157083

GAO

United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-270667

July 5, 1996

The Honorable Richard C. Shelby
Chairman
The Honorable J. Robert Kerrey
Ranking Minority Member
Subcommittee on Treasury,
Postal Service, and General Government
Committee on Appropriations
United States Senate

The Honorable Paul Simon
United States Senate

The Honorable Jim Lightfoot
Chairman
The Honorable Steny H. Hoyer
Ranking Minority Member
Subcommittee on Treasury,
Postal Service, and General Government
Committee on Appropriations
House of Representatives

The Honorable John L. Mica
Chairman, Subcommittee on Civil Service
Committee on Government Reform and Oversight
House of Representatives

The Office of Personnel Management (OPM) plans to privatize its Investigations Service. Because OPM had not analyzed the long-term costs of privatizing the Service, in July 1995, Congress required it to conduct a cost analysis before proceeding with privatization. Congress also required us to determine whether the

assumptions and methodology used for the analysis were reasonable.[1] This letter responds to that requirement.

BACKGROUND

The Investigations Service performs, at the request of federal agencies, background investigations of federal employees, contractors, and applicants to provide a basis for determining (1) an individual's suitability for federal employment and (2) whether an individual should be granted a clearance for access to national security information. OPM's plan would privatize this function through the establishment of a private corporation, to be known as the US Investigations Services, Inc. (USIS).

Former Investigations Service employees would own USIS by means of an employee stock ownership plan. OPM has contracted with USIS for the latter to conduct all background investigations currently being done by OPM. OPM envisions that USIS also would do background investigations for state and local governments and private organizations.

The Office of Management and Budget (OMB) has published a cost comparison methodology that agencies can use when determining whether to perform a function or to outsource it. OMB Circular A-76, together with a supplemental handbook, provides the methodology and a list of cost items for making the cost comparison.[2]

OPM hired a consulting firm, Kormendi\Gardner Partners, to perform the cost analysis. The consultant analyzed information and data provided by OPM and two private companies to measure whether privatizing the Investigations Service--on the terms and conditions that OPM detailed--would be to the federal government's financial advantage. The two private firms were USIS' proposed trustee and the trustee's financial advisor.

The consultant gave a draft report to OPM in December 1995 and issued its final report to OPM in March 1996.[3] The consultant concluded that "the proposed

---

[1]House Report 104-183 and Senate Report 104-121.

[2]The circular is titled Performance of Commercial Activities. The related handbook is titled Cost Comparison Handbook.

[3]Kormendi\Gardner Partners, The Benefits and Costs of the ESOP [Employee Stock Option Plan] Privatization of the Office of Personnel Management Investigations Service (Washington, D.C.: March 5, 1996).

privatization will cost the federal taxpayers considerably less than the current arrangements for providing investigations services to OPM's client federal agencies." These savings would come from the government (1) paying less for investigations services, (2) paying less in pension costs for Investigations Service employees who are to lose their federal employment after privatization, and (3) receiving corporate income taxes from USIS. The savings would be reduced, however, by the cost of severance pay to those terminated federal employees who qualify.

The consultant developed a range of estimated savings under three assumptions: "conservative," "reasonable," and "optimistic." All of the estimates were expressed in net present-value terms and should not be confused with budget savings, which are estimated on the basis of cash rather than present value.[4] The consultant said privatizing the Investigations Service as proposed by OPM would save taxpayers in the range of $60 million (under its conservative assumptions) to $120 million (under its optimistic assumptions).

We reviewed both the draft and final report of the cost study. In January and April 1996, we discussed with Kormendi\Gardner and OPM our concerns with certain assumptions used in preparing the draft and final report. Our views on the final report are summarized below and detailed in enclosure I.

RESULTS

Using OMB Circular A-76 as our guide for comparison, we consider the assumptions and methodology used in the cost study to be generally reasonable, with two basic exceptions. First, we have a concern about an assumption used in the price reduction category, which was one of the savings categories developed by the OPM consultant. In developing the estimated price reduction figure, the consultant compared the prices the Investigations Service and USIS would charge federal customers. OPM provided the consultant with the data on OPM's current prices, as well as the prices to be charged to federal customers under the contract with USIS. These data showed USIS charging lower prices than the Investigations Service to perform the same types of background investigations. The consultant used this pricing data in its draft and final reports.

