DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

Washington, D.C. 20201

JUL 29 2004

TO: Wynethea Walker
Acting Director, Audit Liaison Staff
Centers for Medicare & Medicaid Services

FROM: Joseph E. Vengrin
Deputy Inspector General for Audit Services

SUBJECT: Audit of Pension Costs Claimed for Medicare Reimbursement by Blue Cross and Blue Shield of Texas, Inc. (A-07-03-03046)

Attached is an advance copy of our final report on pension costs claimed for Medicare reimbursement by Blue Cross and Blue Shield of Texas, Inc. (Texas). We will issue this report to Texas within 5 business days. We suggest that you share this report with the Centers for Medicare & Medicaid Services (CMS) components involved with monitoring the Medicare contractors' financial operations, particularly the Office of Financial Management, the Center for Medicare Management, and the Office of the Actuary.

Texas administered Medicare Part A and Part B operations under cost reimbursement contracts with CMS from the start of the Medicare program until the contractual relationship was terminated effective September 30, 1999. In claiming costs, contractors are to follow the principles contained in the Federal Acquisition Regulations, Cost Accounting Standards (CAS), and Medicare contracts.

Our objectives were to determine whether Texas (1) claimed allowable pension costs for Medicare reimbursement for fiscal year (FY) 1995 through FY 1999 and (2) implemented a prior audit recommendation pertaining to FY 1994.

Texas allocated total company CAS pension costs to Medicare for FYs 1995–99. Separately calculated Medicare segment pension costs were materially lower than the claimed allocated pension costs for this same period. The Medicare contract required that pension costs for a Medicare segment be separately calculated when such calculation materially affected the pension costs allocated to the Medicare segment. Because Texas did not separately calculate costs, it overclaimed $2,149,372 in pension costs on its Final Administrative Cost Proposals (FACP) for FYs 1995–99. Texas believed that its allocation methodology was in compliance with the Medicare contract.

Also, Texas did not implement a prior audit recommendation to adjust pension costs on its FY 1994 FACP.

We recommend that Texas remit $3,023,483 ($2,149,372 for FYs 1995–99 and $874,111 for FY 1994) to the Federal Government for the unallowable pension costs claimed on its FACPs as of FY 1999.

Texas stated that its pension cost calculation was in accordance with CAS and that its voluntary cost reductions had implemented the prior audit recommendation. Texas's comments are included in their entirety as Appendix B.

Regardless of whether Texas's pension cost calculations were in accordance with CAS, its methodology for allocating pension costs to the Medicare segment was not in accordance with the Medicare contract. Also, Texas did not provide adequate documentation to show that it had implemented the prior audit recommendation.

If you have any questions or comments about this report, please do not hesitate to call me, or your staff may contact George M. Reeb, Assistant Inspector General for the Centers for Medicare & Medicaid Audits, at (410) 786-7104 or James P. Aasmundstad, Regional Inspector General, Region VII, at (816) 426-3591, extension 225. Please refer to report number A-07-03-03046 in all correspondence.

Attachment

DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General
Offices of Audit Services

Region VII
601 East 12th Street
Room 284A
Kansas City, Missouri 64106

JUL 30 2004

Report Number: A-07-03-03046

Ms. Susan E. Gajda
Vice President
Audit and Performance Services
Health Care Service Corporation
300 East Randolph Street, 11th Floor
Chicago, Illinois 60601-5099

Dear Ms. Gajda:

Enclosed are two copies of the Department of Health and Human Services (HHS), Office of Inspector General (OIG) final report entitled "Audit of Pension Costs Claimed for Medicare Reimbursement by Blue Cross and Blue Shield of Texas, Inc." A copy of this report will be forwarded to the action official noted below for review and any action deemed necessary.

Final determination as to actions taken on all matters reported will be made by the HHS action official named below. We request that you respond to the HHS action official within 30 days from the date of this letter. Your response should present any comments or additional information that you believe may have a bearing on the final determination.

In accordance with the principles of the Freedom of Information Act (5 U.S.C. § 552, as amended by Public Law 104-231), OIG reports issued to the Department's grantees and contractors are made available to members of the press and general public to the extent the information is not subject to exemptions in the Act that the Department chooses to exercise (see 45 CFR part 5).

Please refer to report number A-07-03-03046 in all correspondence.

Sincerely yours,

James P. Aasmundstad
Regional Inspector General
for Audit Services

Enclosures

Direct Reply to HHS Action Official:

James R. Farris, M.D.
Regional Administrator
Centers for Medicare & Medicaid Services
1301 Young Street, Room 714
Dallas, Texas 75202

Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

AUDIT OF PENSION COSTS CLAIMED FOR MEDICARE REIMBURSEMENT BY BLUE CROSS AND BLUE SHIELD OF TEXAS, INC.

JULY 2004
A-07-03-03046

Office of Inspector General

http://oig.hhs.gov

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In accordance with the principles of the Freedom of Information Act (5 U.S.C. 552, as amended by Public Law 104-231), Office of Inspector General, Office of Audit Services reports are made available to members of the public to the extent the information is not subject to exemptions in the act. (See 45 CFR part 5.)

OAS FINDINGS AND OPINIONS

The designation of financial or management practices as questionable or a recommendation for the disallowance of costs incurred or claimed, as well as other conclusions and recommendations in this report, represent the findings and opinions of the HHS/OIG/OAS. Authorized officials of the HHS divisions will make final determination on these matters.

EXECUTIVE SUMMARY

BACKGROUND

Blue Cross and Blue Shield of Texas, Inc. (Texas) administered Medicare Part A and Part B operations under cost reimbursement contracts with the Centers for Medicare & Medicaid Services (CMS) until the contractual relationship was terminated effective September 30, 1999.

Since its inception, Medicare has paid a portion of Medicare contractors' annual contributions to their pension plans. In claiming costs, contractors are to follow the principles contained in the Federal Acquisition Regulations (FAR), Cost Accounting Standards (CAS), and Medicare contracts.

The Medicare contracts provide for either an allocation or a separate calculation of pension costs. However, the separate calculation method must be used if the two methods produce materially different results.

