Department of Health and Human Services
DEPARTMENTAL APPEALS BOARD
Appellate Division

County of Fresno
Docket No. A-17-57
Decision No. 2841
December 28, 2017

DECISION

The County of Fresno, California (Fresno, the County) appeals a determination by Cost Allocation Services (CAS) disallowing $6,271,287 that Fresno claimed, for FY 2015 and FY 2016, as pension costs for county employees who work on federal programs. Fresno claimed the costs, which comprise payments of interest and related expenses on bonds Fresno issued. Such interest on borrowed capital is usually unallowable for federal reimbursement under longstanding government-wide cost principles. A 1994 federal policy, however, contains an exception permitting state and local governments to claim the costs of interest paid on certain types of bonds used to pay for unfunded pension liabilities (and thus to finance otherwise allowable pension costs) but such bond interest must not increase costs to the federal government.

This case raises exclusively legal issues and presents no factual disputes. As we explain, we sustain the disallowance because Fresno's bonds did not fund pension liabilities and increased the costs for which Fresno claimed federal funding, and thus did not meet the plain terms and intent of the exception. Moreover, the costs here also failed to meet the requirements of an expanded exception provided by a 2003 policy permitting claiming interest on certain bonds refinancing bonds that originally financed pension costs so long as the refinanced bonds did not increase the costs to the federal government of the original bonds. CAS here disallowed only the claims based on the refinanced bonds that exceeded what the federal government would have paid under the original bonds.

For the reasons we explain below, we uphold the disallowance in full.

Background – Cost Principles and OMB Policy

I. *The costs of pensions that state and local governments provide for employees, who work on federal programs, including payments to reduce the pension plan's unfunded liabilities, are generally allowable under the applicable cost principles in the regulations.*

Cost principles published by the Office of Management and Budget (OMB) and codified in regulations have long governed the allowability of costs that state and local governments charge to federal awards. They provide general requirements for all costs and specific requirements for individual types of costs. Over time the codification of the cost principles has changed, but the provisions that affect this appeal have remained substantively identical. The cost principles for state, local, and Indian tribal governments have been located in OMB Circular A-87 (1981, 1995), 2 C.F.R. Part 225 (2005) (codifying OMB A-87), and are currently in 2 C.F.R. Part 200 (2013), "Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards," and, for grants awarded by HHS, 45 C.F.R. Part 75.[1]

A county's (or state's) payments for employee pensions may be allowable charges to federal grants to the extent those employees work on federally-funded programs. 2 C.F.R. § 200.431(a), (g); *see, e.g.*, *Me. Dep't of Admin.& Fin. Servs.*, DAB No. 1659, at 9-10 (1998) (state's "employer pension contributions on behalf of state employees … are allowable only to the extent that the employees work on federally-funded programs"), *aff'd, Maine v. Shalala*, 81 F.Supp. 2d 91 (D. Me. 1999); *Okla., ex rel. Office of State Fin. v. United States*, 292 F.3d 1261, 1262 (10th Cir. 2002) ("Oklahoma and its various state agencies are entitled to reimbursement for the federal government's proportionate share of salaries and fringe benefits attributable to federal work being performed by state employees as long as the costs of implementing federal programs are legitimate, necessary, and allowable"), *aff'g Okla. Office of State Fin.*, DAB No. 1668 (1998).

[1] Prior to 2014, the cost principles for state, local, and Indian tribal governments were contained in OMB Circular A-87, which OMB issued in 1981, revised in 1995, and codified at 2 C.F.R. Part 225 in 2005. 46 Fed. Reg. 9548 (Jan. 28, 1981); 60 Fed. Reg. 26,484 (May 17, 1995); 70 Fed. Reg. 51,910 (Aug. 31, 2005). In 2013, OMB consolidated the contents of Circular A-87 and other OMB circulars into one streamlined set of uniform administrative requirements, cost principles, and audit requirements for federal awards, currently at 2 C.F.R. Part 200. 78 Fed. Reg. 78,590 (Dec. 26, 2013). In December 2014, HHS codified the text of 2 C.F.R. Part 200, with HHS-specific amendments, in 45 C.F.R. Part 75, "Uniform Administrative Requirements, Cost Principles, and Audit Requirements for HHS Awards." 79 Fed. Reg. 75,871, 75,889 (Dec. 19, 2014). We cite primarily to the current provisions of Part 200 because the disallowance potentially involves funds awarded by federal agencies besides HHS, and because the substance of the relevant provisions has not changed during the time relevant to this case.

The cost principles allow pensions as a form of fringe benefits provided they "are reasonable and are required by law, non-Federal entity-employee agreement, or an established policy of the non-Federal entity" and "are incurred in accordance with the established policies of the non-Federal entity," if "[s]uch policies meet the test of reasonableness" and "[t]he methods of cost allocation are not discriminatory."[2] 2 C.F.R. § 200.431(a), (g)(1), (2); *see* § 200.430(a) ("[c]ompensation for personal services may also include fringe benefits which are addressed in § 200.431").

For "entities using accrual based accounting, the [pension] cost assigned to each fiscal year is determined in accordance with GAAP [Generally Accepted Accounting Principles]" and "may be computed using a pay-as-you-go method or an acceptable actuarial cost method in accordance with established written policies of the non-Federal entity."[3] *Id.* § 200.431(g)(3), (6).

