

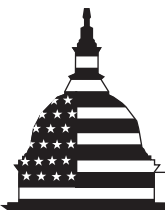
GAO

Report to the Ranking Member,
Subcommittee on Energy and Water
Development, Committee on
Appropriations, U.S. Senate

April 2011

DEPARTMENT OF ENERGY

Progress Made Overseeing the Costs of Contractor Postretirement Benefits, but Additional Actions Could Help Address Challenges



GAO

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Highlights of [GAO-11-378](#), a report to the Ranking Member, Subcommittee on Energy and Water Development, Committee on Appropriations, U.S. Senate

Why GAO Did This Study

The Department of Energy (DOE) relies on contractors to conduct its mission activities. DOE reimburses these contractors for allowable costs, including the costs of providing pension and other postretirement benefits, such as retiree health care plans. Since the economic downturn, DOE has had to devote significantly more funding toward reimbursing these benefit costs, in part because of a decline in interest rates and asset values that has increased contractor pension contributions. In a challenging budgetary environment, further growth in these costs could put pressure on DOE's mission work.

GAO was asked to report on (1) the level of control DOE has over contractor pension and other postretirement benefit costs under its current business model and (2) the changes DOE has adopted since the national economic downturn to manage those costs and the extent to which those changes have enhanced its approach. To do so, GAO reviewed relevant laws, regulations, and DOE guidance; analyzed agency financial data; and interviewed officials.

What GAO Recommends

GAO recommends, among other things, that DOE comprehensively review how it manages contractor postretirement benefit costs and define criteria for evaluating contractor requests to contribute more than the minimum to their pension plans. DOE agreed with three of GAO's recommendations but disagreed with the need to define such criteria.

View [GAO-11-378](#) or key components. For more information, contact Mark Gaffigan at (202) 512-3841 or gaffiganm@gao.gov.

April 2011

DEPARTMENT OF ENERGY

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What GAO Found

Under its current business model, DOE has limited influence over contractor pension and other postretirement benefit costs. For example, contractors sponsor benefit plans and, as a result, control the types of benefits offered to their employees and the strategies for investing pension plan assets. DOE nevertheless ultimately bears the investment risk incurred by the contractors. Moreover, external factors beyond both DOE's and the contractors' control, such as economic conditions and changes in statutory requirements, can significantly affect benefit costs. For example, the investment performance of plan assets can affect pension contributions, while changes in health care law can affect postretirement benefit payments. Even with these constraints, however, DOE can exercise some influence over contractor pension and other postretirement benefit costs through its oversight efforts, reimbursement policy for contractor benefit costs, and contract requirements. Still, the department will ultimately have to reimburse the cost of contractor pension benefits that have already been accrued.

Since the economic downturn deepened in 2008, DOE has taken steps to enhance its management of contractor benefit costs—particularly for contractor pensions—but has not comprehensively reviewed its approach to managing its contractors' other postretirement benefit costs, such as retiree health care coverage. In addition, DOE has not added agencywide information on the costs of its contractors' other postretirement benefits to its annual budget request. As a result, DOE may be delayed in identifying options that might better address the growth of its reimbursement costs and may not provide important information to Congress that could inform annual funding decisions. Moreover, while DOE has, for the most part, continued to use the same reimbursement policy and contract requirements from before the economic downturn, it lacks complete guidance on how program offices should evaluate contractor requests to contribute more than DOE's minimum requirement to their pension plans. DOE is therefore unable to ensure that its offices decide on contractor requests on the basis of consistent criteria reflecting departmentwide goals for managing contractor pension costs. In addition, DOE's existing process for having contractors align their benefit packages with DOE's reimbursement standard is incomplete. Specifically, DOE lacks a comprehensive timetable for when contractors must modify benefit packages whose values exceed DOE's standard. As a result, only 1 of the 16 contractors with benefit packages exceeding DOE's standard for the most recent evaluation period is expected to bring its benefits in line with that standard. Further, DOE guidance allows contracting officers to waive the requirement for contractors to correct benefit packages exceeding DOE's reimbursement standard, but does not detail the criteria contracting officers should follow in making that decision or require a review by DOE headquarters. As a result, some contractors may continue for an undefined period to accrue liabilities and be reimbursed by DOE for benefit packages exceeding the department's reimbursement standard.

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Abbreviations

DOE	Department of Energy
ERISA	Employee Retirement Income Security Act of 1974
NNSA	National Nuclear Security Administration

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Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

April 29, 2011

The Honorable Lamar Alexander
Ranking Member
Subcommittee on Energy and Water Development
Committee on Appropriations
United States Senate

Dear Senator Alexander:

The Department of Energy (DOE) spends about 90 percent of its annual budget on contracts, making it the largest civilian contracting agency in the federal government. Under its decades-old business model, the department relies extensively on contractors to manage and operate its sites and carry out the bulk of its national security, environmental cleanup, and research and development missions. As of September 2010, DOE has 46 such contracts with private companies and nonprofit organizations, including universities. Under the terms of these contracts, DOE reimburses contractors for the allowable costs of performing work, including the costs of providing pension and other postretirement benefits—such as health care, dental, and life insurance benefit plans—to nearly 200,000 current and former contractor employees and their beneficiaries.¹ The contractors sponsor these benefit plans, but DOE is ultimately responsible for reimbursing contractors for allowable plan costs.

Since the economic downturn deepened in 2008, DOE has had to devote significantly more funding to reimbursing contractors for the cost of these employee pension and other postretirement benefits—in part because of a decline in interest rates and asset values, which has increased the amount contractors have needed to contribute to their pension plans. In fiscal year 2009, the department reimbursed \$750 million in contractor pension costs, more than double the amount it had reimbursed in fiscal year 2008 and significantly more than it had budgeted for. According to DOE documents,

¹Employee pension benefits can include, among others, participation in defined benefit and defined contribution plans. In this report, we use the term “pension benefits” to refer to benefits provided by defined benefit plans unless specifically noted. We focus on defined benefit plans because DOE’s reimbursement costs for those plans have significantly increased since 2008. For information on the differences between defined benefit and defined contribution plans, see GAO, *Answers to Key Questions about Private Pension Plans*, [GAO-02-745SP](#) (Washington, D.C.: Sept. 18, 2002).

this increase was driven in large part by a drop in the interest rate used by contractors to calculate their pension plan liabilities, as well as poor asset performance due to market declines. At the same time, reimbursement costs for its contractors' other postretirement benefits grew by 10 percent, to \$389 million. Both costs remained at similarly high levels in 2010 and, according to recent projections, may increase in coming years. While these contractor benefit costs represent only a portion of total contractor compensation, further growth in these costs in an increasingly challenging budgetary environment could put pressure on the funding available for DOE's mission-related activities.

We have previously reported on the challenges DOE faces in managing the costs of its contractors' pension and other postretirement benefits. In 2004, we noted that these costs were significant and growing and recommended that DOE improve its oversight by instituting systematic management review of contractor benefit data, extending requirements for contractors to regularly assess the value of their benefit packages, performing alternative procedures where such an extension was not practical, and incorporating a focus on long-term costs and budgetary implications of decisions pertaining to each component of contractor benefit programs.² We later found that DOE did not always require contractors to modify benefit packages that substantially exceeded the value of their competitors' benefits, potentially adding billions of dollars in long-term costs that DOE would ultimately have to reimburse.³ In 2008, we reported that DOE had taken actions to address the cost of benefits contractors offered to new employees, but that those actions were not expected to substantially affect the department's contractor pension and other postretirement benefit costs for the next 20 to 30 years, since

²GAO, *Department of Energy: Certain Postretirement Benefits for Contractor Employees Are Unfunded and Program Oversight Could be Improved*, [GAO-04-539](#) (Washington, D.C.: Apr. 15, 2004). As of March 2011, we classified one of these four recommendations as having been implemented, specifically, our recommendation that the department extend, to the degree practical, the requirements for contractors to regularly assess the value of their benefit packages.

³GAO, *Department of Energy: Additional Opportunities Exist for Reducing Laboratory Contractors' Support Costs*, [GAO-05-897](#) (Washington, D.C.: Sept. 9, 2005).

incumbent employees would continue to earn benefits under existing plans.⁴

In this context, you asked us to review DOE's approach to managing its contractors' pension and other postretirement benefit costs. Accordingly, this report examines (1) the level of control DOE has over contractor pension and other postretirement benefit costs under its current business model and, (2) within that model, the changes DOE has adopted since the national economic downturn and the extent to which these changes have enhanced its approach to managing contractor pension and other postretirement benefit costs.

To examine the level of control DOE has over contractor pension and other postretirement benefit costs under its current business model, we reviewed relevant laws, regulations, contract provisions, and DOE guidance to identify contractor and department responsibilities for contractor benefit plans. For context, we interviewed DOE headquarters officials and site officials responsible for overseeing contractor operations at six facilities—East Tennessee Technology Park, Los Alamos National Laboratory, Oak Ridge National Laboratory, Sandia National Laboratories, the Savannah River Site, and the Y-12 National Security Complex—and met with representatives of the contractors responsible for managing and operating those facilities. We selected this nonrepresentative sample to provide illustrative examples of such factors as contractor pension plans with varying funding levels, contractor postretirement health care plans with a range of statuses, and facilities overseen by different program offices. To obtain additional insight, we also met with officials from the Department of Defense, the National Aeronautics and Space Administration, and the National Institutes of Health to identify how those agencies manage contractor benefit costs at government-owned, contractor-operated facilities and how their approaches compare with DOE's. We selected this nonrepresentative sample of agencies on the basis of the amount they have spent on contracts for professional, scientific, and technical services at government-owned, contractor-operated facilities during the last 5 years. According to Department of Defense officials, a small percentage of the department's annual budget is spent on contractors for government-owned, contractor-operated facilities. In fiscal year 2010, the National Aeronautics and Space Administration spent \$1.45

⁴GAO, *Department of Energy: Information on Its Management of Costs and Liabilities for Contractors' Pension and Postretirement Benefit Plans*, [GAO-08-642R](#) (Washington, D.C.: June 19, 2008).

billion, or about 8 percent, and the National Institutes of Health expects to have spent about \$460 million, or about 1.5 percent, of their respective annual budgets on contracts for government-owned, contractor-operated facilities. These proportions contrast with DOE's spending about 90 percent, or \$22 billion, of its annual budget on contracts to operate its facilities. Further, we analyzed selected budget, financial, and actuarial data on DOE contractor pension and other postretirement benefit plans to determine cost and liability trends and summarize plan characteristics. We interviewed knowledgeable agency officials about the source of the data and the controls in place to maintain their integrity and found the data to be sufficiently reliable for the purposes of our report. To examine the changes DOE has adopted to enhance its approach since the national economic downturn, we synthesized information from DOE documentation on these changes, as well as information gathered during our interviews. We also analyzed selected DOE contract data and the department's budget requests to Congress for fiscal years 2009 through 2012, as well as the contractors' benefit assessment studies and selected reports to DOE on the status and management of their pension plans.

We conducted this performance audit from May 2010 through April 2011, in accordance with generally accepted government auditing standards. These standards require that we plan and perform the audit to obtain sufficient and appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides such a reasonable basis for our findings and conclusions based on our audit objectives.

Background

DOE's business model relies on contractors to carry out the bulk of the department's mission activities through management and operating contracts and other site contracts for operations at DOE-owned facilities, while employing federal officials to set mission objectives and provide contract oversight. This business model dates from the Manhattan Project, when federal officials contracted with private companies and universities to develop and produce the atomic bomb. Under this business model, contractors manage and operate DOE facilities—including research laboratories, production and test facilities, and nuclear waste cleanup and storage facilities—located throughout the country. Generally, DOE requires these contractors to be corporate entities formed for the specific purpose of managing and operating a facility and requires the contractors to integrate their accounting systems and budget processes with those of the department. DOE also generally requires contractors that take over a contract to hire the existing contractor workforce at a facility. As a result,

with the exception of top managers, the workforce at a facility generally remains in place despite changes in contractors. DOE oversees contractors' activities through its headquarters program offices—primarily the National Nuclear Security Administration (NNSA), the Office of Environmental Management, and the Office of Science—and site offices located at each facility.⁵

Under its business model, DOE reimburses contractors for the allowable costs of employee compensation, including benefits such as pension and other postretirement benefits. DOE is ultimately responsible for reimbursing its contractors for the cost of these benefit plans, and reports a liability or asset in its financial statements for the funded status—that is, plan obligations minus plan assets—of these benefit plans.⁶ When site contracts are recompeted or expire, it is DOE's policy to ensure the continuation of these benefits for incumbent contractor employees and eligible retirees by, for example, requiring the transfer of benefit plan sponsorship responsibilities to a successor contractor or related company.

