OFFICE OF RISK MANAGEMENT
COST SAVINGS UPDATE
FISCAL YEAR 2015

PERFORMANCE AUDIT
PROGRESS REPORT
ISSUED JUNE 23, 2016

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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

June 23, 2016

The Honorable John A. Alario, Jr.,
President of the Senate
The Honorable Taylor F. Barras
Speaker of the House of Representatives

Dear Senator Alario and Representative Barras,

This report provides the results of our final review of the cost savings of the Division of Administration - Office of Risk Management's (ORM) contract with F.A. Richard & Associates as of June 30, 2015, the fifth and final year of the 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

ORM FY15

Louisiana Legislative Auditor
Daryl G. Purpera, CPA, CFE

Office of Risk Management
Cost Savings Update for Fiscal Year 2015

June 2016 *Audit Control #40150027*

Introduction

This report provides the results of our final review of the cost savings of the Division of Administration - Office of Risk Management's (ORM) contract with F.A. Richard & Associates (FARA) as of June 30, 2015, the fifth and final year of the contract.[1] Appendix A contains ORM's response to this report, Appendix B details our scope and methodology, and Appendix C provides an overview of ORM's savings evaluation process.

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 was 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 also projected net program savings of $22 million as a result of the FARA contract, but this savings was not contractually guaranteed. Net program savings consist of FARA's *claims and litigation payment savings* and ORM's *administrative and other cost savings* versus contract costs paid by ORM to FARA. To achieve the projected $22 million in net program savings after paying contract costs of approximately $68 million to FARA, we calculated that ORM needed to save $40 million in *administrative and other costs.* This savings does not take into account the approximately $6.8 million cost increase from the contract amendment.

According to the contract, if FARA did not achieve the guaranteed $50 million in *claims and litigation payment savings*, it must refund the state 3% of the shortfall, up to $1.5 million. If FARA exceeded 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 amount of the contract, whichever is less. The contract states that FARA and ORM were to agree in writing on the specific

[1] ORM provided our office with the results of its cost savings analysis for fiscal year 2015 on December 21, 2015.
[2] According to the contract, the guaranteed savings included payment savings in the categories of *Claims and Related, Division of Risk Litigation,* and *Contract Litigation.*

language and measurement methodologies used to calculate savings.[3] In addition, the 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.

When ORM entered into the contract with FARA in 2010, ORM projected net program savings of $22 million over five years using this formula:

Contract Costs to be Paid to FARA	$68M
ORM's *Administrative & Other Cost Savings*	-$40M
FARA's Guaranteed *Claims & Litigation Payment Savings*	-$50M
Projected Net Program Savings to the State	**($22M)**

[3] While ORM does not have a signed document stating FARA's agreement with the savings methodology, ORM stated that it provided FARA with annual updates to the savings calculations.

Objective: What are the final cost savings results from ORM's contract with FARA as of June 30, 2015?

Overall, we found that by privatizing the state's lines of insurance and loss prevention services from ORM to FARA, the state saved a net of $9.8 million over five years. However, FARA only achieved $43.8 million of its contractually-guaranteed claims savings of $50 million. According to the contract, if the savings are not achieved, FARA must refund to the state 3% of the shortfall, up to $1.5 million. Therefore, we calculated that FARA owes the state $185,288 for not meeting the contractually-guaranteed savings. Net program savings and cumulative cost savings as of June 30, 2015 are described below.

Privatizing the state's lines of insurance and loss prevention services from ORM to FARA saved the state $9.8 million over five years.

Although not guaranteed in the contract, ORM projected that privatizing risk management functions could save the state approximately $22 million over five years. We found that the FARA contract resulted in a net program savings of $9.8 million, which is approximately 44.5% of the $22 million ORM projected. To calculate the net program savings, we subtracted ORM's *administrative and other cost savings* of $27 million and FARA's *claims and litigation payment savings* of $43.8 million from the approximately $61 million (90%) of the original contract cost of $68.1 million that ORM paid FARA, as shown below.

