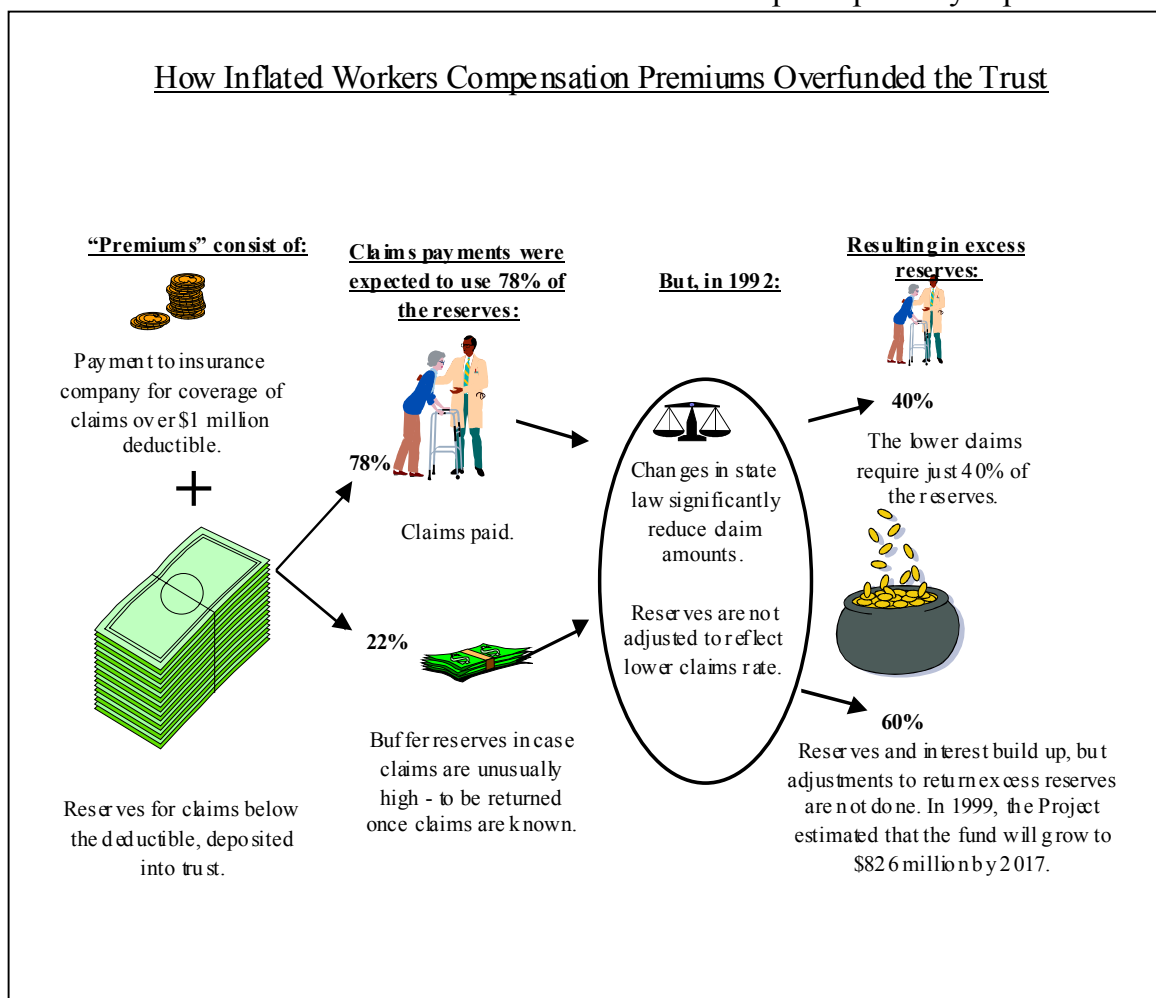
At the outset, it was expected that the Project would incur higher than average numbers of claims. However, the Project has had a better safety record than was expected at the inception of the OCIP. Also, Massachusetts revised its workers compensation law in 1992 to limit the benefits provided. As a result, workers compensation claims across the State were reduced, leading to a 60 percent reduction in workers compensation premiums in Massachusetts since the inception of the OCIP in 1992. However, the premiums were never fully adjusted to reflect the lower than expected workers compensation claims on the Project.

Extent of overpayments was evident in the Project's "loss ratio." Under the OCIP's deductibles, the first \$1 million of each workers compensation claim (up to \$3 million total for the claims related to any one incident) is the responsibility of the Project. Most (91.7 percent in the first 3 years) of the workers compensation premiums paid on the OCIP each year are deposited into the Project's trust account to pay the claims below the deductible. However, the Project did not fully reduce the contributions to the reserves to match the lower claims amounts, resulting in excess reserves. This can be seen in the Project's low "loss ratio."

The loss ratio is the percentage of premium that ends up being paid out in claims and expenses. The original insurance approval documents submitted to the State's Department of Insurance (called a "Rating Plan") indicated the insurance payments were based on the expectation that the Project would have an approximate 78 percent loss ratio. That means, on average, 78 percent of the premiums were expected to be paid out in claims. The remaining 22 percent were collected as a

buffer in case the Project experienced unusually high claims during the year. However, the Project's claims have been consistently much less than the amount that was being billed to the Federal Government. As of the latest data, because losses have been less than expected, the Project's average workers compensation loss ratio is only 40 percent, while the general liability loss ratio is only 36 percent.

Excess reserves should be identified and returned, but the Project planned to use them for investment purposes. Once claims from past years are known, excess reserves are to be returned. This is termed a *reserve adjustment*. It is required by OMB Circular A-87 to be done at least every 2 years.⁹ However, instead of removing the excess reserves, the Project planned to keep all the funds invested in the trust until 2017. The Project's 1999 Finance Plan showed the Project knew that by 2017, the combination of excess reserves and prior overpayments, plus interest earned, would total \$826 million. The Project's 1999 Finance Plan reflected that amount as a "credit" to keep the publicly reported total



⁹ The September 1999 Appropriation Committee Conference report changed this requirement for transportation projects by requiring annual adjustments.

cost of the Project at \$10.8 billion. After we questioned the potential credit, the October 2000 and October 2001 Finance Plans did not include the credit.