OBJECTIVES

Our objectives were to determine whether Texas (1) claimed allowable pension costs for Medicare reimbursement for fiscal year (FY) 1995 through FY 1999 and (2) implemented a prior audit recommendation pertaining to FY 1994.

SUMMARY OF FINDINGS

Texas allocated total company CAS pension costs to the Medicare segment for FYs 1995–99. Separately calculated Medicare segment pension costs were materially lower than the claimed allocated pension costs for this same period. The Medicare contract required that pension costs for a Medicare segment be separately calculated when such calculation materially affected the pension costs allocated to the Medicare segment. Because Texas did not separately calculate costs, it overclaimed $2,149,372 in pension costs on its Final Administrative Cost Proposals (FACP) for FYs 1995–99. Texas believed that its allocation methodology was in compliance with the Medicare contract.

In a previous audit report, we recommended that Texas revise its FACP for FY 1994 to eliminate $874,111 of pension costs in excess of the allowable CAS pension costs. Texas believed that it had made the adjustment through voluntary reductions. However, Texas did not provide adequate documentation to show that the voluntary reductions had implemented the prior recommendation. Therefore, Texas's overclaim of $874,111 in pension costs for FY 1994 is still outstanding.

RECOMMENDATION

We recommend that Texas remit $3,023,483 ($2,149,372 for FYs 1995–99 and $874,111 for FY 1994) to the Federal Government for the unallowable pension costs claimed on its FACPs as of FY 1999.

AUDITEE'S COMMENTS

Texas stated that its pension cost calculation was in accordance with CAS and that its voluntary cost reductions had implemented the prior audit recommendation. Texas's comments are included in their entirety as Appendix B.

OFFICE OF INSPECTOR GENERAL RESPONSE

Regardless of whether Texas's pension cost calculations were in accordance with CAS, its methodology for allocating pension costs to the Medicare segment was not in accordance with the Medicare contract. Also, Texas did not provide adequate documentation to show that it had implemented the prior audit recommendation.

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Glossary of Abbreviations and Acronyms

CAS	Cost Accounting Standards
CMS	Centers for Medicare & Medicaid Services
FACP	Final Administrative Cost Proposal
FAR	Federal Acquisition Regulations
FY	Fiscal Year
OIG	Office of Inspector General

INTRODUCTION

BACKGROUND

Medicare

Texas administered Medicare Part A and Part B operations under cost reimbursement contracts with CMS until the contractual relationship was terminated effective September 30, 1999.

Since its inception, Medicare has paid a portion of contractors' annual pension costs. In claiming costs, contractors are to follow the principles contained in FAR, CAS, and Medicare contracts. To be allowable for Medicare reimbursement, pension costs must be (1) measured, assigned, and allocated in accordance with CAS 412 and CAS 413 and (2) funded as specified by part 31 of FAR.

CMS contracts provide for either an allocation or a separate calculation of pension costs. Under the allocation method, the contractor determines total plan CAS pension costs and allocates a share to Medicare. Under the separate calculation method, the contractor separately identifies the normal costs and amortization for the Medicare segment. The separate calculation method must be used if the two methods produce materially different results.

Regulations

The Medicare contract states: "The calculation of and accounting for pension costs charged to this agreement/contract are governed by the Federal Acquisition Regulation and Cost Accounting Standards 412 and 413."

FAR addresses allowability of pension costs and requires them to be substantiated by funding. CAS 412 regulates the determination and measurement of the components of pension costs. It also regulates the assignment of pension costs to accounting periods. CAS 413 regulates the valuation of pension assets, allocation of pension costs to segments of an organization, adjustment of pension costs for actuarial gains and losses, and assignment of gains and losses to cost accounting periods.

Texas

CMS awarded Texas Medicare A and Medicare B contracts in 1966. Texas formed Trailblazers Health Enterprises, DBA in 1998. Texas merged with Health Care Services Corporation in 1999. After the merger, Texas terminated its contract on September 30, 1999 and closed its Medicare segment.

OBJECTIVES, SCOPE, AND METHODOLOGY

Objectives

Our objectives were to determine whether Texas (1) claimed allowable pension costs for Medicare reimbursement for FY 1995 through FY 1999 and (2) implemented a prior audit recommendation pertaining to FY 1994.

Scope

We reviewed pension costs claimed on Texas's FACPs for Medicare reimbursement for FYs 1994–99. We did not review Texas's internal control structure because it was not relevant to our objectives.

Methodology

We identified Texas's CAS pension costs for the total company and for the Medicare segment. We also determined the extent to which Texas funded CAS pension costs with contributions to the pension trust fund. Using this information, we calculated CAS pension costs that were allowable for Medicare reimbursement for FYs 1995–99. We based the calculations on separately computed CAS pension costs for the Medicare segment and total company CAS pension costs. We worked with the CMS pension actuarial staff to develop a methodology for computing allowable CAS pension costs based on Texas's historical practices. Appendix A contains the details of the pension costs and contributions.

In conducting our review, we used information provided by Texas's actuarial firm, Watson Wyatt Worldwide. The information included pension assets, liabilities, normal costs, contributions, benefit payments, investment earnings, and administrative expenses. We examined Texas's accounting records, pension plan documents, annual actuarial valuation reports, FACPs, and Department of Labor/Internal Revenue Service Form 5500s.

We performed our review in conjunction with a review of Texas's pension segmentation closing (A-07-02-03032, issued June 29, 2004). We used the information obtained and reviewed during that audit in performing this review.

We conducted our audit in accordance with generally accepted government auditing standards.

FINDINGS AND RECOMMENDATION

Texas allocated total company CAS pension costs to the Medicare segment for FYs 1995–99. Separately calculated Medicare segment pension costs were materially lower than the claimed allocated pension costs for this same period. The Medicare contract required that pension costs for a Medicare segment be separately calculated when such calculation materially affected the pension costs allocated to the Medicare segment. Because Texas did not separately calculate costs, it overclaimed $2,149,372 in pension costs on its FACPs for FYs 1995–99. Texas believed that its allocation methodology was in compliance with the Medicare contract.

In addition, Texas did not implement a prior audit recommendation to adjust pension costs on its FY 1994 FACP.

