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Comptroller General
of the United States

United States Government Accountability Office
Washington, DC 20548

November 17, 2005

Congressional Committees

Subject: *Review of OMB Circular A-76 Health Benefit Cost Factor Needed*

Determining whether to obtain required services using government employees or through contracts with the private sector is an important economic and strategic decision for agency managers. In this regard, Office of Management and Budget (OMB) Circular A-76 prescribes policies and procedures for use by agencies as they select service providers through competitions among public and private-sector sources.¹ The Circular is intended to ensure that the competitive sourcing process is conducted as fairly as possible, and that the estimated cost of government performance reflects all of the costs of performing the work in house.

The purpose of this letter is to convey an issue we identified during the course of an ongoing review of how the costs of health benefits for federal and private-sector employees are reflected in public-private competitions conducted by the Department of Defense.² We have determined that the health benefit cost factor prescribed in Circular A-76 may not reflect the current cost to the government of providing health insurance under the Federal Employees Health Benefits Program (FEHBP). The cost to the government of providing health benefits under the FEHBP has risen by more than 65 percent between 1999 and 2005. Yet the health benefit cost factor prescribed in A-76 has not been changed at all in that time. In view of the increased cost of providing health insurance since the cost factor last was revised, we recommend that OMB review the health benefit cost factor to determine if an adjustment is needed and establish a process to update it periodically, as OMB does for other cost factors.

Standard Costing Factors for Estimating Personnel
Costs Include Employee Benefits

Circular A-76 establishes standard costing factors that agencies must use to estimate the costs of in-house performance. When preparing these estimates, agencies use cost

¹OMB Circular A-76, *Performance of Commercial Activities*, revised in May 2003, establishes federal policy and procedures for determining whether commercial activities should be performed in-house, by another federal agency, or by the private sector. Circular A-76 contains procedures agencies must use in calculating and comparing the costs of performance by in-house, private, or public reimbursable sources.

²In response to direction in the conference report on the Ronald W. Reagan National Defense Authorization Act, House Rep. No. 108-767, we are reviewing the implementation of section 8014 of the Department of Defense Appropriations Act, 2005, Public Law No. 108-287. Section 8014 contains requirements concerning the costs of health benefits in public-private competitions conducted by the Department of Defense.

factors that are in effect as of the solicitation closing date, revised to reflect projected changes to these factors during the performance period. To estimate personnel costs, for example, agencies add to basic pay a standard overall factor of 32.85 percent to account for fringe benefits. This overall factor is comprised of several components, including a standard cost factor of 5.7 percent to account for insurance and health benefits, as shown in table 1.

Table 1: Components of Circular A-76 Civilian Position Full Fringe Benefits Cost Factor

Standard cost factor	Percentage of basic pay^a
Insurance and health benefits ^b	5.7
Standard civilian retirement benefit ^c	24.0
Medicare benefit	1.45
Miscellaneous fringe benefits	1.7
Total	32.85

Source: Circular A-76, attachments C and D.

^aCircular A-76 defines basic pay as a civilian employee's annual salary plus other applicable employee pay entitlements, such as premium pay for civilian law enforcement officers.

^bIn addition to FEHBP, employees may receive life insurance benefits through the Federal Employees Group Life Insurance program.

^cThe standard civilian retirement benefit cost factor includes the government share for pension benefits (Social Security, Thrift Savings Plan, Federal Employees or Civil Service Retirement Systems) and the accruing costs for post-retirement health benefits.

According to OMB staff, the 5.7 percent cost factor reflects 0.2 percent for life insurance and 5.5 percent for health benefits. The current insurance and health benefit cost factor is based on actuarial estimates made in 1999.

Health Benefit Factor Not Revised during Period of Substantial FEHBP Cost Growth

Certain factors used in Circular A-76 calculations for computing the government's non-pay and personnel costs are routinely reviewed and adjusted by OMB. These include the standard inflation factor for supplies and equipment and annual federal pay raise assumptions. This periodic review helps to ensure that the cost factors are up to date in order to reflect accurately the full estimated cost of performance. Nonetheless, our discussions with competitive sourcing officials and review of OMB's transmittal memoranda indicate that the insurance and health benefits cost factor has not been reviewed and adjusted with the same frequency as other factors, but rather has been set at 5.7 percent of a position's basic pay since 1999.³

³Circular No. A-76 (Revised), Transmittal Memorandum No. 19, *Performance of Commercial Activities*, March 24, 1999. In this memorandum, OMB revised the then 5.6 percent cost factor for insurance and health benefits up by 0.1 percentage points (on the health insurance side) to 5.7 percent.

In contrast, our review of the federal budget costs for FEHBP and the annual average premium increases announced for FEHBP health insurance plans indicates that civilian employee health benefit costs have increased substantially since OMB last revised this cost factor. Our analysis of federal budget data shows that the government's FEHBP costs in fiscal year 2005 have increased by more than 65 percent relative to fiscal year 1999.⁴ (See table 2.)

Table 2: Federal Government Gross Outlays for FEHBP,^a Fiscal Years 1999 to 2005

Dollars in billions (then-year dollars)							
	1999	2000	2001	2002	2003	2004	2005 ^b
Gross outlays	\$18.5	\$19.6	\$20.8	\$22.7	\$25.0	\$27.4	\$30.7

Source: Budget of the U.S. Government.

