

STATE OF NORTH CAROLINA

PERFORMANCE AUDIT

NORTH CAROLINA STATE HEALTH PLAN FOR TEACHERS AND STATE EMPLOYEES

FY2008 PROJECTED VERSUS ACTUAL RESULTS

APRIL 2009

OFFICE OF THE STATE AUDITOR

BETH A. WOOD, CPA

STATE AUDITOR

PERFORMANCE AUDIT

**NORTH CAROLINA STATE HEALTH PLAN FOR
TEACHERS AND STATE EMPLOYEES**

FY2008 PROJECTED VERSUS ACTUAL RESULTS

APRIL 2009



Beth A. Wood, CPA
State Auditor

STATE OF NORTH CAROLINA
Office of the State Auditor

2 S. Salisbury Street
20601 Mail Service Center
Raleigh, NC 27699-0601
Telephone: (919) 807-7500
Fax: (919) 807-7647
Internet
<http://www.ncauditor.net>

April 30, 2009

The Honorable Beverly Perdue, Governor
Members of the North Carolina General Assembly
Jack Walker, PhD, Executive Administrator, State Health Plan for Teachers and
State Employees

Ladies and Gentlemen:

We are pleased to submit this performance audit titled *State Health Plan for Teachers and State Employee FY2008 Projected versus Actual Results*. The audit objective was to determine the factors that contributed to the Plan's 2008 fiscal year loss. We did not audit Blue Cross Blue Shield of North Carolina administrative costs to determine if the costs were valid or reasonable. Dr. Jack Walker reviewed a draft copy of this report. His written comments are included in the appendix.

The State Auditor initiated this audit of the State Health Plan based on growing concerns expressed by the legislature, public, media, and state employees.

We wish to express our appreciation to the staff of the State Health Plan for Teachers and State Employees for the courtesy, cooperation, and assistance provided to us during the audit.

Respectfully submitted,

A handwritten signature in cursive script that reads "Beth A. Wood".

Beth A. Wood, CPA
State Auditor

TABLE OF CONTENTS

	PAGE
SUMMARY	1
INTRODUCTION	
BACKGROUND.....	4
OBJECTIVES, SCOPE, AND METHODOLOGY	5
FINDINGS AND RECOMMENDATIONS.....	7
APPENDIX	
DEPARTMENT RESPONSE	17
AUDITOR’S RESPONSE	21
ORDERING INFORMATION	23

PERFORMANCE AUDIT

SUMMARY

PURPOSE

The purpose of our audit was to determine the factors that contributed to the North Carolina State Health Plan for Teachers and State Employees (State Health Plan or Plan) 2008 fiscal year loss. We did not audit Blue Cross Blue Shield of North Carolina (BCBSNC) administrative costs to determine if the costs were valid or reasonable. This audit report contains recommendations so that Plan managers, legislators, and oversight agencies can take appropriate corrective action.

RESULTS

State Health Plan revenues and expenses consist of premiums, claims expense, and administrative expense for an Indemnity plan and a Preferred Provider Organization (PPO) plan.

The State Health Plan projected a \$57.9 million net income for fiscal year 2008, but ended with a loss of \$79.7 million (\$137.6 million variance) because the Plan underestimated claims and administrative expenses. Underestimating Plan expenses was a significant problem because the Plan sets premium rates just high enough to meet projected expenses and the desired cash reserve level. Therefore, if expenses are greater than projected there will not be enough revenue from premiums to cover the expenses.

State Health Plan Revenues and Expenses (rounded to millions)

	Projected	Actual	Variance
Total Revenue	\$2,210.9	\$2,273.4	\$62.5
Total Claims Expense	\$2,033.5	\$2,197.3	(\$163.8)
Total Administrative Expense	\$119.5	\$155.8	(\$36.3)
Total Net Income	<u>\$57.9</u>	<u>(\$79.7)</u>	<u>(\$137.6)</u>

Source: Actuarial projections, budget documents, and auditor calculations

The Plan achieved revenues \$62.5 million greater than projected, but that was due to an overall increase in State Health Plan membership. Even though more members resulted in more premiums, the increase in revenues could not compensate for the additional claims expense.

The Plan underestimated total claims expense by \$163.8 million. The higher-than-expected claims expense was the result of more members joining the PPO plan and members using more medical services than projected because healthcare was more affordable. PPO network discounts offset some of the increased use of services cost, but not nearly enough to offset the increased claims expense.

PERFORMANCE AUDIT

The Plan also underestimated total administrative expense by \$36.3 million because the Plan failed to estimate the PPO administrative expense accurately. The majority (85%) of the Plan's PPO administrative expense consists of BCBSNC costs. The Plan reimburses BCBSNC its cost for administering the PPO plan plus a profit percentage. However, the State Health Plan lacked BCBSNC cost data on which to base the PPO administrative expense projection. Former Plan management said they did not provide the actuary the BCBSNC contract due to confidentiality. As a result, the actuary did not have the data needed to produce accurate projections.

The BCBSNC contract limits the Plan actuary's ability to forecast administrative expense accurately because:

- The contract requires the State to reimburse BCBSNC its costs, but does not specify which costs are allowable or how BCBSNC will measure those costs;
- The contract allows BCBSNC to control any audit of BCBSNC costs initiated by the State Health Plan and prohibits an independent auditor from providing the cost data to the Plan;
- The BCBSNC contract is a cost-plus-a-percentage-of-cost contract that provides no incentive to control costs and results in increased revenue to BCBSNC as the State's costs increase.

