

State of Minnesota Office of the State Auditor



**Patricia Anderson
State Auditor**

SERVICE COOPERATIVES' INSURANCE PROGRAMS SPECIAL REVIEW

JUNE, 2005

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The Office of the State Auditor serves as a watchdog for Minnesota taxpayers by helping to ensure financial integrity, accountability, and cost-effectiveness in local governments throughout the state.

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The State Auditor performs approximately 250 financial and compliance audits per year and has oversight responsibilities for over 4,300 local units of government throughout the state. The office currently maintains five divisions:

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Government Information - collects and analyzes financial information for cities, towns, counties, and special districts;

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Office of the State Auditor
525 Park Street, Suite 500
Saint Paul, Minnesota 55103
(651) 296-2551
state.auditor@state.mn.us
www.auditor.state.mn.us

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SERVICE COOPERATIVES’ INSURANCE PROGRAMS SPECIAL REVIEW

JUNE, 2005

The Office of the State Auditor conducted this review in response to concerns we received regarding the management of health insurance provided through service cooperatives to over 700 Minnesota school districts and other local public entities.¹

Specifically, we reviewed the service cooperatives’ use of consulting contracts, and their use of administrative and service fees. We reviewed the service cooperatives’ procedures for monitoring reserve funds and setting annual renewal rates. We also reviewed the service cooperatives’ audits.

During our review of consultant contracts, we found that seven service cooperatives:

- Paid a consultant more than \$600,000 per year without going out for requests for proposals (“RFPs”).
- Agreed that the same consultant could work for Blue Cross and Blue Shield of Minnesota (“the Blues”) to market the Blues’ products to the service cooperatives.
- Entered consultant contracts that did not describe in detail the duties the consultant would perform for the service cooperatives.
- Failed to require invoices or other appropriate documentation from the consultant prior to paying for services.
- Entered verbal agreements regarding the consultant’s compensation.
- Lacked sufficient contracting policies and procedures.

During our review of fees paid by school districts and other local public entities for health insurance, we found that some service cooperatives used administrative insurance fees to pay for non-insurance related programs. We also found that some of the service cooperatives used service fees to fund a “research and development account” that, among other things, was used to pay lobbying expenses.

Based on our review, we believe that some of the service cooperatives are not sufficiently monitoring consultants and third-party vendors. Some of the service cooperatives appear to rely too heavily on their third-party vendor, the Blues. For some of the service cooperatives, we found that:

¹ Our review was not a full audit of the service cooperatives’ health insurance program.

- Reserve funds were not actively monitored.
- Reserve funds are under-funded.
- Annual renewal rates in some instances appear to have been set too low, resulting in losses to reserve funds.

We are concerned about the lack of financial information available to the public for some of the service cooperatives' insurance programs. For some of the service cooperatives, we found that:

- Financial statements are not prepared in accordance with generally accepted accounting principles promulgated by the Governmental Accounting Standards Board.
- Selected members of the public are being denied access to financial statements for the insurance plans, including the extent to which reserve accounts are under-funded.
- Public contracts entered into by the service cooperatives contain clauses that could prevent public review of the contracts.

Our focus is on the benefits that service cooperatives can provide for their school district and other local public entity members. Our goal is to provide recommendations that will permit taxpayers to receive the most benefit from the advantages that cooperative efforts should be able to provide.

I. Background on Service Cooperatives

Service cooperatives were created by the Minnesota legislature to perform planning on a regional basis, and to provide programs for local governments that are better provided by a cooperative than by individual governmental units.² Examples of programs and services provided by service cooperatives include staff development programs, student academic challenges, services for students with special talents and special needs, and cooperative purchasing services.³ Service cooperative members include public school districts, cities, counties, and other governmental units.⁴

Service cooperatives are governed by a board of directors, with participating school board members comprising a majority of the board.⁵ The board of directors has the powers granted to the board in the service cooperative's by-laws.⁶

Service cooperatives are funded with public dollars. Participating members provide financial support to the service cooperative through a service fee, with additional private,

² See Minn. Stat. § 123A.21, subds. 1 and 2.

³ See Minn. Stat. § 123A. 21, subd. 7.

⁴ Nonvoting membership in the service cooperatives is available to nonpublic schools, and other partnership agencies or organizations within the service cooperative. See Minn. Stat. § 123A.21, subd. 3.

⁵ See Minn. Stat. § 123A.21, subd. 4 (a).

⁶ See Minn. Stat. § 123A. 21, subd. 5 (h).

state, and federal supplemental support as available.⁷ A service cooperative is a public corporation and agency, and no earnings or interests of the service cooperative may inure to the benefit of an individual or private entity.⁸

Eight regional cooperatives provide health insurance benefits and services to school districts and other public and non-profit entities.⁹ The Blues have been the insurance carrier for each of the service cooperatives, providing benefits through a partially self-funded, minimum premium arrangement with each of the service cooperatives.¹⁰ Each entity that obtains insurance benefits from a service cooperative signs a Joint Powers Agreement with the service cooperative, authorizing the service cooperative to negotiate insurance coverage on its behalf.¹¹

The service cooperatives informed us that they began offering health insurance in 1985 by offering fully-insured plans. They informed us that they have been “self-insured” since the early 1990s.¹² In a fully insured pool, typically the carrier takes all of the risk.¹³ In a self-insured pool, the risk is on the pool if claims exceed premiums.¹⁴ A fully-insured pool retains less risk than a self-funded pool; however, the cost of this risk transfer is higher contributions to reserves over time.¹⁵ In a self-insured pool, contributions to the reserves should decrease to zero over time (once the reserves are established), if there are no unexpected increases in claims.¹⁶

⁷ See Minn. Stat. § 123A.21, subd. 9 (a).

⁸ See Minn. Stat. § 123A. 21, subd. 9 (e).

⁹ See generally State Wide Health Insurance Pool for School District Employees and Retirees, Study of Feasibility, Costs, Impact, Plan Designs, Funding, Wellness/Consumer Education, and Other Issues For the School Employee Insurance Plan and Design Committee, prepared by Earl L. Hoffman, Reden & Anders, Ltd. (January 23, 2004) (“2004 Statewide Study”), available at:

http://www.state.mn.us/mn/externalDocs/Commerce/School_Insurance_Proposal_012604112352_0123MN_LegislatureRpt.pdf. The eight service cooperatives providing health insurance to their members are Lakes

Country (LCSC), North Central (NCSC), Northeast (NESC), Northwest (NWSC), Resource Training & Solutions (RT&S), South Central (SCSC), Southeast (SESC), and Southwest/West Central (SW/WC SC) Service Cooperatives. Metro ECSU informed us that it does not provide insurance benefits to its members.

¹⁰ 2004 Statewide Study at 5. In very general terms, under the minimum premium funding model, service cooperative members pay a premium-equivalent amount that includes the costs of expected claims, reserve funding, and administrative costs.

¹¹ We were provided with sample joint powers agreements. The joint powers agreements used by South Central, North Central, and Southeast Service Cooperatives have slightly different wording from the joint powers agreement used by the other five service cooperatives.

¹² We use the term “self-insured” because that is the description of the plans used by the service cooperatives. It is our understanding that “self-funded” pools may be the more accurate term. We take no position on when the service cooperatives became self-funded or self-insured.

¹³ See 2004 Statewide Study at 37.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

The service cooperatives reported to us that they had 58,919 contracts in fiscal year 2004. According to 2003 year-end settlement statements, service cooperatives had approximately \$370 million in completed claims.¹⁷ See Attachment A to this report.

II. Consulting Contracts

We asked the service cooperatives to provide us with copies of agreements they had with consultants for health insurance.¹⁸ We found that seven of the service cooperatives did not use effective contract management principles when entering into or implementing a consultant agreement.¹⁹ We also found that some of the agreements raise organizational conflict of interest concerns.

A. Standards for Consulting Contracts

Effective contract management principles seek to provide a process that is open, fair, and as objective as possible, to avoid actual or perceived favoritism or wrongdoing.²⁰ As with all public spending, governmental entities must be held to a high standard regarding the purpose and cost-effectiveness of contract expenditures.²¹

From time to time, governmental entities need to hire consultants with specific technical or professional training. Generally, competitive bids are not required for these professional services contracts, although the governmental entity may choose to use competitive bidding. More commonly, governmental entities use requests for proposals (RFPs) to find a consultant. With an RFP, the entity advertises a request for services, and the interested professionals submit proposals describing what they will do and what it will cost.

General consensus exists regarding effective contract management principles that should be followed by agencies entering into consultant contracts. For example, before hiring a consultant, the League of Minnesota Cities suggests that the governmental entity answer the following questions:²²

¹⁷ As discussed later in this report, not all of the service cooperatives' financial statements contained total claims information. As a result, we used the total completed incurred claims amount reported by the Blues on year-end statements.

¹⁸ Our review of service cooperatives' board of directors meeting minutes reveals that service cooperatives also have a number of consulting agreements in non-health insurance related areas. Our recommendations regarding consulting agreements would apply to all consulting agreements entered into by the service cooperatives.

¹⁹ The seven service cooperatives are Lakes Country (LCSC), Northeast (NESC), Northwest (NWSC), Resource Training & Solutions (RT&S), South Central (SCSC), Southeast (SESC), and Southwest/West Central (SW/WC SC) Service Cooperatives. North Central Service Cooperative (NCSC) did not enter the same consulting agreement as the other seven service cooperatives.

²⁰ See Office of Legislative Auditor, Evaluation Report #03-02 (Professional/Technical Contracting, January 2003), at page 28, available at: <http://www.auditor.leg.state.mn.us/pe0302.htm> . See also February 2005 Update to the 2003 Evaluation Report.

²¹ *Id.*

²² See League of Minnesota Cities, Handbook for Minnesota Cities, Chapter 24, Section VII, available at <http://www.lmnc.org/handbook/chapter24.pdf>.

- Are current employees capable of performing the job?
- Are there alternatives to hiring an outside consultant, such as an advisory task force, or similar consultant work on similar problems for other governmental entities?
- What is the nature of the problem for which a consultant is necessary? For example, the League of Minnesota Cities recommends that a city council should be able to draft a brief statement (100 words or less) to describe what the consultant is to accomplish, or the matter should be discussed further.
- Can the decision to hire a consultant be justified to taxpayers?²³

The Minnesota Legislative Auditor has identified similar effective contracting principles for state agencies entering into professional/technical contracts.²⁴ When selecting the contractor, the Legislative Auditor also includes the need for the agency to ensure that there is no employee or organizational conflict of interest.²⁵ After assessing the need for the contract and selecting the contractor, the Legislative Auditor has identified contracting principles associated with the writing, executing, monitoring, and closing of the contract.²⁶ These include:

- Clearly define roles, responsibilities, and performance expectations of the contractor and agency staff.
- Identify a variety of tools to monitor contract and contractor performance.
- Link payment to the satisfactory completion of specific contract tasks or services, which should be spread throughout the life of the contract.
- Periodically evaluate the progress of the contract and determine if it is prudent to continue.²⁷

The Minnesota Legislative Auditor has specifically examined the hiring and monitoring of consultants for the state employee insurance program.²⁸ The Minnesota Attorney General has also recently described consulting contract standards in the health care arena.²⁹ Both the Legislative Auditor and the Attorney General applied the same

²³ *Id.* at page 24-32.

²⁴ *See* Office of Legislative Auditor, Evaluation Report #03-02 (Professional/Technical Contracting, January 2003), at pages 28 - 31.

²⁵ *Id.* at pages 29 and 36.

²⁶ *Id.* at page 29. Table 2.1 provides a summary of 18 contracting principles for state agencies.

²⁷ *Id.*

²⁸ *See* Office of the Legislative Auditor, Program Evaluation Report #02-06 (State Employee Health Insurance, February 2002), at pages 77 – 86, available at: <http://www.auditor.leg.state.mn.us/ped/2002/pe0206.htm> . The Report notes a RAND study that found about 65% of large employers operating a self-insured health plan reported that they hire external consultants to help make decisions about benefit designs. *Id.* at 77. The RAND study also found that there was no systematic relationship between the use of external consultants and employers' plan costs, whether measured by current premiums or premium increases. *Id.* at 77-78.

²⁹ *See, e.g.*, Volume 4 (Consulting Expenses) of the Attorney General Office's Compliance Review of Fairview Health Services. The Minnesota Attorney General Office's reviews of consulting expenses for Medica, Allina and HealthPartners contain similar descriptions of consulting standards. All of the reviews are available at: <http://www.ag.state.mn.us> .

effective contracting principles.³⁰ Both the Legislative Auditor and the Attorney General recommended that consultant contracts contain comprehensive descriptions of consultant duties and required work products.³¹

State statutes incorporate many of these same safeguards for state agencies entering into professional and technical services contracts.³² For example, state agencies wanting to hire a consultant must be able to provide a description of why the proposed contract is necessary, performance measures or other tools that will be used to monitor and evaluate contract performance, and the agency's plans to notify those who may be able to respond to the solicitation.³³

The Government Finance Officers Association has recently issued recommended practices for health care cost containment.³⁴ One of its recommendations is the exercise of vendor management practices, including sound procurement practices. The suggested practices include setting appropriate compensation for consultants/brokers, and ensuring that vendor interests are aligned with the government's interests.³⁵

As this brief review shows, there is general consensus regarding the steps that should be used by all types of governmental entities when hiring consultants. We found that effective contract management principles were not followed by seven of the service cooperatives when entering into a consultant agreement.

B. Creative Benefit Consultants/Virgil Hammerstad Consulting Agreements

Several of the service cooperatives recruited Mr. Virgil Hammerstad from the Blues in the early 1990s to help manage the service cooperatives' insurance pools.³⁶ Mr. Hammerstad is the principal for Creative Benefit Consultants ("Consultant").³⁷

³⁰ Similar issues were also examined by the Legislative Auditor in its special review of the Minnesota State Retirement Systems' Administration of the Minnesota Deferred Compensation Plan. Report #05-24 (April 20, 2005), available at: <http://www.auditor.leg.state.mn.us/fad/2005/fad05-24.htm>.

³¹ Program Evaluation Report #02-06 at 79; Volume 4 (Consulting Expenses) of the Attorney General Office's Compliance Review of Fairview Health Services. A number of other recommendations are also made in each report.

³² The Department of Administration's Materials Management Division has a Professional/Technical Services Contract Manual that is available at: <http://www.mmd.admin.state.mn.us/mn05001.htm>. The manual walks agencies through the contracting process, and could be used by any public entity.

³³ See Minn. Stat. § 16C.08.

³⁴ See GFOA Recommended Practice, Health Care Cost Containment – 2004, available at: <http://www.gfoa.org/services/rp/documents/HealthCareCostContainment.doc>.

³⁵ *Id.*

³⁶ See March 14, 2005 Lindquist & Vennum letter. Lindquist & Vennum represented six of the seven service cooperatives and Employee Benefits & Insurance Services, Inc. (EBIS; EBIS administers the health insurance program for RT&S and NWCS). South Central Service Cooperative (SCSC) was represented by Bailey, Gage & Krause. Appletree Institute (Appletree) was represented by Borenstein and McVeigh. Appletree administers the health insurance program for Southwest/West Central Service Cooperative (SW/WC SC). NCSC was not represented by an attorney for purposes of our review.

³⁷ *Id.* The service cooperatives' July 1, 2002 through June 30, 2007 agreements were with Creative Benefit Consulting, LLC; the service cooperatives' July 1, 1997 through June 30, 2004 agreements were with

Until 2001, the eight service cooperatives offering health insurance split the cost of Consultant.³⁸ However, in 2001, North Central Service Cooperative (NCSC) decided to end its relationship with Consultant, bringing in-house the services that Consultant and others had previously provided. Each of the remaining seven service cooperatives apparently agreed to cover the payments previously made by NCSC.³⁹

The seven service cooperatives entered into contracts with Consultant. Under the contracts, the service cooperatives paid Consultant over \$600,000.00 per year, on average, for at least the past five years. See Attachment B of this report.

1. Consultant's Agreements with the Service Cooperatives

We were provided with no solicitation documentation or RFPs related to the hiring of Consultant, or the renewals of Consultant's contracts. We were provided with no documentation showing that other consultants were interviewed by the service cooperatives, or that the service cooperatives considered whether an employee could perform services provided by Consultant.

We believe that the contracts with Consultant do not adequately define the work Consultant was to perform, the desired outcome of Consultant's work, the time parameters of the work, or the tools to be used to monitor Consultant's performance. We also found that the service cooperatives entered into verbal agreements regarding Consultant's compensation.

a. Duties not adequately defined

Consultant's duties under the contracts were as follows: act as a consultant for implementing the service cooperative's health and related services program ("program"); develop bid specifications as needed to implement the tasks identified in the program; meet as needed with designated staff for planning and implementation of the program; assist with negotiations which may be required to support the program; provide access to any Minnesota Health Network owned, managed, controlled, or accessible to Consultant or any of its affiliates; provide status reports and supporting documentation for review on a monthly basis; establish a point of presence which provides a 24-hour telephone answering service; and perform other duties as the parties mutually agree upon from time to time as may be necessary to implement the program.⁴⁰

Creative Benefit Consulting, Inc. Creative Benefit Consulting, LLC, was the successor to Creative Benefit Consulting, Inc. Mr. Virgil Hammerstad was chief manager of Creative Benefit Consulting, LLC, and President of Creative Benefit Consulting, Inc. As one of the service cooperative's attorney explained, "CBC is essentially Virgil Hammerstad." See February 3, 2005 letter from Blethen, Gage & Krause.

³⁸ Appletree, rather than SW/WC SC, entered into the contract with Consultant. We are including Appletree instead of SW/WC SC when we reference service cooperatives that entered into agreements with Consultant.

³⁹ See, e.g., April 28, 2003 Southeast Service Cooperative (SESC) Office Memorandum.

⁴⁰ See, e.g., Resource Training & Solutions Insurance Pool Products and Related Services Consulting Agreement (March 2003) at ¶ IV. The service cooperatives hired other consultants to draft the health insurance requests for proposals (bid specifications) and to evaluate the responses. See, e.g., Minnesota

The contracts also grant Consultant “all necessary rights and authority to carry out tasks required under the program,” although the service cooperatives retain “the sole power to formally approve and enter into any contracts which may be negotiated by [Consultant].”⁴¹ Under the agreements, Consultant could subcontract any or all of the tasks Consultant deemed appropriate.⁴²

The contracts’ general requirements that the consultant act “as a consultant,” “meet as needed with staff” and “assist with negotiations which may be required to support the program” do not clearly define the Consultant’s role, responsibilities and performance expectations. The contracts do not identify which contracts Consultant should be negotiating on behalf of the service cooperatives.⁴³ Although the contracts require status reports, they do not clearly define the tasks to be accomplished, link payment to their accomplishment, or identify who within the service cooperatives will monitor Consultants’ performance.

Because the contracts lack written descriptions of the specific services to be performed by the Consultant, it is very difficult for anyone, including the service cooperative directors, to determine whether the terms of the agreements were fulfilled and whether the service cooperatives received good value for their expenditures.

b. Performance measures lacking

Under the contracts, “performance criteria” were to be established “from time to time” by the service cooperatives and Consultant.⁴⁴ However, when we requested copies of the performance criteria, we were informed that the service cooperatives had “not yet located” the documents.⁴⁵

Service Cooperatives Summary Medical Coverage Renewals for 2002 (August 21, 2002) prepared by Earl Hoffman, Reden & Anders, Ltd. (“R&A 2002 Summary”).

⁴¹ See, e.g., Northwest Service Cooperative Insurance Pool Products and Related Services Consulting Agreement (March 2003) at ¶ VII.

⁴² See, e.g., Resource Training & Solutions Insurance Pool Products and Related Services Consulting Agreement (March 2003) at ¶ IV.1.a. We were informed that Consultant does not subcontract any tasks under the agreements, although Consultant has informal and unwritten agreements to buy clerical/administrative services from EBIS (who is under contract with two of the service cooperatives to service their insurance pools), and general executive assistant duties from Benefit Innovations and its principal, Peggy Story. See March 14, 2005 Lindquist & Vennum letter. As recently as 2003, documents identify Ms. Story as a representative of the Blues. See, e.g., September 4, 2003 CBC Minutes, Item 3.0.

⁴³ Furthermore, as discussed more fully later in this report, organizational conflict concerns arise when Consultant negotiates with the Blues on the service cooperatives’ behalf.

⁴⁴ See, e.g., Northwest Service Cooperative Insurance Pool Products and Related Services Consulting Agreement (March 2003) at ¶ IX.

⁴⁵ See March 14, 2005 Lindquist & Vennum letter. Attorneys for Appletree Institute (Appletree) informed us that Appletree’s executive director was not aware of any written performance criteria for Consultant. See April 21, 2005 letter from Borenstein and McVeigh Law Office.

The agreements do not link payment to the satisfactory completion of specific contract tasks or services. We were informed that Consultant does not generate invoices.⁴⁶ When we asked for the status reports produced by Consultant, we were provided with Risk Management Year End Reports prepared by Consultant for the service cooperatives. The Year End Reports contain agenda and some of the handouts for monthly “CBC Meetings.”⁴⁷ Consultant, representatives from the Blues, representatives from the seven service cooperatives, and in recent years, members of the service cooperatives’ “legislative team” attended the meetings.

The Year End Reports contain various memoranda from Consultant, as well as material from the Blues, documents concerning legislative issues, studies by other consultants, legal advice, and other items. It is unclear from these materials what work Consultant performed, and what work others performed.

We found no indication that performance criteria were established pursuant to the contract. In addition, the Year End Reports do not provide adequate information detailing the services actually provided by Consultant.

c. Verbal amendments regarding compensation

Six of the service cooperatives have five-year contracts with Consultant.⁴⁸ The contracts were signed in March 2003, effective for the time period of July 1, 2002 through June 30, 2007. They renew automatically after June 30, 2007, on a year-to-year basis.⁴⁹

Consultant’s pay has been raised through addenda to the contracts. Six of these addenda referenced a verbal agreement raising Consultant’s compensation by \$10,000 per year.⁵⁰

⁴⁶ See March 14, 2005 Lindquist & Venum letter. Lakes Country Service Cooperative (LCSC) pays Consultant’s wireless telephone bill, deducting the amount from the contract compensation amount paid to Consultant by LCSC.