TEXAS ALLOCATED TOTAL COMPANY PENSION COSTS TO THE MEDICARE SEGMENT

According to the Medicare contract, pension costs for a Medicare segment may be allocated or separately calculated, but must be separately calculated when the calculation method materially affects CAS pension costs allocated to the Medicare segment.

Texas allocated total company CAS pension costs to the Medicare segment for FYs 1995–99. Texas's actuary assigned a portion of these costs to plan participants using individual participants' actuarial accrued liability and normal costs. Texas then accumulated the costs by cost center and line of business. Based on this methodology, Texas claimed $22,660,588 in pension costs for reimbursement for FYs 1995–99. However, separately calculated pension costs for the Medicare segment totaled $20,511,216 for this same period. Therefore, a material difference of $2,149,372 existed between the allocated pension costs and the separately calculated pension costs. The $2,149,372 in pension costs represents an overclaim for FYs 1995–99.

The following schedule compares Texas's allocated pension costs claimed on its FACPs with separately calculated CAS pension costs.

PENSION COST CLAIMED VARIANCE

FY	Per Texas	Per OIG	Difference
1995	$4,400,515	$3,947,386	($453,129)
1996	3,555,364	4,228,948	673,584
1997	4,585,355	4,151,680	(433,675)
1998	5,447,292	4,697,709	(749,583)
1999	4,672,062	3,485,493	(1,186,569)
	$22,660,588	**$20,511,216**	**($2,149,372)**

Texas believed that its methodology for allocating total company pension costs to the Medicare segment was in compliance with the Medicare contract.

TEXAS DID NOT IMPLEMENT PRIOR AUDIT RECOMMENDATION

In a previous audit report,[1] we recommended that Texas revise its FY 1994 FACP to eliminate $874,111 of pension costs claimed in excess of allowable CAS pension costs. Texas believed that it had made the adjustment through voluntary reductions. However, Texas did not provide adequate documentation to show that the reductions had implemented the recommendation. Therefore, Texas's overclaim of $874,111 in pension costs for FY 1994 is still outstanding.

RECOMMENDATION

We recommend that Texas remit $3,023,483 ($2,149,372 for FYs 1995–99 and $874,111 for FY 1994) to the Federal Government for the unallowable pension costs claimed on its FACPs as of FY 1999.

AUDITEE'S COMMENTS

Texas stated that its pension cost calculation was in accordance with CAS and asserted that its voluntary cost reductions implemented the prior audit recommendation. Texas's comments are

[1]A-07-95-01149, "Review of Pension Costs Claimed for Medicare Reimbursement by Blue Cross and Blue Shield of Texas," issued on July 11, 1995.

summarized in the following paragraphs and presented in their entirety as Appendix B. Texas's comments also address two other OIG reports. Our responses to those comments are included in the respective reports.

Allocated Pension Costs

Texas did not agree with our statement that its pension costs claimed were not in accordance with the Medicare contract. According to Texas, the allocated pension costs claimed were calculated using a methodology that we agreed to and were aligned with the intent of CAS, made in accordance with CAS, and equitable to the program. Texas further noted that its methodology was an allocation to the segment and to the segment's cost centers, based on individually and actuarially assigned CAS pension costs.

Prior Audit Recommendation

Texas also stated that it had made an adjustment to eliminate the $874,111 for pension costs claimed in excess of the allowable CAS pension costs, as recommended in our prior audit. As evidence of the adjustment, Texas provided a summary of its response to a "Risk Assessment" summary letter. According to Texas's response, "The required adjustment has already been made to the FY 1994 FACP . . . . It was included with various other adjustments on the workpapers which were audited and not separately identified . . . . There should be no further adjustment for this finding . . . ." Texas noted that this statement was consistent with its response to our previous audit.

OFFICE OF INSPECTOR GENERAL RESPONSE

Regardless of whether Texas's pension costs calculations were in accordance with CAS, its methodology for allocating pension costs to the Medicare segment was not in accordance with the Medicare contract as discussed below. Also, Texas did not provide adequate documentation to show that it had implemented the prior audit recommendation.

Allocated Pension Costs

We do not agree with Texas's statement concerning the allowability of its allocation methodology. The Medicare contract required pension costs to be separately calculated when a material difference existed between allocated pension costs and separately calculated pension costs.

Contrary to Texas's assertion that we approved its methodology, in two previous reviews we took exception to the methodology. In our initial review,[2] we noted that Texas did not separately calculate pension costs and recommended that Texas separately compute pension costs for the Medicare segments whenever material differences existed between allocated pension costs and separately computed pension costs. In our followup review,[3] we found that Texas continued to claim allocated pension costs and recommended that it revise its FACP for FY 1994 to eliminate the $874,111 for pension costs in excess of the allowable CAS pension costs mentioned above.

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[2]A-07-91-00472, "Audit of Medicare Contractor's Segmented Pension Cost, Blue Cross and Blue Shield of Texas, Inc.," issued on January 30, 1992.
[3]A-07-95-01149, "Review of Pension Costs Claimed for Medicare Reimbursement by Blue Cross and Blue Shield of Texas," issued on July 11, 1995.

We determined that there was a material difference of $2,149,372 between our separately calculated costs and Texas's allocated costs for FYs 1995–99.

Prior Audit Recommendation

We do not agree with Texas's statement that it had made an adjustment to eliminate the $874,111 for pension costs in excess of the allowable CAS pension costs. Texas provided no documentation showing that an adjustment had been made. According to a CMS official, "the FACP Risk Assessment indicates that the Pension FACP revision of $874,111 was not validated by HCFA [now CMS] and was not included in the settlement, collections, or closing agreements."

