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April 1994

Audit of Sandia Corporation's Pension Plans and Other Prefunded Benefits

United States Government

Department of Energy

memorandum

DATE: April 6, 1994
REPLY TO:
ATTN OF: IG-1
SUBJECT: INFORMATION: Report on "Audit of Sandia Corporation's Pension Plans and Other Prefunded Benefits"
TO: The Secretary

BACKGROUND:

Department of Energy policy is to ensure that contractors operating Government facilities provide for pensions to cover employees working on the Department's contracts. In 1986, the Office of Inspector General reported that Sandia's pension plan assets exceeded liabilities by nearly \$215 million.

Based on prior audits, and the October 1993 change in contractors at Sandia, this audit was conducted to determine whether the Department was adequately protecting the Government's interest in Sandia's pension plans and other prefunded benefits.

DISCUSSION:

The audit disclosed that excess assets in Sandia's pension plans had grown to \$588.9 million as of December 31, 1990. The plans' growing surplus of assets did not benefit Sandia's employees (since the plans provided defined benefits), nor the Department (since the assets were held in trust). If plan terminations and spin-offs occurred, at least \$408.8 million could be returned to the Government without affecting the pension benefits that Sandia employees and retirees have earned.

The Albuquerque Operations Office did not agree with the recommendation that the Government's share of the excess assets be recovered. The Office believed that the plans' projected liabilities were understated, and removing the excess assets would require resumption of annual funding and result in damaged employee morale.

John C. Layton
Inspector General

MASTER

Attachment

cc: Deputy Secretary
Under Secretary
Assistant Secretary for Defense Programs
Director, Office of Contractor Management and
Administration

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U.S. DEPARTMENT OF ENERGY
OFFICE OF INSPECTOR GENERAL

REPORT ON AUDIT OF
SANDIA CORPORATION'S
PENSION PLANS AND OTHER PREFUNDED BENEFITS

Report Number: DOE/IG-0346
Date of Issue: April 6, 1994

Western Regional Audit Office
Albuquerque, New Mexico 87185

REPORT ON AUDIT OF
SANDIA CORPORATION'S
PENSION PLANS AND OTHER PREFUNDED BENEFITS

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U.S. DEPARTMENT OF ENERGY
OFFICE OF INSPECTOR GENERAL
OFFICE OF AUDITS

REPORT ON AUDIT OF
SANDIA CORPORATION'S
PENSION PLANS AND OTHER PREFUNDED BENEFITS

Audit Report Number: DOE/IG-0346

SUMMARY

The Albuquerque Operations Office (Albuquerque) is responsible for administering the Department of Energy's (Department) contract for management and operation of Sandia National Laboratories. Part of this responsibility is reviewing and approving pension plans. The objective of this audit was to determine whether the Department was adequately protecting the Government's interest in Sandia Corporation's (Sandia's) pension plans and other prefunded benefits.

The audit disclosed that Sandia's pension plans had \$588.9 million in excess assets as of December 31, 1990, on a current value basis. If plan terminations and spin-offs occurred, at least \$408.8 million of this amount could be returned to the Government without affecting the pension benefits that Sandia employees and retirees have earned. We recommended that Albuquerque take the necessary action to reduce the excess assets in the pension plans and recover the Government's share.

Albuquerque disagreed with the recommendation. Albuquerque justified leaving the excess assets in the pension plans to fund future plan amendments; to avoid future funding contributions; to avoid the costs and time-consuming administrative steps associated with taking action; and to prevent damaging effects on employee morale. We analyzed these points, and concluded that they should not prevent the Department from initiating action to return excess assets to the Government.

After reviewing earlier versions of this report, management obtained an actuarial analysis of the pension plans. The analysis showed that, even if certain plan adjustments were made, the plans were overfunded by \$256 million as of December 31, 1991 (on an actuarial value basis). Therefore,

both management's analysis and our analysis showed that significant excess funds were available for return to the Government.

Considering the fiscal challenges facing the United States, we believe the Department should aggressively pursue the recovery of excess assets in Sandia's pension plans. However, it is recognized that actions related to pension plans are highly complex, and the recovery of excess assets may require special legislation.

