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United States General Accounting Office
Washington, DC 20548

February 27, 2003

The Honorable Carolyn McCarthy
House of Representatives

Subject: *Retiree Health Benefits at Selected Government Contractors*

Dear Ms. McCarthy:

Since World War II, some employers have voluntarily sponsored postretirement health plans as a benefit to their employees. According to government sources, these health plans constitute the primary source of health coverage for retirees aged 55 to 64 and supplemental coverage for nearly one third of retirees aged 65 or older with Medicare coverage. However, with costs already amounting to hundreds of millions of dollars for large employers and the baby boom generation nearing retirement age, employers are taking actions to control the costs of providing these benefits.

In your letter of April 3, 2002, you expressed concerns that government contractors may be receiving undeserved financial benefits by reducing retiree health benefits that were paid for under government contracts. Because data limitations precluded us from determining whether a trend exists among government contractors to reduce postretirement health benefits, as agreed with your office we selected on a nonstatistical basis three of the largest government contractors to determine (1) what changes, if any, they had made to their retiree health benefit plans and (2) the extent to which government agencies oversee retiree health benefit costs.

The three contractors we reviewed—Lockheed Martin Corporation, Northrop Grumman Corporation, and Raytheon Company—accounted for about 14 percent of all federal contracts awarded in fiscal year 2001 and collectively incurred about $756 million in postretirement health benefits-related costs between 1999 and 2000 (the 2 most recent years for which data are available). Because we selected the contractors on a nonstatistical basis, our results cannot be generalized to all government contractors. However, we obtained data on general trends in employer-sponsored retiree health benefits from two widely cited surveys—conducted by Mercer Human Resource Consulting (Mercer),[1] and Kaiser Family Foundation and Health Research and Educational Trust (Kaiser/HRET). We determined what actions the government takes to oversee retiree health benefit costs at the selected contractors by interviewing officials from the Defense Contract Audit Agency (DCAA) and Defense Contract Management Agency (DCMA)—the two principal agencies responsible for overseeing the selected contractors—and reviewing various audit reports and analyses. For more on our scope and methodology, please see the enclosure.

[1] Prior to April 2002, Mercer was known as William M. Mercer, Incorporated.

Results in Brief

Each of the three contractors we reviewed had adopted various strategies to control retiree health benefit costs, including restricting eligibility; increasing premiums, deductibles and copayments; and limiting future commitments. These actions are consistent with national trend data reflected in the Mercer and Kaiser/HRET surveys. These surveys show decreases in the percentage of large employers[2] offering retiree health benefits and suggest that the erosion of such benefits will likely continue. For example, the most recent Kaiser/HRET survey, issued in 2002, reported that about one-third of large employers offer retiree health benefits—compared to almost half in 1991. The surveys' data do not distinguish between government contractors and those whose business base is nonfederal in nature.

DCMA and DCAA closely monitored postretirement health benefits to ensure charges to the government were made in compliance with federal regulations. As part of their oversight efforts, the two agencies performed risk assessments and conducted regular reviews of the contractors' actual and projected postretirement health benefits costs and the assumptions underlying future cost projections. For the 2 years covered in our review, neither DCAA nor DCMA found any significant problems with the contractors' actual or projected postretirement health benefits costs. For example, DCAA took no exceptions to the projected costs reflected in the contractors' pricing proposals and took exception to less than 1 percent of the $756 million in postretirement health benefits costs incurred by the contractors over the 2-year period.

Background

Government contractors offering postretirement health benefits are subject to various standards and regulations that govern how benefit costs are to be accounted for, how they are allocated among their business units, and what conditions must be met before such costs will be reimbursed by the government. The Department of Defense (DOD) has primary responsibility for ensuring that the three contractors we reviewed complied with these various requirements. To assist DOD procurement officials, DCMA has a specialized review unit—the Contractor Insurance/Pension Review Center—to provide, among other services, technical assistance in reviewing contractor postretirement health benefits plans. Similarly, DCAA provides auditing, accounting, and financial advisory services in connection with the negotiation, administration, and settlement of contracts. At contractors with both defense and nondefense government contracts, other federal agencies often rely on DOD to ensure that their interests are protected.

