

AUDIT REPORT

FOLLOW-UP AUDIT OF HEALTH BENEFIT COSTS AT THE DEPARTMENT'S MANAGEMENT AND OPERATING CONTRACTORS



MAY 2000

U.S. DEPARTMENT OF ENERGY
OFFICE OF INSPECTOR GENERAL
OFFICE OF AUDIT SERVICES

May 11, 2000

MEMORANDUM FOR THE SECRETARY

FROM: Gregory H. Friedman (Signed)
Inspector General

SUBJECT: INFORMATION: Audit Report on "Follow-up Audit of Health Benefit Costs at the Department's Management and Operating Contractors"

BACKGROUND

In Calendar Year (CY) 1998, the Department of Energy (Department) spent about \$480 million to provide health benefits for employees of its contractors. In 1994, the Office of Inspector General (OIG) evaluated the system in place at that time to determine if contractor employee health benefit costs were reasonable. In our June 1994 report, DOE/IG-0350, *Audit of Health Benefit Costs at the Department's Management and Operating Contractors*, we reported that the Department paid more than its fair share of management and operating contractors' employee health benefit costs. We recommended that the Department (1) publish quantitative measurement techniques or standards for use in testing the reasonableness of contractor employees' health benefit costs, (2) require tests of the reasonableness of employees' health benefit costs to be performed periodically, and (3) provide guidance concerning specific health care provisions in Management and Operating (M&O) contracts. In response to the audit recommendations, the Department issued Order 350.1, *Contractor Human Resource Management Programs*, to require that contractors use one of two quantitative measurement techniques to periodically evaluate the reasonableness of employee benefit programs, and to require model contract language addressing employee benefit program features. Health benefit plans are a part of overall contractor employee benefit programs. In addition, the Department increased its staff of benefit experts, prepared a training manual, and held training on Order 350.1 at Departmental field sites.

The objective of this audit was to determine whether the Department's actions in response to Report DOE/IG-0350 have reduced employee health benefit costs.

RESULTS OF AUDIT

The Department's actions in response to the prior audit have significantly reduced employee health benefit costs. Several contractors implemented actions that substantially reduced overall costs while maintaining competitive benefit programs for employees. However, despite these improvements, the Department continued to pay substantially more than competitive market benchmarks per capita for employee health benefits in CY 1998. This occurred because the Department did not require contractors to bring health benefit plan costs in line with competitive market benchmarks and industry practices. Had the Department required the three contractors we examined to bring health benefit plan costs in line with competitive market benchmarks and industry practices, the Department could have saved \$33 million in employee health benefit costs in CY 1998.

MANAGEMENT REACTION

Management did not concur with the finding and recommendations. Management stated that much of the report is incorrectly focused on demonstrating that a facet of the overall benefit issue has not been aggressively pursued by the field offices reviewed while ignoring that the overall cost of contractor benefit programs have been reduced Departmentwide. Also, management contends that the recommendations are inconsistent with Federal and Departmental acquisition regulations and would unduly restrict the Department's ability to exercise prudent business judgement.

The results of this audit are based upon the quantitative measurement techniques contained in a U.S. Chamber of Commerce study, which the Department provided its contractors as an option in Order 350.1, and the results of studies performed for the Department by a national consulting firm. All of the studies produced similar results, suggesting that the Department was paying more than competitive benchmarks per capita for contractor health care benefits. We believe the recommendations are consistent with Federal and Departmental acquisition regulations and would not unduly restrict the Department's ability to exercise prudent business judgement. The recommendations would supplement existing regulations and provide contracting officers with better tools for evaluating the reasonableness of health benefit costs.

Attachment

cc: Under Secretary
Deputy Secretary
Acting Under Secretary for Nuclear Security/Administrator for Nuclear Security

FOLLOW-UP AUDIT OF HEALTH BENEFIT COSTS AT THE DEPARTMENT'S MANAGEMENT AND OPERATING CONTRACTORS

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OVERVIEW

INTRODUCTION AND OBJECTIVE

The Department's Office of Contractor Human Resource Management is responsible for providing heads of site contracting activities with policies and procedures to assist them in assessing whether contractors' health benefit costs are reasonable. The Department spent about \$480 million for its contractors' employee health benefit programs in CY 1998.

