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9 July 2010

Raymond Wong
Cost Accounting Standards Board
Office of Federal Procurement Policy
725 17th Street, NW, Room 9013
Washington, DC 20503
Via e-mail to casb2@omb.eop.gov

Reference: CAS Pension Harmonization NPRM

Dear Mr. Wong:

Northrop Grumman Corporation (NGC) appreciates this opportunity to comment on the CAS Board's Notice of Proposed Rulemaking ("NPRM") issued on May 10, 2010 pertaining to the harmonization of CAS 412 and 413 with the Pension Protection Act of 2006 ("PPA").

We commend the CAS Board for the quality of this NPRM given the complexities and scope of the proposed rules. In our opinion, the CAS Board has made significant progress toward both in simplifying the rule and in eliminating ambiguities by providing comprehensive illustrations. However, we believe that the proposed rules requires improvement in a number of aspects in order to achieve a more satisfactory degree of harmonization with the PPA minimum funding requirements.

In support of industry's efforts to improve the proposed rule, NGC participated in drafting comments and responded to the survey taken by the Aerospace Industries Association (AIA) and the National Defense Industries Association (NDIA). Northrop Grumman strongly supports the joint AIA / NDIA response dated July 9, 2010 and is offering the following additional comments.

Detailed Comments

Elimination of Both Trigger 1 and Trigger 2 from the Threshold Test

Under the NPRM, before a pension plan receives any of the proposed mitigation of harmonization, that plan must pass three triggers. Trigger 1, which the AIA / NDIA letter recommends be deleted, requires that the PPA minimum required amount at the plan level must exceed the CAS pension cost measured based on the current CAS rule. Trigger 2, which is imposed by plan at the segment level, requires that the sum of the PPA minimum actuarial liability plus the minimum normal cost measured on a settlement basis exceeds the sum of CAS actuarial accrued liability plus normal cost measured on a long-term basis. The effect of these triggers is that if the plan cannot satisfy both 1) Trigger 1 at the plan level, and 2) Trigger 2 at the segment level, then harmonization to better match PPA required funding and measured CAS cost is not available. Looking at these threshold requirements from a higher level, they might appear to be reasonable. However, in actual application, these thresholds represent impediments to the intended objective of harmonization.

As articulated in the AIA comment letter, Trigger 1 would likely affect a large number of pension plans and thus serve to very broadly prevent harmonization. We believe this is an unintended consequence of the proposed rule. NGC believes elimination of Trigger 1 represents the single most significant improvement that could be made to the NPRM. In addition, NGC further believes that elimination of Trigger 2 would advance the objective of harmonization with no significant resulting inequities. NGC bases this conclusion

on modeling performed on a number of its own pension plans. Our modeling results indicate that projected CAS cost patterns are much smoother and inherently more predictable if Trigger 2 is also eliminated. NGC's modeling also indicates that elimination of Trigger 2 would not increase overall total costs over a 10-Year forecast period, but would mitigate volatility and thereby create a much smoother and more predictable cost pattern by eliminating the sensitivity to harmonization at the segment level. The elimination of volatility would benefit the government and contractors by creating smoother and less variable funding requirements. As a consequence, NGC believes that Trigger 3, which is an adjusted pension cost threshold test, by itself, best serves the objective of harmonization.

The effect of eliminating these two triggers is evident in the Towers Watson survey of Defense Contractors dated June 2010 (Attachment 1). As indicated in the comparison of harmonization between Scenario 1: "NPRM without TT1" and Scenario 2: NPRM without TT1 and TT2 with MPA >0", the overall effect in terms of costs associated with accelerated recoveries from harmonization is comparable, but Scenario 2, which eliminates Triggers 1 and 2, produces a much smoother costing pattern.

Using another example, to illustrate the extent (or absence) of harmonization, we are enclosing two charts in Attachment 2. Chart 1 shows the prepayment credits over a period of 10 years under four scenarios: Pre NPRM, NPRM, NPRM w/o Trigger 1 and NPRM w/o Triggers 1 and 2 while Chart 2 shows the respective CAS costs under the same scenarios. In this example, Trigger 1 prevents harmonization nearly throughout the entire 10 years. Eliminating Trigger1 would achieve harmonization eventually while eliminating both Trigger 1 and Trigger 2 would accomplish comparable results with much smoother CAS costs for the 10-Year forecast period.