Office of Inspector General

PART I

APPROACH AND OVERVIEW

INTRODUCTION

Department of Energy (Department) policy is to ensure that contractors operating Government facilities provide for pensions to cover employees working on the Department's contracts. Effective October 1, 1993, the Department changed the operating contractor at Sandia National Laboratories. The replacement contractor assumed responsibility for the existing Sandia pension plans, which had over \$1 billion of assets.

The purpose of this audit was to review Sandia Corporation's pension plans and other prefunded benefits. The specific objective was to determine whether the Department was adequately protecting the Government's interest in Sandia's pension plans and other prefunded benefits.

SCOPE AND METHODOLOGY

The audit was conducted from January through September 1993, at Sandia National Laboratories and the Albuquerque Operations Office in Albuquerque, New Mexico. Meetings were also held with the Department's Office of Contractor Management and Administration in Washington, D.C. During the audit, we reviewed four pension plans, two qualified and two nonqualified, and one insurance continuance fund.

To accomplish the audit objective, we:

- o Reviewed applicable sections of the Internal Revenue Service (IRS) Code, the Pension Benefit Guaranty Corporation regulations, and the Employee Retirement Income Security Act;
- o Reviewed Department regulations and policies;
- o Reviewed the Request for Proposal for proposed actions applicable to the new management and operating contractor for Sandia;
- o Interviewed Department, Sandia, IRS, Pension Benefit Guaranty Corporation, and Department of Labor personnel;
- o Analyzed and evaluated IRS Forms 5500 filed by Sandia

for the two qualified pension plans for the years 1981 to 1992, and for the Insurance Continuance Fund for 1992; and,

- o Reviewed Sandia's pension plan provisions for the Retirement Income Plan and the Pension Security Plan.

We relied on actuarial reports, IRS Forms 5500, and audits of the pension plans by independent accounting firms. We did not conduct tests of these reports because they were subject to audit by the Department of Labor and the IRS.

The audit was done according to generally accepted Government auditing standards for performance audits, which included tests of compliance with laws and regulations to the extent necessary to satisfy the audit objective. We limited the review of internal controls because the audit focused on excess assets in plans and ways to return any excess assets to the Government. Because the review was limited, it would not necessarily have disclosed all internal control deficiencies that may have existed at the time of our audit. An exit conference was held with the Director, Human Resources Division, Albuquerque, on December 13, 1993.

BACKGROUND

Department policy is to ensure that contractors operating Government facilities provide pensions for employees working on DOE contracts. The Department is responsible for funding pension plans that are agreed to as part of cost reimbursable contracts with management and operating contractors. Departmental policy requires that these contractors' pension plans satisfy requirements of the IRS, the Department of Labor, and the Pension Benefit Guaranty Corporation, all of which administer portions of the Employee Retirement Income Security Act. Departmental policy also prescribes that contractors follow IRS regulations and Pension Benefit Guaranty Corporation rates for pension plan terminations.

Unlike private sector pension plans where the employer is liable for any underfunding, the Department guarantees to cover any underfunding in the event that pension plan assets are less than pension plan liabilities at plan termination. For assuming this risk, the Department, rather than the contractor, is to receive any excess assets at plan termination.

Sandia Pension Plans

Sandia Corporation operates Sandia National Laboratories for the Department. Until September 30, 1993, Sandia was a wholly-owned subsidiary of American Telephone & Telegraph Company (AT&T). In May 1992, AT&T announced that it would not renew its contract with the Department at its scheduled expiration in September 1993. As a result, the Department issued a Request for Proposal for a replacement contractor. This Request stated that the replacement contractor must agree to assume the existing Sandia pension plans. In July 1993, Martin Marietta Corporation (Martin Marietta) was selected as the replacement contractor, effective October 1, 1993.

At the time of the contract change, Sandia had two qualified pension plans. The Pension Security Plan covered represented and equivalent job classification employees. The Retirement Income Plan covered professional or management employees. At December 31, 1990, these two plans covered about 13,000 participants. Sandia also had two nonqualified pension plans, both of which provided varying benefits solely to top level executives.

