

OFFICE OF RISK MANAGEMENT
COST SAVINGS UPDATE
FISCAL YEAR 2014



PERFORMANCE AUDIT
PROGRESS REPORT
ISSUED SEPTEMBER 9, 2015

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

LEGISLATIVE AUDITOR
DARYL G. PURPERA, CPA, CFE

ASSISTANT LEGISLATIVE AUDITOR
FOR STATE AUDIT SERVICES
NICOLE B. EDMONSON, CIA, CGAP, MPA

DIRECTOR OF PERFORMANCE AUDIT SERVICES
KAREN LEBLANC, CIA, CGAP, MSW

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

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LOUISIANA LEGISLATIVE AUDITOR
DARYL G. PURPERA, CPA, CFE

September 9, 2015

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 our annual update of the cost savings of the Division of Administration's Office of Risk Management (ORM) contract with F.A. Richard & Associates for fiscal year 2014. These results include the cost savings as of June 30, 2014, the end of the fourth 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/aa

ORMFY14

Louisiana Legislative Auditor

Daryl G. Purpera, CPA, CFE

Office of Risk Management

Cost Savings Update for Fiscal Year 2014

September 2015



Audit Control #40140063

Introduction

This report provides our annual update of the cost savings of the Division of Administration's Office of Risk Management (ORM) contract with F.A. Richard & Associates (FARA) for fiscal year 2014. These results include the cost savings as of June 30, 2014, the end of the fourth year of the five-year contract.¹ Appendix A contains ORM's response to this report, and Appendix B details our scope and methodology.

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 contract was originally for \$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 moving 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 guaranteed 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* versus contract costs. In addition to FARA's \$50 million in guaranteed savings, ORM needs \$40 million in *administrative and other cost savings* to achieve its projected \$22 million in net program savings mentioned above. This savings does not take into account the approximately \$6.8 million cost increase from the amendment.

According to the contract, 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.³ 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. As the contract ended June 30, 2015, ORM is currently analyzing cumulative cost savings to determine whether FARA met the \$50 million guarantee. Once ORM's analysis is complete, we will review the results and report on the overall savings achieved from the FARA contract. (See diagram on next page.)

¹ ORM provided our office with the results of its cost savings analysis for fiscal year 2014 on May 5, 2015.

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*.

³ Savings measurement will include adjustments for material changes which are beyond FARA's control, such as changes in law, state budgetary constraints, natural disasters, disruption in the planned contract term, etc.

As a result of its contract with FARA, ORM projects net program savings of \$22 million* using this formula:

$$\text{contract costs} - \text{administrative and other cost savings} - \text{claims and litigation payment savings} = \text{net program savings}$$

*To achieve this, ORM needs \$40 million in *administrative and other cost savings*. However, the \$22 million figure does not take into account the \$6.8 million contract increase from the April 2011 amendment.

As part of its contract with the state, FARA has guaranteed savings of \$50 million in *claims and litigation payments*.

If FARA **does** achieve the \$50 million in *claims and litigation payment 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 **amended** contract, whichever is less)

If FARA **does not** achieve the \$50 million in *claims and litigation payment savings*:

FARA must refund the state **3%** of the shortfall.
(up to \$1.5 million, which is approximately 2% of the **original** contract)

Objective: What is the status of the cost savings results from ORM's contract with FARA as of June 30, 2014?

As discussed previously, 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* versus contract costs. FARA guaranteed \$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 needs \$40 million in *administrative and other cost savings* after contract costs to achieve its projection of \$22 million in net program savings.

ORM's cumulative cost savings in each of these categories as of June 30, 2014, the end of the first four years of the FARA contract, is described below.

At the end of the fourth year of the contract, FARA achieved approximately \$43.3 million (86.6%) of the \$50 million in *claims and litigation payment savings* guaranteed by the contract.

As of June 30, 2014, ORM calculated⁴ that FARA had cumulatively reduced *claims and litigation payments* by approximately \$43.3 million (86.6%) of the \$50 million in payment savings the contract guarantees. The \$43.3 million cumulative total includes approximately \$35.3 million in savings related to claims and litigation payments and \$8 million in savings related to the settlement of workers' compensation claims by FARA. Appendix C provides an overview of ORM's savings evaluation process.