Allowable pension costs may include payments to reduce a pension plan's "unfunded actuarial liability," or UAL (also sometimes called the unfunded accrued actuarial liability, or UAAL). The UAL "is the amount by which the pension fund is deficient of the amount that will be necessary, without further payments, to pay benefits already earned by current and former employees covered by the pension system" and "is determined by an independent actuary[.]" CAS Ex. 6, at 48 (Governmental Accounting Standards Board (GASB) Statement No. 27 ¶ A-6) (UAL is "[t]he excess of the Actuarial Accrued Liability over the Actuarial Value of Assets"); *Cal. Dep't of Fin.*, DAB No. 1592, at 3 (1996) (UAL is "the pension plan's liability for benefits earned by participating employees . . . which exceeds the plan's assets"), *aff'd Brown v. HHS*, No. S-96-1712 FCD/GGH (E.D. Cal. June 16, 1999).[4] Allowable pension cost payments may include payments toward reducing a pension plan's UAL, as long as the payments are determined using the GAAP as the cost principles require.

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[2] The regulations also require that fringe benefits such as pension costs "be assigned to cost objectives by identifying specific benefits to specific individual employees or by allocating on the basis of entity-wide salaries and wages of the employees receiving the benefits." 2 C.F.R. § 200.431(d). CAS has not alleged that any of Fresno's claimed pension costs were improperly allocated or did not reflect the time that employees spent working on federal programs; the only issue is whether those costs otherwise qualified as allowable pension costs.

[3] "*GAAP* has the meaning specified in accounting standards issued by the Government Accounting Standards Board (GASB) and the Financial Accounting Standards Board (FASB)." 2 C.F.R. § 200.49, "Generally Accepted Accounting Principles (GAAP)." Fresno does not dispute that it uses accrual based accounting.

[4] The OMB policy at issue here refers to the UAL also as the unfunded pension liability or simply unfunded liability. Fresno Ex. 4, at 2-3.

II. *Longstanding cost principles bar federal participation in interest on borrowed capital generally, including governmental bonds.*

The cost principles provide that "[c]osts incurred for interest on borrowed capital, temporary use of endowment funds, or the use of the non-Federal entity's own funds, however represented, are unallowable." 2 C.F.R. § 200.449(a). It is undisputed that county bonds generally fall within this category of borrowed capital.

The cost principles governing the payment of employee compensation (including fringe benefits such as pensions) also provide that costs made unallowable by other provisions in the cost principles are not made allowable by virtue of also being costs of compensation for personal or personnel services. 2 C.F.R. § 200.430(d)(1) ("Costs which are unallowable under other sections of these principles must not be allowable under this section solely on the basis that they constitute personnel compensation."). Hence, the mere fact that county bonds are issued in relation to pension costs would not suffice to make interest on those bonds allowable.

III. *In 1994, OMB granted an exception to those cost principles for the cost of interest paid on bonds issued to pay off the UAL of a pension fund so long as such bonds do not increase claims for pension costs.*

In 1994, however, OMB issued a policy permitting states and local governments to claim federal reimbursement for the cost of interest they pay on "pension obligation bonds" (POBs) they issue to finance, or pay off, UALs of employee pension funds. OMB announced this policy in a January 31, 1994 letter from the Chief of OMB's Financial Standards and Reporting Branch to the HHS Office of Grants Management ("1994 OMB Letter"), in response to "inquiries about whether interest on bonded debt issued to fund an unfunded pension liability is an allowable cost under paragraph B.13.b. of OMB Circular A-87," which at that time was the location of the cost principles allowing contributions for employee pension funds. Fresno Ex. 4, at 2 (1994 OMB Letter). OMB stated in relevant part:

> Recently, during this period of lower interest rates, State and local governments have sought to reduce the interest costs on unfunded pension liabilities by selling bonds that bear interest at a rate lower than . . . the interest rate used by actuaries in calculating a government's annual pension contribution requirement. This contribution requirement includes, among other things, an amount to fund a portion of the unfunded liability as well as interest on the unfunded liability.

State and local governments argue that, since interest on unfunded liabilities has been allowed by Federal agencies under the foregoing provisions of Circular A-87 [then at Attachment B, ¶ B.13.b], interest on debt issued to fund the unfunded liability should be allowable if this financing mechanism reduces costs to the Federal Government. . . . the Department of Health and Human Services and other federal agencies interpret Circular A-87 to allow interest on unfunded pension liabilities and . . . State and local governments are being reimbursed for the Federal Government's share of these costs under various grant programs.[5]

In consideration of the foregoing, . . . interest on bonds issued to finance an unfunded pension liability is a surrogate for interest on the unfunded pension liability included in the annual actuarially-determined pension contribution and, therefore, is allowable under paragraph B.13.b of Circular A-87, if the following criteria are met:

1. Debt financing of the unfunded actuarial liability (UAL) is not more costly to the Federal Government than regular pension financing over the remaining unamortized life of the UAL, considering bond principal, interest, issuance costs, and any other relevant factors, as determined at the time of financing. If this criterion is not met, interest on debt issued to finance the UAL will be allowed only to the extent of the regular pension financing.