IRS regulations required Sandia to report pension plan assets and liabilities on both a current value basis and an actuarial value basis. Current value basis, applicable to plan termination, shows the current market value of assets at a fixed point in time. Actuarial value basis, however, assumes the plan is ongoing, and smooths out fluctuations in market value by spreading out any investment gains or losses over a five-year period.

Liabilities, on a current value basis, are the present value of benefits earned by participants as of the beginning of the plan year. On an actuarial value basis, liabilities are determined by adding the present value of benefits already earned by participants to the present value of expected future benefits, and subtracting the present value of future normal cost payments.

On a current value basis, Sandia's plans had \$1.2938 billion of assets and \$704.9 million in liabilities at December 31, 1990. On the same date, the plans had \$1.1742 billion of assets and \$902.6 million in liabilities on an actuarial value basis.

The assets in Sandia's two qualified pension plans were primarily funded by the Government. From 1976 to date, all contributions to Sandia's pension plans were funded by the

Department, without Sandia employee contributions. Prior to 1976, employees contributed to the then-existing single plan. At all times, however, Sandia's employer contributions were fully paid using Government funds.

Office of Inspector General Reports

In December 1986, the Office of Inspector General recommended that Sandia discontinue contributions to the pension plans. At that time, the plans' assets exceeded the liabilities by nearly \$215 million, on an actuarial value basis. Sandia last contributed to the pension plans in 1986.

Recognizing its unique stake in management and operating contractors' pension plans, the Department made changes in its pension policies as a result of an Office of Inspector General report, Report No. DOE/IG-0240, "Management and Operating Contractors' Pension Plans," issued in June 1987. Although the Department has not updated DOE Order 3830.1, it has revised contract language to limit contributions to the greater of the IRS' minimum funding requirement or an amount necessary to fully fund the yearend expected current liability. Additionally, the revised contract language also protects Government assets if either a contract or pension plan were terminated.

On June 8, 1993, the Office of Inspector General issued a Management Alert (Alert), "Sandia Corporation Pension Plans' Assets." The Alert called for the Department to implement appropriate plans to remove the Government's share of \$588.9 million of excess assets in the pension plans prior to the transfer of Sandia from AT&T to Martin Marietta on October 1, 1993. Options for accomplishing this were presented in the Alert. For example, one of the options involved spin-off plans. Under a spin-off, an existing pension plan would be terminated, annuities would be purchased for retirees, a new plan would be created for active employees, applicable taxes would be paid, and the remaining assets would revert to the employer.

Another option was a modified version of a spin-off. Rather than purchasing annuities for the retirees, the retirees would be brought into the plan for active employees. All of the other aspects of a spin-off would remain the same. The modified version, however, would require special legislation.

OBSERVATIONS AND CONCLUSIONS

Although the Department has taken some positive steps to improve management of contractor employee pension plans, it was not adequately protecting the Government's interest in Sandia's pension plans. As of December 31, 1990, Sandia's plans, on a current value basis, had \$588.9 million of excess assets, of which at least \$408.8 million could be returned to the Government.

From 1980 to 1990, the excess assets in Sandia's pension plans had increased from \$204.9 million to \$588.9 million. As shown in the chart below, this growth continued even after Department-funded contributions to the pension plans were discontinued in 1986. Excess assets had reached \$720.9 million by the end of 1991.

Excess Assets in Sandia's Pension Plans
(December 31, 1980 through December 31, 1991)

Despite the growth in excess assets, the Department stated that recovery of the Government's share of these assets through spin-off plans was inappropriate, and did not agree to take action. Considering the budget deficit facing the United States, we believe that the Department should aggressively pursue the recovery of excess assets in Sandia's pension plans. Since actions related to pension plans are subject to a myriad

of regulations, changes to the pension plans would require regulatory approval and would be inherently complex. Recovery of excess assets could also require special legislation.

Taking no action, however, would result in continuing to accumulate assets that exceed the needs of the plans. Such inaction would be contrary to the Department's responsibility to use its taxpayer-provided assets wisely. We believe that the Department could recover the excess without affecting the benefits that Sandia's employees and retirees have earned.