Although other federal agencies use contractors to operate facilities and reimburse those contractors for their allowable benefits costs, DOE is unique in the percentage of its budget that goes to site contractors. For example, while the National Institutes of Health funds a contractor-operated research facility and requires the facility contractor to assume sponsorship of existing employee benefit plans, the agency devotes only about 1.5 percent of its budget toward this contract. In contrast, 90

⁵NNSA was established in 2000 as a separately organized agency within DOE. It is responsible for the nation's nuclear weapons, nonproliferation, and naval reactors programs. 50 U.S.C. § 2401.

⁶For purposes of describing DOE contractor pension liabilities in a consistent format, we use the "projected benefit obligation," which is a liability measure that projects pension benefit obligations in accordance with U.S. generally accepted accounting principles. Projected benefit obligations reflect, as of a given date, the actuarial present value of all benefits attributed by the plan's benefit formula to employee service rendered before that date and are measured using assumptions that include future compensation levels if the pension benefit formula is based on those future compensation levels. Plan assets are usually stocks, bonds, and other investments that have been segregated and restructured (usually in a trust) to provide for pension benefits. The amount of plan assets includes both employer and employee contributions and amounts earned from investing the contributions, minus benefits paid. For other postretirement benefits, the counterpart to the projected benefit obligation is the "accumulated projected benefit obligation." Contractors use certain assumptions when calculating the amounts to be incorporated into DOE's financial statements on other postretirement benefits. These assumptions include medical and dental trend rates, discount rates, and mortality assumptions.

percent of DOE's budget goes toward such contracts. As a result, a large increase in reimbursement costs for contractors' employee benefits is more likely to have a significant impact on DOE's budget than a similar increase would for agencies devoting a smaller percentage of their budget toward contracts for operating government-owned facilities.

DOE's contractors sponsor pension plans for their employees, including both traditional pension plans, known as "defined benefit" plans, and 401(k) or similar plans, known as "defined contribution" plans.⁷ As of September 2010, DOE was responsible for reimbursing contractors for 50 defined benefit plans, including 40 qualified plans and 10 nonqualified plans.⁸ Of the qualified defined benefit plans, 37 are private-sector plans

⁷A defined benefit plan is typically financed by the employer in the private sector and by the employer and employees in the public sector (with the employees' cost fixed and the employer bearing most of the risk of variations in contribution level). Defined benefit plans typically provide retirement benefits in the form of an annuity that provides a guaranteed monthly payment for life, the value of which is often determined by a formula, usually based on years of service and often based on salary as well. A defined contribution plan is financed by employee or employer contributions, or both, into individual accounts set up for each participant. Most defined contribution plans allow participants to direct these contributions to mutual funds and other financial market investments to accumulate pension benefits, dependent on net investment returns, which will then be withdrawn during retirement.

⁸A qualified pension plan is a retirement plan that satisfies certain requirements set forth in the Internal Revenue Code of 1986. 26 U.S.C. § 401. Qualified pension plans are afforded favorable tax treatment in several ways. For example, amounts that the employer contributes to the plan are tax deductible (within limits) in the year contributions are made, and earnings on the investment of plan assets are tax deferred. Two of the "plans" that we refer to as qualified plans are actually defined contribution plans that contain separate defined benefit components. In the case of these two components, the benefits are funded (and reimbursed by DOE) as if they were a single-employer defined benefit plan; thus, as a naming convention, we use the term "defined benefit plan" to refer only to this unique component of the larger plans. A nonqualified pension plan is a plan that does not meet the applicable requirements for tax qualification under the Internal Revenue Code. Nonqualified plans are generally not meant to cover the broad spectrum of employees that a qualified plan covers and are typically designed for highly compensated employees or select company executives.

while 3 are public-sector plans.⁹ DOE's contractors that sponsor private-sector pension plans must comply with the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 (ERISA),¹⁰ which establishes minimum funding standards for the amounts that private-sector plan sponsors must set aside in advance to pay benefits when they are due.¹¹ DOE's current policy is to reimburse contractors for contributions made by the contractors to their qualified defined benefit plans and to reimburse contractors for their nonqualified plans on a pay-as-you-go basis.¹² DOE reimburses contractors for their contributions to defined contribution plans as well.

DOE's contractors also sponsor a variety of other postretirement benefits plans. Although these benefits can include dental and life insurance coverage, the majority of DOE reimbursement costs are for retiree health care benefits. As of September 2010, DOE was responsible for reimbursing 41 contractors for retiree health care payments, although the specific

⁹A private-sector plan can be a single-employer plan, a multiemployer plan, or a multiple-employer plan. A single-employer plan is one established and maintained by only one employer. Such plans can be established unilaterally by the sponsor or through a collective bargaining agreement with a labor union. Generally, the sponsoring employer has the ultimate responsibility for administering the plan. A multiemployer plan is a collectively bargained agreement between a labor union and a group of employers in a particular trade or industry. Multiemployer plans typically cover groups of workers in the unionized sector of such industries as trucking, building and construction, clothing and textiles, and food and commercial workers, among others. Management and labor representatives must jointly govern these plans, in which participants can negotiate the plan benefits through a union. A multiple-employer plan is maintained by more than one employer and is typically established without collective bargaining agreements. A public-sector plan, referred to in statute as a governmental plan (29 U.S.C. § 1002(32)), is one that is offered by governmental employers to their employees, such as the University of California retirement plan.

¹⁰Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at 29 U.S.C. §§ 1001-1461).

¹¹In contrast, public-sector plans are not covered by most requirements under ERISA, including those with respect to plan funding. To receive preferential tax treatment, however, state and local pensions must comply with requirements of the Internal Revenue Code.

¹²Under DOE's policy, contractor contributions to qualified defined benefit plans are reimbursed on the basis of minimum funding requirements set by ERISA and the Internal Revenue Code. These contributions can vary above and below the true long-term cost of the plan and do not necessarily reflect the cost of benefits earned in a particular year. For nonqualified pension benefits and for other postretirement benefits, the pay-as-you-go reimbursements are made after the period over which the benefits were earned. In general, DOE's reimbursements are based on the contractor's cash flow and are not on an accrual basis that would match costs to services received.

benefits offered to retirees varied across contractors. For these other postretirement benefits, DOE's contractors typically do not set aside funds in advance because, in contrast to requirements for funding pension benefits, there are generally no requirements and few incentives to do so. As a result, DOE reimburses contractors on a pay-as-you-go basis for the amount needed to meet the employer's annual share of these costs, and these benefit obligations represent a continuing liability for DOE.

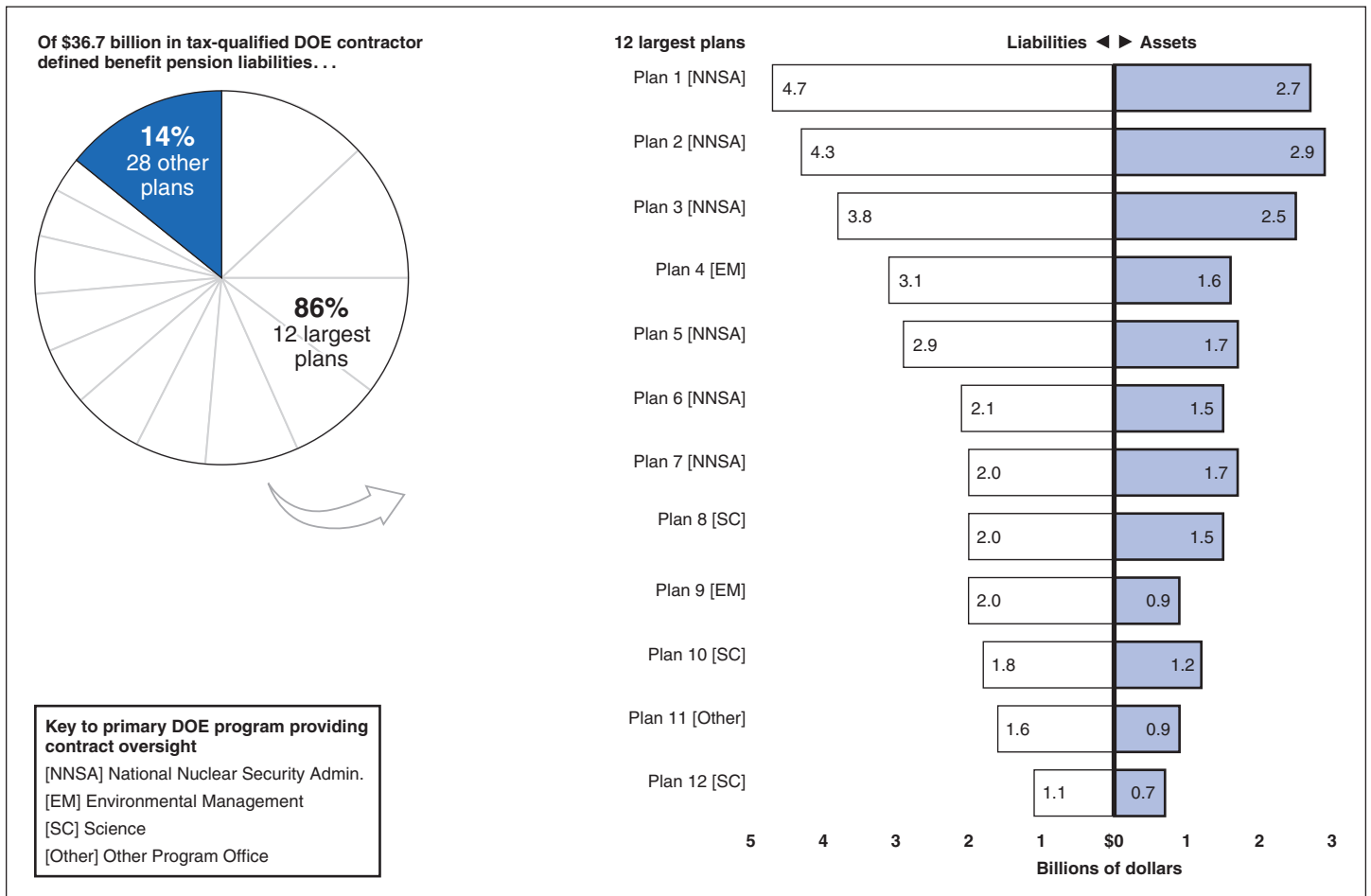
Since September 1996, DOE Order 350.1, Contractor Human Resource Management Programs, has set forth DOE's policy for the oversight and reimbursement of contractor benefit plans. In particular, this order requires that DOE determine whether contractors' benefit costs are reasonable and allowable and therefore reimbursable. To help make this determination, DOE Order 350.1 requires that contractors "benchmark" the value or cost of their total benefit package by conducting either a benefit value or cost study that compares the value or costs of this total benefit package to those of comparable organizations.¹³

A small number of contractor pension plans account for a large percentage of DOE's contractor pension liabilities. As shown in figure 1, 12 plans have liabilities—specifically, projected benefit obligations—that exceed \$1 billion and account for \$31.4 billion, or 86 percent, of the \$36.7 billion in total liabilities represented by all DOE contractor qualified defined benefit plans. Within those 12 plans, pension liabilities are concentrated among a handful of contractor plans.¹⁴ NNSA oversees contractors that sponsor 6 of the 12 plans, including the 3 largest plans that, combined, account for over one-third of all DOE contractor pension liabilities.

¹³In addition, some contractors are contractually required to conduct both benefit value and cost studies.

¹⁴The 12 plans also account for most DOE contractor pension plan assets, participants, and underfunding.