An independent actuarial assessment found that incurred claims totaled only about \$83 million while the trust still contained \$231 million. In its September 13, 1999 response to our prior report, FHWA agreed to determine the actual reserves needed in the trust and to limit reserves to allowable amounts. We advised FHWA that the actual insurance reserve requirements should be routinely quantified with any resulting excess fund balances returned. Pursuant to that agreement, in 2000 FHWA awarded a contract to perform an actuarial study of workers compensation and general liability claims.

Although Federal regulations allow reserves to cover only the present value of liabilities for incurred claims, FHWA directed the contractor to include in its estimations the *future* liabilities and other *future* costs of the insurance program through project completion in 2005. FHWA's action conflicted with Federal regulations, its own September 13, 1999 memorandum, and the direction of Congress. Following FHWA's direction, the actuary estimated that the present value of incurred and future costs on the insurance program would amount to \$246 million by 2005.¹⁰

The independent actuary also provided a clear breakdown that identified what portions of the estimated costs were for incurred claims, future claims, and insurance program management. This enabled us to identify the portions of the \$246 million that were attributable to projected future costs not yet incurred. Of the \$246 million in estimated liabilities, only \$83 million had actually been incurred.¹¹ A total of \$163 million of the estimated costs were not yet incurred, including \$137 million to pay claims and \$26 million to pay insurance management costs that may be incurred through the end of the insurance program.

Reserves exceed incurred liabilities by \$148 million, of which \$133 million are Federal funds. Trust reports show that, as of July 31, 2001, the Central Artery OCIP trust accounts contained about \$231 million. That is \$148 million more than the actuarially determined incurred claims of \$83 million. Because Federal funding was used to pay 90 percent of the cost of insurance on the Project, we estimate the Federal share of the excess reserves to be \$133 million.

Retaining excess reserves violates regulations. We found the Project's plan to retain the excess funding in the insurance trust to pay future year expenses violates

¹⁰ On May 1, 2001, Aon reported these amounts as its high estimate. Incurred and future claim liabilities are stated on a present value basis. All estimated claim valuations are required to be periodically updated by actuarial analysis.

¹¹ Aon reported the known incurred liabilities for the period from project inception through December 31, 1999, stated as of March 31, 2000.

several Federal regulations. Generally, states are allowed to claim Federal reimbursement only for those expenses that have actually been incurred, not for possible future expenses. For example:

- **23 U.S.C. § 121 specifies highway payments are to be made on a reimbursement basis.** Title 23 U.S.C. § 121, *Payment to States for Construction*, establishes the Department's authority to make payments to States on highway projects. Section 121 states in part, "The Secretary, from time to time as the work progresses, may make payments to a State for costs of construction incurred by the State on a project." Thus, FHWA is limited to reimbursing states for incurred costs, not for potential future costs.
- **49 C.F.R. § 18 requires highway projects to follow the cost principles of OMB Circular A-87 and limits payment to reimbursement of incurred costs.** Title 49, C.F.R. "Transportation" identifies the criteria to be used when determining allowable project costs on transportation projects. Section 18.21(j) specifically incorporates the guidance of 23 U.S.C. § 121 and states that payments to states shall be limited to "the Federal share of the costs of construction incurred to date, plus the Federal share of the value of stockpiled materials." Section 18.22 identifies OMB Circular A-87 as appropriate guidance to follow in determining what costs, including insurance costs, are allowable.
- **OMB Circular A-87 limits Federal participation in insurance reserves and prohibits participation in contingency reserves.** OMB Circular A-87, "Cost Principles for State, Local, and Indian Tribal Governments," Attachment B, Section 25 establishes the allowable Federal payments for insurance costs. Federal payment into insurance reserves is limited to only the present value of claims that have actually been incurred, as follows:

Section 25d. (1) provides that "known or reasonably estimated self-insured liabilities, which do not become payable for more than one year after the provision is made, shall not exceed the discounted present value of the liability."

Section 25d. (3) states "Contributions to reserves must be based on sound actuarial principles using historical experience and reasonable assumptions. Reserve levels related to employee-related coverage will normally be limited to the value of claims (a) submitted and adjudicated but not paid, (b) submitted but not adjudicated, and (c) incurred but not submitted."

The above citations make clear the long-standing principle that states may not bill the Federal Government for costs that they have not incurred. We found that

retaining excess Federal funds as advanced payment of future premiums is not allowed.

FHWA Recently Issued Interim Guidance on OCIPs

In September 1999, FHWA agreed to issue a policy to prevent future abuse of OCIP programs. Subsequent to that date FHWA incurred substantial delays in developing this critical policy. However, the new Administrator issued an interim policy on January 8, 2002. The adoption of an OCIP policy is critical to protecting the Highway Trust Fund and FHWA's ability to accomplish its mission. While we are not aware of any other similar instances, if other states began overfunding OCIP insurance programs, the Highway Trust Fund could be overbilled by hundreds of millions of dollars. When Federal funds are unnecessarily deposited in an OCIP, this money is not available to fund Federal highway projects as Congress intended.

On September 13, 1999, FHWA agreed to "issue a policy on insurance programs that ensures the Federal share of premium adjustments on highway projects is immediately applied to other project costs or credited to the State's Federal-aid account, and reserve accounts do not exceed allowable amounts." Further, the Conference Report on House Resolution 2084, Department of Transportation and Related Agencies Appropriation Act, dated September 30, 1999 directed the Secretary of Transportation to:

...issue guidance to ensure: (1) the federal share of premium adjustments on all transportation projects is immediately applied to other project costs or returned to the U.S. Treasury, and (2) reserve accounts balances for insurance programs are adjusted annually so that the reserves do not exceed the amount reasonably needed to pay outstanding claims.

In May 2000, FHWA hired a contractor to assist in developing a policy. The scope of the contract was to (1) prepare an OCIP issues paper, (2) develop an OCIP workshop, (3) prepare a draft OCIP policy, and (4) conduct a workshop to review the draft OCIP policy. However, in May 2001, the contractor advised FHWA that due to business reasons, it could not participate in the development of a national OCIP policy.