The former Plan management did not timely inform the General Assembly Fiscal Research Division (Fiscal Research) or the Committee on Employee Hospital and Medical Benefits (Legislative Committee) about the unanticipated increase in expenses and the potential effect on the Plan's financial status. Fiscal Research was tasked with monitoring the Plan's budget and reporting to the Legislative Committee, but Fiscal Research did not have direct access to the Plan's financial data.

PERFORMANCE AUDIT

RECOMMENDATIONS

State Health Plan management should clearly document the assumptions and methodology used to develop financial projections and provide the documentation to Fiscal Research and the Legislative Committee.

State Health Plan management should develop and implement effective monitoring, which includes comparing financial projections to actual data to determine as early as possible if projections are inaccurate. Plan management should promptly notify Fiscal Research and the Legislative Committee when management identifies financial or operational problems.

The State Health Plan should require a contract attorney or other contract professional to review all Plan contracts before signing to ensure that contract terms and conditions are in the best interest of the State. The Plan should also ensure that all contracts are transparent and allow the Plan to audit and verify contractor cost data.

The General Assembly should consider legislation to place the State Health Plan under the authority of an executive branch agency to ensure proper operational and financial oversight.

The General Assembly should ensure that Fiscal Research has access to State Health Plan data so Fiscal Research can properly perform its monitoring function.

The General Assembly should consider revising the *North Carolina General Statute 135-43(b)* to allow transparency for State Health Plan contracts.

The General Assembly should consider enacting legislation that prohibits state agencies from using cost-plus-a-percentage-of-cost contracts.

AGENCY'S RESPONSE

The Agency's response is included in the appendix.

PERFORMANCE AUDIT

INTRODUCTION

BACKGROUND

North Carolina General Statute Chapter 135, Article 3, authorized the creation of the North Carolina State Health Plan for Teachers and State Employees (State Health Plan or Plan), which became self-funded in October 1982. The Plan provides health care coverage to more than 667,000 teachers, state employees, retirees, current and former lawmakers, university and community college personnel, and hospital staff. The Plan also provides dependent coverage.

The State Health Plan offered an Indemnity plan as a health insurance option until July 1, 2008. An Indemnity plan is a health benefit system in which the insurance company pays a percentage of each covered healthcare service. The healthcare providers set the fee for each service. Beginning October 2006, the Plan introduced the Preferred Provider Organization (PPO) benefit plan. A PPO plan is a healthcare network composed of physicians, hospitals, or other providers, which provides health care services at a reduced fee. The introduction of the PPO plan provided members with three tiers of coverage.¹

Responsible parties discussed in this report include:

Aon Consulting, Inc. - The Plan's consulting actuary. The actuary makes financial projections based on data and information from Plan management and Plan contractors. The Plan uses these projections to establish the biennial budget that it presents to the Legislature. The Plan presents its revenue and expense projections on a cash basis for the biennium.

Blue Cross Blue Shield of North Carolina (BCBSNC) - The medical claims processor for the Indemnity and PPO plans. BCBSNC also provides customer service, utilization management, and PPO network maintenance.

Committee on Employee Hospital and Medical Benefits (Legislative Committee) - Consists of 12 members of the Legislature. The Legislative Committee reviews programs of hospital, medical, and related care as recommended by the Executive Administrator and the Board of Trustees.

Executive Administrator - Responsible for cost management programs, education and illness prevention programs, membership functions, long-range planning, provider and participant relations, and communications.

General Assembly Fiscal Research Division - Provides financial oversight of the Plan. Fiscal Research contracts with Hartman and Associates to make comparative financial projections based on data available from the Plan. Fiscal Research compiles Legislative Actuarial Notes from projections developed by both actuaries, Hartman and Associates and Aon Consulting, and presents the notes to the General Assembly.

¹ The three tiers offered by the PPO plan are the Basic plan (\$25 copayment and 70/30 coverage), the Standard plan (\$20 copayment and 80/20 coverage) and the PPO Plus plan (\$15 copayment and 90/10 coverage).

PERFORMANCE AUDIT

For fiscal year 2008, the Plan's financial statements show total revenues as \$2.27 billion and total expenses as \$2.35 billion. The main source of revenue for the Plan is premium contributions. Benefit payments to medical and pharmaceutical providers make up the majority of the Plan's expenses. The Plan also pays administrative costs to BCBSNC to process claims and manage a network of healthcare providers.

For the current legislative session, the Plan has requested from the General Assembly appropriations of \$250 million from the Savings Reserve Account to address the shortfall in funds. The Plan bases the \$250 million request on the Plan's projections of hospital, medical, pharmacy, and administrative costs through June 30, 2009. The Plan's request is in addition to the premiums it expects to collect during the period.

OBJECTIVES, SCOPE, AND METHODOLOGY

The audit objective was to determine the factors that contributed to the State Health Plan's 2008 fiscal year loss. We did not audit BCBSNC administrative costs to determine if the costs were valid or reasonable.

