Office of Inspector General

Overpayments of Premiums for the Central Artery Project's Owner-Controlled Insurance Program

Federal Highway Administration

Report Number: TR-1999-104
Date Issued: May 24, 1999

DEPARTMENT OF TRANSPORTATION
UNITED STATES OF AMERICA

Memorandum

U.S. Department of Transportation
Office of the Secretary
Of Transportation
Office of Inspector General

Subject: ACTION: Report on Overpayments of Premiums for the Central Artery Project's Owner-Controlled Insurance Program, TR-1999-104

Date: May 24, 1999

From: Lawrence H. Weintrob
Assistant Inspector General for Auditing

Reply to Attn of: JA-30

To: Federal Highway Administrator

This report presents our interim findings on the Owner-Controlled Insurance Program (OCIP) established by the Massachusetts Highway Department for the Central Artery project. We conducted this audit in response to Congressional direction contained in House Report number 105-648. In that report, the Committee directed the Office of Inspector General "to continue to oversee the costs, funding, and schedule of the Central Artery project and to report periodically its results to the Committee."

Our objective in auditing the Central Artery OCIP was to determine whether the workers' compensation and general liability portions of the program were effective in reducing the overall cost of insurance for the project. In conducting our audit, we identified overpayments of Federal funds (including accrued interest) totaling \$150.0 million that warrant your immediate attention. This report addresses those overpayments. *We are recommending that the \$150 million be recovered and appropriately reallocated. If the Central Artery's holding of OCIP overpayments is allowed to stand, it may establish a precedent contrary to existing regulations' prohibition on the use of taxpayer money for investment purposes, and infrastructure programs around the country may start investing grant funds rather than using them for legitimate project expenses. This would clearly be a poor cash management practice for Federal funds.*

We have not completed our audit of the Central Artery OCIP. We expect to issue our final report on the Central Artery OCIP later in fiscal year 1999. The attached interim report should not be construed as reflective of OCIPs in general.

In examining the Central Artery OCIP, we conducted extensive outreach to insurance experts in the Federal government (U.S. Department of Labor), insurance industry (National Association of Insurance Commissioners), and academia (Rutgers

University). We discussed with them how OCIPs are generally structured, how risk is managed through insurance, and what other financial protections against loss (such as reserve funds) are generally considered prudent. More specifically, we also discussed the structure and operation of the Central Artery OCIP with these experts.

We found that the Massachusetts Highway Department overpaid workers' compensation premiums. The premiums are deposited by the insurance company into investment trust accounts owned by Massachusetts Highway Department. The OCIP arrangement is scheduled to continue through the year 2017, when the Massachusetts Highway Department anticipates collecting at least $826 million from the trust accounts.[1] The arrangement is not consistent with Federal guidelines that allow grant recipients to use Federal funds only to pay allowable project costs, not for long-term investments.

In a March 26, 1999, response to our draft of this report, Federal Highway Administration (FHWA) officials disagreed that there have been overpayments. According to the FHWA Massachusetts Division Administrator, Massachusetts faces potential "mammoth" liabilities over and above the insurance coverage purchased. In addition, the FHWA Executive Director claimed all the funds in the insurance trusts are being used solely for insurance purposes, because the trusts have not reached a level that "collateralizes the State's potential exposure" to future claims and expenses. FHWA's speculation about the magnitude of risk is undocumented, and is fundamentally at odds with the opinions of independent insurance experts contained in risk assessments conducted for the project's insurance broker in 1991 and 1998. Furthermore, the Central Artery Finance Plan approved by FHWA is based on an expectation that $826 million from the insurance trust funds will be returned to the State.

Claiming the funds are needed to pay future insurance liabilities while using these same funds as a credit against current costs is inherently inconsistent; project management cannot have it both ways. If FHWA and Massachusetts Highway Department officials believe that the Central Artery has such enormous liability risks, they should require the project to obtain appropriate insurance coverage. Furthermore, if FHWA and the Massachusetts Highway Department sincerely believe the funds are needed to cover future costs, they must not count on the $826 million in future proceeds from the trusts to reduce the overall cost of the project, and must revise the Finance Plan to reflect the almost $12 billion in expected project costs.

