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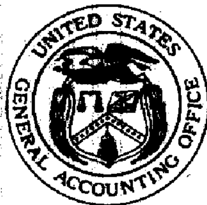
Report to the Chairman, Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, House of Representatives

August 1994

DOE MANAGEMENT

Contract Provisions Do Not Protect DOE From Unnecessary Pension Costs



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Resources, Community, and
Economic Development Division

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August 26, 1994

The Honorable John D. Dingell
Chairman, Subcommittee
on Oversight and Investigations
Committee on Energy and Commerce
House of Representatives

Dear Mr. Chairman:

At your request, we have examined payments made by the Department of Energy (DOE) to the University of California's retirement plan for university employees at three DOE laboratories. Specifically, we examined (1) whether DOE can recover pension fund payments if they are unneeded and (2) whether the provisions in revised contracts will allow DOE to control its future pension costs and prevent unneeded payments. As a result of our review, we are recommending the renegotiation of several contract provisions to minimize future payments and better protect the government's interest in these pension funds.

As arranged with your office, unless you publicly announce its contents earlier, we will make no further distribution of this report until 30 days after the date of this letter. At that time, we will send copies to the Secretary of Energy. We will also make copies available to others upon request.

This work was performed under the direction of Victor S. Rezendes, Director, Energy and Science Issues, who can be reached on (202) 512-3841 if you or your staff have any questions. Major contributors to this report are listed in appendix I.

Sincerely yours,

Keith O. Fultz
Assistant Comptroller General

Executive Summary

Purpose

The Department of Energy (DOE) funds the employer retirement contributions for approximately 18,300 University of California employees who work at three DOE laboratories. Before the October 1992 revisions, the terms of DOE's contracts with the university set no limits on the amount of DOE's pension fund contributions and did not require the university to obtain DOE's approval of changes to pension benefits. Although the University of California Retirement Plan reached full funding in 1986, when the value of its assets equaled or exceeded pension liabilities, the university regents—the trustees of the plan—continued to require employer contributions until November 1990.

The Chairman of the Subcommittee on Oversight and Investigations, House Committee on Energy and Commerce, asked GAO to determine (1) whether DOE can recover pension fund payments if they are unneeded and (2) whether the provisions in the revised contracts will allow DOE to control its future pension costs and prevent such unneeded payments.

Background

DOE has contracts with private firms and universities to operate its facilities, such as the contracts with the University of California for the operation of three DOE laboratories. DOE pays all the costs of operating the laboratories, including the employer contributions for pension benefits for the university employees working at the laboratories and the annual costs of health benefits for retired laboratory employees.

Results in Brief

Although DOE's payments made after the pension fund was fully funded were unneeded, they cannot be recovered from the university because they were required by the contracts. In addition, the unneeded payments cannot be recovered from the pension fund because federal law specifies that funds deposited in an approved retirement plan can be used only for the benefit of the plan's members. Surplus assets can revert to the plan's sponsor if a plan is terminated. However, terminating a pension plan has costs and disadvantages that could offset the benefits achieved. Recently, DOE's Office of Inspector General reported that it may have identified a possible way that DOE could use surplus pension funds, without terminating the plan, to cover its liability for the annual costs of health benefits for retirees from the laboratories.

The revised contracts do not allow DOE much control over how the pension fund's assets are used or minimize DOE's pension fund contributions. While the university must advise DOE about changes that

apply to all of the more than 92,000 members of the plan, DOE's approval is required only for pension benefit changes that are specific to DOE laboratory employees. DOE is also required to make contributions whenever the pension fund's assets are less than 150 percent of current liabilities. This requirement exceeds DOE's January 1988 policy standard, which specifies that contributions be limited to those needed to maintain an equilibrium between assets and current liabilities. DOE's contracts with two other universities contain even fewer cost controls.

Principal Findings

Unneeded Payments Are Not Recoverable, but DOE Could Recover a Portion of the Fund Surplus

DOE's payments between the time the pension plan became fully funded and the time the regents suspended the employer contributions were not needed to ensure the retirement benefits of laboratory employees. The university cannot be compelled to reimburse DOE, because the payments were required by the contracts in effect at that time, under which DOE had agreed to fund the pension costs at the rate established by the university regents. In addition, in order for a plan to retain its tax-exempt status, federal law requires that pension funds be used only for the benefit of the plan's members and their beneficiaries. As a result, the unneeded payments cannot be retrieved from the pension fund.

The unneeded payments contributed to the pension fund's current surplus, however, and federal law allows an employer to recapture surplus pension assets upon a plan's termination after all liabilities have been satisfied. The pension fund had a $1.3 billion surplus as of July 1, 1993, of which about $235 million is attributable to DOE operations. Subject to federal regulation, the university could spin off separate plans, covering only the laboratory employees, that could then be terminated. If the university refuses to act, however, the surplus could be recovered only if DOE's relationship with the university is ended and subsequent arrangements provide for such a recovery. Terminating a plan also has other disadvantages. The amount that can be recovered will depend on what is left after paying the actual costs—rather than the estimates used in valuing the pension plan—of providing the benefits earned by the members. Finally, if the plan is terminated and a new plan established, DOE will have to resume pension fund payments (which could amount to between $100 million and $140 million per year) for the laboratory employees.

DOE's Office of Inspector General recently reported that, subject to certain conditions, some surplus pension funds may be used to pay postretirement health costs. For example, pension funds in excess of 125 percent of current liabilities can be transferred once a year to pay for postretirement health benefits for that year.