During our audit, we also reviewed related issues. We noted that Sandia's Insurance Continuance Fund, like the pension plans, had accumulated excess assets. The excess was disclosed in a December 1992 internal audit report. In response to this report, Sandia recently removed \$68.2 million from the fund and returned it to the Department. We consider the return of the excess assets to be a positive action by management. This issue and other matters related to Sandia's benefits are discussed in Part IV of the report.

The finding contained in Part II should be considered by management when preparing the yearend assurance memorandum on internal controls.

PART II

FINDING AND RECOMMENDATION

Sandia's Pension Plans

FINDING

The Department is responsible for ensuring that management and operating contractor pension plans are properly managed. As of December 31, 1990, \$588.9 million more than was needed was retained in Sandia's pension plans; and, the Department had not initiated action to recover the Government share of these excess assets. The Department gave four reasons for taking no action: (1) future funding deficits; (2) cost associated with taking action; (3) time-consuming administrative steps; and (4) damaging effects on employee morale. We analyzed these reasons and concluded they should not prevent the return of at least \$408.8 million to the Government.

RECOMMENDATION

We recommend that the Manager, Albuquerque, take the necessary action to reduce the assets of Sandia's pension plans to the amount needed to meet the Department's minimum funding requirements and to recover the Government's share of excess assets from the existing plans.

MANAGEMENT REACTION

Management did not concur with the finding and did not agree to implement the recommendation. Part III contains management comments and auditor response.

DETAILS OF FINDING

MANAGEMENT REQUIREMENTS

As part of its cost reimbursable contracts with management and operating contractors, the Department is responsible for providing funding for pension plans. DOE Order 3830.1, "Policies and Procedures for Pension Programs Under Operating and Onsite Service Contracts," August 1982, requires the Department to be responsible for ensuring that contractors properly manage these pension plans. Contracting officers are authorized to approve pension arrangements when contractors are

replaced, approve the reasonableness of pension cost figures in actuarial reports, and approve changes in plan provisions.

DOE Order 3830.1 also requires that management and operating contractor pension plans satisfy requirements of the IRS, the Department of Labor, and the Pension Benefit Guaranty Corporation, all of which administer portions of the Employee Retirement Income Security Act. The policy also calls for contractors to follow IRS rules and Pension Benefit Guaranty Corporation rates for pension plan terminations.

In addition to these specific requirements, the President and the Congress are looking for ways to reduce the Federal budget and deficit. Therefore, it is important for the Department to identify underused and idle assets. Once identified, the Department should take the actions necessary to put the assets to better use and reduce the taxpayers' burden.

PENSION PLAN ASSETS

As of December 31, 1990, the current value of the assets in the pension plans established for Sandia's employees was \$1.2938 billion. Other than \$43 million that represented the value of employee contributions, the balance was attributed to Government-funded contributions. Of the \$1.2938 billion in assets, only \$704.9 million was needed to fund the current liability, leaving \$588.9 million in excess assets.

The growing surplus of pension plan assets benefited neither the employees nor the Department. Since the pension plans were defined benefit plans, retirees could draw only the amounts specified in the existing plans. Thus, a surplus in the plans generally did not augment a retiree's benefits, except for occasional cost-of-living allowances. Because surplus funds in the ongoing plans were held in trust for Sandia's employees, the fund could not readily be returned to the Treasury or used to offset current Departmental costs. Thus, they did not benefit the Government.

A Departmental analysis performed in response to our earlier Alert showed that excess assets could be returned to the Government if spin-offs of the pension plans occurred. Under spin-offs, existing pension plans would be terminated, annuities would be purchased for retirees, new plans would be created for active employees, applicable taxes would be paid, and the remaining assets would revert to the Government. Under modified spin-offs, rather than purchasing annuities for the retirees, the retirees would be brought into the plans for active employees.

EXCESS ASSETS REMAINED

Despite the possibility of recouping excess assets from the Sandia pension plans, the Department chose not to take any action. The Department cited four reasons for taking no action: (1) future funding deficits; (2) cost associated with taking action; (3) time-consuming administrative steps; and (4) damaging effects on employee morale. We analyzed each of these reasons and concluded they should not prevent the return of excess assets to the Government.