We believe there was a problem with using the current prices as those the Investigations Service would charge federal customers in the future. OMB Circular

---

[4]Budget savings are only realized if the Congress has reduced appropriations and lowered discretionary spending caps.

A-76 instructs agencies to determine the most efficient and effective in-house operation for an activity that may be outsourced. It instructs them to use the costs associated with the most efficient organization as the basis for cost comparisons with potential contractors. However, OPM established the Investigations Service's prices in 1994 on the basis of historical operations, including the need to make up certain deficits incurred by OPM in the past. As such, the prices OPM gave to the consultant for use in the cost study did not reflect the Investigations Service at its most efficient.

Although OPM may not have been required to make an efficiency assessment of the Investigations Service,[5] we believe it would have been prudent to do so, especially since OPM had information that raised doubts about the accuracy of this price estimate. For example, the OPM Inspector General reported in 1994 that OPM had been unable to accurately forecast the investigative workload and adjust staffing levels accordingly, which contributed to an operating deficit. The Inspector General also reported that the Investigations Service had been burdened with an excessive share of OPM's overhead charges. According to the report, these factors led to an operating deficit and the need for the Investigations Service to raise prices in order to eliminate that deficit.[6]

An OPM official acknowledged that the prices given to the consultant were not indicative of the true costs of conducting investigations. Moreover, he said that the deficit had essentially been reduced and that OPM would be looking to decrease current prices to client organizations. Because OPM did not determine whether the Investigations Service could be made more efficient, there is no way to know (1) what pricing would reflect the Investigations Service's costs in the future and (2) how that pricing would affect the consultant's estimates of savings.

Our second concern involves the consultant's analysis of the reduced federal pension costs that would result from privatization. The study depicts these savings as all occurring in the first year of the privatized operations, although it recognized that these reduced costs would be realized over a period of many years. According to the consultant, since the economic event inducing the savings would take place at the

---

[5]An OMB official we spoke with did not think OPM was required to follow OMB Circular A-76 because OPM no longer wanted to perform background investigations. However, he believed it was important that the government's costs reflect the most efficient organization in order to have an equitable comparison.

[6] Office of the Inspector General, Evaluation Report: Systemic Issues Contributing to the Financial Difficulties of the OPM Revolving Fund (August 1994).

time that current OPM Investigations Service employees were terminated, it was decided to reflect the full present value of the pension cost savings in the first year after privatization.

While we do not question the consultant's methodology in arriving at the savings, reflecting the full value of these savings in the first year of operation is not consistent with the study's treatment of other cost elements, such as corporate income tax revenues and savings achieved through lower prices for investigations. Although the presentation does not affect the overall calculation of pension savings over time, it makes it difficult to assess the potential savings or loss to the government in the first few years after privatization or to determine when the break-even point might reasonably be expected to occur.

Subsequent to issuing its final report, the consultant provided us with a revised estimate of the reduced pension costs spread over a period of years that is consistent with the treatment of other cost elements, such as corporate income tax revenues and savings achieved through lower prices for investigations. Spreading the reduced pension costs over the years suggests an estimated net loss to the government in the first year after privatization. On a net present value basis, it is estimated that the government would not realize any net savings until the fourth year of privatization.[7] (See table I.3.)

Despite our reservations about the consultant's pricing data and depiction of pension savings, we have no reason to question the cost study's general conclusion that privatization would be likely to produce a net savings to the government in the long term, although the effect on the budget has not been evaluated. It is important to recognize, however, that any new business faces many uncertainties that can affect profitability. The consultant's study points out some of these uncertainties and alerts the reader to them in several places. For example, the study recognizes that income tax revenues could be lower than anticipated if USIS' income were to be lower than anticipated. Furthermore, these indirect tax effects would not be counted in estimating budget effects. Downsizing in civilian agencies also could reduce revenues by reducing the demand for USIS' investigations.

