

**NORTH CAROLINA STATE HEALTH PLAN
FOR TEACHERS AND STATE EMPLOYEES**
Raleigh, North Carolina

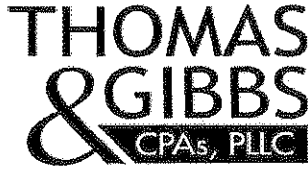
**Preferred Provider Organization
Administrative Expenses**

Independent Accountants' Report
On Applying Agreed-Upon Procedures

June 30, 2009

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June 30, 2009

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Independent Accountants' Report on Applying Agreed-Upon Procedures

Dr. Jack Walker
Executive Administrator
North Carolina State Health Plan
for Teachers and State Employees
Raleigh, North Carolina

We have performed the procedures enumerated below, which were agreed to by the North Carolina State Health Plan for Teachers and State Employees (the "Plan"), solely to assist the Plan in its evaluation of the administrative expenses charged by BlueCross BlueShield of North Carolina, the Plan's Claims Processing Contractor (the "CPC"), in connection with the Preferred Provider Organization ("PPO") Administrative Services Only Agreement (the "ASO Agreement") dated February 28, 2006, as amended. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of the Plan. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

For the period of July 1, 2008 through June 30, 2009, we were engaged to apply the following procedures, which the Plan specified:

1. Obtain a description of the CPC's methodology used to charge and allocate costs to the Plan under the ASO Agreement.
2. Obtain the periodic cost-plus settlement statements, the monthly reports of actual costs incurred and the PMPM (per-member-per-month) estimated invoices submitted to the Plan by the CPC for the period of July 1, 2008 through June 30, 2009.
3. Verify and agree the periodic cost-plus settlement statements, the monthly reports of actual costs incurred and the PMPM estimated invoices submitted to the Plan by the CPC to supporting documentation maintained by the CPC for personnel costs, direct (assignable and shared) costs, and indirect cost and report any noted instances of noncompliance.
4. Compare the CPC's charges to the requirements for the ASO Agreement and report any noted instances of noncompliance.
5. Verify and agree the CPC's supporting documentation to the cost centers (department units) and their assigned cost drivers.

6. Determine whether the cost centers associated with the sales and marketing of the CPC are included in the CPC's monthly report of actual costs incurred.
7. Determine whether the allocated costs include executive or other bonuses, advertising or promotional cost, entertainment cost (including disallowed cost such as lobbying, meals or alcohol) or other unusual costs.
8. For direct personnel costs, obtain the CPC's worksheets used to support personnel cost charged to the Plan for claims processing, network management, customer service, member enrollment, premium billing and collection, administrative services and other direct personnel costs.
9. For direct personnel costs, verify that costs are supported by payroll records and other evidential records that are appropriate to document these specific costs.
10. For other direct expenses, obtain the CPC's worksheets used to support non-personnel costs charged to the Plan.
11. Obtain the CPC's worksheets used to support the overhead and administrative costs charged to the Plan.
12. Compare the CPC's cost allocation methodology for consistency with prior projects implemented for the Plan.

The results of our procedures are documented in the *Results of Agreed-Upon Procedures* section of our report.

We were not engaged to, and did not conduct an examination, the objective of which would be the expression of an opinion on the adequacy of the CPC's processing controls and procedures. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of the North Carolina State Health Plan for Teachers and State Employees and BlueCross BlueShield of North Carolina, and is not intended to be, and should not be, used by anyone other than these specified parties.

James S. Gillette CM, PLLC

Durham, North Carolina
December 29, 2009

EXECUTIVE SUMMARY

PURPOSE

The purpose of our agreed upon procedures engagement was to provide information to the Plan that would assist the Plan's management in evaluating the nature and extent of the administrative and overhead expenses being paid to the Plan's Claims Processing Contractor (the "CPC") in connection with the Administrative Services Only Agreement ("the ASO Agreement"; "the Agreement"). The Plan's objectives for the engagement were to determine the following:

1. The validity of the CPC's administrative charges, including direct and indirect costs and the method for allocating overhead costs.
2. The reasonableness of the contracted administrative rate (i.e., the per member per month, (PMPM), fee paid by the Plan based on membership as a means of funding administrative expenses), and
3. Whether the administrative costs charged to the Plan were in compliance with the current ASO Agreement between the Plan and the CPC.

The ASO Agreement is a "Cost Plus" agreement; in other words, it provides for reimbursement of actual costs (direct, indirect and overhead) plus a specified profit percentage.

RESULTS

We did not note any instances of non-compliance relating to the CPC's allocation of direct, indirect or overhead costs under the ASO Agreement. The ASO Agreement's language is broad and non-specific as to the costs to be allocated. For example, Section 3.1.1 of the ASO Agreement identifies "direct and indirect costs incurred by BCBSNC and/or its affiliates related to administering the operations of the Group Health Plan" as administrative cost, but does not specify what costs are allowable or how they will be measured.

The ASO Agreement under section 3.1.2 defines overhead as "general corporate expense incurred by BCBSNC and/or its affiliates in conducting business, including but not limited to human resources, finance, legal and other functions not connected with administering the Group Health Plan." It further states "BCBSNC shall allocate overhead to the Cost Plus methodology consistent with BCBSNC's standard business practices, as applied to all BCBSNC lines of business". Under this definition, a share of virtually all the CPC's costs that are not directly or indirectly charged, are allocable as overhead to the Plan regardless of whether there is a direct link or benefit to the Plan.