Future Funding Deficits

The Department justified retaining the excess assets as needed for funding future plan amendments. Amendments occurred about every three years to adjust pension benefits for inflation. The Department initially stated that if future amendments were recognized, the pension plans could potentially be underfunded.

Historically, however, plan adjustments have not resulted in deficits. Since 1980, each of the plans had five amendments that increased retiree benefits, yet pension plan excess assets continued to increase.

Additionally, calculations by Sandia's actuary showed that even if modifications were made to the pension plans, excess assets, on an actuarial value basis, would still be \$256 million as of December 31, 1991. Further, the actuary estimated that excess assets would continue to increase through January 1, 1994.

Costs Associated with Spin-Off Plans

The Department stated that the return of excess assets to the Department would be affected by one-time adjustments associated with spin-off plans, and the need to resume annual funding.

One-time Adjustments. The Department stated that if spin-offs occurred, the amount of excess assets to be returned to the Department would be \$192.1 million, rather than \$588.9 million, due to three adjustments associated with spin-off plans. These adjustments were the Pension Benefit Guaranty Corporation cost adjustment, the excess asset transfer, and Federal taxes. The amounts provided by the Department for these adjustments are shown in Exhibit A.

The Department increased the plans' termination liabilities to reflect Pension Benefit Guaranty Corporation actuarial assumptions. We agree that the existing IRS code necessitated this adjustment, which would reduce excess assets from \$588.9 million to \$545.1 million.

The IRS code also required a transfer of 25 percent of the \$545.1 million of excess assets to the successor plans, in order for those plans to be qualified plans. This transfer would reduce remaining excess assets from \$545.1 million to \$408.8 million. Finally, the Department stated that Federal excise and income taxes would total \$216.7 million, further reducing excess assets to \$192.1 million.

By focusing on the amount of excess assets to be returned to the Department, the Department did not give sufficient recognition to the total return of excess assets to the Government as a whole. Since both Federal excise taxes and income taxes would be payable to the IRS, payment of these taxes would result in a total of \$408.8 million in excess assets returned to the Government, as shown in Exhibit B.

Annual Funding. In addition to one-time adjustments, the Department stated that it would have to resume annual funding of employer contributions to the pension plans if spin-offs occurred. The Department estimated that annual funding of at least \$20 million to \$30 million would be required after spin-offs, while annual funding would not be required if there were no spin-offs. Further, management felt that Sandia's investment strategy would become more conservative if the current cushion of excess assets were removed, resulting in lower returns that could require increases in the Department's future contributions.

Our analysis showed, however, that annual funding could be offset by the interest saved through return of excess assets to the Government. Returning \$408.8 million to the Treasury could save about \$24 million annually in interest cost to the Treasury, based on the 30-year bond rate of 5.88 percent as of September 13, 1993. Annual interest savings could exceed \$24 million, since excess assets have continued to grow.

Time-Consuming Administrative Steps

The Department stated that the administrative steps in a spin-off would be time-consuming and, therefore, could not be accomplished before the contractor change. For example, the Department would have to notify the affected employees, prepare benefits statements for those who would receive annuities, file

with the Pension Benefit Guaranty Corporation, file for a letter of determination with the IRS, and require the new contractor to create a new plan document.

Although these administrative steps are time-consuming, and may not have been completed before the contractor change, we do not believe these facts should prevent management from initiating appropriate action to recover the Government's share of the Sandia pension plans' excess assets.

Damaging Effects on Employee Morale

The Department believed there would be damaging effects on employee morale if excess assets were removed from the pension plans. The Department cited potential problems related to giving employees lump sum distributions from the current plans. Another adverse effect the Department identified was a possible loss of future cost-of-living increases for retirees that received annuities. Management also stated that an attempt to terminate Sandia's pension plans and revert excess assets to the Government would result in class action lawsuits and costly litigation. Management felt that effects of such a reversion would probably not be limited to Sandia, but would also affect the morale of employees of other Department contractors.

While we respect the Department's interest in employee morale, we believe that damaging effects on employee morale need not occur. Under current laws, Sandia would have to purchase annuities for retirees and vested terminated employees, and transfer assets to a new pension plan for current employees. Since it would be preferable for all retired, terminated, and current employees to retain the benefits of their existing plans, we believe the Department should request special legislation to permit the removal of excess assets without disturbing Sandia employees' benefits. Such action would not inflict any harm on the employees, since their benefits would continue. Therefore, we see no reason why employee morale should be impacted if the Department is successful in taking appropriate action.