The OIG issued a report on the *Audit of Health Benefit Costs at the Department's Management and Operating Contractors* (DOE/IG-0350) in June 1994. The objective of the audit was to determine whether the Department's share of costs for contractor employee health benefits was reasonable. The audit concluded that the Department paid more than its fair share of employee health benefit costs. The OIG recommended that the Department, (1) publish quantitative measurement techniques or standards for use in testing the reasonableness of contractor employees' health benefit costs; (2) require tests of the reasonableness of employees' health benefit costs to be performed periodically, and (3) provide guidance concerning specific health care provisions in M&O contracts.

In response to the prior audit, the Department benchmarked medical benefits and costs using outside, independent consultants, and issued Order 350.1, *Contractor Human Resource Management Programs*. The order requires that heads of contracting activities conduct evaluations of the reasonableness of employee benefit programs. It also requires that contractors develop and implement employee benefit programs to assure that costs are allowable and reasonable in accordance with Federal and Departmental acquisition regulations; periodically use professionally recognized measures to compare their benefit programs to other organizations; develop corrective action plans to achieve conformance when benefit values or costs vary from the benchmark by more than 5 percent; and submit the plan to the contracting officer for approval. Health benefit plans are a part of overall contractor employee benefit programs. In addition, the Department increased its staff of benefit experts, prepared a training manual, and held training on Order 350.1 at Departmental field sites.

In addition to Report DOE/IG-0350, the OIG issued Report ER-B-99-03, *Westinghouse Savannah River Company's Health Benefit Plan*, in January 1999. The audit concluded that a portion of Westinghouse Savannah River Company's CYs 1997 and 1998 health benefit plan cost was unreasonable because the contractor paid health care providers in the Aiken, South Carolina area at rates that were

higher than the standard Blue Cross/Blue Shield - South Carolina rates for the area. The Savannah River Operations Office did not concur with the audit conclusions. However, it did agree to limit future reimbursements for health benefits to the standard rates for the area.

The objective of this audit was to determine whether the Department's actions in response to Report DOE/IG-0350 have reduced employee health benefit costs.

CONCLUSION AND OBSERVATIONS

The Department's actions in response to the prior audit have significantly reduced employee health benefit costs. Several contractors implemented actions that substantially reduced overall costs while maintaining competitive benefit programs for employees. For example, between 1996 and 1998, Westinghouse Savannah River Company increased the proportion of health care costs paid by the employee from 12 percent to 14 percent and competitively awarded a new subcontract for the administration of its managed health care system. As a result of these and other actions, Westinghouse Savannah River Company reduced health benefit costs for active employees by about \$8 million in 1998.

In terms of current health care cost containment efforts, these were positive steps. However, the Department continued to pay substantially more than competitive market benchmarks per capita for employee health benefits in CY 1998. This occurred because the Department did not require contractors to bring employee health benefit plans in line with competitive market benchmarks and industry practices. Had the Department required the three contractors we examined to bring health benefit plan costs in line with competitive market benchmarks and industry practices, the Department could have saved about \$33 million in employee health benefit costs in CY 1998.

The audit identified issues that management should consider when preparing its yearend assurance memorandum on internal controls.

(Signed)
Office of Inspector General

REASONABLENESS OF HEALTH BENEFIT COSTS

Positive Steps Were Taken

The Department took positive steps toward reducing employee health benefit costs. The Office of Procurement and Assistance Management hired a national consulting firm to perform detailed health benefit reviews at five of the Department's largest M&O contractors in 1995. The results confirmed the prior OIG audit finding and determined that the Department could save \$36 million annually if the contractors brought employees' medical benefits in line with competitive market benchmarks. The consultants identified several opportunities to reduce health plan costs and still leave intact an attractive health benefit package for contractor employees. In 1996, the Department contracted with the same consulting firm for a per capita cost analysis of all M&O contractors' health benefit programs. The consultants concluded that the average contractor's costs for active employees exceeded competitive market benchmarks by about \$89 million annually using national benchmarks and about \$119 million annually using regional benchmarks.

