



STATE OF NORTH CAROLINA

PERFORMANCE AUDIT

OVERSIGHT OF THE NORTH CAROLINA

STATE HEALTH PLAN

FOR TEACHERS AND STATE EMPLOYEES

OCTOBER 2008

OFFICE OF THE STATE AUDITOR

LESLIE W. MERRITT, JR., CPA, CFP

STATE AUDITOR

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October 13, 2008

The Honorable Mike Easley, Governor
Members of the North Carolina General Assembly
Jack Walker, PhD, Executive Administrator, State Health Plan for Teachers and State Employees

Ladies and Gentlemen:

We are pleased to submit this performance audit titled *Oversight of the State Health Plan for Teachers and State Employees*. The audit objective was to determine if there is adequate and effective oversight of the State Health Plan. Dr. Jack Walker reviewed a draft copy of this report. His written comments are included in the appendix.

The State Auditor initiated this audit to identify improvement opportunities in State Health Plan oversight based on growing concerns expressed by the state employees, legislature, public, and media.

We wish to express our appreciation to the staff of the State Health Plan for Teachers and State Employees for the courtesy, cooperation, and assistance provided us during the audit.

Respectfully submitted,

A handwritten signature in cursive script that reads "Leslie W. Merritt, Jr.".

Leslie W. Merritt, Jr., CPA, CFP
State Auditor

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SUMMARY

PURPOSE

This audit report evaluates the oversight of the North Carolina State Health Plan for Teachers and State Employees (State Health Plan or Plan) and makes recommendations so its management, Board of Trustees (Board), and the General Assembly can take appropriate corrective action.

RESULTS

Oversight of the State Health Plan is inadequate and ineffective.

The Plan lacks executive branch oversight that is clearly responsible and accountable for Plan decision-making and operational results. Consequently, the Plan's Executive Administrator is able to conduct daily operations without appropriate oversight for significant periods of time.

The executive branch of state government is responsible for implementing and managing the policies and programs established by the legislative branch. The executive branch should be responsible for the Plan's management functions such as hiring and firing the Executive Administrator, determining the Executive Administrator's compensation, evaluating the Executive Administrator's performance, and authorizing contracts. Thirty-five states operate their state health plan under an executive branch agency.

In North Carolina, the Plan operates without executive branch oversight. The Plan's Board provides some oversight. However, the Board lacks authority to hire and fire the Executive Administrator, determine the Executive Administrator's compensation, evaluate the Executive Administrator's performance, or authorize contracts. The lack of authority limits the Board's ability to provide effective oversight of the Plan's administration. Also, the Board has not received financial information necessary to provide proper oversight of the Executive Administrator and the Plan's operations.

North Carolina General Statutes give the Commissioner of Insurance, an executive branch agency, the authority to hire and fire the Plan's Executive Administrator. But in practice, the primary authority over the Plan is a legislative body, the Committee on Employee Hospital and Medical Benefits (Legislative Committee). However, the Legislative Committee does not meet frequently enough to provide adequate managerial oversight. In addition, the Legislative Committee's influence over the Plan's management functions may violate the North Carolina State Constitution's separation of powers clause, creates the potential for undue political influence in the Plan's administrative decisions and contract negotiations, and creates the opportunity for conflicts of interest.

RECOMMENDATIONS

The General Assembly should enact legislation to place the State Health Plan under the authority of an executive branch agency to ensure proper operational and financial oversight.

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If the General Assembly allows the State Health Plan to continue operating under the current oversight structure, the General Assembly should enact legislation to give the Board full authority to provide proper operational and financial oversight.

AGENCY'S RESPONSE

The Agency's response is included in the appendix.

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INTRODUCTION

BACKGROUND

North Carolina General Statute Chapter 135, Article 3, authorized the creation of the North Carolina State Health Plan for Teachers and State Employees (State Health Plan or Plan), which became self-funded in October 1982. The State of North Carolina makes health insurance coverage available to its employees, retired employees and their dependents.

Responsible parties discussed in this report include:

Committee on Employee Hospital and Medical Benefits (Legislative Committee) – Consists of 12 members of the legislature. The Legislative Committee reviews programs of hospital, medical, and related care as recommended by the Executive Administrator and the Board of Trustees.