In the summer of 2001, FHWA selected a new contractor to complete the work, which was scheduled for completion in February 2002. Moreover, some FHWA officials did not appear to have placed a high priority on issuing the policy. In transmitting the statement of work for the new contractor to the FHWA Massachusetts Division Office, one FHWA Headquarters official wrote "As you will see we are not attempting to meet any July deadline for the OIG!!" [Emphasis in original.] After we informed the new Federal Highway Administrator of the

delays, she took prompt action to move the policy forward. An interim policy was issued on January 8, 2002 (Exhibit D). That policy was distributed to all FHWA Division offices, and it was posted on the agency's Internet site.

New Insurance Agreements Conflict with Federal Regulations and Congressional Direction

During the interim, while FHWA developed its national OCIP policy, the Project and AIG renegotiated the insurance agreements. Key contract provisions were renegotiated which made it more difficult to recover premium overpayments. Moreover, the new agreements do not comply with OMB Circular A-87 requirements.

Specifically, after our May 24, 1999 audit report, the Project renegotiated both the workers compensation and general liability insurance agreements with the insurance carrier.¹² These amended and restated agreements restrict the return of future premium overpayments and excess reserves in violation of OMB Circular A-87. Rather than returning overpayments when they are identified, the new workers compensation and general liability agreements direct them to be kept in the trust.

Under the revised agreements, the Project is continuing to earn interest on excess reserves, increasing its investment income at the expense of the Federal Government. This situation is inappropriate and needs to be corrected, either by revising the agreements to comply with Federal guidance or by ceasing Federal participation in the OCIP program. In responding to this report, FHWA and the Project agreed to cease future Federal participation in the program by withdrawing remaining Federal funds from the trust by the end of this fiscal year.

The following paragraphs describe how the revised agreements work and why they do not comply with OMB Circular A-87.

No provision for returning premium overpayments. The amended and restated agreements for both workers compensation and general liability insurance restrict the return of future premium overpayments. For example, rather than allowing the return of overpayments when they are identified, the new workers compensation and general liability agreements call for them to be kept in the trust. Section 8.06 of the workers compensation agreement states, in part:

[If an] Audit Premium Credit [is] due to the Owner, the Company shall...either deposit such Audit Premium Credit into the...Excess Loss Fund Account, or apply such credit against any Obligations of

¹² Revised agreements for both workers compensation and general liability were issued in 2001.

the Owner then due...including, without limitation, the payment of any installment of Premium of another Policy Period.

Simply stated, Section 8.06 directs that overpayments be used to pay premiums due or be retained in the trust to pay future premiums. There are no provisions for returning overpayments to the Project. This essentially prevents the Project from recovering insurance overpayments at the time they are identified.

No provision for identifying and returning excess reserves. The original workers compensation agreement provided for the reduction of trust balances when the present value of the trust fund was greater than the value of actuarially projected losses and expenses. That is, if the trust had more funds than needed to pay incurred claims, the Project would be entitled to withdraw the excess funds from the trust. Revisions to the workers compensation agreements eliminated these procedures for adjusting the reserves in the trust, which facilitated the Project's retention of Federal overpayments and interest. (We note that, notwithstanding the lack of provisions in the agreements to allow the withdrawal of excess funds, the Project withdrew \$50 million in excess reserves in 2001.)

Revised agreements are inconsistent with Federal regulations. The above changes make the revised insurance program inconsistent with OMB Circular A-87 requirements. Specifically, OMB Circular A-87 Section 4(a) requires return premium and other refunds to be used to reduce costs or credited to the Federal award, rather than being held in the trust for investment purposes. In addition, Circular A-87 Attachment B, paragraph 25(d), requires that insurance reserves be adjusted at least every 2 years so the balance does not exceed allowable amounts. Congress tightened that requirement for transportation projects by directing the adjustments to insurance be done annually. FHWA has not acted on the renegotiated insurance agreements. However, by not insisting that the insurance program be structured *and operated* in compliance with Federal regulations and congressional direction, FHWA enabled the Project to continue to hold a significant amount of excess Federal money.

Costs Unallowable. Because the new agreements are not in compliance with OMB Circular A-87 requirements, the premiums and other costs incurred under the program are not eligible for Federal reimbursement (whether paid for with excess Federal funds held in the trust or with new Federal money). Several Federal regulations (Title 23 U.S.C., Title 49 CFR, and OMB Circular A-87) require FHWA to comply with specific cost principles when reimbursing states for insurance costs incurred. FHWA is responsible to ensure compliance with all appropriate limits on highway project costs. Title 49 CFR 18.43 also contains enforcement provisions that specify appropriate remedies for noncompliance. Section 18.43(a) states, in part:

...the awarding agency may take one or more of the following actions, as appropriate in the circumstances: (1) Temporarily withhold cash payments..., (2) Disallow...all or part of the cost of the activity or action not in compliance, (3) Wholly or partly suspend or terminate the current award for the grantee's program..., (4) Withhold further awards for the program, or (5) Take other remedies that may be legally available.

In a letter dated June 4, 1999, we advised the FHWA Administrator that renegotiations were ongoing for the Project's workers compensation agreement. Our letter cautioned the former Administrator not to approve any renegotiated agreement that did not fully protect Federal funds in the OCIP, including ensuring that only amounts actually needed for insurance purposes are retained by the Project.

Responding to this report, FHWA and the State have agreed to cease future Federal participation in the OCIP program by removing all Federal funds from the OCIP trust. Once all Federal funds are removed from the trust, FHWA will not need to be involved with agreements between the State and its insurance carrier.

FHWA Stewardship Improving, but Still Needs Work

On May 3, 2000, the Inspector General testified before the Senate Committee on Commerce, Science and Transportation that FHWA's failure to protect the Federal investment on the Central Artery represented an alarming lapse in oversight. Since that time, FHWA has taken some steps to improve its oversight. In 2000, FHWA issued improved guidance for financial reporting and created a Major Projects Team at headquarters. Recently, FHWA issued its *Policy on Stewardship and Oversight of the Federal Highway Programs*, and started doing annual risk assessments of the states to identify areas for oversight emphasis and process reviews. In 2002, FHWA issued the interim policy on OCIPs. We believe these actions will, in time, help improve FHWA's stewardship of Federal funding.