2. All net bond proceeds are made part of pension fund assets.

3. The funding for bond principal and interest is (a) included in each period's pension requirement (e.g., annual, biennial, or other); (b) computed in the same manner as the actuary's amortization of the UAL at the time of the conversion to debt financing, and (c) calculated using the weighted average interest rate on the bonds for the period in place of

[5] According to CAS, and not disputed by Fresno, a portion of a state or local government's payments to reduce a pension fund's UAL is considered "interest" under actuarial principles but is not interest on borrowed capital that the cost principles make unallowable and is thus an allowable pension cost, if determined in accordance with GAAP. CAS Br. at 7 ("[p]ayments for amortized UALs . . . include both payments towards the total UAL amount and an 'interest' component [that] is not interest paid to a lender of borrowed funds [but] is a component of the actuarial calculations necessary to amortize the UAL"), citing CAS Ex. 6, at 54 (GASB Statement No. 27 ¶ C-5); CAS Ex. 8, at 13-14 (GASB Implementation Guide ¶ 39); *see also* Rousseau Decl. at 3 ¶ 11 ("[t]he state or local government is obligated to amortize the UAL over a period established by law or agreement with the pension system, typically at an assigned interest rate established by the pension system, which assigned interest rate is usually the same as the actuary's assumed rate of investment return on pension fund assets (sometimes referred to as the 'Actuarial Rate'").

> the actuarially-assumed interest rate. The period's pension requirement consists of funding for bond principal and interest applicable to the period and the pension contribution requirement computed by the actuary for normal costs and any UAL not funded by the bonds. Alternatives to (b) and (c) may be used if they do not result in substantially different pension charges.
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> This interpretation only addresses the criteria that should be met for an entity to recover interest on bonds issued to fund unfunded pension liabilities.

Id. at 2-3.

IV. *In 2003, CAS's predecessor agency provided advice to another county allowing interest on POBs that refinance allowable pension POBs but only to extent the costs do not exceed those of the original POBs.*

In December 2002, another California county, Sacramento County, asked the State Controller and CAS's predecessor agency, the HHS Division of Cost Allocation (DCA), about the permissibility of doing what Fresno later did – issuing POBs to refinance POBs originally issued to pay off a pension plan UAL. DCA, in a February 13, 2003 letter to the California State Controller ("2003 DCA Letter"), stated that the costs of the refinanced POBs would be allowable if less than the costs of the POBs they replaced. In response to the question "Under what condition is the refinancing of pension obligation bonds (POBs) an allowable cost?" the DCA letter advised that–

> While the 1994 policy statement [i.e., the 1994 OMB Letter] did not discuss refinancing of the POBs, it is our opinion that if the aggregate cost of the refinanced POBs is less costly than the POBs that it replaces, the refinanced POBs would be acceptable under the 1994 policy statement. Conversely, if the aggregate cost of refinancing the POBs is more costly than the POBs that it replaces, the excess cost would not be allowable. This interpretation is consistent with the 1994 policy that made the original POB allowable if it accomplishes the same purpose at a lower cost.

Fresno Ex. 5, at 3. The California State Controller's office sent the 2003 DCA Letter to California county auditor-controllers under memo of April 9, 2003, advising that–

> If your county is considering or in the process of refinancing POBs, please review this letter to insure that they are adhering to this policy. Basically, if the aggregate cost of the refinanced POBs is less costly that the POBs they replace, the refinanced POBs would be an allowable and allocable cost for

> federal reimbursement. Conversely, if the aggregate cost of refinancing the POBs is more costly that the POBs they replace, the excess cost would not be allowable and claimable. This interpretation is consistent with the 1994 policy statement issued by the Office of management and Budgets (OMB) which determined that the interest on bonds issued to fund unfunded pension liabilities was an allowable cost under OMB Circular A-87.

Fresno Ex. 5, at 1.

Factual Background

I. *Fresno issued POBs in 1998 to pay off the UAL of its employee pension fund, and issued POBs in 2003 to refinance the 1998 POBs.*

Fresno issued POBs in 1998 to fund (that is, pay off) the UAL of its employee pension fund. CAS determined those POBs were consistent with the 1994 OMB Letter and hence interest on those bonds was allowable. CAS explains that "[t]he total cost of the POBs issued [in 1998] was $260,559,687, which represented a savings of $39,585,708 over the then-existing UAL of $300,145,395." CAS Brief (Br.) at 10. Fresno does not dispute those facts.[6] *See* Declaration of Jean M. Rousseau, CPA, Fresno County Administrative Officer at 3 ¶ 13. CAS states that "[s]ince the 1998 POBs represented a net cost savings, the interest and other associated costs were allowable under the terms of the 1994 OMB guidance." CAS Br. at 10. The "1998 POBs" had a term of 10 years. Rousseau Decl. at 3 ¶ 13.