Cumulative Five-Year Contract Costs Paid to FARA	$61M
ORM's *Administrative & Other Cost Savings*	-$27M
FARA's *Claims & Litigation Payment Savings*	-$43.8M
Net Program Savings to the State	**($9.8M)**

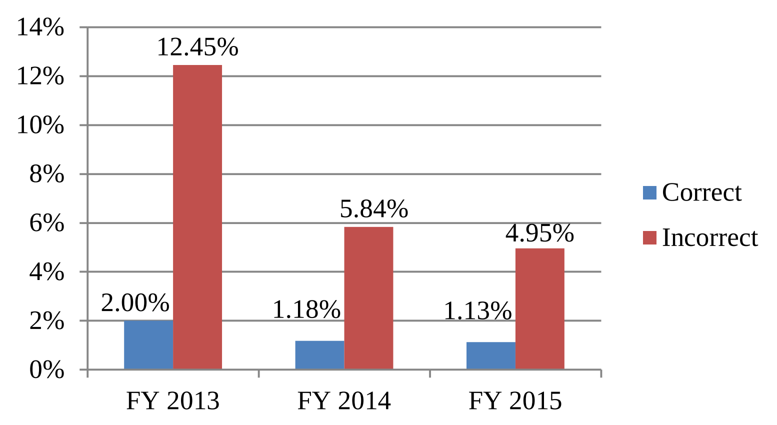
At the end of the five-year contract, FARA achieved approximately $43.8 million (87.6%) of the $50 million in *claims and litigation payment savings* guaranteed by the contract.

As of June 30, 2015, ORM calculated[4] that FARA had cumulatively reduced *claims and litigation payments* by approximately $48.0 million (96%) of the $50 million in payment savings the contract guarantees. Since this was the final year of the five-year contract, we used staff with economic expertise to review the final year as well as previous years to ensure the accuracy 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.

the savings and any applicable penalties. We determined that ORM incorrectly calculated the inflation rate related to the property line of insurance for fiscal years 2013, 2014, and 2015. This mathematical error resulted in ORM applying an incorrect inflation factor from fiscal years 2013 through 2015 which overstated FARA's *claims and litigation payment savings.* Exhibit 1 shows the correct inflation factors for property labor and materials in comparison to ORM's calculated inflation factors for each of the three fiscal years that FARA administered the property line of insurance.

Exhibit 1
Inflation Factors Used for Property Savings Calculations
Fiscal Year 2013 through Fiscal Year 2015



Source: Prepared by legislative auditor's staff using cost indices developed by Xactimate and information provided by ORM.

As a result, FARA's correct savings as of June 30, 2015, should be $43.8 million, or 87.6% of the $50 million guaranteed by the contract. Since FARA did not achieve the $50 million in savings as guaranteed, the contract requires that FARA refund the state 3% of the shortfall, up to $1.5 million.

We calculated that FARA owes the state $185,288 for not achieving the required $50 million in guaranteed savings; however, ORM only invoiced FARA for $59,252 due to concerns about the inflation rate applied to property lines of insurance. On December 28, 2015, ORM notified FARA that the state's savings analysis showed that FARA did not meet the $50 million guarantee by approximately $2.0 million and therefore owed $59,252 (3% of the incorrect $2.0 million shortfall). After we completed our review and notified ORM of our analysis, ORM agreed that it had used the wrong inflation rate in fiscal years 2013 through 2015 for property lines of insurance and therefore incorrectly calculated FARA's savings. Based on the correct inflation rates and corrected savings of $43.8 million, we calculated that FARA should owe the state $185,288, or 3% of the $6.2 million shortfall as stipulated in the contract. However, ORM stated that it only invoiced FARA for $59,252, as based on its professional judgment and day-to-day involvement with property claims, the inflation factors they used more accurately reflect the inflation rate for property lines of insurance during the contract period.

Exhibit 2 includes a breakdown of the approximately $43.8 million of cumulative *claims and litigation payment savings* achieved by FARA, by line of insurance, through fiscal year 2015.