ACTION IS NEEDED TO RECOVER EXCESS ASSETS

If the Government took the necessary action to recover the Government's share of the excess assets in Sandia's pension plans, a minimum of \$408.8 million could be returned to the U.S. Treasury. These funds would be available for use by the Department or other agencies. At a time when the President and

the Congress are seeking to reduce the Federal budget and deficit, it would be prudent for the Department to take aggressive action to recover the excess assets.

Savings to the Government could be even greater if the Department sought and received special legislation that recognized the unique pension situations facing the Department and its major contractors. Special legislation could be designed to permit recovery of excess assets without spin-offs. This approach could allow the Government to avoid spin-off adjustments, permitting recovery of all excess assets.

In recovering excess assets, the Department has an opportunity to achieve two compatible goals. First, the Department would make a contribution to reducing the nation's deficit, one of the most urgent issues facing the President and the Congress. Second, the Department could continue to provide the pension benefits that Sandia employees and retirees have earned.

PART III

MANAGEMENT AND AUDITOR COMMENTS

In responding to the Official Draft report, the Director, Human Resources Division, Albuquerque, nonconcurred with the finding and recommendation. Some of management's comments are included in Part II. The recommendation, a summary of the remaining management comments, and our response follow.

Recommendation. We recommend that the Manager, Albuquerque, take the necessary action to reduce the assets of Sandia's pension plans to the amount needed to meet the Department's minimum funding requirements and to recover the Government's share of excess assets from the existing plans.

Management Comments. Nonconcur. Albuquerque believed that the Office of Inspector General overstated the estimated financial benefit. According to Albuquerque, the projected liabilities in the plans are understated when considering plan changes and expected future service credit.

Auditor Comments. We disagree because calculations by Sandia's actuaries showed that the December 31, 1991, excess assets on an actuarial value basis would still be \$256 million even if Sandia modified the pension plans so that future salary and wage changes are reflected in the liabilities (down from \$399 million of excess assets if the plans were not modified). In addition, the actuary estimated that the excess assets would continue to increase through January 1, 1994.

Management Comments. It is doubtful that the unions would agree to a unilateral termination or spin-off of their pension plan. Pursuant to labor law, any changes to the Pension Security Plan must be negotiated. As of December 31, 1990, the difference between the market value of trust assets and the present value of accumulated benefits for the Pension Security Plan was \$122.9 million. If Sandia were unable to successfully negotiate this with the unions, this figure would not be included in the amount returned to the Government.

Auditor Comments. Management has the opportunity to negotiate this issue when contemplating the update of the benefit formula. If management could not successfully negotiate the issue, the amount returned to the Government would be affected. We believe that the unions are more likely to accept an arrangement for the Government to remove excess assets if their members understand that benefits are unaffected.

Management Comments. The investment markets have provided above average returns for the past 10 years, and it would not be prudent to assume that similar returns will occur regularly in the future. The assets held in trust for the participants in Sandia's pension plans were fully used and invested in the capital markets. The growth in Sandia's pension fund assets has in large part been a function of its long-term asset allocation investment strategy during the 1980s and 1990s. There is little doubt that investment returns in the future will not replicate any of the stock, bond, or real estate returns of the 1980s. For example, the return of the S&P 500 index during the 1980s was over 18 percent, which was roughly double prior long-term historical returns. Consequently, we would not expect Sandia's pension trust to grow at the same rate in the near future as it has in the recent past.

Auditor Comments. Management's comments imply that reduced investment returns will eliminate the excess assets. Such a position is not supported by the income and expense data for the plans, for the years 1983 through 1991. Income during those years was almost four times expenses. Therefore, even if income during those years had been halved, excess assets would have continued to grow. From this data, we conclude that lower returns in the future will not eliminate the excess assets.