It is also important to recognize that, in a companion letter to be issued shortly on the privatization of OPM's Investigations Service, we discuss our concerns about access to records. Private contractors such as USIS may have difficulty in obtaining certain

---

[7]The cash budget costs and savings effects would differ from those shown on a net present value basis.

records used in background investigations. OPM, to our knowledge, has not yet resolved this issue. In the event that this issue is not resolved, it could have a negative impact on USIS' future profitability.

APPROACH

To determine whether the consultant employed reasonable assumptions and an appropriate methodology, we evaluated the savings and cost categories that formed the basis of the consultant's study. To guide us in assessing the study, we used the cost methodology provided in OMB Circular A-76 and the cost items identified in the A-76 handbook because they were issued by OMB to help executive agencies make sound cost analyses of activities that might be commercialized. We discussed the study's assumptions and methodology with OPM officials responsible for the privatization effort and with representatives of Kormendi\Gardner. We did not verify the accuracy of the cost data that the consultant used.

We did our work in Washington, D.C., from September 1995 to March 1996 in accordance with generally accepted government auditing standards. We requested comments on a draft of this letter from the Director of OPM. Those comments follow.

AGENCY COMMENTS AND OUR EVALUATION

In a May 28, 1996, letter, the OPM Director provided comments on a draft of this letter (see enc. II). In general, the Director said OPM was pleased that we had no reason to question the cost study's overall conclusion that privatization would be likely to produce a net savings to the government in the long term.

The OPM Director also commented on our view that the prices OPM gave to the consultant for use in the cost study did not reflect the Investigations Service at its most efficient. In response to this point, the OPM Director said efficiency could not be absolutely gauged until a break-even operation was reached and maintained and that the Investigations Service had attained a break-even status for only about 3 of the last 12 years, and had been unable to sustain that level for very long. He also noted that the Investigations Service has no control over the amount of the work it receives or where the work falls geographically and that it cannot efficiently and effectively respond to market changes. The Director further said that, while the Investigations Service had developed a truly business-like orientation, it was still running a $300,000 revolving fund deficit at the end of March 1996 and that breaking even could continue to be problematic given the vagaries of the investigations program.

We believe that securing a valid estimate of the efficiency of the Investigative Service is not dependent on a break-even level being reached and maintained. OMB Circular A-76 recognizes that agencies will need to apply certain estimates and assumptions in developing the most efficient in-house operation. This is what was done for USIS pricing. Portions of the cost analysis dealing with USIS operations, including possible price reductions and tax revenues, were based on forecasts and estimates, which cannot be absolutely gauged. In addition, we believe USIS would be confronted with the same uncertainties that OPM cites for the Investigations Service – that is, a lack of control over the amount of work it receives and where the work falls geographically.

Further, we note that the $300,000 deficit that existed at the end of March 1996 was a sharp reduction from the $14.4 million deficit that existed as of the end of fiscal year 1995. This indicates, in our opinion, that the Investigations Service was made more business-like and efficient and that the pricing that resulted from the new efficiency might have been more reflective of the cost of investigations.

We recognize that OPM might not have been required to follow A-76 guidance. However, we continue to believe that the cost study would have produced a better estimate of the true savings if OPM had provided pricing information that more closely reflected the Investigations Service at its most efficient, as described in A-76 guidance.

In commenting on our concern that the cost study depicts all savings in pension costs as occurring in the first year of the privatized operations, OPM noted that the consultant had provided us with a revised estimate of the pension costs spread over a period of years.

The new information provided by the consultant satisfied our concern that pension costs should be spread over a period of years. As we noted in the draft letter, spreading the pension cost savings over time changed the initial results of the privatization. For example, according to the consultant's new data, the first year of the privatization would produce an overall loss of $5.7 million. (See table I.3.) This loss would not be recovered until the fourth year of the privatization, when a break-even point would be achieved. The new information was not included in the consultant's study that OPM provided to Congress; that version of the study showed an overall savings of $7.1 million during the first year. Information showing that it would take 4 years to recover initial losses caused by privatization could be important in assisting Congress in its deliberations over the privatization of the Investigations Service.