Figure 1: DOE Contractor Qualified Defined Benefit Plans with Liabilities Exceeding \$1 Billion



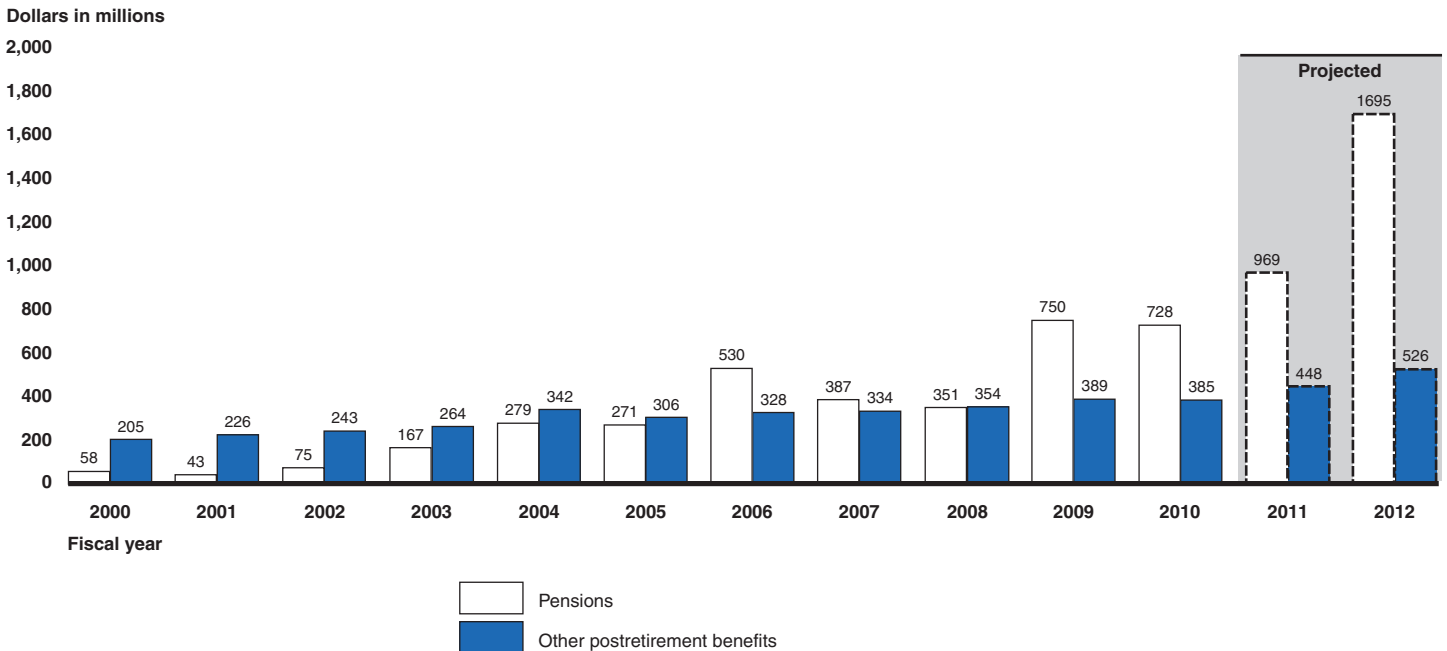
Source: GAO analysis of DOE data.

Note: Graphs are based on DOE accounting and actuarial data as of September 30, 2010. The names of these plans have been removed because DOE believes that the plans' funded status is proprietary. The plan numbers in this figure do not necessarily correspond to the same plans as numbered in Table 3 of this report. For purposes of describing DOE contractor liabilities in a consistent format, we use the projected benefit obligation, which is a liability measure that projects benefit obligations in accordance with U.S. generally accepted accounting principles. Assets are measured as the fair market value of assets, a measure also in accordance with U.S. generally accepted accounting principles. Amounts reported on a financial accounting basis are not the same as figures reported on a statutory funding basis.

As shown in figure 2, DOE's costs for reimbursing contractor pension and other postretirement benefits have grown since 2000 and are projected to increase in coming years. From fiscal year 2000 to fiscal year 2010, DOE's annual costs for reimbursing contractor pension contributions ranged

from a low of \$43 million in 2001 to a high of \$750 million in 2009. Although projections of future contributions are inherently sensitive to underlying assumptions and can change significantly over time, DOE estimates, on the basis of data provided by its contractors in November 2010, that necessary contractor pension contributions may rise markedly in fiscal year 2012—to almost \$1.7 billion—in large part because of expected increases among plans with the largest liabilities. Although useful as an indicator of the financial pressures that could lie ahead, this projection is subject to much uncertainty because of factors that could result in changes in the size or timing of needed contributions to meet future years' funding requirements. Specifically, projections are particularly sensitive to the future economic environment, especially with respect to future interest rates and asset returns, and also could be affected by legislative changes to funding rules. For example, an October 2009 DOE analysis showed that projected minimum required contributions among the 10 largest contractor pension plans could vary by \$2 billion or more in any given year during fiscal years 2012 through 2019, depending on changes in interest rates. Although DOE's reimbursement costs for its contractors' other postretirement benefits have not fluctuated as widely as contractor pension costs, those costs have grown steadily since 2000 at an average annual rate of 8 percent and are currently projected to rise at a slightly higher rate of 9 percent over the next 5 years.

Figure 2: DOE Reimbursements for Contractor Pension Contributions and Other Postretirement Payments for Fiscal Years 2000 through 2012



Source: DOE.

Note: Amounts listed for fiscal years 2011 and 2012 are projections as of November 2010.

Within Its Current Business Model, DOE Has Limited Influence over Contractor Pension and Other Postretirement Benefit Costs

Under its current business model, DOE has limited influence over contractor pension and other postretirement benefit costs. Specifically, contractors sponsor the plans and therefore control the types of benefits offered employees and the investment strategies for allocating pension plan assets; they also determine the amounts paid into plans. In addition, external factors beyond both DOE's and the contractors' control, such as economic conditions and changes in statutory requirements, have significant effects on benefit costs incurred by contractors and, in turn, affect the amount of allowable costs that DOE reimburses contractors. Despite these constraints, however, DOE can exercise some limited influence over contractor pension and other postretirement benefit costs through its oversight efforts, reimbursement policy, and contract requirements.

Contractors, Not DOE, Sponsor and Manage Their Employee Benefit Plans

DOE has limited influence over contractor pension and other postretirement benefit costs under its current business model because contractors, not DOE, sponsor the plans. As shown in table 1, contractors control the types of benefits offered to employees and the benefit plans' design.¹⁵ Moreover, contractors are responsible for managing those plans, including selecting strategies used to invest pension plan assets and determining, within statutory requirements, how much is paid into the plans. Because contractors control both the design and management of employee benefit plans, their decisions can significantly affect the magnitude of benefit costs and the volatility of pension contributions. Nevertheless, although DOE has limited influence over these decisions, the department is responsible for reimbursing its contractors for the allowable costs of providing pension and other postretirement benefits, including retiree health care, to current and former employees and their beneficiaries.¹⁶

¹⁵According to DOE officials, while contractors determine the benefit plans offered to employees and the plans' design, the department currently incorporates language in recompleted contracts that requires DOE approval for any nonstatutory pension plan changes that may increase costs or liabilities. In addition, the contract language asserts that no presumption of allowability will exist when a contractor implements a new benefit plan or makes changes to existing benefit plans until the department makes a determination of cost allowability.

¹⁶According to DOE documents, the determination of what constitutes an allowable cost for reimbursement of contractor employee benefits is based on numerous factors, including (1) cost provisions in the Federal Acquisition Regulation (FAR) and the Department of Energy Acquisition Regulation, (2) contract requirements, (3) collective bargaining agreements between contractors and their employees represented by unions, and (4) policy requirements. Following FAR cost principles, consideration of whether compensation costs incurred under a government contract with a commercial organization are allowable includes whether they are, among other things, reasonable, allocable, and compliant with applicable standards and terms of the contract. 48 C.F.R. § 31.201-2 (2009). A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business. 48 C.F.R. § 31.201-3 (2009).

Table 1: Areas of Contractor Control over Benefit Costs

Benefit plan design	Determine type of pension benefits offered to employees (e.g., defined benefit vs. defined contribution pension plan) Determine other postretirement benefits made available to employees (e.g., retiree health) and employee share of costs, if any Control other elements of plan design (e.g., eligibility and vesting requirements, formulas used to determine benefits owed to employees)
Benefit plan management	Determine investment strategies for plan assets Determine, within statutory requirements, amounts to be paid into benefit plans

Source: GAO analysis of DOE documents and statements made by DOE officials.

According to DOE documents and officials, contractors decide what type of benefits to provide to their employees and how to design benefit plans, and these decisions are part of an overall compensation strategy devised to recruit and retain the workers they need to fulfill their mission.¹⁷ With respect to pensions, contractors may offer defined benefit plans, defined contribution plans, or both, and the content of the plans may vary. For example, the contractor at DOE's Oak Ridge National Laboratory offers both a defined benefit plan and a defined contribution plan to all employees, while the contractor at DOE's Savannah River Site offers a defined benefit plan and a defined contribution plan to employees hired before August 1, 2008, but only a defined contribution plan to employees hired after that time.¹⁸ Contractors may change the pension benefits offered to employees, in accordance with ERISA,¹⁹ and many have been doing so, echoing the overall national trend from defined benefit to

¹⁷DOE Order 350.1 provides that DOE must approve contractor benefit plans and proposed changes to those plans for reimbursement purposes.

¹⁸Incumbent employees—employees hired before August 1, 2008—as well as new hires employed on or after that date at the Savannah River Site are eligible to participate in the Savings and Investment Plan, a 401(k) defined contribution plan. But the plan policy for contractor matching of employee contributions varies depending on whether the participant is an incumbent employee or new hire. Specifically, for incumbent employees, the contractor will match 50 cents on every 1 dollar the employee saves in the plan, up to 6 percent. For new hires, the contractor will also match 50 cents on every 1 dollar, but up to 8 percent, and also provides a nonelective contribution of 5 percent of compensation.

¹⁹ERISA protects pension benefits already earned based on service, compensation, or other relevant factors to date, but plan sponsors can alter or eliminate future benefit accruals.

defined contribution plans.²⁰ For instance, the contractor at Sandia National Laboratories changed its benefit package so that non-union employees hired after December 31, 2008, have a defined contribution plan, while existing employees remain participants in a defined benefit plan.²¹

Contractors also determine other elements of plan design, such as eligibility and vesting requirements, within the parameters set by the Internal Revenue Code and ERISA. Moreover, in the case of defined benefit plans, contractors determine, among other things, the formula used to calculate benefits owed to employees, as well as additional provisions affecting costs, such as early retirement. In the case of defined contribution plans, they determine how much to match employee contributions and what investment options employees will have, among other things.

In addition to their control over pension benefits, contractors also control their offerings for other postretirement benefits, and they can change these packages as they deem appropriate, subject to DOE approval for reimbursement purposes. For example, at Sandia and Los Alamos National Laboratories, new hires receive access-only postretirement health care benefits, which means that, as retirees, they will have to pay the plan's full benefit premiums.²² At DOE's Savannah River Site, the contractor has steadily increased its retirees' share of health care and dental costs since 2003, although the contractor continues to subsidize a portion of the premiums.

Contractors also manage the pension plans they offer, and they have a fiduciary responsibility to manage plan assets in the sole interest of the

²⁰Some contractors have collective bargaining agreements that require them to negotiate any changes to their benefit plans with employees, though some collective bargaining agreements do not affect what specific benefits contractors can offer.

²¹Appendix II shows some of the changes contractors have made to their plans in recent years.

²²If the "full" benefit premium charged to retirees is the same rate charged to younger, active employees, then the postretirement benefits are actuarially subsidized, and a postretirement liability is supposed to exist.

plans' beneficiaries.²³ The contractors' fiduciary role takes precedence over their responsibility to DOE and therefore limits DOE's influence over the plans and the associated costs. Plan management includes selecting investment strategies for defined benefit pension assets.²⁴ In choosing strategies for investing defined benefit plan assets, contractors make a trade-off between risk and return. For example, bonds, because of their higher correlation to pension liabilities, can decrease the volatility in plan funding and potentially required contributions. On the other hand, equities generally come with greater risk, but also greater expected returns relative to bonds. Consequently, investment strategies relying relatively more on equity returns are likely to provide volatile plan funding and contributions.

The performance of contractors' investment portfolios can affect the contributions contractors make to the plans and, in turn, their reimbursable costs. For example, declines in the fair market value of plan investments decrease the funded status of the plan.²⁵ In such a situation, contractors may be required to increase their annual pension contributions over a period of years, which DOE may in turn be obligated to reimburse.²⁶ Moreover, volatile investment returns can result in fluctuations in pension contributions from year to year. As a result, DOE ultimately bears the investment risk incurred by the contractor sponsoring the plan. DOE officials stated that the agency encourages contractors to make investment decisions that reduce volatility but—because DOE's role

²³Private-sector contractors are subject to ERISA, which establishes four standards of conduct for a fiduciary, including (1) a duty of loyalty, (2) a duty of prudence, (3) a duty to diversify investments, and (4) a duty to follow plan documents to the extent that they comply with ERISA. 29 U.S.C. § 1104(a)(1).

²⁴Appendix III provides information on how DOE contractor plans invest their assets. The asset-weighted allocation average of assets (i.e., weighted by assets aggregated over all plans) for DOE contractors' defined benefit plans is 58 percent equities, 33 percent fixed income (bonds), and 9 percent other assets.

²⁵Alternatively, increases in the fair market value of a defined benefit pension's assets increase the funded status of pension benefits.

²⁶ERISA, as amended, sets funding standards for determining the minimum contributions that private-sector plan sponsors must make each year to tax-qualified plans; these standards are based on a target objective of a fully funded plan. 29 U.S.C. § 1082. A fully funded plan is one in which the assets held in the pension trust are sufficient to pay the benefits that plan participants have earned. The employer generally bears the investment risk for the assets held by the plan. If the assets decrease in value, the plan sponsor may be required to make additional contributions to the pension fund. Under the Pension Protection Act of 2006, any shortfall of plan assets compared with plan liabilities must be amortized over 7 years, absent any legislative relief. 26 U.S.C. § 430(c).

is limited to oversight and contractors have the fiduciary responsibility for plan administration—does not provide guidance on how to do so, nor otherwise dictate how contractors should allocate plan assets.