Although we recognize FHWA's recent efforts, we note that there were significant delays since September 1999 to initiate action to recover all excess reserves and issue a policy on OCIPs, despite the fact that (1) independent actuarial studies verified that the incurred liabilities of the program were far less than the reserves held, (2) Congress gave clear and unequivocal direction to recover excess reserves and implement a policy to prevent future occurrences, and (3) FHWA had committed to taking these actions in its September 13, 1999 agreement with our office. The new FHWA Administrator and other senior management have recognized the need for improved stewardship and oversight. Although initial steps have been taken this change will likely require a long-term effort. We also note that FHWA and Project managers are now committed to making these adjustments

as evidenced by both their response to our March 11, 2002 Report on the October Finance Plan for the Central Artery/Tunnel Project and the adjustments reflected in the Finance Plan.

RECOMMENDATIONS

We recommend that the Federal Highway Administrator:

1. Ensure the Project completes the withdrawal of \$133 million in excess Federal reserves held in the OCIP trust and either applies the funds to other allowable project costs or returns the money to the State's Federal-aid account.
2. Require the Project to complete an ongoing independent audit of the Central Artery OCIP trust accounts to verify the account balances and interest earned. To ensure the audit complied with Government Auditing Standards, the audit results will be subject to review by the OIG.
3. Cease Federal participation in the OCIP unless workers compensation and general liability agreements are revised to be consistent with Federal regulations and the interim policy.
4. Issue a final OCIP policy within 30 days or make the interim policy permanent.

MANAGEMENT COMMENTS AND OIG RESPONSE

On May 7, 2002 we provided a draft of our report to the FHWA and to the Project. Both provided comments in June 2002. Both FHWA and the Project disagreed that the OCIP program had accumulated excess reserves; however, they agreed to implement the first three recommendations. FHWA also agreed to implement the fourth recommendation, although not in a timely manner. (The Project and FHWA's complete responses are in Appendices I and II.)

Consistent with the first recommendation, FHWA and the Project agreed to withdraw \$133 million in remaining Federal funds from the OCIP trust by the end of the fiscal year. They also agreed with the second recommendation to ensure the completion of an independent audit of the OCIP trust. In June 2002, Pannell Kerr Forster PC (auditors hired by the Project) issued its report on the audit of the workers compensation accounts within the Project's OCIP trust through June 30, 2001. Pannell Kerr Forster PC is performing a separate audit on the general liability accounts within the Project's OCIP trust, which has not been completed to date. Regarding the third recommendation, FHWA and the Project agreed to cease

Federal participation in the OCIP and the State intends to withdraw all remaining Federal funds as of the end of the fiscal year.

Responding to the fourth recommendation, FHWA agreed to issue a final OCIP policy, but did not indicate when it would be issued. FHWA stated that it needs to conduct further research into industry practices and procedures and to coordinate with other Federal agencies. We do not believe additional research is needed to issue a final policy. The interim policy adequately reflects the key Federal requirements that (1) Federal funds are to be used only to fund reserves for incurred claims, and (2) OCIP reserves for highway projects are to be adjusted not less than annually. Because more than 3 years have passed since FHWA agreed to issue policy guidance, and the interim policy addresses the key requirements, further delay is unwarranted.

Both FHWA and the Project also expressed the view that their management of the OCIP program had been appropriate. The Project noted that the OCIP program had been funded in accordance with prudent risk management practices, that FHWA had approved the program at key decision points, and that the program had been implemented in accordance with applicable laws and regulations. FHWA stated that it allowed the Project to accumulate enough reserves to cover all claims through the end of construction based on the guidance that was in place at the time and that it took the necessary steps to ensure that the reserves were not overfunded.

We acknowledge that the actions now being taken by FHWA and the Project should correct the problems, but we disagree with FHWA's statement that the funding of the OCIP was appropriate. First, Federal laws and regulations prohibit the accumulation of reserves to pay "claims" that have not yet been incurred. This applies whether the program is subject to current OMB guidelines or the OMB guidelines in effect when the Project began.

In addition, in several prior reports, we and others have shown conclusively that the former Project management had overpaid insurance premiums. Our 1999 report also found that the Project showed the estimated future trust balance as an offset to current costs in its 1999 Finance Plan, thus keeping the publicly reported cost of the Project at just \$10.8 billion. (Exhibit B summarizes the prior reports.) Essentially, from 1992 through 1997, the Project billed the Highway Trust Fund for insurance at a substantially higher amount than the Project's actual insurance costs. The Project did not return the overpayments to the Federal Government but retained and invested them. Those reserves accumulated by the Project far exceeded what the bona fide risk assessments and actuarial studies had identified as potential liabilities. In fact, the Project's 1999 Finance Plan showed that the balance in the OCIP trust fund at project completion would exceed the Project's insurance needs by \$826 million. According to the Project's 1999 Finance Plan, the funds were to

be returned to the State of Massachusetts for use on other State-sponsored projects. Moreover, that \$826 million was used as an accounting credit to make the Project appear significantly less costly.

ACTION REQUIRED

In accordance with DOT Order 8000.1C, we request that FHWA notify us when the Project has returned the \$133 million to the Federal-aid account as agreed in Recommendation 1. We also request that FHWA notify us when the audit of the general liability accounts in the OCIP trust is completed. Since the workers compensation accounts have been audited, the intent of Recommendation 2 will be satisfied upon the completion of the general liability audit and after our review of the working papers for both audits. Ceasing future Federal participation in the OCIP in lieu of revising the insurance agreements meets the intent of Recommendation 3, therefore no further action is needed. Regarding Recommendation 4, we maintain that FHWA should issue a final policy within 30 days, and request that FHWA reconsider its decision to delay the issuance of the final OCIP policy.