We are making three recommendations to FHWA regarding the Central Artery OCIP: First, recover the $150.0 million (Federal share of $166.7 million) in premium overpayments and interest earned related to payments made through 1997, as well as

[1] The March 1999 Project Management Monthly Report shows an additional $209 million OCIP credit, bringing the combined credits to over $1.0 billion.

any further overpayments and interest that have since accrued, and either apply the funds to current project costs or return the money to the U.S. Treasury. Second, on an annual basis, determine actual insurance requirements and ensure any overpayments involving Federal funds are recovered and applied to current costs or returned to the U.S. Treasury. And third, review the policy regarding reimbursement for insurance and establish guidelines to ensure any future overpayments of insurance premiums on highway projects are recovered and applied to current costs or returned to the U.S. Treasury.

We request that you provide written comments within 15 days. If you concur with our findings and recommendations, please indicate for each recommendation the specific actions taken or planned and the target dates for completion. If you do not concur, please provide your rationale. Furthermore, you may provide alternative courses of action that you believe would resolve the issues presented in this report.

If you have any questions, please contact me at x61992 or my Deputy Assistant Inspector General for Highways and Highway Safety, Patricia J. Thompson, at x60687.

#

U.S. Department of Transportation
Office of Inspector General

Overpayments of Premiums for the Central Artery Project's Owner-Controlled Insurance Program

Federal Highway Administration

SYNOPSIS

We conducted this audit of the Central Artery project's Owner-Controlled Insurance Program (OCIP) in response to Congressional direction contained in House Committee Report number 105-648. In that report, the Committee directed the Office of Inspector General "to continue to oversee the costs, funding, and schedule of the Central Artery project and to report periodically its results to the Committee." The objective of this audit was to determine whether the workers' compensation and general liability portions of the program were effective in reducing the overall cost of insurance for the project. (Attachment A.)

In auditing the Central Artery OCIP, we conducted extensive outreach to insurance experts in the Federal government (U.S. Department of Labor), insurance industry (National Association of Insurance Commissioners), and academia (Rutgers University). We discussed with them how OCIPs are generally structured, how risk is managed through insurance, and what other financial protections against loss (such as reserve funds) are generally considered prudent. More specifically, we also discussed the structure and operation of the Central Artery OCIP with these experts.

In the course of the audit, we identified significant overpayments of insurance premiums, which are the subject of this interim report. Due to the magnitude of the overpayments, we are issuing this interim report to facilitate timely management action. This report should not be construed as reflective of OCIPs in general. We have not completed our audit of the Central Artery OCIP. We plan to issue our final report on the Central Artery OCIP later in fiscal year 1999.

RESULTS-IN-BRIEF

The Massachusetts Highway Department has overpaid workers' compensation premiums, with 90 percent of the overpayments being made with Federal funds. These funds are held in trusts owned by the Massachusetts Highway Department. They are currently invested by a subsidiary of the insurance company in a portfolio that includes Walt Disney, Wal Mart, General Electric, and U.S. Treasury notes. The overpayments and accrued interest total at least \$166.7 million, of which \$150.0 million are Federal funds. We are recommending that these funds be recovered and appropriately reallocated. If the Central Artery's holding of OCIP overpayments is allowed to stand, it may establish a precedent contrary to existing regulations' prohibition on the use of taxpayer money for investment purposes, and infrastructure programs around the country may start investing grant funds rather than using them for legitimate project expenses. This would clearly be a poor cash management practice for Federal funds.

The Central Artery's October 1998 annual Finance Plan projects that the excess funds generated by overpaid premiums will grow to $826 million when the OCIP ends in the year 2017.[1] The Finance Plan uses the excess funds as a "credit" to offset current costs and reduce the cost of the project to $10.8 billion, rather than almost $12 billion.

