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ONE HUNDRED ELEVENTH CONGRESS
Congress of the United States
House of Representatives
COMMITTEE ON ENERGY AND COMMERCE
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MEMORANDUM

April 14, 2010

To: Chairmen Henry A. Waxman and Bart Stupak

Fr: Committee on Energy and Commerce Majority Staff

Re: Investigation of the Impact of the Health Care Reform Law on Large Employers

On March 23, 2010, President Obama signed into law the Patient Protection and Affordable Care Act (Pub. L. 111-148). Starting on March 24, 2010, several large employers filed statements with the Securities and Exchange Commission (SEC) that alerted their investors to a noncash charge against the companies' first quarter earnings due to a provision of the Act that ended the deductibility of a government subsidy for retiree prescription drug coverage. These SEC filings raised questions about the impact of the Act on large employers.

On March 26, 2010, the Committee sent letters to four companies – AT&T, Verizon, Caterpillar, and Deere & Co. – inquiring about the projected impact of the health care reform law on each company. Since that time, the majority Committee staff has reviewed records produced by each company. The staff also has met or spoken with representatives of the companies, as well as with a number of industry trade associations and interested parties, including the Business Roundtable, the American Benefits Council, the HR Policy Association, the Financial Accounting Standards Board (FASB), the American Academy of Actuaries, several health economists, officials from the Centers for Medicare and Medicaid Services (CMS), and organizations representing retired workers and unionized workers.

This preliminary investigation indicates:

(1) The companies acted properly and in accordance with accounting standards in submitting filings to the SEC in March and April;

(2) Although the SEC filings were proper and in accordance with SEC rules and Generally Accepted Accounting Principles, the filings report the present value of an adverse financial impact that will be incurred over decades. The actual impact on annual

company cash flows will be only a fraction of the amount of the noncash charges reported to the SEC.

(3) The provision that is the subject of the SEC filings, which ends the deductibility of the government subsidy for retiree drug coverage but does not end the subsidy itself, is only one of multiple provisions in the new law that affect large employers. Several companies and their representatives said that if the new law is implemented correctly, the overall impact of the law on large employers could be beneficial. They also said that they could not make specific assessments that quantify these potential benefits until the details of several programs are developed.

I. The Companies Acted Properly in Filing with the SEC

In 2003, the Medicare Prescription Drug Improvement and Modernization Act included a government subsidy to help businesses provide qualified prescription drug coverage to their retirees. Under the Retiree Drug Subsidy (RDS) program, companies were entitled to federal payments equal to 28% of the allowable gross retiree prescription drug costs. The 28% subsidy was not taxed and, in addition, the companies were allowed to deduct the amount of the subsidy from their income as though it was the companies' own spending rather than taxpayer funds. This policy, which allowed the companies to deduct an expense they did not incur, was highly unusual.

The 28% subsidy has been a lucrative subsidy. The RDS program has paid $14.6 billion directly to businesses since 2006 to subsidize employer coverage of retiree drug benefits. For some companies, this subsidy has been worth many millions of dollars. Since 2006, AT&T has received $451 million, Verizon $332 million, Caterpillar $74 million, and Deere & Co. $56 million in federal subsidies under the program.[1] These are merely the subsidy amounts and do not take into account the value of the tax deduction provided in the 2003 law.

The new health reform law retains the 28% subsidy enacted in 2003, but it changes the policy regarding the deductibility of the subsidy. Under the new law, companies will no longer be able to deduct the value of the subsidy as a business expense effective in 2013.

This change in the tax treatment of the subsidy prompted several companies to file reports with the SEC immediately after passage of the law. In its filing, AT&T reported a one-time $1 billion charge against earnings.[2] Verizon reported a $970 million charge.[3] And Caterpillar and Deere & Co. reported a $100 million and $150 million charge respectively.[4]

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[1] Briefing by Centers for Medicare and Medicaid Services, to House Energy and Commerce Committee Majority Staff (Apr. 8, 2010). This information was provided to the Committee by CMS in response to the Committee's request. Payment totals represent the actual subsidy amounts paid under current law through April 2, 2010. Subsidy amounts are based on cost and other information provided to CMS by the companies. Data regarding AT&T includes SBC Communications and BellSouth which have the same Authorized Representative as AT&T.

[2] AT&T, Form 8-K (Mar. 23, 2010).

These one-time charges were required by applicable accounting rules. Under Generally Accepted Accounting Principles as determined by the FASB, companies are required to take a noncash charge against current earnings to recognize a tax liability for the estimated future tax effects of a new law. This noncash charge must reflect the entire present value of the loss of future tax deductions on the subsidy, and it must be taken in the period in which the law is enacted. Moreover, if the level of the impact is deemed "material" under SEC regulations, the company must file the report promptly following the triggering event, in this case the enactment of the law.

Independent experts, including representatives of the FASB and the American Academy of Actuaries, told the Committee that the filings made by AT&T, Verizon, Caterpillar, and Deere & Co. were in compliance with these accounting standards.

II. The SEC Filings Do Not Reflect Annual Cash Flow Impacts

While the SEC filings were proper under the accounting standards, they can also be misconstrued. Although the reported noncash charges are quite large, the impact is spread over a long period of time. The tax change also does not take effect until 2013. The actual impact on the companies' annual cash flows will be much smaller than the amount reported in the filings.

Companies that made the filings calculated the present day value of taxes that will be paid over 30 or more years. In fact, AT&T told the Committee staff that its figure was calculated to "infinity."[5] Although the other companies did not provide an exact time period, according to standard accounting practices they likely calculated the charge over the estimated lifetimes of current and future retirees expected to receive drug benefits.