Between 1996 and 1998, the Department and its contractors implemented several cost-reduction measures recommended by the consultants. For example, Westinghouse Savannah River Company increased the proportion of health care costs paid by active employees from 12 percent to 14 percent, and competitively awarded a new subcontract for the administration of its managed care system for less overall costs. Also, Lockheed Martin Energy Systems increased its employees' contributions from 9 percent to 12 percent, modified the preferred-provider-organization plan to a point-of-service plan utilizing a primary care physician to manage patient care, and eliminated costly health maintenance organization options.

The heads of field elements reported that the actions taken by their contractors generated annual savings of \$66.2 million in 1997 and \$55.7 million in 1998. We could not obtain sufficient data to verify the savings reported. However, we determined that the actions taken by Westinghouse Savannah River Company reduced employees' health care costs by about \$8 million in 1998.

Health Benefit Costs Still Exceed Competitive Market Benchmarks

The Department's actions since the prior audit were only partially effective in reducing contractor employee health benefit costs. The health benefit cost per capita for contractor employee health plans is still substantially higher than competitive market benchmarks. According to a study by the U.S. Chamber of Commerce, the benchmark for employers' contributions to employee health benefits was about \$2,232 per employee in CY 1998. By comparison, the average cost per employee for Westinghouse Savannah River Company

was \$3,213; the average cost per employee for the University of Chicago at the Argonne National Laboratory was \$3,232; and the average cost per employee for Lockheed Martin Energy Systems at the Y-12 Plant was \$5,356. Thus, the Department's costs exceeded the Chamber of Commerce's benchmark by about 44 percent at Westinghouse Savannah River Company, 45 percent at Argonne National Laboratory, and 140 percent at Lockheed Martin Energy Systems.

**Corrective Action Required
the Use of Quantitative
Measurement Techniques**

The prior OIG report on contractors' health benefit plan costs determined that the Department's costs were excessive because contracting officers were not required to evaluate and approve health benefit plans using quantitative measurement techniques or standards. To correct this concern, the Department benchmarked medical benefits and costs using outside, independent consultants, and issued Order 350.1 to require that heads of contracting activities assure that employee benefit program costs are allowable and reasonable in accordance with Federal and Departmental acquisition regulations. Additionally, the order requires that contractors periodically use professionally recognized measures to compare their employee benefit programs to other organizations; develop a corrective action plan to achieve conformance when benefit values or costs vary from the study benchmark by more than 5 percent; and submit the corrective action plan to the contracting officer for approval.

Order 350.1 required the heads of contracting activities to evaluate the reasonableness of overall employee benefit program costs in accordance with Federal Acquisition Regulation (FAR) 31.205-6 and Department of Energy Acquisition Regulation (DEAR) 970.3102-2. The regulations require that total employee compensation be reasonable for the work performed. The FAR 31.205-6(b) states that compensation will be considered reasonable if each of the allowable elements making up the employee's compensation package is reasonable. When a specific compensation item is challenged, the contracting officer will consider the magnitude of other compensation elements, which may be lower than would be considered reasonable in themselves.

The order states that contractors' benefit programs would be considered reasonable if they do not exceed the benchmark, using either the Chamber of Commerce Study or the Value Study method, by more than 5 percent. The benchmark used in the Chamber of Commerce Study is the average cost to the employer of benefits per

employee for all major U.S. industries. This benchmark is then compared to the average employer contribution cost of the Department's contractors to evaluate cost reasonableness. The Value Study, on the other hand, does not evaluate the cost of benefits to the employer. Instead, the Value Study is an actuarial study that uses a benchmark, called the net benefit value, to measure the relative worth of competing programs to employees, regardless of the cost of the programs to the employer. If the overall benefit package exceeds the benchmark selected to evaluate the benefit program by more than 5 percent, the Department requires that the contractor prepare a corrective action plan to bring its benefit program back to reasonable levels.