Employers have several options on how to account for their postretirement health benefits costs. According to DCAA and DCMA officials, most contractors use the "pay-as-you-go"—or cash—method. Under this method, contractors only record the actual benefit costs they pay on their retired employees behalf. The other principal accounting method used is accrual accounting. Under this method, contractors record the amount of the benefits earned by current employees, even though the benefits will not be paid until the employees retire. Under either method, contractors generally accumulate their postretirement health benefits costs in an overhead account. These costs are then

[2] Large employers are much more likely to offer retiree health benefits. For example, a recent Kaiser/HRET study states that retiree health benefits are offered by 34 percent of large firms (200 or more workers) compared to just 5 percent of all small firms (less than 200 workers). Mercer considers large employers as those firms having at least 500 employees.

allocated to their various business units and in turn to both government and non-government contracts. As such, postretirement health benefits costs are not direct contract costs; rather, they are considered an indirect expense.

Under the Federal Acquisition Regulation, the government will reimburse postretirement health benefits costs if such costs have been properly charged to government contracts. However, because contractors using the accrual method of accounting will not pay post-retirement health benefits to current workers until they retire, the regulations require contractors to deposit the amount they intend to claim for reimbursement with an insurer or other trustee that maintains a separate account exclusively to provide benefits to retirees. If contractors subsequently reduce or eliminate benefit programs and receive funds back from these accounts, they must refund to the government a fair share of any amount that had been paid for by the government.

Actions Taken at Selected Government Contractors to Control Benefit Costs Mirror National Trends

The contractors we reviewed have taken a number of actions to control or manage the cost of providing health benefits to their retirees. These actions—such as reducing benefits; increasing premiums, deductibles, or copayments; or eliminating benefits for new employees—were consistent with the actions taken by large employers, in general, over the past decade.

The three contractors we reviewed have taken actions to manage and control postretirement health benefits costs. These actions include the following:

- One of the 3 contractors decided in 1992 to impose a spending cap on its retiree health benefits payments. Implemented on January 1, 1999, this spending cap was equal to the actual cost the contractor incurred in 1998 and made retirees responsible for any additional premium increases. This contractor also eliminated postretirement health benefits for employees hired after 1992.

- Another of the 3 contractors stopped providing retiree health benefits to all newly hired employees in 1995. In addition, effective January 1, 2003, this contractor requires retirees covered by a health plan acquired through a merger to begin contributing to their plan premium.