Board of Trustees (Board) - Consists of nine appointed members who serve in an advisory role to the Executive Administrator. The Board provides advice on Plan policies and reviews claim appeals.

Executive Administrator – Responsible for cost management programs, education and illness prevention programs, membership functions, long-range planning, provider and participant relations, and communications.

Commissioner of Insurance – Appoints and removes the Executive Administrator. The Commissioner sets terms of employment and salary upon advice of the Legislative Committee.

For fiscal year 2007-2008, the Plan's financial statements show total revenues as \$2.26 billion and total expenses as \$2.35 billion. The Plan provides health care coverage to more than 649,000 teachers, state employees, retirees, current and former lawmakers, university and community college personnel, hospital staff and their dependents.

OBJECTIVES, SCOPE, AND METHODOLOGY

The audit objective was to determine whether there is adequate and effective oversight of the State Health Plan.

The State Auditor initiated this audit to identify improvement opportunities in State Health Plan oversight based on growing concerns expressed by the state employees, legislature, public, and media.

The audit scope included all Plan oversight from July 1, 2007, through July 31, 2008. We conducted the fieldwork from July 2008 to September 2008.

To determine whether there is adequate and effective oversight for the State Health Plan, we conducted interviews of State Health Plan staff, Board members, Legislative Committee

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members, and General Assembly Fiscal Research Division personnel. We reviewed information, conducted interviews, or sent questionnaires to determine the health plan administration and structure within all 50 states. We reviewed Board minutes, Legislative Committee minutes, and *North Carolina General Statutes*.

Because of the test nature and other inherent limitations of an audit, together with limitations of any system of internal and management controls, this audit would not necessarily disclose all performance weaknesses or lack of compliance.

We conducted this performance audit according to generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence that provides a reasonable basis for 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.

We conducted this audit under the authority vested in the State Auditor of North Carolina by *North Carolina General Statute 147.64*.

FINDINGS AND RECOMMENDATIONS

OVERSIGHT AUTHORITY FOR THE STATE HEALTH PLAN IS UNCLEAR

In July 1994, the Office of the State Auditor issued a performance audit report that identified problems with the oversight structure of the North Carolina State Health Plan for Teachers and State Employees (State Health Plan or Plan). The report states,

“Our review of this structure and interviews with the individuals involved indicate that this organizational placement does not work effectively or efficiently. While the legislation assigns responsibility for administering the Plan to the Executive Administrator, it does not clearly assign the authority for decision making. The existence of both a Board of Trustees and a legislative oversight committee creates numerous problems in gaining consultation and concurrence as outlined in the legislation and ultimately does not allow for accountability of decision making.”

The 1994 report noted that the State Health Plan was not placed under the authority of an executive branch agency, the Board of Trustees (Board) had no authority and only served an advisory function, and the Committee on Employee Hospital and Medical Benefits (Legislative Committee) was the Plan’s primary oversight authority.

The same conditions exist today.

No Executive Branch Oversight

The State Health Plan lacks executive branch oversight that is clearly responsible and accountable for decision-making and operational results.

The executive branch of state government is responsible for implementing and managing the policies and programs established by the legislative branch.

In the case of the State Health Plan, the executive branch should be responsible for management functions such as hiring and firing the State Health Plan’s Executive Administrator, determining the Executive Administrator’s compensation, evaluating the Executive Administrator’s performance, approving long-range plans, monitoring operational performance, and approving contracts.

Thirty-five states provide executive branch oversight by placing their state health plan under the authority of an executive agency. Twelve of the 35 states operate their state health plan as a human resources function, which the National Association of State Personnel Executives says may improve effectiveness and efficiency. Twenty-three of the 35 states operate their state health plan under various other departments such as administration, controller, insurance, management and budget, and treasurer.

In North Carolina, however, the State Health Plan does not operate under the authority of an executive agency. The Board provides some oversight for the Plan.

FINDINGS AND RECOMMENDATIONS

Board Lacks Authority and Adequate Information

The State Health Plan's Board lacks the authority and does not receive the financial information necessary to provide proper oversight of the Executive Administrator and the Plan's operations.

Fifteen states, including North Carolina, operate the state's health plan without executive branch oversight. In 13 of the 15 states, the board of trustees has varying levels of authority over the executive administrator and state health plan operations. Louisiana and North Carolina are two exceptions where the board lacks authority.