New Contract Terms Do Not Ensure DOE's Control Over Use of or Contributions to the Pension Fund

The contracts with the university before the 1992 revisions did not require DOE's approval of any changes to the plan. The revised 1992 contracts require the university to advise DOE of any changes that apply to the entire plan, but DOE's approval is required only for changes that are specific to DOE laboratory employees.

The university regents have made a number of benefit changes that have significantly reduced the pension fund surplus. Reducing the surplus brings closer the point in time when employer contributions will have to be resumed. Between July 1, 1990, and July 1, 1993, the regents approved increased benefits estimated to cost about $1.5 billion, including changes to the cost-of-living formula, a reduction in the age at which members can retire with maximum benefits, and two voluntary early retirement programs. As of July 1, 1993, the surplus had fallen to $1.3 billion, of which about $235 million was associated with the DOE laboratory employees. The regents have approved benefits that will use an additional $0.6 billion of the surplus—benefits that have not yet been reflected in the pension fund valuation.

DOE's approval was not needed for any of these changes. A third voluntary separation program is the only change that has been approved since the new contracts were signed. To address concerns raised by DOE, the university reduced proposed benefit increases offered to the laboratory employees under this program. However, the benefits under the program will still cost over $117,000 per retiree, and as pointed out by university officials, the university was not required by the contracts to accede to DOE's wishes.

Because the revised contracts stop DOE's pension fund contributions when assets are equal to 150 percent of current liabilities for the entire fund, DOE could be required to make pension fund contributions even if the assets associated with its laboratory employees meet the criterion. In addition, the 150-percent-of-current-liabilities criterion in the contract exceeds DOE's policy, which specifies that contributions should stop when assets are equal to current liabilities.

DOE officials said that they have found it impractical to apply the DOE policy to commingled plans such as the university plan. Even though the laboratory employees represent only 20 percent of the active members of the university's retirement plan, GAO believes that contributions should be based on the need for funds to cover the pension liabilities for just those employees. As illustrated by recent experience—the latest capital accumulation provisions and the second and third voluntary separation programs—different budgetary limitations made it necessary to provide different levels of benefits to the laboratory and nonlaboratory employees. In addition, as DOE itself noted in establishing the funding policy, the additional 50-percent cushion included in the 150-percent-of-current-liabilities criterion is not needed for the DOE contractors' pension plans, since DOE must fully fund contractors' pension benefits when a contract with one of its management and operating contractors is terminated. Finally, under the 1992 revised contract, the university is required to prepare a separate accounting that reflects the portion of the pension fund attributable to the DOE laboratory employees.

DOE's contracts with Princeton and Stanford Universities, two other university contractors with defined benefit plans, also require DOE's approval only for changes that are specific to employees at the DOE facilities. Those contracts also place no limit on DOE's pension fund contributions.

Recommendations

While DOE cannot recover unneeded payments, GAO recommends that the Secretary of Energy evaluate the advantages and disadvantages for all of the alternatives available to recover surplus pension funds associated with the laboratory employees and initiate action to recover the surplus funds if recovery is to the government's advantage. GAO further recommends that the Secretary review ongoing contracts with all management and operating contractors with defined benefit pension plans to determine if they provide for DOE's approval of changes to pension benefits and limit DOE's contribution to the amount needed to maintain an equilibrium between assets and current liabilities. GAO also recommends that the Secretary initiate negotiations with the University of California and other contractors, as necessary, to revise the contracts to implement these controls over pension plan changes and DOE's contributions.

Agency Comments

As agreed, GAO did not obtain DOE's written comments on a draft of this report. GAO discussed the facts in this report with DOE officials at

headquarters and the Oakland Operations Office, including the Director of DOE's Office of Procurement, Assessment and Property, and with contractor officials from the University of California and the Lawrence Livermore National Laboratory. With minor clarifications, these officials generally agreed with the facts presented. Although DOE headquarters officials believed that more emphasis should have been given to the progress they have made in improving oversight of pension fund activities, they agreed that the contracts still do not allow DOE to control its pension fund costs.

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Abbreviations

DOE	Department of Energy
GAO	General Accounting Office
IRC	Internal Revenue Code
IRS	Internal Revenue Service
OIG	Office of Inspector General

Introduction

The Department of Energy (DOE) has management and operating contracts with private firms and universities to operate various DOE facilities, such as its multipurpose research laboratories. DOE reimburses the contractors for the overall costs of operating these facilities, including the employer contributions made to the retirement plans to provide for the future pension benefits of the contractor employees.

Background

DOE has contracts with the University of California for the management and operation of the Lawrence Livermore National Laboratory and Lawrence Berkeley Laboratory, both in California, and the Los Alamos National Laboratory in New Mexico. These relationships have been in effect for many years; the latest 5-year contract extensions became effective on October 1, 1992. The university employees working at these three DOE laboratories are members of the University of California Retirement Plan.

The University of California Retirement Plan was established in 1961. Since then, essentially all university employees have been covered by the retirement plan.[1] The University of California Regents are the pension fund trustees. The retirement plan is a defined benefit plan. Under a defined benefit plan, employees are promised specific benefits at retirement funded by contributions from the employer and the employees plus the income earned from the investment of those contributions. Depending on the income earned, the amounts of the employer's and the employees' contributions are periodically adjusted. The benefits provided are determined by formulas that calculate the pension income on the basis of such factors as the employee's salary, age, and years of service.