Following are examples of cost centers allocated to the Plan as overhead which, as defined by the ASO Agreement, are allowable. The examples do not represent a complete list of cost centers that are allocated to the Plan as overhead. However, the cost centers either met our

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threshold for testing or we believe contain expenses the Plan should discuss limiting or excluding under the ASO Agreement.

Board of Trustees: This cost center consists of costs supporting the activities of the Board of Trustees. Specific accounts in this cost center include:

- Board fees/retainers
- Board retreats
- Meeting expense – food
- Corp. Promotional

Corporate level expense: This cost center has a phased allocation where portions are allocated to the Plan as direct and indirect costs and the balance as overhead. This cost center has multiple functions. One function is to adjust accounts to actual (i.e. - accruals that require periodic adjustment to actual). It also appears to function as a “catch all” for costs that are not allocated elsewhere. Direct and indirect allocated expenses for November 2008, our test month, totaled [REDACTED]. Upon inquiry, the CPC informed us that approximately [REDACTED] of these costs pertained to Blue Card administrative fees. By comparison, overhead cost allocated via this cost center for the test month was [REDACTED].

Overhead expense accounts in this cost center include:

- External audit fees
- Travel
- Corporate sponsorship

Further cost center examples include:

- Chief Executive Officer
- Corporate Projects
- Corporate Capitalized Labor
- Law
- e-Business
- Data Networking Hardware & Software
- Fringe Benefits
- Facilities Projects
- Treasury
- State Administrative Services
- Decision Support

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- Class Action

The expenses included in these cost centers are allocated to the Plan in a variety of manners. Some are allocated in the same proportion as direct and indirect expenses are allocated to the Plan and the CPC's various lines of business. Class Action is a cost center that is used to aggregate outside legal expenses for litigation. The CPC informed us that these costs are allocated among the lines of business that are impacted by the litigation in some measure of the extent to which each is impacted.

Other overhead cost centers are allocated based on an analysis by the CPC of the lines of business and the relative benefit those lines of business receive from the various expenses in the cost center (i.e. – Corporate Projects, Corporate Capitalized Labor). Still others are allocated based on membership count (i.e. e-Business) or claims (i.e. State Administrative Services).

For the period of July 1, 2008 through June 30, 2009, total overhead costs were [REDACTED] and accounted for [REDACTED] of the administrative costs paid by the Plan to the CPC under the ASO Agreement.

The ASO Agreement does not preclude the inclusion of overhead costs described above and our procedures indicate the CPC allocated overhead to the Plan in a manner consistent with the CPC's other lines of business. However, we believe, especially in a "Cost Plus" agreement, it would be prudent to specifically define the allowable and unallowable overhead costs.

We noted one instance of non-compliance with the ASO Agreement as a result of our procedures. Exhibit A, Section 3.2 of the ASO Agreement requires the parties to work together in "good faith" at the end of the second (2nd) agreement period (June 30, 2008) to determine an appropriate cap on Cost Plus. According to Section 3.2, if such agreement could not be reached within 60 days following the end of the second (2nd) agreement period, the CPC was to determine and communicate a cap on Cost Plus according to the default formula set out by the agreement. Per our inquiry, the parties did not work together in determining an appropriate cap on Cost Plus, nor did the CPC determine and communicate the cap using the default formula as required by the agreement. In order to comply with the ASO Agreement, the calculation of the Cost Plus cap should occur each year.

We believe the lack of compliance with Section 3.2 of the ASO Agreement represented a missed opportunity for the Plan to potentially negotiate a Cost Plus cap that would more effectively limit future administrative and overhead costs charged by the CPC. In the absence of such negotiations, the CPC continued to charge the Plan the actual costs without evaluating their relationship to the cap.

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Following our inquiry of the parties regarding their compliance with Section 3.2 of the ASO Agreement, each party provided us with a calculation of the Cost Plus cap according to the default formula contained in the ASO Agreement. We did not perform any procedures to determine the accuracy of their calculations and make no representations as to their appropriateness. As calculated by the parties, the cap under the default formula was greater than the PMPM actually paid by the Plan [REDACTED] for the period July 1, 2008 through June 30, 2009.

RECOMMENDATIONS

As previously noted, the terms of the ASO Agreement are sufficiently non-specific as to allow the CPC to charge a portion of virtually all its expenses to the Group Health Plan. We recommend the Plan engage in discussions with the CPC to determine specific costs that should be identified for exclusion from allocation. The cost allocation methodology used by the CPC is sufficiently flexible to allow for specific adjustments and exclusions of costs.

We recommend the Plan enter into discussions with the CPC aimed at clarifying and providing transparency to the types of overhead expenses that will be charged to the Group Health Plan.

We also recommend a change to the default formula under Section 3.2.1 of the ASO Agreement. As currently written, the default formula allows costs to increase annually by CPI (Consumer Price Index) plus four (4.0) percentage points. In comparison, the average rate of inflation during the nine year period of 2000 through 2008 was 2.9%.