Contractors Were Not Required to Develop Plans Consistent with Competitive Market Benchmarks

The Department paid more than competitive market benchmarks per capita for employee health benefits because it did not require contractors to bring health benefit costs in line with competitive market benchmarks or industry practices. The Department considered the test of reasonableness at FAR 31.205-6 and DEAR 970.3102-2 to be sufficient for determining the reasonableness of overall employee benefit costs, and it considered the use of competitive market benchmarks or industry practices inappropriate for evaluating the reasonableness of employee health benefit costs.

The evaluations of overall employee benefit programs that were performed by the contractors reviewed could draw no conclusions about whether costs exceeded competitive market benchmarks. Therefore, the evaluations would not trigger the preparation of corrective action plans to reduce costs to reasonable levels. Departmental Order 350.1 provided contractors with an option to use either the Chamber of Commerce Study or the Value Study method to evaluate benefit programs. Based on the results of this audit, we found that the Chamber of Commerce Study method, because it includes the employer's actual cost in its calculations, is a valid basis for evaluating benefit program costs. In contrast, the Value Study method has an inherent weakness in that it disregards the actual cost to the employer. For this reason, we believe that the Value Study method should not be used as the primary basis for evaluating these programs. Yet, all of the contractors reviewed selected the Value Study method to evaluate the reasonableness of their overall employee benefit programs. In each case, the Value Study method concluded that the value of the contractors' benefit programs to its employees was within the 5 percent range of acceptability. The order did not require the contractors to take any further action.

If the Chamber of Commerce Study method had been used to evaluate the reasonableness of employee benefit program costs, all of the contractors reviewed would have exceeded the 5 percent range of acceptability. According to the 1999 Chamber of Commerce Study, the benchmark for overall employer benefit costs was estimated to be \$14,655 per employee per year. By comparison, the average CY 1998 cost was \$18,087 at Westinghouse Savannah River Company, \$19,406 at the University of Chicago at the Argonne National Laboratory, and \$21,251 at Lockheed Martin Energy Systems at the Y-12 Plant. This was 23 percent, 32 percent, and 45 percent above the Chamber of Commerce benchmark, respectively. Based on current Department policy, such findings would have required the contractors to reduce costs to reasonable levels.

During the audit, the Office of Procurement and Assistance Management questioned the validity of the Chamber of Commerce Study, stating that it was not representative of the demographics, election choices, or risk factors associated with the Department's contractor employees. Management stated that the Department identified appropriate benchmarks by hiring the consulting firm in 1995 and 1996 to conduct benefit cost analyses on a contract-by-contract basis using national and regional benchmarks. Management contended that the results of these studies gave contracting officers the tools needed to identify areas where additional actions could be taken to better manage health care costs.

We agree that the results of the consultants' studies gave contracting officers the tools needed to identify opportunities to better manage health care costs. However, we found no evidence that the study results were used to develop plans to bring any of the contractors' health plan costs into line with the benchmarks used in the studies. Also, despite the consultants' findings that corrective actions were needed at each of the contractors reviewed, none of the contractors were required to develop corrective action plans or implement any of the consultant's recommendations.

Even if the Chamber of Commerce Study method or other cost benchmarks had been used, there was no requirement in the order to assure that the excessive costs of the contractors' health benefit plans would be reduced. The order only required that overall benefit costs be evaluated. It was silent on whether or not to evaluate the reasonableness of any individual benefit plan costs, including the

costs of employee health benefit plans. It was also silent on the conditions that would trigger a mandatory corrective action plan for any specific benefit plan. For example, if overall benefit costs were reduced to 5 percent over competitive market benchmarks, and the costs of all benefit plans, except health benefit plans, matched competitive market benchmarks, the order would allow health benefit costs to be 29 percent above competitive market benchmarks without requiring a corrective action plan of any kind.