⁴⁷ Through the years, the meetings have had different names: Service Cooperative Insurance Meeting, CBC Insurance Meeting, and CBC Meeting. We will identify these meetings in this report as the CBC Meetings.

⁴⁸ See Northwest Service Cooperative Insurance Pool Products and Related Services Consulting Agreement (March 2003; \$85,000 per year effective July 1, 2002); Southeast Service Cooperative Insurance Pool Products and Related Services Consulting Agreement (March 2003; \$70,000 per year effective July 1, 2002); Lakes Country Service Cooperative Insurance Pool Products and Related Services Consulting Agreement (March 2003; \$74,500 per year effective July 1, 2002); Resource Training & Solutions Insurance Pool Products and Related Services Consulting Agreement (March 2003; \$80,000 per year effective July 1, 2002); Northeast Service Cooperative Insurance Pool Products and Related Services Consulting Agreement (March 2003; \$78,783 per year effective July 1, 2002); South Central Service Cooperative Insurance Pool Products and Related Services Consulting Agreement (March 2003; \$107,443 per year effective July 1, 2002). Appletree provided us with a three-year contract for \$100,000 per year for July 1, 2002 through June 30, 2003, and \$108,000 per year beginning on July 1, 2003. The contract was signed by Appletree on June 18, 2003.

⁴⁹ The contracts continue on a year-to-year basis unless written notice is given at least 90 days prior to the next yearly renewal date.

⁵⁰ See Addendum to Northwest Service Cooperative Insurance Pool Products and Related Services Consulting Agreement (dated June 30, 2003; \$95,000 per year effective July 1, 2002); Addendum to Southeast Service Cooperative Insurance Pool Products and Related Services Consulting Agreement (June

Specifically, the addenda stated that the service cooperatives entered into a verbal agreement with Consultant “sometime during 2002”, and Consultant’s “compensation was in fact increased by \$10,000 during 2002 in accordance with this verbal agreement.”⁵¹

It took almost one year for these verbal agreements to be reduced to writing. If the “verbal agreement” was implemented “sometime during 2002”, it is unclear why the March 2003 agreements did not reflect the \$10,000 increase, and why the increase had to be subsequently incorporated in addenda. In addition, it appears that at least one of the service cooperatives’ boards of directors did not approve, until 2003, the pay increase to Consultant that was effective “sometime during 2002.”⁵²

Finally, the agreements contained a clause that allows the service cooperatives to agree to additional compensation beyond the stated contract compensation amount. This clause allows the service cooperatives to obtain services without going through a contracting process that would formalize the negotiations and document the contract terms.⁵³

2. Consulting Agreements Recommendations

The review and approval of contracts by the board of directors is intended to provide a level of accountability regarding the necessity of the services and the reasonableness of the cost. We believe the boards have a responsibility to their members and to taxpayers to adopt and implement effective contract management principles.

Because the contracts do not identify objectives, set timeframes, or describe specific tasks or services to be performed, the service cooperatives are vulnerable to excessive billing. In addition, vague contract terms make it impossible for the service cooperatives to enforce the terms of the agreements if there is a dispute. The lack of invoices makes it

30, 2003; \$80,000 per year effective July 1, 2002); Addendum to Lakes Country Service Cooperative Insurance Pool Products and Related Services Consulting Agreement (July 1, 2003; \$84,500 per year effective July 1, 2002); Addendum to Resource Training & Solutions Insurance Pool Products and Related Services Consulting Agreement (August 1, 2003; \$90,000 per year effective July 1, 2002); Addendum to Northeast Service Cooperative Insurance Pool Products and Related Services Consulting Agreement (June 30, 2003; \$88,783 per year effective July 1, 2002); Addendum to South Central Service Cooperative Insurance Pool Products and Related Services Consulting Agreement (July 2, 2003; \$117,443 per year effective July 1, 2002). Resource Training & Solutions also has an Addendum, dated November 2, 2004, that reflects another “verbal agreement” reached sometime in 2004, providing for another \$10,000.00 pay increase. Addendum to Resource Training & Solutions Insurance Pool Products and Related Services Consulting Agreement (November 2, 2004; \$100,000 per year effective July 1, 2004).

⁵¹ Attachment B appears to confirm that the increases took place in 2002. This verbal agreement appears to have occurred about the time that NCSC ended its contract with Consultant.

⁵² See, e.g., April 15, 2003 RT&S Board of Directors’ meeting minutes (approve Addendum to Agreement, giving Consultant an additional amount of \$10,000 to \$90,000; no further explanation for increase provided in minutes). RT&S paid Consultant \$98,750 for the time period July 2002 through June 2003. See Attachment B.

⁵³ The Legislative Auditor recently found similar problems with verbal agreements and additional compensation clauses in its special review of Minnesota’s Deferred Compensation Plan. Report 05-24 at 9-10.

difficult for the service cooperatives to determine the validity of the expenses, or to compare the compensation paid to the services provided.

We recommend that the service cooperatives adopt the following procedures when hiring consultants:

- Identify why a consultant is necessary and complete a written description of the scope of the consultant's project before hiring the consultant.
- Determine the business objective and cost-savings connected with the hiring of the consultant.
- Determine whether using consultants, rather than obtaining similar services from existing or new employees, is the most economical choice or "best value."⁵⁴
- Utilize RFPs, or some other solicitation package, to select consultants.⁵⁵
- Require written contracts that describe:
 - the services to be provided;
 - a timeframe for completion;
 - the cost and payment terms;
 - documentation that must be submitted for payments to be made;
 - adequate monitoring tools;
 - measurable performance standards; and
 - the service cooperative staff person responsible for oversight of the contract.
- Identify in writing any contracts that the consultant is authorized to negotiate on behalf of the service cooperatives.
- Prohibit the consultant from subcontracting, assigning, or transferring any obligations under the contract without the service cooperative's prior written consent.⁵⁶
- Do not allow the consultant to begin work, and do not make payments, until the contract is properly executed and approved by the service cooperative's board of directors.
- Reduce oral agreements regarding compensation increases to writing before the increased compensation is paid.
- Require adequate documentation to support fees. For consultants hired on an hourly rate basis, invoices should be required that detail the hours of work performed, including: the day and time the work was performed, the services performed each hour, and the person who performed the work.

⁵⁴ Under procurement statutes for the State of Minnesota, "best value" is defined as: "[A] result intended in the acquisition of all goods and services. Price must be one of the evaluation criteria when acquiring goods and services. Other evaluation criteria may include, but are not limited to, environmental considerations, quality, and vendor performance." Minn. Stat. § 16C.02, subd. 4. These criterion would be useful for any public entity to consider.

⁵⁵ Section 12 of the Professional/Technical Services Contract Manual published by the Minnesota Department of Administration's Materials Management Division provides sample forms to be used during the selection process.

⁵⁶ After taking the time to select a consultant, the service cooperative should maintain control over who is actually performing the work. Otherwise, the entire solicitation effort to find the appropriate consultant could be negated.

- Require that all expenses be itemized on the invoice with supporting documentation attached.

The service cooperatives are using public funds. Effective contract management principles seek to provide transparency and accountability in the use of public funds. The service cooperatives failed to employ effective contract management principles in these consultant contracts.

3. Consultant's Agreement with the Blues

In addition to Consultant's contracts with the service cooperatives, we were provided a five-year "Service Cooperative Consulting Agreement" that Consultant entered into with the Blues, effective July 1, 2003.⁵⁷ As a result, Consultant appears to be working for both the service cooperatives and the Blues. We question whether the service cooperatives have fully considered the organizational conflict of interest issues involved with these contracts.

Specifically, according to the contract, Consultant was hired by the Blues to provide the Blues with at least 800 hours per year of "consulting, general advisory and other services to or on behalf of [the Blues] as may be relevant to providing health benefits coverage administrative services to [the service cooperatives]."⁵⁸ One of Consultant's specific duties under the agreement was to market the Blues services to the service cooperatives.⁵⁹

As a result of this contract, Consultant appears to have a financial incentive to keep the service cooperatives with the Blues. The Blues agreed to pay Consultant \$8,928 on a quarterly basis, for each of the seven service cooperatives for which Consultant provided services on behalf of the Blues.⁶⁰ Thus, Consultant was able to earn almost \$250,000 per

⁵⁷ Service Cooperative Consulting Agreement, between the Blues, CBC and Mr. Hammerstad, effective July 1, 2003 ("Blues-CBC Agreement"), at ¶¶ 6 (a)(i), 6 (b) and 14 (f). The Blues-CBC Agreement collectively refers to CBC and Mr. Hammerstad as "Consultant." *Id.* at page 1. The Blues-CBC Agreement references an earlier Consulting Agreement between the Blues, CBC and Mr. Hammerstad, with a July 1, 2002 effective date.

⁵⁸ Blues-CBC Agreement at ¶ 3.

⁵⁹ The Blues-CBC Agreement's description of Consultant's duties for "consulting, sales and marketing, general advisory, and other services to or on behalf of [the Blues]" were: 1) "Marketing Efforts" - assisting the Blues with the continued market development, sales and marketing of the Blues' health benefits administrative services to the service cooperatives; 2) "Related Services" - consulting, general advisory and other services relating to the Blues' efforts to provide third party administrator and ancillary services to the service cooperatives; and 3) "Sales Information" - consulting, general advisory and other services to the Blues relating to providing health benefits coverage administrative services to the service cooperatives, and discussing with the Blues any changes in market or other conditions in the provision of those services which "might materially affect current or potential sales of products to [the service cooperatives]." Blues-CBC Agreement, Exhibit A.

⁶⁰ The \$8,929 per quarter per service cooperative compensation was to begin on July 1, 2003. Blues-CBC Agreement at ¶ 6 (a)(i). The payments were reduced to \$4,465 per quarter per service cooperative (approximately \$125,000 per year; $\$4,465 \times 4 = \$17,860$; $\$17,860 \times 7$ service cooperatives = \$125,020) under the Blues-CBC Agreement beginning on July 1, 2006, and continuing through April 1, 2008. As of January 1, 2005, Consultant was to develop a plan to allow the Blues to provide the services that Consultant had been providing to the service cooperatives. Blues-CBC Agreement at ¶ 7.

year from the Blues for, in part, marketing the Blues' products to the service cooperatives.⁶¹ In addition, the Blues could end Consultant's Agreement with the Blues if the Blues stopped doing business with the service cooperatives, or if the Blues' volume of business with the service cooperatives declined by 50% or more.⁶²

In our view, a potential conflict exists when the service cooperatives seek proposals for products offered by the Blues and other vendors. As part of Consultant's contract with the Blues, Consultant agreed not to directly or indirectly provide services to anybody competing with the Blues, or to interfere with the Blues' relationships with any of its current customers.⁶³ Therefore, if products offered by one of the Blues' competitors were more advantageous to the service cooperatives' members, the contract would appear to preclude Consultant from helping the service cooperatives procure those non-Blues products.

Under the agreement with the Blues, Consultant could directly place service cooperative members with the Blues if the service cooperative decided to use another third party administrator for services similar to those the Blues had been providing. Therefore, if the service cooperatives ever decide to leave the Blues, the agreement appears to allow Consultant to try and place the service cooperative groups with the Blues, either directly or through another pooling arrangement.⁶⁴ If Consultant were to take groups away from the service cooperatives' pools, in order to keep the group's business with the Blues, Consultant would be working against the service cooperatives' interests.

Consultant represented to the Blues that his agreement with the Blues was not a conflict with any of Consultant's existing agreements.⁶⁵ Furthermore, the service cooperatives appear to have known that Consultant was also working for the Blues. We were provided with copies of an Acknowledgement and Consent signed by six of the service cooperative executive directors, and the President of Appletree Institute, stating that the consulting agreement between Consultant and the Blues had been disclosed to the service cooperatives.⁶⁶

⁶¹ \$8,928 X 4 = \$35,712; \$35,712 X 7 service cooperatives = \$249,984.

⁶² Blues-CBC Agreement at ¶ 5 (d).

⁶³ Blues-CBC Agreement at ¶ 10.

⁶⁴ Blues-CBC Agreement at ¶ 10.

⁶⁵ Blues-CBC Agreement at ¶ 14 (a).

⁶⁶ The Acknowledgement signed by the executive directors of the Lakes Country, Northeast, Northwest, South Central, and Southeast Service Cooperatives, and the President of Appletree Institute (which works with the Southwest/West Central Service Cooperative) provides:

The undersigned ____ Service Cooperative ("MSC") hereby acknowledges that the following has been disclosed to MSC.

[Consultant and the Blues] have entered into a five-year consulting agreement wherein [Consultant] provide consulting, general advisory, and other services to [the Blues] relating to Minnesota Service Cooperatives, subject to the terms and conditions of the agreement.

[Consultant] have provided similar services to [the Blues] in past years.

The Consent provides:

By this acknowledgement, the MSC consents to the termination of its contractual relationship, if any, with [Consultant], except as may be otherwise agreed to by [the Blues].

The Blues-CBC Agreement was "null and void" if the Acknowledgement and Consent Form was not executed by each service cooperative on or before March 1, 2004. Blues-CBC Agreement, at ¶ 4.

Five of the service cooperatives also consented to terminating their contracts with Consultant (and any entity wholly-owned by Consultant, or any of Consultant's affiliates) if the Blues did not agree to the contracts.⁶⁷ As a result, it appears if Consultant were to serve the service cooperatives in any manner contrary to the Blues' best interests, the Blues had the power to cancel the service cooperatives' contracts with Consultant.

The service cooperatives have informed us that Consultant has contributed greatly to their health insurance program. Indeed, our review of the CBC Meeting minutes discloses that Consultant is active in many aspects of the service cooperatives' insurance business, with little apparent supervision. The service cooperatives' claimed reliance on Consultant is consistent with our general observation that the service cooperatives rely too heavily on their consultants and third-party vendors to provide certain basic information about their insurance programs.⁶⁸ Because the service cooperatives appear to rely heavily on Consultant, the appearance of conflicts of interest cannot be ignored, and the potential for actual conflicts is increased.

We believe the board of directors for the service cooperatives, not the executive directors, should be making determinations regarding potential conflicts of interest. We reviewed the service cooperatives' board of directors meeting minutes, and found no evidence that the acknowledgements and consents were discussed and approved by the service cooperatives' boards of directors.⁶⁹

Consultant's contract with the Blues raises the following concerns:

However, the signature for the Blues is dated April 26, 2004. The other signatures are dated April 20, 2004, April 21, 2004, and April 30, 2004. Therefore, it appears that the Blues did not exercise the "null and void" provision. Furthermore, we were informed by Lindquist & Vennum that the Blues-CBC Agreement was in effect at the time of our review. We were informed that at least two of the people who signed the Acknowledgements/Consents had not seen the Blues-CBC Agreement prior to signing the documents.

The Acknowledgement and Consent signed by the executive director of Resource Training & Solutions (RT&S) acknowledges a six-year consulting agreement. RT&S's document is dated July 29, 2002. (We were informed that RT&S's executive director believes he used the wrong year when he signed the document.) RT&S's Acknowledgment discloses that the agreement between Consultants and the Blues "provides for a dispute resolution process in the event any such service might conflict with [Consultant's] duties and responsibilities to the Service Cooperative." RT&S's consent provides: "By this acknowledgement, the Service Cooperative consents to contractual relationships between [the Blues and Consultant]."

⁶⁷ See Acknowledgement and Consent for Lakes Country, Northeast, Northwest, and South Central Service Cooperatives, and Appletree Institute.

⁶⁸ Our general observation about the service cooperatives' reliance on consultants and third-part vendors will be discussed further in this report during our discussion of the annual rate setting process and reserve monitoring. The Office of the Legislative Auditor made similar observations during its evaluation of State Employee Health Insurance. See Office of the Legislative Auditor, Program Evaluation Report (State Employee Health Insurance, February 2002), at page 78.

⁶⁹ At this point, a dispute resolution process has been set out if any of the service cooperatives raise the potential conflict issue. Blues-CBC Agreement at ¶¶ 3, 14 (a) and 14 (i).

- The service cooperatives' bargaining power as a pool is diminished if the Blues' interests, rather than the service cooperatives' members interests, are being advanced by the Consultant.
- Consultant appears to have a financial incentive (1) to keep the service cooperatives with the Blues, and (2) to directly place service cooperative members with the Blues if a service cooperative were to stray from the Blues.
- The Blues may have an unfair competitive advantage, including information about the service cooperatives that is not available to competitors.
- Consultant may have a bias in favor of the Blues because the contract compensates Consultant for marketing the Blues' products and the Blues' organization to the service cooperatives.
- By giving the Blues authority to cancel the service cooperatives' contracts with Consultant, Consultant has been given a financial incentive to provide advice that serves the Blues' interests.

We believe that the contract between Consultant and the Blues raises serious questions about the impartiality and objectivity of the advice provided to the service cooperatives by Consultant. It also raises the potential that a competitive advantage has been given to the Blues. The apparent conflicts reduce the confidence that the public, service cooperative members, and potential service cooperative vendors (other than the Blues) will have in the service cooperatives' decisions.

4. Organizational Conflicts of Interest Recommendations

Service cooperatives should be mindful of organizational conflicts of interest when they obtain consulting services. Minnesota state agencies must avoid, mitigate or neutralize organizational conflicts when contracting for goods or services. We believe that potential organizational conflicts should be considered by any public entity.

An organizational conflict of interest exists when: (1) a consultant is unable, or potentially unable, to render impartial assistance or advice because of existing or planned activities, or because of relationships with other persons; or (2) the consultant's objectivity in performing the contract work is or might be otherwise impaired; or (3) the consultant has an unfair competitive advantage.⁷⁰ Consultant's contract with the Blues raises each of these concerns.

Policies regarding organizational conflicts of interest seek to ensure adherence to two underlying principles: (1) preventing the existence of conflicting roles that might bias a consultant's judgment; and (2) preventing unfair competitive advantage in the awarding of contracts. Consultant's agreement with the Blues threatens both of these principles.

Conflict of interest and ethical practices requirements are critical factors in the evaluation and selection of a consultant. To avoid both real and apparent conflicts of interest, and to

⁷⁰ See, e.g., Minnesota Department of Administration Policy & Procedure Admin 01-13, Organizational Conflicts of Interest Policy (November 1, 2001), available at: <http://www.mmd.admin.state.mn.us/pdf/alpn9.pdf>.

encourage competition for the service cooperatives' business, we recommend that the service cooperatives adopt third-party contracting policies that avoid, mitigate or neutralize organizational conflicts of interest. These policies will help ensure that the service cooperatives enter into contracts that best serve their members, and wisely spend the public funds entrusted to them.

We recommend that prior to entering consulting contracts, the service cooperatives ask the following questions:⁷¹

- Are there conflicting roles that might bias a consultant's judgment in relationship to the consultant's work for the service cooperative?⁷²
- Will the consultant provide assessments or evaluations of itself, or another entity with which the consultant has a financial relationship?
- Will the consultant provide assessments or evaluations of a competitor where detrimental findings could serve, directly or indirectly, the interests of the consultant?
- Will the consultant's advice lay the groundwork for decisions on future contracts or acquisitions?
- Should restrictions on the consultant's ability to compete for future work be placed in the initial contract?
- Will the consultant have access to not public data or other information that could provide the consultant with an unfair advantage in later competition for a contract with the service cooperative?⁷³

To help avoid organizational conflicts of interest, all solicitation documents should include a provision that requires potential consultants to provide information concerning any past, present, or planned interest relating to the work, and whether the consultant has a possible organizational conflict of interest. The interest could be financial, contractual, organizational, or otherwise. If the consultant does not disclose any information about a possible conflict, the solicitation document should provide that, by submitting the offer or signing the contract, the consultant warrants, to the best of their knowledge and belief, that no facts exist relevant to a possible organizational conflict.⁷⁴

Before waiving an organizational conflict of interest, we recommend that the service cooperatives' boards of directors make a written determination that includes the following findings:

⁷¹ Many of these questions are adapted from the Department of Administration's Organizational Conflicts of Interest Policy.

⁷² The consultant's ability to give impartial advice to the service cooperative could appear to be undermined by the consultant's financial or other business relationships.

⁷³ Providing the consultant with access to the service cooperatives' plans, opinions, interpretations, or positions could be perceived as unfair by a competing vendor who is not given similar access.

⁷⁴ The Department of Administration's Organizational Conflicts of Interest Policy contains a sample provision for state agencies.

- The work cannot reasonably or satisfactorily be performed except by the consultant whose interests give rise to a question of conflict of interest; and
- Contract administration and monitoring methods can be employed to neutralize the conflict.⁷⁵

We believe the acknowledgements and consents signed by the executive directors of the service cooperatives fail to meet these standards. By executing the documents, the executive directors appear to have decided that Consultant's work is in their best interest, not just in the Blues' best interest. However, that position reinforces one of our concerns discussed more fully later in this report, that the service cooperatives do not appear to adequately monitor their third-party vendor, the Blues. We believe the service cooperatives have not fully considered the effect that their relationship with the Blues has when seeking competitive proposals for service cooperative business, monitoring reserve funds held by the Blues, or setting annual insurance rates. In short, by agreeing that Consultant could also work for the Blues, the service cooperatives have taken yet another step toward increased interdependence with this third-party vendor.

C. South Central Service Cooperative's Contract with Consultant IntVeld

We also found contract management and organizational conflict of interest concerns with consulting agreements that South Central Service Cooperative (SCSC) entered into with Mr. Larry IntVeld ("SCSC's Consultant").⁷⁶ However, SCSC took steps to mitigate these concerns once we brought them to SCSC's attention.

1. Duties and Performance Standards

From 1995 through March 2003, SCSC's Consultant was hired to provide SCSC with the following services: facilitation of employer group goals and objectives relative to employee benefits, and on-going consultation, facilitation, and maintenance of employer group goals for each SCSC participant with which SCSC's Consultant had a working relationship.⁷⁷ We also were provided with addenda hiring SCSC's Consultant to develop and conduct a series of insurance education seminars, and to review medical insurance plans and provide a cost review. In March 2003, SCSC's Consultant was hired to represent SCSC at individual health insurance pool renewal meetings.⁷⁸ We believe it was appropriate for SCSC to enter separate agreements with its Consultant when services were required for specific tasks.⁷⁹

⁷⁵ The potential conflict situation increases the need to have Consultant's duties clearly defined in the service cooperatives' contracts with Consultant.