To reiterate, failure to eliminate both Trigger 1 and Trigger 2 would likely cause the measurement of CAS pension costs to fluctuate back and forth between two different attribution methods and two different discount rates. Although elimination of Trigger 1 as suggested by the AIA / NDIA letter is a very positive step, the rationale behind Trigger 2 only adds complications; frustrates the objective of harmonization; and reduces predictability while promoting volatility. Therefore, NGC recommends that the CAS Board retain only Trigger 3 and eliminate Triggers 1 and 2.

Pension Segment Closing Adjustments Should be Based on the MAL and be effective Immediately without Any Transitional Phase-in

With the exception of a plan termination, the NPRM provides that segment closing or voluntary plan curtailment calculations are to be determined using the AAL under the accrued benefit cost method (CAS 413-50(c)(12)), which is based on long-term actuarial assumptions. As pointed out in the AIA / NDIA letter, by resetting the final liability to the AAL, the effect of CAS harmonization over the prior periods will be undone by the required pension segment closing adjustment calculation. This is inconsistent with the intent of Congress in drafting the PPA, the mandated harmonization and the objective of a final true up in the pension costs upon a curtailment or segment closing. Simply stated, at the point of segment closing or plan curtailment, there will be no future periods to true up the funded status. The NPRM's transition rules should not be applied to segment closing adjustments.

Prepayment Credit Application at Beginning of the year

The illustrations included in the NPRM suggest the prepayment credit should be applied as of the beginning of the year. Contractors usually fund on a quarterly basis to facilitate compliance with the requirements of FAR 31.205-6. NGC is concerned that the illustration will be misconstrued as a requirement that will create disparity in cost reimbursement for two similarly situated contractors. For example, Contractor A satisfies funding for CAS by cash contributions while Contractor B satisfies funding by utilizing the prepayment credit available in the plan.

In accordance with the illustration, Contractor B's reimbursement would be limited to the amount as of the beginning of the year, resulting in Contractor B being disadvantaged by losing the applicable quarterly interest credits. However, the cost would be recovered throughout the year, not on the first day of the year. NGC does not believe this result is equitable or consistent with the intent of the NPRM. We request

that the illustration be modified to reflect periodic application of any prepayment credits on a quarterly basis.

Desirable Change Treatment for Actuarial Asset Value

The PPA has its own mandatory set of asset smoothing requirements. However, because neither the ANPRM nor the NPRM included pension asset smoothing as part of the mandatory harmonization provisions, changes in contractors' practices are not covered by mandatory equitable adjustment provisions of the CAS. However, pension costs are developed taking into consideration the funded status of plans, which are ultimately driven by both liability and asset values. Accordingly, NGC believes that it is appropriate for the CAS Board to expressly provide for desirable change treatment for the alignment of asset smoothing methods including accepting the ERISA mandated method or other reasonable asset valuation methods.

Additional Opportunities for Public Comment

As emphasized in its comment letter to the ANPRM issued on September 2, 2008, NGC believes that a proposed rule of this magnitude is best addressed by an iterative process where only minor changes are incorporated between the last NPRM and a final rule. Therefore, because of the significant changes being recommended, NGC believes that issuance of a second NPRM is necessary before proceeding to the final rule.

Conclusion

Once again, NGC would like to commend the efforts of the CAS Board to date and express appreciation for the careful consideration of prior comments by respondents in drafting this NPRM. We trust that the CAS Board will fully consider and address our comments. If you have any questions or need additional information, please contact Gordon Johns at 310-229-1323.

Susan Cote
Vice President
Corporate Contracts, Pricing and Supply Chain

Attachment 1 – Towers Watson Survey of Defense Contractors

Attachment 2 – Modeled Sample Plan

TOWERS WATSON
NOTICE OF PROPOSED RULEMAKING ON CAS HARMONIZATION
SURVEY OF DEFENSE CONTRACTORS
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This survey was conducted to assist the Aerospace Industries Association and other interested parties submitting comments to the Cost Accounting Standards (CAS) Board regarding the CAS Harmonization Rule Notice of Proposed Rulemaking (NPRM) issued on May 10, 2010.

The NPRM introduces a two-part threshold test before a contractor can assign a CAS cost that is the greater of:

- the regular CAS cost, which is determined by using the regular accrued liability (AL) and the regular Normal Cost (NC), i.e., values under current CAS 412 and 413; and
- the minimum CAS cost, which is determined by using a minimum accrued liability (MAL) and normal cost (MNC) based on PPA or PPA-like valuation discount rates.