We appreciate the courtesies and cooperation of representatives of FHWA; the Massachusetts Turnpike Authority; the Massachusetts Highway Department; Bechtel/Parsons Brinckerhoff; Pannel Kerr Forster PC; and Sheppard, Riley and Coughlin. If you have questions, please contact Theodore Alves, Deputy Assistant Inspector General for National Transportation Infrastructure Activities, at (202) 366-0687 or me at (202) 366-1992.

EXHIBIT A. OBJECTIVE, SCOPE AND METHODOLOGY

Objective

The objective of this audit was to evaluate the actions taken by the Federal Highway Administration (FHWA) as a result of its September 13, 1999 letter, which describes the agreed upon corrective actions to be taken in response to our prior audit report.¹³ In particular, FHWA agreed to have the Project use prior overpayments to pay premiums needed during the next 2 policy years (November 1, 1999 through October 31, 2001). FHWA also agreed to secure the immediate return of all remaining premiums and to issue a policy to ensure that (1) premium adjustments are immediately applied to other Project costs and (2) reserve amounts do not exceed allowable amounts.

Scope

This review focused on the corrective actions included in FHWA's September 13, 1999 memorandum. Accordingly, we limited our examination to reviewing documentation associated with this objective through March 2002. We used information provided to us by FHWA, the Project, and associated contractors and vendors. We relied on the work of Pannell Kerr Forster PC when verifying the return of trust fund monies to the Project.

Methodology

We reviewed the audit report on Overpayment of Premiums for the Central Artery Project's Owner Controlled Insurance Program dated May 24, 1999, to understand the OCIP program and the reasons for the recommendations. We obtained correspondence from FHWA, State, and Project officials on the recommendations, subsequent agreements (September 13, 1999), and actions taken.

We reviewed OCIP workers compensation and general liability agreements, including any recent drafts related to the 1998 renewals. We interviewed representatives of FHWA, the Massachusetts Turnpike Authority; the Massachusetts Highway Department; Bechtel/Parsons Brinckerhoff; Pannell Kerr Forster PC; and Sheppard, Riley and Coughlin to determine the status of resolution actions and other OCIP related issues.

¹³ Report Number TR-1999-104, Overpayment of Premiums for the Central Artery Project's Owner Controlled Insurance Program, May 24, 1999.

We reviewed FHWA, State, and Project files to determine what has actually been done to accomplish each recommendation. We obtained sufficient evidence to support the status of recommendations. We contacted the independent auditors, Pannell, Kerr Forster PC, and obtained and reviewed their reports and other available documentation related to trust fund activity. Although not complete, we used this information to verify, to the extent possible, the use of trust fund monies to repay the Federal-aid account and pay insurance premiums for 2 policy years. Pannell Kerr Forster PC continues to take steps to obtain sufficient information to conduct the audit of the OCIP trust.

We reviewed the work and actuarial study of Aon Risk Services, Inc., an insurance consultant, regarding the reasonableness of the existing fund balance, and the level of future workers compensation and general liability payments.

Our audit was performed from April 2001 through March 2002, in accordance with the Government Auditing Standards prescribed by the Comptroller General of the United States.

EXHIBIT B. BACKGROUND AND PRIOR AUDIT COVERAGE

Background

The Central Artery Project is the largest transportation infrastructure project in the nation. Planning for the Project began in 1981. In 1984, the Massachusetts Highway Department (MHD) awarded a management consultant contract to the joint venture of Bechtel/Parsons Brinckerhoff (B/PB) to manage Project design and construction activities, including the management of the Project's insurance program. Construction of the Project was authorized to begin in 1991. Under a State law enacted in March 1997, the Massachusetts Turnpike Authority (MTA) assumed ownership and management of the Project. Currently, the Project is scheduled to be completed in 2005, at an estimated cost of approximately \$14.6 billion.

In 1991, the Project contracted for a risk assessment to determine its insurance needs. Based on the results of that risk assessment, an owner controlled insurance program (OCIP) was initiated in 1992. An OCIP, also known as "wrap-up," "coordinated," or "blanket" insurance, is an alternative to traditional insurance management on construction projects. In a typical OCIP, the owner of a large construction project buys insurance that provides workers compensation, general liability, and other coverage for the organization as well as for the contractors and all other parties to the project. This is in contrast to the standard practice on construction projects, where contractors, subcontractors, engineering consultants, architects, construction managers, and the owner each buy their own insurance.

By using an OCIP, the owner (or the insurance broker) can negotiate with underwriters to obtain better terms than could individual project participants negotiating alone. OCIPs can also lower the overall project cost through centralized management of insurance claims and the establishment of a project-wide safety program. Under the Central Artery OCIP, the Project entered into a workers compensation agreement and a general liability agreement with the insurance carrier, AIG, and MHD.

The Central Artery OCIP agreements are a blend of purchased coverage and self-insurance. The purchased insurance includes \$200 million of coverage against the risk of catastrophic general liability losses, and coverage for workers compensation claims to the limits established by Massachusetts law. However, the Project self-insures against most losses on the Project because the deductibles on the purchased coverage policies are very high. Under the policy deductibles, the Project pays the first \$1 million per workers compensation claim (\$3 million per incident), and

\$2 million per general liability claim (\$6 million per incident). Because of the high deductibles, almost all claims to date have been paid by the Project, not AIG.

Funds to cover self-insured claims and expenses are placed in the trust accounts owned by MHD. The accounts are held at the State Street Bank in Boston, Massachusetts. The funds held in the trust are invested and managed by a subsidiary of the insurance carrier (AIG Capital Management Corporation).

AIG also provides the claims handling services for the Project, and withdraws funds from the trust accounts as needed to pay the claims below the deductible and other expenses. The insurance carrier was given a “security interest” in the funds in the trust accounts to the extent they are needed to cover incurred claims and expenses. AIG also shares in part of the investment income earned by the funds invested in the trust. Under the original agreements, MHD and the insurance company were to annually determine the appropriate amount needed as collateral against expected claims. The agreement also established procedures for adjusting the collateral annually based on the calculation, and specifically authorized the MHD to recover any excess from the trusts.