Under the University of California Retirement Plan, the basic monthly pension income is a percentage (not to exceed 100 percent) of the employee's highest average monthly salary over a 3-year period. This percentage is determined by the employee's age at retirement. The percentage increases from 1.09 percent for every year of service for members retiring at age 50 to 2.41 percent for members retiring at age 60. For example, an employee retiring at age 60 with 30 years of service would receive 72.3 percent (30 years x 2.41 percent) of his or her average monthly income. This basic monthly pension is adjusted if the retiree is

[1]Some university employees who were employed before the establishment of the University of California Retirement Plan, including 438 employees at the three DOE laboratories as of January 1994, are covered by the older and larger California Public Employees Retirement System, which covers California's state and local government employees. This report does not discuss this plan or the benefits provided to its members.

entitled to receive Social Security benefits. Employees hired before April 1, 1976, were not required to participate in Social Security coverage.

As of July 1, 1993, 18,344 of the 92,093 active members of the University of California Retirement Plan (or about 20 percent) were employed at the three DOE laboratories. In addition, 3,872 of the 23,043 people currently receiving benefits from the University of California plan (or about 17 percent) had been associated with these laboratories.

DOE also pays for the postretirement health benefits for the university employees who retire from the three laboratories. In accordance with DOE's policy, these costs are funded each fiscal year on a "pay-as-you-go" basis.

Growth of the Pension Fund Surplus

The value of the retirement plan's assets has grown tremendously over the last several years, primarily because of favorable investment conditions, which provided high rates of return and interest income. Over the last 7 years, on the average, investment and interest income accounted for about 88 percent of the pension fund's annual growth. The remaining 12 percent in growth was the result of contributions by the state of California (about 3 percent), DOE (about 2 percent), the employees (about 3 percent), and other sources (about 3 percent).

The university employs an actuarial firm to advise the regents about retirement plan policies and to perform annual valuations of the plan's assets and liabilities. According to the annual actuarial valuations, the retirement plan became fully funded—that is, assets equaled or exceeded liabilities—at some point between July 1, 1986, and July 1, 1987.[2] As shown in table 1.1, the pension fund has been in a surplus situation ever since.

[2]These values are based on the retirement plan's actuarial assumptions, which take into account factors such as the present value of the assets, the expected rate of return on investments, the value of future contributions, the plan's expenses, and the amount and timing of benefit payments. The benefits to be paid are, in turn, based on factors such as future compensation, cost-of-living allowances, mortality rates, retirement age, and employment turnover.

Table 1.1: Pension Fund Surplus, Based on the Actuarial Value of Assets and Liabilities as of July 1 of Each Plan Year

Dollars in millions

Plan year	Assets	Liabilities	Surplus
1985	$ 4,469.6	$ 4,697.9	($ 228.3)
1986	$ 5,555.0	$ 5,576.0	($ 12.0)
1987	$ 7,104.2	$ 6,385.9	$ 718.3
1988	$ 8,486.2	$ 6,892.3	$1,593.9
1989	$ 9,988.7	$ 7,700.7	$2,288.0
1990	$11,762.3	$ 8,490.4	$3,271.9
1991	$12,896.0	$ 9,754.3	$3,141.7
1992	$14,007.4	$11,568.7	$2,438.6
1993	$15,132.6	$13,827.4	$1,305.1

The university and DOE also use other measures for valuing assets and liabilities, such as the "market value" of assets—the cash value if sold on a certain date—and "current" liabilities—the cost of benefits if the plan was terminated on a certain date. The annual actuarial reports of the plan include these values, which help the regents determine the status of the plan under various circumstances.

As of July 1 each year, the university's actuarial firm reports the value of the plan's assets and liabilities and projects what these values will be on June 30 of the following year. These projections are then used to determine the amount of contributions that will be needed during the year to ensure that the defined benefits can be paid. However, because of the growth of the retirement plan's assets, which have had an annualized rate of return of about 14.5 percent over the last 10 years, the actuarial firm recommended and the university regents adopted lower contribution rates. Effective November 1990, the university suspended the employer's contributions.

Office of Inspector General's Report Critical of DOE's Oversight and Controls Over University Pension Plan

In September 1992, the DOE Office of Inspector General (OIG) criticized DOE's oversight of the university pension fund's activities, reporting that DOE had not implemented controls to ensure that its share of assets in the pension fund was adequately protected.[3] The report concluded that DOE officials were constrained from implementing DOE's pension fund policies by the terms of the contracts with the university. Under the contract terms in effect at that time, DOE had agreed to abide by whatever pension program strategy and approach the regents applied to the entire university work force.

Because of the contract terms, DOE could not implement its policy to minimize contributions to the pension plan, and the university was not required to obtain DOE's approval for changes to the provisions of the retirement plan. The Office of Inspector General reported that, as a result, DOE contributed about $230 million to the fund after it had reached full funding in 1986, and the university had unilaterally used about $280 million of surplus pension fund assets to increase members' retirement benefits.

Objectives, Scope, and Methodology

The Chairman, Subcommittee on Oversight and Investigations, House Committee on Energy and Commerce, requested that we determine (1) whether DOE can recover payments to the University of California Retirement Plan if they are unneeded and (2) whether provisions in the current contracts will allow DOE to control its future pension costs and prevent unneeded payments.

We conducted our review at DOE headquarters; at DOE's Oakland Operations Office in Oakland, California; and at the University of California's Office of the President, Systemwide Benefits Programs, also in Oakland, California, from June 1993 through May 1994. Our work was done in accordance with generally accepted government auditing standards.