APPENDICES

BLUE CROSS BLUE SHIELD OF TEXAS/TRAILBLAZERS
STATEMENT OF ALLOWABLE PENSION COSTS
PLAN YEAR BEGINNING 1994 THROUGH PLAN YEAR BEGINNING 1999

Date	Description		Total Company	Other Segments	Medicare Segment # 1	Medicare Segment # 2	Medicare Segment # 3	Medicare Segment # 4	FEP Segment # 7
1995	Contribution(s)	1/	$17,429,064	$14,208,928	$123,512	$832,787	$1,917,210	$346,627	$0
	Discount for Interest	2/	(728,406)	(593,829)	(5,162)	(34,804)	(80,125)	(14,486)	0
04/01/1994	Pres Val Contributions	3/	16,700,658	13,615,099	118,350	797,983	1,837,085	332,141	0
04/01/1994	Prepayment Credit	4/	0	0	0	0	0	0	0
04/01/1994	Pres Value of Funding	5/	16,700,658	13,615,099	118,350	797,983	1,837,085	332,141	0
04/01/1994	Assigned Pension Cost	6/	9,118,333	6,032,775	118,350	797,982	1,837,085	332,141	0
04/01/1994	CAS Funding Target	7/	9,118,333	6,032,775	118,350	797,982	1,837,085	332,141	0
04/01/1994	% Funded	8/		100.00%	100.00%	100.00%	100.00%	100.00%	0.00%
04/01/1994	Funded Pension Cost	9/		6,032,775	118,350	797,982	1,837,085	332,141	0
	Allowable Interest	10/		263,122	5,162	34,804	80,125	14,486	0
	Allocable Pension Cost	11/		6,295,897	123,512	832,786	1,917,210	346,627	0
	Medicare LOB%	12/		5.80%	85.33%	22.17%	99.55%	99.55%	5.80%
	Allowable Pension Cost	13/	2,908,834	365,162	105,393	184,629	1,908,583	345,067	0

BLUE CROSS BLUE SHIELD OF TEXAS/TRAILBLAZERS
STATEMENT OF ALLOWABLE PENSION COSTS
PLAN YEAR BEGINNING 1994 THROUGH PLAN YEAR BEGINNING 1999

Date	Description	Total Company	Other Segments	Medicare Segment # 1	Medicare Segment # 2	Medicare Segment # 3	Medicare Segment # 4	FEP Segment # 7
1996	Contribution(s)	$13,179,301	$10,391,285	$94,099	$761,233	$1,932,684	$0	$0
	Discount for Interest	(419,883)	(331,059)	(2,998)	(24,252)	(61,574)	0	0
04/01/1995	Pres Val Contributions	12,759,418	10,060,226	91,101	736,981	1,871,110	0	0
04/01/1995	Prepayment Credit	8,188,911	5,247,089	99,290	803,228	2,039,304	0	0
04/01/1995	Pres Value of Funding	20,948,329	15,307,315	190,391	1,540,209	3,910,414	0	0
04/01/1995	Assigned Pension Cost	15,702,430	10,061,416	190,391	1,540,209	3,910,414	0	0
04/01/1995	CAS Funding Target	15,702,430	10,061,416	190,391	1,540,209	3,910,414	0	0
04/01/1995	% Funded		100.00%	100.00%	100.00%	100.00%	0.00%	0.00%
04/01/1995	Funded Pension Cost		10,061,416	190,391	1,540,209	3,910,414	0	0
	Allowable Interest		158,428	2,998	24,252	61,574	0	0
	Allocable Pension Cost		10,219,844	193,389	1,564,461	3,971,988	0	0
	Medicare LOB%		5.70%	78.22%	21.69%	98.51%	0.00%	5.70%
	Allowable Pension Cost	4,985,937	582,531	151,269	339,332	3,912,805	0	0
	Fiscal Year Pension Cost 14/	$3,947,385	$473,847	$128,331	$261,980	$2,910,694	$172,533	$0

BLUE CROSS BLUE SHIELD OF TEXAS/TRAILBLAZERS
STATEMENT OF ALLOWABLE PENSION COSTS
PLAN YEAR BEGINNING 1994 THROUGH PLAN YEAR BEGINNING 1999

Date	Description	Total Company	Other Segments	Medicare Segment # 1	Medicare Segment # 2	Medicare Segment # 3	Medicare Segment # 4	FEP Segment # 7
1997	Contribution(s)	$13,185,789	$10,952,971	$95,516	$553,871	$1,583,431	$0	$0
	Discount for Interest	(526,064)	(436,983)	(3,811)	(22,097)	(63,173)	0	0
04/01/1996	Pres Val Contributions	12,659,725	10,515,988	91,705	531,774	1,520,258	0	0
04/01/1996	Prepayment Credit	5,665,571	3,642,655	86,538	501,803	1,434,575	0	0
04/01/1996	Pres Value of Funding	18,325,296	14,158,643	178,243	1,033,577	2,954,833	0	0
04/01/1996	Assigned Pension Cost	11,669,533	7,502,879	178,244	1,033,577	2,954,833	0	0
04/01/1996	CAS Funding Target	11,669,533	7,502,879	178,244	1,033,577	2,954,833	0	0
04/01/1996	% Funded		100.00%	100.00%	100.00%	100.00%	0.00%	0.00%
04/01/1996	Funded Pension Cost		7,502,879	178,243	1,033,577	2,954,833	0	0
	Allowable Interest		160,408	3,811	22,097	63,173	0	0
	Allocable Pension Cost		7,663,287	182,054	1,055,674	3,018,006	0	0
	Fiscal Year Pension							
	Medicare LOB%		4.40%	53.51%	18.30%	94.24%	0.00%	4.40%
	Allowable Pension Cost	3,471,959	337,185	97,417	193,188	2,844,169	0	0
	Fiscal Year Pension Cost	$4,228,948	$459,858	$124,343	$266,260	$3,378,487	$0	$0

BLUE CROSS BLUE SHIELD OF TEXAS/TRAILBLAZERS
STATEMENT OF ALLOWABLE PENSION COSTS
PLAN YEAR BEGINNING 1994 THROUGH PLAN YEAR BEGINNING 1999

