OFFICE OF RISK MANAGEMENT
COST SAVINGS UPDATE
FISCAL YEAR 2012

PERFORMANCE AUDIT
ISSUED JUNE 19, 2013

LOUISIANA LEGISLATIVE AUDITOR
1600 NORTH THIRD STREET
POST OFFICE BOX 94397
BATON ROUGE, LOUISIANA 70804-9397

LEGISLATIVE AUDITOR
DARYL G. PURPERA, CPA, CFE

FIRST ASSISTANT LEGISLATIVE AUDITOR AND STATE AUDIT SERVICES
PAUL E. PENDAS, CPA

DIRECTOR OF PERFORMANCE AUDIT SERVICES
NICOLE B. EDMONSON, CIA, CGAP, MPA

FOR QUESTIONS RELATED TO THIS PERFORMANCE AUDIT, CONTACT EMILY WILSON, PERFORMANCE AUDIT MANAGER, AT 225-339-3800.

Under the provisions of state law, this report is a public document. A copy of this report has been submitted to the Governor, to the Attorney General, and to other public officials as required by state law. A copy of this report is available for public inspection at the Baton Rouge office of the Louisiana Legislative Auditor.

This document is produced by the Louisiana Legislative Auditor, State of Louisiana, Post Office Box 94397, Baton Rouge, Louisiana 70804-9397 in accordance with Louisiana Revised Statute 24:513. Four copies of this public document were produced at an approximate cost of $18.28. This material was produced in accordance with the standards for state agencies established pursuant to R.S. 43:31. This report is available on the Legislative Auditor's website at www.lla.la.gov. When contacting the office, you may refer to Agency ID No. 9726 or Report ID No. 40120066 for additional information.

In compliance with the Americans With Disabilities Act, if you need special assistance relative to this document, or any documents of the Legislative Auditor, please contact Kerry Fitzgerald, Chief Administrative Officer, at 225-339-3800.

LOUISIANA LEGISLATIVE AUDITOR
DARYL G. PURPERA, CPA, CFE

June 19, 2013

The Honorable John A. Alario, Jr.,
President of the Senate
The Honorable Charles E. "Chuck" Kleckley,
Speaker of the House of Representatives

Dear Senator Alario and Representative Kleckley:

This report provides the current status of the Division of Administration's Office of Risk Management (ORM) contract with F.A. Richard & Associates as of April 30, 2013. This report also provides an update of the cost savings as of June 30, 2012, the end of the second year of the five-year contract. Appendix A contains ORM's response to this report. I hope this report will benefit you in your legislative decision-making process.

We would like to express our appreciation to the management and staff of ORM for their assistance during this audit.

Sincerely,

Daryl G. Purpera, CPA, CFE
Legislative Auditor

DGP/ch

ORM 2013

1600 NORTH THIRD STREET • POST OFFICE BOX 94397 • BATON ROUGE, LOUISIANA 70804-9397
WWW.LLA.LA.GOV • PHONE: 225-339-3800 • FAX: 225-339-3870

Louisiana Legislative Auditor
Daryl G. Purpera, CPA, CFE

Office of Risk Management
Cost Savings Update - Fiscal Year 2012

June 2013

Audit Control # 40120066

Introduction

This report provides the current status of the Division of Administration's (DOA) Office of Risk Management (ORM) contract with F.A. Richard & Associates (FARA) as of April 30, 2013, and an update of the cost savings results as of June 30, 2012.[1] We conducted this audit as a follow-up to our July 2012 performance audit that contained the cost savings results as of June 30, 2011, the end of the first year of the five-year contract. Appendix A contains ORM's response to this report and Appendix B details our scope and methodology. Our objectives were as follows:

> **Objective 1: What is the chronology and current status of ORM's contract with FARA as of April 30, 2013?**
>
> **Objective 2: What is the status of the cost savings results from ORM's contract with FARA as of June 30, 2012?**

Background

ORM's Contract with FARA. On June 8, 2010, ORM awarded FARA a contract to privatize the state's lines of insurance and loss prevention services. The original amount of the contract was $68,118,971 and was amended on April 7, 2011, to the total amount of $74,930,868 (an increase of 10%). According to ORM, additional funds were needed for the acceleration of the lines of insurance to FARA because of the high turnover of ORM employees. This is a five-year contract beginning July 1, 2010 and ending on June 30, 2015.