We examined DOE's policies on the payment of retirement fund contributions, the DOE Office of Inspector General's September 1992 report and supporting documentation, and the applicable provisions of the contracts that were in effect at the time the questioned payments were made. We also examined documents describing the policies and procedures for the retirement plan and actuarial reports showing the status of the pension fund during this period. We discussed these issues

[3] Report on Pension Fund Activities at Department Laboratories Managed by the University of California, September 22, 1992 (DOE/IG-0314).

with officials of DOE, the University of California, and the University of California's actuarial firm, Towers, Perrin, Forster, and Crosby.

We examined the provisions of the revised contracts, discussed the effect of the changes with DOE and university officials, and reviewed selected laws and regulations affecting the recovery of excess pension funds.

We also examined two other DOE contracts with nonprofit educational institutions with defined benefit pension plans to see whether these contracts provided controls that would protect the government's interests in these pension funds. The contracts examined were with Princeton University, which operates the Princeton Plasma Physics Laboratory, and Stanford University, which operates the Stanford Linear Accelerator Center.

As requested, we did not obtain DOE's written comments on a draft of this report.

Unneeded Payments Cannot Be Recovered; However, Surplus Funds Could Be Recovered From the Plan

Before October 1992, the terms of DOE's contracts with the University of California placed no limit on the amount of DOE's pension fund contributions. DOE had agreed to fund contributions for the laboratory employees at the rates established by the University of California Regents. Even though the pension plan became fully funded—assets equaled or exceeded liabilities—the regents continued to require employer contributions. As a result, DOE made retirement plan contributions that were not needed to ensure the retirement benefits of the laboratory employees. Because requiring these payments was consistent with the contracts, DOE cannot recover these funds from the university. The regents did suspend employer contributions in November 1990, and DOE has made no payments since that time.

In addition, DOE cannot recover the unneeded payments from the pension plan itself, because federal tax law requires that moneys in the pension fund can be used only for the benefit of the plan's members. The unneeded payments, however, contributed to the current $1.3 billion pension fund surplus—of which $235 million is associated with the university employees at the three DOE laboratories. Federal law does provide that under certain circumstances surplus assets can revert to the plan's sponsor if the plan is terminated. If the university is not willing to terminate the plan, DOE would have to terminate its relationship with the university to recover the surplus funds associated with the laboratory employees. The opportunity to recover these surplus funds, however, must be weighed against the disadvantages associated with terminating a pension plan (or contract with the university) and the fact that DOE would have to resume pension fund contributions that could amount to between $100 million and $140 million each year.

Recently, DOE's Office of Inspector General reported that it may have identified a potential way for DOE to use surplus pension funds to pay the costs of postretirement health benefits for employees retired from the DOE laboratories.

DOE's Payments Were Required by the Contracts and Cannot Be Recovered

Under the contracts with the university in effect before October 1, 1992, DOE had agreed to make pension fund contributions for the laboratory employees at the rates established by the University of California Regents. No other limitation was placed on these pension fund contributions. These rates established the employer's contributions to the pension plan as a percentage of each employee's salary and applied to employees at all of

the university locations and campuses as well as those at the three DOE laboratories.

As noted in chapter 1, between July 1, 1986, and July 1, 1987, the retirement plan became fully funded—that is, the plan's assets equaled or exceeded the plan's liabilities, on the basis of the actuarial assumptions. In fact, by the July 1, 1987, valuation of the pension fund, the plan had a surplus of more than $700 million. Thus, additional contributions were not needed to ensure the retirement benefits of the plan's participants. The university regents adopted progressively lower rates for the employer contributions, but they did not suspend these contributions until November 1990. Although the university's actuary and auditors cited the large surplus of assets in excess of liabilities—over $3 billion by the July 1, 1990, valuation—as the reason for suspending contributions to the retirement plan, the university's Vice President for Benefit Programs told us that the state's fiscal crisis and its effect on the university's budget was the primary motivation behind the regents' decision to discontinue the employer contributions.

The Office of Inspector General reported that DOE's contributions totaled about $230 million after the fund reached full funding in 1986. DOE officials question that amount, since the fund was not reported to be at full funding until the July 1, 1987, valuation. DOE's payments after July 1, 1987, were about $168 million. Regardless of the amount, DOE officials told us that they were not monitoring the surplus level reported by the university. Furthermore, the payments were allowable costs because the contracts required DOE to make them. As such, the university cannot be compelled to reimburse DOE.

Unless the University Agreed to a Complete or Partial Plan Termination, Contract Termination Would Be Required to Recover Pension Funds

For a governmental defined benefit retirement plan to maintain a tax-exempt status, the plan must comply with the federal exclusive benefit rule. This rule requires that the assets of the pension plan be maintained in a trust that prohibits the use of any part of the fund, or the fund's income, for any purpose other than the benefit of the plan's employees and their beneficiaries. This means that the assets of the retirement plan are not available for any nonplan purpose, such as the recovery of unnecessary payments. Federal law does allow a government employer to recapture surplus pension assets upon a government plan's termination if the plan's liabilities to all participants and beneficiaries are first satisfied. If the university took such an action, it could recover any remaining surplus and thus give DOE the opportunity to recover from the university that portion of

the surplus funds associated with the laboratory employees. However, it might not be necessary for the university to terminate the entire plan to recover the surplus assets. Subject to Internal Revenue Code requirements separate plans covering just the laboratories could be spun off. The separate plans covering the DOE laboratory employees could then be terminated and reconstituted, allowing recovery of any remaining surplus funds once the liabilities to all participants and beneficiaries are first satisfied. A new plan—or separate plans for the different groups involved—could then be established to provide for the employees' retirement benefits as they are earned in the future. A separate plan may also allow DOE more control over fund payments and surplus levels.