In 2002, Fresno issued further POBs to refinance a portion of the 1998 POBs at a total cost of $211,944,361 and claimed the costs of its interest payments on the 2002 POBs as pension costs, as it had done with the 1998 POBs. CAS Br. at 10; Rousseau Decl. at 4 ¶ 14. Fresno's interest payments on the 2002 POBs grew each year until, beginning with FY2015, they exceeded Fresno's costs for the 1998 POBs that CAS had allowed, leading to the disallowance. CAS states that "[t]hese [2002] refunding POBs decreased short-term costs for the County by lowering the annual debt service for seven years" but that "[t]he 2002 POBs, however, extended the County's debt service schedule by an additional ten years, with the result that over the life of the refunding POBs the County

[6] As stated earlier, none of the dollar figures or other facts CAS cites are in dispute, and the case presents solely legal issues.

would incur an additional $77,648,502 in costs over the costs of the 1998 POBs." CAS Br. at 10. Additionally, "[t]he 2002 POBs were also more costly than the original UAL that had been financed by the 1998 POBs; total costs over the lifetime of the 2002 refunding POBs are $38,062,794 greater than the costs associated with the original UAL." *Id*. at 10-11.

II. *Representatives of CAS's predecessor informed Fresno as early as October 2003 that Fresno's refinancing bonds did not meet requirements for federal allowability.*

In October 2003, DCA representatives met with the Fresno County Auditor/Controller and other county representatives "to discuss the acceptability of Fresno County's (the County) 2002 POB," according to an October 23, 2003 letter from the then-DCA Director to the Fresno Auditor/Controller. Fresno Ex. 7. That letter stated:

> OMB Circular A-87 provides that interest on borrowed capital, however represented, is not allowable. One exception was made by OMB in its 1994 policy interpretation on the premise that interest on the POB is a surrogate for the interest on the UAAL and is acceptable if it results in lower cost. Once a POB is issued to replace the UAAL, the cost of the POB becomes the monetary benchmark. Thus, if a POB is refinanced and results in greater cost, that additional cost is considered unallowable interest (i.e. not surrogate Interest as in the original POB because there is no longer a UAAL). Because of this, each POB must be viewed as a separate transaction and must be kept distinct to assure compliance with the lower cost requirement of the 1994 policy. This was the basis of the DCA's clarification letter of February 13, 2003.
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> The County had refinanced the 1998 POB with the 2002 POB, however, for a longer term and at a greater total cost. The County had indicated that if it had known the additional cost would not be allowed, the County would not have gone through with the 2002 refinancing. We indicated that we could not accept this as a basis to allow the excess cost.

Fresno Ex. 7; *see also* Fresno Ex. 8 (2010 email exchange between DCA and Fresno explaining that no formal final agency decision had yet implemented the 2003 advice because Fresno had not at that point yet sought to include the excess refinancing costs in its county cost allocation plans).

III. *On February 8, 2017, CAS disallowed the excess interest cost claims attributable to the 2002 POBs for FY 2015 and 2016.*

The CAS disallowance letter determined that $6,271,287 of the federal share of interest on the 2002 POBs was unallowable. Disallowance Letter at 1. The disallowance letter explained that the interest costs could not be allowable under the 1994 OMB Letter because it "does not address the allowability of interest on bonds issued to refinance POBs." *Id.* Further, the disallowance letter recognized the 2003 DCA Letter's "opinion . . . that . . . refinanced POBs would be acceptable under the OMB policy interpretation" if "the aggregate cost of the refinanced POBs is less costly than the POBs that it replaces" but that "if the aggregate cost of refinancing the POBs is more costly than the POBs that it replaces, the excess costs would not be allowable." *Id.* at 2. The disallowance letter concludes that:

> The County's 2002 Refunding POBs are more costly than the portion of the 1998 POBs they replaced; therefore, the additional $77,648,502 of debt service cost is unallowable. The total 1998 POB and 2002 Refunding POB costs can only be reimbursed up to $260,559,687.

Id. CAS determined that there were thus "unallowable 2002 POB costs for FY 2015 and FY 2016, $13,780,774 and $15,963,492, respectively" and that the federal share of those amounts, plus imputed interest, was $6,271,287. *Id.* CAS did allow costs of the 2002 POBs up to the allowable amounts of the 1998 POBs.

Analysis

I. *Summary*

We sustain the disallowance because Fresno's payments on the 2002 POBs do not meet the terms of the 1994 OMB Letter, which provides a limited, narrow exception to cost principles that would otherwise bar federal reimbursement of interest paid on POBs. As such, CAS reasonably applied the 1994 OMB Letter to require that Fresno comply with its plain language. The plain language allows interest only on POBs issued to pay off the UAL; does not reference "replacement" POBs issued to refinance or refund the original, allowable POBs that paid off the UAL; and also requires that POBs not increase pension costs charged to federal funds.

DCA's subsequent determination in the 2003 DCA Letter to also allow claims for interest on certain "replacement" POBs *expanded* the ability to claim interest on bonds that the 1994 OMB Letter granted, and did not limit any previous rights to claim such interest, as Fresno contends. The expansion in the 2003 DCA Letter, however, plainly limited such interest claims to situations where the refinancing would further reduce the federal government's share of pension costs.

Fresno argues that its claims for costs of the 2002 POBs are allowable under the 1994 OMB Letter and that the 2003 DCA Letter should be disregarded as an invalid attempt at retroactively restricting the allowability of such costs. Fresno premised its contentions on the erroneous belief that its POB costs would be allowable pension costs under the cost principles absent restrictions imposed by the 2003 DCA Letter.