Cost Savings to be Achieved from the Contract. With this contract, FARA guarantees savings of $50 million in *claims and litigation payments*[2] to the State of Louisiana. ORM projected net program savings of $22 million as a result of the FARA contract. Net program savings consist of *claims and litigation payment savings* and *administrative and other cost savings.* In addition to FARA's $50 million in guaranteed savings, ORM will need $40 million in *administrative and other cost savings* to achieve its projection of $22 million in net program savings mentioned above. This savings does not take into account the $6.8 million cost increase from the amendment.

[1] ORM provided our office with the results of its cost savings analysis on March 25, 2013.
[2] According to the contract, the guaranteed savings include payment savings in the categories of Claims and Related, Division of Risk Litigation, and Contract Litigation.

Objective 1: What is the chronology and current status of ORM's contract with FARA as of April 30, 2013?

As of April 30, 2013, ORM had transferred seven of its nine lines of insurance and associated services to FARA. This completed the first three phases of the implementation schedule. According to the contract, Phase IV is scheduled to transfer by November 1, 2013, but ORM anticipates that it will accelerate this transfer to FARA on July 1, 2013. Exhibit 1 lists the four phases of the transfer of ORM's nine lines of insurance and associated services, including the implementation dates.

Exhibit 1
Implementation Schedule
As of April 2013

Phase	Line of Insurance or Service	Original Contract Implementation Date	Actual and Revised Implementation Date
I	• Loss Prevention Services	9/1/2010	7/2/2010
	• Workers' Compensation		9/1/2010
	• Subrogation Recovery		9/1/2010
	• Second Injury Fund Recovery		9/1/2010
II	• Property	1/1/2012	1/16/2012
III	• Medical Malpractice	1/1/2013	8/1/2012
	• General Liability		7/1/2011
IV	• Road Hazard • Auto Liability/Physical Damage	11/1/2013	ORM estimates accelerated transfer date of 7/1/2013.

Source: Prepared by legislative auditor's staff using information provided by ORM.

Staffing. As of April 2013, ORM had reduced its staff from 140 to 79 employees, a reduction of 61 employees (43.6%) from fiscal year 2010.[3] According to ORM, once all of its lines of insurance and associated services have transferred to FARA, its staff will be further reduced by 19 full-time positions, leaving a staff of 60 employees.[4] This will be a total decrease of approximately 80 (57%) employees from fiscal year 2010.[5]

Chronology of FARA Contract. Exhibit 2 shows a detailed chronology of the privatization of ORM's lines of insurance and associated services to FARA from September 2009 through June 2015.

[3] Total employee counts include full-time, part-time, and student worker positions and vacancies.
[4] The remaining 60 employees will staff ORM's legal, underwriting, information technology, contracts, accounting, and administrative functions.
[5] In our July 2012 report, ORM estimated a total decrease of 90 employees once the implementation schedule is complete. This decrease included the loss of student workers, but ORM currently cannot project how many student workers it will lose after the final implementation occurs.

Exhibit 2
Chronology of the Privatization of ORM's Lines of Insurance and Associated Services
September 2009 through April 2013