DOE cannot unilaterally decide that the pension plan should be completely or partially terminated; only the university can initiate the actions needed to terminate the plan. If the university is not willing to terminate the plan, DOE would have to terminate its relationship with the university to achieve any change to the pension plan's provisions affecting the laboratory employees.

If the DOE contracts with the university were to be terminated, several different approaches could be followed. In the unlikely event that none of the current employees remain at the laboratories, the contracts specify that DOE would be liable for the cost of any portion of the pension benefits earned by the laboratory employees that exceeded the pension fund's assets attributed to those employees. Conversely, the regents would have to reimburse DOE for the excess when the value of assets attributable to the laboratory employees is greater than the corresponding liability. If the members of the current retirement plan are transferred to a new contractor hired to operate the facility, the value of assets associated with the DOE laboratories (less the assets needed to satisfy the liabilities of pensioners, survivors, terminated vested members, and active laboratory employees retained by the university) will be transferred to the successor pension plan. The successor plan would have to be terminated and reestablished and the accrued benefits of all members satisfied before DOE could recover any remaining surplus pension funds.

Any changes to the retirement plan would probably be viewed with suspicion by the affected employees. Even though federal law is designed to ensure that all benefits owed the plan's members are fully satisfied, the uncertainty caused by the action to terminate the plan would probably have a negative effect on the members' morale.

Uncertainty also exists as to the amount that DOE could recover if the plan were terminated. The amount recovered would depend on when the plan was terminated. In 1990, the surplus was over $3 billion. By 1993, the surplus had fallen to just $1.3 billion, in part because, as discussed in the next chapter, the regents had approved increased benefits for the plan's members. Of the current $1.3 billion surplus, only $235 million is associated with the university employees at the three DOE laboratories. As noted in chapter 1, the surplus was calculated using the actuarial value of the plan's liabilities and is based on various assumptions about such things as future compensation, cost-of-living allowances, retirement age, and employee turnover. The amount available for recovery, however, will be determined by the actual costs involved in providing annuities to satisfy the actual liabilities (benefits) owed to members at the time of the plan's termination and the administrative costs of terminating and reestablishing the plan.

Finally, if DOE were able to recover any remaining surplus funds upon the termination of the plan (or any successor plan), DOE would then have to resume employer contributions to cover the pension benefits being earned by the employees at the three laboratories. DOE has not made any contributions since November 1990, when the employer contributions were suspended. The actual contribution would, of course, be set by the University of California Regents on the basis of the actuarial evaluations of what would be needed to cover normal costs. Using the data from the July 1, 1993, actuarial reports, these costs for the laboratory employees totaled over $140 million. The university officials pointed out, however, that DOE would not have to contribute this whole amount because some portion of the amount would be covered by employee contributions. The payments, therefore, could be between $100 million and $140 million each year.

OIG Reports That a Portion of the Surplus Funds Might Be Available to Offset Postretirement Health Benefit Costs

A recent report[1] by DOE's Office of Inspector General identified another potential alternative that might allow the University of California Regents to use a portion of the pension fund surplus to offset current expenses. The May 1994 report noted that, subject to certain conditions, some surplus pension funds may be used to pay for postretirement health benefits. Since DOE pays these costs as they are incurred, the use of surplus pension funds would offset the need for current expenditures.

[1]Report on the Follow-Up Inspection of Selected Aspects of the Department of Energy's Administration of Post Retirement Health Benefits, May 5, 1994 (DOE/IG-0348).

The report further states that

- only pension funds that exceed 125 percent of current liabilities can be transferred to pay for postretirement health benefits;
- these transfers, which can be made only once a year, must be used to pay retirees' health benefits liability for the year of the transfer; and
- the transfers must be made in tax years beginning before January 1, 1996.

Section 420 of the Internal Revenue Code, enacted in 1990, would allow the University of California Regents, subject to certain conditions, including those listed by the Inspector General, to transfer retirement assets to medical benefit accounts without adverse tax consequences. The cost of post-retirement health benefits for the retirees from the three DOE laboratories amounted to $40 million during the year ended June 30, 1994.

Conclusions

The previous contracts with the university placed no limitation on DOE's pension fund contributions. Consequently, DOE paid unneeded employer contributions to the fully funded retirement plan for the university employees at the three DOE laboratories. Because of the contract terms and federal law, these unneeded payments cannot be recovered from either the University of California or the pension fund itself.

As allowed by federal law, however, termination of the plan or the portion associated with the DOE laboratory employees would provide an opportunity for DOE to recover the remaining surplus pension funds, which were the result of the unneeded contributions as well as successful investment decisions. Termination of the university's contracts would also allow recovery of remaining surplus assets, in accordance with the contracts' provisions. The termination of the plan would require the agreement of the university or its successor contractor, and any change could also affect the employees' morale. The amount to be recovered will depend on the cost of providing the benefits owed to the employees as of the date of termination and the administrative costs involved. Finally, if the current pension plan were terminated, DOE would have to resume employer contributions to the new pension fund that could total from $100 million to $140 million each year.

Finally, according to the Inspector General's report, transferring a portion of the surplus to cover current postretirement health benefit costs might allow DOE to offset current costs. This would avoid many of the disadvantages associated with terminating a pension plan.

Recommendations

We recommend that the Secretary of Energy (1) evaluate the advantages and disadvantages of all of the alternatives available to recover surplus pension funds associated with the laboratory employees and (2) initiate action to recover the surplus funds if recovery is to the government's advantage.