After Year Three of the contract, ORM changed its methodology for estimating savings to include the results of FARA's workers' compensation claims settlements.⁵ During the third year of the contract, FARA had taken an aggressive approach to settling state workers' compensation claims. As a result of this push, FARA settled 212 claims in fiscal year 2013 for an increase in settlements of 107.8% from fiscal year 2012 and a cumulative savings of approximately \$13.5 million. According to ORM, however, state budgetary constraints in fiscal year 2014 prevented ORM from allowing FARA to continue settling claims so aggressively. These budget cuts, coupled with accounting adjustments to previous savings,⁶ resulted in an approximately \$5.5 million settlement deficit during fiscal year 2014, for a cumulative savings of

⁴ ORM's cost savings evaluation is based on the difference between projected costs if ORM had not privatized versus the actual amount of expenditures accumulated by FARA since the privatization. See Appendix C for an overview of ORM's savings evaluation process.

⁵ ORM's previous methodologies did not include the cost savings from FARA's settlement of workers' compensation claims during fiscal years 2011 and 2012.

⁶ In fiscal year 2014, ORM amortized cumulative savings from the prior three years, accounting for approximately \$1.4 million of the \$5.5 million settlement deficit in Year Four.

\$8 million from settlements after four years. Exhibit 1 contains a summary of the cumulative savings related to FARA's settlement of workers' compensation claims during the first four years of the contract.

Exhibit 1 Summary of Workers' Compensation Claims Settlement Savings Achieved by Privatization to FARA Fiscal Year 2011 through Fiscal Year 2014					
	FY 2011 (Contract Year 1)	FY 2012 (Contract Year 2)	FY 2013 (Contract Year 3)	FY 2014 (Contract Year 4)	Total Settlement Savings Years 1-4
A. Number of Claims Settled by FARA	101	102	212	165	
B. Estimated Cost to State of Settled Claims*	\$12,865,417	\$11,955,615	\$40,099,462	\$14,117,802	
C. Total Settlements Paid	\$3,883,458	\$3,363,274	\$12,732,861	\$7,822,406	
D. Actual Settlement Savings by FARA (B-C)	\$8,981,959	\$8,592,341	\$27,366,601	\$6,295,396	
E. Estimated Target Settlement Savings by ORM**	\$10,469,302	\$10,469,302	\$10,469,302	\$10,469,302	
F. Settlement Savings Realized by Privatization (D-E)	(\$1,487,343)	(\$1,876,961)	\$16,897,299	(\$4,173,906)	\$9,359,089
G. Amortization of Prior Years Cumulative Savings					(1,353,300)
H. Cumulative Savings from Settlements through Year Four of FARA Contract (F+G)					\$8,005,789
*ORM estimated these amounts using a sample of claims settled and discounted for an average of 10 years. **Target savings are based on actual settlement savings achieved by ORM in FY 2010. Source: Prepared by legislative auditor's staff using information provided by ORM.					

Exhibit 2 includes a breakdown of the approximately \$43.3 million of cumulative *claims and litigation payment savings* achieved by FARA, by line of insurance, through fiscal year 2014.

Exhibit 2 Cumulative Claims and Litigation Payment Savings Achieved by FARA, By Line of Insurance Fiscal Year 2011 through Fiscal Year 2014		
Line of Insurance	Savings	Time Administered by FARA
Workers' Compensation	\$24.4 million*	4 years
General Liability	5.7 million	3 years
Property	4.3 million	2.5 years
Medical Malpractice	7.6 million	2 years
Transportation	1.3 million	1 year
Road Hazard	41,000	1 year
Total Savings	\$43.3 million	
*Includes \$8 million in cumulative savings from settlement of workers' compensation claims. Source: Prepared by legislative auditor's staff using information provided by ORM.		

FARA's cumulative savings of \$43.3 million are approximately 10.7% ahead of schedule at the end of fiscal year 2014 based on ORM's projections. ORM had projected cumulative *claims and litigation payment savings* of approximately \$4.8 million in Year One, \$11.2 million in Year Two, \$11.4 million in Year Three, and \$11.7 million in Year Four of the contract, for a total of \$39.1 million in savings for the first four years of the FARA contract, as shown in Appendix D. (See row "Less proposed savings – Claims.")

ORM achieved savings of approximately \$20.3 million (50.1%) 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, 2014, ORM had achieved approximately \$20.3 million (50.8%) of the *administrative and other cost savings* it needs to achieve \$22 million in expected net savings. These savings are not guaranteed by the contract. Therefore, ORM has one more year to achieve the remaining \$19.7 million (49.2%). ORM did not develop projections for the amount of savings in this category that it would attain during each year of the contract. According to ORM, the remaining \$19.7 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 net program savings of approximately \$16.6 million through Year Four of the FARA contract, or 75.5% of the \$22 million projected over the five-year contract period.