In responding to a draft of this report, the Central Artery Project Director and FHWA Executive Director disagreed with our recommendation to recover the overpaid premiums, claiming that these funds (and the accrued interest) are needed to cover potential liabilities. Claiming the excess funds are needed to cover future liabilities, while at the same time citing these funds as a credit against ultimate project costs is inherently inconsistent; project management cannot have it both ways. If FHWA and Massachusetts Highway Department officials believe that the Central Artery has such enormous liability risks, they should require the project to obtain appropriate insurance coverage. Furthermore, if FHWA and the Massachusetts Highway Department sincerely believe the funds are needed to cover future costs, they must not count on the $826 million in future proceeds from the trusts to reduce the overall cost of the project; and must revise the Finance Plan to reflect the almost $12 billion in expected project costs.

Insurance Premiums Were Overpaid

Massachusetts Highway Department payment records show that, between 1992 and 1997, the project paid $368.7 million in estimated premiums, of which 90 percent were paid for with Federal funds. Workers' compensation and general liability premiums accounted for $335.4 million of the total premiums paid. These premiums were overpaid by $132.7 million during the first 3 years because the estimated insurance premiums were set using a higher number of workers than were actually employed on the project. Premiums were underpaid slightly in subsequent years because the estimated premiums were lowered when the program was renewed in 1996.

Audits performed by the insurance company showed the net estimated premiums exceeded appropriate premium amounts for 1992-1997 by over 39 percent, or $129.8 million. The overpayments are being held in trusts owned by the Massachusetts Highway Department. Assuming interest at 6 percent compounded annually, the overpaid premiums and accrued interest now total $166.7 million,

[1] The March 1999 Project Management Monthly Report shows an additional $209 million OCIP credit, bringing the combined credits to over $1.0 billion. We note that the project is scheduled to be completed in 2004, 13 years before receipt of the excess funds.

the Federal share of which is approximately $150.0 million (Figure 1). Federal guidelines require the overpayments and interest to be immediately recovered and either used to pay current project costs or the Federal portion returned to the U.S. Treasury.[2]

Figure 1 – Overpayments of Central Artery Workers Compensation and General Liability Premiums (in millions)

Premium Period	Estimated (Paid) Premium	Audited Premium	Overpayment
1992-93	$66.6	$22.0	$ 44.6
1993-94	77.3	46.6	30.7
1994-95	105.3	47.9	57.4
1995-96	42.0	43.0	(1.0)
1996-97	44.2	46.1	(1.9)
Sub-Total	$ 335.4	$ 205.6	$ 129.8
Investment Income Earned on Overpayments			$ 36.9
Total Overpayments plus Earned Investment Income			$166.7
90% Federal Share of Overpayments plus Earned Investment Income			**$150.0**

In 1998, the Auditor of the Commonwealth of Massachusetts reported the overpayments and recommended that the excess be reclaimed and used to pay current project costs. Central Artery project management declined to implement the Auditor's recommendation, stating "the trust fund now prudently anticipates the higher risks we face during the current peak construction period...." The Auditor replied that there was no need to fund potential losses over actuarial projections, since actuarially projected losses are recognized and funded as part of each program. The Auditor concluded, "[T]he funding of a contingency that is unlikely to materialize is not prudent use of project funds, especially in light of the favorable claims being experienced under both insurance programs." Our review confirms the Auditor's finding that premiums were overpaid.

FHWA and Massachusetts Highway Department Dispute OIG Findings

In their responses to a draft of this report, the FHWA Executive Director and Central Artery Project Director disagreed that there have been overpayments. The FHWA Executive Director stated the funds in the insurance trusts are being used solely for insurance purposes because the funds have not reached a level that "collateralizes the State's potential exposure." According to the FHWA Massachusetts Division Administrator, Massachusetts faces potential "mammoth" liabilities over and above the insurance coverage purchased. The Division Administrator went so far as to say the potential liabilities are so large that it would be impossible to overpay the insurance.

[2] OMB Circular A-87 "Cost Principles for State, Local and Indian Tribal Governments;" 23 CFR Part 140; the Cash Management Improvement Act of 1990; and 49 CFR Part 18.