The two parts of the threshold test are as follows:

- Threshold Test 1 (TT1). This test is met if the ERISA minimum required contribution for the plan exceeds the total regular CAS cost for the plan. This test is applied at the plan level.
- Threshold Test 2 (TT2). This test is met if the sum of MAL and MNC is greater than the sum of the regular AL and NC. This test is applied at the segment level.

The Advance Notice of Proposed Rulemaking (ANPRM) introduced the "Mandatory Prepayment Credit (MPC). The MPC was defined in the ANPRM to be the amount of the ERISA minimum required funding in excess of the pension cost assigned to a cost accounting period. The accumulated value of the MPC's was defined to be the Mandatory Prepayment Account (MPA).

The NPRM removed the MPC and MPA concepts. However, for purposes of this survey, an MPA is defined to be equal to the CAS Prepayment Credit Balance less the total ERISA Credit Balance as of each valuation date, with a minimum value of zero. Also, a Transitional MPA (TMPA) is defined to be the MPA as of the beginning of the 2011 cost accounting year.

For this survey, the new pension CAS rules are assumed to first become applicable in 2011. The choice of 2011 is merely for illustrative purposes and should not be construed as indicative of the preferred effective date of the survey respondents. Survey respondents were asked to provide data based on a 10-year forecast of costs.

Thanks to all government contractors who participated in this survey and their actuaries who assisted in gathering the data. Please contact Judy Ocaya at judy.ocaya@towerswatson.com with any questions regarding this survey.

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1. **Survey Respondents.** Eleven companies responded to this survey, submitting data for a total of 20 defined benefit plans.

2. **Mandatory Prepayment Credit Account at Transition (TMPA).** A TMPA balance was reported for 15 of the 20 plans (75%). As a percent of the total market value of assets, the TMPA's ranged from 0.7% to 35.0%, with an average value of 16.6%.

3. **Alternative Rules.** The NPRM plus three alternative sets of rules were studied. The other sets of rules are as follows:
   - Same as the NRPM, but without the first threshold test TT1
   - Same as the NPRM, but replacing the threshold tests TT1 and TT2 with the condition MPA > 0. Note that data was not provided for one out of the 20 plans for this set of rules.
   - Same as the NPRM, but removing the five-year phase-in period for reflecting the MAL and the MNC in the minimum CAS cost calculation.

	NPRM, As Is	NPRM, but without TT1	NPRM, but replacing TT1 and TT2 with MPA > 0	NPRM, but without five-year phase-in period for MAL and MNC
Relevant tests	TT1 for the entire plan and TT2 for all segments in each plan	TT2 for all segments in each plan	MPA > 0	TT1 for the entire plan and TT2 for all segments in each plan
Projected percentage passing relevant tests	Passing all 10 years • 15% of plans Passing at least 5 of the 10 years • 45% of plans Fail TT2 though pass TT1 • 15% of plans	Passing all 10 years • 60% of plans Passing at least 5 of the 10 years • 85% of plans	Passing all 10 years • 74% of plans Passing at least 5 of the 10 years • 100% of plans	Passing all 10 years • 20% of plans Passing at least 5 of the 10 years • 55% of plans Fail TT2 though pass TT1 • 15% of plans

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	NPRM, As Is	NPRM, but without TT1	NPRM, but replacing TT1 and TT2 with MPA > 0	NPRM, but without five-year phase-in period for MAL and MNC
Average increase in present value of 10-year CAS costs	20% higher under this NPRM than under current rules	37% higher under this modified NPRM than under current rules	37% higher under this modified NPRM than under current rules	
Comparison with CAS costs under current rules	Average ratio of new CAS costs to current CAS costs • Year 1 - 114% • Year 2 - 128% • Year 3 - 137% • Year 4 - 146% • Year 5 - 137% • Year 6 - 131% • Year 7 - 94% • Year 8 - 93% • Year 9 - 89% • Year 10 - 85% Average change in annual CAS costs for first 5 years • +32% Average change in annual CAS costs for last 5 years • - 1%	Average ratio of new CAS costs to current CAS costs • Year 1 - 115% • Year 2 - 132% • Year 3 - 140% • Year 4 - 151% • Year 5 - 163% • Year 6 - 156% • Year 7 - 145% • Year 8 - 133% • Year 9 - 117% • Year 10 - 98% Average change in annual CAS costs for first 5 years • +40% Average change in annual CAS costs for last 5 years • +30%	Average ratio of new CAS costs to current CAS costs • Year 1 - 115% • Year 2 - 134% • Year 3 - 143% • Year 4 - 154% • Year 5 - 165% • Year 6 - 158% • Year 7 - 141% • Year 8 - 129% • Year 9 - 110% • Year 10 - 88% Average change in annual CAS costs for first 5 years • +42% Average change in annual CAS costs for last 5 years • +26%	Average ratio of new CAS costs to current CAS costs • Year 1 - 167% • Year 2 - 159% • Year 3 - 152% • Year 4 - 145% • Year 5 - 124% • Year 6 - 118% • Year 7 - 89% • Year 8 - 91% • Year 9 - 87% • Year 10 - 84% Average change in annual CAS costs for first 5 years • +49% Average change in annual CAS costs for last 5 years • - 6%