Prior Audit Coverage Identified Overbilling

The Project’s OCIP has been the subject of several reviews and audits. In 1996, a FHWA Task Team review identified OCIP overpayments and advised FHWA and the Project senior staff to use investment income funds to reduce the cost of the project. However, FHWA Division staff did not require the Project to withdraw the excess funds. In 1998, the Massachusetts State Auditor reported the insurance overpayments and recommended that the excess be reclaimed and used to pay current Project costs. Project management declined to implement the State Auditor’s recommendation stating, “the Trust fund now prudently anticipates the higher risks we face during current peak construction period.” The State Auditor concluded, “... the funding of a contingency that is unlikely to materialize is not prudent use of project funds, especially in light of the favorable claims being experienced under both [general liability and workers compensation] insurance programs.”

On May 24, 1999, we reported that MHD payment records showed that between 1992 and 1997, the Project paid the workers compensation and general liability premiums estimated at \$335.4 million. However, annual premium audits conducted by the insurance company found that the actual premiums due were only \$205.6 million, a difference of \$129.8 million, 90 percent of which were Federal funds. This overbilling occurred because the estimates used to set the premiums were based on a work schedule that anticipated using a large number of workers in the early years to complete the Project. That work schedule never materialized, so

the Project actually employed far fewer workers than originally estimated in calculating the premiums. In addition, from its beginning, the Project experienced far fewer claims than anticipated.

Rather than being returned to fund other Project costs, the overpayments were held in a trust owned by MHD. The Project planned to keep the overpayments and continue investing additional excess insurance payments through 2004. They projected that the reserve would grow to at least \$826 million. With the dissolution of the trust in 2017, these funds would be made available for other State highway projects. In March 2000, in response to the \$1.4 billion Project cost increase, a Federal Task Force conducted a review of the Project. The task force issued a report, which included a recommendation that the OCIP credits not be allowed as offsets to reduce the cost of the Project.

Trust documents indicated that the trust investment return rate was expected to be 6 percent. Using that rate, we estimated that the value of the overpayments and interest totaled about \$166.7 million. Since the Federal Government paid 90 percent of the cost of the program, we calculated that \$150 million of the overpayments and interest were Federal funds that should be returned. We recommended that FHWA recover the overpayments and interest and appropriately apply these amounts to other Project purposes. We also recommended that FHWA determine the Project's annual insurance reserve requirements and establish policy guidelines to ensure that future overpayments are recovered. On September 13, 1999, in response to the report findings and recommendations, FHWA agreed to the following:

1. The premium adjustments and interest related to these adjustments would be used to make scheduled OCIP workers compensation estimated premium payments due for the next policy year, starting November 1, 1999, and for the next policy year, beginning November 1, 2000.
2. All remaining premium adjustments in excess of the amount needed to make the payments specified in above item #1, plus any amount of the adjustments already used to make premium payments for policy years 1997-98 and 1998-99, will be immediately returned to the Project and used to pay Project costs, or credited to the State's Federal-aid account.
3. FHWA will issue a policy on insurance programs that ensures the Federal share of premium adjustments on highway projects is immediately applied to other Project costs or credited to the State's Federal-aid account, and reserve accounts do not exceed allowable amounts.

FHWA officials also agreed to conduct an actuarial study to determine the present value of liabilities related to outstanding claims. The data would provide more

precise estimates of the amounts actually needed to pay incurred claims.

Citing FHWA's agreement, a September 1999 Appropriations Conference Committee report¹⁴ directed the Secretary of Transportation to issue guidance to ensure (1) the Federal share of premium adjustments on all transportation projects is immediately applied to other project costs or returned to the U.S. Treasury and (2) reserve accounts balances for insurance programs are adjusted annually so that the reserves do not exceed the amount reasonably needed to pay outstanding claims.

¹⁴ Conference Report on House Resolution 2084, Department of Transportation and Related Agencies Appropriations Act dated September 30, 1999.

EXHIBIT C. AGREEMENT TO RESOLVE OCIP ISSUES DATED DECEMBER 10, 2001

Agreement to Resolve OCIP Issues And Allow Acceptance of CA/T Finance Plan Update

1. FHWA will issue a policy on Owner Controlled Insurance Programs (OCIPs) requiring that Federal participation in reserve funds be limited to the present value of incurred claims and other eligible costs as defined in OMB Circular A-87.
2. This new policy, as applied to the CA/T OCIP, will result in the disallowance of OCIP trust balances in excess of the actuarial valuation of incurred claims. This excess is estimated at \$133 million. The actual amount of disallowed excess Federal funds and the relative portions of principal and interest will be verified by March 31, 2002 using the 2001 actuarial assessment and an on-going MTA-sponsored audit of the CA/T Project trust. The DOT Inspector General will review of the results of the MTA-sponsored audit to ensure compliance with government auditing standards.
3. Disallowed Federal funds are to be withdrawn within 3 months of the date of this agreement. Interest will continue to accrue on the funds until they are withdrawn. That interest will also be withdrawn.
4. The disallowed Federal funds may be used for other CA/T project costs or transferred to the statewide transportation program. Principle amounts included in the disallowed funds have already been counted against the cap on Federal funds (\$8.549 billion) but interest has not. Any interest amounts used for the CA/T project will count against the cap on Federal funds.
5. In order to obtain DOT acceptance of the CA/T finance plan now, MTA will certify in the Finance plan that non-Federal funds will be used to replace any disallowed funds transferred to the statewide program.

Agreed on December 10, 2001

(Original signed by)

Kenneth M. Mead
Inspector General

(Original signed by)

Mary E. Peters
Federal Highway Administrator

EXHIBIT D. FHWA INTERIM OCIP POLICY



U.S. Department
of Transportation

**Federal Highway
Administration**

Memorandum

Subject: INFORMATION: Interim Owner Controlled
Insurance Program Policy

Date: January 8, 2002

Reply to: HIPA-30

From: King W. Gee
Program Manager, Infrastructure

CBU Program Managers
SBU Directors

Division Administrators

Background

Owner Controlled Insurance Programs (OCIPs) are an effective way to improve the safety of construction operations and reduce the cost of insurance on large projects. The basic operational features of an OCIP are: (1) the owner purchases insurance coverage (all or some specific elements) to cover all contractors and subcontractors on a project; (2) there is an integrated owner-contractor managed safety program on the project; and (3) claims are processed centrally. Overall, the use of an OCIP can save money on large projects through lower bulk insurance rates, improved safety management processes, and reduced disputes between contractors over who was responsible for a particular loss.