^aThe FEHBP fund provides for the cost of health benefits for (1) active employees; (2) employees who retired after June 1960 or their survivors; (3) those annuitants transferred from the Retired Employees Health Benefits fund program; and (4) the related expenses of the Office of Personnel Management in administering the program.

^b2005 outlays are estimated.

Additionally, the annual open-season enrollment announcements from the Office of Personnel Management (OPM) indicate that average FEHBP premium increases have ranged between 7.9 and 13.3 percent per year during the period from 1999 to 2005.⁵ (See table 3.) The government-paid portion of FEHBP premiums averages 71 percent.⁶

Table 3: Average FEHBP Premium Increases, 1999 to 2005

	1999	2000	2001	2002	2003	2004	2005
Average percentage increase	9.5	9.3	10.5	13.3	11.1	10.6	7.9

Source: OPM announcements of FEHBP open season premium changes.

Despite these changes in federal employee health benefit costs under FEHBP, the Circular A-76 health benefits cost factor, which is designed to reflect the health care

⁴This increase reflects both the increase in premiums paid by active federal employees and retirees and the increase in the amount paid by the government for all participants. However, the insurance and health benefit cost factor used in Circular A-76 is based only on the costs borne by the government (not enrollee premiums) and only on behalf of active federal employees (not retirees). Increases in government costs for retirees are reflected in the standard civilian retirement benefit cost factor.

⁵OPM develops two figures for annual FEHBP premium changes: one in the fall prior to open season enrollment, when negotiations with the plans are complete, and the second after enrollment has occurred. The difference is that there may be some change in enrollment following the open season, with some people leaving plans with higher premium cost increases and joining plans with lower cost increases. In October 2005, OMB provided us OPM's post-open season enrollment FEHBP premium changes between 1999 and 2005 which showed that premium increases ranged between 7.4 and 12.7 percent.

⁶The implications of higher government-paid costs from increased FEHBP premiums since 1999 will have to be determined through actuarial analyses based on other related changes over time, such as changes in the average salaries of active federal employees and their participation rates in the FEHBP.

cost to the government for in-house performance, has not been adjusted by OMB at all during that time.

Conclusion

Health care costs are a large and growing consideration both for the private sector and for government operations. Yet despite recent increases in the government's cost of health care premiums, the cost factor in Circular A-76 designed to reflect these costs has not been adjusted in the past 6 years. We recognize that an adjustment of this factor could result in higher estimates of the total cost of government performance, and in some cases this could affect the outcome of public-private competitions. Nevertheless, the sourcing principles adopted by the Commercial Activities Panel,⁷ call for competitions between government and private-sector sources to be conducted as fairly as possible. In our view, fairness requires that any cost factor used in estimating the cost of performance, whether by private or public sector sources, be as accurate and current as possible in order to protect the integrity of the process.

Recommendations for Executive Action

In order to ensure the health benefit cost factor appropriately reflects up-to-date and accurate assumptions, we recommend that the Director of OMB take the following two actions:

- Reevaluate the health benefit cost factor to determine if an adjustment is necessary, based on the most current federal health insurance costs under FEHBP.
- Establish procedures to provide for periodic updates of the health benefit cost factor in view of changes over time to the government's costs associated with FEHBP benefits.

Agency Comments

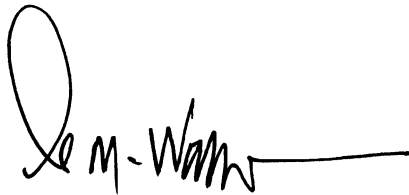
We provided a draft of this letter to OMB for review and comment. OMB did not provide official agency comments, but OMB staff provided technical suggestions, which we incorporated as appropriate. The staff also stated that OMB is working with OPM in reviewing the health benefit and insurance cost factors and is looking at options for reviewing these factors on a more regularized cycle.

⁷Commercial Activities Panel, *Improving the Sourcing Decisions of the Government* (Washington, D.C.: Apr. 30, 2002).

Scope and Methodology

The information in this letter is based on ongoing GAO work and limited additional work conducted from February through October 2005, in accordance with generally accepted government auditing standards. In conducting our work, we reviewed federal budget data and OPM announcements regarding FEHBP costs between 1999 and 2005, and A-76 policies and procedures for preparing personnel cost estimates for in-house performance, including the personnel health benefit factor used in making estimates for government cost. We also held discussions with competitive sourcing officials at the Department of Defense and OMB.

We are sending a copy of this letter to the Director for the Office of Management and Budget and other interested congressional committees. We will provide copies to others upon request. This letter will also be available on GAO's home page at <http://www.gao.gov>. If you have any further questions or would like to discuss this matter in more detail, please call me or Katherine Schinasi, Managing Director, Acquisition and Sourcing Management (ASM), who may be reached at (202) 512-4841. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. This letter was prepared under the direction of Bill Woods, Director, ASM. GAO staff who made contributions to this letter were Carolyn Kirby, Assistant Director; John Dicken; Rosa Johnson; Charles Perdue; Russ Reiter; Sylvia Schatz; Natalie Schneider; Robert Swierczek; and Tony Wysocki.

A handwritten signature in black ink, appearing to read "D M Walker", with a long horizontal line extending to the right.

David M. Walker
Comptroller General
of the United States

(120491)

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