Plan management also includes making decisions about funding contractor pension plans. Contractors, not DOE, are responsible for determining, within statutory requirements, the amounts they pay into their benefit plans. Funding requirements vary among the defined benefit plans offered by DOE contractors, making it difficult to obtain a clear picture of pension contribution requirements across plans and over time. For example, three different sets of funding requirements apply to the range of DOE contractor pension plans.²⁷ Additionally, three contractor pension plans, including the second largest plan, were eligible for special provisions from plan year 2008 to plan year 2010, which reduced their plan liabilities.²⁸ Figure 3 illustrates the distribution of general funding requirement types among DOE contractor pension plans.

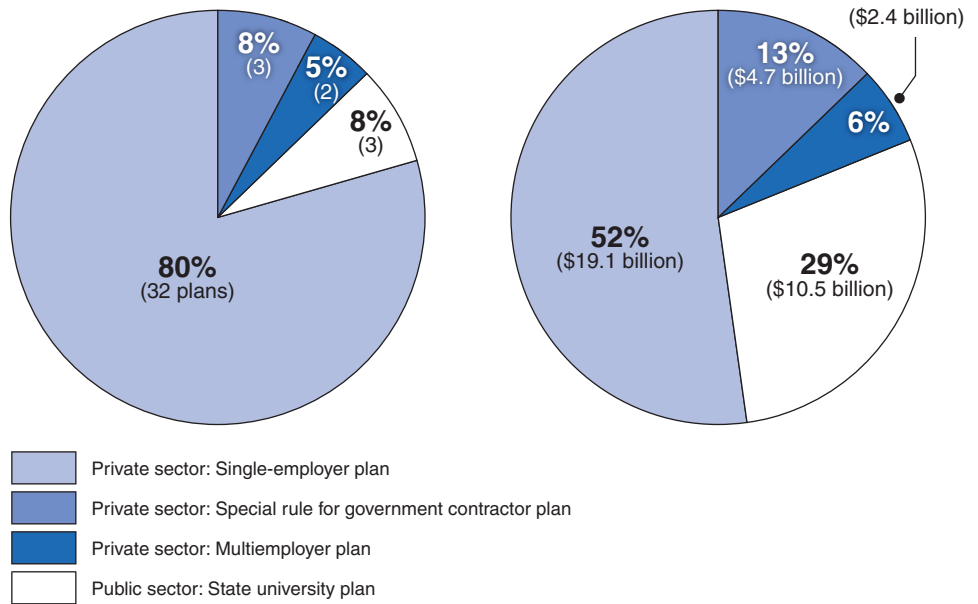
²⁷A large majority of DOE contractor pension plans are subject to ERISA's private-sector pension requirements, specifically, requirements applicable to single-employer plans, which govern plan funding and ultimately contributions. Two plans are subject to ERISA's private-sector pension requirements applicable to multiemployer plans. But although DOE contractors have only three plans that are public-sector plans—each related to the University of California Retirement Plan—those three plans represent nearly 30 percent of DOE's contractor pension liabilities. Public-sector plans are not covered by Title 1 of ERISA because they are "governmental plans" specifically excluded from such coverage. 29 U.S.C. § 1003(b)(1). In addition, federal law generally does not require state and local governments to prefund or report on the funding status of their pension plans, although they are governed by state and local laws that may provide for plan funding. For a more detailed discussion of overall state and local retirement benefit funding, see GAO, *State and Local Government Retiree Benefits: Current Funded Status of Pension and Health Benefits*, [GAO-08-223](#) (Washington, D.C.: Jan. 29, 2008).

²⁸Pension Protection Act of 2006, Pub L. No. 109-280, § 106, 120 Stat. 780, 817-18. The sponsoring contractors of these three plans have been eligible for a special government contractor provision that allows the plan to discount the actuarial value of plan liabilities in such a way that, all else equal, reduces plan liabilities relative to certain other private-sector plans. To be eligible for this special rule, a plan must be a private-sector plan maintained by a corporation whose primary source of revenue is derived from business with the U.S. government and is subject to federal and defense acquisition regulations. Revenues from such business must exceed \$5 billion and pension plan costs must be assignable to a particular accounting standard. With respect to funding, this provision allowed eligible contractors to measure liabilities using an alternative rate for plans years beginning after December 31, 2007, and potentially extending through January 1, 2011.

Figure 3: Distribution of General Funding Requirement Types by DOE Contractor Qualified Defined Benefit Plans and as a Percentage of DOE Contractor Defined Benefit Liabilities

Percentage of defined benefit plans by applicable funding rules

Percentage of projected benefit obligations by applicable funding rules



Source: GAO analysis of DOE data.

Note: Charts are based on DOE accounting and actuarial data as of September 30, 2010. For purposes of describing DOE contractor liabilities in a consistent format, we use the “projected benefit obligation,” which is a liability measure that projects benefit obligations in accordance with U.S. generally accepted accounting principles. Percentages may not sum to 100 percent because of rounding. The sponsoring contractors of the three “special rule” plans have been eligible for a special government contractor provision that allows the plan to discount the actuarial value of plan liabilities in such a way that, all else equal, reduces plan liabilities relative to certain other private-sector plans. To be eligible for this special rule, a plan must be a private-sector plan maintained by a corporation whose primary source of revenue is derived from business with the U.S. government and is subject to federal and defense acquisition regulations. Revenues from such business must exceed \$5 billion, and pension plan costs must be assignable to a particular accounting standard. With respect to funding, this provision allowed eligible contractors to measure liabilities using an alternative rate for plans years beginning after December 31, 2007, and potentially extending through January 1, 2011.

Contractors, according to the funding requirements applicable to their qualified pension plans, determine the minimum contribution they must

make to the plans.²⁹ A contractor's minimum contribution is generally considered an allowable cost for reimbursement by DOE because the contractor incurs this cost to meet its contractual obligation with DOE to maintain the pension plan's eligibility for favorable tax treatment under the Internal Revenue Code.³⁰ While contractors are obligated to pay only the minimum required contribution, under DOE policy they can also ask the department to reimburse them if they contribute more than the minimum. A contractor might choose to contribute more than the minimum in the current year to, for example, avoid benefit restrictions that would otherwise come into effect on the basis of the pension plan's funding level.³¹ In addition, a contractor might wish to contribute more than the minimum to build credit balances that it could use in future years to try to level the amount it budgets for pension contributions.³²

External Factors beyond DOE and Its Contractors' Control Can Significantly Affect Benefit Costs

External factors over which DOE and its contractors have no control, including economic conditions and changes in statutory requirements, can significantly affect contractor reimbursement costs. For instance, changes in economic conditions can significantly affect necessary pension plan contributions, which are, in part, determined by actuarial assumptions about the future, and these assumptions are used to calculate the value of plan assets and liabilities, such as employee turnover, and compensation increases. Furthermore, minimum contribution requirements can vary from year to year as the result of fluctuations in the investment

²⁹The various sets of funding requirements use differing methods and actuarial assumptions to determine funding and required contributions, which can vary across plans and over time.

³⁰The Internal Revenue Code specifies requirements for a retirement plan to be considered "qualified" and receive preferential tax treatment. 26 U.S.C. § 401. In a qualified plan (1) the employer can deduct from income the amount that it contributes to the plan as a business expense, (2) the amount the employer contributes on plan participants' behalf is not treated as income to the participants until distributed, and (3) the investment earnings of a qualified pension trust are not taxed as income to the employer nor to plan participants until distributed. 26 U.S.C. §§ 162, 404 and 501(a). A qualified retirement plan may be either a defined benefit plan or a defined contribution plan.

³¹For example, in accordance with the Internal Revenue Code, if a single-employer pension plan's funding level falls below certain specified thresholds, then certain restrictions may be placed on the benefits provided by the plan, such as lump-sum payments. 26 U.S.C. § 436(d).

³²Credit balances can be earned when a plan sponsor contributes more to its pension plans than required. Under certain conditions, sponsors can use these balances to offset required contributions until the balances are exhausted.

performance of plan assets. For example, the significant decline in value of the financial markets in 2008 caused a considerable drop in plan assets. In addition, changes in the interest rate can significantly affect contractor pension contributions.³³ For instance, according to DOE officials, a drop in interest rates has contributed to increases in calculated plan liabilities, which, along with other factors, has led to a significant increase in contractor pension contributions. Officials further noted that, in part because of recent economic conditions, some contractors contributed to their pension plans for the first time in years.³⁴ For example, a contractor at Oak Ridge National Laboratory told us that in fiscal year 2010, in part as a result of the recent financial market crisis and changing interest rates, it budgeted for the first contributions to the site's defined benefit plan since 1984.³⁵ The variability in investment returns and interest rates, which influences the calculation of plan contributions, also adversely affects DOE's ability to accurately forecast the costs of pension contributions in its budget requests.³⁶

³³The interest rate assumption is a key assumption used to determine the present value of plan liabilities. All else equal, a lower interest rate has the effect of increasing the present value of plan liabilities. Present-value calculations reflect the time value of money—that a dollar in the future is worth less than a dollar today, because the dollar today can be invested and earn interest. Thus, using a lower interest rate will increase the present value of a stream of payments, which implies that a higher level of assets today will be needed to fund those future payments.

³⁴The effect of the economic environment on pension assets is not unique to DOE; in general, contribution obligations for pension plans sharply increased after 2008 as a result of the economic downturn. Because of the economic downturn, the average pension funded ratio (the ratio of plan assets to plan obligations) by the 100 largest corporate defined benefit plans has been less than 100 percent since July 2008 and was less than 80 percent as of May 2010.

³⁵As of 2009, Oak Ridge National Laboratory's defined benefit plan had approximately 9,800 participants.

³⁶According to DOE officials, projections of future pension plan contributions are made 18 months in advance of when the actual contributions will be known. These projections are highly sensitive to underlying data, methods, and assumptions, and actual actuarial valuations may yield different contribution levels. This situation further complicates the department's ability to accurately forecast the costs of pension contributions in its budget requests.

Changes in economic conditions can also affect other postretirement benefit costs.³⁷ Changes in health care and other cost trends can influence the cost of these benefits and, in turn, the amount that must be reimbursed by DOE. For example, officials at DOE's Savannah River Site explained that as health care costs increase nationally, the cost of providing retiree health care to their employees has also increased. Los Alamos National Laboratory officials attributed their rising health care costs to a variety of factors, including increases in emergency room and radiology costs.

Changes in statutory requirements can also have a significant effect on contractor benefit costs. For example, the funding requirements that govern a large majority of DOE contractor private-sector pension plans have been changed or significantly amended over the last 5 years. One of the most sweeping amendments to ERISA and the minimum-funding rules occurred with the passage of the Pension Protection Act of 2006.³⁸ This act—prompted, in part, by the default of several large pension plans—increased the minimum funding requirements for pension plans and sought to strengthen the private pension system.³⁹ Many of the funding rule changes for single-employer plans came into effect slowly, however, and included special rules that provided funding relief for certain plan sponsors. Additionally, almost as soon as the act began to take effect in 2008, the economy weakened, and further statutory and regulatory changes occurred that had the overall effect of reducing or delaying

³⁷Typically, DOE contractors pay for other postretirement benefits on a pay-as-you go basis. In turn, DOE reimburses contractors for the amount needed to meet the contractor's annual share of these costs. From fiscal year 1997 to fiscal year 2007, the net funded status of contractors' other postretirement benefits generally declined from an underfunding of \$5.0 billion to \$10.3 billion. These benefit obligations will represent an ongoing liability to DOE because, in contrast to defined benefit pensions, these benefits are generally not funded in advance of being paid.

³⁸Pub. L. No. 109-280, 120 Stat. 780.

³⁹Some analyses had identified weaknesses in the funding rules before passage of the Pension Protection Act of 2006. We previously reported on such weaknesses in the funding rules, finding that, over the 1995 to 2002 period that was studied, a majority of sponsors of the 100 largest defined benefit plans each year, on average, made no cash contributions to their plans. See GAO, *Private Pensions: Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules*, [GAO-05-294](#) (Washington, D.C.: May 31, 2005).

pension contributions that would otherwise have been required.⁴⁰ The number and timing of statutory and regulatory changes since the enactment of the Pension Protection Act of 2006 makes it difficult to determine how much of an effect the law has had on contractor contribution requirements. During our site visits, some contractors reported an increase to their minimum required contributions since the act's implementation, but these increases are the combined result of multiple factors, including economic and demographic experience and legislative changes. Contractor costs for other postretirement benefits can also be influenced by changes in statutory requirements. For instance, according to DOE documentation, passage of the Patient Protection and Affordable Care Act in 2010⁴¹ may affect contractors' other postretirement benefits in a variety of ways, such as by levying an excise tax on high-cost health plans.