There are many variations in how an OCIP can be set up. For example, the project owner can purchase coverage, self-insure, or devise a program that blends the two. By retaining more of the risk (through self-insurance or higher deductibles) the owner can obtain lower premiums for the coverage actually purchased. When the insurance program contains a significant element of self-insurance (either a direct self-insurance program or a program with large deductibles) the owner is usually required to provide assurance they will have the money to make those long-term payments as

they come due. The State Insurance Agency (and the insurance company, when it pays claims and then recovers deductibles from the owner), may require the owner to provide a letter of credit or establish a reserve account to guarantee it will have the resources to meet its obligations.

The NCHRP is currently preparing a synthesis of best practices regarding the use of OCIPs on projects, and this report is scheduled to be released this winter. We have also procured consultant services to provide FHWA offices and our partners with best practices on the use of OCIPs on projects as well as programs. Upon the completion of this consultant activity, FHWA will issue more extensive information and guidance on how to establish OCIPs.

However, there is a need for immediate interim policy regarding the appropriate use of Federal funds.

Policy

Federal aid funds can be used to participate in OCIPs on Federal-aid projects. OMB Circular A-87 provides guidance and establishes limits on Federal reimbursement of insurance costs. Typical costs that may be eligible for Federal-aid funding include:

1. Costs incurred in the preparation of an OCIP plan, including the procurement of consultant services, the establishment of a letter of credit or the establishment of reserve accounts, and the selection of an insurance provider.
2. Premiums for purchased coverage, up to reasonable limits consistent with standard industry practices.
3. Costs incurred because of losses not covered under nominal deductible insurance coverage, and minor losses not covered by insurance, such as spoilage, breakage, and the disappearance of small hand tools, which occur in the ordinary course of operations.
4. Contributions to reserve accounts to pay allowable retained costs (e.g., self-insured losses/losses under deductibles, and associated expenses) provided:
 - (a) The reserve account balance does not exceed the actuarially projected value of incurred claims. Incurred insurance claims include claims:
 - (a) submitted and adjudicated but not paid;
 - (b) submitted but not adjudicated;
 - (c) incurred but not submitted.These amounts should be determined not less than annually by an independent actuary.
 - (b) For incurred claims that will pay out in future years (e.g., disability),

the reserve is limited to the present value of the expected payment. The difference between the present and future value of the payment is made up by the interest earned on the reserve account, thereby reducing the total cost of the program to the owner and the Federal Government.

- (c) The reserve account balance is adjusted annually, as necessary, to ensure compliance with this policy.

Costs that will typically not be eligible for Federal-aid funding include:

1. Any costs or reserve amounts for damage to Federal property.
2. Actual losses that could have been covered by permissible insurance (including self-insurance).
3. Future costs (except for the present value of incurred claims as described above).
4. Insurance that protects contractors against losses for the cost of correcting the contractor's own defects in materials or workmanship.

Insurance refunds must be credited against insurance costs in the year the refund is received.

If annual actuarial reviews of reserve accounts disclose excess balances, the Federal share of the excess amount shall be promptly removed from the reserve account(s) and applied to other allowable project costs or returned to the State's Federal-aid account.

EXHIBIT E. CONTRIBUTORS TO THIS REPORT

THE FOLLOWING INDIVIDUALS CONTRIBUTED TO THIS REPORT.

<i>Name</i>	<i>Title</i>
Theodore P. Alves	Deputy Assistant Inspector General for National Transportation Infrastructure Activities
Michael D. Gulledge	Program Director
Peter Babachicos	Project Manager
William Lovett	Auditor
John Hannon	Auditor
Laurence Burke	Analyst

APPENDIX I. FHWA COMMENTS

U.S. Department of Transportation
Federal Highway Administration

Memorandum

Subject: ACTION: Response to OIG Revised Draft Report on Actions Taken to Recover Excess Reserves From the Central Artery/Tunnel Project's Owner Controlled Insurance Program, Project No. 01130061000 **Date:** June 10, 2002

From: Mary E. Peters /S/M. Peters Administrator **Reply to:** HIPA

To: Kenneth M. Mead Inspector General (JA-30)

The Federal Highway Administration (FHWA) has reviewed the draft revised report issued by your Office (OIG) on May 7, 2002, concerning the Owner Controlled Insurance Program (OCIP) on the Central Artery/Tunnel Project (CA/T). The comments offered below are compiled from our Massachusetts Division Office and our Office of Program Administration.

Based on the resolution of OCIP issues with the OIG and the Massachusetts Turnpike Authority as part of the 2001 CA/T Finance Plan acceptance, we do not intend to address each finding in the draft audit report. However, we wish to reiterate our fundamental position that FHWA approved the OCIP (considered large deductible third-party vendor provided insurance coverage) in 1992 as an eligible construction cost under Title 23 and regulations under which FHWA operated which allowed reserves to cover claims through the end of construction. Under this definition, FHWA took the necessary steps to ensure the reserves were not over-funded. With our recent issuance of an interim OCIP policy in coordination with your Office, our specific disagreements with OIG become moot on future projects that use an OCIP. Based on this policy we can accept the recommendations in the draft audit report. Our specific comments with regard to each recommendation follow:

1. Recommendation: Ensure the Project completes the withdrawal of \$133 million in excess Federal reserves held in the OCIP trust and either applies the funds to other allowable costs or returns the money to the Federal-aid accounts.

Response: The CA/T project will be withdrawing \$133 million from the OCIP shortly after passage of State Transportation Infrastructure Fund legislation required for final approval of the CA/T 2001 Finance Plan. It is expected that this will happen prior to Massachusetts Legislature adjournment in July 2002. The monies will be returned to the Federal-aid account and re-obligated for other eligible project costs.