⁷⁶ Some of the SCSC contracts were with IntVeld, Inc.

⁷⁷ See Independent Consultant Agreement – Larry IntVeld, dated March 25, 1995, and subsequent addenda.

⁷⁸ See Independent Consultant Agreement – Larry IntVeld, dated March 25, 2003.

⁷⁹ We note that SCSC's Consultant assisted SCSC with the health insurance RFP process in 2004. See March 18, 2004 SCSC Insurance Advisory Committee Meeting minutes. We were not provided with any agreement that specifically described his role in that process.

We also note that, unlike the contracts with Consultant Hammerstad/CBC, SCSC's contracts with Consultant IntVeld were generally renewed annually through addenda signed prior to the dates on which they took effect.

Our primary concern was with the most recent agreement that SCSC entered into with its consultant.⁸⁰ That consulting agreement did not contain a comprehensive description of duties, the work product required, or a timetable; it simply hired him "to provide consultation services to SCSC dealing with the SCSC School Health Insurance Pool in any manner and fashion as directed by SCSC's Executive Director."⁸¹ In addition, SCSC's Consultant was given the authority to enter into negotiations on behalf of SCSC, without any identification of the specific negotiations SCSC's Consultant was authorized to conduct.⁸²

As we have previously discussed, consulting agreements should clearly define the roles, responsibilities and performance expectations of both the consultant and the service cooperative staff. SCSC's most recent consulting agreement did not set specific timetables or establish ways the consultant's performance would be monitored. The agreement did not link payments to the satisfactory completion of specific contract tasks or services.⁸³

After we began making inquiries, SCSC decided to hire SCSC's Consultant as an employee. We believe SCSC's decision was appropriate.

2. Conflict of Interest Concerns

Since 1995, it appears that SCSC was aware that its Consultant might be providing consulting services to employee unions in school districts that were part of SCSC's insurance pool.⁸⁴ We understand that SCSC's Consultant represented teachers in negotiations with at least two school districts that were part of SCSC's pool.⁸⁵ In these situations, the school district, as a member of SCSC, may find itself with SCSC's Consultant on the opposite side of a bargaining table when health insurance matters are being discussed. These situations raise questions about whether SCSC's Consultant had special access to information about the school districts, or about insurance programs

⁸⁰ 2005 Independent Consulting Agreement (SCSC and IntVeld).

⁸¹ *Id.* at ¶ 2.

⁸² SCSC retained the authority to approve and to enter into any contracts negotiated by SCSC's Consultant.

⁸³ SCSC's Consultant's compensation was originally established as a fractional percentage of the annualized group rates; that was later changed to monthly fees plus expenses, and then to a daily rate plus expenses. The most recent contract provided a daily rate for his compensation. We did not review the invoices submitted to SCSC by SCSC's Consultant.

⁸⁴ *See* Independent Consulting Agreement – Larry Intveld, effective September 1, 1995, at page 3 (SCSC "understands that Consultant may be providing consulting services to one or more current SCSC pooling participant(s)").

⁸⁵ Both Stillwater Area School District and North St. Paul School District informed us that SCSC's Consultant was a member of the teachers' negotiation team. For example, in the Stillwater Area School District, we were informed that SCSC's Consultant was a member of the teacher union negotiation team that obtained a Memorandum of Understanding from the school district that the Blues would continue to be the District's insurance carrier.

offered by the service cooperatives or the Blues. School districts that are service cooperative members may question whether this type of inside information was used against them during negotiations.

After we began to make inquiries, SCSC approved a revision to SCSC's Consultant's contract.⁸⁶ The revised consulting agreement recognized that SCSC's Consultant provides services to other service cooperatives, to pool participants, and to other organizations and teacher unions. In addition, the revised agreement contained a conflict of interest provision requiring SCSC's Consultant to resolve any conflict or appearance of a conflict to SCSC's satisfaction.⁸⁷ We acknowledge SCSC's efforts to address our concerns with this contract.

Because SCSC has decided to hire its consultant as an employee, we recommend that SCSC take this opportunity to adopt an employee conflict of interest policy that will avoid any appearance of impropriety by SCSC employees.

D. Consultant Contracts for Health Insurance RFPs

Seven of the service cooperatives hired additional consultants to assist them in the RFP process that must take place at least every five years for the selection of health insurance carriers.⁸⁸ We believe these contracts are appropriate where the service cooperatives lack the expertise to handle the RFP process with existing employees. We believe that independent consultants were also warranted in light of the organizational conflict issues raised by Consultant Hammerstad/CBC. We recommend that the service cooperatives utilize RFPs, or some other solicitation package, to select the consultants.

We have fewer concerns with these agreements. For example, several of the service cooperatives entered an agreement with Milliman, Inc., for actuarial assistance during the RFP and health plan bidding process for cities, counties and other entities in 2005.⁸⁹

⁸⁶ 2005 Independent Consulting Agreement (SCSC and IntVeld).

⁸⁷ *Id.* at ¶ 4.0. Prior to waiving a potential conflict, SCSC's board of directors should make a written determination that includes the following findings:

- The work cannot reasonable or satisfactorily be performed except by the consultant whose interests give rise to a question of conflict of interest; and
- Contract administration and monitoring methods can be employed to neutralize the conflict.

Additional protection from conflict of interest concerns would have been gained if SCSC had more specifically defined the consultant's duties to expressly include only services that would not present a conflict situation.

After we raised our concerns, SCSC also inserted a conflict of interest provision in its contract with Consultant Hammerstad/CBC. We note that Mr. IntVeld's revised contract also contained a non-exclusivity provision; Consultant Hammerstad/CBC's revised contract did not contain a non-exclusivity provision.

⁸⁸ See Minn. Stat. § 471.6161, subd. 4. The seven service cooperatives issue separate health insurance RFPs for the school district pools, and for the cities, counties and other government agency ("CCOGA") pools. Additional RFPs have been used for other forms of insurance offered by the service cooperatives.

⁸⁹ See, e.g., Consulting Services Agreement between Milliman and Southeast Service Cooperative entered into on February 22, 2005. According to the Agreement's timetable, the CCOGA's health plan is up for renewal on January 1, 2006; proposals were going to be due from vendors on April 1, 2005; and the service

Specifically, the service cooperatives hired Milliman to draft and distribute the RFPs to potential vendors, and to independently analyze the proposals received.⁹⁰ For each phase of the project, deadlines are set, the work to be performed is summarized, and the estimated costs are provided. The Milliman contract's itemization for each phase of the consultant's work stands in sharp contrast to the agreements that the service cooperatives entered into with Consultant Hammerstad/CBC.

From our review of CBC Meeting minutes, it appears that Consultant Hammerstad/CBC has not worked on the RFP process in 2005.⁹¹ Because it is imperative that the service cooperatives use truly independent consultants to assist them in obtaining insurance for their members, we believe that it is appropriate for the service cooperatives to remove Consultant from the RFP process. However, under his contracts with the service cooperatives, Consultant is "responsible for developing bid specifications as needed to implement the tasks identified in the program."⁹² It appears that the contracts do not accurately reflect the duties Consultant performs for the service cooperatives. We recommend that the service cooperatives revise their contracts with Consultant to describe accurately the services provided by Consultant, and to adjust Consultant's compensation if warranted.

E. North Central Service Cooperative - A Different Approach

The North Central Service Cooperative (NCSC) originally joined the other service cooperatives in hiring Consultant. Until June 2001, NCSC was paying Consultant \$70,000 per year.⁹³ It was NCSC's understanding that their payments represented 1/8 of Consultant's fees. NCSC is a relatively small service cooperative, and NCSC decided to bring in-house the services that Consultant and others had previously performed for them. NCSC claims that it obtained cost savings by bringing these services in-house.

In 2004, NCSC requested proposals for health insurance for its combined school, city, county and other governmental pool. NCSC used one of its own employees to draft the

cooperatives wanted to reach a final decision by August 1, 2005. It is our understanding that an RFP for many of the school pools will be conducted in 2007.

⁹⁰ See, e.g., November 29, 2004 letter to Lakes Country Service Cooperative's Executive Director from Milliman, attached as Exhibit A to the February 22, 2005 Consulting Services Agreement.

⁹¹ From the October 18, 2004 CBC Minutes, it appears that Consultant Hammerstad/CBC suggested that the executive directors meet with potential consultants for the RFP process. See Item 4.6. From the subsequent minutes, it appears that Consultant Hammerstad/CBC has refrained from working on the RFP process.

⁹² See, e.g., Northwest Service Cooperative Insurance Pool Products and Related Services Consulting Agreement dated March 2003 at ¶ IV.1.c.

⁹³ See Insurance Pool Products and Related Services Consultant Agreement between CBC and NCSC (term: July 1, 2000 through June 30, 2001). We were provided with NCSC's payment history for Hammerstad/CBC from April 1997 through April 2001. NCSC paid Hammerstad/CBC \$17,500 per quarter. Prior to 1998, NCSC was paying another consultant \$65,000 per year. See NCSC Consulting Agreement dated June 30, 1997 between NCSC and The Jessop Agency of Staples, Inc. According to an expense history that NCSC provided to us, it appears that the last NCSC payment to The Jessop Agency was in January 1998.

RFP, and NCSC staff evaluated the responses received.⁹⁴ NCSC has entered into a one-year operating agreement with the Blues as a result of its RFP process.⁹⁵

We believe that NCSC used effective contracting procedures by evaluating whether current employees could perform required services, rather than expending additional funds on a consultant.⁹⁶

F. Service Cooperative Bylaws, Policies and Procedures

The care, management, and control of a service cooperative are vested in its board of directors.⁹⁷ Some of the board of director's powers and duties are specifically set forth in statutes.⁹⁸ The statutes provide that the board shall have authority to "maintain and operate" the service cooperative.⁹⁹ The board of directors must "exercise all powers and carry out all duties delegated to it by members under provisions of the SC bylaws."¹⁰⁰

We reviewed the service cooperatives' bylaws. In describing the board of director's powers, service cooperative bylaws generally mirror the statute. In this regard, they generally provide that the board of directors is authorized to enter into contracts.¹⁰¹ The bylaws also generally authorize the appointment of an executive director and outline the executive director's powers and duties.¹⁰² These powers and duties generally do not include the power to contract, but may include the authority to write drafts for expenditures properly approved by the board of directors.¹⁰³

Both SESC and SW/WC SC have policies regarding consultants. The SW/WC SC policy deals primarily with internal procedures for contract approval. The SESC policy provides that consultant contracts must be described in writing and signed. It also states that such agreements will:

[S]pecify purpose, services and responsibilities of the parties, terms of considerations, liabilities, length and termination of agreement, contact

⁹⁴ We note that the RFP process is used by public entities in a variety of situations, often without the assistance of outside consultants.

⁹⁵ The wording of the Operating Agreements for the other seven service cooperatives is almost identical. The NCSC Operating Agreement differs from those seven agreements.

⁹⁶ We note that often the service cooperatives jointly hired consultants, and then evenly divided the costs of the consultants. As a result, the costs for the smaller service cooperatives are higher per contract than the costs for the larger service cooperatives. Each service cooperative's board of directors needs to determine if the costs are warranted, or if the services should be brought in-house.

⁹⁷ See Minn. Stat. § 123A.21, subd. 4.

⁹⁸ See, e.g., Minn. Stat. § 123A.21, subd. 5.

⁹⁹ *Id.*

¹⁰⁰ Minn. Stat. § 123A.21, subd. 5 (h).

¹⁰¹ See, e.g., LCSC Bylaws (May 11, 2000), III, D, (6), (7); Minn. Stat. § 123A.21, subd. 5 (f), (g).

¹⁰² See, e.g., RTS Bylaws (October 2, 2002), pp. 4-5. This position is sometimes entitled "director" or "regional director". See, e.g., NESC Bylaws (director); LCSC Bylaws (regional director).

¹⁰³ See, e.g., LCSC Bylaws; RTS Bylaws; SW/WC SC Bylaws; NESC Bylaws; SCSC Bylaws. The SESC Bylaws authorize the executive director to initiate transactions on behalf of the board of directors "when required to meet purchase and contract terms."

information, and any other information required to ensure clarity and mutual understanding by the parties.¹⁰⁴

We also reviewed conflicts of interest policies that we received from some of the service cooperatives.¹⁰⁵ These policies generally prohibit conflicts of interest on the part of employees and/or directors. The SW/WC SC policy closely tracks Minnesota statutes by generally prohibiting directors from having a personal financial interest in contracts.¹⁰⁶ The RT&S conflict of interest policy includes “representatives” in its admonition that employees and representatives are expected to make decisions that are “free from improper influence or the appearance of improper influence.”

We found that some of the service cooperatives do not have adequate contracting policies and procedures, and others did not implement existing policies. We recommend that all service cooperatives adopt and implement written policies and procedures for contracting that incorporate the recommendations contained in this report.

G. Additional Contracting Recommendations

In addition to consulting contracts for health insurance, service cooperatives have consulting agreements in other areas. We recommend that the service cooperatives adopt and implement policies and procedures that incorporate effective contracting management principles. These standards exist to ensure that arms length transactions are taking place, and the organization is obtaining the best value for its money.

During our review of the consultant contracts, we found that some of the contracts lacked clauses that should be included in local government contracts. Specifically, we recommend that the service cooperatives incorporate the following provisions into their contracts:

- **Audit clause.** All contracts, or any pass-through disbursement of public funds to a vendor of goods or services, made by a unit of local government must include, either express or implied, an audit clause that provides that the books, records, documents, and accounting procedures and practices of the vendor or other party, that are relevant to the contract or transaction, are subject to examination by the

¹⁰⁴ “430 Consultants/Contractors”, April 5, 2005 Lindquist & Vennum letter.

¹⁰⁵ These include policies from RT&S, LCSC, NESC and SW/WC SC. While SW/WC SC did not hire Hammerstad/CBC as a consultant, Appletree Institute did. Appletree Institute’s conflict of interest policy applies to Appletree Institute’s directors, officers and staff. Policy Concerning Conflict of Interest (February 21, 2003). It also includes “agents under its control” in a prohibition of solicitation or acceptance of “gratuities, favors, or anything of monetary value from contractors, donors, grantees or parties to sub agreements (with the exception of accepting unsolicited gifts of nominal value).” *Id.*

¹⁰⁶ See Minn. Stat. §§ 471.87-.89. See SW/WC SC Policy 210 Conflict of Interest - Service Cooperative Board Members (August 22, 2001). In contrast, the Appletree Institute’s policy provides for disclosure of a conflict and nonparticipation in deliberations or decisions regarding the matter. Policy Concerning Conflict of Interest (February 21, 2003).

contracting agency and the legislative auditor or the state auditor, as appropriate, for at least six years.¹⁰⁷

- **Data practices.** If a contractor is provided access to data maintained by a government entity or performs any of the entity’s functions, the contractor must agree to comply with all requirements of the Minnesota Government Data Practices Act, and the contract should clearly state that all data created, collected, received, stored, used, maintained and disseminated by the contractor is subject to the Act.¹⁰⁸

We recommend that the service cooperatives consider including the following provisions in their consulting contracts:

- **Unilateral termination.** This provision would permit the service cooperative to unilaterally terminate the contract prior to completion, upon payment of just compensation, if the service cooperative determines that further performance under the contract would not serve the service cooperative’s purposes.¹⁰⁹
- **Retainage clause.** This provision would withhold at least 10% of the compensation due under the contract until the final product has been reviewed by the service cooperative’s board of directors.¹¹⁰ The balance due would be paid when the board of directors determines that the consultant has satisfactorily fulfilled all the terms of the contract.

We also saw “hold harmless” provisions in the consultant contracts, where the service cooperatives agreed to defend, indemnify and hold the consultant harmless from claims made against the consultant under the contract. Under such a clause, the service cooperatives agreed to reimburse or pay compensation for losses or damages resulting from the consultant’s actions. Generally, Minnesota’s indemnification requirements refer only to officers and employees, and do not extend to independent contractors.¹¹¹ We note that SCSC removed the “hold harmless” provisions during the recent revisions of their consulting agreements. We recommend that the other service cooperatives review their contracts, and consider removing the potential liability that broad “hold harmless” clauses may create for the service cooperatives and their members if one of the consultants is sued for negligence, poor performance, or some other act under the contract.

We recommend that the board of directors for each service cooperative review its responsibilities to its members. Every contract entered into by the service cooperatives should increase the confidence that the public, service cooperative members, and potential vendors have in the service cooperatives’ decisions. Each board should be

¹⁰⁷ See Minn. Stat. § 16C.05, subd. 5. The audit clause in the 2002 Operating Agreements is more limited. See, e.g., RT&S 2002 Operating Agreement at ¶ 10.12.

¹⁰⁸ See Minn. Stat. § 13.05, subds. 6 and 11.

¹⁰⁹ Such a provision is required in all state professional/technical services contracts. See Minn. Stat. § 16C.08, subd. 5(a).

¹¹⁰ See, e.g., Minn. Stat. § 16C.08, subd. 5(b).

¹¹¹ See Minn. Stat. § 466.01, subd. 6. The service cooperatives are “public corporations” under Minn. Stat. § 123A.21, subd. 9(e); and therefore a “municipality” under Minn. Stat. § 466.01, subd. 1.

cautious not to abdicate its responsibilities to vendors, consultants or the service cooperative's executive director.

In the future, the service cooperatives' contracts should reflect sound contracting principles and include all provisions required by law to be in public contracts. Making these changes will help assure that the public's interest is reflected in the service cooperatives' contracts. The service cooperatives should take steps to improve both the transparency and the accountability of their contracts.

III. Administrative Fees

The service cooperatives negotiate operating agreements with the Blues on behalf of their members. Under the operating agreements, the members of the insurance pools pay both the Blues and the service cooperative fees for their administration of the insurance program.¹¹² Lakes Country, Northeast, Northwest, Resource Training and Solutions, South Central, Southeast, and Southwest/West Central Service Cooperatives have each agreed that they will be paid an administrative fee of \$9.85 per contract per month ("pcpm").¹¹³ North Central Service Cooperative has agreed to be paid an administrative fee of \$5.00 pcpm.¹¹⁴

The joint powers agreements that the school districts enter into with the service cooperatives authorize the service cooperatives to act on their behalf for the administration and funding of group employee benefits.¹¹⁵ The joint powers agreements also provide that all program funds received by the service cooperatives may be used only for providing group employee benefits and other financial and risk management services, including the payment of the service cooperative's administrative fee.¹¹⁶ The joint powers agreements expressly authorize the payment of administrative fees for services rendered by the service cooperative under the operating agreement with the Blues and under the joint powers agreement.¹¹⁷

¹¹² Services the Blues must provide under the 2002 Operating Agreements include: identifying other potential service cooperative pool members, claims administration, providing access to the Blues' network providers, administration of drug manufacturer rebates (for which the Blues keeps 8% as an administrative fee; refund amounts exclude certain other fees/compensation), and plan administrative services. *See, e.g.*, RT&S 2002 Operating Agreement at ¶¶ 3.1(c), 3.4, 3.7, and 3.9

¹¹³ *See, e.g.*, 2002 RT&S Operating Agreement at ¶ 5.3, and Exhibit A at ¶ 18. Among the service cooperatives responsibilities under the Operating Agreement are coordinating with the Blues for promotion of the service cooperative pool, executing the joint powers agreement with members, and negotiating the Operating Agreement with the Blues on the members' behalf. *See, e.g.*, 2002 RT&S Operating Agreement at ¶¶ 4.1, 4.3 and 4.4.

¹¹⁴ NCSC 2004 Operating Agreement at ¶ 5.3. According to the Legislative Auditor's State Employee Health Insurance Program Evaluation (Report #02-06) at page 77, the Department of Employee Relations was paid about \$3.70 pcpm to administer the state health plan.

¹¹⁵ *See* Joint Powers Agreement for Group Employee Benefits and Other Financial and Risk Management Services (example received from Lindquist & Vennum) ("Joint Powers Agreement") at ¶¶ 1.1, 4.1.

¹¹⁶ *See, e.g.*, Joint Powers Agreement at ¶ 6.2. The Board maintains sole discretion over the disposition of payments made by the members under the agreement. *Id.* The agreement specifically authorizes payment of the service cooperative's administrative fee. *Id.* (defines the "service fee" as the administrative fee).

¹¹⁷ *Id.* at ¶¶ 4.5 (service fee) and 6.2 (f) (program funds may be used to pay service fee), and Addendum A (defines the service fees as the \$9.85 pcpm administrative fee).

Because the service cooperative members specifically agreed to pay the administrative fees, the service cooperatives have argued that the administrative fees do not have to be used for insurance-related expenses.¹¹⁸ We disagree. The service cooperative members agreed to payment of administrative fees only for services provided by the service cooperatives under insurance-related contracts; not for services provided by the service cooperatives in other programs.¹¹⁹ In any event, we believe service cooperative members have a right to expect that insurance fees will be used for insurance-related programs.

We asked the service cooperatives to provide us with information regarding their use of the administrative fees. The administrative fees received by the service cooperatives are reflected in Attachment C to this report. We found that five of the service cooperatives used part of the fees for non-insurance related programs.¹²⁰ In our view, there is a lack of transparency in the use of these fees by the five service cooperatives. In addition, as discussed later in this report, we believe that some of the service cooperatives should use these fees to better monitor their insurance program, including its reserves and third-party vendor (the Blues).

A. Resource Training & Solutions

Resource Training & Solutions (RT&S) has contracted with Employee Benefits & Insurance Services, Inc., (EBIS) to service its insurance pools.¹²¹ Under the contracts, EBIS assists RT&S with the administration of the pools and provides various insurance-related consulting services.¹²² EBIS is paid 25% of the \$9.85 pcpm fee, or \$2.45 pcpm; RT&S keeps the remaining \$7.40 pcpm.¹²³

¹¹⁸ See May 13, 2005 Lindquist & Vennum letter, pages 8 - 12.