The State Auditor initiated this audit based on growing concerns expressed by the legislature, public, media, and state employees.

The audit scope included financial projections, financial results, and contract information from February 2006 through December 2008. We conducted fieldwork from July 2008 to March 2009.

To meet our objective, we conducted interviews with personnel at the State Health Plan, Fiscal Research, and Aon Consulting, Inc. We reviewed State Health Plan e-mail correspondence, management meeting minutes, and Board of Directors meeting minutes. We also reviewed Legislative Committee minutes and North Carolina General Statutes. We analyzed membership totals and financial data using reports from the Plan and its contractors. We reviewed the PPO contract, examined State contracting policies, and identified contracting best practices.

Because of the test nature and other inherent limitations of an audit, together with limitations of any system of internal and management controls, this audit would not necessarily disclose all performance weaknesses or lack of compliance.

We conducted this performance audit according to generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence that provides a reasonable basis for findings and conclusions based on our audit objectives. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

We conducted this audit under the authority vested in the State Auditor of North Carolina by *North Carolina General Statute 147.64*.

[This Page Left Blank Intentionally]

FINDINGS AND RECOMMENDATIONS

INACCURATE PROJECTIONS RESULTED IN A \$79.7 MILLION LOSS

The North Carolina State Health Plan for Teachers and State Employees (State Health Plan or Plan) projected a \$57.9 million net income for fiscal year 2008, but ended with a loss of \$79.7 million, a \$137.6 million difference between projected and actual results. Although the Plan achieved greater-than-expected revenues, the Plan experienced a loss because it significantly underestimated claims expense. The Plan also underestimated administrative expense due to a lack of cost data on which to base projections. Additionally, the former Plan management failed to inform the Legislature in a timely manner about the Plan's financial status.

Revenue Was \$62.5 Million Greater Than Projected

State Health Plan revenue consists of Medicare Part D subsidies, investment earnings, premium contributions for the Indemnity plan, and premium contributions for the Preferred Provider Organization (PPO) plan. Premium contributions make up 97.8% of Plan revenue.

Even though Table 1 below shows that total State Health Plan revenue exceeded projections by more than \$62.5 million, the greater-than-expected total revenues were simply the result of a net increase in Plan membership.

Table 1: Revenue Summary (rounded to millions)

	Indemnity	PPO	Total
Projected	\$ 963.3	\$1,247.6	\$2,210.9
Actual	\$ 727.5	\$1,545.9	\$2,273.4
Variance	(\$235.8)	\$ 298.3	\$ 62.5

Source: Actuarial projections, budget documents, and auditor calculations

Projected revenue for the Indemnity plan was \$963.3 million and actual revenue was \$727.5 million, \$235.8 million less than projected. The decrease in revenue is attributable to fewer members than expected enrolled in the Indemnity plan. The Plan offered two enrollment periods during fiscal year 2008 in which members shifted from the Indemnity plan to the PPO plan. Indemnity plan enrollment decreased by approximately 76,000 members.

Projected revenue for the PPO plan was \$1,247.6 million and actual revenue was \$1,545.9 million, \$298.3 million more than projected. Although PPO plan revenue was greater than expected, PPO claims expense was significantly more than revenue. The increase in revenue is due to greater-than-expected membership enrollment in the PPO plan. Membership increased for the PPO plan by about 106,500. This includes the 76,000-member shift from the Indemnity plan and new member enrollment of about 30,500 members. New members consisted in part of current state employees and dependents who were not enrolled in the State Health Plan.

Underestimated Claims Expense by \$163.8 million

State Health Plan claims expense consists of claims from medical providers (hospitals and doctors) and pharmacies (prescription drugs) for the Indemnity plan and the PPO plan.

FINDINGS AND RECOMMENDATIONS

Table 2 below shows that the State Health Plan underestimated total claims expense for fiscal year 2008 by \$163.8 million. Although the Indemnity plan claims expense was lower than expected, the State Health Plan had higher-than-expected claims expense because PPO plan members used more healthcare services on a per-member basis than projected. Additionally, total State Health Plan membership increased due to more affordable health insurance.

Table 2: Claims Expense Summary (rounded to millions)

	Indemnity	PPO	Total
Projected	\$ 907.1	\$ 1,126.4	\$ 2,033.5
Actual	\$ 778.1	\$ 1,419.2	\$ 2,197.3
Variance	\$ 129.0	(\$ 292.8)	(\$ 163.8)

Source: Actuarial projections, budget documents, and auditor calculations

To develop the financial projection, the Plan's actuary (Aon Consulting) considers historical medical and pharmacy claims expense trends to establish a baseline estimate. The actuary adjusted the baseline to account for benefit changes for the Indemnity plan and to account for benefit changes, expected increase in service use, and anticipated PPO network provider discounts for the PPO plan. Plan management requests several iterations of the projections from the actuary to decide on the assumptions and projection to use. The Executive Administrator selects the projection most in line with Plan goals for an upcoming biennium. The Plan then forwards the selected projection to Fiscal Research.

Indemnity Plan

Projected claims expense for the Indemnity plan was \$907.1 million for fiscal year 2008. Actual claims expense was \$778.1 million, which is \$129.0 million less than expected.