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	NPRM, As Is	**NPRM, but without TT1**	**NPRM, but replacing TT1 and TT2 with MPA > 0**	**NPRM, but without five-year phase-in period for MAL and MNC**
Progress in harmonization	Percent of plans with no MPA by 10th year • 5% Average ratio of new MPA to MPA under current rules by 10th year • 71% Average ratio of new MPA to MPA under current CAS • Year 1 - 100% • Year 2 - 96% • Year 3 - 92% • Year 4 - 87% • Year 5 - 81% • Year 6 - 77% • Year 7 - 74% • Year 8 - 74% • Year 9 - 73% • Year 10 – 71%	Percent of plans with no MPA by 10th year • 15% Average ratio of new MPA to MPA under current rules by 10th year • 33% Average ratio of new MPA to MPA under current CAS • Year 1 - 100% • Year 2 - 96% • Year 3 - 90% • Year 4 - 85% • Year 5 - 77% • Year 6 - 67% • Year 7 - 57% • Year 8 - 47% • Year 9 - 38% • Year 10 - 33%	Percent of plans with no MPA by 10th year • 5% Average ratio of new MPA to MPA under current rules by 10th year • 32% Average ratio of new MPA to MPA under current CAS • Year 1 - 100% • Year 2 - 96% • Year 3 - 89% • Year 4 - 83% • Year 5 - 74% • Year 6 - 64% • Year 7 - 55% • Year 8 - 44% • Year 9 - 38% • Year 10 - 32%	Percent of plans with no MPA by 10th year • 5%

4. **Assignable Cost Limitation (ACL).** Alternative definitions of the ACL were studied. The average increases in the present values of 10-year CAS costs under the NPRM relative to those under current CAS are as follows.

ACL = NNN% x (Liability + Normal Cost) - Assets where Assets = CAS Actuarial Value of Assets		
NNN = 100%	NNN = 110%	NNN = 125%
+20%	+26%	+27%

ACL = NNN% x (Liability + Normal Cost) - Assets where Assets = min (CAS Actuarial Value of Assets, CAS Market Value of Assets)		
NNN = 100%	NNN = 110%	NNN = 125%
+19%	+23%	+23%

Attachment 2 – Modeled Sample Plan

Chart 1 – Prepayment Credits

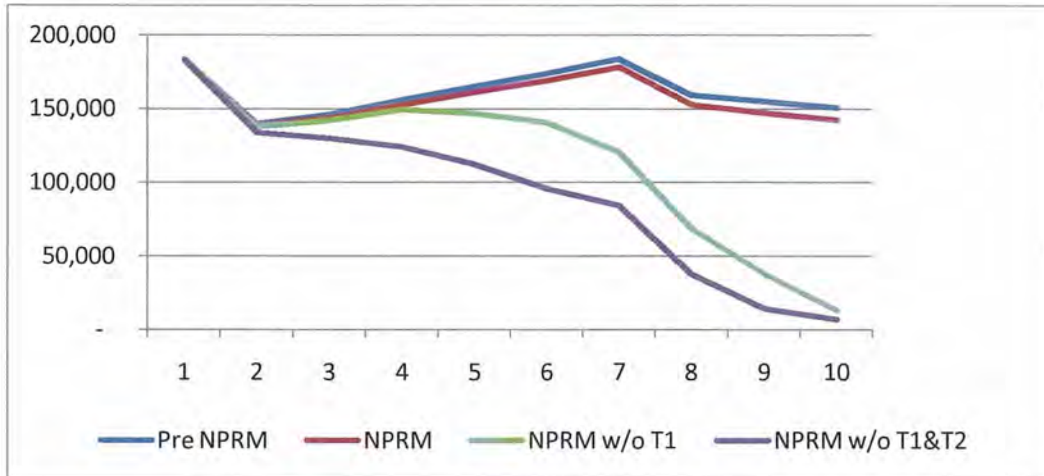

Chart 2 – CAS Costs