Date	Description
September 2009	In 2009, the Division of Administration (DOA) consults with the Reason Foundation to determine which of ORM's services could potentially be provided by the private sector. On September 2, 2009, the Reason Foundation presents to the Streamlining Commission that DOA has a key privatization opportunity with the claims processing function of ORM.
November 2009	On November 13, 2009, ORM issues a request for proposal (RFP) for Claims Administration and Loss Prevention Services.
March 2010	On March 15, 2010, the evaluation committee completes its final evaluations and the Commissioner of Administration selects FARA to privatize ORM's lines of insurance and associated services.
May 2010	On May 19, 2010, ORM justifies the privatization of its lines of insurance and associated services to the Joint Legislative Committee on the Budget (JLCB), including the advantages of privatization, the estimated cost savings, and the reduction of 85 ORM employees over 40 months. Since the RFP was for a five-year contract, ORM had to obtain JLCB's approval per R.S. 39:1514(D). On May 27, 2010, ORM presents the results of the evaluation committee's selection of FARA to the JLCB.
June 2010	On June 8, 2010, ORM awards FARA a contract to privatize the state's lines of insurance and associated services for a total of $68,118,971 over five years.
July 2010	On July 2, 2010, ORM accelerates the transfer of Loss Prevention over to FARA from the original implementation date of September 1, 2010, because of the high turnover of ORM employees. (PHASE I) Per the contract, FARA is required to offer employment to all ORM employees displaced by the implementation of the contract for a minimum of one year.
September 2010	On September 1, 2010, Workers' Compensation, Subrogation Recovery, and Second Injury Fund Recovery transfer over to FARA. (PHASE I)
April 2011	On April 7, 2011, ORM amends the contract amount from $68,118,971 to $74,930,868 (an increase of 10%) for the acceleration of the transfer of General Liability and any additional lines of insurance to FARA.
May 2011	On May 10, 2011, the House Appropriations Committee meets to discuss the performance of FARA and the 10% amendment. On May 20, 2011, Avizent acquires FARA; however, ORM states that this acquisition will not affect operations. FARA continues to employ Louisiana-based employees for the ORM contract.
July 2011	On July 1, 2011, ORM accelerates the transfer of General Liability over to FARA from the original implementation date of January 1, 2013, because of the high turnover of ORM employees. (PHASE III)
December 2011	On December 20, 2011, York Services Group acquires Avizent; however, ORM states that this acquisition will not affect operations. FARA continues to employ Louisiana-based employees for the ORM contract.

Exhibit 2
Chronology of the Privatization of ORM's Lines of Insurance and Associated Services
September 2009 through April 2013

Date	Description
January 2012	On January 16, 2012, ORM transfers Property over to FARA. The original implementation date of January 1, 2012, was delayed to allow for additional time for testing and data conversion. (PHASE II)
April 2012	As of April 30, 2012, FARA employs 55 Louisiana-based employees in three offices for the ORM contract.
August 2012	On August 1, 2012, ORM transfers Medical Malpractice over to FARA, accelerating the original implementation date of January 1, 2013. (PHASE III)
April 2013	As of April 30, 2013, FARA employs 80 Louisiana-based employees in four offices for the ORM contract. Of these 80 Louisiana-based employees, eight are former ORM employees. The contract requires FARA to offer employment to all ORM employees displaced by privatization for at least one year.
November 2013 *(anticipated)*	FARA is scheduled to implement Road Hazard and Auto Liability/Physical Damage by November 1, 2013. However, as of April 30, 2013, ORM anticipates that it will accelerate the transfer of this phase to July 1, 2013. (PHASE IV)
June 2015 *(anticipated)*	The contract with FARA ends on June 30, 2015. According to ORM, it will create a new RFP for a third party administrator to administer the state's lines of insurance and loss prevention services prior to this date.

Source: Prepared by legislative auditor's staff using information provided by ORM.

Objective 2: What is the status of the cost savings results from ORM's contract with FARA as of June 30, 2012?

As discussed earlier in this report, ORM projects net program savings of $22 million as a result of the FARA contract. Net program savings consist of *claims and litigation payment savings* and *administrative and other cost savings* versus contract costs. FARA guarantees $50 million in *claims and litigation payment savings* to the state during the five-year term of its contract with ORM. In addition to the $50 million in guaranteed savings, ORM will need $40 million in *administrative and other cost savings* to achieve its projection of $22 million in net program savings.

ORM's cumulative cost savings results as of June 30, 2012, the end of the first two years of the FARA contract, in each of these categories is described below.

FARA achieved approximately $20.3 million (40.6%) of the $50 million in *claims and litigation payment savings* guaranteed by the contract.