Exhibit 2
Cumulative Claims and Litigation Payment Savings Achieved by FARA, By Line of Insurance
Fiscal Year 2011 through Fiscal Year 2015

Line of Insurance	Savings	Time Administered by FARA
Workers' Compensation	$22.5 million*	5 years
General Liability	4.7 million	4 years
Property	5.2 million	3 years
Medical Malpractice	13.6 million	3.5 years
Transportation	(2.2 million)	2 years
Road Hazard	0.1 million	2 years
Total Savings	**$43.8 million**	

*Includes $1.1 million in cumulative savings from settlement of workers' compensation claims.
Source: Prepared by legislative auditor's staff using information provided by ORM.

Recommendation 1: Based on the terms of the contract, ORM should invoice FARA the full penalty amount of $185,288 that it owes for not meeting the guaranteed savings of $50 million.

Summary of Management's Response: ORM disagrees with this recommendation. ORM states that it does not agree that the calculation of cost savings achieved by FARA using the corrected average inflation provides a reasonable estimate of FARA's savings. According to ORM, the actual property inflation in Louisiana during the time period of the FARA contract was greater than the average inflation. In addition, ORM stated that to subsequently invoice FARA for a greater amount based on a cost savings methodology different from what was presented to and accepted by FARA would put ORM in a posture that may not be in compliance with the terms of the contract.

LLA's Additional Comments: The savings and resulting penalty amount we calculated was not based on a different cost savings methodology than the one presented to FARA. Instead, we corrected a formula error ORM made in applying that cost savings methodology.

APPENDIX A: MANAGEMENT'S RESPONSE

Office of Risk Management
State of Louisiana
Division of Administration

JOHN BEL EDWARDS
GOVERNOR

JAY DARDENNE
COMMISSIONER OF ADMINISTRATION

June 17, 2016

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

Re: Response to LLA's Performance Audit Report on FARA Cost Savings as of June 30, 2015, on the Division of Administration's Office of Risk Management

Dear Mr. Purpera:

The Division of Administration (DOA) would like to thank you and your staff for conducting the final performance audit on the cost savings related to DOA's Office of Risk Management (ORM) contract with F.A. Richard & Associates (FARA). The five year contract with an amended maximum payout of $74.9 million was concluded at June 30, 2015, with total contract payments of $62.2 million. This resulted in almost $12.7 million (17%) of the contract being unexpended, a result that is indicative of ORM's vigilant management of the contract.

The Office of the Louisiana Legislative Auditor (LLA) used staff with economic expertise to review the fiscal evaluation of cost savings under the FARA contract at the end of both fiscal years 2014 and 2015. Late in LLA's fiscal year 2015 review, a mathematical error impacting cost savings related to the property line of insurance was identified and brought to ORM's attention by LLA.

In reviewing the information discovered during LLA's review of fiscal year 2015 cost savings information, ORM determined that a formula error had been made in the annual calculation of the 5-year average inflation using a particular property valuation and damage appraisal inflation tool. However, we do not agree that the calculation of cost savings achieved by FARA using the corrected average inflation provides a reasonable estimate of FARA's savings. We believe the actual property inflation in Louisiana during the time period of the FARA contract was greater than the average inflation, developed appropriately, using the property inflation tool.

Upon review, ORM has confirmed that the property inflation tool was not Louisiana specific, but was based on the national market. Recurring catastrophic events that continued to impact the state during the contract period produced inflation that was not typical nationwide. When the tool was initially selected to be used in the calculation of cost savings for fiscal year 2013, ORM's fiscal analysts requested and received validation that the average inflation calculations produced were reasonable, based on the professional judgment of in-house property insurance managers with many years of industry experience in Louisiana.