Although the Indemnity plan claims expense was less than projected, the claims expense on a cost-per-member basis indicates that the plan underperformed. As of June 2008, the actual Indemnity plan enrollment was approximately 76,000 less than the enrollment number that the actuary used to create the fiscal year 2008 projection. When calculated on a cost-per-member basis, the Indemnity plan claims expense was approximately \$59 million more than would be expected based on actual enrollment. Therefore, the Indemnity plan underperformed in a manner that is not evident from a simple comparison of projected to actual results.

The population characteristics of the remaining Indemnity plan members may provide an explanation for the unexpectedly high cost-per-member claims expense. A study conducted by BCBSNC suggested that the Indemnity plan had an older and perhaps less healthy population of members who used more services, which resulted in increased claims expense.

PPO Plan

Projected claims expense for the PPO plan was \$1,126.4 million. Actual claims expense was \$1,419.2 million, or \$292.8 million more than expected. Underestimating Plan expenses was a significant problem because the Plan sets premium rates just high enough to meet projected

FINDINGS AND RECOMMENDATIONS

expenses and the desired cash reserve level. Therefore, if expenses are greater than expected there will not be enough revenue from premiums to cover expenses.

The State Health Plan expected some increase in the PPO claims expense. The Plan assumed that PPO members would use more services because the PPO plan was less expensive to members than those same services were under the Indemnity plan. The PPO also provided more services such as routine hearing and eye exams. Additionally, the PPO plan did not have limits on the number of office visits for physical, occupational, and other therapy types. According to the former Chief Operating Officer, “The theory behind the PPO was to remove the financial barriers and to promote preventive care.” The State Health Plan expected increased claims expense in the short term from the increased use of preventive care services, but preventive care would save the Plan money in the long term by reducing the use of more expensive inpatient and outpatient services.

However, the State Health Plan expected PPO provider discounts to offset any increase in the first-year PPO claims expense. BCBSNC negotiates provider discounts with hospitals and medical providers for the PPO plan. The State Health Plan estimated \$171.4 million savings from provider discounts. According to the actuary’s analysis, actual provider discounts were \$158.2 million. Actual discounts were \$13.2 million less than expected, and the savings were not enough to offset the increase in PPO claims expense caused by greater-than-projected member use of services.

PPO plan claims expense also increased because new members joined the plan. As of June 2008, the number of members in the PPO plan was about 106,500 more than projected. The increase was a result of approximately 76,000 members shifting from the Indemnity plan to the PPO plan as well as an overall 30,500-member increase in PPO membership. The increased number of members resulted in an increased number of claims and claims expense.

Underestimated Administrative Expense by \$36.3 Million

State Health Plan administrative expense includes staff salaries, rent, utilities and contracts for services such as BCBSNC and Medco Health Solutions.

Table 3 below shows that the State Health Plan underestimated total administrative expense for fiscal year 2008 by \$36.3 million.

Table 3: Administrative Expense Summary (rounded to millions)

	Indemnity	PPO	Total
Projected	\$ 58.7	\$ 60.8	\$ 119.5
Actual	\$ 60.4	\$ 95.4	\$ 155.8
Variance	(\$ 1.7)	(\$ 34.6)	(\$ 36.3)

Source: Actuarial projections, budget documents, and auditor calculations

FINDINGS AND RECOMMENDATIONS

To project administrative expense for the Indemnity plan and the PPO plan, the Plan's actuary used consumer price index (CPI) trend data adjusted for an expected 3% cost increase over the prior year and any assumed contractual changes.

Indemnity Plan

Projected administrative expense for the Indemnity plan was \$58.7 million for fiscal year 2008. Actual administrative expense was \$60.4 million, which was \$1.7 million more than expected. This difference is not significant.

PPO Plan

Projected administrative expense for the PPO plan was \$60.8 million for fiscal year 2008. Actual administrative expense was \$95.4 million, which was \$34.6 million more than expected.²

One reason for the underestimated PPO administrative expense was the lack of BCBSNC cost data. BCBSNC administrative charges were \$81.1 million (85%) of the PPO's \$95.4 million total administrative expense.³ The BCBSNC claims administration contract is a cost-plus-a-percentage-of-cost contract in which the Plan reimburses BCBSNC its costs for administering the State Health Plan's PPO plan plus a profit percentage. To create an accurate administrative expense projection, the Plan's actuary needed to know the costs that constitute the BCBSNC administrative charges and the factors that affect those costs. However, the Plan's actuary did not have access to the BCBSNC contract. The former Chief Operating Officer said, "Aon never received the BCBS contract due to confidentiality." We noted in a previous audit report on State Health Plan oversight that Fiscal Research also lacked access to the Plan's contractor information because of confidentiality agreements.⁴

Another reason for the underestimated PPO plan administrative expense projection was an increase in PPO plan membership. As noted earlier, the number of members in the PPO plan was about 106,500 more than projected as of June 2008. The increase was a result of approximately 76,000 members shifting from the Indemnity plan to the PPO plan as well as an overall 30,500-member increase in PPO membership. The increased number of members resulted in an increased number of claims which in turn resulted in increased administrative expense.

² Actual PPO administrative expense may have been \$4 million less and claims expense \$4 million more according to BCBSNC records. This cannot be independently verified as the Plan did not track the amounts and the timing of BCBSNC administrative expense withdrawals from the Plan claims payment account for fiscal year 2008.