On another matter, the OPM Director cited a concern we raised about the ability of USIS to obtain certain records used in background investigations. We said that OPM

had not yet resolved this issue and that, in the event it is not resolved, there could be a negative impact on USIS' future profitability. The OPM Director said that OPM was confident that it would be able to obtain whatever information it needed to ensure complete, high quality investigative products. The Director also said that OPM would manage the collection of data and records in a manner that would allow no compromise in its standards of excellence.

We initially raised our concern about access to records in a draft letter to OPM dealing with noncost savings issues pertaining to OPM's planned privatization, including access to records. OPM provided comments on that draft letter, including comments on the access-to-records issue similar to those described previously. At this point, we are not totally convinced that OPM has resolved all access-to-records issues. For example, recent discussions we held with state representatives suggested that there might be problems in obtaining needed background information from certain states. We will address this issue and OPM's comments in our forthcoming letter on noncost savings issues, which will allow for a more comprehensive discussion of the matter.

- - - - -

As agreed with your offices, we will send copies of this letter to the Directors of OPM and OMB and to Kormendi\Gardner Partners. We will also send copies to other interested parties and make copies available to others upon request.

Please contact me at (202) 512-6594 or Richard Caradine at (202) 512-8109 if you have any questions or require more information.

Timothy P. Bowling
Associate Director
Federal Management and
Workforce Issues

OUR ANALYSIS OF THE CONSULTANT'S FOUR CATEGORIES OF SAVINGS OR COSTS

The OPM study reached a conclusion that privatizing the Investigations Service would result in significant savings to the government, ranging from at least $60 to $80 million under its "conservative" scenario, $80 to $100 million under its "reasonable" scenario, and $100 to $120 million under its "optimistic" scenario. Table I.1 is extracted from the study and shows the anticipated benefits and costs developed by the consultant under its conservative scenario, computed on the basis of the total net present value, due to (1) price reductions, (2) corporate income taxes, (3) pension savings, and (4) an offset for severance pay.

Table I.1: Summary of Benefits and Costs of Privatization (in Millions)

Source of benefits or (costs)	1996	1997	1998	1999	2000	Beyond	Totals
Price reductions	$0.4	$0.5	$1.8	$3.1	$2.5	$35.1	$43.4
Federal corporate income taxes	3.0	2.3	1.6	1.3	1.2	17.4	26.7
Reduced pension costs	12.1						12.1
(Severance pay)	(8.4)						(8.4)
Total	$7.1	$2.8	$3.4	$4.4	$3.7	$52.4	$73.8

Note: Numbers may not add due to rounding and are expressed in present value terms.

Source: OPM study dated March 5, 1996.

What follows is a summary of how the OPM consultant arrived at these estimates and our observations on the methodology and assumptions used.

PRICE REDUCTIONS

Table I.1 shows total benefits of about $8 million over the 5-year period of the OPM-USIS contract (a 3-year contract period plus a possible 2-year extension) through price reductions by USIS. Beyond the first 5 years, a savings of $35 million is estimated, for

a total of about $43 million. Cost savings were calculated based on present-value terms and do not represent budget savings.

The consultant calculated the costs of USIS by multiplying the projected number of investigations required by customer agencies by the projected costs to the agencies for each of the various types of investigations. To estimate the projected demand for investigative services, OPM used estimates from its client agencies. It then adjusted these projections based on OPM experience. To estimate costs for conducting investigations, OPM used prices set forth in the contract with USIS for each type of investigation that will be paid by client agencies. Because the contract states that OPM will provide USIS with significant support resources and will incur oversight and administrative costs, USIS will actually receive 75 percent of the prices charged. The remaining 25 percent will go to cover OPM costs and overhead. According to the cost study, the price of investigations contracted for with USIS reflect reductions that are to be accrued through more efficient USIS operations, as well as through the entry of USIS into new markets.