In North Carolina, the State Health Plan's Board serves an advisory role and does not have the authority to hire, fire, or evaluate the Executive Administrator. The Board also lacks authority to authorize or reject proposed contracts between the Plan and third parties. This lack of authority limits the Board's ability to provide effective oversight of the Plan's administration.

Another problem is the Board does not receive adequate information to provide effective financial oversight. According to Board members, financial reports presented to the Board do not provide comparative data that would enable Board members to know the financial standing of the Plan. At the April 2008 Board meeting the Board requested, "...changing to a fiscal year report to determine where the Plan stands year-to-date on a timeline." The Board Chair stated, "... this is what the Board desires to review – a month-by-month report on projection and actual performance." Additionally, the Board does not review and approve the Plan's budget before it goes to the legislature for the appropriations process. The Board received some 2007-2009 biennium budget information in February 2007 and was promised later updates. However, a former Board member said the Board was not presented the Plan's budget until after the legislature had passed a budget and closed the legislative session.

The lack of Board authority has made some members unclear about their oversight role. A former Board chair requested clarification regarding the decision-making authority of the Board and the Executive Administrator. He also requested clarification about whose opinion takes precedence when the Board and the Legislative Committee disagree on an issue involving the Plan.

In response to the request, the Plan's attorney met with the Board in September 2008 to discuss the Board's roles and responsibilities. At the next meeting, the Board will discuss whether to seek additional authority through General Statute amendments or to maintain the current structure.

FINDINGS AND RECOMMENDATIONS

Legislative Oversight Is Not Enough

Guidance for healthcare organization management makes several recommendations for proper oversight.¹ The oversight body should be a key decision maker in terms of financial oversight. Management should present information such as membership data priced at blended premium rates, medical expenses, administrative costs, balance sheet, and cash flow statements to the oversight body. Recommended financial performance indicators include trends, industry comparisons, expectations, and benchmarks. Detailed financial information should roll up to a summary level to facilitate presentation to key decision makers. Management should provide monthly reports that identify any deviation from budget expectations to the oversight body so that it can take corrective action.

The Legislative Committee does not meet frequently enough nor receive the information necessary to provide adequate managerial oversight of the Plan.

The Legislative Committee does not meet monthly to review management reports and take corrective action. North Carolina law only requires the Legislative Committee to meet quarterly. *North Carolina General Statute* 135-38 states, “The Committee shall meet not less than once each quarter to review the actions of the Executive Administrator and Board of Trustees.” The Legislative Committee co-chairs said that they meet informally with the State Health Plan Executive Administrator every month or two to discuss the financial status of the Plan. However, during fiscal year 2007-2008 the full Legislative Committee only met on May 15, 2008. According to meeting minutes, no financial information was presented to the Legislative Committee during the meeting.

Also, the Legislative Committee may not receive all of the information it needs to provide adequate managerial oversight of the Plan. The General Assembly Fiscal Research Division (Fiscal Research) provides financial oversight of the Plan by monitoring the budget and provides information to the Legislative Committee’s co-chairs when needed or requested. Fiscal Research reviews monthly reports from the Plan that include claims costs, revenue, administrative costs, cash balance, and budget-to-actual data. However, the Legislative Committee may not receive complete information from Fiscal Research because Fiscal Research does not have complete access to the Plan’s operational information. Due to federal healthcare information privacy laws and vendor confidentiality agreements, Fiscal Research does not have access to all Plan contractor information.

In addition, Fiscal Research does not have direct access to the Plan’s financial data and must rely on reports from the Plan. In September 2008, the State Health Plan projected a loss of \$264 to \$280 million for fiscal year 2008-2009. Fiscal Research said it asked Plan management in January 2008 whether the Plan needed to revise projections; Plan

¹ Griffith, John R. *The Well-Managed Healthcare Organization – Fourth Edition*. Chicago: AUPHA Press, 1999. Kongstvedt, Peter R. *Essentials of Managed Health Care – Fourth Edition*. Boston: Jones and Bartlett Publishers, Inc., 2003.