³ The remaining \$14 million consisted of administrative expense for Medco Health Solutions (about \$9 million), State Health Plan staff and expenses (about \$4 million), and other miscellaneous contracts and services (about \$1 million).

⁴ Office of the State Auditor. Oversight of the North Carolina State Health Plan for Teachers and State Employees. October 2008

FINDINGS AND RECOMMENDATIONS

State law was drafted such that it made some terms of the BCBSNC contract confidential. *North Carolina General Statute 135-43(b)* states:

The terms pertaining to reimbursement rates or other terms of consideration of any contract between hospitals, hospital authorities, doctors, or other medical providers, or a pharmacy benefit manager and the Plan, or contracts pertaining to the provision of any medical benefit offered under the Plan, including its optional alternative comprehensive benefit plans, and programs available under the optional alternative plans, shall not be a public record under Chapter 132 of the General Statutes for a period of 30 months after the date of the expiration of the contract.

BCBSNC made the contract available to the public on March 12, 2009, in response to requests from media.

Nevertheless, the Plan's actuary could not have determined BCBSNC cost data from the contract. The contract lists cost components, but does not provide detailed descriptions of those components.

For example:

- The contract identifies “direct and indirect costs incurred by BCBSNC and/or its affiliates related to administering the operations of the Group Health Plan” as a cost component, but the contract does not specify exactly what costs are allowable or how the costs will be measured;
- The contract identifies BCBSNC overhead as a cost component, but does not specify how the overhead will be calculated or allocated to the State Health Plan except that the methodology will be “consistent with BCBSNC’s standard business practices”;
- The contract identifies “initial costs incurred by BCBSNC in developing and launching the Group Health Plan, as well as costs incurred in developing new products and services” as a cost component, but does not specify exactly what those costs are or how they will be measured; and
- The contract identifies a “cost plus cap” (guaranteed maximum), but does not specify an amount. The contract requires that “the parties shall work together in good faith to determine an appropriate cap.” If the Plan and BCBSNC cannot reach an agreement, BCBSNC will calculate the cap in good faith and notify the State Health Plan of the calculation.

Furthermore, the Plan's actuary could not have obtained BCBSNC's cost data from an audit to ensure that projections are based on actual costs. The contract terms allow BCBSNC to control any audit of BCBSNC cost data initiated by the State Health Plan and prohibits an independent auditor from providing the cost data to the Plan.

FINDINGS AND RECOMMENDATIONS

For example, the contract stipulates the following conditions for an independent audit of BCBSNC costs:

- The contract with the independent Certified Public Accountant (CPA) shall be executed by BCBSNC;
- BCBSNC shall arrange for the audit by making reasonable contractual arrangements with the CPA, including a requirement that the CPA execute a confidentiality agreement with BCBSNC; and
- The CPA's confidentiality agreement will restrict the CPA to providing to the State Health Plan only the final results of such audit and a description of the audit methodology used. All other Confidential Information, including but not limited to BCBSNC's actual cost components, will remain strictly confidential. (Auditor added emphasis).

Considering the fact that the contract does not specifically identify allowable BCBSNC costs for an auditor to use as criteria and that audited BCBSNC cost components must remain confidential, any independent auditor's report is likely to prove less than useful to the Plan and its actuary. The resulting report would likely only conclude whether BCBSNC costs are reasonable when compared to industry standards and whether BCBSNC followed its standard business practices when allocating overhead.

Consequently, the State Health Plan has agreed to a contract that requires the Plan to reimburse BCBSNC its costs, but does not allow the Plan to verify those costs or even know what they are. Therefore, BCBSNC could charge the Plan for expenses and overhead that Plan management might not agree were true costs of the Plan.

Did Not Inform the Legislative Oversight Committee

The former State Health Plan management knew or should have known that PPO expenses were exceeding projections. Plan management should have assessed the effect on the Plan's financial status and notified the Plan's oversight body: the Committee on Employee Hospital and Medical Benefits (Legislative Committee).

Plan management should have known about the Plan's financial status from management's monitoring procedures. The federal Governmental Accountability Office recommends that management perform ongoing monitoring on a real-time basis and react to changing conditions. Ongoing monitoring activities should include regular management and oversight communication, regular comparisons of expected and actual performance, and an analysis of any variances from those expectations.

A projected claims cost-per-month was available for Plan management to use in monitoring Plan performance. Based on auditor analysis, actual claims cost in the PPO plan began to exceed projected costs by almost \$13 million in January 2008. During the last six months of

FINDINGS AND RECOMMENDATIONS

fiscal year 2008, average costs exceeded projected cost by approximately \$12 million per month.

In a previous audit report on State Health Plan oversight, the General Assembly Fiscal Research Division (Fiscal Research) said it asked the former Plan management in January 2008 whether the Plan needed to revise projections; management said that a revision was not necessary.

Fiscal Research also requested access to the Plan's data warehouse and reports in a standardized format that would allow for comparisons between periods. However, State Health Plan management did not provide Fiscal Research with access to the data warehouse or the reports.