Management Comments. Sandia's actuaries have indicated that if the plans were terminated and successor plans established, the new plans would immediately incur actuarial losses and have assets that were significantly less than accrued liabilities. The actuaries estimated that the losses would increase annual funding and operating budget requirements. In addition, removal of excess assets would result in a more conservative investment strategy, translating to greater Departmental contributions and additional budget requirements in the future.

Auditor Comments. We recognize that the Department may have to resume making contributions to the plans, and that more refined calculations are needed before the Department's and Sandia's actuaries can determine the amount of those contributions. We consider the \$30 million annual future funding requirement to be an estimate, not a precise calculation based on actuarial studies. An alternative would be to remove excess assets only to the extent needed to provide equilibrium between the plans' annual incomes and expenses. Regarding the impact of removing excess assets, we do not believe it is the taxpayers' responsibility to provide excess assets to assist in Sandia's investment strategy.

Management Comments. The \$24 million in interest, estimated by the Office of Inspector General, that would be saved by the Government from recouping a \$408.8 million surplus is significantly less than the loss to the Government of the plans' investment earnings. Based on the 11.3 percent 5-year average rate of return, this interest loss amounts to over \$44 million.

Auditor Comments. The plans' investment earnings provide no gain to the Government because the excess assets are retained in the plan. A basic point of the report is that the excess assets benefit neither Sandia employees and retirees nor the Government. Changes to the rate of return do not result in any gain or loss to the Government.

Management Comments. The potential savings in interest cost is overstated. It is not reasonable to assume that any reversion to the Government would produce interest savings at the 30-year bond rate. The Government has recently shortened the maturity of its bond offerings and the average maturity of all outstanding Treasury bonds is currently 9.4 years, according to Salomon Bros. The yield on a bond of that maturity is approximately one-half percent less than a 30-year bond. If Treasury bills are considered, then the average yield of the outstanding Government debt would drop by another one-half percent.

Auditor Comments. Information obtained from the U.S. Treasury Department did not support management's argument that 4.88 percent was the appropriate interest rate to use to calculate interest savings. As of November 30, 1993, the average interest rate for total outstanding marketable public debt (including Treasury bills, notes, and bonds) was 6.235 percent.

In addition, the amount of interest saved depends on the amount of excess assets returned and the Treasury borrowing rate. Reducing the 5.88 percent borrowing rate by one percent would reduce the saved annual interest on \$408.8 million returned from about \$24 million to about \$20 million. However, excess assets had grown from \$588.9 million in 1990 to \$720.9 million in 1991. A corresponding 22 percent increase in excess assets to be returned to the Government would be from \$408.8 million in 1990 to \$498.8 million in 1991. Interest savings on \$498.8 million at 4.88 percent would be about \$24 million, or \$31.1 million at 6.235 percent. Whether such savings would offset the annual contribution would depend on the amount of the contribution, which has not yet been determined. Even if the

savings were slightly less than the contribution, the immediate need to reduce the deficit might be more important.

Management Comments. One of the reasons the Federal deficit is an urgent issue is that it has the effect of reducing money set aside in private savings and investments. The proposal to terminate Sandia's pension plans and return excess assets to the Government would compound the problem by removing additional private sector savings that was invested in the capital markets and helping to fund economic growth.

Auditor Comments. Returning the excess assets would not affect the amount of money available for private investment. Each dollar returned is one less dollar to be borrowed by the Government.

PART IV

OTHER MATTERS

The review of Sandia's pension plans and other prefunded benefits disclosed additional matters requiring management's attention.

1. Insurance Continuance Fund

DOE Order 3890.1A, "Contractor Insurance and Other Health Benefit Programs," generally prohibited the prefunding of contractor retiree benefits unless required by state or Federal statute. Funding was to be provided for on a pay-as-you-go basis.

Sandia had an Insurance Continuance Fund to pay retiree death benefits associated with basic and supplemental group life insurance policies. Sandia established the fund because the contract with AT&T provided that the compensation and benefits policies and practices of Sandia were to be in accordance with the normal practices of AT&T. AT&T had such a fund.

Although there was no known statutory requirement to prefund the retiree life insurance benefit, the fund contained \$137.3 million as of April 30, 1993. About half of the fund, \$64.5 million, was excess assets, as only \$72.8 million was needed to cover the actuarial liability.