¹¹⁹ See Joint Powers Agreement at ¶ 4.5; SCSC Joint Powers Agreement at ¶ 4.3; SESC Joint Powers Agreement at ¶ 4.5.

¹²⁰ The five service cooperatives were RT&S, NWSC, SW/WC SC, Lakes Country and NESC.

¹²¹ See, e.g., Servicing Agreement with Resource Training & Solutions dated July 1, 2002 (5 year term; replacing prior agreement).

¹²² Some of the contracted administrative services performed by EBIS include: administration of accounts, receiving premium payments, verifying that premiums are paid, assisting the administrator of the Health Care Pool and the service cooperative in making sure debits or other transfers are made, and summarizing each account for premiums and claims paid. Consulting services under the contracts include: negotiations with insurance carriers and/or providers regarding dental and life insurance, disability income, flex benefit plans; developing and promoting property casualty and workers compensation programs; marketing with the service cooperative to increase enrollment; and developing new benefit programs. See, e.g., Servicing Agreement with Resource Training & Solutions (EBIS) dated July 1, 2002 at ¶¶ 3 and 4. Although RT&S has a contract with Consultant Hammerstad/CBC, it appears that EBIS consults with the RT&S on many health insurance issues. For example, it appears that EBIS has presented the results of the yearly rate negotiations with the Blues. See, e.g., RT&S Insurance/Risk Management Advisory Committee Meeting minutes for July 8, 2004 and July 3, 2003.

¹²³ See, e.g., Servicing Agreement with Resource Training & Solutions (EBIS) dated July 1, 2002 at ¶ 6.

RT&S informed us that it had 10,641 contracts in fiscal year 2004, and received \$1,363,197 in administrative fees.¹²⁴ RT&S informed us that EBIS received 25% of that amount (\$340,756), leaving RT&S with \$1,022,441 in fees.

According to RT&S, the fees are used for RT&S's general operating expenditures and to subsidize other RT&S programs and services. If funds remain at the end of the year, RT&S puts the balance into its operating fund balance. According to RT&S, the current undesignated fund balance represents about eight months of RT&S' operating expenses.

In fiscal year 2004, RT&S reported to us that it used \$515,461 of the health insurance administrative fees on "administrative services and overhead expenses," including office space, equipment, supplies, and staff support for the programs offered by RT&S. Programs supported by insurance fees included: K-12 professional development for educators and school staff (\$98,797 in subsidies); software and leadership development training to school districts, communities, businesses and individuals (\$49,326 in subsidies); and recognition events (banquets) for 140 educators and 145 students (\$6,326 in subsidies). Other programs required no subsidies because RT&S charged sufficient program fees in those areas to fully cover program expenses.¹²⁵

We question why the software and leadership development training provided to the community, businesses, and individuals should be subsidized by insurance charges imposed on school districts, cities, and counties. We question why insurance payments paid by cities and counties should be spent on K-12 professional development programs, and educator/student recognition events (banquets). We also question whether the service cooperative should expend public funds on staff banquets when public entities are generally precluded from doing so.¹²⁶

RT&S explained to us why it uses insurance fees to fund these non-insurance related programs:

Without the administrative fees from Blue Cross/Blue Shield, we would not be able to offer these programs at the level and cost that we do. Many if not all of these programs would no longer be available to the school districts. . . . In 1995, our legislative appropriation was removed. We were told by the legislature to be even more entrepreneurial and creative.¹²⁷

¹²⁴ We noted that there is a difference between the administrative fees reported to us by the service cooperatives, and the fees that are calculated if the number of contracts reported to us is multiplied by \$9.85, and then by 12 (e.g., 10,641 contracts X \$9.85 = \$104,813.85; \$104,813.85 X 12 months = \$1,257,766.20). This difference is probably due to changes in the number of contracts during the year. As a result, where available, we used the amount of administrative fees that the cooperatives reported to us.

¹²⁵ The fee-supported programs included spelling bees, chess tournaments, knowledge bowl competitions for students, young authors and young artists conferences for students, educator networks, health and safety consultation and training, and cooperative purchasing services to governmental and non-profit agencies.

¹²⁶ See School District Expenditures (January 14, 2004) at page 6 and City Expenditures and the Public Purpose Doctrine (February 7, 2003) at page 7 available at www.auditor.state.mn.us.

¹²⁷ See Use of Blue Cross/Blue Shield Administrative Fees, Resource Training Solutions, April 22, 2005.

The legislature may have wanted the service cooperatives to be “more entrepreneurial and creative.” However, we do not believe that school districts, cities, and counties should be charged unnecessary insurance fees to pay for other RT&S programs. The costs of these other programs should not be buried in the ever-increasing cost of providing health insurance to public employees.

B. Northwest Service Cooperative

Northwest Service Cooperative (NWSC) also contracts with EBIS to service its insurance pools, paying EBIS 25% of the \$9.85 pcpm fee.¹²⁸ NWSC informed us that it had 6,332 contracts in fiscal year 2004, generating approximately \$748,442 in fees for NWSC.¹²⁹ NWSC informed us that most of the fees are used to pay Consultant Hammerstad/CBC and EBIS, and the balance is used for general NWCS operations and to subsidize programs and services offered to NWSC members.¹³⁰

NWSC’s auditor has noted that NWSC’s main source of revenue was the insurance pool, and several programs offered by NWSC were not self-supporting.¹³¹ The auditor recommended that the programs be evaluated to determine if they are self-sufficient, and that NWSC look for ways to diversify revenue.¹³² We agree with the auditor’s comments. We are troubled that other programs are being funded with fees imposed on cities, counties, and schools for health insurance.

C. Southwest/West Central Service Cooperative

¹²⁸ See, e.g., Servicing Agreement with Northwest Service Cooperative (EBIS) dated September 1, 2000 at ¶ 5.

¹²⁹ We calculated the administrative fees for FY 2004: 6,332 contracts X \$9.85 = \$62,370.20; \$62,370.20 X 12 months = \$748,442.40.

¹³⁰ NWSC broke down its use of the \$9.85 pcpm fee as follows:

<u>Insurance Expenses</u>	
Governing board, advisory committee costs, salary costs for insurance program coordinator and staff	\$1.55
Wellness, preventive care, RSR funding and RFP of plans	\$1.63
Consultants – plan design and plan administration	\$3.46
Legal, audit, communication, utilities, agency insurance travel/conferences, and office space	\$1.28
Member meetings, program publications, printing and materials, supplies, and program equipment	<u>\$0.96</u>
Subtotal:	\$8.88
 <u>Other General Fund Revenue Applications</u>	
Grant writing, student academics, teacher staff development, school media services and member services	\$0.97
Total:	\$9.85

¹³¹ See Northwest Service Cooperative No.928, Comments to Management to Improve Internal Accounting Controls and Procedures, June 30, 2003.

¹³² *Id.*

Southwest/West Central Service Cooperative (SW/WC SC) contracted with Appletree Institute (“Appletree”), a non-profit corporation, to administer SW/WC SC’s insurance programs.¹³³ According to its contract, Appletree provides various services to SW/WC SC, including developing, soliciting, and analyzing RFPs for Group Employee Benefits and other financial and risk management services, providing actuarial analysis, conducting year-end settlements with providers, managing the IBNR and RSR funds, and marketing.¹³⁴ Appletree, rather than SW/WC SC, contracts with Consultant Hammerstad/CBC.

We are again concerned about the use of insurance fees for non-insurance related programs. Out of the \$9.85 pcpm administrative fee, Appletree receives \$6.65 pcpm, and SW/WC SC keeps \$3.20 pcpm as an “origination fee.”¹³⁵ SW/WC SC informed us that it had 5,007 contracts in 2003 - 2004. After payments to Appletree, SW/WC SC retained \$192,269 in administrative fees.¹³⁶ SW/WC SC informed us that it transferred \$118,998 of that amount into student activities programs to underwrite their costs. The programs included knowledge bowls, spelling bees, young artists/young writers, junior achievement, and career exploration days. SW/WC SC explained to us that it would not have been able to provide the programs without the support from the health insurance fee.

Prior to July 1, 2003, we understand that Appletree received the \$9.85 pcpm fee.¹³⁷ Appletree used the fees during the year to conduct its operations for SW/WC SC, and then made grants at the end of the year from its net revenues to SW/WC SC to be used for educational purposes. For the fiscal year ending June 30, 2003, Appletree gave SW/WC SC \$250,000 for program support; for the fiscal year ended June 30, 2002, Appletree gave SW/WC SC \$410,000 in program support.¹³⁸

We agree that the fees are properly paid to SW/WC SC, rather than to Appletree. But we are troubled that Appletree was able to give yearly “grants” back to SW/WC SC. We do not believe it was appropriate to funnel health insurance fees through Appletree; fees that were later returned to SW/WC SC as a “grant” for educational purposes.

D. Lakes Country Service Cooperative

Lakes Country Service Cooperative (LCSC) administers its health insurance programs with the Blues. LCSC informed us that it had 5,778 contracts in fiscal year 2004,

¹³³ See Southwest/West Central Service Cooperatives Services Contract with Appletree Institute (three year term) dated August 2000; Services and Operations Contract for Risk Management Programs and Services (four year term) dated May 2003.

¹³⁴ Services and Operations Contract for Risk Management Programs and Services between SW/WC SC and Appletree dated May 2003 at ¶ 5.2.

¹³⁵ Services and Operations Contract for Risk Management Programs and Services between SW/WC SC and Appletree dated May 2003 at ¶ 6.5.

¹³⁶ 5007 contracts X 12 months X \$3.20 = \$192,268.80.

¹³⁷ See April 13, 2005 letter from Borenstein and McVeigh Law Office.

¹³⁸ SW/WC SC Financial Statements, June 30, 2003 at page 21; Appletree Audit Report for the Years Ended June 30, 2003 and 2002 at page 2 and 10; Appletree Audit Report for the Years Ended June 30, 2003 and 2002 at page 11. For fiscal year 2003, Appletree also paid SW/WC SC more than \$150,000 for SW/WC SC’s risk management program and contracted executive services.

resulting in approximately \$683,000 in insurance administrative fees.¹³⁹ LCSC informed us that \$8.79 pcpm (approximately \$609,500 per year) is used to support the insurance program, and the remainder (approximately \$73,500 per year) is used for student programs, staff development for LCSC’s members, facilities upkeep and maintenance, and agency equipment.¹⁴⁰

E. Northeast Service Cooperative

Northeast Service Cooperative (NESC) also administers its health insurance programs with the Blues. NESC informed us that it had approximately 6,888 contracts in fiscal year 2004, generating \$814,150.31 in administrative fee payments.

NESC provided us with information that appears to show that only \$0.40 out of the \$9.85 pcpm fee (\$33,280.77) was used for risk management. However, NESC also provided us with calculations showing subsidies to NESC’s General Fund. From those calculations, it appears that approximately \$1.91 of the \$9.85 pcpm fee, or more than \$157,000 in fiscal year 2004, was used by NESC on non-insurance related programs and activities such as cooperative purchasing, academic programs, education services, information technology, computer repair center, and environmental health and safety.¹⁴¹ It appears that another \$7.54 of the \$9.85, or more than \$620,000, was used on what NESC identified to us as “fixed expenditures,” including costs for the executive director, the board of directors, business, fiscal and legal services, newsletters, property and casualty insurance, facility rental, and building operations and maintenance.¹⁴²

NESC’s annual financial statements note that the insurance administrative fee is a significant amount of the revenue recorded in the NESC’s General Fund.¹⁴³

¹³⁹ We calculated the administrative fees for FY 2004: 5,778 contracts X \$9.85 = \$56,913.30; \$56,913.30 X 12 months = \$682,959.60.

¹⁴⁰ Specifically, LCSC informed us that for fiscal year 2004, the \$9.85 pcpm fees was used as follows:

	LCSC
Salaries and benefits for employees working on the insurance program	\$3.84
Wellness support/insurance education for members	\$1.88
Paid to Rate Stabilization Reserve Claims Account	\$0.34
Communications	\$0.68
Annual audit, liability insurance, legal fees, and research and development of new products (such as the VEBA)	\$0.57
Supplies, material and equipment	\$0.15
Indirect: Board member expenses, sub-pay for advisory committee meetings, etc.	\$1.33
General operations	\$1.06
TOTAL	\$9.85

¹⁴¹ 6,888 contracts X 12 months = 82,656; 82,656 X \$1.91 = \$157,872.96.

¹⁴² 82,656 X \$7.54 = \$623,226.24.

¹⁴³ See NESC Annual Financial Statements as of June 30, 2004, at page 35, note 9; NESC Annual Financial Statements as of June 30, 2003, at page 37, note 9.

F. Southeast Service Cooperative

Southeast Service Cooperative (SESC) informed us that it had 5,663 contracts in fiscal year 2004, resulting in approximately \$669,000 in insurance administrative fees. SESC informed us that the entire amount is used to support the insurance program.¹⁴⁴ Most notably, SESC is using a portion of these fees to fund one of its insurance reserves. We believe SESC’s use of the fees is appropriate where the reserve is under-funded.

G. South Central Service Cooperative

South Central Service Cooperative (SCSC) also administers its health insurance programs with the Blues. SCSC’s annual financial statements show the fee as a separate revenue fund. In fiscal year 2004, SCSC received \$2,265,406 in administrative fees.¹⁴⁵ According to its financial statements, SCSC spent only \$885,371 of that amount on “district support services.”¹⁴⁶ The remainder (\$1,380,035) was added to the fund’s balance.

As of June 30, 2004, the fund had a balance of \$8,788,492.¹⁴⁷ We reviewed the administrative fees received by SCSC for fiscal year 2001 through fiscal year 2004. It appears that SCSC used, on average, only 40% of the administrative fee collected, with the remainder accumulating in the separate revenue fund. SCSC informed us that the nearly \$8.8 million balance in the fund is an extra insurance reserve.

As discussed later in this report, SCSC appears to have an under-funded insurance reserve fund. As a result, the balance in the administrative fee fund may be needed for insurance reserves.¹⁴⁸ SCSC informed us that it has an on-going disagreement with the Blues regarding the calculation of SCSC’s reserve funds. As discussed later in this

¹⁴⁴ Specifically, SESC informed us that for fiscal year 2004, the \$9.85 pcpm fees was used as follows:

	SESC
Salaries and benefits for employees working on the insurance program	\$1.11
Wellness support/insurance education for members	\$0.11
Paid to Rate Stabilization Reserve Claims Account	\$5.35
Communications	\$0.10
Annual audit, liability insurance, legal fees, and research and development of new products (such as the VEBA)	\$0.91
Supplies, material and equipment	\$0.03
Indirect: Infrastructure, board member expenses, program oversight, accounting, technology support	\$2.24
TOTAL	\$9.85

¹⁴⁵ SCSC informed us that it had 16,303 contracts in fiscal year 2004.

¹⁴⁶ See SCSC Annual Financial Report for Year Ended June 30, 2004, at pages 26 and 31.

¹⁴⁷ *Id.*

¹⁴⁸ To determine whether the administrative fee balance is needed for the insurance reserves requires an examination of the IBNR and the RSR, discussed later in this report. While it is appropriate to keep the reserves funded, over-funding the reserves is also problematic. If a reserve is significantly over-funded, it appears that rebates to the members should be considered.

report, we recommend that SCSC use some of these administrative fees to resolve its reserve fund issues.

H. North Central Service Cooperative

Unlike the other service cooperatives, North Central Service Cooperative (NCSC) and the Blues agreed that NCSC would receive only \$5.00 pcpm, or approximately \$150,000 per year.¹⁴⁹ We were informed that the administrative fee pays for an NCSC employee who works in the insurance area, 40% of the business office, 40% of the executive director, and ancillary fees such as license renewals.

I. Recommendations

In some service cooperatives, the administrative fees paid by school districts for insurance are being used for non-insurance related programs. The joint powers agreements that the school districts enter into with the service cooperatives authorize the service cooperatives to act on their behalf for the administration and funding of group employee benefits.¹⁵⁰ We question whether the service cooperatives are acting within that scope of authority when, in order to fund other service cooperative programs, they negotiate administrative fees in excess of the fees actually used to administer the insurance program. At the very least, these actions lack transparency.

We believe that service cooperative members should be able to decide directly which additional service cooperatives programs they wish to support, rather than supporting programs indirectly through insurance fees. If the fees are not needed for the administration of the insurance program, we recommend that the fees be reduced, or that rebates be given to the members. However, given our concerns discussed later in this report regarding appropriate monitoring of renewal rates and insurance reserve funds, we believe that the service cooperatives may need to spend the fees for their stated purpose: administering the insurance program.

We recommend that:

- Service cooperatives spend health insurance administrative fees on health insurance services.¹⁵¹
- Any transfers of insurance funds, including administrative fees, to the general fund should be reflected in the service cooperatives' financial statements.¹⁵²

¹⁴⁹ See NCSC Financial Statements for Year Ended June 30, 2004, at page 22 and 23 (administrative fees of \$144,768.29 for fiscal year 2004); NCSC Financial Statements for Year Ended June 30, 2003, at page 6 (administrative fees of \$157,850.39 for fiscal year 2003). NCSC informed us that it had 2,307 contracts in fiscal year 2004.

¹⁵⁰ See Joint Powers Agreement Example at ¶¶ 1.1, 4.1. In the joint power agreements, school districts also agree that the service cooperatives may receive the administrative fee. *Id.* at ¶ 4.5.

¹⁵¹ As discussed later in this report, the service cooperatives may want to increase their oversight of these services.

¹⁵² This would allow the service cooperative members to see how their insurance payments are being used by the service cooperatives.

IV. Service Fees/Research and Development Fees

Seven of the service cooperatives receive a per contract per month (“pcpm”) fee from the Blues for “research and development activity,” including the development and maintenance of “The Minnesota Provider Network” (“Network”).¹⁵³ Specifically, the Blues agreed to pay service fees to the service cooperatives for the development and management of the Network: \$0.60 pcpm for the first year, and \$0.30 pcpm for the second through the fifth year.¹⁵⁴

In addition, the service cooperatives agreed to work with the Blues in the development of new products - products that the Blues could then use for their other customers.¹⁵⁵ The Blues agreed to pay the seven service cooperatives a one-time fee of \$0.72 if the Blues sold one of these products to someone who was not in the service cooperatives’ pools.¹⁵⁶ Each of the service cooperatives agreed to furnish the Blues with written reports on a quarterly basis “describing its product development work and special services and sharing its work product.”¹⁵⁷

We were not able to track these fees in the individual service cooperatives’ financial statements. However, we noticed that an “R & D Account” was a topic at the monthly CBC Meetings. Therefore, we requested information from the service cooperatives about these fees.

A. Use of the Service Fees

We were told that the service cooperatives have not received any of the one-time \$0.72 product development fees; but they have received the \$0.60/\$0.30 pcpm Network service fees. While the fees were for developing and maintaining the Network, we found that the fees were used for other purposes, including lobbying.

We were informed that Consultant Hammerstad/CBC developed the Network, and donated it to the service cooperatives.¹⁵⁸ We were told that a few of the providers

¹⁵³ See, e.g., LCSC’s 2002 Operating Agreement at ¶ 5.5, and Exhibit A, Section 17. The seven service cooperatives are Northeast, Northwest, Lakes Country, Southwest/West Central, Resource Training & Solutions, South Central, and Southeast. The NCSC 2004 Operating Agreement does not contain a provision that is comparable to ¶ 5.5; it does, however, contain the same Exhibit A, Section 17 language. NCSC informed us that it does not receive these fees.

¹⁵⁴ See, e.g., LCSC’s 2002 Operating Agreement at Exhibit A, Section 17.

¹⁵⁵ See, e.g., LCSC’s 2002 Operating Agreement at ¶ 5.5.

¹⁵⁶ *Id.* at ¶ 5.5 and Exhibit A, Section 17.

¹⁵⁷ *Id.* at ¶ 5.5. For example, the service cooperatives provided the Blues with legal work conducted on behalf of the service cooperatives. See, e.g., September 4, 2003 (Item 4.1) CBC Minutes.

¹⁵⁸ See May 13, 2005 Lindquist & Vennum letter at pages 5 and 14; May 6, 2002 CBC Minutes, item 12.0 (Hammerstad created Network a year ago; will transfer Network to seven service cooperatives for their sole ownership; service cooperatives agree to pay an outstanding obligation from July 2001 to June 2002, in the amount of \$70,000, for developing the Network; executive directors vote 7 to 0 in favor of signing a non-compete with the Blues); October 1, 2002 CBC Minutes, Item 6.0 (transfer of Network and operating agreements will be formally approved at next CBC meeting); November 7, 2002 CBC Meeting, Item 6.0

(representing only a small portion of the providers available through the Blues) have agreed to additional discounts for service cooperative members beyond the Blues-negotiated discounts.¹⁵⁹ We were told that the Network is currently operated as part of the larger Blues Network.¹⁶⁰ As a result, it appears that the current ownership of the Network is unclear.¹⁶¹

Specifically, we were provided with copies of documents showing that the Network was a limited liability company (“LLC”) formed in 2001, with Consultant as its sole member.¹⁶² In November 2002, three service cooperatives and four nonprofit entities related to the service cooperatives were assigned membership in the LLC.¹⁶³ In 2004, RT&S became the sole member of the LLC, and the other LLC members received Operations Contracts. The agreements signed in 2004 were “effective November 6, 2002.” According to the Operations Contracts, the Blues agreed to pay service fees to the LLC for research and development associated with the operation of the Network, and the

(approve SCSC to hold Network agreement and LCSC responsible for payment of bills); April 20, 2004 CBC Minutes, item 4.4 (Hammerstad reports transfer of Network to RT&S; RT&S to hold Operating Agreement).

We were informed that the May 6, 2002 CBC Minutes indicating that \$70,000 was outstanding for development of the Network was an error. June 14, 2005 Lindquist & Vennum letter. Given the lack of specificity in the consulting contract, we are unable to resolve if Consultant was paid by the service cooperatives to develop the Network, or if Consultant developed the Network apart from his work with the service cooperatives. Consultant’s 1998 and 2003 consulting agreements with the service cooperatives required Consultant to provide access to any Minnesota Health Network owned, managed, controlled or accessible to CBC or any of its affiliates. *See, e.g.*, NWSC Insurance Pool Products and Related Services Consulting Agreement, November 1998 Agreement at ¶ IV.1.f and 2003 Agreement at ¶ IV.1.f.