Date	Description	Total Company	Other Segments	Medicare Segment # 1	Medicare Segment # 2	Medicare Segment # 3	Medicare Segment # 4	FEP Segment # 7
1998	Contribution(s)	$17,029,639	$12,949,265	$148,163	$1,122,751	$2,438,145	$0	$371,315
	Discount for Interest	(690,899)	(525,358)	(6,011)	(45,550)	(98,916)	0	(15,064)
04/01/1997	Pres Val Contributions	16,338,740	12,423,907	142,152	1,077,201	2,339,229	0	356,251
04/01/1997	Prepayment Credit	7,188,224	4,464,842	98,889	749,363	1,627,302	0	247,828
04/01/1997	Pres Value of Funding	23,526,964	16,888,749	241,041	1,826,564	3,966,531	0	604,079
04/01/1997	Assigned Pension Cost	17,521,216	10,883,001	241,041	1,826,564	3,966,531	0	604,079
04/01/1997	CAS Funding Target	17,521,216	10,883,001	241,041	1,826,564	3,966,531	0	604,079
04/01/1997	% Funded		100.00%	100.00%	100.00%	100.00%	0.00%	100.00%
04/01/1997	Funded Pension Cost		10,883,001	241,041	1,826,564	3,966,531	0	604,079
	Allowable Interest		271,399	6,011	45,550	98,916	0	15,064
	Allocable Pension Cost		11,154,400	247,052	1,872,114	4,065,447	0	619,143
	Fiscal Year Pension Medicare LOB%		3.90%	69.68%	17.42%	95.29%	0.00%	3.90%
	Allowable Pension Cost	4,831,401	435,022	172,146	326,122	3,873,964	0	24,147
	Fiscal Year Pension Cost	$4,151,680	$386,104	$134,781	$259,655	$3,359,067	$0	$12,073

BLUE CROSS BLUE SHIELD OF TEXAS/TRAILBLAZERS
STATEMENT OF ALLOWABLE PENSION COSTS
PLAN YEAR BEGINNING 1994 THROUGH PLAN YEAR BEGINNING 1999

Date	Description	Total Company	Other Segments	Medicare Segment # 1	Medicare Segment # 2	Medicare Segment # 3	Medicare Segment # 4	FEP Segment # 7
1999	Contribution(s)	$12,870,206	$8,847,294	$137,557	$1,016,149	$2,308,672	$0	$560,534
	Discount for Interest	(529,204)	(363,788)	(5,656)	(41,783)	(94,929)	0	(23,048)
04/01/1998	Pres Val Contributions	12,341,002	8,483,506	131,901	974,366	2,213,743	0	537,486
04/01/1998	Prepayment Credit	6,486,208	3,767,456	92,964	686,731	1,560,238	0	378,819
04/01/1998	Pres Value of Funding	18,827,210	12,250,962	224,865	1,661,097	3,773,981	0	916,305
04/01/1998	Assigned Pension Cost	15,689,161	9,112,912	224,865	1,661,098	3,773,981	0	916,305
04/01/1998	CAS Funding Target	15,689,161	9,112,912	224,865	1,661,098	3,773,981	0	916,305
04/01/1998	% Funded		100.00%	100.00%	100.00%	100.00%	0.00%	100.00%
04/01/1998	Funded Pension Cost		9,112,912	224,865	1,661,097	3,773,981	0	916,305
	Allowable Interest		229,223	5,656	41,783	94,929	0	23,048
	Allocable Pension Cost		9,342,135	230,521	1,702,880	3,868,910	0	939,353
	Fiscal Year Pension Medicare LOB%		3.00%	65.63%	16.98%	98.61%	0.00%	3.00%
	Allowable Pension Cost	4,564,017	280,264	151,291	289,149	3,815,132	0	28,181
	Fiscal Year Pension Cost	$4,697,709	$357,643	$161,719	$307,635	$3,844,548	$0	$26,164

BLUE CROSS BLUE SHIELD OF TEXAS/TRAILBLAZERS
STATEMENT OF ALLOWABLE PENSION COSTS
PLAN YEAR BEGINNING 1994 THROUGH PLAN YEAR BEGINNING 1999

Date	Description	Total Company	Other Segments	Medicare Segment # 1	Medicare Segment # 2	Medicare Segment # 3	Medicare Segment # 4	FEP Segment # 7
1999	Contribution(s)	$8,233,665	$5,937,154	$72,297	$615,435	$1,292,777	$0	$316,002
	Discount for Interest	(490,391)	(353,612)	(4,306)	(36,655)	(76,997)	0	(18,821)
04/01/1999	Pres Val Contributions	7,743,274	5,583,542	67,991	578,780	1,215,780	0	297,181
04/01/1999	Prepayment Credit	3,389,093	1,943,975	45,494	387,273	813,501	0	198,850
04/01/1999	Pres Value of Funding	11,132,367	7,527,517	113,485	966,053	2,029,281	0	496,031
04/01/1999	Assigned Pension Cost	8,648,912	4,960,994	116,100	988,314	2,076,042	0	507,462
04/01/1999	CAS Funding Target	8,648,912	4,960,994	116,100	988,314	2,076,042	0	507,462
04/01/1999	% Funded		100.00%	97.75%	97.75%	97.75%	0.00%	97.75%
04/01/1999	Funded Pension Cost		4,960,994	113,485	966,053	2,029,281	0	496,031
	Allowable Interest		170,964	3,853	32,798	68,894	0	16,840
	Allocable Pension Cost		5,131,958	117,338	998,851	2,098,175	0	512,871
	Fiscal Year Pension Medicare LOB%		2.40%	56.09%	15.51%	97.74%	0.00%	2.40%
	Allowable Pension Cost	$2,406,969	$123,167	$65,815	$154,922	$2,050,756	$0	$12,309
	Fiscal Year Pension Cost	$3,485,493	$201,716	$108,553	$222,035	$2,932,944	$0	$20,245

**BLUE CROSS BLUE SHIELD OF TEXAS/TRAILBLAZERS
STATEMENT OF ALLOWABLE PENSION COSTS
PLAN YEAR BEGINNING 1994 THROUGH PLAN YEAR BEGINNING 1999**

FOOTNOTES

1/ We obtained total company contribution amounts and dates of deposit from IRS Form 5500 reports. The contributions included deposits made during the plan year and accrued contributions deposited after the end of the plan year but within the time allowed for filing tax returns.

2/ We subtracted interest that was included in the contributions deposited after January 1 of each year to discount the contributions back to their beginning-of-the-year value. For purposes of this appendix, we computed interest as the difference between the present value of contributions, at the valuation interest rate of 8 percent, and the actual contribution amounts.