**Department Could Have
Avoided \$33 Million in 1998**

Had the Department required the three contractors we examined to bring health benefit plan costs in line with competitive market benchmarks, using either the benchmarks published in the Chamber of Commerce Study or those used by its national consulting firm, the Department could have avoided \$33 million in employee health care costs in CY 1998.

RECOMMENDATIONS

We recommend that the Director, Office of Procurement and Assistance Management amend Departmental Order 350.1 to require that:

1. Contracting officers periodically determine the reasonableness of contractors' health benefit costs, and overall benefit program costs, using the Chamber of Commerce Study or other cost benchmarks published by national consulting firms; and
2. Contractors develop corrective action plans to reduce health benefit costs to within the 5 percent range above competitive market benchmarks.

**MANAGEMENT
REACTION**

Management did not concur with the finding and recommendations. Management stated that much of the report is incorrectly focused on demonstrating that a facet of the overall benefit issue has not been aggressively pursued by the field offices reviewed while ignoring that the overall cost of contractor benefit programs have been reduced Departmentwide.

Management disagreed with Recommendation 1, stating that the recommendation requires changes to the Department's Order that are inconsistent with the FAR and DEAR. Neither the FAR nor the DEAR cost principles contemplate the singling out of one element of compensation, nor do either define the standard for reasonableness as adherence to a national average cost. FAR and DEAR cost principles treat the determination of reasonableness as a complex,

multi-variable analysis, based on qualitative judgment as well as quantitative analysis. Requiring the Department to rigidly adhere to a single quantitative standard as a part of this determination, regardless of the source of that standard, and without reference to the rest of the elements of total compensation, is myopic and conflicts with Federal and Departmental regulations. Further, it will seriously undermine Departmental contractors' ability to recruit and retain sufficient and appropriate human resources during an unprecedented period of scarcity in the U.S. labor market that based on current demographic projections is expected to continue into the future.

Management also disagreed with Recommendation 2. Management stated that required adherence to an average annual national health benefit cost is a Departmental policy issue that requires stakeholder input. Stakeholders include but are not limited to the DOE Field Management Council, Principal Secretarial Officers, commercial and non- and not-for-profit organizations likely to contract with the Department for management and operation of Department-owned facilities, the Office of General Counsel, the Commission on Maintaining United States Nuclear Weapons Expertise, and members of Congress. Current Federal and Departmental policy require the use of FAR and DEAR compensation cost principles, and permit the use of a much broader standard of cost reasonableness. In a rapidly changing operating environment, flexibility to use prudent business judgement is appropriate and necessary to meet mission requirements. It was management's view that implementation of Recommendation 2 would unnecessarily restrict the Department's ability to exercise prudent business judgement and there is zero probability that the Department and stakeholders would permit promulgation of such a policy.

Management also commented that the FAR recognizes the need for professional judgement. Judgement is contemplated, indeed required, in the application of cost principles by the contracting officer. Prudent business judgement would neither be required, nor permitted if contracting officers were required to compare contractor health benefit costs to a national average as the primary test of reasonableness.

AUDITOR COMMENTS

Management's comments are not responsive to the finding or recommendations.

We are unable to report on the trend in overall benefit costs incurred by the Department's contractors because we did not examine this broad measure of costs. However, we did measure one of its

significant components, health benefit costs for active contractor employees. The report documents the reduction in these health benefit costs over the last few years. However, the report demonstrates that further reductions are necessary if those costs are to approach the level being paid by similar commercial firms.

Management's objection to Recommendation 1 is based on the premise that the FAR and DEAR prohibit the evaluation of individual components of benefit costs. However, FAR 31.205-6(b) states that compensation will be considered reasonable if each of the allowable elements making up the employee's compensation package is reasonable. Further, the regulation states that contracting officers may challenge the reasonableness of any individual element of compensation paid.