DOE Can Exercise Some Influence over Benefit Costs through Its Oversight Efforts, Reimbursement Policy, and Contract Requirements

Despite the constraints posed by DOE's current business model, our analysis of DOE documents—including department policy, budget documents, and contract provisions—indicates that the agency has several means—oversight efforts, reimbursement policy, and contract requirements—by which it can exercise some limited influence over contractor pension and other postretirement benefit costs (see table 2). While DOE will ultimately have to reimburse the cost of contractor pension benefits that have already been accrued, it can use these means to exert some influence over future benefit costs.

⁴⁰For example, the Worker, Retiree, and Employer Recovery Act of 2008 provided plan sponsors with temporary further relief from the changes in the Pension Protection Act of 2006 (Pub. L. No. 110-458, 122 Stat. 5092), as did IRS guidance in 2009 concerning interest rates that could be used to value plan liabilities in some cases. More recently, the Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010 provided relief to private-sector pension sponsors, in part, by allowing certain sponsors to elect one of two possible schedules to reduce or delay contributions attributable to certain funding shortfalls stemming from the economic downturn. Pub. L. No. 111-192, 124 Stat. 1280. During our site visits, we asked DOE contractors if they planned to elect one of the schedules, and some said they were considering doing so but had not determined which, if any, of the schedules made the most sense for their specific pension plan or overall budget situation.

⁴¹Pub. L. No. 111-148, 124 Stat. 119 (2010).

Table 2: Areas of Limited DOE Influence over Contractor Benefit Costs

Oversight	Determines the amount of detailed information collected from contractors on benefit costs and the degree to which the information is reviewed and communicated to others (e.g., congressional decision makers); this does not directly control costs, but it does increase awareness of cost management and encourages discussion with contractors on ways to mitigate costs
Reimbursement policy	Establishes requirements defining the extent to which contractor benefit costs qualify for reimbursement (e.g., approving any benefit plan changes that affect reimbursement, defining the amount of pension contributions that DOE will reimburse the contractor)
Contract requirements	Establishes contract provisions defining degree of flexibility that contractors have in structuring and changing their benefit packages

Source: GAO analysis of DOE documents.

First, DOE decides its degree of oversight over benefit costs, including the amount of detailed information related to these costs that it collects and reviews and the extent to which it communicates that information to department officials and congressional decision makers. While DOE's oversight efforts do not control costs directly, according to department officials, they help increase awareness of cost management on the part of both the department and contractors and can encourage discussion between the two on ways to mitigate costs where appropriate. Specifically, DOE determines the amount of information contractors must provide about benefit costs and the frequency with which they must do so, the degree of departmental review, and how readily available that information is to decision makers. For instance, DOE policy requires contractors to periodically assess their benefit packages and submit the results of these evaluations to the department. Generally, the contractor must take corrective action if the value of the benefit package exceeds 105 percent of comparable companies' plans.⁴² Moreover, DOE requires contractors to provide the department with cost projections and information on direct

⁴²According to department policy and guidance, DOE must approve the comparable companies, of which the contractor must select no less than 15, for the benefit assessment. DOE guidance states that the group of comparable companies must comprise the contractor's parent organization, if applicable, and organizations in the same industries from which the contractor competes for employees. Each company selected for comparison must compete for nonexecutive staff in the same industry as the contractor, or the contractor must document that it gained or lost four or more nonexecutive staff to the company during the prior 5 years who have the same skill sets as professional staff of the company.

and indirect costs as they relate to pension and other postretirement benefits.

Second, through its reimbursement policy, DOE sets requirements that determine the extent to which contractor benefit costs qualify for reimbursement. In April 2006, in response to growing liabilities for contractor employee benefits, DOE issued Notice 351.1, which provided that the department would continue to reimburse contractors for the allowable benefit costs for incumbent employees and eligible retirees but limit reimbursement for new employees to the costs of “market-based” pension and health benefit plans. A pension plan was deemed market-based when, among other things, the plan was a defined contribution plan. In June 2006, however, DOE suspended the notice, and in response to stakeholder and congressional concerns, subsequently decided not to reissue it.⁴³ Although the policy change was ultimately reversed, it demonstrated that DOE can potentially use its reimbursement policy to exercise some influence over contractor benefit packages. Currently, DOE policy provides for reimbursement of a contractor’s minimum required pension contribution while giving program offices the discretion to approve higher reimbursement levels. In addition, in accordance with department policy, contractors must obtain DOE approval for any plan changes that can affect reimbursement costs. In asking to change a plan, a contractor must submit justification that, among other things, estimates savings or costs and provides the basis for this determination.

Third, DOE establishes contract requirements that determine the degree of flexibility contractors have in structuring and modifying their benefit packages and, through these requirements, can exercise some influence

⁴³DOE later requested public comment on how to address the challenge posed by increasing costs and liabilities associated with its contractor employee pension and medical benefits. 72 Fed. Reg. 14,266 (Mar. 27, 2007). In response, critics shared their concerns that requiring defined contribution plans would actually increase contractor expenses in the short term because of the age profile of new hires. More specifically, they noted that new employees are typically younger than the average employee in the workforce and that while market-based defined contribution plans typically provide the same contribution for all employees regardless of age, defined benefit plans are, in part, a function of age, with younger employees costing much less than older employees. Another public comment stated that actual benefit costs would not decrease unless contractors established defined contribution plans with benefits that were less generous than those provided under their current defined benefit plans. Critics also noted that, although it made sense to control costs by putting limits on the level of plan costs or benefits, constraining the structure of contractor plans (such as defined benefit versus defined contribution) could have negative effects on a contractor’s ability to effectively manage its workforce.

over contractor decisions on benefits. Although DOE cannot unilaterally alter an existing contract, it can negotiate with a contractor to include new provisions in an existing contract, as well as in a contract that is extended or newly awarded. By contractually obligating successor contractors to assume sponsorship of existing benefit plans, DOE has generally required that benefits be continued for existing employees and eligible retirees. Since 2005, however, the department has used a contract provision requiring contractors to provide market-based pension and health care benefit plans for new employees.⁴⁴ As a result, some contractors have shifted from providing all employees defined benefit plans to offering new employees defined contribution plans, and some contractors have also stopped providing other postretirement benefits to new employees. For example, in 2006, the new contractor that assumed responsibility at Los Alamos chose to offer new employees only a defined contribution plan, while giving incumbent employees who worked at the site before the transition the option of participating in a defined benefit plan or the defined contribution plan.⁴⁵ The contractor at Savannah River also closed its defined benefit plan to employees hired after 2009 and, in addition, ceased offering some other postretirement benefits to new employees. According to NNSA officials, NNSA is now exploring a further shift in contract requirements for sites it oversees, to allow successor contractors to alter existing employees' benefit packages.⁴⁶

⁴⁴DOE currently defines a benefit package as market based if an assessment shows that the value or cost of the package does not exceed 105 percent of the average value or cost of comparable companies' benefit packages.

⁴⁵Those incumbent employees who chose the compensation package including a defined contribution plan at the new contractor remain as separated-vested participants in the former contractor's plan—the University of California Los Alamos National Laboratory defined benefit plan.

⁴⁶According to DOE documents, in providing successor contractors with flexibility to change incumbent employees' benefits, NNSA asks contractors to develop a level of total compensation which, within available funds, attracts, motivates, and retains a highly competent workforce and maintains a competitive position in the applicable labor markets. However, NNSA does not prescribe a particular method to achieving efficiencies, nor does it express a preferred solution in terms of approach or savings.

DOE Has Taken Steps to Enhance Its Management of Contractor Pension Costs but Has Not Comprehensively Reviewed Other Postretirement Benefits or Issued Complete Guidance

Since the economic downturn deepened in 2008, DOE has taken steps to enhance its management of contractor benefit costs—particularly for contractor pensions—but gaps remain in its approach. Before 2008, DOE had made some changes but had not exercised the full range of measures at its disposal. Since then, DOE has taken additional steps to address its approach to contractor benefit costs, but more could be done. Specifically, DOE has strengthened its oversight of contractor pension costs, but it has yet to review its approach to overseeing other postretirement benefit costs or to clearly inform Congress of those costs and their potential impact on mission work. As a result, DOE may be delayed in improving its oversight of those benefits, and potentially not provide important information to Congress that could inform annual funding decisions. DOE has, for the most part, continued to insert the same contract requirements since 2005 and use the same reimbursement policy since 1996, but it lacks clarifying guidance to ensure a consistent approach to evaluating contractor benefit costs. As a result, DOE is unable to ensure that program offices apply that policy consistently, and it continues to reimburse contractors for benefit packages that have exceeded its standard for a prolonged period.

DOE Has Strengthened Its Oversight of Contractor Pension Costs, but It Has Yet to Review and Clearly Communicate to Congress the Cost of Other Postretirement Benefits

DOE has strengthened its oversight of contractor pension costs by changing how it collects, analyzes, and communicates information on those costs. First, in a January 2010 memo, the department announced the creation of an annual review process to more systematically analyze the status of each contractor's pension plan and the contractor's strategy for managing the plan. Second, DOE created a central database in October 2010 to regularly collect and report information on contractor benefit costs. Third, DOE increased the information it communicates to Congress on contractor pension costs by adding an explanation of those costs to its fiscal year 2011 budget request. The department has done less on other postretirement benefit costs, however. DOE officials had stated that they expected to begin a review in spring 2010 of the department's approach to other contractor benefits similar to the one done for contractor pensions, but as of January 2011, the department has not followed through with these plans. Moreover, DOE has not added information to its budget request on its contractors' nonpension postretirement benefit costs. While contractor pension costs have risen sharply since 2009, the cost of other postretirement benefits is also significant and growing.

In January 2010, DOE set up an annual review process for contractor pensions that allows the department to more systematically analyze contractor pension data and each contractor's strategy for managing its plan. Specifically, DOE guidance requires each contractor to submit a

standard report on its pension plans at the start of each year. This report must include information on the plan's current funding status and the contractor's estimates for how much it will need to contribute to the plan during the current fiscal year and the 4 fiscal years after that. In addition, the contractor must provide the key assumptions and methods used to develop its estimates. If the estimates indicate that a plan's funding level could drop enough to force the contractor to impose benefit restrictions, the contractor must describe the impact of the benefit restrictions, the number of employees the restrictions might affect, the additional funds needed to avoid those restrictions, and whether it recommends contributing those funds to the pension plan.⁴⁷ The contractor must also include an assessment of its pension plan's investment management and the results of its current investment strategy. After contractors submit this report, DOE guidance requires contractor personnel to meet with department officials from headquarters and the field to discuss the contractor's pension strategy and the reasons for any differences between its current pension contribution estimates and prior estimates. In addition, DOE officials and contractor personnel are to discuss how the contractor intends to increase the predictability of its pension contributions and contain current and future costs. According to DOE guidance, a goal of this annual review process is to improve the accuracy and predictability of DOE budget forecasting for funding its contracts by requiring contractors to provide their estimated contribution amounts to their pension plans, both for the immediate year and the subsequent years, on the basis of a range of actuarial assumptions. In addition, these discussions are meant to provide DOE with opportunities to increase its ability to share information concerning contractor costs with key stakeholders across the department.

DOE has also created a central database to regularly collect information on contractor benefit costs, which is intended to facilitate analysis, as well as ensure current reporting on those costs. DOE set up the database in October 2010 and is requiring contractors to regularly update information on their benefit plan costs and characteristics. Specifically, DOE guidance

⁴⁷The Pension Protection Act of 2006 established benefit restrictions for private-sector single-employer plans that may occur if a plan's funding level falls below certain specified thresholds. § 103, 120 Stat. 809-16 (codified as amended at 29 U.S.C. § 1056(g)). If the funding level, based on the adjusted funding target attainment percentage, falls below 80 percent, then certain restrictions may be placed on the benefits provided by the plan, including limits on the provision of lump-sum benefit payments. If funding falls below 60 percent, then additional restrictions may apply, including a restriction on future benefit accruals and a prohibition on lump-sum benefit payments. A somewhat similar concept based on funding thresholds exists for private-sector multiemployer plans.

requires contractors to report on, among other things, their current pension assets and liabilities and 5-year budget projections for pension and other benefits. Before implementing the database, DOE relied on ad hoc data requests to contractors to collect information on pension plans and other postretirement benefits. For example, in 2010, DOE requested pension and other benefit data from each contractor and shared that information in the form of site-specific “snapshots” to all of its contractors and program offices. In contrast to these data requests, which DOE and contractor officials at several sites found redundant or time-consuming, DOE guidance explains that the database is intended to provide a structure for capturing information obtained through the annual pension review process, as well as to expand data collection to other contractor benefits and readily report information on those benefits. By scheduling regular data requests and storing information in a central system, DOE has taken actions that help to streamline the data collection process and facilitate analysis and up-to-date reporting on contractor benefit costs.