2. Recommendation: Require the Project to complete the ongoing independent audit of the Central Artery OCIP trust accounts to verify the account balances and interest accrued by April 30, 2002. To ensure the audit complied with Government auditing standards, the audit results will be subject to review by the OIG.

Response: The independent audit of the CA/T OCIP trust account for the Workers Compensation Fund has been completed and the report released. The OIG has been provided a copy of the report and is undertaking a review of the working papers used to develop the audit. The independent audit of the smaller General Liability Fund is targeted for completion by the end of June. The FHWA will assure that the account balances and interest computations are done through the time that Federal funds are maintained in the OCIP.

3. Recommendation: Cease Federal participation in the OCIP unless workers compensation and general liability agreements are revised to be consistent with Federal regulations and the interim policy.

Response: No further Federal participation in the OCIP is contemplated and the State intends to withdraw the existing balance of Federal funds from the OCIP before the end of the fiscal year.

4. Recommendation: Issue a final OCIP policy within 30 days.

Response: The development of a final FHWA OCIP policy will address several issues that will require assessment of industry practices and procedures and additional coordination with other Federal Agencies (the Office of Management and Budget and the Department of the Treasury). We do not believe that these activities will enable us to issue the final policy within 30 days. Among these issues are the determination of the appropriate period of time to gain a safety history at the beginning of a project upon which to base premiums and the proper length of time to perform actuarial determinations of reserve balances.

In addition to the responses to the specific recommendations, FHWA would like to address some additional points in the report.

We are unsure of the relevance of your citation, at the bottom of page 11 and into page 12, that an FHWA Official wrote that FHWA would not attempt to meet the July 2001 completion date for the issuance of the OCIP policy. The report stated, at the beginning of the paragraph, that the FHWA schedule for completion of the OCIP guidance and policy statement was in February 2002 due to the original contractor backing out of performing their task in May 2001. Our Headquarters Office was advising the Division that a major interruption had occurred and FHWA would not be able to meet its initial completion date. In fact, the new contractor was not brought on board until late September 2001.

Lastly, you describe that the new/renewal agreements negotiated by the State with AIG were in conflict with Federal regulations. The FHWA has not approved these agreements nor is it our intent to do so. As you state later in the report, Massachusetts intends to remove all Federal funds from the OCIP in the near future.

Thank you for the opportunity to comment on this draft report. It is our intent to execute all recommendations as quickly as possible and bring closure to all issues of Federal interest associated with the OCIP. Please feel free to contact me on any issues associated with this project.

APPENDIX II. CA/T PROJECT COMMENTS



Massachusetts Turnpike Authority
Central Artery/Tunnel Project

June 6, 2002

Kenneth Mead, Inspector General
United States Department of Transportation
400 Seventh Street, SW - Room 9210
Washington, DC 20590

RE: DOT IG Draft OCIP Report

Dear Mr. Mead:

Thank you for the opportunity to review and comment on the draft report entitled "Actions Taken to Recover Excess Reserves From the Central Artery/Tunnel Project's Owner Controlled Insurance Program."

As you are aware, in the course of addressing the issues raised by the DOT IG regarding the FFY 2001 CA/T Project Finance Plan, we furnished to both the DOT IG and FHWA substantial material responding to the DOT IG's specific concerns regarding the Project's Owner Controlled Insurance Program (OCIP). Among other things, we recently advised that the OCIP had been structured and funded in accordance with prudent risk management practices, that the Project obtained FHWA approval at each key decision point, and that the OCIP had been implemented in accordance with applicable laws and regulations.

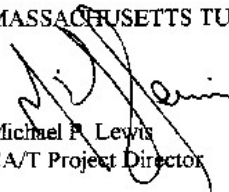
In addition, over the past few years, the CA/T Project has worked in good faith with FHWA and the DOT IG to address concerns the DOT IG raised in its 1999 audit of the OCIP, including conducting a peer review of the OCIP, cooperating with the FHWA (through AON) review of the OCIP, conducting an updated actuarial review, implementing CPA audits, and making appropriate funding and structural modifications as a result of these reviews and assessments. Finally, in connection with the Finance Plan, we again worked diligently to fashion a solution to the DOT IG's continuing concerns regarding the funding and structuring of the OCIP.

For the reasons stated above, we do not agree with the underlying reasoning and conclusions of the draft report, however, we share the interest of all parties to bring the issues of the OCIP to final closure. Accordingly and consistent with our recent Finance Plan adjustments, we have agreed to work with FHWA to implement all recommendations of this report as efficiently and expeditiously as possible. We will ensure that the OCIP is managed in full conformance with the new policies that are being developed by the FHWA. It is also a priority of the Project to remove all remaining federal funds from the OCIP Trust.

Again, we appreciate the opportunity to comment on the draft report. If you have any questions, please feel free to contact me.

Sincerely,

MASSACHUSETTS TURNPIKE AUTHORITY



Michael P. Lewis
CA/T Project Director

2002-874L
AD-2.4

cc: Matthew Amorello, Chairman

Addendum – Textual description of the diagram of page 8 of the audit.

Note: this addendum was not included with the report submitted to Congress.

How Inflated Workers Compensation Premiums How Inflated Workers Compensation Premiums Overfunded the Trust

The illustration shows how the inflated workers compensation premiums overfunded the trust. It shows that premiums consist of payments made to insurance company for insurance coverage of claims over \$1 million deductible. The other portion of the premium provides for the development of insurance reserves to pay claims below the deductible which is deposited into the trust. Next shows how claims payments were expected to be used. The first 78 percent was for anticipated claims with the remaining 22 percent to be used as a buffer for higher than expected claims, which is to be returned once claims are known. Next, it shows that in 1992, the state law significantly reduced claim amounts therefore the level of reserves needed were lower due to a lower than expected claims rate. Lastly, this resulted in excess reserves. The lower claims rate of 40 percent allowed the trust to accumulate a reserve of 60 percent rather than the 22 percent buffer. Therefore, in 1999, the Project estimated that the fund will grow to \$826 million by 2017. These excess funds could then be used for non insurance purposes.