3/ The present value of contributions is the value of the contributions discounted from the date of deposit back to April 1. For purposes of this appendix, we deemed deposits made after the end of the plan year to have been made on the final day of the plan year.

4/ A prepayment credit represents the premature funding from the previous year(s). A prepayment credit is created when contributions, plus interest, exceed the end-of-year CAS funding target. A prepayment credit may be carried forward, with interest, to fund future CAS pension costs.

5/ The present value of funding represents the present value of contributions plus prepayment credits. This is the amount of funding that is available to cover the CAS funding target measured at April 1 of each year.

6/ The CAS pension costs, computed at April 1 of each year, provide the basis to compute the allowable pension cost that can be charged to Medicare.

7/ The CAS funding target must be funded by current or prepaid contributions to satisfy the funding requirement of FAR 31.205-6(j)(3)(I).

8/ The percentage of costs funded is a measure of the portion of the CAS funding target that was funded during the plan year. Since any funding in excess of the CAS funding target is considered premature funding in accordance with CAS 412.50(a)(7), we determined that the funded ratio may not exceed 100 percent. We computed the percentage funded as the present value of funding divided by the CAS funding target. For purposes of illustration, the percentage of funding has been rounded to four decimals.

9/ We computed the funded CAS pension cost as the CAS funding target multiplied by the percent funded.

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STATEMENT OF ALLOWABLE PENSION COSTS
PLAN YEAR BEGINNING 1994 THROUGH PLAN YEAR BEGINNING 1999

10/ We assumed interest on the funded CAS pension cost is to accrue in the same proportion as the interest on contributions bears to the present value of funding. However, we limited interest by FAR 31.205-6(j)(3)(iii), which does not permit the allowable interest to exceed the interest that would accrue if the CAS funding target were funded in four equal installments deposited within 30 days of the end of the quarter.

11/ The allocable CAS pension cost is the amount of pension cost that may be allocated for contract cost purposes.

12/ We calculated allowable pension costs of the Medicare and other segments based on the Medicare line of business (LOB) percentage of each segment. We obtained the percentages from documents that Texas provided.

13/ We computed the allowable pension cost as the plan year pension cost multiplied by the Medicare LOB percentage.

14/ We converted the plan year allowable CAS pension costs to a fiscal year basis (October 1 through September 30). We calculated the fiscal year pension costs as one-half (1/2) of the prior plan year's costs plus one-half (1/2) of the current plan year's costs (i.e., 1/2 of plan year beginning 4/1/1994 plus 1/2 of plan year beginning 4/1/1995 = FY 1995). Costs charged to the Medicare contract should consist of the Medicare segment's direct pension costs plus pension costs attributable to indirect Medicare operations.

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March 30,2004

James P. Aasmundstad
Regional Inspector General for Audit Services, Region VII
601 East 12th Street
Room 284A
Kansas City, Missouri 64106

Subject: USDHHS, OIG, OAS Draft Audit Reports related to Blue Cross and Blue Shield Of Texas (former) Medicare Contract (terminated September 30, 1999)--
--Report#A-07-03-03032 titled Blue Cross and Blue Shield of Texas Pension Segment Closing Audit (dated July 2003)(audit#1 of the series below)
--Report#A-07-03-03046 titled Review of Pension Costs Claimed for Medicare Reimbursement by Blue Cross and Blue Shield of Texas, Inc. (dated September 2003)(audit#2 of the series below)
--Report#A-07-03-03040 titled Audit of Post Retirement Benefit Costs Claimed Claimed for Medicare Reimbursement by Blue Cross and Blue Shield of Texas Inc. (dated February 2004)(audit#3 of the series below)

Dear Mr. Aasmundstad:

The subject draft reports, referred to below as audits #1, #2, and #3 in a series respectively, are the result of OIG on-site reviews performed during October 2002 and February 2003 as well as prior and subsequent exchanges of information between OIG (including Office of the Actuary), Blue Cross and Blue Shield of Texas (a Division of Health Care Service Corporation, a Mutual Legal Reserve Company), HCSC's engaged outside Actuarial Consultant (Watson Wyatt), and to some extent Blue Cross and Blue Shield of South Carolina staff (including their outside Actuarial firm Chicago Consulting Actuaries) materially through July and October of 2003. We have remained in periodic contact with the audit team during the intervals of audits, follow-up, and draft series issuance. Our pre-arranged approach and intention was to review and respond to the three audit drafts in the series collectively at the same time based on receipt of the last. We appreciate the OIG/HHS/CMS efforts, cooperation, and professional approach in these matters.

The background information contained in the "Background-Texas" sections of each report (each attached for reference) seems to adequately characterize the history and circumstances leading to these final audits under the Medicare Program, therefore we have not restated that here. Each audit/audit report is very specific to an area of contract cost reimbursement and highly technical in nature. Each audit report incorporates reference to Medicare Program/CMS/HCFA/HHS rules, CAS, FAR, FPR, the actual Medicare Contracts, contractor practices, previous audits, and certain events or transactions which we have reviewed but which we have not attempted to re-

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audit or refute in detail and which we do not attempt to restate or pick-apart in our response.

We view and have approached this series of three audit drafts as related and to an extent interdependent. The three draft reports and the handling of the recommendations collectively address three remaining primary open issues related to or resulting from the termination of the Texas Medicare Contract(s) effective September 30, 1999.

Audit #1 draft identifies "excess" pension plan assets at a point in time associated with Medicare Segmentation and CAS methodologies which the OIG recommends HCSC remit (from corporate assets since that can not/should not occur from the remaining ongoing qualified Pension plan after all former Medicare employees were paid accrued lump sum benefits in full) to the Federal Government (based on the concept that the Government Program had over time actually reimbursed previous pension contribution cost claims pursuant to that "excess" funding).

Audit #2 draft is related to the historical annual allowable administrative cost (pension contributions allocated) claims (FACP based) of BCBSTX and based on the auditors' review of previous governmental cost filings, books, records, methods, audit reports and actuarial data (or retrospectively re-applied auditor methodology against that same information) leads the OIG to recommend that HCSC remit $3,023,483 identified as "unallowable costs" to the Federal Government.