To calculate the savings to the government, the prices to be charged client agencies under the contract with USIS were compared to estimated prices that would have been charged if OPM's investigations functions continued to be performed by OPM employees. The cost study indicated that OPM's prices were based on "current" Investigations Service prices. These prices were then used to calculate the costs that OPM would incur if the government were to continue the investigative function. The consultant based this cost calculation on the same projected demand for investigations used in the calculations for USIS. Comparison of total USIS costs with OPM costs on a present-value basis showed a significant savings by privatizing.

Our Analysis

Using OMB's A-76 cost comparison criteria to guide our analysis, we noted that the OPM consultant's study generally incorporated the OMB-prescribed cost elements when comparing the cost of in-house versus contract performance of the investigations functions. For example, the government's side of the cost comparison equation contained such costs as personnel, material and supply, and overhead. USIS' costs contained such prescribed elements as the price of the contract and the cost to the government of administering the contract. However, our analysis indicated that the consultant's cost comparison may not be based on comparable assumptions.

Generally, a cost comparison of performing a function in-house versus outsourcing (such as advocated in Circular A-76) assumes a level playing field by estimating costs associated with the most efficient in-house operation against the estimated cost of

outsourcing. In other words, the in-house function generally prepares a study to determine how to make it as efficient as possible and to use the associated costs as a basis to compete with the outsourcing proposal. In the subject comparison, this was not done. It appears that the estimated costs associated with the assumption that OPM would continue operating the investigative function reflect historical inefficiencies and are not necessarily reflective of current operations and costs or potential cost improvements. On the other hand, the estimated costs of USIS are based on a proposed efficient organization that not only will charge the government less for its services, but is also projected to be able to bring down costs even more through the introduction of new business. In effect, the estimated costs of in-house performance and contract performance are not truly comparable and thus do not provide support for a conclusion of what the "true" savings might be. We discussed this observation with the OPM consultants who said that their analysis of cost savings represented a judgment based upon the factual evidence at hand, as provided by OPM.

In June 1995, we testified before the House Subcommittee on Civil Service, Committee on Government Reform and Oversight, on privatizing OPM's Investigations Service. (See GAO/T-GGD-95-186.) We cited previous OPM Inspector General reports that noted several deficiencies in the management of OPM's investigative activities. For example, the Inspector General reported that OPM had not been able to accurately forecast its investigative workload and adjust staffing levels accordingly and that this had contributed to operating deficits. Also, the Inspector General noted that OPM's investigative services had been burdened with an excessive share of OPM's overhead charges, which also contributed to the operating deficit.

OPM's Director also testified at the June 1995 hearing that, in order to stop the accumulation of deficits in its revolving fund, OPM took steps to put the investigations function on a sound financial footing through the development and implementation of an investigations business plan, which was based on OPM's hopes for a stable market for the Investigations Service's work and for high productivity from its professional staff. The business plan, dated May 1994, provided recommendations for increasing revenue and reducing costs, ensuring break-even or better operations, and positioning the program to operate effectively in the competitive marketplace. The plan cited the importance of a change in culture, a reassessment of the Investigations Service's procedures and policies in light of its customer's needs, and the marketing of current and new products with the needs of current federal customers in mind in order to provide for the overall financial security and efficiency of the program.

These proposed improvements seem to have placed OPM in an improved position. However, the cost study used pricing data developed by OPM in 1994 as part of its fiscal years 1994 to 1998 Revolving Fund Financial Plan. According to an OPM official,

the prices that OPM set in 1994 reflected higher than actual costs of conducting investigations in order to create a surplus to use to pay down the existing operating deficit. OPM officials told us that more current costs were not developed because the Investigations Service would soon cease operations. The officials said that, if the Investigations Service were to continue in business, more current information would be developed. They also said that, because the revolving fund deficit has been reduced, the older, higher prices that are currently being charged by OPM would have to be reduced, since OPM is not allowed to keep any surplus or profit.

CORPORATE INCOME TAXES

As table I.1 shows, the OPM study estimates savings based on USIS' return to the government, in the form of corporate income taxes, of more than $9 million over the possible 5-year period of the contract. Beyond the first 5 years, revenues are estimated to be about $17 million. Estimates are based on present-value terms. The taxes are expected to be generated from profits on (1) existing products and (2) new products. Table I.2, which also was extracted from the consultant's study, provides a more detailed presentation of the tax revenues expected to be received by the government subsequent to privatization. These figures also are present-value terms.