Documented Risks Do Not Justify Overpayments

We found there are no documented risks that justify the overpayments. The Central Artery project's risks and estimated potential liability, in the event catastrophic accidents were caused by the project, were identified in a 1991 Risk Assessment conducted by the project's insurance broker in conjunction with a risk management and actuarial consultant. General liability insurance coverage of $200 million was purchased based on the identified risks. Moreover, in a March 30, 1998 draft "Risk Assessment Report" conducted for the insurance broker, an independent insurance expert evaluated the currency of the 1991 assessment. The assessment found "the chances of a complete and total loss are infinitely small" and concluded, "On the whole, the 1991 Risk Assessment Report addressed the risks of loss with a reasonable methodology." The draft assessment states, however, that if officials still had concerns, the Central Artery could purchase an additional $100 million of coverage (raising total coverage to $300 million) through the end of peak construction in 2001. The cost of the additional coverage was estimated to be between $750,000 and $1 million. The premium cost to raise the coverage from $200 million to $300 million is low in comparison to the amount required for the initial $200 million in coverage because (1) the amount paid for the initial coverage is not all "premium," but includes collateral for expected claims below the deductible, and (2) there is less risk that losses will mount to the higher levels of the additional coverage.

In January 1999, the insurance broker stated, "We are satisfied that the loss limit thresholds selected are appropriate and the continued emphasis on safety will keep losses well under control." The project has chosen not to purchase additional coverage.

We also found that the 1996 workers' compensation agreement, which includes the requirement for collateral to be held in the trusts, establishes procedures for adjusting the collateral annually and authorizes the Massachusetts Highway Department to recover any excess from the trusts. As of December 31, 1998, the OCIP trust accounts held $264.6 million.[3] This level of collateral is not required, a fact that is demonstrated by the Massachusetts Highway Department's use of $22 million in excess trust monies to pay part of the premiums in subsequent policy years. Specifically, $6 million was applied toward the 1995/1996 premium, and $16 million was applied to the 1996/1997 premium. After recovery of the $150.0 million Federal share of the overpayments, approximately $114.6 million will remain in the trust.

SYNOPSIS

[3] The overpayments we are reporting resulted from an excess of "estimated" over "audited" premiums. Recovery of the Federal share of these overpayments will leave approximately $114.6 million in the trusts, the amount that would have been reserved under the audited premiums. However, it appears the collateral included *within* the audited premium may also have been overpaid. Our review of the OCIP remains ongoing. Any excess collateral in the audited premium will be in addition to the $166.7 million ($150.0 million Federal share) in gross premium overpayments reported herein.

We conclude that, if the project runs a credible risk of liability for causing catastrophes beyond what was identified in the 1991 Risk Assessment, this has neither been documented nor disclosed to the public. Because the project has chosen not to purchase additional insurance coverage and has already used some excess funds to pay premiums, we are not persuaded by the argument that the overpayments are needed for insurance purposes.

Use of Grant Funds for Investment Not Authorized

Regarding the use of the trust funds credits, the Project Director of the Central Artery project stated that, when the $826 million in credits are received in 2017, the funds will be used for highway construction projects in the State. The Project Director's statement directly contradicts FHWA's and his own position that there are no excess insurance payments, and their argument that the excess funds in the trusts are necessary to cover future losses on the Central Artery project.

Federal policies restrict recipients of Federal highway funds to using the money for project-related purposes, not for long-term investments. The accumulation of Federal funds in long-term investments to offset costs is inconsistent with Federal regulations, as well as OMB Circular A-87 and the Cash Management Improvement Act. Federal regulations require the overpayments, including any interest that has been generated on those funds, to be immediately applied to current project costs or the Federal share returned to the U.S. Treasury.

Recommendations

We recommend the FHWA:

1. Recover the $150.0 million Federal share of the premium overpayments and interest earned related to payments made through 1997, as well as any further overpayments and interest that have since accrued, and either apply the funds to current project costs or return the money to the U.S. Treasury.
2. On an annual basis, determine actual insurance requirements and ensure any overpayments involving Federal funds are recovered and applied to current costs or returned to the U.S. Treasury.
3. Review its policy regarding reimbursement for insurance and establish guidelines to ensure any future overpayments of insurance premiums on highway projects are recovered and applied to current costs or returned to the U.S. Treasury.[4]

[4] This is a reiteration of a recommendation from our April 1998 Report on the Central Artery/Ted Williams Tunnel project.