As of June 30, 2012, ORM calculated[6] that FARA had cumulatively reduced *claims and litigation payment savings* by approximately $20.3 million (40.6%) of the $50 million in payment savings the contract guarantees. These savings are approximately 26.9% ahead of schedule for fiscal year 2012 based on ORM's projections. ORM had projected cumulative *claims and litigation payment savings* of approximately $4.8 million in fiscal year 2011 and $11.2 million in fiscal year 2012, for a total of $16 million for the first two years of the FARA contract, as shown in Appendix D (see "Less proposed savings - Claims").

If FARA does not achieve the $50 million in *claims and litigation payment savings*, it must refund the state 3% of the shortfall, up to $1.5 million, which is approximately 2% of the $68.1 million contract.[7] If FARA exceeds the $50 million in savings, the state will pay an additional 3% of the savings greater than $50 million, up to $1.5 million or the maximum of the contract, whichever is less.

[6] ORM's cost savings analysis is based on the difference between projected costs if ORM had not privatized versus the actual amount of expenditures incurred by FARA since the privatization. See Appendix C for ORM's methodology for projected costs, which we reviewed for reliability and reasonableness.
[7] According to the contract, savings measurement will include adjustments for material changes which are beyond FARA's control, such as changes in law, natural disasters, disruption in the planned contract term, etc.

ORM achieved savings of approximately $6.6 million (16.5%) of the $40 million in *administrative and other cost savings* it needs to achieve its projected net program savings of $22 million.

As of June 30, 2012, ORM had achieved approximately $6.6 million (16.5%) of the *administrative and other cost savings* it needs to achieve $22 million in net savings. Therefore, ORM has three years to achieve the remaining $33.4 million (83.5%). ORM did not develop projections for the amount of *administrative and other cost savings* it would attain during each year of the contract. According to ORM, the remaining $33.4 million *in administrative and other cost savings* will come from reductions in budget items such as contract costs, salaries and benefits, office rent, telecommunications, software licenses, etc.

ORM achieved approximately $10.3 million (46.8%) of the $22 million it projects in net program savings.

Taking into account FARA's *claims and litigation payment savings*, ORM's *administrative and other cost savings*, and the approximately $16.6 million (24.4%) that ORM has paid FARA toward the original contract cost of $68.1 million, net program savings as of June 30, 2012, is approximately $10.3 million. The calculation is as follows:

> *Cumulative Two Year Contract Costs ($16.6 million) - Administrative and Other Cost Savings ($6.6 million) - Claims and Litigation Payment Savings ($20.3 million) =*
> ***$10.3 million Net Program Savings***

This amount is approximately 46.8% of the $22 million ORM projects in net program savings over the five-year contract period. ORM had projected additional program costs of approximately $659,000 in fiscal year 2011 and net savings of approximately $5.4 million in fiscal year 2012 for cumulative program cost savings of approximately $4.7 million after year two of the FARA contract, as shown in Appendix D [see "Net Program Costs/(Savings)"]. Therefore, the cumulative net program savings of $10.3 million for fiscal year 2012 are ahead of schedule by approximately 119% based on ORM's projections.

APPENDIX A: MANAGEMENT'S RESPONSE

BOBBY JINDAL
GOVERNOR

KRISTY H. NICHOLS
COMMISSIONER OF ADMINISTRATION

State of Louisiana

Division of Administration
Office of Risk Management

June 7, 2013

Mr. Daryl Purpera, CPA
Legislative Auditor
1600 North Third Street
Post Office Box 94397
Baton Rouge, LA 70804-9397

Re: Response to Performance Audit Report on Cost Savings Update on the Division of Administration's Office of Risk Management

Dear Mr. Purpera:

The State of Louisiana Division of Administration (DOA) would like to thank you and your staff for conducting a performance audit update on the chronology, current status and update of the cost savings of the Office of Risk Management (ORM's) contract with F.A. Richard & Associates (FARA). As you noted, the final phase of this contract will be implemented in July 2013, and will result in the privatization of claims administration for all lines of coverage as well as for loss prevention services.

In monitoring and managing the cumulative fiscal outcomes of the phased privatization of claims administration and loss prevention services through the FARA contract, ORM has focused on two objectives:

- Analysis of claims and litigation payment savings to ensure that FARA's contractual savings guarantee of $50 million is on course.