Table I.2.: Projected Federal Income Tax Payments by USIS (in Thousands)

	1996	1997	1998	1999	2000	Beyond	Total
Current products	$2,941	$2,079	$1,250	$735	$520	$7,435	$14,961
New products	17	195	340	545	695	9,931	11,724
Total	$2,958	$2,274	$1,590	$1,281	$1,216	$17,366	$26,685

Note: Numbers may not add due to rounding and are expressed in present value terms.

Source: OPM study dated March 5, 1996.

The OPM consultant based the estimated tax revenues on income statement projections developed for OPM by another consulting firm. As shown in table I.2, tax revenues from current OPM products are expected to decrease over the years. Tax revenues based on new business that USIS anticipates generating are expected to increase over the years. The consultant's cost study recognized that, if the profitability of USIS were to be lower or higher than estimated, the tax revenues to be

received by the government would be correspondingly lower or higher than projected in the study. The consultant also correctly pointed out that the tax revenues relating to new products might be lower than projected in the study if the new products replaced existing private sector products on which taxes were already being paid to the government.

Our Analysis

According to OMB guidance, the potential federal income tax revenue must be considered when developing the cost of contract performance. We believe that the study appropriately considered such taxes. We recognize, however, that the amount of taxes ultimately paid to the government will be based on the income that USIS is successfully able to generate. To the extent that such income may not be realized, the taxes would also be reduced. As previously noted, the study recognized this possibility.

It appears that the projected tax revenues relating to new products (new business) would be the most uncertain of the tax revenue projections. This uncertainty exists for two reasons. First, as the OPM study notes, some of the tax revenues might be based on new business that USIS competes for and then takes away from competitors currently providing such services. These competitors would in all likelihood be paying corporate income taxes on profits generated from such business. If USIS won business away from these competitors, any taxes that USIS paid from this business would replace taxes that its competitors would have paid.

The second reason for uncertainties pertaining to tax revenues concerns USIS' ability to parlay its position as OPM's exclusive contractor into new, nonfederal government markets. Several references in OPM's contract with USIS suggest that USIS' access to federal, state, and local records for work to be done under the contract with OPM may be used to facilitate expanding USIS' market for new business. The OPM contract with USIS also shows that OPM intends to seek authorization from OMB to perform investigative services for state and local governments, and if this strategy is successful, this work would be done by USIS under the contract with OPM. OPM's plan would permit state and local governments to use USIS services on a non-competitive basis, a feature which could be attractive to those governments.

In April 1996, OPM officials said they had not yet requested such authorization from OMB and did not know how OMB would respond to such a request. However, OPM requested similar authorization from OMB in 1994, before the privatization decision, as part of its own internal effort to make its investigative function more efficient and profitable. OMB denied OPM's 1994 request, noting that "In accordance with the

Intergovernmental Cooperation Act (31 U.S.C. section 6506) and OMB Circular A-97, background investigative services do not meet the criteria of 'specialized or technical services'. The Intergovernmental Cooperation Act (ICA) was intended to encourage intergovernmental cooperation but not upset ordinary business channels. We believe background investigative services could be provided by the private sector."

It seems to us that OMB's rationale for denying OPM's 1994 request may also apply to any new request since background investigative services do not meet the criteria of specialized or technical services. It also appears to us that such authorization, if granted, would upset ordinary business channels since other contractors would not have the opportunity to compete for the potential new business from state and local governments. Under the ICA, OPM would enter into an intergovernmental agreement to provide investigative services to a state or local government. OPM would honor that agreement through its contract with USIS, thus providing a stream of additional work for USIS without it having to compete for the work.