The result is that the annualized impact on each company will be less than the amount charged against earnings. AT&T reported a one-time charge of $1 billion to the SEC, but documents provided to the Committee estimate that the tax change will reduce the value of the subsidy by just $44 million annually.[6] Caterpillar reported a one-time charge of $100 million, but the documents it provided to the Committee estimate that the annual cost will be just $8 to $10 million.[7] While Verizon reported a one-time charge of $970 million, it predicted an annual

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[3] Verizon Communications, Inc., Form 8-K (Apr. 1, 2010).

[4] Caterpillar, Inc., Form 8-K, (Mar. 23, 2010); Deere & Company, Form 8-K (Mar. 23, 2010).

[5] Briefing by Bruce Byrd, Vice President and General Counsel, Washington AT&T Services, Inc., to House Energy and Commerce Committee Majority Staff (Apr. 9, 2010).

[6] Presentation to the AT&T Board of Directors (Mar. 25, 2010) (AT&T-EC-00008).

[7] Financial Impact of Senate Healthcare Reform (Mar. 29, 2010) (CAT_WAXMAN_000047).

decrease in net income of $100 million, less than 1% of the $10.4 billion in net income the company reported for 2009.[8]

According to independent analysts such as Credit Suisse and UBS, the actual impact of the new provision on the companies is likely to be minimal. In a series of investor reports and advisories issued after enactment of the law, they have discounted the impact of the tax law change on companies.[9]

III. The Overall Impacts of the Health Reform Law on Large Employers Could Be Beneficial

The staff discussions and the documents received by the Committee indicate that that the change in the retiree drug provision is only one of many provisions in the new health reform law that affect large employers. A key question is whether on balance the new law will benefit or harm these companies.

The staff asked the companies and their trade associations this question. In a meeting on April 8, 2010, John Castellani, the President of the Business Roundtable, said, “If implemented right, the law has the potential to make employers and employees better off because it could bend the cost curve.” Mr. Castellani stressed that this is the central goal for businesses under health care reform because the cost of health care currently is the biggest uncontrollable cost for employers.[10]

A similar view was expressed by individual companies. AT&T is the largest employer of full-time unionized employees in the country. In a letter to the Committee, Wayne Watts, Senior Executive Vice President and General Counsel stated: “Should the structural reforms intended to reduce the costs of delivering healthcare under the PPACA ultimately prove successful over time, self-insured companies like AT&T would likely benefit from such reduced costs.”[11]

Verizon told the staff: “We have supported the need for health care reform as costs continue to increase for our company, the beneficiaries who get their insurance through Verizon and for the country. It is critically important to bend the cost curve to get health care spending under control. We are hopeful that in the longer term, structural changes in the health care

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[8] Senior Vice President and Controller Robert J. Barish’s March 26, 2010 Message to the Verizon Board (VZ-HEC 00002); Verizon Communications, Inc., Form 10-K (Feb. 26, 2010).

[9] *See* Credit Suisse, *Raising Taxes, the Medicare Drug Subsidy: Don’t Overreact to the Hit to Earnings* (Mar. 24, 2010); UBS, *Change in Medicare Part D Subsidy – Impacts on First Quarter 2010 Earnings* (Mar. 25, 2010).

[10] Briefing by John Castellani, President, Business Roundtable, to House Energy and Commerce Committee Majority Staff (Apr. 8, 2010).

[11] Letter from Wayne Watts, Senior Executive Vice President and General Counsel, AT&T, to Rep. Henry Waxman, Chairman, House Energy and Commerce Committee, and Rep. Bart Stupak, Chairman, Subcommittee on Oversight and Investigations, House Energy and Commerce Committee (Apr. 12, 2010).

marketplace will help meet this goal. The correct implementation of the reforms associated with the legislation is important to achieving long term savings for the country and for Verizon."[12]

Caterpillar told the Committee staff that they "wanted to see reform" in the health care area and were pleased with the greater emphasis on wellness and preventative care and on rewarding and recognizing quality of care, but indicated that the company does not know at this time how the reforms will play out long term.[13] Caterpillar explained to Committee staff that it opposed the change in the deductibility of the government subsidy for retiree drug coverage because of the cost to the company.

Among the areas identified by Mr. Castellani, the companies, and other business associations as offering potential benefits are: (1) the individual obligation to maintain coverage and expanded access to coverage, which may result in a reduction of cost shifting of the expense of caring for the uninsured to large businesses; (2) transparency provisions, including release of the Medicare claims database; (3) the reinsurance program for early retirees; (4) elimination of the Medicare "donut hole"; (5) the operation of the insurance exchanges and their potential availability to employers; (6) delivery system reform; and (7) promotion of wellness and prevention programs.

Among the provisions identified by the companies that could impose new costs on the companies, in addition to the elimination of the deductibility of the prescription drug subsidy, are: (1) the requirement for dependent coverage up to age 26; (2) an excise tax on certain plans; (3) a prohibition on waiting periods longer than 90 days for employees to opt for employer health insurance; and (4) the elimination of annual and lifetime caps on coverage.

There was consensus among the business executives that how the new law is implemented will be the critical factor in determining what they recognize to be the potential to reduce health care expenses for large employers in the years ahead. This will require continued oversight as the new law is implemented.

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[12] E-mail from Andrew Mekelburg, Vice President, Federal Government Relations, Verizon Communications, Inc., to House Energy and Commerce Committee Majority Staff (Apr. 13, 2010).

[13] Briefing by Clay Thompson, Global Director, Governmental Affairs, Caterpillar, Inc., to House Energy and Commerce Committee Majority Staff (Apr. 12, 2010).