I believe that the inflation factors used by ORM's fiscal team in estimating cost savings for the property line of insurance provided a reasonable basis for estimating the market conditions during the contract period. Had LLA identified the error and brought it to the attention of ORM during their review of either fiscal year 2013 or 2014, ORM would have had an opportunity to research and identify a different inflation tool or approach that may have been more suitable for the Louisiana market. Because the error was identified in LLA's last and final review of ORM's costs savings analysis and the contract term has expired, the opportunity to research and apply a different approach is not available.

Section 5.0 of ORM's contract with FARA states that the language and methodologies used for determining cost savings will be agreed upon by both FARA and the State. For each year of the contract, ORM shared with FARA a report of the fiscal evaluation of cost savings under the contract. The final phase in development of cost savings methodology occurred during the analysis of fiscal year 2014, after all lines of insurance had transitioned to FARA. ORM's methodology and evaluation of cost savings were shared with and reviewed by FARA for final acceptance and agreement, in compliance with the terms of the contract. FARA acknowledged to ORM their acceptance and agreement of ORM's methodology and evaluation of cost savings in person and by email.

Based on ORM's methodology for determining costs savings that was agreed upon and accepted, FARA was invoiced a total of $59,252.79. This amount indicates a shortfall of less than 4% in achieving the expected cost savings. The contract stipulated that FARA would achieve $50 million in guaranteed cost savings. The cumulative savings realized by FARA under the contract totaled over $48 million. The net program savings recognized in the final evaluation prepared by ORM totaled over $14 million. We believe that to subsequently invoice FARA for a greater amount based on a cost savings methodology different from what was presented to and accepted by FARA would put ORM in a posture that may not be in compliance with the terms of the contract, and the increased invoice amount proposed by LLA may be subject to dispute by FARA.

Thank you again for your efforts in reviewing the cost savings achieved each year while the contract with FARA was in place. As your reports over the last 5 years support, significant cost savings were achieved with this effort by ORM.

Sincerely,

Marsha Pemble

State Risk Assistant Director

Cc: J.S. "Bud" Thompson, Jr., State Risk Director
Jay Dardenne, Commissioner of Administration
Barbara Goodson, Deputy Commissioner
Desiree Honore Thomas, Assistant Commissioner
Afranie Adomako, Director of Management & Finance
Marsha Guedry, Internal Audit Administrator
Marella Houghton, Deputy Undersecretary

APPENDIX B: SCOPE AND METHODOLOGY

We conducted this audit under the provisions of Title 24 of the Louisiana Revised Statutes of 1950, as amended, and 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, 2014, through June 30, 2015. Our objective was to determine the cost savings results from ORM's five-year contract with FARA ending on June 30, 2015.

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 objective. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. To answer our objective, we reviewed internal controls relevant to the audit objective and performed the following audit steps:

- Obtained ORM's summary of cumulative cost savings for the FARA contract as of June 30, 2015, on December 21, 2015. However, LLA had to delay analysis until the end of February because DOA's Office of Financial and Support Services, which assisted in preparing the analysis, was significantly reorganized during this time and had other priorities in addition to our requests for information.

- Obtained and analyzed the reliability and reasonableness of ORM's estimated cost savings methodology and analysis for fiscal year 2015, which did not change from fiscal year 2014 methodology.

- Verified ORM's actual contract costs paid to FARA 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. In addition, some actual expenditures for other claims-related costs were verified with the expenditure report from Business Objects.

- Recalculated ORM's projected costs and actual costs and verified the amounts with supporting documentation for accuracy and reliability. Confirmed these calculations with ORM management.

APPENDIX C: OVERVIEW OF ORM'S SAVINGS EVALUATION PROCESS FISCAL YEAR 2015

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, and again in Year Five.

General Liability. The evaluation of the General Liability line of business was through the continuation of the method established in fiscal year 2012 and followed in subsequent years. 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 2015 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 the Property line of business. Projected in-house cost estimates for fiscal year 2015 were based on the average of actual data from calendar years 2007 through 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 was 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 coverage 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 the Transportation line of business. Projected in-house program cost estimates for fiscal year 2015 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 of 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 2015 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 of 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.