Also, Recommendation 1 does not ask contracting officers to rigidly adhere to a single quantitative standard as the only element in determining reasonableness. The recommendation merely asks that contracting officers be required to periodically use a quantitative cost benchmark to evaluate contractor health benefit costs. In order for the contracting officers to make rational decisions about the reasonableness of costs, they should be measured against quantitative cost benchmarks.

Finally, with regard to Recommendation 1, Management believes that if the contracting officers evaluate health benefit costs for reasonableness it will interfere with the contractors' ability to attract and retain qualified employees. This position contradicts the letter from the Director, Office of Contractor Human Resource Management to the Manager of the Savannah River Operations Office, dated November 3, 1995. The letter stated that the implementation of the recommendations contained in the consultant's study would still leave intact an attractive benefit program for Westinghouse employees. We agree with the Director's original assessment that contractor health benefit costs can be reduced without impairing the contractors' ability to offer competitive health benefit plans as a means of attracting and retaining qualified employees.

Management's disagreement with Recommendation 2 is based on its prediction that it would not be possible to obtain stakeholder approval to issue such a policy. However, the Department has already issued the exact same policy for its contractors in DOE Order 350.1 Chapter V, Employee Benefits. The Order states that "...when the contractor per capita cost per full-time employee is greater than 5 percent above the

comparator for other organizations, the contractor shall submit to the Contracting Officer a corrective action plan to achieve conformance with the range of acceptability.... The plan shall include specific benefit plan changes and a timetable for implementation and shall be approved by the Contracting Officer.” Recommendation 2 would merely require contracting officers, as Departmental representatives, to insure cost studies are performed, and used to control costs.

Finally, neither of our Recommendations would prohibit the exercise of prudent business judgement. In fact, purposefully setting a policy that ignores cost as one of the measures of reasonableness would be the opposite of prudent business judgement.

Appendix

SCOPE

The audit was performed from March 15 to August 2, 1999. The auditors reviewed health benefit costs for CY 1998 at three contractors: Westinghouse Savannah River Company in Aiken, South Carolina; Lockheed Martin Energy Systems in Oak Ridge, Tennessee; and the University of Chicago-Argonne National Laboratory in Chicago, Illinois.

METHODOLOGY

To accomplish the audit objective, we:

- Reviewed Report DOE/IG-350, *Audit of Health Benefit Costs at the Department's Management and Operating Contractors*;
- Researched Federal regulations governing the reasonableness of contractors' health benefit costs;
- Reviewed the Department's contracts with the contractors listed above;
- Reviewed health benefit plans for the contractors listed above;
- Evaluated the Value Studies performed for the contractors listed above;
- Used national benchmark measures to determine the reasonableness of overall contractor employee benefit program costs, and more specifically the reasonableness of contractor employee health benefit plan costs;
- Compared the results of the sites' Value Studies with Chamber of Commerce Study results;
- Compared the benefit studies performed by the sites to a national consulting firm's benchmarks;
- Determined the rate of health care inflation between CYs 1996 and 1998; and,
- Estimated the amount of unreasonable costs incurred by the Department in CY 1998 as a result of not evaluating and approving employee health benefit costs using national norms.

The audit was performed in accordance with generally accepted Government auditing standards for performance audits and included tests of internal controls and compliance with laws and regulations to the extent necessary to satisfy the audit objective. Accordingly, we assessed the internal controls over health benefit costs at the three sites. Because our review was limited, it would not necessarily have disclosed all internal control deficiencies that may have existed at the time of the audit.

We relied on computer-generated data provided by the sites' contractors regarding employee health benefit costs. An evaluation of the general operational controls at the sites showed that yearly expenditure reports sent to the Department's Contractor Human Resources Management understated employee health costs. Since these costs were understated, there is no assurance that other reported costs are accurate. As a result, our estimate of unreasonable costs is qualified, accordingly.

As part of our review, we evaluated the Department's expectations and performance measures for M&O contractors' employee health benefit plans. We did not identify any instances where the Department did not comply with the Government Performance and Results Act of 1993.

We held an exit conference with the Office of Contract and Resource Management on March 9, 2000.

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