Taking into account FARA's *claims and litigation payment savings*, ORM's *administrative and other cost savings*, and the approximately \$47 million (69%) that ORM has paid FARA toward the original contract cost of \$68.1 million, net program savings as of June 30, 2014, are approximately \$16.6 million. While the formula for calculating net program savings has not changed, ORM's methodology for estimating the *claims and litigation payment savings* now includes savings from workers' compensation settlements, as previously discussed. The formula is:

$\begin{aligned} &\text{Cumulative Year Four Contract Costs (\$47 million) - Administrative and Other Cost Savings} \\ &\quad (\$20.3 \text{ million}) - \text{Claims and Litigation Payment Savings (\$43.3 million)} \\ &= \text{\$16.6 million Net Program Savings} \end{aligned}$

This amount is approximately 75.5% 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 during Year One, net savings of \$5.4 million during Year Two, net savings of \$5.3 million in Year Three, and net savings of \$5.9 million in Year Four of the contract, for cumulative net program savings of approximately \$15.9 million after four years of the FARA contract. Therefore, the cumulative net program savings of \$16.6 million at the end of fiscal year 2014 are ahead of schedule by approximately 4.4% based on ORM's projections, as shown in Appendix D. (See row "Net Program Costs/Savings.")

APPENDIX A: MANAGEMENT'S RESPONSE

BOBBY JINDAL
GOVERNOR



KRISTY H. NICHOLS
COMMISSIONER OF ADMINISTRATION

State of Louisiana

Division of Administration
Office of Risk Management

September 3, 2015

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: Office of Risk Management Cost Savings
Update for Fiscal Year 2014

Dear Mr. Purpera:

The State of Louisiana Division of Administration (DOA) would like to thank you and your staff for conducting a performance audit on the cost savings related to DOA's Office of Risk Management (ORM) contract with F.A. Richard & Associates (FARA). I am happy to see that your report confirms that the cost savings amounts calculated by ORM staff through June 30, 2014 have in fact exceeded the targeted savings.

The cost saving expectations that were presented to the Joint Legislative Committee on the Budget as part of the approval process of the initial contract consist of two components:

1. A contractually guaranteed \$50 million in claims and litigation payment savings - approximately \$43.3 million has been realized to date, which is ahead of schedule by 10.7%; and
2. \$22 million in net savings to ORM - approximately \$16.6 million has been achieved to date, which is ahead of schedule by 4.4%.

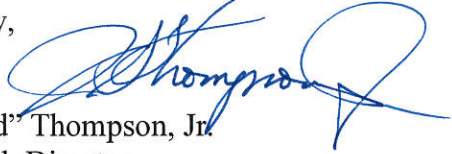
These savings noted in #1 and #2 above were calculated using ORM activity through June 30, 2014. A full year remains on the contract from this date to achieve the remaining targeted savings.

As discussed with your audit team in previous audits, ORM believes that the component presented in your report described as "Administrative and Other Cost Savings" is

misleading. ORM disagrees with isolating this component of cost savings as it is already factored into the calculation of net savings to ORM.

Thank you again for your efforts in reviewing this program. We are proud of what has been achieved so far, and will continue working toward a successful conclusion of the project.

Sincerely,


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

CC: Kristy Nichols
Thomas Groves
Benjamin Huxen
Greg Dupuis
Charlotte Hawkins
Patti Gonzalez
Marsha Guedry
Ann Wax
Marsha Pemble

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 time period from July 1, 2013, through June 30, 2014. Our objective was to determine the status of the cost savings results from ORM's contract with FARA as of June 30, 2014.

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 costs savings for the FARA contract as of June 30, 2014, on May 5, 2015.
- Obtained and analyzed the reliability and reasonableness of ORM's estimated cost savings methodology and analysis for fiscal year 2014.
- 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 methodology as seen 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 transaction-level payment data extracted from FARA's claims processing system (ICE). In addition, 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 verified the amounts back to supporting documentation for accuracy and reliability. Confirmed these calculations and referred any discrepancies⁷ to ORM staff, who will make appropriate adjustments in the cost savings evaluation for fiscal year 2015.

⁷ Net discrepancies identified resulted in \$89,553 less in *claims payment savings* at the end of fiscal year 2014.

APPENDIX C: OVERVIEW OF ORM'S SAVINGS EVALUATION PROCESS Fiscal Year 2014

During the contract Request for Proposal evaluation process (November 2009 through May 2010), ORM estimated net program savings of \$22.2 million over the five-year period through privatization of claims administration services to a third-party administrator (TPA). This early savings analysis was based on *Projected Costs* that assumed the full administration of claims would continue in-house by ORM. These costs were then reduced by the anticipated net savings through privatization to a TPA.