Fresno presents three numbered arguments in support of this position. First, Fresno argues that the disallowance "is void" because it "relies on a substantive standard of law adopted by HHS without notice-and-comment rulemaking" (that is, the 2003 DCA Letter limiting federal reimbursement for replacement POBs to the allowable costs of the POBs they replace). Fresno Br. at 9-17 (capitalization omitted). Next, Fresno argues that CAS engaged in "impermissible retroactive conduct" in taking the disallowance because the 2003 DCA Letter was issued after Fresno issued the 2002 POBs. *Id.* at 18-20; *see id.* at 4 ("[t]he County did not receive notice of [OMB's February 13, 2003] letter until April 2003"). Finally, Fresno argues, should the Board not reverse the entire disallowance, it should at least allow the costs of the 2002 POBs that did not exceed Fresno's earlier, allowable UAL costs (those paid off by the 1998 POBs). *Id.* at 21-22 ("[i]f the Board were to find that HHS could cap the County's allowable pension costs (which the County does not concede)," then "[t]he possible cap on the County's allowable pension costs stems from the 1994 OMB interpretation" – the 1994 OMB Letter – and "the UAL figure is still the appropriate benchmark"); *see also* Fresno Reply at 1-2, 5-10 (reiterating these "three key points" from Fresno's brief).

As we discuss in more detail below, these arguments provide no basis to reverse or reduce the disallowance. Fresno does not dispute CAS's position that Fresno's payments on the 2002 POBs were payments of interest on borrowed capital. As such, they would be unallowable under the cost principles except to the extent they comply with the 1994 OMB Letter. The 1994 OMB Letter granted only a narrow, limited exception to that bar on interest on borrowed capital and the claims at issue do not fall within the terms of that exception. Moreover, Fresno's attacks on the 2003 DCA Letter are essentially inapposite because the 2003 DCA Letter is not the reason the claims are unallowable but simply provides a further limited exception. CAS already applied that exception to permit Fresno to claim interest on the 2002 POBs to the extent the costs do not exceed those of the 1998 POBs. Hence, Fresno provides no basis to further reduce (much less reverse) the disallowance.

II. *Fresno's claims for POB interest are unallowable under applicable cost principles unless they meet the terms of the exception provided by the 1994 OMB Letter.*

Fresno argues that "language from the 1995 version of ***OMB Circular A-87***" making pension costs allowable as compensation for personnel services "lacks any restriction related to POBs" and "makes no mention of the 1994 OMB policy interpretation" and that "***the regulation*** addressing the allowability of pension plan costs," currently at 2 C.F.R. § 200.431(g), similarly "makes no reference to bond or debt costs related to a local government's pension costs[.]" Fresno Br. at 5, 7 (emphasis added). Fresno further argues that "the ***cost principles*** applicable to fringe benefits . . . do[] not make any distinctions based on the use of debt to fund pension plan costs" and that "[n]othing in the existing statute or ***regulations*** created any cap on reimbursement simply because the County issued the Refunding POBs; as pension costs they should have been treated as such without any discriminatory limits."[7] *Id.* at 5, 11 (emphasis added); *see also id.* at 11 ("there was no pre-existing ***statutory or regulatory*** duty involving Refunding POBs that [DCA] needed to clarify through the February 2003 letter"). These arguments clearly treat all of the costs of Fresno's 2002 POBs as allowable pension costs under the cost principles. Fresno's demand that the Board reverse the entire disallowance similarly relies on Fresno's assertion that the POB costs are all allowable pension costs, as it seeks reimbursement greater than the limits the 1994 OMB Letter set for allowable POBs, the limits Fresno says the Board should apply only "[i]n the alternative."[8] *Id.* at 1-2, 23.

Fresno's arguments fail because they ignore the cost principles' longstanding and well-established prohibition on federal reimbursement for the cost of interest paid on borrowed capital, currently at 2 C.F.R. § 200.449(a). That prohibition was in place (although its location differed) from well before 1994. Fresno's brief simply ignores that prohibition. However, CAS makes clear in its response brief its position that Fresno's payments on the 2002 POBs constituted interest on borrowed capital for which federal reimbursement was plainly barred unless such payments meet the conditions in the 1994 OMB letter. We thus agree with CAS that "[t]he disputed costs in this matter are interest on the capital [Fresno] borrowed in issuing the [2002] POBs, and they do not fall within any exception to the interest prohibition set forth in Circular A-87." CAS Br. at 12. Hence, as CAS

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[7] Fresno does not identify the "existing statute" it references here.

[8] As mentioned, CAS has not disallowed all of the costs Fresno claimed for its 2002 POBs, and has allowed those amounts that do not exceed the allowable amounts Fresno could have claimed for the costs of the 1998 POBs, which were less than the costs for Fresno's earlier payments for the pension plan UAL.

states, "[b]ased purely on the terms of Circular A-87, the disputed costs here would be disallowed as 'costs incurred for interest on borrowed capital.'" *Id*. at 15. CAS also explains that the 1994 OMB Letter permitting claims for interest paid on POBs issued to pay off a pension plan UAL is "a narrow" and "limited exception to the general unallowability of costs related to interest on borrowed capital" that OMB granted under its "authority to recognize such limited exceptions to the rules in Circular A-87 in appropriate circumstances."[9] *Id*. at 13, 19, 20.