While DOE has reviewed its approach to overseeing contractor pension plans, it has yet to devote a similar level of attention to other postretirement benefits. While our analysis of DOE financial data indicates that other postretirement benefit costs have generally been less volatile than those of pension plans, these costs have steadily risen over the last 10 years, amounting to \$385 million in fiscal year 2010. According to federal standards for internal control, federal agencies are to employ internal control activities, such as top-level review, to help ensure that management’s directives are carried out and to determine if the agencies are effectively and efficiently using resources to assess risks from both internal as well as external sources.⁴⁸ Consistent with these standards, DOE has collected and analyzed some information on the risk it faces from other postretirement benefits. For example, in May 2010 DOE issued a summary of its analysis on contractor pension plan and other benefits, including postretirement health care benefits. But it has not comprehensively reviewed its approach to overseeing those benefits or correspondingly changed its policy on how it manages other contractor benefit costs. DOE officials had stated that they expected to begin a review of benefits other than pensions in spring 2010. As of January 2011, however, DOE had yet to begin its planned review, according to an agency official, because of the department’s continuing work on contractor

⁴⁸GAO, *Standards for Internal Control in the Federal Government*, [GAO/AIMD-00-21.3.1](#) (Washington, D.C.: November 1999).

pensions. This official stated that the department still planned to review its approach to other postretirement benefits, but it was not clear when the review would begin.

Without comprehensively reviewing its approach to overseeing other contractor benefits, including postretirement benefits other than pensions, DOE may be delayed in improving its oversight of those benefits and identifying policy options that might reduce or better address the growth of reimbursement costs. For example, in a 2004 report on this topic, we recommended that DOE incorporate into its oversight process a focus on the long-term costs and budgetary implications of decisions pertaining to each component of contractor benefit programs, especially pension and postretirement health benefits, which have budgetary requirements beyond the current year.⁴⁹ DOE has taken steps to incorporate such a focus into its oversight of contractor pension costs through its annual review process, but it has yet to incorporate a similar focus on long-term costs and budgetary implications into its oversight process for other postretirement benefit costs. Further, while DOE reimburses other postretirement benefits on a pay-as-you-go basis, an option for addressing its liabilities is to reimburse contractors for prefunding some or all retiree benefits, particularly those associated with health care, before employees retire. By reimbursing contractors for prefunding these benefits, DOE may be able to reduce the unfunded liability reported in its financial statements and take advantage of the compounding effects of investment returns on plan assets. Nevertheless, while prefunding more effectively recognizes costs when the associated work is being performed, in the short term prefunding might require higher contractor contributions, which would in turn increase DOE's short-term reimbursement costs. In addition, opportunities for prefunding other postretirement benefits and nonqualified pension benefits are more restricted than for tax-qualified benefits. By not comprehensively reviewing its approach to its contractors' other postretirement benefits, DOE has yet to systematically weigh the advantages and disadvantages of these and other potential policy changes that might enhance its approach.

Moreover, although DOE has taken steps to improve its communication to Congress of key information concerning contractor pension costs, it has yet to provide similar information on the costs of other postretirement benefits and their potential impact on mission work. DOE expanded the

⁴⁹ [GAO-04-539](#).

information it provides to Congress in its fiscal year 2011 budget request by adding a discrete section explaining contractor pension costs.⁵⁰ This section outlined contractor pension costs for the upcoming fiscal year and 2 prior years by program office and site. In addition, the section included a discussion of the challenges and risks DOE faces in managing contractor pension costs. The addition of this information is an improvement over prior budget requests, which included only isolated references to contractor pension costs and did not provide an agencywide picture of the magnitude of those costs. But DOE did not provide the pension information in a format consistent with the appropriation accounts that Congress uses to provide funding to the department. As a result, the information may be less useful to Congress than it otherwise could be. Moreover, DOE did not include agencywide information on other postretirement benefit costs in its fiscal year 2011 request, nor did it add such information to its fiscal year 2012 request. Yet DOE reimbursements to contractors for other postretirement benefits have risen steadily from roughly \$306 million in fiscal year 2005 to \$385 million in fiscal year 2010. By not including an explanation of these costs in its budget request, DOE is not providing Congress with complete information on the full cost of its contractor retirement benefits and their potential impact on the resources DOE has available to accomplish its mission work. As a result, Congress lacks important information that could inform its annual funding decisions.

DOE Has Largely Continued Its Existing Contract Requirements and Reimbursement Policy but Lacks Clarifying Guidance to Ensure a Consistent Approach to Contractor Benefit Costs

DOE has, for the most part, continued to insert the same contract requirements since 2005 and use the same reimbursement policy from 1996, but it lacks complete guidance on how program offices should evaluate contractor requests to contribute more than the minimum required to their pension plans, and it also lacks a comprehensive timeline for modifying contractor benefit packages with values that exceed DOE standards. DOE has inserted language into new and renewed contracts that ties the reimbursement of contractor benefit costs for new employees to market-based benefit packages and increases how frequently contractors must assess their benefit packages. DOE Order 350.1 does not reflect these updated requirements, although DOE officials said the department plans to revise the order by removing certain sections and

⁵⁰Within its fiscal year 2011 budget request, DOE states that it reimburses contractor contributions as a part of indirect costs—those not charged directly to a specific program—and that budgetary line items that include reimbursements assume an indirect rate anticipated to be sufficient to meet the contributions.

adding applicable provisions to its acquisition regulations. But because of procedural delays and the sensitive nature of the order's content, officials stated they do not expect this revision of the order for some time.

Aside from a brief change in 2009, DOE has largely maintained its reimbursement policy for contractor benefits.⁵¹ The Office of Management and Budget's implementing guidance emphasizes the need for agencies to develop policies that ensure the effectiveness and efficiency of their operations. In keeping with this guidance, DOE's policy, as reflected in DOE Order 350.1, is to reimburse contractors for the minimum amount required by ERISA or more on a case-by-case basis.⁵² Also in keeping with Office of Management and Budget guidance, DOE reimbursement policy defines the reasonableness of reimbursement costs by requiring contractors to benchmark the value of pension and other benefits with those of comparable companies and to reduce the value of benefits if they exceed the overall benchmarked average by more than 5 percent.

Nevertheless, DOE lacks complete guidance on how its program offices should evaluate contractor requests to contribute more than the minimum required to their pension plans in order to carry out this revised policy. In particular, DOE has not outlined a standard process or criteria for evaluating requests to contribute more. Despite Office of Management and Budget criteria, DOE program officials we interviewed were not aware of any departmentwide guidance on factors to consider when deciding to approve or deny contractor requests to contribute more than the minimum. For instance, DOE does not specify whether program offices should place a higher priority on minimizing contribution volatility or

⁵¹From September 1996 until November 2009, DOE's policy, as reflected in DOE Order 350.1, was to reimburse contractors for their pension plan contributions according to the minimum amount required by ERISA. After November 2009, DOE changed its policy to reimburse contractors for the contributions needed to keep pension plans funded to at least 80 percent to avoid benefit restrictions. In February 2010, DOE formally changed its policy to reimburse contractors for the minimum amount required by ERISA or more on a case-by-case basis. DOE expected this latest change to significantly reduce its contractor pension reimbursement costs in fiscal year 2010.

⁵²In a January 2010 memo announcing this change, DOE explained that, regardless of the minimum, it would reimburse contractors for contributions necessary to keep their plans at least 60 percent funded to avoid restrictions on future benefit accruals. In the same memo, DOE noted that reimbursement of contractor contributions that exceed the ERISA minimum will require DOE headquarters approval. DOE's reimbursement policy addresses private-sector pension plans; it does not specifically address public-sector plans.

reducing cost when evaluating contractor requests.⁵³ As a result, DOE's program offices use different evaluation procedures and may not consider the same factors when deciding whether to approve or deny contractor reimbursement requests.

By using different evaluation procedures, DOE program offices may implement DOE's reimbursement policy inconsistently. For example, according to DOE officials, NNSA and the Office of Science have generally approved contractor requests to contribute additional funds to their pension plans for reasons such as leveling site or program office budget costs, while the Office of Environmental Management has generally denied such requests and instead directed those additional funds toward mission work. In particular, one site official stated that Environmental Management's denial of a contractor request to contribute more than the minimum in 2010, with the intent of reducing future reimbursement costs, prompted the site to alter its planned budget allocations and mission work. Additionally, this denial resulted in a drop in the plan's funding to a level at which plan restrictions went into effect for employees. In contrast, NNSA approved a similar request aimed at managing the anticipated rise in future pension costs. NNSA officials stated that in making these decisions, the office considers whether the contractor has made a compelling case that the higher contribution will reduce or level future budget costs. According to another DOE official, the Office of Science uses a set of criteria based on prior pension management performance, as well as an analysis of the contractor's assumptions and investment strategies. An official from the Office of Environmental Management stated that, unlike NNSA and the Office of Science, the office will not reimburse pension contributions exceeding the minimum unless funding at the minimum level would restrict benefits. Without standard guidance for its program offices, DOE is unable to ensure that its offices are deciding on contractor requests on the basis of consistent criteria reflecting departmentwide goals for managing contractor pension costs. As a result, program offices may not systematically consider both near-term mission needs and

⁵³Holding pension contributions to the minimum may reduce DOE reimbursement costs in the current year and allow additional funds to be used for mission work but could result in higher minimum contributions in other years. Contributions above the minimum, on the other hand, may better address funding shortfalls and level annual budget costs. With this trade-off in mind, a National Laboratory Directors Council working group emphasized that a balanced approach is needed and recommended, among other things, that DOE allow contractors to contribute more than the minimum required. Also, DOE officials stated that any requests to increase employer contributions must be cost-effective and reduce future liabilities.

potential spikes in future reimbursement costs when reaching their decisions.

In addition, DOE's existing process is incomplete for correcting contractor benefit packages that exceed its reimbursement standard. Specifically, DOE lacks a comprehensive timetable for when a contractor must modify the value of its benefit package to fall within DOE's reimbursement standard. DOE requires contractors to regularly assess whether the value of their benefit packages is reasonable relative to comparable companies and to take corrective actions if they do not meet that standard.⁵⁴ Specifically, DOE guidance requires contractors to implement corrective action plans if the assessments, known as value studies, show that the value of a contractor's benefit package is more than 5 percent of the average value of 15 selected entities in similar lines of industry.⁵⁵ DOE guidance stresses that the goal of the value study is to measure the relative worth of a contractor's total benefits package, regardless of the actual payroll costs associated with the benefits.⁵⁶

DOE guidance requires contractors to implement corrective action plans within 2 years, but the guidance does not include a defined timeline by when contractors must submit, and DOE contracting officers must decide whether to approve, contractors' corrective action plans. As a result, some contractors with benefit package values exceeding 105 percent may spend several years developing corrective action plans. From our analysis of DOE data, of the 20 contractor benefit packages most recently assessed as exceeding the 105 percent standard, 3 were being corrected as of February

⁵⁴DOE Order 350.1 requires contractors to assess the value of their benefit packages every 3 years, though DOE requirements inserted into some contracts require these assessments every 2 years.

⁵⁵DOE officials stated that while the value study focuses on companies in a similar industry, at times other companies are included. In addition, the DOE contracting officer must approve the list of comparable companies used in the value study.

⁵⁶Rather than measure actual cost, the value study assigns a theoretical cost on the basis of what is included in the benefit package, which is then used to compare contractor benefits to one another. By calculating the same dollar value of benefits based on the same plan provisions, the value study eliminates random differences in cost. For example, a contractor's value study score that is 105 signifies that the contractor's employees are actuarially projected to receive 5 percent more benefits than comparable company employees. The value study measures all benefits, including defined benefit and defined contribution plans, matching savings plans, death and disability benefits, preretirement and postretirement health care, and time off with pay. It does not measure contractor salary compensation.

2010. Of those 3 benefit packages, one is expected to be reduced to below DOE's standard, but another is expected to exceed DOE's standard even after the contractor finishes taking its corrective actions, and it is unclear whether the third benefit package's corrective actions will bring the score to below DOE's standard.⁵⁷ Contractors for 5 benefit packages that exceed DOE's standard, some from as early as 2008, have yet to implement corrective action plans, either because the contractors are developing them or because DOE has yet to approve them.⁵⁸ For example, one contractor whose August 2008 value study showed its benefits exceeding the threshold value does not yet have an approved corrective action plan, more than two and a half years after discovering its benefits were too high. According to a DOE document, the contractor submitted a corrective action plan that was disapproved by NNSA and, after analyzing different alternatives at NNSA's request, decided to resubmit its original plan for reconsideration. As of February 2011, NNSA had notified the contractor that approval of its corrective action plan was being deferred pending the results of the contractor's 2011 value study. In another instance, DOE directed a contractor to develop a corrective action plan in May 2010 after the contractor's July 2009 value study exceeded DOE's standard. According to a DOE document, the contractor submitted a corrective action plan in September 2010, but that plan has yet to be approved by NNSA because the plan, as submitted, was lacking in detail. As a result, only one contractor with benefit packages exceeding DOE's standard for the most recent evaluation period is expected to bring its benefits in line with DOE's requirements.