Audit #3 is related to the extraordinary circumstance at contract end when during the directed transition of the Texas Medicare Contract from BCBSTX (TrailBlazer Health Enterprises, LLC a wholly owned subsidiary which held the contract at the time) to Blue Cross and Blue Shield of South Carolina as a condition of transition/sale BCBSTX/HCSC agreed to fund a trust with the actuarially determined accumulated "past service cost" necessary to provide a (future post-retirement) health care benefit upon retirement for transitioned (retained in employment of new contractor) employees and leads the OIG to recommend that BCBSTX (HCSC) withdraw its original previously un-reimbursed estimated cost claim of $6,000,000 ($5,159,732 actual deposited after close).

While associating the results of all three audits in the series is important to conclusion, audit#1 and portions of #2 must be tied together and are interlocked in arriving at logical consistent finding. HCSC in conjunction with Watson Wyatt actually calculated and furnished the resulting amount quoted in audit #1 directly from its own maintained valuations and records based on strict collaborative application of techniques required and employed in CAS pension accounting and segmentation rules. The resultant amount is effectively partially based and effectively also partially derived based on the cost computations, allocations, charges, submissions, and reimbursement (and visa versa) along the way. Therefore, if it represents is a good acceptable result, which parties

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already agree it equitably does, then the related basis or pathway leading to it (partially subject of audit#2) is virtually substantiated and if that were to be altered the result could be altered.

Audit #2 has two distinct separate areas it explores for finding. One aspect is purely related to findings/recommendations from a past (last period ending before this audit period begins) pension segmentation audit where parties mutually agreed on valuation and charge techniques under CAS to be employed going forward and which resulted in certain booked adjustments to program costs. As a result of the booked adjustments to program costs a piece (pension plan years and program fiscal years crossed) of the cost adjustment credit the program would receive fell in a prior already filed year. The piece of credit that fell into that previously just filed year was embedded within overall amounts "reduced", not claimed and not reimbursed from that previous year. The adjustment was properly calculated which resulted in a portion being credited into the open year but the properly apportioned amount of the credit amount falling back into the prior program year was not "refunded/refundable/re-reportable" because it was effectively not charged or reimbursed within the actual final FACP. This method of cost reduction-to-unallowable cost offset is acceptable and was actually documented in 1995 HCFA memoranda. We have previously replied to the auditors on this aspect of audit#2 as excerpted again in reply here, as follows:

".....Related to the below your additional question...While researching the records we found that we had apparently received a "Risk Assessment" summary letter with some questions related to the 91-94 reviews (received and replied in 99) which had included among other things a verification of the handling of your same 94 pension audit amount/question. That response (drafted June 99 for HCFA RO Dallas---paraphrased---"HCFA recommends that the FACP's be reduced by $874,111 to reflect an adjustment identified in the pension segment audit....The required adjustment has already been made to the FY 1994 FACP....It was included with various other adjustments on the workpapers which were audited and not separately identified.....There should be no further adjustment for this finding....") was found to be consistent with our initial response to the 94 audit, with follow up correspondence, with the 94 filing workpapers we reviewed, and was accepted by and closed with HCFA. The amount "credited" based on method alignment agreed upon during the audit related to CAS limits for that isolated period versus contributions for that isolated period were properly allocated to the Medicare lines. The actual credit was tabulated based on our consistent allocation method but still represented the underlying theory represented by the 94 audit finding amount (audit finding amount was estimated to be $874,111), and our reply. Our Medicare lines' credit (Total and Medicare lines impact documented in our materials furnished during your current audit) was actually for a total of $1,046,280. The available "Voluntary Cost Reductions" at 9-30-94 were $5,432,232. In essence the FY 94 Medicare charges for pension cost were reduced by $1,046,280. from the original filed FACP reported amounts. We do find the action and amounts as described here to be properly supported in the original FACP workpaper file, in subsequent correspondence, and in the risk assessment reply…………"

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The second aspect of audit #2 is much more complicated and required significant review on our part to understand the wording of the finding and the actual auditor calculations/workpapers underlying the auditor's approach and apparent finding. We previously replied in-part to the auditors on this bullet of the early draft as follows:
".....We have invested time carefully reviewing your draft#2, including with Watson Wyatt CAS staff and attempting to reconcile the different numbers and approaches. We have needed to locate/dig back through older FACP files/workpapers to address certain points. Proper consideration of draft/aspect #2 requires a certain amount of correlation with draft/aspect #1, and to an extent with past filings and with past audits.....we have been off and on somewhat perplexed while we examined this draft#2 and have needed to set it asidelpick it back up/reflect over several possible questions/alternatives. We have been careful to take extra time and have considered discussing some of our initial concerns.....it is possible that the bestlrnost efficient way to handle this complicated topic is by written reply protocol..........".

After that and further detail consideration we do not and can not agree (supported firmly by the re-review of our involved, experienced outside Actuary) with the statement made in and throughout the second finding (basically--"Texas not basing its pension claims ...on separately calculated pension costs for the Medicare segment....."). We have in fact consistently based our pension valuations, allocations, computations, and charges on very well engineered, acceptable, agreed, consistent methods aligned with the intent of CAS, in accordance with CAS and equitable to the program involved. These employed methods in our opinion have been previously reviewed/effectively agreed by the OIG during and following prior pension related audits (and which is supported evidenced in prior audits related to years not questioned). After considerable reexamination of all of the historical data used in our original results and furnished during the audit as well as what was furnished back by the auditor we find that: the findings and calculations demonstrated in audit#2finding#2 may in fact first simply miss entirely the actual methodology that was employed by us (allocations to segment and to cost centers within CAS limits actually directly based on individual actuarial assigned pension CAS cost) and how that ties perfectly well into the results of audit #1; the auditor methods are seemly re-applied employing top-sided global desk techniques that we do not fully comprehend nor agree apply consistently in context with our overall factors and outcomes which are based on solid approaches; the auditor approach results IF presumed on the surface to be otherwise validly approached are flawed within themselves because they do not incorporate accurate starting amounts for years 94 and 99 (the auditor apportions pension plan years contribution activity to equate to FY years using arbitrary ½ year conventions ignoring that the numbers on the lead-in year are already set at 56.2% and numbers on the ending truncated/valued short year would be at 100% or at a minimum 99.6% if you discount a trailing contribution adjustment deposit made a month late)(which IF plugged into the auditor formula would result in a surface comparative difference result of $765,539 not $2,149,372 IF method were otherwise accepted).