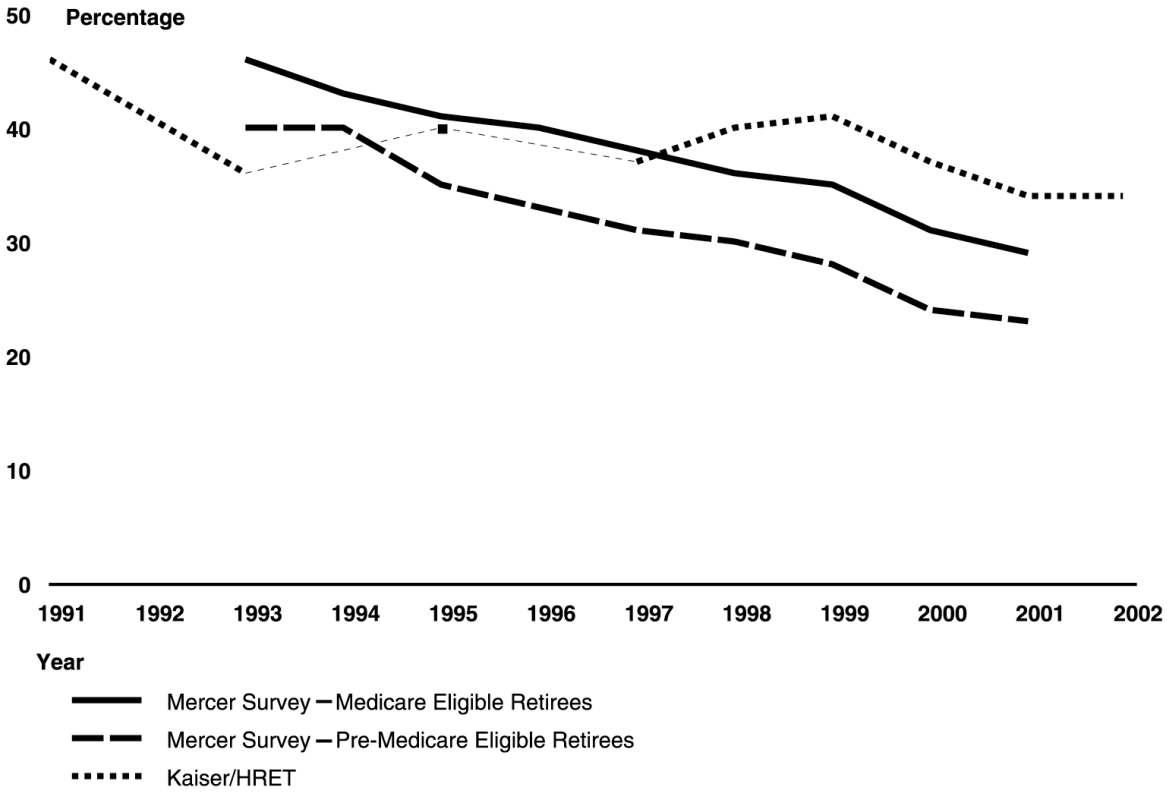
- The third contractor increased retirees' premiums, copayments and deductibles. For example, the copayment retirees must pay for an office visit on one of its plans doubled from $10 to $20.

These actions are similar in nature to those reported in surveys of large employers in general. For example, in November 2001, we testified[3] that the availability of employer-sponsored retiree health benefits has declined over the last decade. Surveys conducted by Mercer and Kaiser/HRET show decreases in the percentage of large employers offering retiree health benefits and suggest that the erosion of such benefits will likely continue. For example, the Kaiser/HRET survey reported that while 46 percent of large

[3] U.S. General Accounting Office, *Retiree Health Insurance: Gaps in Coverage and Availability*, GAO-02-178T (Washington, D.C.: Nov. 1, 2001).

employers offered retiree health benefits in 1991, only 34 percent offered such benefits in 2002 (see fig. 1). Employers attempted to control their costs by (1) reducing benefits, (2) increasing premiums, deductibles, or copayments, or (3) eliminating benefits for new employees. These surveys' data, however, do not distinguish between government contractors and those whose business base is nonfederal in nature.[4]

Figure 1: Proportion of Large Employers Offering Retiree Health Benefits



Source: Kaiser/HRET employer benefit surveys from 1991-2002, and Mercer Human Resource Consulting surveys from 1993-2001.

Notes: The Mercer data represent retiree health benefits offered by employers with at least 500 employees, whereas the Kaiser/HRET data represents employers with at least 200 employees.

The Kaiser/HRET survey did not report on employer sponsorship of retiree health benefits in 1994 and 1996. KPMG Peat Marwick conducted the survey for the Kaiser/HRET between 1993 and 1997.

DOD Agencies Closely Monitored Retiree Health Benefit Costs at Selected Contractors

DCAA and DCMA closely monitored the contractors' postretirement health benefits costs at the contractors we reviewed to ensure that costs charged to the government were in compliance with federal regulations. For the 2 years covered in our review, neither DCAA nor DCMA found any significant problems with the contractors' actual or projected postretirement health benefits costs.