Furthermore, DOE guidance states that, on the basis of a contractor's written justification, contracting officers may waive the requirement for contractors to develop a corrective action plan. But neither DOE policy nor guidance provide details on the process the contracting officers should use or the factors they should consider when deciding whether to waive the corrective action plan requirement. Moreover, the DOE headquarters offices with responsibility for overseeing contractor human

⁵⁷The 20 benefit packages (of the 56 most recent value studies) that exceeded DOE's standard are sponsored by 16 contractors.

⁵⁸Four of the other 12 contractor benefit packages most recently assessed as exceeding the 105 percent standard were not subject to corrective action because, in most cases, the contractors sponsoring those benefit packages provide corporate benefits subject to Office of Management and Budget Circular A-21 for Educational Institutions. For the other 8 contractor benefit packages, the requirement for corrective actions had been waived by a DOE contracting officer.

resource management issues are not required to review the contracting officers' decisions to issue waivers.⁵⁹ In addition, a DOE official stated that the agency does not have departmentwide criteria for evaluating contracting officers' rationale for waiving corrective action. As a result, DOE lacks assurance that contractor requests to waive corrective action plans are being consistently evaluated across the department or that decisions to allow benefit plans to remain above DOE's standard—sometimes significantly—are based on departmentwide criteria.⁶⁰ For the most recent value study, our analysis of DOE data showed that contracting officers issued waivers to eight contractors for a range of reasons, including marginal differences between DOE's standard and the contractor's score and recognition of a contractor's previous efforts to reduce its score. Also according to DOE data, officials waived the requirement for one contractor whose score exceeded the DOE standard in part because of opposition from the site's employee group. As a result, contractors whose scores exceed DOE's standard may remain above that level for an undefined period and continue to accrue liabilities and be reimbursed for the cost of benefits that may not meet DOE's standard.

Conclusions

Given DOE's long history of using contractors to accomplish its mission and its growing unfunded liabilities for contractor pension and other postretirement benefits, it is important that DOE manage its contractual obligations associated with those benefits so as to ensure both the successful accomplishment of its mission objectives and the cost-effective use of government resources. While contractor retirement benefits are only one piece of total contractor compensation, in an era of federal budget constraints, DOE will likely continue to face significant challenges managing the costs of those benefits and mitigating their impact on funding available for the department's mission activities. In particular, in some cases it will have to reimburse the costs of the substantial pension liabilities its contractors have accumulated over decades. While the volatility of pension contributions and the growth in other postretirement benefit costs are not unique to DOE's contractors, the department's

⁵⁹DOE's Office of Procurement and Assistance Management is responsible for overseeing contractor human resource management issues at non-NNSA sites, and NNSA's Office of Acquisition and Supply Management is responsible for overseeing those issues at NNSA sites.

⁶⁰For example, according to DOE data, a contracting officer waived the corrective action plan requirement for a contractor whose value study score was 112.1.

extensive reliance on contractors and its limited influence over their benefit packages makes the department's budget particularly sensitive to these factors. DOE's recent review of contractor pension plans and the resulting oversight and transparency improvements are positive steps. Nevertheless, DOE has yet to comprehensively review its approach to managing other postretirement benefit costs as it has for contractor pensions, although the cost of these benefits is growing and could put pressure on the department's budget in coming years. Without comprehensively reviewing its approach to managing other contractor benefit costs, DOE may miss opportunities to make policy changes that could improve oversight, enhance efficiency, and potentially reduce its reimbursement costs in the future.

Moreover, given the potential magnitude of contractor benefit costs, it is important that DOE keep Congress informed about amounts budgeted for all such costs, the factors that affect those costs, and the department's plans for mitigating possible mission impacts if contractor benefit costs rise. DOE is collecting this information from its contractors but, with the exception of defined benefit plans, has yet to provide Congress with agencywide information on contractor benefit costs for use in annual budget deliberations. Without this information, policymakers will not have a full understanding of the context in which they are making funding decisions or of how benefit reimbursement costs might affect the department's mission work in coming years.

It is also important that DOE consistently apply its policies for overseeing and reimbursing contractor benefit costs to ensure timely compliance by all contractors. Without consistent criteria for program offices to consider when evaluating contractor requests to contribute more to their pensions than the minimum required by law, department management lacks assurance that its offices are systematically considering both near-term mission needs and potential spikes in future reimbursement costs when reaching their decisions. Furthermore, without a defined timetable for when corrective action plans need to be in place or clear criteria for DOE contracting officers to use in deciding to waive corrective action, DOE will continue to have contractor benefit packages with values exceeding its standards and will accrue additional liabilities—which the department must ultimately reimburse—for an extended period of time. In addition, without headquarters review of contracting officer decisions to waive corrective action plans, DOE lacks assurance that contractor waiver requests are being evaluated consistently across the department.

Recommendations for Executive Action

To further improve DOE's approach to managing contractor pension and other postretirement benefit costs, we recommend that the Secretary of Energy take the following four actions:

- Conduct a comprehensive review, similar to the review of contractor pensions, of the department's approach to managing other contractor benefit costs, including other postretirement benefits, and evaluate options for improving oversight and better managing the cost of these benefits.
- Expand the information provided to Congress during its annual budget deliberations to include, for example, nonpension postretirement benefit costs by site, program office, and appropriation account, as well as a discussion of factors that affect these contractor benefit costs and DOE's plans for managing those costs in coming years.
- Issue guidance to program offices overseeing contractors with defined benefit plans that defines criteria to be considered when evaluating contractor requests to contribute more than the minimum to their pension plans.
- Clarify existing guidance on correcting contractor benefit packages that exceed DOE's standard by:
 - establishing a defined timeline by when contractors must submit corrective action plans to their DOE contracting officer if the value of their benefit package is determined to exceed DOE's standard, as well as a timeline for when DOE contracting officers must reach a decision on such plans;
 - developing criteria for contracting officers to use when deciding whether to waive a required corrective action plan; and
 - requiring review of these contracting officer decisions by the responsible headquarters office to help ensure consistent application of the criteria across the department.

Agency Comments and Our Evaluation

We requested comments on a draft of this report from the Secretaries of Defense, Energy, and Health and Human Services, and from the Administrator of the National Aeronautics and Space Administration. The Secretaries of Defense and Health and Human Services and the Administrator of the National Aeronautics and Space Administration had

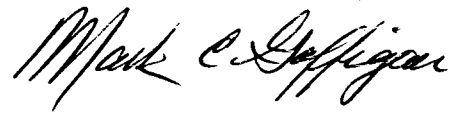
no comments. On April 18, 2011, we received written comments from the Department of Energy, which are summarized below and reprinted in appendix I. In addition, DOE provided technical comments, which we incorporated in the report as appropriate.

In its written comments, DOE did not state whether it concurred with our findings. DOE agreed with three of our recommendations but disagreed with the recommendation that the Secretary of Energy issue guidance to program offices that defines criteria to be considered when evaluating contractor requests to contribute more than the minimum to their pension plans. DOE stated that more stringent guidance regarding the use of additional funds is not needed and that each program office is best suited for determining whether additional contributions are the best use of funds in a given year. We did not recommend that DOE issue more stringent guidance or that program offices should have less flexibility in deciding whether to approve or disapprove contractor requests. Rather, we noted that DOE lacks complete guidance to its program offices on the common factors that they should consider when making their decisions. We agree that program offices may reasonably come to different decisions given their particular circumstances. Nevertheless, we continue to believe that DOE should provide a consistent set of factors for program offices to consider when making those decisions. Without such criteria, DOE lacks assurance that program offices are systematically considering both near-term mission needs and potential spikes in future reimbursement costs when reaching their decisions.

As agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to the appropriate congressional committees; Secretaries of Energy, Defense, and Health and Human Services; Administrator of National Aeronautics and Space Administration; and other interested parties. The report will also be available at no charge on GAO's Web site at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact me at (202) 512-3841 or gaffiganm@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix IV.

Sincerely yours,

A handwritten signature in black ink that reads "Mark E. Gaffigan". The signature is written in a cursive style with a large, stylized 'M' and 'G'.

Mark E. Gaffigan
Managing Director
Natural Resources and Environment

Appendix I: Comments from the Department of Energy



Department of Energy
Washington, DC 20585

April 18, 2011

Mr. Mark Gaffigan
Managing Director, Natural Resources and Environment
U.S. Government Accountability Office
441 G Street
Washington, D.C. 20548

Dear Mr. Gaffigan:

The Department of Energy (DOE or Department) has reviewed the Draft Government Accountability Office (GAO) Report entitled "Department of Energy Progress Made Overseeing the Costs of Contractor Postretirement Benefits, but Additional Actions Could Help Address Challenges" (GAO-11-378).

The Department is pleased that the GAO recognizes the progress that has been made with respect to providing oversight to the costs associated with contractor postretirement benefits while also recognizing that additional steps are needed. In addition, we appreciate the GAO's recognition of the parameters under which the Department operates with respect to contractor benefits.

In the past year, in an effort to improve oversight, the Department has:

- developed a central repository for pension and postretirement plan information which increases the ease in collecting updated information from the contractors as well as provides Department users with the ability to compare information among the plans and determine trends among the contractor populations;
- acquired the capability to model financial and economic impacts across the complex's contractor pension plans;
- completed the second annual comprehensive pension management plan review (as discussed in the Draft Report) that furthers the robust interchange between the Department and its Management and Operating (M&O) and facilities management contractors; and
- initiated the second annual survey of the comprehensive contractor employee benefits analysis which will again be shared with the contractors and programs as well as compared to industry benchmarks. This process continues to encourage contractors to share best practices regarding plan management and communicate the Department's concerns with respect to the costs associated benefits.

It is important to note that one of the contributing factors to the increased costs associated with the contractor pension plans is the change in funding requirements that were imposed by the 2006 Pension Protection Act (PPA). The specific changes contributing to the rising costs of these plans include: 1) a lower required interest rate to value the



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liabilities; 2) a shorter smoothing period to determine the plan assets; and,
3) acceleration of the period over which the shortfall must be made up.

We understand that using the projected benefit obligations and assets from the Department's financial statements provides the GAO with a straightforward manner of comparing the contractor plans since the liabilities for each of the plans are determined using the same discount rate (5 percent) and determined as of the same date (September 30, 2010). However, the DOE emphasizes that actual reimbursements of pension contributions are based on the much higher interest (discount) rates actually used by the plans and on liability figures that do not reflect assumed future salary increases as do the liabilities disclosed in the Department's financial statements, as shown in Figure 1 of the Draft Report. Thus, the liabilities used in the comparisons are much higher than the liabilities used to determine the contributions that are actually reimbursed.

As mentioned in the Draft Report, there were three single contractor employer plans that were exempt from the PPA requirements until fiscal year 2011. One of those plans is the second largest contractor plan by financial statement measurements, and its reimbursable contributions were therefore based on liabilities much less than those shown in Figure 1 of the Draft Report.

It is important to note, that while DOE is not the plan sponsor or the employer, DOE does more than reimburse costs for these plans. The DOE approved the initial adoption of these plans and must approve any non statutory pension plan changes that may increase costs or liabilities. While at the time of a new contract, the DOE has generally required contractors to assume sponsorship of the defined benefit plans covering eligible legacy employees, the contractors have much more flexibility with respect to developing benefit packages for other employees so long as the packages are designed to attract and retain a work force suited to the missions involved. Departmental funding policy also clearly states that contractors will be reimbursed for the minimum required contribution pursuant to Employee Retirement Income Security Act (ERISA), unless the Department approves an exception. That policy in turn would be expected to influence the contractor's funding decisions with respect to these plans.

Enclosed are the Department's detailed response to GAO's specific recommendations and separate technical and factual comments on specific language in the Draft Report. We look forward to working with your team on future engagements.

Sincerely,



Christine Marcus
Deputy Chief Financial Officer

**GAO-11-378 –“Department of Energy Progress Made Overseeing the Costs of
Contractor Postretirement Benefits, but Additional Actions Could Help Address
Challenges”**

Response to the GAO Recommendations for Executive Action

Recommendation 1: Conduct a comprehensive review, similar to the review of contractor pensions, of the department’s approach to managing other contractor benefit costs, including other postretirement benefits to evaluate options for improving oversight and better managing the costs of these benefits.

DOE Comment: DOE agrees that the postretirement benefits programs of contractors would benefit from additional oversight from the DOE. In connection with the benefits survey, the DOE is asking for five year projections of postretirement contributions and intends to combine information gathered during the survey with the information gathered for financial statement purposes in order to make a better determination of the expectation of future costs associated with these plans.