¹⁵⁹ June 14, 2005 Lindquist & Vennum letter. We were originally told that the Network provides deeper pricing discounts than any other comprehensive network in Minnesota. May 13, 2005 Lindquist & Vennum letter; May 20, 2005 Borenstein and McVeigh letter.

¹⁶⁰ June 14, 2005 Lindquist & Vennum letter.

¹⁶¹ *See, e.g.*, May 20, 2005 Borenstein and McVeigh letter. The service cooperatives provided us with a copy of the Network’s directory. It contains the Blues’ registered marks, and appears to be published and copyrighted by the Blues in 2001. According to the Directory, “Network providers have agreements with [the Blues] on behalf of the Minnesota Service Cooperatives for the Minnesota Provider Network to provide patients with medically appropriate, cost-effective care.” Directory at page 2.

¹⁶² *See* Certificate of Organization (July 16, 2001).

¹⁶³ We were provided with documents signed in November 2002 by the executive directors of SESC, NWSC (signing for Northwest Management Corporation), LCSC (signing for Cooperative Resources, Inc.), SCSC, RT&S (signing as CEO of Quality Innovations and Resources), and NESC; and the President of Appletree. From our review of service cooperative board of director meeting minutes, it appears that some of the service cooperative boards did not accept the Network donation until fall 2003. *See, e.g.*, SCSC October 1, 2003 Board of Director meeting minutes; September 24, 2003 SESC Board Meeting Minutes at page 3 (proposed donation of provider network in equal shares with other SC pools); October 29, 2003 SESC Board Meeting Minutes at page 2 (motion passed to accept part interest in Minnesota Provider Network, LLC, pursuant to terms outlined in the Assignment of Membership Interest and Amended Operating Agreement); June 23, 2004 SESC Board Meeting Minutes at page 3 (rescinded prior membership agreement in Provider Network; transfer network management to RT&S; approved agreement with RT&S for SESC to participate as a member). In the documents, the service cooperatives agree to pay \$15,000 for costs and expenses related to the transaction incurred by the LLC or Consultant. Assignment of Membership Interest and Amendment of Member Control and Operating Agreement of Minnesota Provider Network, LLC at ¶ 6.

LLC agreed to “timely remit” to the service cooperative all service fees received by the LLC, less any expenditures agreed upon by the parties.¹⁶⁴

We learned that SCSC received the following service fees on behalf of the seven service cooperatives (or the LLC):¹⁶⁵

Fiscal Year 2003:	\$442,798.39
Fiscal Year 2004:	\$230,851.50
July 1, 2004 through May 16, 2005:	\$205,366.50

The service fee (R & D) fund received an additional \$196,731.58 in fiscal year 2004 that was identified to us as payments from other service cooperatives, bringing the total fund revenue in the fund in fiscal year 2004 to \$427,583.08. In fiscal year 2005, the fund received an additional \$84,000 from RT&S, for a total amount (through May 16, 2005) of \$289,366.50.

According to SCSC’s financial report, this fund was the “Provider Network Fund” and was used to account for research and development (“R & D”) for “Minnesota Service Cooperatives.”¹⁶⁶ LCSC’s executive director authorized expenditures from this fund, and SCSC reviewed the expenditures before making payments.¹⁶⁷ Having reviewed the LLC’s Operations Contracts, the fund appears to be the LLC’s account. Some of these funds were returned to the individual service cooperatives.¹⁶⁸ However, we also found that the fund was used for lobbying, legal, actuarial, consulting and marketing expenditures.¹⁶⁹ According to SCSC’s records, total fund expenditures

¹⁶⁴ See Agreement to Retire Membership Interest, Exhibit A, Operations Contract at ¶ 2. The Operations Contract contains a confidentiality provision that will be discussed later in this report.

¹⁶⁵ We understand that fiscal year 2003 represents the \$0.60 pcpm fee; fiscal year 2004 represents the \$0.30 pcpm fee. The fees are reported as a special revenue fund in SCSC’s Annual Financial Report for YE June 30, 2003 (page 9, note 1, and pages 21 and 26), and in SCSC’s Annual Financial Report for YE June 30, 2004 (page 15, note 2, and pages 26 and 30). Special revenue fund accounts are for revenue sources that are legally restricted to expenditures for specified purposes. SCSC’s FY 2004 at page 12, note 1.

¹⁶⁶ See SCSC’s Annual Financial Report for YE June 30, 2003 (page 9, note 1). SCSC’s Financial Report for YE June 30, 2004 does not provide a description of the fund.

¹⁶⁷ According to the minutes of the November 7, 2002 CBC Meeting, as corrected at the December 9, 2002 CBC Meeting, SCSC was made responsible for receiving the Minnesota Network fees, and Lakes Country was made responsible for invoicing and reconciling expenses. See November 7, 2002 CBC Minutes, Item 6.0, and December 9, 2002 CBC Minutes, Item 4.0. We were informed that, for the sake of efficiency, various service cooperatives assumed specific responsibilities for the Network: RT&S holds the LLC on behalf of the participating service cooperatives; SCSC is the fiscal agent, “receiving and paying out money for authorized purposes”; and the executive director of LCSC receives bills and approves the expenditures. June 14, 2005 Lindquist & Vennum letter. We were also informed: “These procedures have been in effect since the donation was accepted, but were not originally documented; this oversight is now being rectified.”

Id.

¹⁶⁸ SCSC’s FY 2004 Financial Statement showed that expenditures exceeded appropriations in this fund by \$536,562.00 (note 2, page 15). SCSC informed us that, in fiscal year 2004, SCSC returned the fiscal year 2003 and 2004 fund balances to the individual service cooperatives.

¹⁶⁹ It appears that some of the “actuarial work” paid out of the service fees was used in connection with the service cooperatives’ lobbying efforts. For example, Milliman was hired to review materials concerning the 2004 Statewide Study. This report, dated January 23, 2004, was completed by Reden & Anders for use

(excluding the fiscal year 2003 fund balance returned to the service cooperatives) were as follows:

Fiscal Year 2003:	\$113,241.33
Fiscal Year 2004:	\$422,004.55
7/1/04 – 5/16/05:	\$184,901.84

The revenues and expenditures from the service fees (R & D) fund are reflected in Attachment D of this report.

Where the fee is paid to the service cooperatives for developing and maintaining the Network, we question the use of this fee as a lobbying fund. Service cooperative members ultimately bear the cost of these service fees because the service cooperatives and the Blues are already paid administrative fees that should cover any actual Network maintenance costs borne by the service cooperatives. Rather than negotiating this payment for the service cooperatives (or the LLC) to use as a lobbying fund, we recommend that the service cooperatives negotiate lower rates for their members. At a minimum, service cooperative members should be informed how these fees are being spent.

B. Authorization of Service Fee (R & D) Fund Activity

We also question who is authorizing expenditures from, and the additional service cooperative contributions to, the service fee (R & D) fund. The fund is comprised of payments made under the operating agreements that the service cooperatives negotiated with the Blues on behalf of their members, as well as other payments from individual service cooperatives. However, it appears to us that the executive directors approved additional payments to the fund, and expenditures from the fund. It is unclear to us whether these actions were taken on behalf of a joint powers entity, an “informal confederation” of the seven service cooperatives, or the LLC.

The Minnesota Multi-Regional Service Agency (MRSA) was created as a joint powers entity in late 2001.¹⁷⁰ It was originally comprised of five of the seven service cooperatives, although all seven of the service cooperatives belonged to the joint powers entity at the time of our review.¹⁷¹ The MRSA’s board of directors is comprised of two

by the Legislature to determine the feasibility of a new risk pool covering Minnesota school districts. A memorandum on Consultant Hammerstad/CBC’s letterhead dated January 27, 2004 advises that Milliman’s January 7, 2004 report “should not be sent to Education Minnesota and the facts may be used to promote our view of the study.” The memorandum also states that a Milliman representative is working closely with two of the lobbyists. An invoice from Milliman for December 2003 and January 2004 in the amount of \$80,250 states that the services include “Assistance with State Study (including report dated 1/7/04, various meetings and calls, as directed by V. Hammerstad).”

¹⁷⁰ See Joint and Cooperative Agreement Minnesota Multi-Regional Service Agency (signed in December 2001 and January 2002) (“MMRSA Agreement”). The name of the joint powers entity was later changed to MRSA.

¹⁷¹ See MRSA’s website at <http://www.mnmrsa.org/History.htm>. The original MRSA joint powers agreement was signed in December 2001 and January 2002 by NWSC, LCSC, RT&S, SW/WC SC, and NESCS. SCSC appear to have joined MRSA in January 2003. See January 15, 2003 MRSA Board of

board members (or their voting board member designee) from each of the service cooperatives. Under the MRSA joint powers agreement, the MRSA Board must establish an Executive Council consisting of the executive directors of the participating service cooperatives.¹⁷² The Executive Council is authorized to take any action in the name of, or on behalf of, the Board.¹⁷³ The Executive Council is also granted specific authorization to enter into contracts and other legal instruments, and to expend funds.¹⁷⁴

We were provided with copies of three lobbying contracts signed in 2004.¹⁷⁵ Two of the contracts were between a lobbyist and SCSC, operating “on behalf of participating [MRSA].” The third was a contract between the lobbyist and SCSC. We also received a copy of an MRSA contract with a legislative information specialist.¹⁷⁶

MRSA has its own funds.¹⁷⁷ According to MRSA’s meeting minutes, SW/WC SC is MRSA’s fiscal host.¹⁷⁸ We reviewed the MRSA fund’s activity, but did not find all of the lobbying expenditures.¹⁷⁹ Instead, as confirmed by SCSC’s executive director, the lobbying expenditures appear to have come from the service fee (R & D) fund held by SCSC.

We reviewed meeting minutes in an attempt to determine when the use of the service fee (R & D) funds for these lobbying expenditures was approved by each of the seven service

Director Meeting minutes. SESC appears to have joined MRSA in January 2004. *See* January 14, 2004 MRSA Board of Director Meeting minutes. The MRSA Board of Directors Meeting minutes reflect discussions about the possibility that NCSC would join MRSA, but concern was expressed about NCSC’s “cooperative intent.” *See, e.g.*, March 21, 2002 MRSA Executive Council Meeting minutes (NCSC submitted letter of request to join MRSA); July 22, 2004 MRSA Board of Directors Meeting minutes. Metro ECSU’s membership was discussed at the April 4, 2005 Board of Directors meeting. April 4, 2005 MRSA Board of Directors Meeting minutes.

¹⁷² MMRSA Agreement at IV, Section 6. According to its website, the seven service cooperative executive directors meet together monthly to discuss issues of common interest to their service cooperatives. The minutes of the June 9, 2004 CBC Meeting reflect a recommendation to the MMRSA Board that future monthly meetings should be hosted by MMRSA. June 9, 2004 CBC Minutes, Item 2.0.

¹⁷³ MMRSA Agreement at IV, Section 6; Bylaws at III.E.6.

¹⁷⁴ MMRSA Agreement at IV.10 (contracting authority), and VI.1 (other legal instruments; expend MMRSA funds “in accordance with the procedures established by law for the expenditure of funds by the parties”); Bylaws at III.E.10, and VII.1.

¹⁷⁵ We did not receive copies of earlier lobbying contracts.

¹⁷⁶ MRSA Contract for Information Specialist Services (July 2003). *See* October 7, 2003 CBC Minutes, Item 4.16; September 5, 2003 MRSA Executive Council Meeting minutes.

¹⁷⁷ Service cooperatives appear to pay \$15,000 annually to join MRSA.

¹⁷⁸ *See* July 31, 2002 and July 16, 2003 SW/WC SC Board of Director Meeting minutes. We are concerned that the minutes of one of the MRSA Executive Council meetings reflect discussion of opening a separate account for MRSA outside the SW/WC SC fiscally hosted account. *See* MRSA Executive Council meeting minutes for June 16, 2003 (discuss opening MRSA account outside SW/WC SC fund), and July 23, 2003. In addition, the September 15, 2003 MRSA Board of Directors meeting minutes reflect that funds had been transferred to RT&S. We are unclear what funds that would be.

¹⁷⁹ We note that expenditures in the MRSA preliminary budget were predicted to exceed revenues. *See* July 15, 2002 MRSA Board of Directors meeting minutes. While the MMRSA Agreement requires that the MRSA’s fund must be audited annually, we were informed that the funds were not audited. *See* MMRSA Agreement at VI, Section 5.

cooperatives. It appears to us that the executive directors were primarily responsible for determining from which account the lobbying expenditures would be paid.

For example, we found that the MRSA Executive Council (comprised of the executive directors) discussed the lobbying contracts and extensions of the contracts, approved the legislative information specialist contracts, approved creation of a political action committee (PAC), noted that each service cooperative needed to pay lobbyist principal fees, and discussed project expenses.¹⁸⁰ In addition, the minutes of the May 10, 2004 MRSA Executive Council meeting reflect that the executive directors discussed the Network and the purpose of the R & D fund.¹⁸¹

Similarly, we found that the lobbying contracts were discussed at, and some of the lobbyists attended, the CBC Meetings (attended by the executive directors). For example, as early as July 30, 2002, the CBC Meeting minutes reflect that one of the lobbyists had joined the group, and that Consultant Hammerstad and the executive directors of RT&S and SCSC were “the new legislative heads of the Service Cooperatives.”¹⁸² The CBC Meeting minutes also reflect that payments for lobbyist contracts were transferred to the “R & D account” effective July 1, 2003.¹⁸³ CBC Meeting minutes reveal discussions of expenditures from the service fee (R & D) fund and reports on the account’s status.¹⁸⁴

It appears that the MRSA Board of Directors discussed legislative matters at several meetings and approved “consultant/advocate agreements” at the July 22, 2004 meeting.¹⁸⁵ However, we found no evidence that the MRSA Board of Directors decided to pay the lobbying expenses from the service fee (R & D) account. In addition, we question whether MRSA would have the authority to expend funds from the service fee (R & D) account, especially when one of the seven service cooperatives contributing to the fund did not join MRSA until 2004.¹⁸⁶

¹⁸⁰ See, e.g., MRSA Executive Council meeting minutes for April 14, 2003, May 22, 2003 (discussing history, strengths of each lobbyist), July 23, 2003, September 5, 2003.

¹⁸¹ See May 10, 2004 and June 14, 2004 Executive Council Meeting minutes.

¹⁸² See July 30, 2002 CBC Minutes, Item 4.0. See also November 7, 2002 CBC Minutes, Item 9.0 (Consultant and lobbyist want to come up with new positive plan). We note that Consultant’s contracts did not reflect this change in his responsibilities.

¹⁸³ See July 29, 2003 CBC Minutes, Item 10.0. According to the CBC Meeting minutes, the service cooperative executive directors were told that, if the account was in need of funds, the bills would be paid and SCSC would send the service cooperatives an invoice. See December 16, 2003 CBC Minutes, Item 14.0; January 27, 2004 CBC Minutes, Item 13.

¹⁸⁴ See, e.g., September 4, 2003 CBC Minutes, Item 4.4 (attorney paid out of Network access fees); January 15, 2003 CBC Minutes, Item 4.1 (return money to service cooperatives); February 8, 2005 CBC Minutes (discuss which lobbyist bills not yet paid).

¹⁸⁵ See July 22, 2004 MRSA Board of Directors Meeting minutes (approve agreements).

¹⁸⁶ If Metro ESCU, NCSC, or any other entity joins MRSA, those entities would not appear to have authority to expend funds received under the operating agreements on behalf of seven of the service cooperatives’ members.

We found that SCSC’s Board of Directors meeting minutes reflect that SCSC was “hosting” one of the lobbying agreements as early as July 2000.¹⁸⁷ The minutes for some of the board of director meetings of the seven service cooperatives also reflect discussions of legislative matters, and some of them specifically reference and approve the lobbying contracts.¹⁸⁸ However, we found no evidence in the minutes that each of the service cooperatives approved using the service fee (R & D) account to pay the lobbyists.

The lobbying expenditures were reported to the Campaign Finance and Public Disclosure Board by an entity called Minnesota Service Cooperatives (“MSC”).¹⁸⁹ When we asked about MSC, we were told: “MSC was an informal confederation of SCs. It was never formally organized and ceased operation in 2001.”¹⁹⁰ According to MRSA Executive Council Meeting minutes, this “loose knit confederation” was dissolved in 2003, and remaining MSC funds were to be distributed back equally to the service cooperatives.¹⁹¹ We were told that after MRSA was formed, the lobbyist principal reports were to have been filed on behalf of MRSA, but continued to be filed using MSC, “to alleviate confusion and to clarify the source of the reports.”¹⁹²

The MSC has a PAC naming RT&S’s executive director as its chair, and LCSC’s executive director as its treasurer. The PAC reported that it maintains an account in Fergus Falls, Minnesota (LCSC’s location) and is “concerned with education issues as well as insurance issues.” The filing reported that the PAC received no administrative assistance from a nonprofit corporation, and made \$500 in political contributions to both of the two major parties in 2004. The formation and work of the PAC was discussed at MRSA Board of Director and Executive Council meetings, CBC Meetings, and some of

¹⁸⁷ See July 5, 2000 and July 11, 2001 SCSC Board of Director Meeting minutes.

¹⁸⁸ See, e.g., October 18, 2000 SW/WC SC Board of Director Meeting minutes (MSC 2001 legislative initiatives); March 20, 2002 NESC Board of Director Meeting minutes (discuss legislative activity); December 17, 2003 NESC Board of Director Meeting minutes (approve lobbyist contract); August 6, 2003 and September 3, 2003 SCSC Board of Director Meeting minutes (approve MRSA’s lobbying contracts); August 4, 2004 SCSC Board of Director Meeting minutes (approve lobbying contracts). See also June 30, 2003 SESC Board of Director Meeting minutes (concern expressed regarding MRSA’s lobbying contracts).

¹⁸⁹ MSC filed annual reports as a lobbyist principal since at least 2002. Resource Training & Solutions’ executive director certified the reports. MSC reported that it spent the following on lobbying efforts to influence legislative action, administrative action, or official action of metropolitan governmental units in Minnesota:

2002	\$ 45,000
2003	\$ 69,530
2004	\$131,100

Lobbying expenses by local units of government must also be reported to our Office. See Minn. Stat. § 6.76. We received no report of lobbying expenditures from MRSA or MSC.

¹⁹⁰ See May 13, 2005 Lindquist & Vennum letter, at page 14.

¹⁹¹ See March 12, 2003 MRSA Executive Council Meeting minutes (unanimous motion to have remaining MSC funds distributed back equally to all regions; all regions participating in MRSA agreed to roll funds into MRSA) and March 17, 2003 MRSA Board of Directors Meeting minutes (agreement among executive directors to dissolve MSC Association, a “loose knit confederation”). We are uncertain what funds MSC had. See also March 19, 2003 NESC Board of Director meeting minutes (direct remaining fund balance in MSC account to operating fund for MRSA).

¹⁹² See May 23, 2005 Lindquist & Vennum letter at page 2.

the individual service cooperative board of directors meetings.¹⁹³ Indeed, the November 16, 2004 RT&S Board of Directors Meeting minutes state that RT&S's executive director has been deeply involved in political fundraising and political contributions.¹⁹⁴

Rather than avoiding confusion by reporting that the lobbying funds were from a non-existent group identified as MSC, the reports filed with the Campaign Finance Board create confusion, in our view. If the expenditures were from the LLC, the reports should have so stated. If the MRSA approved the lobbying contracts, MRSA should have paid these expenses from its account. We believe that a "loose knit confederation" of service cooperatives does not have authority to expend service fee (R & D) funds.

We also question the authority of the service cooperative to operate the LLC. Receiving the LLC from Consultant cannot be used as a subterfuge to escape the provisions of the law preventing public entities from creating a corporation.¹⁹⁵ It also cannot be used as a subterfuge to conceal the source of the funds or their expenditures. We note that the joint powers agreements the school districts and other local public entities entered into with the service cooperatives, do not authorize the service cooperatives to negotiate with the Blues to receive payments for the LLC.¹⁹⁶ Finally, if the service cooperatives ended their relationship with the Blues, it appears that the LLC's payments may cease. As a result, the service cooperatives appear to have an incentive to stay with the Blues.

We recommend that the service cooperatives:

- Clarify what entity entered into each of these lobbying contracts, and what funds should be used to pay for the contracts.
- Do not use funds held on behalf of the seven service cooperatives, such as the service fee (R & D) account, to pay lobbying contracts entered into by MRSA.
- Avoid acting as "an informal confederation" of service cooperatives when the expenditures of public funds are involved.
- Determine what public entity is approving the LLC's actions.
- Clarify why service cooperatives are making additional payments into the service fee (R & D) account.

¹⁹³ See, e.g., MRSA Board of Directors Meeting minutes for September 15, 2003, November 17, 2003, March 15, 2004, May 15, 2004 (PAC information and legislative initiative cards in Board's packet; review of fund status), October 4, 2004; MRSA Executive Council Meeting minutes for December 8, 2003 (update on PAC formation), February 9, 2004 (review of PAC fund), March 8, 2004 (PAC information and legislative initiative cards); October 7, 2003 CBC Minutes, Item 4.9 (approval of PAC); December 16, 2003 CBC Minutes Item 9.0 (reporting funds in PAC account); January 27, 2004 CBC Minutes, Item 9.0; February 17, 2004 RT&S Board of Directors Meeting minutes (RT&S board members encouraged to contribute to PAC).

¹⁹⁴ November 16, 2004 RT&S Board of Directors Meeting minutes at page 4.

¹⁹⁵ See Minn. Stat. § 465.717, subd. 1 (prohibits political subdivisions from creating corporations, whether for profit or not for profit, unless explicitly authorized to do so by law).

¹⁹⁶ See Joint Powers Agreement at Addendum A ("service fees" defined as \$9.85 pcm administrative fees).

We recommend that the board of directors for each of the service cooperatives, and for the MRSA, take an active role in determining how service cooperative funds are expended. Service cooperatives are supposed to be member controlled. This is especially important where the service cooperatives are spending funds received under agreements that they negotiated on their members' behalf. Because school district employees pay a share of their health insurance costs, we believe that individual service cooperative boards and the MRSA Board must be especially cautious when lobbying expenditures are used for issues upon which school district employees may hold different views than the service cooperatives.