In its reply brief, Fresno does not dispute any of CAS's factual statements or its characterization of the 1994 OMB Letter. Nor does Fresno make any clear objection to the discussion of the overarching prohibition on interest on borrowed capital in CAS's response brief on the grounds that this history was not set out in the disallowance letter, which merely explained why the exceptions did not apply. In any case, even if we concluded that the disallowance letter did not provide adequate notice of the relevance of the longstanding prohibition, we would permit CAS to raise these arguments in its response brief because the Board has long held that the respondent federal agency "may raise new grounds for a disallowance after a disallowance letter is issued as long as the appellant is afforded an opportunity to respond." *Tex. Health & Human Servs. Comm.*, DAB No. 2187, at 5 n.3 (2008), and *N.Y. State Dep't of Soc. Servs.*, DAB No. 1666, at 20 (1998); *see also, e.g.*, *Pa. Dep't of Pub. Welfare*, DAB No. 1278, at 27 (1991) ("The Board has previously held that a party may raise new arguments before the Board as long as the other party has an adequate opportunity to respond to those arguments"), *aff'd*, *Pennsylvania v. HHS*, No. 92-337 (W.D. Pa. July 15, 1993).[10]

Fresno does not deny in its reply brief that the costs of the 2002 POBs consisted of interest paid on borrowed capital that is unallowable under the cost principles, except to the extent the payments complied with the terms of the 1994 OMB Letter, as CAS argues. Fresno now concedes that the 1994 OMB letter is "an exception to the general rule in OMB Circular A-87" barring interest paid on borrowed capital and asserts that "[t]here is no suggestion that the County was unaware of the provisions of the Circular." Fresno Reply at 3. Fresno also denies that it "seeks a 'new and unbounded exception [to]

[9] CAS cites 2 C.F.R. § 200.102, which permits OMB to "allow exceptions for classes of Federal awards or non-Federal entities subject to the requirements of this part when exceptions are not prohibited by statute" and "in unusual circumstances." CAS Br. at 13.

[10] We also note that, as mentioned earlier, CAS's predecessor, informed Fresno in 2003 that POB costs are "interest on borrowed capital" that would ordinarily be unallowable absent the 1994 OMB Letter, which was "an exception" to OMB Circular A-87's proviso "that interest on borrowed capital, however represented, is not allowable." Fresno Ex. 7 (Oct. 23, 2003 letter from DCA Director to Fresno Auditor/Controller). Thus, Fresno in fact had notice at the time it appealed the disallowance that POB interest is, absent the exception set forth in the1994 OMB Letter, unallowable interest on borrowed capital.

a long-time cost allocation rule'" against reimbursing interest paid on borrowed capital, as CAS argues, and claims it "has never argued that it is entitled to unlimited reimbursement" for the costs of the 2002 POBs. *Id.* at 2. That denial, however, is belied by Fresno's continuing to seek reimbursement for costs in excess of the cap the 1994 OMB Letter imposes for allowable POBs. *See id.* at 10 (if Board does not reverse entire disallowance then "[i]n the alternative, the County's pension plan costs can only be disallowed by HHS to the extent that those costs exceed the determined unfunded actuarial liability for its pension plan costs"). As stated earlier, Fresno's arguments clearly treat all the costs of Fresno's 2002 POBs as allowable pension costs under the cost principles.

To be clear, the disallowed costs of Fresno's 2002 POBs would ordinarily be unallowable under the cost principles but for the limited, narrow exception OMB granted in the 1994 OMB Letter. As that OMB policy issuance created this exception and did not simply confirm a previously-existing right to claim costs of bond interest, CAS could reasonably apply it strictly, according to its plain language. As we discuss next, Fresno's claims for interest on the 2002 POBs did not comply with the plain language of 1994 OMB Letter, and was contrary to the letter's stated purpose of reducing – or at least not increasing – pension costs charged to federal awards.

III. *The disallowed 2002 POB costs do not meet the terms of the 1994 OMB Letter.*

We consider next whether the 2002 POBs met the terms of the 1994 OMB Letter, given that it was, at the time the 2002 POBs were issued, the sole basis for allowing, as pension costs, the costs of interest paid on bonds. We conclude that Fresno could not reasonably base its issuance of the 2002 POBs on the 1994 OMB Letter, because the issuance meets neither the plain terms of the letter nor its stated intent of not increasing pension costs charged to federal awards.

Fresno argues that the 2002 POBs comply with the 1994 OMB Letter because the Letter "plainly stated that 'interest on bonds issued to finance an unfunded pension liability is a surrogate for interest [on] the unfunded pension liability included in the annual actuarially-determined pension contribution, and[,] therefore[,] is allowable[.]'" Fresno Reply at 4, quoting 1994 OMB Letter, Fresno Ex. 4, at 2.