The former Executive Administrator spoke at the January 22, 2008, State Health Plan management meeting. In part, minutes of the meeting state that the management team:

Discussed ramifications of releasing Plan data to outside agencies, especially to Fiscal Research where information could influence legislators; important to balance politics versus possibility of taking data and coming up with skewed analysis. [Plan management] needs to discuss all aspects: strategically, legally, and politically.

In addition, Plan management may not have communicated all available information to Fiscal Research and the Legislative Committee.

In an interview with the auditors, the Plan's former Chief Operating Officer said that on more than one occasion the former Executive Administrator stated that no information is to go to the Legislators or Fiscal Research without his expressed permission.

Additionally, the former Executive Administrator presented information about expected savings from the PPO plan to the Legislative Committee on May 15, 2008, without mentioning the State Health Plan's financial problems.

The Plan's management meeting minutes and the former Executive Administrator's nondisclosure of financial problems further support the conclusions in our previous audit report. The report noted that Fiscal Research did not have direct access to the Plan's financial data, had to rely on reports from the Plan, and received Plan reports that did not allow for comparisons between projected and actual. Because Fiscal Research provides financial oversight of the Plan by monitoring the budget and providing information to the Legislative Committee, our report concluded that the Legislative Committee might not have received all of the information needed to provide appropriate oversight of the Plan's operations and financial status. Our report also concluded that an executive branch agency could provide more effective oversight than the legislative branch can provide.

FINDINGS AND RECOMMENDATIONS

Additional Notes Regarding the BCBSNC PPO Contract

It is important to note that the BCBSNC PPO contract's per-member per-month (PMPM) reimbursement rate is not the State Health Plan's or BCBSNC's actual cost. The PMPM rate is an advanced payment plan based on an estimate of BCBSNC cost. For any given year, BCBSNC will not know the total actual cost for administering the PPO plan until after it has provided services. To receive periodic payments, BCBSNC estimates expenses for the year and divides the estimated cost by an estimated number of plan members and the number of months to arrive at a PMPM estimated reimbursement rate. The State Health Plan receives monthly invoices from BCBSNC based on the PMPM estimated reimbursement rate multiplied by the actual number of members in the PPO plan. The fact that the BCBSNC contract requires the State Health Plan and BCBSNC to periodically cost-settle is evidence that the PMPM rate does not represent actual BCBSNC cost and is only an estimate.

It is also important to note that the cost-plus-a-percentage-of-cost type of contract that the Plan used with BCBSNC is not in the best interest of the State. The contract creates a potential conflict of interest for the vendor. One publication notes:

The cost-plus-a-percentage-of-cost contract provides for the seller to receive reimbursement for its costs and a profit component, called a fee, equal to some predetermined percentage of its actual costs. Thus, as costs go up, so does profit. This arrangement is a poor one from the buyer's standpoint; it provides no incentive to control costs because the fee gets bigger as the costs go up.⁵

The federal government has prohibited the use of such contracts by federal agencies since 1941.⁶ The federal government allows other forms of cost-plus contracts such as the cost-plus-fixed-fee contract; however, cost-plus contracts generally increase risks for the purchaser. A February 2009 Treasury Inspector General for Tax Administration audit report states, "Cost-reimbursement contracts, which reimburse contractors for all their costs, represent the highest monetary risk to the federal government." Additionally, 21 states have statewide or agency-specific laws that prohibit the use of such contracts.

It would have been prudent to have the BCBSNC contract reviewed by a contract attorney or other contract professional before it was signed to ensure that the contract terms and conditions protected the State's interest and allowed the Plan access to necessary cost data. However, no one outside of the State Health Plan reviewed the contract for risks to the State. The Plan's former Chief Operating Officer and the former Director of Network Operations and Strategic Planning (Director) negotiated the contract on the Plan's behalf. The former Chief Operating Officer is not an attorney or contract professional. The former Director is an attorney and currently works as an attorney with BCBSNC. However, the former Director told the auditors that she did not act as the Plan's counsel while negotiating the BCBSNC

⁵ Garrett, Gregory A. World Class Contracting: How Winning Companies Build Successful Partnerships in the e-Business Age. Chicago: CCH Incorporated, 2001

⁶ Arrowsmith, Sue., John Linarelli, and Don Wallace. Regulating Public Procurement: National and International Perspectives. Boston: Kluwer Law International, 2000

FINDINGS AND RECOMMENDATIONS

contract. Therefore, no one reviewed the BCBSNC contract from the perspective of an attorney or contract professional on the State Health Plan's behalf before the Executive Administrator signed the contract. As a result, the State Health Plan agreed to a multi-million dollar cost-plus contract that does not allow access to cost data necessary to manage the Plan.

Recommendation:

State Health Plan management should clearly document the assumptions and methodology used to develop financial projections and provide the documentation to Fiscal Research and the Legislative Committee.

State Health Plan management should develop and implement effective monitoring, which includes comparing financial projections to actual data to determine as early as possible if projections are inaccurate. Plan management should promptly notify Fiscal Research and the Legislative Committee when management identifies financial or operational problems.

The State Health Plan should require a contract attorney or other contract professional to review all Plan contracts before signing to ensure that contract terms and conditions are in the best interest of the State. The Plan should also ensure that all contracts are transparent and allow the Plan to audit and verify contractor cost data.

The General Assembly should consider legislation to place the State Health Plan under the authority of an executive branch agency to ensure proper operational and financial oversight.