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However, while having to continue to locate and go back through all of the detail and audit trail involved in re-consideration of the problems presented in audit#2 (which ripples back to audit #1) we have discovered at least two things. One we will herein adjust immediately (revised copy to be furnished electronically for the auditors'/actuary's files). The second may need at least to be carefully considered in context by parties.
First--The summary spreadsheet furnished as supporting audit #1 results titled "Remaining Medicare Assets" failed to copy down a set of attributable allocation percentages only in the "other" column in the early years of 91, 92, 93 immediately following years of 0% and where contribution had re-commenced. This correction results in an additional small attribution of "other" contributions which slightly raises the ending Medicare ending weight ratio applied to ending assets which results in an addition of $398,518 in "Medicare portion of remaining assets" identified or an ending identified remaining asset number of $11,152,093 related to audit#1 vs $10,753,575 reported. Nothing else about the underlying methods or ultimate results changed.
Second—We did not attempt to factor for this circumstance in our calculations but upon discovery of the earlier FACP work papers while researching audit #2 finding#1and#2 it is interesting to note that we were not able to claim the actual properly based equitable pension contribution allocation during past FY 93 (which is crossed by the settlement nature of the audit #1) due to budgetary cost cut-backs and more voluntary cost reductions. Those filing work papers reflect a reduction of $1,258,436 in pension costs not filed/not claimed. This very well could be a factor when considering refunding of identified excess assets it would seem.

Audit #3 presents a dilemma related to laws, regulations, timing, facts and circumstances, what is logical, what is fair, what makes the most sense in context, and intents. BCBSTX exited the Medicare contractor business by agreement after having successfully with much favorable recognition participated in the program since its inception. BCBSTX and the long term employees of its Medicare division had been dedicated and had contributed to the development of the overall program and its operation. The government we think appreciated the efforts described and the government was aware of and participated to an extent in the negotiating of the "transition" of the Texas contact to a comparable contractor. The interest of the transitioning long term employees and the stability of operation of the contract for the Medicare beneficiaries was a paramount concern. Texas management (and SC management) approached the transition carefully within the constraints of operating the program as it advanced. Both parties to the transaction worked ethically to handle the payment and continuation of a form of pension benefits for impacted employees. Both parties sought a way under the rules and past practices to ensure the impacted employees would be able to retain a reasonable form of retiree health benefit.

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The method that surfaced that would ensure retiree health benefit (accruals) for active impacted employees (retired employees by the way were on a pay-as-you-go basis and that future cost was not sought from the government but Texas has continued to pay that cost) was to create/fund a trust fund out-of-corporate-pocket(Texas) in support of past-service cost already actuarially accrued (but not yet claimed or reimbursed under a pay-as-you-go approach) for that benefit for those employees on top of which the new employer would then only need to fund future service cost accruals. Otherwise under the given ongoing possible budgetary constraints of the new employer the benefit might not have been continued based on lengthy prior service. $5,159,732 was funded by BCBSTXMCSC and handed over to a trust to be operated by the new contractor BCBSSC. The agreement and the trust (which is being modified we now understand by BCBSSC to qualify with OIG instructions/findings) was designed to be tightly monitored and controlled so that the funds and growth could only be used for the specific impacted employees as they worked to fruition. The transition/sale agreement also required the new employer which was already a Medicare contractor to attempt to value and budget the funded past service costs in their normal post-retirement medical valuation process creating legitimate future amortized program cost claims IF the government was not going to reimburse the initial funding as part of the contract termination final filings by Texas. BCBSSC has not filed any related cost amortizations and may not have the budget room to do so, and may be facing future program budgetary changes that may preclude them from being able to do that. BCBSTXMCSC one might say continued to "do the right thing" when it funded these costs in an effort to support the transition of the employees and the stability of the program. BCBSTX would have in the long run if it had stayed in the contract presumably continued these benefits and charged the program on a cash basis over time for these same related costs. BCBSTXMCSC has made reasonable attempts to recover these costs under avenues that applied to it as a Medicare program contractor. BCBSTX has no other direct method for future reimbursement from the government since it is no longer a Medicare contractor, except through the audit review/settlement process. BCBSTXMCSC it seems after discussion with BCBSSC again finally recently (due to this audit result) may not have BCBSSC as a reasonable resource for reimbursement of these costs. HCSC does not find the finding as stated in the audit draft as acceptable. HCSC does have (and did furnish detail actuarial calculation files supporting this funded cost) and can supply any further information needed with dual actuarial firm support. HCSC prefers not to withdraw the basis for the claim of these costs. HCSC appeals to the governmental agencies that issue the audits, review the audits, and consider settlements to reconsider recognition of these reasonable legitimate costs associated with audit draft #3.

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Based on this collective response we propose the following related to finalization, closure and settlement of these audits and will act promptly upon issuance of final audit reports or agreements reflecting the above, the same, and the below. We will work with the OIG or other agencies on any additional reasonable information needed to consider this.

Audit draft #1 HCSC recognizes in excess pension plan assets at a point--- $11,152,093.
Audit draft #2 HCSC rests on its allocated and filed pension costs----------$-0-
Audit draft #3 HCSC splits the funded costs with the government
and will advise BCBSSC not to attempt claims
of these related reimbursed costs in the future --------$ (2,579,866)
Total from HCSC to Federal Government as full/final settlement-----------$ 8,572,227

Please let us know when you have reviewed and considered these responses. If you have any questions we will assist. When you issue your final reply or your final reports we will promptly reply further.

Thank you and your staff again for your time, patience, professionalism, and consideration. Please send any reply or questions to Gene George (address below)(972-766-6192)(email Gene_George@bcbstx.com) who coordinated the audit activity from an operational/historical standpoint so those may be expedited as necessary internally.

Cordially,

Gene George

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Attachments OIG audit draft copies