That language shows why the 1994 OMB Letter does not support Fresno's claims for the 2002 POBs. The 1994 OMB Letter by its terms requires that allowable POBs must be issued "*to finance an unfunded pension liability*," which did not include the 2002 POBs, because when Fresno issued the 2002 POBs, Fresno's employee pension plan *had no unfunded pension liability* or UAL. Fresno does not dispute that "[a]t the time that the

County financed the 2002 POBs, the original UAL financed by the 1998 POBs no longer existed" because "[i]t had been paid off by the proceeds of the 1998 POBs," as CAS states. CAS Br. at 17; *see also id*. at 11 ("the 1998 POBs eliminated the UAL that had existed in 1998"); Rousseau Decl. at 3 ¶ 13 (1998 POBs "were intended to allow the County to pay its mandatory obligation to the pension fund established for County employees"). The 1994 OMB Letter reiterates this basic requirement that allowable POBs be issued to finance – i.e., pay off, eliminate – a pension plan's unfunded liability or UAL. It requires that "[d]ebt *financing of the unfunded actuarial liability (UAL)* is not more costly to the Federal Government than regular pension financing," and cautions that it "only addresses the criteria that should be met for an entity to recover interest on bonds issued *to fund unfunded pension liabilities*." By its terms, the 1994 OMB Letter thus provided an exception to the cost principles' ban on claiming interest on borrowed capital, for POBs issued to eliminate the unfunded liabilities of employee pension funds, and did not extend that exception to bonds later issued later to refinance or replace the original POBs that eliminated the unfunded liability.

Additionally, in the 1994 Letter itself, OMB treated POB interest as "a surrogate" for interest on the unfunded pension liability implies that the unfunded liability – and its attendant actuarial interest – no longer exists after it has been financed or paid off through the issuance of the POBs. Had there still been a UAL after POB financing, there would be no need for a "surrogate" to take the place of the interest *previously* owed on the former UAL.[11] Therefore, as the proceeds of the 2002 POBs could not have financed or paid off a UAL that no longer existed, they did not satisfy the plain language requirement of the 1994 OMB Letter's exception to the cost principles. *See* CAS Br. at 9 ("[t]he 1994 OMB [Letter] made no reference to POBs issued in order to refinance previously-issued POBs" and under its terms, "[t]he original UAL would thus be eliminated, and rather than making regular payments for the amortized UAL, the employer [i.e., the state or local government] would instead make regularly scheduled bond payments").

Finally, the stated intent of the 1994 OMB Letter was to reduce, or at least not increase, the amount of expenditures charged to federal funds as pension costs. The letter states that OMB's determination to permit states and local governments to claim bond interest costs was prompted by their desire "to reduce the interest costs on unfunded pension liabilities" and that bond interest should be allowable "if this financing mechanism reduces costs to the Federal Government." Fresno Ex. 4, at 2. The OMB letter accordingly required that POBs be "not more costly to the Federal Government than

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[11] *See* Merriam-Webster.com, https://www.merriam-webster.com/dictionary/surrogate ("substitute"); Dictionary.com ("surrogate" means "a substitute").

regular pension financing." *Id*. at 3. Fresno's issuance of the 2002 POBs was inconsistent with this stated purpose because it ultimately increased the costs Fresno claimed beyond the costs of the original 1998 POBs – and beyond the higher level of the UAL costs that the 1998 POBs had been issued to reduce. In this regard, Fresno does not challenge CAS's determination that "[t]he 2002 POBs were also more costly than the original UAL that had been financed by the 1998 POBs; total costs over the lifetime of the 2002 refunding POBs are $38,062,794 greater than the costs associated with the original UAL." CAS Br. at 10-11.

Fresno argues that the 2002 POBs did comply with the 1994 OMB Letter because OMB "stated plainly that interest on POBs is an allowable cost and did not leave any open issues to be determined later." Fresno Br. at 12; *see also* Fresno Reply at 3 ("plain language of the 1994 OMB [Letter] made interest costs on 'bonded debt' issued to fund an unfunded pension liability–here, the 2002 POBs–allowable because they are a 'surrogate' for the County's UAL"). Fresno's description of the 1994 OMB Letter is incomplete. The 1994 OMB Letter contained specific conditions, including that it applied only to "bonds issued to fund unfunded pension liabilities." The 2002 POBs could not meet this requirement because, as explained, they were instead issued to refinance the earlier, 1998 POBs that *had* funded the previous UAL of Fresno's pension plan, rendering it impossible for subsequent bonds to fund the UAL.

Fresno also argues that "[t]here is no authority" for CAS's position that the 1994 OMB Letter supports the disallowance because the letter "made no reference to POBs issued in order to refinance previously-issued POBs" (CAS Br. at 9), which Fresno calls "a litigation position that is not entitled to any weight." Fresno Reply at 4. We disagree. Contrary to Fresno's contention, the authority arises not from any CAS litigation position but from the plain language of the 1994 OMB Letter allowing the payment of interest only on "bonds issued to finance an unfunded pension liability." The 1994 Letter on its face does not include bonds that, like the 2002 POBs, refinance the original POBs, not the unfunded liability that the original POBs eliminated. Fresno does not deny CAS's point that once POBs permitted by the 1994 OMB Letter are issued the "original UAL" would "be eliminated, and rather than making regular payments for the amortized UAL," the state or local government "would instead make regularly scheduled bond payments." CAS Br. at 9. CAS's view of the 1994 OMB Letter on appeal is, moreover, consistent with the 2003 DCA Letter, which noted that "the 1994 policy statement did not discuss refinancing of the POBs," so it is clear that the plain language reading is not one which CAS developed only in this litigation.