The General Assembly should ensure that Fiscal Research has access to State Health Plan data so Fiscal Research can properly perform its monitoring function.

The General Assembly should consider revising the *North Carolina General Statute 135-43(b)* to allow transparency for State Health Plan contracts.

The General Assembly should consider enacting legislation that prohibits state agencies from using cost-plus-a-percentage-of-cost contracts.

[This Page Left Blank Intentionally]

APPENDIX



4901 Glenwood Avenue, Suite 150, Raleigh, NC 27612-3854 Phone: 919-881-2300 Fax: 919-881-2308

April 23, 2009

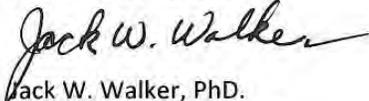
Beth A. Wood, CPA
State Auditor
2 S. Salisbury St.
20601 Mail Service Center
Raleigh, NC 27699-7500

Dear Ms. Wood,

The North Carolina State Health Plan for Teachers and State Employees (Plan) is in receipt of the draft report of the performance audit conducted by your office titled *FY2008 Projected versus Actual Results* and dated April 9, 2009. The Plan has reviewed the report, as requested, and prepared its written response to be incorporated as part of the final report. The Plan's responses to the major findings and recommendations are attached.

The exit conference has been scheduled for 10:00 a.m. on Wednesday, April 29, 2009, at our Plan office. We appreciate the thoroughness and professionalism that your staff has extended to the Plan during this extended review period.

Respectfully submitted,


Jack W. Walker, PhD.
Executive Administrator



APPENDIX

North Carolina State Health Plan (Agency) Response to North Carolina State Auditor's Performance Audit Report "FY2008 Projected Versus Actual Results" April 2009

Revenue Was \$62.5 Million Greater Than Projected

The Plan agrees with the Auditor's finding. It is interesting to note that the PPO Plan offered a lower premium than the Indemnity Plan. Therefore, the Plan saw a decrease in revenue on a per member basis, but because of PPO membership growth realized higher than projected total revenue.

Underestimated Claims Expense by \$163.8 million

The Plan agrees with the Auditor's finding. The Plan, in conjunction with Aon Consulting, completed its analysis of FY 2008 claims expense in September 2008. This analysis revealed three primary causes of the underestimation of claims expense.

- The Plan failed to realize projected savings in provider payments through the PPO network. The Plan utilized out dated Indemnity Plan discount information to develop its forecast.
- Additional costs due to benefit enrichment in the PPO were higher than projected.
- Finally, the Plan experienced higher than projected utilization rates, particularly in outpatient services.

Underestimated Administrative Expense by \$36.3 million

The Plan agrees with the Auditor's finding but also wishes to explain a related and important issue that contributed to the underestimation of administrative expense. When the BCBSNC PPO contract was instituted, the former Plan administrators did not share the contract nor did they inform the Plan's actuary or the legislative Fiscal Research staff of significant components within the contract that affected the calculation of administrative fees. The current administration does not agree with the former administration's position that the Plan did not have the authority to share this otherwise confidential information with its actuary. The PPO Contract explicitly noted a "PMPM Estimate"⁷ of administrative costs, which was originally set at \$11.57. This amount was not based on a true estimate of BCBSNC's projected costs to administer the PPO contract; the current administration is unclear as to the basis for this first "PMPM Estimate." The \$11.57 PMPM amount was provided to the actuary to develop the FY2008 budget. However, as the Auditor notes, this contract was "Cost Plus" and all administrative costs had to be reimbursed; therefore, a mechanism called "Shared Network Savings"⁸ was developed to create an additional methodology for payment of those administrative costs in excess of the estimate. This mechanism caused claims payments to be increased by 5% of the difference between the billed amount and the allowed amount of provider charges. These payments created a pool of funds from which BCBSNC was reimbursed for their administrative expenses that were in excess of the base PMPM Estimate of \$11.57. Over time, this pool of funds exceeded the actual incurred costs. After the first year the Plan received a refund of

⁷ See PPO Contract, Exhibit A

⁸ See PPO Contract, Exhibit A

APPENDIX

approximately \$24 million. Thereafter, the refunds were made more frequently. This mechanism reportedly was not understood by many in the former administration and most importantly not by the Plan's actuary. Once it was understood, the current administration began negotiating with BCBSNC to eliminate the "Shared Network Savings" mechanism and replace it with a more straightforward process for funding administrative expenses and to establish a more even and predictable cash flow. Shared Network Savings was terminated and replaced with a PMPM Estimate that more nearly reflects actual costs. This change was incorporated in Amendment Four to the PPO Contract effective January 1, 2009.

To conclude, in addition to the issues noted by the auditor, the FY2008 budget was not accurate in forecasting administrative expenses related to the claims processing contract because the BCBSNC PPO Contract was not made available to key parties and because the terms of reimbursement were not explained adequately.

Did Not Inform the Legislative Oversight Committee

The Plan agrees with the Auditor's finding.

Additional Notes Regarding the BCBSNC PPO Contract

The Plan shares the Auditor's concerns about the Cost Plus contract and the challenges of effectively managing such an arrangement.

Recommendation:

The current Executive Administrator, Deputy Executive Administrator, and Chief Financial Officer joined the Plan after the departure of the former administration. The current administration has begun steps to address many of the issues in this report.