To maintain member control of the service cooperatives, we recommend that MRSA reconsider the provision in its joint powers agreement authorizing the Executive Council to enter into contracts and to expend MRSA funds. We also recommend that the service cooperative boards re-examine the LLC, and exercise control over the LLC's funds.

V. Reserve Funds

The service cooperatives informed us that they have been "self-insured" since the early 1990s.¹⁹⁷ In a self-insured pool, the risk is on the pool if claims exceed premiums.¹⁹⁸ In contrast, in a fully-insured pool, typically the carrier takes all of the risk.¹⁹⁹ As a result, self-insured pools must have reserves to cover the pool's risk.

We understand that the Blues provided funding for the reserves in 1992.²⁰⁰ The service cooperatives then acquired their reserves from the Blues over a five-year period, between 1998 and 2002.²⁰¹ Once reserves are established in a self-insured pool, contributions to the reserves should decrease to zero, if there are no unexpected increases in claims.²⁰²

We reviewed the insurance reserves maintained by the service cooperatives, and found that many of the reserves are under-funded. In addition, we note that some of the reserves have been under-funded for some time. We have concerns that consistent under-funded reserves suggests that premiums may have been set too low. We also have concerns that some of the service cooperatives may not have been adequately monitoring their reserves.

¹⁹⁷ We use the term "self-insured" because that is the description of the plans used by the service cooperatives. It is our understanding that "partially self-funded" pools may be the more accurate term for the Minimum Premium Funding plans offered by the service cooperatives. According to the Operating Agreement for Health Insurance Pool (effective October 1, 1998) at Section 9, the transition from fully-insured to the Minimum Premium Funding Arrangement occurred in 1992. We take no position on when the service cooperatives became self-funded or self-insured.

¹⁹⁸ See generally 2004 Statewide Study. In very general terms, under the minimum premium funding model, service cooperative members pay a premium-equivalent amount that includes the costs of expected claims, reserve funding, and administrative costs.

¹⁹⁹ See 2004 Statewide Study at 37. A fully-insured pool retains less risk than a self-funded pool; however, the cost of this risk transfer is higher contributions to reserves over time. *Id.*

²⁰⁰ See Operating Agreement for Health Insurance Pool (effective October 1, 1998) at Section 9.

²⁰¹ *Id.*

²⁰² See 2004 Statewide Study at 37. Once the reserves are established, pool members should receive additional cost savings. *Id.*

A. Under-funded Reserves

As a self-insured risk pool, the service cooperatives maintain two insurance reserves: a reserve for costs incurred but not yet reported (IBNR) and a rate stabilization reserve (RSR).²⁰³ Both of the reserves are owned by the service cooperatives.²⁰⁴

The IBNR is a reserve for costs incurred but not reported.²⁰⁵ It is a termination reserve, to handle “run-out” claims if the service cooperatives’ arrangement with the Blues would end.²⁰⁶ At year-end, the Blues determine the IBNR calculations.²⁰⁷ If necessary, funds from the RSR are used to fund the IBNR.

An RSR is a fund held by a self-funded risk pool to cover possible losses caused by underestimating claims and other expenses.²⁰⁸ Each month a portion of the premiums paid by the school districts is deposited into the RSR to maintain this fund.²⁰⁹ The RSR is used to fund the difference between the expected claims (reflected in the premium level set for each school district), and the actual claims (up to the point where stop loss coverage begins).²¹⁰ Basically, the RSR provides cash flow for the insurance program.²¹¹

In most cases, the Blues hold the RSR for the service cooperatives, and the service cooperatives agree to provide funds to the RSR in the amounts, and at the times, determined by the Blues.²¹² At year-end, the Blues determine the RSR amounts.²¹³ If the RSR is sufficiently funded, the service cooperatives can use the additional funds to reduce rate increases or to provide programs geared toward reducing the plan’s costs.²¹⁴ Negative balances in the RSR represent advances by the Blues to the service cooperatives and should be reflected as a liability on the service cooperatives’ financial statements.²¹⁵

²⁰³ See, e.g., LCSC’s 2002 Operating Agreement, Exhibit A.

²⁰⁴ See, e.g., LCSC’s 2002 Operating Agreement at ¶ 9.1 and Exhibit A.

²⁰⁵ See, e.g., LCSC’s 2002 Operating Agreement, Exhibit A at page 2

²⁰⁶ See, e.g., LCSC’s 2002 Operating Agreement, Exhibit A at page 2. It does not include claims that are subject to stop-loss coverage.

²⁰⁷ See, e.g., LCSC’s 2002 Operating Agreement, Exhibit A.

²⁰⁸ The RSR is also used to fund the IBNR. 2002 Operating Agreement, Exhibit A at page 7. In addition, IBNR over-funding may be transferred to the RSR. 2002 Operating Agreement, Exhibit A at Section 13(d).

²⁰⁹ SESC Notes to the Financial Statements, June 30, 2004, note 1, page 15.

²¹⁰ For the service cooperatives, the RSR is used to fund the difference between the premium rate at the 100% level and the pool’s maximum liability at the 110% level (the aggregate attachment point). See, e.g., SESC Notes to the Financial Statements, June 30, 2004, note 1, page 15. See generally 2004 Statewide Study. The attachment point is where the risk of a self-funded pool ends, and the risk of the stop loss carrier (the Blues) begins. Most of the service cooperatives have also purchased stop-loss insurance from the Blues to pay individual insurance member claims in excess of a set amount.

²¹¹ See SESC Notes to the Financial Statements, June 30, 2004, note 1, page 15.

²¹² See, e.g., LCSC’s 2002 Operating Agreement at ¶¶ 9.1 and 9.3. Under the operating agreements, the service cooperatives determine who holds the funds, although the Blues must be given access to the funds. *Id.* at ¶ 9.3.

²¹³ The year-end RSR calculation also includes items such as provider savings fees, drug manufacturer rebates, and IBNR funding. See, e.g., LCSC’s 2002 Operating Agreement, Exhibit A at ¶ 13.

²¹⁴ See Minnesota Service Cooperatives Summary Medical Coverage Renewals for 2002 (August 21, 2002) prepared by Earl Hoffman, Reden & Anders, Ltd. (“R&A 2002 Summary”) at page 9.

²¹⁵ See SESC Notes to the Financial Statements, June 30, 2004, note 1, page 15.

We were told that the service cooperatives have adopted policies setting the optimum RSR at 10% of the following year's premiums.²¹⁶ We were told that the service cooperatives are actively striving to fund the RSR at the 10% of premiums level.²¹⁷

We reviewed the year-end settlement statements that the service cooperatives received from the Blues for the school plan and for the cities, counties, and other government agencies "CCOGA" plan. The results are reflected in Attachment E of this report.²¹⁸ Out of the sixteen plans that we reviewed for fiscal year 2003, fourteen of them were under-funded, by a total of almost \$32 million.²¹⁹ If the plans were terminated, the service cooperatives could be responsible for that liability.²²⁰ Two of the sixteen plans were over-funded, by a total of almost \$1.9 million.

B. Monitoring Reserves

The operating agreements provide that each year the Blues must calculate year-end settlements for each service cooperative.²²¹ Specifically, as part of the year-end settlements, the Blues must provide the service cooperatives with a monthly accounting of each participant's account, the reserves, stop-loss settlements, a maximum year-end retro assessment, and a year-end cooperative settlement.²²² If there is a dispute regarding the year-end settlements, the service cooperatives must notify the Blues within fifteen days.²²³

We found that some of the service cooperatives have not significantly monitored the RSR, apart from those year-end settlements. They have explained to us that they have not done so because the RSR is complex and ever-changing, and the Blues have the information needed to determine the RSR.

We understand that the RSR is a fluid account, but we believe the service cooperatives must take steps to monitor the RSR, on an on-going basis. For example, "claims paid" is one component of the year-end RSR calculation. Under the operating agreements,

²¹⁶ See May 23, 2005 Lindquist & Vennum letter at page 2.

²¹⁷ *Id.* Reden & Anders recommends a stabilization reserve of 11.8% of claims for a voluntary pool. 2004 Statewide Study at page 21.

²¹⁸ Fiscal year 2003 is presented in the attachment because it is the last year for which we received complete information.

²¹⁹ Some of the service cooperatives have claimed that this information should not be made available to certain members of the public. As discussed later in this report, we disagree.

²²⁰ See, e.g., SCSC CCOGA Minimum Premium Funding Plan Financial Statements and Supplementary Information Years Ended December 31, 2001 and 2000.

²²¹ See, e.g., LCSC's 2002 Operating Agreement, Exhibit A.

²²² The general components of the year-end RSR calculation include: rate Stabilization reserve at beginning of period; premium rate buy-down, less administrative portion; monthly minimum premium; claims paid by insurance company; claims charged to group bank accounts; interest earned on rate stabilization reserve; net credit (charge) for costs incurred but not reported; interim provider year-end settlement refund to RSR; insurance company year-end premium adjustment; other adjustments. See, e.g., RT&S Minimum Premium Funding Plan Financial Statements Years Ended December 31, 2002 & 2003 at page 2.

²²³ See, e.g., LCSC's 2002 Operating Agreement, Exhibit A at page 8. See also SESC Notes to the Financial Statements, June 30, 2004, note 1, page 15.

“claims paid” information must be provided to the service cooperatives on a weekly basis.²²⁴ A comparison of “claims paid” to “expected claims” can be routinely calculated by the service cooperatives.

We recommend that the service cooperatives obtain from the Blues the information necessary to monitor the service cooperatives’ reserves. It is our understanding that the Blues have been providing the service cooperatives with a quarterly tracking report. For each school district, the report lists the income (premiums), the actual claims, the administrative fees, the expected claims, and some of the other components affecting the RSR. The tracking report then shows the gain or loss to the RSR for each school district based on those components. This year the Blues began to provide the service cooperatives with monthly RSR tracking documents. However, the monthly summaries are not itemized by school district. Such itemization would be helpful to the service cooperatives for tracking purposes.

If a service cooperative is unable to adequately monitor its reserve funds, we recommend that outside assistance be obtained. For example, three of the service cooperatives have hired others to help monitor their claims and reserve funds.²²⁵ This is an appropriate use of the administrative fees that the service cooperatives receive under the operating agreements.

In 2002, Reden & Anders recommended that the service cooperatives have an independent party periodically evaluate the reserves.²²⁶ We agree, but it appears that not all of the service cooperatives have done so. This would also be an appropriate use of the administrative fees.

We understand that KPMG was engaged by NWSC to provide actuarial assistance to review compliance with the operating agreements for the July 1996 through June 1997 (fiscal year 1997) settlement period.²²⁷ In a report dated October 2000, KPMG estimated how much should have been maintained in the IBNR. Specifically, KPMG calculated an IBNR amount that was less than the amount calculated by the Blues. If less money is needed for the IBNR, more money remains in the RSR.²²⁸

South Central Service Cooperative (“SCSC”) and the Blues jointly hired Milliman in 2003 to review the 2001 year-end settlement calculations. Specifically, SCSC had fifteen

²²⁴ See, e.g., LCSC’s 2002 Operating Agreement, Section 3 (the Blues’ administrative responsibilities), 3.4.e (claims administration-advise SC of amount of claims paid and fee charged).

²²⁵ EBIS is used by RT&S and NWSC. Appletree is used by SW/WC SC.

²²⁶ R&A Analysis of Proposals 2002 at page 1. Reden & Anders specifically noted that it did not review the Blue’s IBNR calculations. *Id.*

²²⁷ See Third Party Administrator Actuarial Review for Minnesota Service Cooperatives, Final Report – October, 2000 by KPMG, LLP. KPMG conducted the actuarial review of the IBNR and the RSR for Northwest Service Cooperative, but we were informed that all of the service cooperatives shared in the cost of this analysis and reviewed the conclusions. See May 23, 2005 Lindquist & Vennum letter at page 2.

²²⁸ Differences between the RSR calculated by the Blues and by KPMG would have resulted in a \$600,000 refund due to the service cooperative. Third Party Administrator Actuarial Review for Minnesota Service Cooperatives, Final Report - October, 2000 by KPMG, LLP at page 15. KPMG admits that it was able to calculate the IBNR with the benefit of hindsight.

points of disagreement with the Blues' calculations, for a total of \$5.4 million in dispute.²²⁹ Milliman explained the difference between the two calculations, but we understand SCSC still questions some of the year-end settlements. We recommend that SCSC take independent action to resolve these concerns.²³⁰ That would be an appropriate use of administrative fees.

In February 2005, Southeast Service Cooperative ("SESC") questioned the Blues about SESC's "consistent pool deficits."²³¹ As a result of these questions, we understand that processes have been put in place for sharing financial data and rating information in an effort to bring the school pool into a positive position. We also understand that the Blues are now accepting the recommendation of SESC's independent actuarial study by Reden & Anders showing higher medical trends for SESC's geographic areas. We believe these types of questions must be raised with the Blues as part of the service cooperative's active monitoring of its third-party vendor.

Some of the service cooperatives had separate audits conducted for their city, county, and other government agency plans (CCOGA). However, from our contacts with the audit firm that audited most of these insurance plans, and from our review of the firm's work papers, we learned that the auditing firm primarily relied on documents received from the Blues to verify the RSR.²³² The auditing firm considered the Blues to be an independent third-party. During an audit, information received from an independent third-party generally has more integrity, and requires less audit testing than information received from the firm being audited. However, we believe that the Blues are not a truly independent third-party because they administer the insurance risk program, have access to the RSR, and determine the year-end settlements. Also, the audit firm elected not to request a service organization's auditor's report on the transactions of the pools administered by the Blues.²³³ Therefore, we believe that information received directly from the Blues should not be solely relied upon as independent verification of the plan, and further audit testing is required.

²²⁹ See March 13, 2003 letter from Mr. William F. Bluhn of Milliman USA to Ms. Nancy Nelson of the Blues, and Mr. Lee Martisko, SCSC, page 2.

²³⁰ We understand that SCSC is working with an audit firm on these issues.

²³¹ February 15, 2005 letter from SESC Executive Director Suzanne Riley written to Mr. Dick Niemiec, Senior Vice President, Corporate Affairs, the Blues. Specifically SESC is disputing the 2003-04 school pool settlement indicating that SESC had a negative RSR balance of nearly \$1.5 million and an IBNR account that was under-funded by \$477,570.98. According to Management's Discussion in SESC's Financial Statements, the Risk Management Pool Fund maintains liabilities to the Blues due to negative settlements. SESC Financial Statements Year Ended June 30, 2004 at page 8.

²³² Because the auditors received their information from the Blues, some of the service cooperatives are claiming that the separate plan audits should not be available to all members of the public. See June 10, 2005 letter from Lindquist & Vennum at page 2. As discussed later in this report, we disagree.

²³³ Codification of Statements on Auditing Standards Section 324, Service Organizations, addresses the auditor's consideration of the impact on internal controls of an entity whose transactions are processed by a service organization.

We believe that the service cooperatives should consistently audit the performance of their health plans.²³⁴ The United States General Accounting Office suggests that systematic audits of plan internal controls, such as procedures for processing claims, can help identify overpayments and underpayments due to error or fraud. During the Office of the Legislative Auditor reviews of the State Employee Health Insurance program, a repeated recommendation has been the consistent auditing of health plan performance.²³⁵

We believe that some of the service cooperatives have relied too heavily on their third-party vendor regarding year-end settlement calculations of reserve funds. The service cooperatives should take steps to monitor the activities of any third-party vendor. This is especially critical when the third-party has control over public funds.

C. The Annual Renewal Process

Each year during the five-year operating agreement, the Blues estimate future claims based on claims experience and actuarial studies to determine the amount service cooperative members should pay for insurance during the next year.²³⁶ The seven service cooperatives then negotiate with the Blues to determine the rates the service cooperative members will be charged for their insurance coverage.²³⁷

During the 2002 RFP process, Reden & Anders noted that they could not assess the reasonableness of the renewal premiums the service cooperatives received from the Blues because they did not have enough experience data, plan change and rate history, or the Blues' manual rates.²³⁸ Given the long-term relationship that the service cooperatives have had with the Blues, we question why the service cooperatives could not provide Reden & Anders with the necessary experience data, plan change and rate history.

Two of the service cooperatives (SCSC and SESC) provided us with several years worth of data comparing the actual claims for each school district in the pool, with the expected claims, by year. It appears that actual claims for several school districts repeatedly exceeded expected claims. Simply stated, it appears that the premiums were consistently set too low. As a result, because the service cooperatives are self-insured, the pool's reserves are picking up the difference.²³⁹

²³⁴ The service cooperatives have a right to audit provision in the 2002 Operating Agreements. *See, e.g.*, RT&S's 2002 Operating Agreement at ¶ 10.12.

²³⁵ Office of the Legislative Auditor, Program Evaluation Report #02-06: State Employee Health Insurance (February 2002) at page 83, noting similar recommendations in previous audits. The audits would be based on the standards recommended by the American Institute of Certified Public Accountants' *Statement on Auditing Standards (SAS) 70: Reports on the Processing of Transactions by Service Organizations*.

²³⁶ *See* SESC Notes to the Financial Statements, June 30, 2004, note 1, page 15.

²³⁷ *See, e.g.*, SCSC's 2002 Operating Agreement at ¶¶ 4.1, 6.2, 6.3 and Exhibit A.

²³⁸ *See* R&A Analysis of Proposals 2002 at page 7. Without a competing proposal, Reden & Anders noted that they could not compare the Blues' renewal to another carrier's projection. *Id.* However, Reden & Anders were able to review two samples of the Blues' renewal process and found that the process makes reasonable assumptions about the credibility of experience by group size and the weighting of past years' experience. *Id.* at 2.

²³⁹ Generally, the pool's reserves pick up the amount that actual claims exceeded expected claims until the stop loss insurance applies. The service cooperatives have set a 10% risk corridor.

We understand that SCSC hired Milliman to help SCSC assess the annual renewals for 2005 – 2006, and SESC hired Reden & Anders to help assess medical trends in SESC’s region. These are appropriate uses of the administrative fees that the service cooperatives receive under the operating agreements.

While repeatedly underestimating claims may seem like a good thing for individual school districts and other local public entities, the other pool members in the self-funded pool will be required to pay out of reserve funds the difference between actual and expected claims. In the current operating agreements, the Blues have specifically agreed not to under-rate plan participants for the purpose of triggering the risk held by the service cooperatives under the agreement, and to act in good faith by setting rates consistent with sound underwriting principles.²⁴⁰ This provision in the current operating agreement replaced language in the prior operating agreement expressly authorizing the service cooperatives to select an outside auditing firm to conduct a “formal audit of loss experience and revenues.”²⁴¹ We believe the prior language may have been more useful in the service cooperatives’ monitoring of the Blues.

We are concerned that some of the service cooperatives may have relied too heavily on the Blues’ determination of annual rates. We believe the service cooperatives must independently evaluate the rates quoted by the Blues at each annual renewal.²⁴² We recommend that the service cooperatives preserve and exercise the option of obtaining outside audits to determine accurate renewal rates.

D. Other Service Cooperative Reserves

Most of the individual service cooperatives with under-funded RSRs have other funds that may be available in place of the RSR. Our estimates of additional available service cooperative reserves are included in Attachment F of this report.²⁴³ Thus, even though the RSR is under-funded, most of the service cooperative would be able to meet their liability to the Blues by using other funds. However, even service cooperatives in a positive financial position could find themselves in a negative financial position if the RSR is continually under-funded.

For fiscal year 2003, it appears that two service cooperatives did not have sufficient additional reserves to fully fund the RSR. One of those service cooperatives, SESC, is using over half of the administrative fees it collects from the Blues to help re-build the

²⁴⁰ See, e.g., LCSC’s 2002 Operating Agreement at ¶ 5.1.g.

²⁴¹ See, e.g., LCSC’s 1998 Operating Agreement at ¶ 5.1.h. The 2002 Operating Agreement has a more limited audit provision. See, e.g., LCSC’s 2002 Operating Agreement at ¶ 10.12.

²⁴² We note that Consultant Hammerstad/CBC included memoranda about the annual rate negotiations in the Year End Risk Management Reports.

²⁴³ We generally used amounts identified as unreserved or unrestricted in the service cooperatives’ financial statements. The actual amounts available could be reduced by restrictions on those resources not identified in the financial statements. Also, we did not include balances reported in agency funds, since agency funds do not report fund equity.

RSR. SESC informed us that it would need to obtain a loan to fund its negative reserve balance if its relationship with the Blues ended.

The other service cooperative, SCSC, had a change of more than \$7.6 million between its final RSR calculated at year-end by the Blues for fiscal year 2003 and fiscal year 2004. As a result, SCSC is in a positive financial position for fiscal year 2004 if other SCSC reserves are considered. However, we are concerned that SCSC told us that it does not understand why such a large swing in the reserves occurred.²⁴⁴

We were provided with a copy of a report that Towers Perrin conducted on behalf of the Statewide Health Care Advisory Committee in 1999.²⁴⁵ At that time, Towers Perrin noted that the service cooperatives' RSRs were not funded to their target level.²⁴⁶ According to Towers Perrin, service cooperatives with under-funded reserves are at risk if claims experience exceeds expected claims over multiple years.²⁴⁷ As a result, Towers Perrin's first short-term recommendation was that the service cooperatives should eliminate as much of the RSR deficit as possible.²⁴⁸

We believe that the Towers Perrin recommendation is equally valid today: the reserves should be fully funded. Some of the service cooperatives appear to have made no structural changes to correct the under-funding of their reserves. Under the service cooperatives' self-insured plans, the premiums the schools and other local public entities pay the service cooperatives contain an amount for the RSR. If that amount is consistently inadequate to cover the RSR, the service cooperatives' members are not being charged enough for insurance coverage.

We find it troubling that some of the service cooperatives are using administrative fees for non-insurance related purposes, when it appears that those funds are needed to fully fund the reserves, and to provide better monitoring of the reserves and renewal rates.