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 the Division of Administration's Office of Finance and Support Services (OFSS) personnel working in a concerted effort with ORM leadership 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 projected 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., (NCCI) 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 (CPI) data published by the Bureau of Labor Statistics of the U.S. Department of Labor.

In Year Three, a new evaluation component was added to estimate and include the savings for the state from FARA's strategic settlement of Workers' Compensation claims. For this aspect of cost savings, OFSS worked closely with the ORM Claims Unit professionals that monitor the Workers' Compensation program components administered by FARA. Settlement savings were compared to targeted settlement savings. This evaluation method was continued in Year Four with Year Four settlement savings compared to the targeted settlement savings and further reduced by the amortization of the cumulative savings from the three prior years.

General Liability. The evaluation of General Liability was through the continuation of the method established in fiscal year 2012 and followed again in fiscal year 2013. 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 costs incurred by ORM served as the starting point to arrive at the allocation of projected costs for General Liability. Projected in-house ORM program cost estimates for fiscal year 2013 and fiscal year 2014 were based on the average of actual data from fiscal years 2009, 2010, and 2011. 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 all other costs of the General Liability line of business using the CPI data published by the Bureau of Labor Statistics of the U.S. Department of Labor.

Property. ORM management chose to evaluate direct savings only on regular claims (defined as non-catastrophic), since the impact of catastrophic events is simply not predictable. Since this line of business is also less predictable, a special approach was developed to estimate realistic projected costs for comparison to actual costs of Property Claims Administration under FARA. The average of five years of historical costs incurred by ORM served as the starting point to arrive at the allocation of projected costs for Property. Projected in-house program cost estimates for fiscal year 2014 were based on the average of actual data from calendar years 2007 to 2011. An annual inflation factor of 1.6% was used to project costs in the Contract Litigation and Division of Risk Litigation programs. For Property costs that relate to construction, ORM developed a five-year average inflation, using cost indices developed by Xactimate, a service company that supports the insurance and reconstruction repair industries. Annual inflation factors were used for all other costs of the Property line of business using the CPI data published by the Bureau of Labor Statistics of the U.S. Department of Labor.

Medical Malpractice. Since this line of business is a liability line, the approach developed for the General Liability line was used to estimate costs.

Transportation. The Transportation line of business comprises coverages for Auto Liability, Auto Physical Damage, Wet Marine, and Aircraft. ORM evaluated all of the coverages in the same manner as General Liability. The average of three prior fiscal years of historical costs incurred by ORM served as the starting point to arrive at the allocation of projected costs for Transportation. Projected in-house program costs estimates for fiscal year 2014 were based on the average of actual data from fiscal years 2011, 2012, and 2013. For Auto Liability, the annual inflation factor was based on the CPI data published by the Bureau of Labor Statistics of the U.S. Department of Labor. For the remaining lines of coverage the annual inflation factor was based on the CPI for Insurance and Related Items published by the Bureau of Labor Statistics and the U.S. Department of Labor. An annual inflation factor of 1.6% was used to project costs in the Contract Litigation and Division of Risk Litigation programs.

Road Hazard. Litigated Road Hazard payments appropriated by the Legislature are made by the State Treasurer and were not included in the evaluation. Non-litigated Road Hazard claims are paid by ORM and were evaluated in the same manner as Transportation. The average of three prior fiscal years of historical costs incurred by ORM served as the starting point to arrive at the allocation of projected costs for Non-litigated Road Hazard costs. Projected in-house program cost estimates for fiscal year

2014 were based on the average of actual data from fiscal years 2011, 2012, and 2013. An annual inflation factor was based on the CPI for Insurance and Related Items published by the Bureau of Labor Statistics and the U.S. Department of Labor. An annual inflation factor of 1.6% was used to project costs in the Contract Litigation and Division of Risk Litigation programs.

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

APPENDIX D: ESTIMATED TOTAL PROGRAM COSTS AND NET SAVINGS

Fiscal Year 2011 through Fiscal Year 2015

		FY 2011	FY 2012	FY 2013	FY 2014	FY 2015	Five-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 COST	\$304,463,756	\$255,348,869	\$269,621,072	\$285,274,430	\$302,487,200	\$1,417,195,327
FARA - Savings Per Contract	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 COST	\$305,122,743	\$249,963,557	\$264,322,941	\$279,343,127	\$296,222,360	\$1,394,974,728
	Net Program Cost/(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 2011.

Note: The green shaded columns denote the four fiscal years covered in this report.

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