Current Contract Terms Do Not Ensure DOE's Control Over Use of or Contributions to Pension Fund

DOE has little control over how funds in the University of California Retirement Plan are used. DOE's 1992 revised contracts with the university still allow the university to change the benefits provided to all pension plan participants, including those at the DOE laboratories, without DOE's approval. DOE's approval is needed only for changes that are specific to the DOE laboratory personnel. In recent years, the university has made numerous retirement plan changes that have increased the employees' retirement benefits and decreased the pension fund surplus. While DOE officials agree that the existing contracts with the university do not give them the ability to control proposed pension fund changes that affect all plan members, they point out that they have made considerable progress in the past several years in working with the university to adjust proposed changes affecting the laboratory employees. Because the contracts do not require the university to agree to any of DOE's changes, however, the university is still determining the extent to which DOE can control pension fund activities and their resulting costs.

Although the revised contracts established a limit on DOE's pension fund payments, DOE's contributions can be required when the retirement plan's total assets are less than 150 percent of current liabilities. This requirement exceeds DOE's policy of limiting contributions to those necessary to maintain equilibrium between a plan's assets and liabilities. In addition, the contract limitation is determined by the status of the entire plan, not just the portion associated with the employees at the DOE laboratories. According to DOE officials, they have found it impractical to apply the DOE policy to commingled plans such as the university plan. However, even though the DOE laboratory employees are members of the larger university plan, they have not received the same benefits as university employees in several recent retirement program changes. In addition, the university is required to submit a separate accounting for the pension fund assets and liabilities related to the DOE laboratory employees.

DOE's Approval Not Needed for Changes to the Pension Plan

The regents have made a number of changes to the retirement plan benefits that have reduced the pension fund surplus. Although DOE's pension plan policy provides that DOE approval should be required for any pension plan changes, DOE's earlier contracts with the university did not include such a requirement. In addition, the revised contracts effective October 1, 1992, still do not require the university to get DOE's approval for any retirement plan changes that apply to all of the plan's participants. In these instances, the contracts specify that the university will advise DOE about the proposed changes. The contracts require only that the university

get prior DOE approval for laboratory-specific changes that would increase the cost of the contracts beyond the cost approved by the regents for university employees.

Changes to Retirement Plan Benefits Have Reduced the Pension Fund Surplus

In recent years, the University of California Regents have made a number of changes in retirement plan benefits that increased benefits to employees and reduced the pension fund surplus. Between July 1, 1990, and July 1, 1993, the latest actuarial valuation of the fund, the fund surplus fell from $3.3 billion to $1.3 billion, in part because the regents approved benefit changes that cost an estimated $1.5 billion. An additional $0.6 billion in changes has not yet been reflected in the valuation of the pension fund. Although these changes have not increased either DOE's or the university's current costs, they will bring closer the point at which employer contributions to the retirement plan will have to be resumed. As discussed in chapter 1, DOE makes the employer contributions for university employees at the three laboratories (about 20 percent of active members), while the university makes the contributions for the remaining 80 percent of the members. Some of the changes will increase pension costs for all future employees. The changes include:

- Modifying the retirement plan's formula for cost-of-living adjustments. This change was effective July 1, 1992, and is estimated to cost about $590 million.
- Lowering from 63 to 60 the age at which maximum retirement benefits could be earned. This change was effective July 1, 1992, and is estimated to cost about $144 million.
- Increasing the retirement benefits for eligible participants, including those at the three DOE laboratories, through capital accumulation provisions that credited special retirement accounts with amounts equal to specified percentages of the employees' salaries. These accounts, which will also earn interest until closed, will provide a pension supplement that will be paid to the employees when they leave the university or retire. As shown in table 3.1, this change is estimated to cost about $349 million.

Table 3.1: Eligible Employees, Credits Received, and Total Cost of the First Capital Accumulation Provision

Dollars in millions

Eligible employees include active plan members as of	Cost	Capital accumulation credits received
April 1, 1992[a]	$169	5 percent of compensation received during the period from January 1, 1991, through December 31, 1991
July 1, 1992	89	2.5 percent of compensation received during the period from July 1, 1991, through June 30, 1992
July 1, 1993	91	2.5 percent of compensation received during the period from July 1, 1992, through June 30, 1993
Total	**$349**	

[a]To be eligible for this first allocation, the employees also had to have been continuously employed by the university from December 31, 1991, through April 1, 1992.

In addition, since 1990, three voluntary early retirement programs have been offered, primarily to reduce the university's work force in order to deal with the state of California's fiscal constraints and budgetary crisis. Each of the incentive programs increased the retirees' highest average compensation by 7 percent and provided transition assistance payments of 3 to 6 months' salary. Additional service and age credit were also offered. The first program, which was offered to all retirement plan members, and the second program, which was offered only to nonlaboratory employees, provided 5 additional years of service credit. The third program offered nonlaboratory employees a combined age and service credit of 8 years, while laboratory employees were offered a combined age and service credit of 6 years.[1] Table 3.2 shows the average cost per retiree for each of the voluntary separation programs.

[1]Several laboratory employees, however, have initiated a class action suit claiming unfair treatment because they were not offered the same benefits as the other university employees in the third voluntary separation program.