- Analysis of net savings under the FARA contract to make certain that the projected $22 million reduction in total program cost for the risk management program overall is accomplished.

I am happy to see that your report – which covers contract performance through June 30, 2012, or the end of the second year of the five-year contract – confirms that the results have already significantly exceeded expectations. As the report notes, claims and litigation payment savings of approximately $20.3 million are about 27 percent ahead of schedule compared to ORM's original projections. Even more impressively, cumulative net program savings of $10.3 million through fiscal year 2012 are ahead of schedule by almost 120 percent.

ORM management will continue to work diligently in monitoring both the contract services and related fiscal impact to make sure that this cost-saving initiative continues to show positive results for the state.

Sincerely,

J.S. "Bud" Thompson, Jr.
State Risk Director

CC: Kristy H. Nichols
Patti Gonzalez
Marsha Pemble
Ann Wax
Steven Procopio
Marsha Guedry
Michael DiResto
Monique Appeaning
Ray Stockstill

ORM Response to LLA Performance Audit 6-7-13.docx

APPENDIX B: SCOPE AND METHODOLOGY

We conducted this review under the provisions of Title 24 of the Louisiana Revised Statutes of 1950, as amended. We conducted this audit in response to legislative interest. Our review focused on the privatization of ORM and the outsourcing of its services to FARA, and covered the period from July 1, 2011 through April 30, 2013. The audit objectives were to answer the following questions:

1. What is the chronology and current status of ORM's contract with FARA as of April 30, 2013?

2. What is the status of the cost savings results from ORM's contract with FARA as of June 30, 2012?

We conducted this performance audit in accordance with generally accepted government auditing standards issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our 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. To answer our objectives, we reviewed internal controls relevant to the audit objectives and performed the following audit steps:

- Received ORM's summary of cumulative cost savings for the FARA contract as of June 30, 2012, on March 25, 2013.

- Interviewed ORM staff to determine the updated chronology of ORM's contract with FARA through April 30, 2013.

- Obtained and analyzed the reliability and reasonableness of ORM's estimated cost savings methodology (Appendix C) and analysis for fiscal year 2012.

- Tested a sample of ORM's calculations of estimated cost savings from independent expenditure documentation for fiscal year 2012.

- Verified ORM's actual contract costs with ISIS data using the Expenditure report from Business Objects.

- Verified ORM's projected cost for the lines of insurance transferred to FARA using the cost savings methodology in Appendix C and supporting documentation received from ORM management.

- Verified ORM's actual cost for the lines of insurance transferred to FARA using supporting documents from ORM and data dumps of individual transactions from FARA's claims processing system (ICE). In addition to the data dumps, some actual expenditures for other claims related costs were verified to the Expenditure report from Business Objects.

- Recalculated ORM's projected costs and actual costs and reconciled the amounts to supporting documentation to determine reliability. Confirmed these calculations with ORM staff.

APPENDIX C: ORM'S METHODOLOGY FOR PROJECTING COSTS

Note: *ORM had not formalized its methodology for projecting costs associated with the FARA contract when we conducted the cost savings analysis for our July 2012 performance audit. However, it has since formalized the process, as outlined below, and plans to use the same methodology for the remaining three years of the FARA contract.*

According to ORM, ORM calculated cost savings through privatization to FARA based on Projected In-House Program Costs (Projected Costs) compared to actual expenditures. Projected costs represent the estimated total cost to ORM had it continued to operate the program in-house rather than outsourcing claims administration and loss prevention to a private provider. Five-year (fiscal year 2011 through fiscal year 2015) projected cost estimates were developed by ORM's accounting unit during the contract evaluation process in fiscal year 2010. These costs were summarized by ORM's four budget programs: Administration, Claims and Related, Contract Litigation, and Division of Risk Litigation.