The DOE will weigh the advantages and disadvantages of including an annual review and discussion of the postretirement benefits at the same time that the pension plans are reviewed, or holding the postretirement benefits review at a separate time in order to focus appropriate attention on these benefits.

Recommendation 2: Expand the information provided to Congress during its annual budget deliberations to include, for example, other postretirement benefit costs by site, program office, and appropriation account, as well as a discussion of factors that affect these contractor benefit costs and DOE’s plans for managing these costs in coming years.

DOE Comment: The DOE agrees with this recommendation and will prepare an additional section of the annual budget request to include other postretirement benefits costs by program office. This section of the budget request will also include a discussion of factors that affect these contractor benefit costs, and the DOE’s plans for managing these costs in the coming years beginning with the Fiscal Year 2013 Budget Request.

Recommendation 3: Issue guidance to program offices overseeing contractors with defined benefit plans that defines criteria to be considered when evaluating contractor requests to contribute more than the minimum to their pension plans.

DOE Comment: The DOE does not agree that more stringent guidance regarding the use of additional funds is needed. Each program office is best suited for determining whether additional contributions are the best use of funds in a given year based on the identified

mission work for the year, the program office's budget, the plan participant impacts, the amount of the request, the contractor's rationale for additional funding, and the opportunity cost associated with the additional funds.

The GAO report finds as evidence that more guidance is required due to the fact that the National Nuclear Security Administration (NNSA) and the Office of Science (Science) approved additional funds for the pension plans in fiscal year 2010 while the Office of Environmental Management (EM) did not. Although the respective program offices provided different reasons for approving or denying a request for additional funds, making those additional contributions was the best use of funds given the needs of the specific program office.

EM management compared the amount of the contractor's request to prevent the plan restrictions with the number of plan participants potentially affected by the restrictions (as well as the magnitude of the impact on those individuals) and concluded that the amount of funding required per participant would not be a cost-effective use of DOE funds.

Given the economic conditions and the unemployment rates at the time, EM decided it was more prudent to apply the funds above the ERISA minimum contribution reimbursement to mission work rather than to the defined benefit pension plan sponsored by an EM contractor. Had EM funded the reimbursement of the pension at the level necessary to avoid plan restrictions, EM contractors would potentially have had to lay off existing employees.

Although DOE prefers to maintain flexibility to deal with situations such as the above on a case by case basis, and thus does not wish to establish stringent guidelines, DOE does agree that documenting the current process the program offices use to reach the decisions would be helpful and will continue to document the basis for the decisions made. The DOE will have such documentation in place before the next contribution review cycle.

Recommendation 4: Clarify existing guidance on correcting contractor benefit packages that exceed DOE's standard by:

- **Establishing a defined timeline by when contractors must submit corrective action plans to their DOE contracting officer if the value of their benefit package is determined to exceed DOE's standard, as well as a timeline for when DOE contracting officers must reach a decision on such plans;**
- **Developing criteria for contracting officers to use when deciding whether to waive a required corrective action plan.**

DOE Comment: The DOE agrees with this recommendation and will issue guidance to the Field Offices that establishes a defined timeline for the submission of a corrective

**Appendix I: Comments from the Department
of Energy**

action plan when the value of the contractor's benefit package exceeds DOE's standard. The guidance will also include criteria for contracting officers to use when deciding whether to waive a required corrective action plan and when contracting officers will be required to seek Headquarters approval.

Appendix II: Status of DOE Contractor Defined Benefit Plans

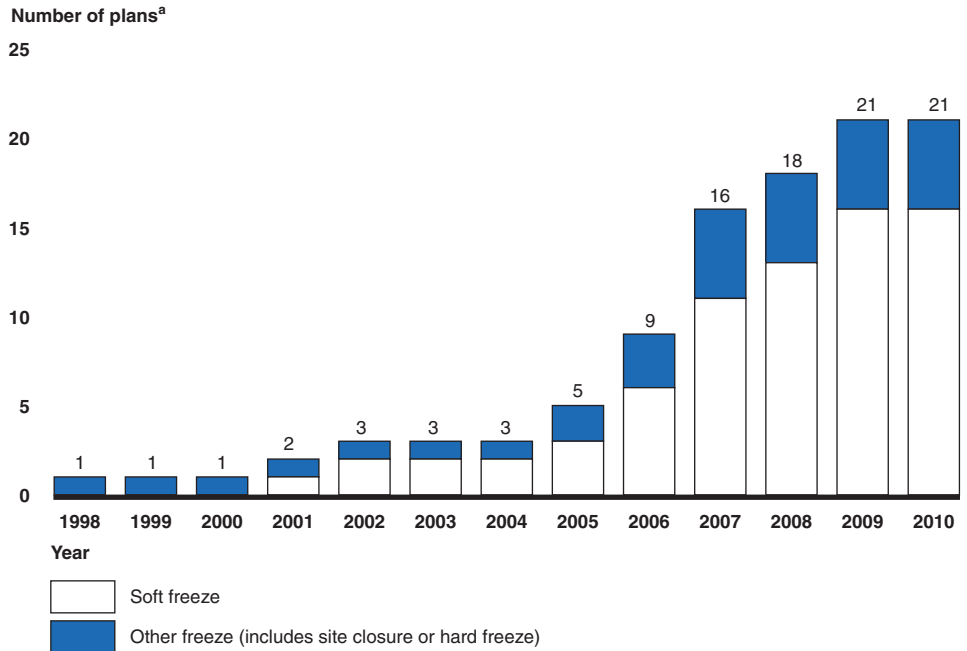
The number of current Department of Energy (DOE) contractor defined benefit plans open to new entrants has been dropping over the last decade, particularly since 2005, while the number of frozen plans has increased.¹ Of the 40 tax-qualified defined benefit plans currently sponsored by DOE contractors, only 1 was frozen as of 2000 (see fig. 4). By 2006, about one-fourth (9) of currently sponsored tax-qualified DOE contractor defined benefit plans were frozen in some way. By 2010, of the 40 tax-qualified defined benefit plans sponsored by DOE contractors, 21 were frozen in some way, and 19 plans were open to new entrants. This trend in plan freezes over time is similar to the trend discussed in another report, which found that, among currently frozen plans nationwide, half of plan freezes were implemented after 2005.²

¹A defined benefit plan freeze is a plan amendment that closes—but does not terminate—the plan to new entrants and may limit future benefit accruals for some or all active participants (i.e., current employees) in the plan.

²GAO, *Defined Benefit Pensions: Plan Freezes Affect Millions of Participants and May Pose Retirement Income Challenges*, [GAO-08-817](#) (Washington, D.C.: July 21, 2008).

**Appendix II: Status of DOE Contractor
Defined Benefit Plans**

Figure 4: Freeze Status of Current DOE Contractor, Tax-Qualified Defined Benefit Plans: Cumulative Number of Freezes by Initial Year of Freeze



Source: GAO analysis of DOE data.

Note: Graph is based on DOE accounting and actuarial data as of September 30, 2010. Plans are listed cumulatively according to their currently described freeze. If DOE indicated a current freeze, we reviewed plan documents or conferred with DOE to find the initial date of the freeze. Thus, we do not track freezes among plans that terminated before 2010, and we do not indicate if the initial freeze was different from the current freeze. A soft freeze is a type of freeze that may reduce future benefit accruals for some or all active participants. Closing the plan to new entrants is common among DOE contractor plans. A hard freeze is a freeze under which future benefit accruals cease for active participants. A site closure is effectively like a hard freeze because the plan no longer has any active participants. All of the freezes in this "other" category were site closures and not hard freezes. Two of the "plans" that we refer to as qualified plans are actually defined contribution plans that contain separate, defined benefit components. In the case of these components, the benefits are funded (and reimbursed by DOE) as if they were a single-employer defined benefit plan and thus, as a naming convention, we use the term defined benefit plan to refer only to this unique component of the larger plans.

^aTotal number of plans = 40 in 2010, varied in previous years.

Appendix III: Investment Allocation of DOE Contractors' Defined Benefit Plans

Table 3 shows the investment allocations of each DOE contractor tax-qualified defined benefit plan by percentage and dollar values as of September 30, 2010. As noted in the report, contractors—not DOE—are responsible for selecting strategies used to invest pension plan assets. Each tax-qualified, DOE contractor defined benefit plan is unique in its investment allocations. For example, certain plans have as much as 73 percent of plan assets invested in equities, whereas a few plans have no equity investment. The overall mix of assets across DOE contractor plans is 58 percent equities, 33 percent bonds, and 9 percent other assets (see last row of table 3).¹ An asset allocation of 60 percent equities and 40 percent bonds is often considered a “typical” asset allocation for many defined benefit plans.

Table 3: DOE Contractor Tax-Qualified Defined Benefit Pension Plan Asset Allocations, in Percentages and in Dollars, Ranked by Dollar Amount of Assets in Equities as of September 30, 2010

Plan Number	Responsible Program Office ^a	Percentage of assets in equities	Percentage of assets in fixed income	Percentage of assets in other assets	Dollar value (in millions) of equities assets	Dollar value (in millions) of fixed income assets	Dollar value (in millions) of other assets
1	NNSA	69%	31%	0%	\$1,982	\$890	\$0
2	NNSA	57	25	18	1,513	664	478
3	NNSA	57	25	18	1,401	615	443
4	Environmental Management	59	35	6	966	573	98
5	NNSA	56	44	0	963	756	0
6	Science	57	25	18	874	383	276
7	NNSA	59	28	13	862	409	190
8	NNSA	47	53	0	806	908	0
9	Science	61	27	12	725	321	143
10	Environmental Management	58	38	4	539	354	37
11	Other	56	38	6	489	331	52
12	Science	63	32	5	436	221	35
13	NNSA	57	25	18	280	123	88
14	NNSA	71	29	0	255	105	0

¹Other assets may include, among other things, asset-backed commercial paper, private investment funds (including hedge funds), and real estate investment funds.

**Appendix III: Investment Allocation of DOE
Contractors' Defined Benefit Plans**

Plan Number	Responsible Program Office ^a	Percentage of assets in equities	Percentage of assets in fixed income	Percentage of assets in other assets	Dollar value (in millions) of equities assets	Dollar value (in millions) of fixed income assets	Dollar value (in millions) of other assets
15	NNSA	60	3	37	184	9	114
16	NNSA	64	36	0	165	93	0
17	NNSA	56	1	43	153	3	117
18	Environmental Management	60	35	5	146	85	12
19	NNSA	57	25	18	124	54	39
20	Other	23	71	6	120	372	31
21	NNSA	53	42	5	98	78	9
22	Other	70	28	2	84	33	2
23	NNSA	46	50	4	45	49	4
24	Environmental Management	66	34	0	42	22	0
25	NNSA	60	40	0	41	27	0
26	Environmental Management	66	34	0	41	22	0
27	Other	18	82	0	22	98	0
28	NNSA	60	35	5	22	13	2
29	NNSA	59	4	37	22	1	13
30	Other	25	67	8	20	53	6
31	NNSA	60	40	0	15	9	0
32	NNSA	64	36	0	11	6	0
33	Other	73	27	0	9	3	0
34	Other	24	69	7	7	21	2
35	Environmental Management	50	46	4	6	6	0
36	Environmental Management	48	30	22	2	1	1
37	Other	0	100	0	0	43	0
38	Science	0	100	0	0	<0.1	0
39	Science	0	100	0	0	<0.1	0
40	Science	-44 ^b	-56 ^b	0	-17 ^b	-22 ^b	0
	Portfolio across all DOE contractor tax-qualified defined benefit plans	58%	33%	9%	\$13,453	\$7,732	\$2,192

Source: GAO analysis of DOE data.

**Appendix III: Investment Allocation of DOE
Contractors' Defined Benefit Plans**

Note: Table is based on DOE accounting and actuarial data as of September 30, 2010. The names of these plans have been removed because DOE believes that the plans' asset allocations may be proprietary. The plan numbers in this table do not necessarily correspond to the same plans as numbered in Figure 1 of this report. Two of the "plans" that we refer to as qualified plans are actually defined contribution plans that contain separate, defined benefit components. In the case of these two components, the benefits are funded (and reimbursed by DOE) as if they were a single-employer defined benefit plan and thus, as a naming convention, we use the term defined benefit plan to refer only to this unique component of the larger plans.

^aOther = Office of Civilian Radioactive Waste Management, Office of Energy Efficiency and Renewable Energy, Office of Legacy Management, or Office of Nuclear Energy.

^bNegative asset values are reported because more plan benefit payments have been made than contributions on behalf of the contractor plan. Thus, these values represent an amount payable by DOE upon closing of the contract.

Appendix IV: GAO Contact and Staff Acknowledgments

GAO Contact

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Staff Acknowledgments

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