FINDINGS AND RECOMMENDATIONS

management said that a revision was not necessary. Fiscal Research said it first noticed budget problems with the Plan in March 2008. Fiscal Research said it did not receive the April 2008 financial report from the Plan until June, which delayed identifying any further budget problems. Fiscal Research also said that the reports received from the Plan prior to July 2008 were not sufficient to properly assess any problems. Fiscal Research said it repeatedly requested that the Plan provide additional financial information in a standardized format that would allow for comparisons between time periods. According to Fiscal Research, the Plan never provided such information.

Consequently, the Legislative Committee may not have had all of the information it needed to provide appropriate oversight of the Plan's operations and financial status.

Separation of Powers

The Legislative Committee performs management functions that may violate the North Carolina State Constitution's separation of powers clause.

The separation of powers clause states, "The legislative, executive, and supreme judicial powers of the State government shall be forever separate and distinct from each other." However, the primary authority over the Plan is a legislative body rather than an executive body.

The Legislative Committee performs several management functions for the State Health Plan. For example, the Legislative Committee's executive committee (the Committee's co-chairs) can hire, fire, and set the compensation of the State Health Plan's Executive Administrator. *North Carolina General Statute 135-39.4A* states the Commissioner of Insurance shall appoint, set the term of employment and salary, and remove from office the State Health Plan's Executive Administrator "...upon the advice of an executive committee of the Committee on Employee Hospital and Medical Benefits."

The Commissioner of Insurance, however, said that he primarily serves as the "messenger" for the Legislative Committee's executive committee. The Commissioner explained the circumstances surrounding the dismissal of the former and the hiring of the current Executive Administrator. The Commissioner said he received a call from the Legislative Committee co-chairs on July 1, 2008, and was instructed to dismiss the former Executive Administrator. A letter to the Commissioner from the Legislative Committee co-chairs instructed the Commissioner to hire the current Executive Administrator at a \$200,000 annual salary.

The Commissioner also emphasized that he has no oversight role over the State Health Plan or its Executive Administrator. Legislation does not clearly assign responsibility to evaluate the Executive Administrator's performance, and there is no documented formal evaluation of the previous Executive Administrator's performance during the two and a half years that he served. A Legislative Committee co-chair said that the Executive Administrator primarily reports to the Legislative Committee and technically to the Commissioner of Insurance.

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The Legislative Committee is also involved in State Health Plan administrative decisions. The Executive Administrator cannot negotiate certain contracts without first consulting with the Legislative Committee. *North Carolina General Statute 135-39.4A* states,

“The Executive Administrator may also negotiate, renegotiate and execute contracts with third parties in the performance of his duties and responsibilities under this Article; provided any contract negotiations, renegotiations and execution with a Claims Processor, with an optional hospital and medical benefit plan or program authorized under G.S. 135-40, with a preferred provider of institutional or professional hospital and medical care, or with a pharmacy benefit manager shall be done only after consultation with the Committee on Employee Hospital and Medical Benefits.”

When considered in conjunction with the Legislative Committee’s demonstrated ability to hire and fire the Plan’s Executive Administrator, the above statute creates the opportunity for a conflict of interest. The statute specifically requires the Executive Administrator to consult with the Legislative Committee before negotiating contracts with Blue Cross Blue Shield of North Carolina (claims processor), Medco Health Solutions (pharmacy benefit manager), and other healthcare service providers. Consequently, the Legislative Committee can influence contract negotiations with the Plan’s vendors by influencing the Executive Administrator’s decisions. The appearance of a conflict of interest would exist if a Legislative Committee member had influence over a contract’s negotiation and received campaign contributions, gifts, or trips from that contractor.

Regardless of whether conflicts of interest actually occur, the Legislative Committee’s influence over the management functions of negotiating contracts and hiring, firing, and setting the compensation for the Executive Administrator may violate the intent of the separation of powers clause.

The separation of powers issue was raised before. On October 19, 1994, a Legislative Committee meeting was held in response to the July 1994 audit report to discuss the possibility of placing the State Health Plan under the authority of an executive agency. At the meeting, a former Deputy State Treasurer said,

“Our understanding of the separation of powers is that the legislative branch of government establishes policy through the enactment of laws and the appropriation of resources, while the executive branch carries out (or executes) and administers these laws. In the case of the Health Plan, the practical effect of the current organizational structure is that the legislative branch, through this Committee on Employee Hospital and Medical Benefits, is the ultimate administrator. ...What we are saying is that it matters little where the Health Plan Office is housed in the executive branch so long as this Committee exercises many of the usual executive branch functions.”