Table 3.2: Number Eligible, Number Retired, and Average Cost Per Retiree for Three Voluntary Early Retirement Programs

	DOE laboratory employees	Other university employees	Total
First program			
Number eligible	1,692	5,814	**7,506**
Number retired	609	2,932	**3,541**
Average cost per retiree[a]	$ 64,039	$ 82,810	**$ 79,582**
Second program			
Number eligible	N/A[b]	8,434	**8,434**
Number retired	N/A	2,278	**2,278**
Average cost per retiree[a]	N/A	$ 70,500	**$ 70,500**
Third program[c]			
Number eligible	4,424	8,127	**12,551**
Number retired	1,779	2,804	**4,583**
Average cost per retiree[a]	$117,488	$128,234	**$124,063**

[a]DOE officials point out that retirement costs are funded in part by employee contributions, in addition to the employer contributions and investment earnings.

[b]N/A = Not applicable.

[c]Does not include faculty members who have until July 1, 1994, to retire.

The $450 million cost of the first and second voluntary early retirement programs was reflected in the pension fund's July 1, 1993, valuation. The cost of the third program—which was estimated to total about $545 million as of July 1, 1993—has not yet been applied in calculating the pension fund's valuation.

In addition to the third voluntary separation program, the regents have also approved two other capital accumulation provisions, estimated to cost about $70 million. Of this amount, about $21 million has not yet been reflected in the valuation of the pension fund. These provisions were designed to offset a salary reduction caused by the state of California's budget shortfall. Since the DOE laboratory employees were not affected by the salary reduction, they are not eligible to receive these two capital accumulation provisions.

The regents have also approved a redirection of employees' contributions from the defined benefit plan to a supplemental plan (in which participation had formerly been voluntary). Effective November 1, 1990, when the employer contributions were discontinued, the university

regents reduced some employees' contributions and began depositing a portion of the remaining contributions in the supplemental plan. Since July 1, 1993, none of the employees' contributions have been deposited in the defined benefit plan. The funds in the supplemental plan will provide the employees with additional benefits upon retirement. While we could not quantify the impact of this change on the pension fund surplus, the employees' contributions into the defined benefit plan fell from more than $87 million during the plan year ending June 30, 1990, to just over $14 million during the plan year ending June 30, 1993.

Although Not Required to Do So, the University Reduced Some Proposed Benefits

According to DOE officials, the requirement in the revised contracts that the university advise DOE about proposed changes means that the university must provide adequate notice and allow DOE an opportunity to negotiate changes it believes are needed. The officials believe that they have made considerable progress in the past several years in getting the university to adjust proposed changes to reflect DOE's concerns.

For example, the third voluntary early retirement program is the only plan change adopted since the revised contracts were signed. DOE had objected to the university's proposed program because some of the provisions were more generous than the provisions offered by other DOE contractors, and they were concerned that essential scientific expertise might be lost through these retirements. Because of the loss of needed expertise, the university had to rehire many laboratory retirees after previous early retirement programs, sometimes for extensive periods of time.[2] The university gave DOE certain assurances that rehiring of the voluntary retirees would be limited. The rehiring restrictions included the following: (1) no retirees will be rehired for 3 months after their retirement, the time period covered by the transition payment; (2) any retirees rehired will not be employed full time; (3) retirees cannot be paid more than 85 percent of their pay rate at retirement; and (4) the cumulative payroll for all rehires at each laboratory cannot exceed 15 percent of the payroll for all retirees at that laboratory at the time of their retirement. The university also reduced the additional credit offered to the laboratory employees for the number of years of age and service that would be used to determine retirement income. While this change reduced the cost of the early retirement program for the laboratory employees, as shown in table 3.2, the average cost per employee was still $117,488 for the 1,779 laboratory employees

[2]In 1993, the Inspector General reported that in fiscal year 1992 the Livermore Laboratory had rehired—at a cost of over $3 million—over 220 of the employees who had retired under voluntary separation programs. In fact, 15 employees who retired under a December 1990 special incentive retirement program were still employed at the time of the Inspector General's review.

who accepted the early retirement offer. In addition, because DOE's approval is not required by the contract, the university is determining the extent to which DOE can control pension fund activities and their resulting cost. While the university made several changes to the proposed program, the university's Assistant Vice President for Benefit Programs pointed out that the university is not required by the contracts to accede to DOE's wishes.

Contribution Limit in New Contracts Still Requires Higher Payments Than DOE's Policy

The most recent contracts with the university for the operation of the three DOE laboratories continue to require DOE to fund the employer's cost of the university pension plan at the rates established by the regents. The contracts do, however establish a limit on what DOE must pay by providing that "the DOE funded contribution shall not exceed the full funding limit as defined in the IRC [Internal Revenue Code] section 412." Section 412 essentially limits the amount of tax-deductible pension plan contributions that an employer can make to a qualified defined benefit plan to those necessary to maintain the plan's assets equal to 150 percent of current liabilities.[3] As of July 1, 1993, the pension plan's assets exceeded 150 percent of the current liabilities by about $825 million. Since, as a nontaxable entity, the university is not paying federal income taxes, the IRC limitation is applicable only because it is specified as the funding limit in the contracts with DOE.

DOE's contributions under this funding limitation will still exceed DOE's policy. DOE's January 1988 policy is to minimize payments to contractors' pension plans. Specifically, DOE's policy states that the primary funding objective should be for contractors to maintain asset levels necessary to satisfy benefits earned to date (that is, current liabilities). Therefore, according to the policy, if it is anticipated that the value of a plan's assets will exceed the current liability at the end of a plan year, DOE should not make any contributions during that year.