- The Plan has "re-casted" the current operating budget, confers regularly with the Plan actuary, Fiscal Research and the General Assembly, as well as the Plan's Board of Trustees, the Office of State Budget and Management and many others as needed to provide appropriate reporting and sound fiduciary management of the Plan and its finances. The Plan has revised its financial reports to include actual, budgeted and variance to budget columns for both the month and year to date. Also, the Plan has developed utilization reports through BCBSNC and in collaboration with Fiscal Research, that provide the information necessary for the Plan and Fiscal Research to more effectively monitor the Plan's performance.
- The Plan has communicated regularly with clear and concise financial and operational reporting to its Board of Trustees, Fiscal Research and the legislative Co-chairs and Legislative Oversight Committee.
- The prior administration had begun to formalize its contracting procedures and the Plan has continued to refine and improve these processes. The contracting results are reviewed with

APPENDIX

experts from the Division of Purchase and Contract, the Plan's in-house Counsel and procurement staff, and the Attorney General's office to assure appropriate oversight and management of our vendors and other contractual relationships. In addition, the Plan's Board approves all contracts in excess of \$500,000.

- The Plan has requested and obtained advice from the Attorney General in interpreting NCGS 135-43(b) (a confidentiality statute applicable to the Plan's agreements) and has since released more information than previous interpretations of the statute had allowed. The Plan is committed to transparency whenever possible without damaging its ability to negotiate successfully for competitive rates and terms.
- While the current administration did not enter into the existing PPO contract, it is the agreement under which BCBSNC administers the PPO plan and does not expire until 2013. The Plan has been able to negotiate some changes to the agreement with BCBSNC. (The contract does allow for amendment, provided that both parties mutually agree.) Through amendments, the Plan eliminated participation in the Blue Points program and, as previously noted, Amendment Four enabled the Plan to end the Shared Network Savings methodology. BCBSNC has agreed to work with the Plan to amend the audit provision of the contract to allow for direct participation by the Plan and afford more transparency into any audit findings and results. The Plan intends to audit BCBSNC's administrative expenses and will advertise for bids to do so during the current fiscal year. In the interim, the Plan continues to work with BCBSNC to identify cost savings strategies in the management of the agreement.
- Given the size and complexity of the Plan and the services necessary to process claims, the Plan will begin the procurement process no later than 30 months prior to the expiration of the current agreement period which is June 30, 2013. The Plan is committed to the competitive bidding process in procuring the next Claims Processing Contractor contract.
- The Plan's Board of Trustees is generally supportive of the need to restructure oversight of the State Health Plan and has established a subcommittee to study the current statutory requirements for oversight of the Plan. Others in the Legislature have put forth their own ideas as to appropriate oversight and governance. The recently passed Senate Bill 287 establishes a Blue Ribbon Task Force to study this and other governance and management issues for the Plan. The Plan will work diligently under any oversight structure that is deemed appropriate by the General Assembly.

Auditor's Response

Note of Clarification to the State Health Plan's Response:

Under the heading "Underestimated Administrative Expense by \$36.3 million", the State Health Plan notes, "The Shared Network Savings was terminated and replaced with a PMPM (per-member per-month) Estimate that more nearly reflects actual costs."

Two points should be highlighted.

First, the use of the Shared Network Savings mechanism obscured the actual Blue Cross Blue Shield of North Carolina (BCBSNC) administrative costs for the Preferred Provider Organization (PPO) plan. The original BCBSNC contract stated an \$11.57 PMPM estimate of BCBSNC's administrative costs. However, a new \$15.15 PMPM estimate of BCBSNC's administrative costs was established as a result of terminating the Shared Network Savings mechanism, effective January 1, 2009. Therefore, approximately \$3.58 PMPM in BCBSNC estimated administrative cost was not reflected in the original PMPM contract rate, but rather was paid through the Shared Network Savings mechanism. The BCBSNC PPO contract required the Shared Network Savings to be designated as a claims expense. This practice over-reported claims expense and under-reported administrative expense.

Second, the use of the Shared Network Savings mechanism gave the impression that the PPO administrative cost would be less than the Indemnity plan's administrative cost. State Health Plan invoices show that the Indemnity plan's PMPM rate was higher than the PPO \$11.57 contact rate for fiscal year 2008. Because the PMPM rate for the PPO contract was originally set at \$11.57 instead of the more realistic \$15.15 PMPM rate, the PPO plan's estimated administrative cost appeared to be less than the Indemnity plan's estimated administrative cost. Also, the additional cost may not be justified. Current State Health Plan management is working with BCBSNC to better understand the costs relative to services rendered for both plans to ensure that any differences in administrative costs are appropriate.

[This Page Left Blank Intentionally]

ORDERING INFORMATION

Audit reports issued by the Office of the State Auditor can be obtained from the web site at www.ncauditor.net. Also, parties may register on the web site to receive automatic email notification whenever reports of interest are issued. Otherwise, copies of audit reports may be obtained by contacting the:

Office of the State Auditor
State of North Carolina
2 South Salisbury Street
20601 Mail Service Center
Raleigh, North Carolina 27699-0601

Telephone: 919/807-7500

Facsimile: 919/807-7647