PENSION COSTS

Table I.1 shows an estimated savings to the government from reduced pension costs of about $12 million, based on present-value terms. Pension savings would be realized for two reasons. First, since the amount of an employee's annuity is based on the average of his/her high-3 years of pay, this amount would be lower for those OPM employees who were terminated from federal employment at the time of privatization, because they would no longer receive federal pay raises. Second, the annuity as a percentage of the average high-3 would be lower because an employee's completed years of service would be fewer upon termination than if the employee had continued his or her employment with OPM. The consultant prepared separate calculations for those OPM employees currently under the Civil Service Retirement System and those employees under the Federal Employees Retirement System.

In its study, the consultant also recognized that some current OPM employees who would be terminated due to the privatization would qualify for an immediate annuity under federal retirement rules. The consultant calculated the costs attributable to those immediate retirements and factored those costs into its calculations of the estimated net reduction in the government's pension liability resulting from the privatization.

Our Analysis

We do not question the methodology used in arriving at estimated pension savings to the government due to the termination of affected federal employees upon completion

of the privatization. We noted, however, that the study depicts these savings as occurring in the first year of privatized operations, although the study also recognized that such savings would actually be realized over a period of years. According to the consultant, because the economic event inducing the savings occurs immediately at the time when OPM terminates its investigations functions performed by federal employees, it was decided to reflect the full present-value benefit of the pension savings in the first year after privatization.

In our opinion, the recognition of these savings in the first year of operation is not consistent with the treatment in the cost study, as shown in table I.1, of other cost elements, such as corporate income tax revenues and savings achieved through lower prices for investigations. Although the presentation in the study of the anticipated pension savings does not affect the overall calculation of cost savings to the government, it does make it difficult to assess the potential savings or loss to the government in the first few years after privatization or when the break-even point might reasonably be expected to occur.

We asked the consultant to calculate the effect of spreading the $12.1 million of pension cost savings over time to reflect the actual yearly net savings. On May 6, 1996, the consultant provided us with the data shown in table I.3, which indicate that spreading the pension savings would result in a $5.7 million loss during the first year of the privatization. This loss would not be recovered until the fourth year of the privatization.

Table I.3: Revised Summary of Benefits and Costs of Privatization (in Millions)

Source of benefits or (costs)	1996	1997	1998	1999	2000	Beyond	Totals
Price reductions	$0.4	$0.5	$1.8	$3.1	$2.5	$35.1	$43.4
Federal corporate income taxes	3.0	2.3	1.6	1.3	1.2	17.4	26.7
Reduced pension costs	(0.7)	(0.6)	(0.5)	(0.5)	(0.5)	14.9	12.1
(Severance pay)	(8.4)						(8.4)
Total	($5.7)	$2.2	$2.9	$3.9	$3.2	$67.3	$73.8

Note: Numbers may not add due to rounding and are expressed in present value terms.

Source: OPM consultant, May 6, 1996.

SEVERANCE PAY

The OPM study considered the principal cost to the government of the privatization to be the severance pay to the employees whose federal employment would be terminated. This amount, estimated on the basis of present value to be more than $8 million, was deducted from the estimates of savings in order to determine the net savings resulting from the privatization.

Our Analysis

According to OMB guidance, any one-time costs incurred because of the conversion from in-house performance to contract performance should be recognized in the cost comparison. We believe that the deduction for estimated severance pay to terminated employees is an appropriate and necessary reduction from the overall savings estimates, and is in accordance with OMB instructions.

AGENCY COMMENTS FROM OPM

UNITED STATES
OFFICE OF PERSONNEL MANAGEMENT
WASHINGTON, D.C. 20415

OFFICE OF THE DIRECTOR

MAY 28 1996

Mr. Timothy P. Bowling
Associate Director, Federal Workforce
and Management Issues
United States General Accounting Office
Washington, DC 20548

Dear Mr. Bowling:

Thank you for your letter of May 16, 1996, with which you forwarded a draft version of your proposed report to congressional requesters on your Cost Analysis: Privatization of OPM's Investigations Service. We appreciate the opportunity to comment.

Your report is based on an analysis of the cost benefit study done for OPM by Kormendi/Gardner Partners, a private consulting firm. This study, as you point out, concluded that privatizing the Investigations Service as proposed by OPM would save the taxpayers in the range of $60 million under conservative assumptions to $120 million under optimistic assumptions. Savings would come from the government by "(1) paying less for investigation services, (2) paying less in pension costs for Investigations Service employees who are to lose their federal employment after privatization, and (3) receiving corporate income taxes from the privatized operation."