As a result of a Sandia internal audit, Sandia removed \$68.2 million from the fund, including a \$3.7 million capital adjustment, and returned it to the Department in August 1993. Assets equal to the actuarial liability of \$72.8 million were left in the fund.

With the change in management and operating contractor at Sandia, the Department had the opportunity to terminate the entire fund and to require Sandia to comply with the Department's pay-as-you-go policy. But, management disagreed that the fund be terminated. Management stated that Sandia's contract with the insurance company provided that the fund was to be used solely to provide retired life insurance coverage and that Sandia should have no right to reclaim the fund unless the coverage itself was discontinued. Further, the fund deposit with the insurance company reduced the risk charges that otherwise would have been charged, thereby reducing the premium.

We believe that contractor change at Sandia has provided the opportunity to eliminate prefunding of retiree benefits,

thus achieving compliance with the DOE Order. Further, while the premium may be reduced because of the fund, there is an offsetting cost, the Government's borrowing cost.

2. Nonqualified Pension Plan and Investment Counseling

Department of Energy Acquisition Regulation 970.22 required wages, salaries, and employee benefits (employee compensation) to be reasonable and to follow area practices, valid patterns, and well-established practices of the contractor. Under the AT&T contract, Sandia's employee compensation practices were to be based on AT&T's practices. With the change of the management and operating contractor, the Department needs to ensure that Sandia's employee compensation complies with Department policies.

Two cost categories that we believe the Department should review for compliance are the nonqualified pension plan costs and the personal investment consulting costs. For Fiscal Year 1993, one Sandia nonqualified pension plan had budgeted \$32,000 for payments to top executives. The only justification was the need to match the pensions of other AT&T executives. For the same year, Sandia had also budgeted \$200,000 for personal investment counseling for its top executives.

Management stated that supplemental executive retirement plans were well established and widely used in the private sector to attract and retain highly qualified upper management employees. The Personnel Appendix to the new contract required pay-as-you-go funding and Contracting Officer approval of the plans and amendments. Further, the contractor was required to annually report to the Contracting Officer the number of individuals receiving benefits, the benefits and expenses paid, and any other data requested by the Contracting Officer. Management also stated that costs for personal investment counseling were not allowable under the new contract.

In our opinion, the justification for the nonqualified pension plan no longer existed as of September 30, 1993. Therefore, it should be eliminated unless it can be justified by the new management and operating contractor.

PART V

Exhibit A

**Excess Assets That Could Be
Returned To The Department**

(Using December 31, 1990 Data; dollars in millions)

Market Value of Assets		\$1,293.8
Less: Current Liability for Plans		
1. Present Value of Accrued Benefits for Active Employees	\$368.0	
2. Present Value of Accrued Benefits for Retirees and Terminated Vested Employees	<u>336.9</u>	<u>704.9</u>
Subtotal		\$ 588.9
Less: Adjustment for Pension Benefit Guaranty Corporation Assumptions		<u>43.8</u>
Excess Assets at Termination		\$ 545.1
Less: 25 Percent Excess Asset Transfer		<u>136.3</u>
Subtotal (Excess Assets that Could be Returned to the Federal Government, Exhibit B)		\$ 408.8
Less: 20 Percent Federal Excise Tax	\$ 81.8	
33 Percent Federal Income Tax	<u>134.9</u>	<u>216.7</u>
Excess Assets that Could be Returned to the Department		<u>\$ 192.1</u>

Exhibit B

**Excess Assets That Could Be
Returned To The Federal Government**
(Using December 31, 1990 Data; dollars in millions)

Market Value of Assets		\$1,293.8
Less: Current Liability for Plans		
1. Present Value of Accrued Benefits for Active Employees	\$368.0	
2. Present Value of Accrued Benefits for Retirees and Terminated Vested Employees	<u>336.9</u>	<u>704.9</u>
Subtotal		\$ 588.9
Less: Adjustment for Pension Benefit Guaranty Corporation Assumptions		<u>43.8</u>
Excess Assets at Termination		\$ 545.1
Less: 25 Percent Excess Asset Transfer		<u>136.3</u>
Excess Assets that Could be Returned to the Federal Government		<u>\$ 408.8</u>

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