In addition, the IRC's limitation on retirement contributions is computed on the entire fund, not just the portion of the fund associated with the DOE

[3]IRC section 412(c)(7)(A) defines the full-funding limitation as the excess of the lesser of (1) 150 percent of current liability or (2) the accrued liability (including normal cost) under the plan, over the lesser of (1) the fair market value of the plan's assets or (2) the value of such assets determined under the plan's actuarial method. The current liabilities are the plan's liabilities to the employees and their beneficiaries measured as if the pension plan had been terminated at that specific point in time. The accrued liabilities are based on the projected benefits expected to be earned by retirement and assume that the employees will continue to work and earn higher salaries. Because the accrued liabilities are generally greater than 150 percent of the current liabilities, the full-funding limit is generally referred to as 150 percent of the current liabilities.

employees. If the value of the assets for the entire retirement plan is less than 150 percent of the current liabilities, DOE could be required to resume contributions, even if the assets associated with any or all of the laboratories exceed 150 percent of current liabilities.

According to officials in DOE's Office of Procurement, Assessment and Property, they have found it impractical to apply the DOE policy to commingled plans such as the university plan. Because they have agreed to allow the laboratory employees to be members of the university's retirement plan, they believe that they have to follow the policies set by the university for the entire plan. However, DOE noted in establishing its pension fund contribution policy that the IRC limit is too high for the DOE contractors' pension plans because it provides an additional 50-percent cushion that is not needed. DOE based this decision on the fact that DOE must fully fund contractors' pension benefits if a contract with one of its management and operating contractors is terminated. In addition, recent experience—the latest capital accumulation provisions and the second and third voluntary separation programs—has shown that it is sometimes necessary to provide a different level of benefits to the laboratory and nonlaboratory employees. Finally, the university is also required by the latest contracts to prepare a separate accounting that reflects the portion of the pension fund attributable to the DOE laboratory employees.

Similar Problems Exist With Other DOE Contracts

DOE's contracts with two other nonprofit educational institutions with defined benefit plans—Princeton University for the operation of the Princeton Plasma Physics Laboratory and Stanford University for the operation of the Stanford Linear Accelerator Center—also have deficiencies. First, the contracts provide that these institutions must advise DOE of any changes that affect all of the plans' members but are required to get DOE's approval for only those changes that are specific to laboratory employees.

These contracts also do not contain any limit on the pension fund contribution to be paid by DOE. In DOE's contract with Princeton University, DOE agreed to pay the pension costs for the plan's laboratory participants at the rate established by the university. The Stanford University contract, which is similarly worded, simply requires DOE to pay the pension cost for the plan's participants under the contract. As with the previous University of California contracts, these contract provisions (1) provide no limit on contributions that can be required from DOE by the universities and (2) do not provide DOE with the authority to enforce its pension plan policies,

such as limiting contributions to those necessary to maintain equilibrium between the plan's assets and current liabilities.

Our examination of the latest actuarial reports for the laboratory segments of the Princeton and Stanford pension plans shows that DOE is making contributions to both funds. Because the Stanford plan's liabilities associated with the laboratory are well in excess of the plan's associated assets, it is appropriate under DOE's policy to continue contributions until liabilities and assets are in equilibrium. However, DOE's contributions to the Princeton plan, which had about $3.4 million of laboratory-associated assets in excess of liabilities at the beginning of the 1993 plan year, are (1) not necessary to ensure the laboratory employees' benefits and (2) exceed DOE's contribution policy. While the fully funded status of the plan is acknowledged in the actuary report, Princeton required DOE to contribute $718,000 for the plan year ending June 30, 1993.[4]

Conclusions

While DOE believes it has made progress in working with the university to get proposed benefits changed to reflect DOE's concerns, current contracts still allow the university to make changes that affect all participants in the retirement plan, including those at the DOE laboratories, without DOE's approval. Between 1990 and 1993, the university made changes to the retirement plan that used up $1.5 billion of the pension fund surplus. Additional changes, which are estimated to cost about $0.6 billion, have not been reflected in the latest fund valuations.

This erosion of the pension fund surplus has shortened the time until DOE will have to resume its employer contributions. In addition, even though these benefit increases do not affect DOE's current costs because they are covered by the pension fund surplus, changes such as reducing the age at which members can receive maximum benefits have obligated DOE to provide future employees with these increased benefits. DOE's contracts with two other educational institutions with defined benefit plans contain similar deficiencies.

The new contracts between DOE and the university still require larger payments than those that are required under DOE's pension fund policy. DOE's contracts with two other educational institutions with defined benefit plans place no limit on the amount of DOE's employer pension contributions. DOE officials believe that it is impractical to impose DOE's

[4]When the employees currently covered by Princeton's defined benefit plan are transferred to Princeton's defined contribution plan in 1994, DOE will no longer be making payments to the defined benefit plan.

pension funding policy on commingled plans such as the University of California plan. However, we do not see why DOE should follow the contribution policy the university established for the rest of its employees when (1) the larger funding cushion is not needed for the DOE laboratory employees because DOE is required to fully fund contractors' pension benefits if a contract is terminated, (2) the DOE laboratory employees have not always been given the same benefits as the other university employees, and (3) the university is already required to provide a separate accounting of the pension fund activities for the DOE laboratory employees.

Recommendations

To improve control over the Department's liability for pension fund contributions, we recommend that the Secretary of Energy (1) review ongoing contracts with all management and operating contractors that have defined benefit pension plans to determine if they provide for DOE's approval of pension benefit changes and limit DOE's contribution to that needed to maintain an equilibrium between assets and current liabilities and (2) initiate negotiations with the University of California and other contractors, as necessary, to revise the contracts to implement these controls.

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Related GAO Product

Cost Accounting: Department of Energy's Management of Contractor Pension and Health Benefit Costs (GAO/AFMD-90-13, Aug. 29, 1990).

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