Fresno argues further that the requirement that POBs not increase costs did not disqualify the 2002 POBs because the 1994 OMB Letter "did give express guidance as to what happens when the POB costs do not decrease costs when compared to the pre-existing UAL: in this situation, 'interest on debt issued to finance the UAL will be allowed only to the extent of [the] regular pension financing.'" Fresno Reply at 3, quoting Fresno Ex. 4, at 3. This language does not help Fresno, because, as we explained, when Fresno issued the 2002 POBs there was no more "regular pension financing" of its UAL, due to the 1998 POBs. The language Fresno quotes also serves to again reinforce that the 1994 OMB Letter addressed (and thus permitted, as a limited exception to the cost principles) only the use of POBs that replace "regular pension financing" of unfunded liabilities, and not the subsequent use of POBs to replace earlier POBs. The language permitting costs up to the level of prior payments for actuarial UAL interest thus applied only to the qualifying POBs that the1994 OMB Letter authorized. Nothing in the 1994 OMB Letter reasonably supports the issuance of bonds that *increase* costs beyond the level that the federal government had been paying at the time the bonds were issued, which, in this case, was the costs of Fresno's 1998 POBs. It is undisputed that the 2002 POBs increased Fresno's claimed costs beyond even what had served as the cap of the allowable costs of the original 1998 POBs.

For these reasons, there is no basis to reduce the disallowance to permit Fresno to claim costs in excess of what it had claimed for the allowable 1998 POBs. Fresno's argument that "the UAL figure is still the appropriate benchmark" because "the POBs function as a surrogate for the UAL," Fresno Br. at 22, fails to recognize that the UAL no longer existed when Fresno claimed the 2002 POBs. It also misstates the 1994 OMB Letter, which states that it is the "*interest* on bonds issued to finance an unfunded pension liability" that "is a surrogate for *interest* on the unfunded pension liability included in the annual actuarially-determined pension contribution." Fresno Ex. 4, at 2. As there was no longer any "interest" component of Fresno's "annual actuarially-determined pension contribution," there was no longer any "UAL figure" to be the upper limit for allowable POBs. The POB interest would not be a "surrogate," or substitute, for the prior UAL interest if the latter figure continues to be the "benchmark" or upper limit of allowable POB interest. In any event, Fresno's argument would result in an increase in pension costs, contrary to the purpose and plain language of the 1994 OMB Letter authorizing the payment of POB interest.

In sum, the 1994 OMB Letter authorized the payment of interest on a specific type of bond – issued to pay off and eliminate pension plan unfunded liabilities – with the stated purpose of lowering, or at least not increasing, claims for pension costs. OMB in doing so granted an exception to cost principles that, it is not disputed, would otherwise bar the payment of interest on such bonds. Fresno instead claimed the cost of bonds that did not pay off an unfunded pension plan liability and that increased Fresno's claims for pension costs. No reasonable reading of the 1994 OMB Letter supports Fresno's actions in issuing the 2002 POBs.

IV. *Fresno's arguments regarding the 2003 DCA Letter provide no basis to reverse or lower the disallowance.*

We have concluded that the 1994 OMB Letter fully supports the disallowance; therefore, we need not address, for the purpose of ruling in this case, Fresno's argument that CAS improperly applied the 2003 DCA Letter retroactively, or its principal argument, that the 2003 DCA Letter is a substantive rule improperly issued without required notice-and-comment rulemaking.

The latter argument, we note, reflects Fresno's position, rejected above, that its interest payments for the 2002 POB were allowable pension costs under the cost principles. *See, e.g.*, Fresno Br. at 11 (arguing in support of Fresno's rulemaking argument that "[n]othing in the existing statute or regulations created any cap on reimbursement simply because the County issued the Refunding POBs"). This argument fails to acknowledge that the 1994 OMB Letter was a narrow, limited exception to those cost principles that, as such, did not provide blanket authority to claim interest costs of all POBs. As such, the 2003 DCA Letter expanded the ability to claim POB costs granted in the 1994 OMB Letter by permitting types of POBs not addressed in that document and continuing its requirement that bond issuances not increase pension costs claimed for federal funding. Thus, the 2003 DCA Letter did not "create a new substantive rule" or "change[] the law defining allowable costs associated with pension plan costs" or "establish a standard that goes beyond the statute, HHS's cost allocation regulations, and even beyond the 1994 OMB [Letter,]" as Fresno maintains in arguing that it was an improperly issued substantive rule.[12] Fresno Br. at 9, 11, 14.

Fresno also wrongly cites DCA's "February 2003 letter as the sole basis for the disallowance." *Id.* at 13. This is not correct; the disallowance letter also states that the 1994 OMB Letter "does not address the allowability of interest on bonds issued to refinance POBs." Disallowance Letter at 1. As we discussed above, given the facts that

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[12] Fresno did not identify the statute it believes the 2003 DCA Letter went beyond.

the cost of bond interest is generally unallowable under the cost principles and that the 1994 OMB Letter was the sole basis for permitting POBs, the absence of any language in that policy authorizing "replacement" POBs is not reasonably read as permitting the use of POBs other than those it specifically authorized and which increase costs charged to federal funds.

Far from being the basis of the disallowance, the 2003 DCA letter is the only source of authority for claiming interest on replacement POBs. In recognition of that authority, DCA has already allowed Fresno's claims to the extent that they met the terms of the exception to the cost principles granted by the 2003 DCA letter.

Conclusion

For the reasons stated above, we sustain the disallowance.

/s/

Leslie A. Sussan

/s/

Susan S. Yim

/s/

Christopher S. Randolph
Presiding Board Member