FINDINGS AND RECOMMENDATIONS

Legislative Changes of 1985

The current oversight structure is a result of legislative changes made in 1985.

The 1994 State Auditor's report indicated that the legislature intended to exercise executive control over the State Health Plan. The report states,

“In 1985, significant legislative changes were made to *North Carolina General Statute 135* in an effort by the legislature to gain more direct control over the Plan. The original legislation established a Board of Trustees which was assigned the authority and responsibility for Plan administration. The Director answered to the Board. The 1985 legislation changed the Board's responsibility to an advisory role only and established the position of Executive Administrator, with the Insurance Commissioner given the responsibility for appointing and removing the Executive Administrator. The legislation directed the Executive Administrator to consult with the Board and the legislative oversight committee, the Committee on Employee Hospital and Medical Benefits, regarding Plan operations. In all other respects, the Plan remained a separate entity. The overall authority of the Executive Administrator was increased from that of the original Director, but the legislation required him to consult with the Board and to gain concurrence from the legislative oversight committee for major decisions.”

In a meeting with the auditors in August 2008, the Commissioner of Insurance also said that the legislature intended to control the State Health Plan. The Commissioner explained that the legislators wanted to retain control over the State Health Plan, so they included the Department of Insurance in the hiring and firing of the Executive Administrator to comply with the North Carolina State Constitution's separation of powers clause.

In response to the July 1994 audit report, draft legislation was created in January 1995 called,

A Bill Entitled An Act to Transfer the Administration of the Teachers' and State Employees Comprehensive Major Medical Plan to the Department of State Treasurer and to Vest Administrative Authority Over the Plan in the Board of Trustees.

The draft legislation would have placed the State Health Plan under the authority of the State Treasurer and given the Board authority to hire, fire, and determine compensation for the Executive Administrator. The Board would also have received authority to approve contracts between the State Health Plan and third parties.

However, the legislation was never enacted. The State Health Plan continues to operate without executive branch oversight, and the Board continues to serve an advisory role only.

FINDINGS AND RECOMMENDATIONS

Problems with Current Oversight Structure

The lack of executive branch authority makes it unclear who is accountable for oversight of State Health Plan decision-making and operational results and allows the Executive Administrator to conduct daily operations without oversight for significant periods of time.

For example, the Plan acknowledges a \$137 million budget shortfall for fiscal year 2008 and projects a loss of \$264 to \$280 million for fiscal year 2008-2009. On October 1, 2008, the Plan's website stated,

“At the State Health Plan, we are continuing the analysis of our financials to better understand the budget shortfall of \$137 million for Fiscal Year 2008 (after adjusting for delayed claims payments). As a result of the analysis, we found that administrative expenses were underestimated and that our forecasting model was incorrect.”

During the 2008 fiscal year, all of the entities involved in the Plan's oversight lacked the authority, the access, or the time to properly evaluate the former Executive Administrator's estimates, administrative decisions, and operational results. The Plan's Board served in an advisory capacity and lacked authority to make decisions; the Board and Fiscal Research had difficulty in obtaining the information needed to analyze the Plan's financial position, and the Legislative Committee met too infrequently to review financial data and provide adequate oversight.

In addition, the current oversight structure allows the Legislative Committee to influence the Plan's management functions which may violate the North Carolina State Constitution's separation of powers clause, creates the potential for undue political influence in the Plan's administrative decisions and contract negotiations, and creates the opportunity for conflicts of interest.

Recommendation: The General Assembly should enact legislation to place the State Health Plan under the authority of an executive branch agency to ensure proper operational and financial oversight.

If the General Assembly allows the State Health Plan to continue operating under the current oversight structure, the General Assembly should enact legislation to give the Board full authority to provide proper operational and financial oversight.

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APPENDIX



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October 6, 2008

Leslie M. Merritt, Jr., CPA, CFP
State Auditor
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Dear Mr. Merritt:

My executive staff and I have reviewed the draft of the 2008 audit report, titled *Oversight of the State Health Plan for Teachers and State Employees* which was provided to me on October 3, 2008. We have no questions or comments related to this draft.

Sincerely,

Jack W. Walker, PhD.
Executive Administrator

JWW:lsm

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