The contract required implementation using a phased approach; therefore, evaluation was necessary to split the summary projected costs into categories to define projected costs allocable to in-house lines of business and the lines handled by FARA under the phased implementation. This work was completed by ORM's accounting unit and based on the following assumptions:

- **Workers' Compensation.** Since this line of business is predisposed to follow predictable trends, the actual historical costs incurred by ORM in Fiscal Year 2010 served as the starting point to arrive at projects costs allocable to Workers' Compensation. Annual inflation factors were applied to Indemnity and Medical costs using Louisiana trend data compiled by the National Council on Compensation Insurance, Inc., to estimate realistic projected costs for comparison to actual costs of Workers' Compensation Claims Administration under FARA. An annual inflation factor of 1.6% was used to project costs in the Contract Litigation and Division of Risk Litigation programs. Annual inflation factors were developed for other cost categories of the Workers' Compensation line of business using the Consumer Price Index data published by the Bureau of Labor Statistics of the U.S. Department of Labor.
- **General Liability.** Since this line of business is less predictable, a different approach was developed to estimate realistic projected costs for comparison to actual costs of General Liability Claims Administration under FARA. The average of three prior fiscal years of historical cost incurred by ORM served as the starting point to arrive at the allocation of projected costs for General Liability. Projected in-house program cost estimates for fiscal year 2012 were based on the average of actual data from fiscal year 2009, fiscal year 2010, and fiscal year 2011. An annual inflation factor of 1.6% was used to project costs in the Contract Litigation and Division of Risk Litigation programs. Annual inflations factors were developed for all other costs of the General Liability line of business using the Consumer Price Index data published by the Bureau of Labor Statistics of the U.S. Department of Labor.

APPENDIX D: ESTIMATED TOTAL PROGRAM COSTS AND NET SAVINGS
FISCAL YEAR 2011 THROUGH FISCAL YEAR 2015

		FY10-11	FY11-12	FY12-13	FY13-14	FY14-15	5 Year Total
ORM In-house	Administration	$13,455,132	$13,719,609	$14,170,188	$14,662,661	$15,242,043	$71,249,633
	Claims and Related	260,741,997	211,499,667	224,812,818	239,457,094	255,565,607	1,192,077,183
	Division of Risk Litigation	17,311,747	17,588,735	17,870,154	18,156,077	18,446,574	89,373,287
	Contract Litigation	13,967,380	14,190,858	14,417,912	14,648,598	14,882,976	72,107,724
	Less savings from planned improvements - Subrogation Recovery contract	(450,000)	(900,000)	(900,000)	(900,000)	(900,000)	(4,050,000)
	Less savings from planned improvements - Pharmacy Benefit Manager	(562,500)	(750,000)	(750,000)	(750,000)	(750,000)	(3,562,500)
	TOTAL PROGRAM COSTS	**$304,463,756**	**$255,348,869**	**$269,621,072**	**$285,274,430**	**$302,487,200**	**$1,417,195,327**
FARA - savings per vendor	Original Contract cost*	$10,002,833	$11,216,448	$14,070,715	$16,261,603	$16,567,373	$68,118,972
	Plus estimated ORM costs - Administration	10,658,786	9,921,349	8,419,292	6,894,600	6,845,560	42,739,587
	Plus estimated ORM costs - Claims and Related	257,996,997	208,205,167	220,963,868	235,048,249	251,090,877	1,173,305,158
	Plus estimated ORM costs - Division of Risk Litigation	17,311,747	17,588,735	17,870,154	18,156,077	18,446,574	89,373,287
	Plus estimated ORM costs - Contract Litigation	13,967,380	14,190,858	14,417,912	14,648,598	14,882,976	72,107,724
	Less proposed savings - Claims	(4,815,000)	(11,159,000)	(11,419,000)	(11,666,000)	(11,611,000)	(50,670,000)
	TOTAL PROGRAM COSTS	**$305,122,743**	**$249,963,557**	**$264,322,941**	**$279,343,127**	**$296,222,360**	**$1,394,974,728**
	Net Program Costs/(Savings)	**$658,987**	**($5,385,312)**	**($5,298,131)**	**($5,931,303)**	**($6,264,840)**	**($22,220,599)**

*ORM based all cost savings estimations on the original contract cost and did not re-estimate based on the 10% increase approved in April 2010.
Note: The green shaded columns denote the two fiscal years covered in this report.
Source: Prepared by legislative auditor's staff using information provided by ORM.