On page 4 of your draft, you express a concern about an assumption used in the price reduction category of savings, in that Kormendi/Gardner Partners used the prices currently charged by OPM to its customers. You cite OMB Circular A-76 as instructing agencies to determine the most efficient and effective in-house operation for an activity that may be outsourced. As you know, with respect to any cost-benefit comparison, as part of the initial review, OMB developed estimates of government-wide savings to be realized by privatizing OPM's investigation and training functions. Under the unique and ground breaking approach presented here -- that is, proceeding with privatization by contract with an ESOP corporation-- OMB has informed OPM that no further cost analysis is required of OPM pursuant to OMB Circular A-76 in order to proceed.

You concede that OPM may not have been required to make an efficiency assessment of the Investigations Service, and that an OMB official you spoke with did not think OPM was required to follow OMB Circular A-76.

You state that the prices OPM gave to the consultant for use in the cost study did not reflect the Investigations Service at its most efficient. If you equate being most efficient with break-even operation under our revolving fund, the program has attained that level for only about 3 years out of the last 12, and has not been able to sustain that level for very long, for reasons beyond its control. The Investigations Service has no control over the amount of work it receives or where the work falls geographically and cannot efficiently and effectively respond quickly enough to market changes to avoid fiscal harm given the public sector constraints which limit our ability to do so.

While it is true that the program has developed a true business-like orientation and has taken in more than it has spent for several months, as of the end of March of this year it was still running a revolving fund deficit in the amount of $300 thousand. Efficiency could not be absolutely gauged until a break-even operation was reached and maintained, which could continue to be problematical given the vagaries of our program.

You identify a second concern involving the consultant's analysis of the reduced federal pension costs that would result from privatization, in that the study depicts these savings as all occurring in the first year of the privatized operations. As your draft later states on page 6 that the consultant provided you with a revised estimate of the reduced pension costs spread over a period of years, we assume this is no longer a concern.

On page 6 of your draft, you identify a concern, first noted in another draft letter on the privatization of OPM Investigations, regarding the ability of the privatized company to obtain certain records used in background investigations. As we stated in our comments on that earlier draft, we are confident that OPM will be able to obtain whatever information it needs to ensure complete, high quality investigative products. OPM will manage the collection of data and records in a manner that allows no compromise to our standards of excellence.

We are pleased that your draft states that you "have no reason to question the cost study's general conclusion that privatization would be likely to produce a net savings to the government in the long term." Any delay in implementing the contract would have the counter productive result of cutting into those savings. The projected savings to the taxpayer when coupled with the seamless transition for OPM's customers and humane treatment of OPM's investigations staff, certainly justifies the effort we have made in this privatization process.

Sincerely,

James B. King
Director

ENCLOSURE III

MAJOR CONTRIBUTORS TO THIS LETTER

GENERAL GOVERNMENT DIVISION

Richard W. Caradine
Domingo Nieves
Gerard S. Burke

NATIONAL SECURITY AND INTERNATIONAL AFFAIRS

Leo G. Clarke III

OFFICE OF THE GENERAL COUNSEL

Alan N. Belkin
Jessica A. Botsford

(410008)

Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are $2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:

U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20884-6015

or visit:

Room 1100
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC

Orders may also be placed by calling (202) 512-6000
or by using fax number (301) 258-4066, or TDD (301) 413-0006.

Each day, GAO issues a list of newly available reports and testimony. To receive facsimile copies of the daily list or any list from the past 30 days, please call (202) 512-6000 using a touchtone phone. A recorded menu will provide information on how to obtain these lists.

For information on how to access GAO reports on the INTERNET, send an e-mail message with "info" in the body to:

info@www.gao.gov

United States
General Accounting Office
Washington, D.C. 20548-0001

Bulk Rate
Postage & Fees Paid
GAO
Permit No. G100

Official Business
Penalty for Private Use $300

Address Correction Requested