We are concerned that under-funded RSRs may place additional pressure on the service cooperatives to remain with the Blues. Finally, we note that the service cooperatives pay interest to the Blues when the plans are under-funded.²⁴⁹ Although the interest rate is low, it is money the service cooperatives would not need to spend if the reserves were adequately funded.

²⁴⁴ May 20, 2005 meeting with SCSC representatives.

²⁴⁵ See Minnesota Statewide Healthcare Coalition Advisory Committee Final Report, Revised December 12, 1999 by Towers Perrin.

²⁴⁶ *Id.* at page 4.

²⁴⁷ *Id.*

²⁴⁸ *Id.* at 10.

²⁴⁹ See 2002 Operating Agreement, Exhibit A, pages 4, 5, and 7. Interest amounts, at the United States Treasury Bill amount, are charged to the service cooperatives and included within the year-end settlement calculation for the RSR.

VI. Financial Statement Reporting

We found that the service cooperatives' accounting and financial reporting practices for the insurance risk plans and the reserves were not consistent.²⁵⁰ Two of the service cooperatives have separate audits for the service cooperative, and for each of the insurance plans (schools and CCOGA).²⁵¹ One service cooperative has a service cooperative audit that includes the insurance plans.²⁵² The remaining service cooperatives have a service cooperative audit, as well as a separate audit for one of the plans (CCOGA).²⁵³

Attachment G of this report identifies how differently the service cooperatives have reported the insurance risk pools in their financial statements. The service cooperatives' insurance risk pool activities (or parts of those activities) have been reported as agency funds, special revenue funds, trust funds, enterprise funds, component units, or even as items within the general fund. The insurance pool activities are similar among all the service cooperatives and should be reported consistently and in conformity with generally accepted accounting principles (GAAP) for local governments.²⁵⁴

Under GAAP, the insurance risk pools are considered public entity risk pools and should be reported as enterprise funds in the service cooperatives' financial statements.²⁵⁵ North Central Service Cooperative's financial statements reflect the insurance risk pool as an enterprise fund, and provide an example of the format for properly reporting the service cooperative's insurance risk pool activities.²⁵⁶

We found an absence of identifiable information regarding the insurance risk pools in some of the service cooperatives' financial statements. This raises concerns about the fair presentation of some of the service cooperatives' financial statements. In addition, where separate pool audits were completed, we found that the notes to the service cooperatives' financial statements do not always disclose that there were separate plan

²⁵⁰ All eight service cooperatives had different accounting firms conduct the latest audits provided to this Office.

²⁵¹ RT&S and NWSC.

²⁵² NCSC.

²⁵³ No separate audit was conducted of the school plan.

²⁵⁴ Generally accepted accounting principles for state and local governments are established by the Governmental Accounting Standards Board (GASB).

²⁵⁵ GAAP defines a public entity risk pool as a cooperative group of governmental entities joining together to finance an exposure, liability, or risk. *See* GASB Codification § Po20.109. An enterprise fund may be used to account and report any activity for which a fee is charged to external users. *See* GASB Codification §1300.109. Public entity risk pools are required to account for their activities in an enterprise fund. *See* GASB Codification §Po20.115.

²⁵⁶ We found technical errors and other concerns in a number of the service cooperatives' audited financial statements, and related audits, including NCSC's financial statements. We will address those reporting issues with the individual audit firms and the service cooperatives in the near future.

audits.²⁵⁷ Furthermore, compliance with Governmental Accounting Standards (GASB) is required for public entity risk pools. None of the service cooperatives' financial reports or separate pool audit reports included supplementary information on revenues and claims development history as required by GASB for public entity risk pools.²⁵⁸

We specifically looked at how the insurance reserves were reported by the service cooperatives. Generally, we found an RSR amount reported on the separate pool audits, but we did not find a disclosure in the service cooperatives' financial statements if the reserves were under-funded. As a result, a review of the service cooperative's financial statements would not necessarily reveal that the RSR is under-funded.

We recommend that the service cooperatives work with their auditors and review the applicable standards to ensure that their accounting and reporting is in compliance with appropriate governmental standards. In the near future, this Office will be completing a statement of position regarding financial reporting for the health insurance risk pools.

VII. Public Access to Financial Information

We are concerned that some of the service cooperatives provided us with operating agreements that they entered with the Blues on behalf of public entities that are denoted as "CONFIDENTIAL TRADE-SECRET" documents. In addition, service cooperatives acquiring the Network LLC agreed to keep information about the LLC "in trust and confidence." We believe that contracts entered into by public entities, expending public funds, should be available to the public for review.

We are also concerned that one of the service cooperatives has taken the position that almost all of the financial data contained in its separate plan audit is not available to selected members of the public.

Finally, we are concerned that six service cooperatives expended considerable attorney fees responding to our requests for information concerning the use of public funds.

A. Service Cooperative Operating Agreements

The service cooperative operating agreements are public contracts entered into by government entities. They describe and authorize the expenditure of public funds by the

²⁵⁷ The notes to the financial statements for LCSC (year ended June 30, 2004), NWSC (year ended June 30, 2004), NESC (year ended June 30, 2004), and SESC (year ended June 30, 2004) do not state that there are separate audits for the CCOGA pools. GASB Statement No. 14, The Financial Reporting Entity, requires disclosure in the notes to the financial statements of the existence of separately issued financial statements for certain related entities. Some of the service cooperatives have claimed that the separate plan audits were "internal audits" for "internal consumption." As discussed later in this report, we believe audits of public funds are public. *See* Minn. Stat. § 13.392, subd. 1.

²⁵⁸ *See* GASB Codification § Po20.148.

service cooperative board of directors, which can only approve contracts at public meetings.²⁵⁹ Nevertheless, the agreements contain the following provision:

[The service cooperative and the Blues] agrees to furnish any information requested by the other party that is reasonably necessary to administer this agreement. Each party agrees not to release any information concerning matters covered by this Agreement or the Exhibits to a third party without the consent of the party that provided it . . .²⁶⁰

While private parties may be able to agree to provisions like this, public entities in Minnesota are subject to the Minnesota Government Data Practices Act and other laws that control classification of data.²⁶¹

In recognition of the public policy to make operations of public institutions open to the public, the courts construe such laws as the Minnesota Government Data Practices Act in favor of public access.²⁶² Any contract provision that purports to classify data in a manner inconsistent with state law is void.²⁶³ The Minnesota Commissioner of Administration has consistently ruled that public contracts are public data.²⁶⁴

The service cooperatives are government entities subject to the Data Practices Act. As such, their contracts are public and contract provisions to the contrary are void. The public has a right to know how public officials are spending and encumbering public funds. The operating agreements are public data in spite of the contract language to the contrary.

²⁵⁹ Minn. Stat. § 123A.21, subd. 5 (2004) (Service cooperative board of directors has authority to operate the service cooperative and the power to enter into contracts); Minn. Stat. § 13D.01, subd. 1 (2004) (Meetings of the governing board of a public body must be open to the public).

²⁶⁰ See e.g. LCSC 2002 Operating Agreement ¶ 10.6. The Blues were given permission to release information for the purposes of: verifying coverage, prescription drugs audits, as required by law, research, and to comply with HIPPA regulations.

²⁶¹ “All government data collected, created, received, maintained or disseminated by [a public entity]” shall be public unless otherwise classified by statute or, temporary classification or federal law as non-public. . . . Minn. Stat. § 13.03, subd. 1 (2004). If a government entity enters into a contract with a private person to perform any of its functions, the government entity shall include in the contract terms that make it clear that all of the data created, collected, received, stored, used, maintained, or disseminated by the private person in performing those functions is subject to the requirements of the data practices act and that the private person must comply with those requirements as if it were a government entity. Minn. Stat. § 13.05, subd. 11 (2004). If the required language is not included in a contract, it is implied by law and the private party to the contract must act in accordance with the data practices act. See e.g. *WDSI, Inc. v. The County of Steel*, 672 N.W.2d 617 (Minn. App. 2003). (“Although that mandate was not expressly reflected in the contract, it applies nevertheless, and neither contracting parties nor courts can simply ignore it.”).

²⁶² *Prairie Island Indian Community v. Minnesota Dept. of Public Safety*, 658 N.W.2d 876, 883-84 (Minn. App. 2003).

²⁶³ See *Indep. Sch. Dist. No. 877 v. Loberg*, 123 N.W.2d 793 (1963), quoting *N. P. Rye. Co. v. Thornton Bros. Co.*, 206 Minn. 193, 196, 288 NW 226, 227 (1939) (“If a contract transgresses the law or contravenes public policy, it is void”).

²⁶⁴ Dept. of Admin Advisory Ops. 03-003; 03-027. The Commissioner of Administration has authority to give written opinions on questions related to public access to government data, rights of subjects of data or classification of government data. Minn. Stat. § 13.072, subd. 1 (2004).

During the course of our review, attorneys representing some of the service cooperatives stated that the Blues have asserted that the operating agreements constitute “trade secret” information. However, the operating agreements cannot be trade secrets under the applicable statutory definition.²⁶⁵

Generally, “trade secret information” can cover information if it is proven that the information provided to a government entity by an outsider is valuable to the outsider because others who can gain economic value from it do not know the information. Examples have included private business’ income, expenses, and vacancy information provided to county tax authorities;²⁶⁶ and a management services agreement between two private businesses that was submitted to the Minnesota Department of Health.²⁶⁷

In this situation, however, the operating agreements in question memorialize the exercise of government authority by the service cooperatives, which are government entities. This includes the terms and conditions of public expenditures for insurance coverage in consideration for millions of dollars of public funds paid to the Blues. The operating agreements are not simply information supplied by the Blues; they are government acts that authorize the expenditure of public funds and describe how a government self-insured program will operate. A government entity cannot hide how it spends public funds by calling its own public contracts “trade secrets” of a vendor.

B. Network Agreements

In acquiring the Network, the service cooperatives signed agreements that contained the following provision:

In the course of performing its duties under this contract, each party may obtain information relating to the other party’s services or programs, which is of a confidential and proprietary nature. Both parties shall at all times, during both the term of this Operations Contract and after its termination, keep in trust and confidence all proprietary information. Neither party shall disclose any such proprietary information other than in the course of duties of this contract without the other parties [sic.] written consent. The definition of proprietary information shall include, but not be limited to, all official and non-official conversations, actions, issues, information, data, negotiations, financial information, contracts,

²⁶⁵ Pursuant to Minn. Stat. § 13.37, subd.1, government data cannot be classified as not public “trade secret information,” unless it is (1) supplied by the affected individual or organization, (2) the subject of efforts by the individual or organization that are reasonable under the circumstances to maintain its secrecy, and (3) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use. A government entity claiming trade secret protection bears the burden of establishing that the data in question satisfy the requirements of Minn. Stat. § 13.37. See Dept. of Admin. Advisory Op. 03-017.

²⁶⁶ *EO-Nicollet Mall, L.L.C. v. County of Hennepin*, File Nos. 29743, 28793, 28457 (Minn. Tax Ct. Order dated May 3, 2004), 2004 WL 1161412.

²⁶⁷ Dept. of Admin Advisory Op. 03-009 (April 15, 2003).

agreements, personal opinions, trade secrets and any and all other aspects of other contracts or agreements between the parties which have any direct or indirect relationship to operations and services related in any way to the performance of the contract. This provision does not apply to disclosure of information as required by taxing, governmental or regulatory authorities, or as required in connection with a financial audit or legal process.²⁶⁸

Again, while private parties may be able to agree to provisions like this, public entities in Minnesota are subject to the Data Practices Act and other laws that control classification of data. Under the Data Practices Act, “the fact that data are proprietary does not, in and of itself, mean that they are protected from disclosure.”²⁶⁹ Again, public contracts must contain provisions recognizing that the data will be administered consistent with the Data Practices Act, and make it clear that all data in the hands of the private entity hired to perform a government function are subject to the Act.²⁷⁰

The service cooperatives’ contracts are public data and contract provisions to the contrary are void. Instead of the confidentiality provision quoted above, the contract should contain a provision saying the parties will comply with the Data Practices Act. Like the operating agreements, the network agreements are public data in spite of the contract language to the contrary. We recommend that the service cooperatives refrain from including confidentiality provisions that are contrary to Minnesota law in their contracts.

C. Service Cooperative Plan Audits

The purpose of a financial audit report is to accurately present an entity’s financial statements. An audited financial report contains the auditor’s attestation that the financial statements are presented fairly in all material respects, in conformity with generally accepted accounting principals. As noted elsewhere in this report, under generally accepted accounting principles, insurance risk pools should be reported as enterprise funds in the service cooperatives’ financial statements.

We understand that all of the service cooperatives consider their service cooperative audits to be available to the public. In addition, some of the service cooperatives informed us that they consider their insurance pool audits to be public and they make them available upon request.

RT&S, however, has adopted a different position, based upon a recent legislative change that makes “[c]laims experience and all related information received from carriers and claims administrators” participating in the service cooperatives’ health insurance plans

²⁶⁸ Member Control & Operating Agreement, Minnesota Provider Network, LLC, Exhibit A (Nov. 6, 2002), ¶4.

²⁶⁹ Dept. of Admin. Advisory Op. 99-047 (Dec. 9, 1999).

²⁷⁰ Minn. Stat. § 13.05, subs. 6, 11 (2004).

nonpublic data unless the executive director of the service cooperative determines that the release of the data will not be detrimental to the plan or the program.²⁷¹

RT&S's position is described in recent Department of Administration Advisory Opinions.²⁷² In RT&S's situation, an individual initially requested "all financial documents pertaining to the health insurance pool." The requestor explained his request, stating, in part:

I am NOT interested in the individual claims data of each school district. I am only interested in receiving the financial records pertaining to the health insurance pool. The financial records I am requesting should show all inflows and expenditures pertaining to the health pool, as well as all "stabilization accounts."²⁷³

Responding on RT&S's behalf, RT&S's attorney denied access, indicating that he had advised RT&S that the release of the data to the requestor would "likely be detrimental to the pool" because the requestor was a licensed insurance broker, who was not requesting the information on behalf of a pool member.²⁷⁴

At issue was whether the law applies to all of a service cooperative's insurance pool financial data (including financial data within the service cooperative) or only to claims experience and related information received from carriers and claims administrators.

The Commissioner of Administration ruled: "data that [RT&S] collects, creates, and maintains that are not 'claims experience and all related information' from carriers and claims administrators are not protected pursuant to section 13.203."

Because it appeared that RT&S maintained some financial data responsive to the request, the Commissioner opined that it did not appear that RT&S had complied with the Data Practices Act in responding to the request.²⁷⁵ In a subsequent opinion, the Commissioner ruled that RT&S was not in compliance with the Data Practices Act "in requiring a data requester to inspect data at its attorney's office, which is located in a different city."²⁷⁶

In contacts with this office, RT&S's attorney places great emphasis on the identity of the requestor. The implication seems to be that RT&S will release the information unless the requestor is in the insurance industry. Specifically, RT&S's the attorney informed us:

²⁷¹ See Minn. Stat. § 13.203 (2004).

²⁷² See Dept. of Admin. Advisory Ops. 05-011 (March 14, 2005), and 05-020 (May 20, 2005).

²⁷³ October 8, 2004 Leyk to RT&S letter. See also October 28, 2004 Leyk to RT&S letter, ("I am not interested in claims information for which this statute applies. I would like to inspect the financials of [RT&S] that pertain to the health pool, NOT claims information").

²⁷⁴ October 26, 2004 Lindquist to Leyk letter.

²⁷⁵ The opinion did not determine whether the financial information in a health pool audit could be protected by Minn. Stat. § 13.203. In regard to the audit, the Commissioner ruled that RT&S should either provide the data or inform the requestor that it is not public.

²⁷⁶ Dept. of Admin. Advisory Op. 05-020 (May 20, 2005).

[T]he executive directors routinely provide claims data and related information to members and other requestors when they determine that releasing the data will not harm the pool. [The person requesting the data], however, is a licensed insurance broker with no current active interest in the program. We are concerned that [he] will use the data to “cherry pick” the best groups, and the Executive Director was unable to determine that this practice would not be detrimental to the plan or program.²⁷⁷

This type of differentiation among those requesting data is generally prohibited. The Data Practices Act generally prohibits government entities from requiring requestors “to identify themselves, state a reason for, or justify a request to gain access to public government data.”²⁷⁸ It appears that the data in question should be classified based on its content, not the identity of the requester.

RT&S’s attorney asserts that according to RT&S’s accounting firm, “all of the financial information they rely upon to create the [school pool] audit are claims data and other information produced by [the Blues].”²⁷⁹ He also asserts that the school pool audits:

“are internal audits for [RT&S]. They are not the general audit prepared for public consumption They are for internal consumption, and provided to those who naturally have access to claims data because they are engaged in the process of procuring insurance.”²⁸⁰

The implication is that RT&S believes insurance pool audits are entirely nonpublic, unless the service cooperative executive director determines that the release of specific portions would not be detrimental to the plan or program.

Available information relating to these audits does not indicate that these reports are “internal audits.” Auditing standards require that if an auditor’s report is intended for specified parties or purpose, the independent auditor’s report should identify the report as a restricted use report.²⁸¹ The independent auditor’s reports on RT&S’s Minimum Premium Funding Plan’s financial statements for the years ended September 30, 2003 and 2002, and City, County, OGA Minimum Funding Plan financial statements for the

²⁷⁷ May 13, 2005 Lindquist & Venum letter at page 15. We understand that the requester was originally attempting to respond to an RFP that RT&S issued at the end of 2002 for life and long-term disability insurance. See, e.g., January 7, 2003 Letter from Daniel Weir, RT&S to Leyk (“We have received an unprecedented number of requests for additional specifications and follow up questions. The inquiries we have received have included different questions from different carriers. Due to the limitations of the current RFP timeline, we are requesting that all follow up questions be included with the RFP response.”); January 20, 2003 letter from Leyk to RT&S requester enclosing response to RFP that included several questions that the requester believed needed to be answered before a quote could be released.

²⁷⁸ Minn. Stat. § 13.05, subd. 12 (2004).

²⁷⁹ June 10, 2005 Lindquist & Venum letter. As discussed previously in this report, we have concerns about solely relying on information received from the Blues during the plan audits.

²⁸⁰ *Id.*

²⁸¹ See Codification of Statements of Auditing Standards Section 532, *Restricting the Use of An Auditor’s Report*. Restricting the use of the auditor’s report would not change its classification as public data.

years ended December 31, 2003 and 2002, did not identify that the reports were intended only for specified parties. Also, the engagement contract, signed by RT&S's executive director, identifies the objective of the audit is the expression of an opinion on the fair presentation of the financial statements and does not indicate that the results of the engagement are intended only for a specific purpose or specified parties.²⁸²

Based on this approach, RT&S "asked Milliman to review these audits and determine whether and to what extent redactions were appropriate. We were informed that the standard provided to Milliman was whether the data in the audit could be used by an insurance company to prepare an unsolicited bid on the pools or members."²⁸³ These instructions assume that the release of any data in an audit is detrimental to the plan if it could be used to prepare an unsolicited bid. Based on these standards, redacted copies of audits were prepared.

We received a copy of RT&S' redacted plan audits. Information about the RSR and IBNR has been redacted. Thus, for example, the redacted plan audit states that the reserve may be under-funded if the plan is terminated, but does not tell the reader the dollar amount by which the reserve may be under-funded.²⁸⁴ If the RSR is sufficiently funded, the service cooperatives can use the additional funds to reduce rate increases or to provide programs geared toward reducing the plan's costs. Without the RSR information, service cooperative members and other public entities are unable to determine the likelihood of receiving these savings.

RT&S redacted the plan audits' schedule of claims, including actual claims and expected claims, by school district. As a result, the public is unable to determine if their school district's actual claims were higher than expected. This information might help explain an increase in the school district's premiums, or an increase in costs due to prior decisions to fund health care benefits for retirees. Covered employees, employers and the public need this information to understand the status and health of the public insurance pools.

Much of the information RT&S removed from public review is expressly required as disclosures in an audit of insurance-related activities of public entity risk pools under GASB Standards. For example, information about claims expenses is a specifically required disclosure; this has been removed by RT&S.²⁸⁵ Similarly, administrative expenses have been removed from the plan audit, so the public will not be able to determine how much is being spent on administration of the plan. Again, we believe this information is needed to accurately present the insurance pools' financial statements in compliance with GASB Standards. It should also be available to the public.

²⁸² An audit engagement contract or letter defines the objectives, responsibilities and terms of the audit engagement.

²⁸³ *Id.*

²⁸⁴ Specifically, the redacted school plan audit states: "The Aggregate percentage reserve at September 30, 2003 is calculated to be [] If the plan is terminated, the reserve may be underfunded by []."

²⁸⁵ See GASB Codification § Po20.147.

RT&S informed us that the state public entity risk pools, such as the State Employee Group Insurance Plan (SEGIP) and the Public Employees Insurance Program (PEIP), have similar statutory authority to redact data that may be detrimental to the plan or program.²⁸⁶ However, SEGIP and PEIP have not used the statute to deny basic information to the public regarding claims and administrative expenses. To the contrary, that information is available on the State of Minnesota website.²⁸⁷

While we understand that the service cooperatives may be concerned about losing pool members, this legislative change should not be used to hide the information needed to understand the service cooperative's handling of public funds, to thwart competition for the provision of health care insurance for public entities, or to prevent a review of the adequacy of the service cooperative's reserves.

Only by reviewing the insurance pool audits can an accurate picture of the financial status of the service cooperatives be obtained. Only by understanding the financial status of the insurance pools can school districts and other public entities make an informed decision about the merits of joining the pool. The insurance plan audits contain information regarding public funds that we believe the public deserves to know.

The information contained in a government entity's financial statements is information the government entity should have in its possession.²⁸⁸ We do not believe the language of Minn. Stat. § 13.203 authorizes government entities to hide important portions of a government entity audit by asserting that their own financial statements are "information received from" a claims administrator or insurance company. Any insurance plan's financial condition is necessarily going to contain data relating to claims, which then determine premiums, administrative expenses, and fund reserves. Knowing about the high claims or the low reserves of any government entity might raise questions by taxpayers, teachers, insurance agents, or other concerned citizens; but that does not mean releasing the financial statements is detrimental to the government entity's insurance pool.