For the three contractors we reviewed, DCMA and DCAA performed risk assessments and conducted regular reviews of the contractors' actual and projected postretirement

[4] The contractors we reviewed had both federal and nonfederal customers, but each ranked among the top 5 of government contractors based on dollars awarded in fiscal year 2001. Net sales to the U.S. government accounted for 78 percent of the contractor's calendar year 2001 business base at Lockheed Martin and at Northrop Grumman, and for 67 percent at Raytheon.

health benefits costs and the assumptions underlying future cost projections. For example, DCMA assessed the accuracy of the contractors' actuarial projections of postretirement health benefits costs, and assisted DCAA in evaluating forward pricing rate proposals.[5] DCAA performed audits, annually or more frequently, of the contractors' actual and projected postretirement health benefits costs and verified that the contractors had made payments to appropriate trust accounts.

Our review of DCAA and DCMA postretirement health benefits-related reports found that both agencies identified only minor problems with the contractors' postretirement health benefits costs. For example, DCAA took exception to less than 1 percent of the $756 million in postretirement health benefits costs incurred by the contractors in calendar years 1999 and 2000—the 2 most recent years for which DCAA had completed audits. In addition, DCAA did not question any projected costs included in the contractors' forward pricing rate proposals. While DCMA questioned some of the assumptions used to project future costs, it noted that the impact would be negligible.

Agency Comments and Our Evaluation

DOD officials notified us via electronic mail that they had no comments on the draft report we provided to them.

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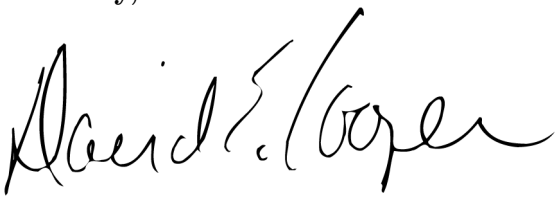
We are sending copies of this letter to the Secretary of Defense; the Director, Defense Contract Audit Agency; the Director, Defense Contract Management Agency; and interested congressional committees. We will also provide copies to others on request. This letter will also be available at no cost on the GAO Web site at http://www.gao.gov.

If you have questions about this letter, please contact me on (617) 565-7500 or Timothy DiNapoli at (202) 512-4841. Key contributors to this assignment were Kenneth Patton, Ralph Roffo, and Jeffrey Rose.

Sincerely,



David E. Cooper
Director, Acquisition and Sourcing Management

[5] Forward pricing rate proposals are contractor estimates of indirect costs to be used in pricing government contracts.

Scope and Methodology

To illustrate the type and nature of changes government contractors made to their postretirement health benefits plans, we selected on a nonstatistical basis three of the five largest government contractors, based on value of contracts awarded during fiscal year 2001: Lockheed Martin Corporation, Northrop Grumman Corporation, and Raytheon Company. We obtained information on each organization's postretirement health plans and discussed with cognizant officials the changes they made to their plans. Because we did not select the contractors on a statistical basis, our results cannot be generalized to all government contractors. However, we obtained updated information on the general trends in employer-sponsored retiree health care benefits from publicly available private sector consultant data.

To determine the extent of the government's oversight of retiree health benefit costs at these contractors, we interviewed officials from the Defense Contract Audit Agency (DCAA) and Defense Contract Management Agency (DCMA). We discussed (1) how actual and projected postretirement health benefits costs are reflected in government contracts, (2) how they monitor and evaluate these costs, and (3) what actions they take to protect the government's interest. We also reviewed the most recent audit reports relevant to the selected contractors' postretirement health benefits plans, including those concerning the contractors' forward pricing agreements proposals and incurred cost submissions. The incurred cost audit reports covered calendar years 1999 and 2000. Forward pricing rate proposal audit reports covered up to 2006. We did not independently assess the reliability or accuracy of the data relied on by DCAA and DCMA during their audits. We also interviewed officials from the Departments of Defense and Labor, respectively, and the Office of Federal Procurement Policy.

Our work was performed between August 2002 and January 2003 in accordance with generally accepted government auditing standards.

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