We do not believe Minnesota law authorizes service cooperatives to create one audit for "public consumption" and another on their public insurance pools for "internal consumption," hidden from public scrutiny. In fact, GASB standards require government insurance pool activity to be included in the service cooperative audit, as an enterprise fund.

Minnesota has a long tradition of making information regarding the use of public finances available to the public. All parties seem to agree that the service cooperative audits are public. We believe audit reports regarding the financial statements of

²⁸⁶ See, e.g., Minn. Stat. § 13.67 (e).

²⁸⁷ The Comprehensive Annual Financial Report is available at <http://www.finance.state.mn.us/accounting/2004/2004cafr.pdf>. PEIP Development Information is found on page 116. PEIP is included as a nonmajor enterprise fund on pages 145 – 151. SEGIP's information is found on pages 153 – 159.

²⁸⁸ See Minn. Stat. § 15.17 (2004) (Government entities "shall make and preserve all records necessary to a full and accurate knowledge of their official activities.")

government entities are public, whether prepared by the State Auditor, the Legislative Auditor, a CPA in private practice or an internal auditor.²⁸⁹

The public should have access to the complete audit reports of government entities. Only when the entire reports are public can the taxpayers know that the financial information is presented fully and in conformance with professional accounting standards.

D. Costs of Responding to State Auditor's Inquiries

Seven of the service cooperatives decided to involve attorneys in our review, a decision apparently made by the executive directors at an MRSA Executive Council meeting.²⁹⁰ In contrast, NCSC simply provided us directly with the information we needed for our review. Another service cooperative began by responding to our questions through its attorney, but then decided to respond to our inquiries directly.²⁹¹ The remaining six service cooperative expended considerable attorneys fees simply to respond to our requests for information.²⁹²

We question whether the attorney expenditures were warranted where the information we were requesting was information about public finances. For the most part, we were discussing service cooperative policies and procedures that should have been readily available to the public. We believe that the service cooperatives that worked with us directly were better able to explain their policies and procedures to us, to eliminate some of our concerns, and to raise additional issues that they believed we should explore. They were also able to provide us with documents quickly.

We believe the service cooperatives' boards of directors should review whether the attorney costs expended for this review were warranted. We believe the boards should re-examine who is authorized to make such expenditures. We believe that an open accounting of the use of public funds should be readily available to every member of the public, without the costly intervention of attorneys.

VIII. Competition Concerns

Pooling arrangements are intended to provide good value to school districts and other local public entities. By offering self-insured programs, the service cooperatives are able to avoid some of the expenses incurred by fully insured plans, specifically the premium tax and the Minnesota Comprehensive Health Association (MCHA) assessment.²⁹³ In

²⁸⁹ See Minn. Stat. §§ 3.979; 6.715; 13.392 (2004) (data relating to audits by the legislative auditor, the state auditor or the internal audit office of a state agency or political subdivision are specifically classified as not public only until the final audit report is published.).

²⁹⁰ See February 7, 2005 MRSA Executive Council Meeting minutes.

²⁹¹ SCSC at first required us to speak to its attorney to obtain information, but later simply had us contact it directly.

²⁹² EBIS and Appletree also responded through attorneys.

²⁹³ See RT&S Analysis of Proposals for Medical Coverage October 1, 2002 through September 30, 2003 (July 10, 2002), prepared by Earl Hoffman, Reden & Anders, Ltd., at page 8 (saves approximately 3.4% of

addition, insurance pools should be able to offer low administrative charges.²⁹⁴ Based upon recent experiences by some school districts and our review of service cooperative practices, it is not clear that the service cooperatives have used the best practices to take advantage of these theoretical savings.

A. RFP Process for Health Insurance

Concerns have been expressed that the Blues are consistently the service cooperatives' insurance carrier.²⁹⁵ The consistent selection of a single vendor as the service cooperatives' carrier, by itself, would not necessarily be a reason for concern. In addition, we have been told that in some parts of the State, the Blues have the most extensive network.²⁹⁶ However, given the organizational conflicts we found during our review, the recent experiences of some school districts, the Network donated to the service cooperatives, and the upcoming RFPs for service cooperative school plans, we believe a closer examination of the RFP process is warranted.

Under Minnesota law, the service cooperatives must request proposals from carriers at least every five years.²⁹⁷ In 2001 and 2002, six of the service cooperatives hired Reden & Anders to draft the RFPs for school health insurance proposals, to evaluate the proposals received, and to review operational issues.²⁹⁸ Proposals were sent to various health insurers, health plans, and brokers.²⁹⁹ In response to the RFP, only one service cooperative received a proposal for full medical coverage from anyone other than the Blues.³⁰⁰

premium); 2004 Statewide Study at page 38 (assumes premium taxes and MCHA assessments are 3.8% of insured premium).

²⁹⁴ See, e.g., R&A 2002 Summary at Attachment 1, page 3.

²⁹⁵ See, e.g., RT&S School District Insurance Risk Management Meeting minutes (July 17, 2002) (“In the past the Service Cooperatives have been challenged as to their relationship with [the Blues].”). Reden & Anders recently examined who provided Minnesota school districts with health insurance coverage. 2004 Statewide Study at page 23. For claims paid for school district members during the June 1, 2001 through June 30, 2002, Reden & Anders found that 54% of the claims paid were from the Blues, 22% from Medica, 17% from HealthPartners, 3% from Preferred One, and the remaining 4% from smaller carriers. *Id.* All of the service cooperatives' claims would have been paid through the Blues.

²⁹⁶ We note, however, that other statewide insurance programs offer carriers other than the Blues. For example, the Public Employees Insurance Plan (PEIP) offers three claims administrators, none of which are the Blues; and the State Employee Group Insurance Plan (SEGIP) offers three claims administrators, one of which is the Blues.

²⁹⁷ See Minn. Stat. § 471.6161, subd. 4.

²⁹⁸ See R&A 2002 Summary. The six service cooperatives were Lakes Country, Northeast, Northwest, Resource Training & Solutions, Southeast and Southwest/West Central. South Central Service Cooperative (SCSC) engaged Reden & Anders to review 1) the method and factors that the Blues use to set renewal rates, 2) the competitiveness of the Blues' expense charges and stop loss rates, and 3) the appropriateness of SCSC's current stop loss level; and to comment on plan design issues and the relative cost of the SCSC plan versus a possible statewide plan. SCSC Analysis of Medical Coverage Renewal for July 1, 2002 through June 30, 2003 (August 14, 2002) by Earl Hoffman, Reden & Anders at page 1.

²⁹⁹ See, e.g., Lakes Country Service Cooperative Analysis of Proposals for Medical Coverage July 1, 2002 through June 30, 2003 (April 15, 2002) by Earl Hoffman, Reden & Anders at page 6 and RFP Recipients chart (“R&A Analysis of Proposals 2002”).

³⁰⁰ The proposal was from Sioux Valley Health Plan for Southwest/West Central Service Cooperative.

The service cooperatives informed us that they did not use Consultant to draft the RFP and to evaluate the RFP responses for health insurance carriers in 2002 because they did not want to appear too close to the Blues.³⁰¹ However, according to CBC Meeting minutes, Consultant distributed the RFP to the service cooperatives for review, and requested suggested changes or corrections to the RFP, before Reden & Anders was hired.³⁰² In addition, according to the minutes, Reden & Anders was then “contracted under [Consultant’s] direction.”³⁰³ As a result, it appears that Consultant was participating in the RFP process.

Reden & Anders did not ask the other carriers why they did not respond to the RFP, but Reden & Anders offered possible reasons for the lack of response.³⁰⁴ The possible reasons offered by Reden & Anders were: 1) an inability or unwillingness to match the current benefit plans, which Reden & Anders stated was a necessity since the plans are collectively bargained; 2) an inability or unwillingness to duplicate the minimum premium funding approach used by the service cooperatives; 3) concerns about bringing charges or stop loss rates to a low enough level; and 4) an inability to receive broker commissions.³⁰⁵

At the same time that the RFP for the school plans were being obtained in 2002, the service cooperatives also released an RFP for administration of six service cooperatives’ medical spending accounts (MSA), voluntary employee benefits association (VEBA) and other financial services. Reden & Anders was also engaged to help the service cooperatives select the provider for these services.³⁰⁶ Only one proposal was received, and the Blues own the majority of the entity submitting the proposal.³⁰⁷

Reden & Anders noted that the MSA and VEBA services in the RFP were not yet operational in any of the service cooperatives, so other potential providers may have had concerns about when the programs would be operational, and the cash flow that would result from the programs.³⁰⁸ Reden & Anders also noted that other providers may have had concerns about their ability to integrate the administration of these plans with the underlying health plans, offered by the Blues.³⁰⁹ Reden & Anders recommended that the service cooperatives re-open the MSA and VEBA RFP process in three years because the plans would then have track records that should attract more proposals from providers.³¹⁰

³⁰¹ CBC Minutes for January 16, 2002 state that Consultant presented a proposal from Earl Hoffman, who is with the actuarial firm Reden & Anders. The minutes state: “By contracting with Reden & Anders and obtaining an outside third party analysis of the RFP results, our members should recognize the due diligence efforts to impartially review the results of the RFP Process.”

³⁰² CBC Minutes for January 16, 2002.

³⁰³ *Id.*

³⁰⁴ R&A Analysis of Proposals 2002 at page 6.

³⁰⁵ *Id.*

³⁰⁶ See Minnesota Service Cooperatives Analysis of Proposals and Recommendations for: Medical Spending Account Administration, Voluntary Employee Benefits Association Administration, and Financial Services Starting July 1, 2002, by Earl Hoffman, Reden & Anders (June 12, 2002) at page 1.

³⁰⁷ *Id.* at page 2

³⁰⁸ *Id.*

³⁰⁹ *Id.*

³¹⁰ *Id.* at 4

In general, Reden & Anders believed that “seeking some diversity among the various service vendors would be beneficial to the service cooperatives and would enhance the service cooperatives’ negotiation position on all parts of the health coverage and services package.”³¹¹

We also believe that diversity among service vendors would benefit the service cooperatives and their members. We are concerned that the service cooperatives may have become too close to the Blues. For example, seven of the service cooperatives are sharing work product regarding VEBA with the Blues.³¹² However, there are competitors offering similar plans.³¹³ While we understand the service cooperatives need to work closely with their third party vendor, we are concerned that sharing the service cooperative’s work product with the Blues may provide the Blues with an unfair competitive advantage when RFPs for these services are released.

Similarly, if the service cooperatives had a Network of providers donated to them, the service cooperatives could have tried to make the Network available to all carriers. Instead, the Blues now use the Network, and it appears that the Blues may have gained a competitive advantage from an asset that was allegedly donated to the service cooperatives. Finally, the Blues payment of service fees allegedly for maintenance of the Network creates another incentive for the service cooperatives to remain with the Blues.

In short, we recommend that the service cooperatives review their relationship with the Blues. We recommend that the service cooperatives avoid providing the Blues with competitive advantages that may preclude other providers from submitting successful proposals.³¹⁴ Specifically, we recommend that the service cooperatives:

- Discuss with potential 2002 bidders the reasons that they did not submit a proposal.
- Explore methods to make their requests for proposals more attractive to other bidders. These methods could include:
 - Reserving the right to choose different carriers for different portions of their plans.³¹⁵
 - Transitioning to a limited number of common plan designs to encourage more carriers to provide competing proposals.³¹⁶
- Insure that potential vendors have complete and accurate data upon which to base their proposals.

³¹¹ *Id.*

³¹² *See, e.g.*, September 4, 2003 CBC Minutes, Items 4.1 and 4.4 (report on attorney’s activities). *See also* October 7, 2003 CBC Minutes, Item 4.4 (service cooperatives’ attorney and the Blues attorney researching non-profit rules).

³¹³ *See* 2004 Risk Management Year End Report, December 6, 2004 CBC Meeting at page 35.

³¹⁴ We recognize concerns expressed by one of the service cooperatives, that the Blues may not bid on the service cooperative’s business if the service cooperative seeks to work with other providers.

³¹⁵ This recommendation was made by Reden & Anders in 2002. *See* R&A 2002 Summary at page 6.

³¹⁶ This recommendation was made by Reden & Anders in 2002. *See, e.g.*, RT&S R&A Analysis of Proposals 2002 at page 5; R&A 2002 Summary at page 7. Reden & Anders noted that Lakes Country Service Cooperative had already begun that transition. *Id.*

- Reconsider what advantages service cooperative members receive by sharing work product with the Blues.
- Consider using the RFP process more frequently as market conditions change.³¹⁷

In short, recommended practice for health care cost containment includes periodic re-bidding of the health care plan vendors.³¹⁸ We recommend that the service cooperatives take additional steps to obtain the most competitive services possible for their members.

B. Recent School District Experiences

We received concerns about the experiences of some school districts that had been members of a service cooperative’s pool. The pooling of school districts should lead to lower insurance rates. For example, the Blues have agreed to provide the service cooperatives’ pools with a minimum of 4% less than comparable fully-insured or self-insured rates offered by the Blues.³¹⁹ Yet some school districts have found that they can secure better rates on their own.

We recognize that a central dilemma facing group “affinity” pools is keeping groups with good experience and low claims in the pool.³²⁰ As a result, most of the joint powers agreements between the school districts and the service cooperatives provide that any school district seeking or accepting proposals for health insurance without the service cooperative’s approval may be deemed to have withdrawn from the service cooperative’s health insurance pool.³²¹ In addition, the entity is prohibited from participating in the pool for two years.³²² If the school district withdraws from the pool, benefit fund reserves attributable to contributions made by the school will not be refunded.³²³ Despite these restrictions, school districts have gone out on their own to seek insurance coverage.

The joint powers agreement is silent regarding the payment of liabilities incurred by a school district that leaves the pool at a point where the school district’s claims exceed expected claims. As a result, several school districts have left the pools, leaving the pools with negative balances that the remainder of the pool must cover.³²⁴ Indeed, schools with

³¹⁷ South Central Service Cooperative (SCSC) decided to implement the RFP process in 2004 for its school insurance pool for service year July 1, 2004 through June 30, 2005. Three carriers responded to SCSC’s proposal. The process resulted in litigation, and the Blues ultimately remained SCSC’s carrier. We understand that the litigation included issues regarding whether HealthPartners could insure some of SCSC’s members while the five-year contract with the Blues was in effect. We recommend that the service cooperatives preserve their ability to seek competitive proposals for their health insurance programs as market conditions change.

³¹⁸ See GFOA Recommended Practice, Health Care Cost Containment – 2004, available at <http://www.gfoa.org/services/rp/documents/HealthCareCostContainment.doc>.

³¹⁹ See, e.g., SCSC’s 2002 Operating Agreement at ¶ 3.2.b.

³²⁰ See R&A 2002 Summary Attachment at page 3.

³²¹ See, e.g., Joint Powers Agreement for Group Employee Benefits and Other Financial and Risk Management Services (SCSC) at ¶ 5.3.2. SEESC’s recent joint powers agreements do not contain this provision.

³²² *Id.* at ¶ 5.4.2.

³²³ *Id.* at ¶ 6.3.1.

³²⁴ See 2002 Operating Agreement, Exhibit A at Section 10.

negative claim histories appear to have an incentive to leave the pool because they will not have to help pay for future reserves needed to fund the deficit that they helped create.

We note that Towers Perrin in 1999 recommended that the service cooperatives consider modifying the joint powers agreements so that groups leaving the service cooperative retain responsibility for their run-out claims.³²⁵ We recommend that the service cooperatives re-consider that recommendation. In addition, the service cooperatives may want to consider clarifying their statutory authority so that remaining pool members are not penalized with liabilities created when entities with poor claims ratings leave the pool, and the schools are not rewarded for leaving the pool when they have a high loss ratio.³²⁶

We are also concerned that some school districts reported to us that they achieved lower costs than those offered by a service cooperative by joining a fully-insured program. As discussed previously in this report, the self-insured service cooperative plan typically should cost less than a fully-insured plan because the self-insured plan bears all the risk and does not pay certain taxes and assessments.³²⁷

1. Rosemount-Apple Valley-Eagan School District

Rosemount-Apple Valley-Eagan Independent School District No. 196 (“Rosemont”) received health insurance through South Central Service Cooperative (“SCSC”). The school district informed us that they recently received an estimate from SCSC that their rates would be raised approximately 8% if they stayed with SCSC, with no guarantee for the following years. As a result, the school district hired a consultant and released an RFP in February 2005.³²⁸ They received responses from five providers, offering three fully-insured and four self-funded proposals.³²⁹ The school district’s insurance committee determined that one of the fully-insured proposal offered significant cost savings over their current rates over a two-year period, and recommended to the School Board that it accept the fully-insured proposal.

We are concerned that a fully-insured program could be offered at less cost than the service cooperative’s self-insured program. We also are concerned because SCSC provided us with documentation showing that the school district appears to have had actual claims that were higher than expected claims, leaving the pool to absorb the difference.

2. Burnsville-Eagan-Savage School District

³²⁵ See Minnesota Statewide Healthcare Coalition Advisory Committee Final Report, Revised December 12, 1999 by Towers Perrin, at pages 10 and 19.

³²⁶ See Minn. Stat. §§ 123A.21, subd. 9 and 123A.24, subd. 1.

³²⁷ If it would be determined that the premium taxes or assessments were due, the 2002 Operating Agreements provide that the service cooperatives will reimburse the Blues for all amounts paid. See, e.g., RT&S’s 2002 Operating Agreement at Section 7.

³²⁸ CBIZ, 2005 Medical Request for Proposal Report for ISD 196, March 2005, p.1.

³²⁹ CBIZ, 2005 Medical Request for Proposal Report for ISD 196, March 2005, p.1.

In 1998, Burnsville-Eagan-Savage Independent School District No. 191 (“Burnsville”) issued RFPs for health insurance for its employees. As a result of the RFP process, the school district switched to the Blues through SCSC, obtaining what the school district believed were considerable cost savings. Recently, another carrier provided the school district with an unsolicited proposal for health insurance coverage, that the School Board apparently rejected. However, according to the school district, the Blues provided the school district with a reduction in their rates after they received the unsolicited proposal.

In 2004, the school district decided to issue another RFP for health insurance coverage. It hired a consultant to write the RFP and analyze the proposals received.³³⁰ The school district received proposals from all four major carriers at rates that were below the annual increases it had experienced over the past ten years.³³¹ For a fully-insured plan, the school district considered a proposal offering only a 2.2% increase; however the school district decided to use a different plan, with potential savings estimated by the school district to be \$1,000,000 - \$2,000,000.³³²

We are concerned that once again, a fully-insured plan appears to be available at less cost than the self-insured plan offered by the service cooperative. In addition, from the information provided to us by SCSC, it appears that the Burnsville School District may have had actual claims that were less than expected claims for the past three years; but over a six year period with the service cooperative, the District had more actual claims than expected claims, resulting in the other members of the pool absorbing the extra costs of Burnsville’s claims.

3. Stillwater Area School District

Stillwater Area Schools, Independent School District No. 834 (“Stillwater”) had been with SCSC for several years. Stillwater informed us that, in 2004, another carrier offered to provide Stillwater with a health insurance plan that it claimed would lower Stillwater’s rates for comparable coverage. SCSC informed Stillwater that it could not use the other carrier.³³³ After the other carrier approached Stillwater, we were told that the Blues offered Stillwater fully-insured health insurance coverage, independent from SCSC, at no increase in price. In February 2005, Stillwater put out an RFP for health and other insurance packages.³³⁴ We understand that the Blues submitted a proposal that would provide no change in Stillwater’s medical insurance premiums in the first year.³³⁵

³³⁰ See CBIZ Benefits & Insurance Services, Inc. Consulting Agreement dated July 2001. We were informed that the consulting agreement was extended annually. The school district agreed to pay CBIZ \$12,000 each year, with special projects (such as the RFP) billed at \$150.00 per hour.

³³¹ See April 21, 2004 ISD 191 Memorandum. The school district invited SCSC to submit a proposal. SCSC informed the school district that it was in violation of its joint powers agreement. See March 11, 2004 Letter to ISD 191 from Les Martisko, SCSC’s Executive Director, and Wanda Sommers Nielsen, Director of Operations/Insurance Consultant.

³³² See April 21, 2004 ISD 191 Memorandum. The school district is going to be using a Select 105 Plan.

³³³ A lawsuit resulted between the Blues, SCSC and the other carrier.

³³⁴ Stillwater uses a third-party to administer their insurance benefits. Stillwater used that third-party to write the RFP.

³³⁵ Another carrier submitted a proposal with a 20.6% increase for medical insurance premiums; two other carriers declined to submit proposals.

Once again, a fully-insured plan appears to be competitive with the service cooperative's self-insured plan. This is particularly troubling because the Blues appear to be offering the fully-insured plan at costs that are lower than its self-insured plan offered through the service cooperatives. However, the service cooperative's operating agreement with the Blues appears to require the Blues to provide the service cooperative's pool with a rate that is a minimum of 4% less than comparable fully-insured or self-insured rates offered by the Blues.³³⁶

4. Recommendations

While it is beyond the scope of this review to determine why some school districts are receiving better rates when they independently seek fully-insured coverage, it is troubling that some school districts seem to be able to obtain better results outside the service cooperative's plan. We recommend that service cooperatives:

- Track claims data and other components of the reserve funds.
- Set accurate premiums during the renewal process.
- Use administrative fees to better administer the insurance program.
- Fully fund reserves.
- Explore methods of increasing competition during the RFP process.

IX. Conclusion

We believe that service cooperatives can provide substantial benefits for their members. Increased transparency and accountability in the use of public funds by some of the service cooperatives will permit taxpayers to receive the most benefit from the advantages that cooperative efforts should be able to provide.

Specifically, we found that a contract between a consultant hired by seven of the service cooperatives and the Blues raises organizational conflict of interest concerns. It raises questions about the impartiality and objectivity of the advice provided to the service cooperatives by the consultant. It also raises the potential that a competitive advantage has been given to the Blues. The apparent conflict reduces the confidence that the public, service cooperative members, and potential service cooperative vendors (other than the Blues) will have in the service cooperatives' decisions.

We found that some of the service cooperatives do not have adequate contracting policies and procedures, and others did not implement existing policies. We recommend that the service cooperatives adopt and implement written policies and procedures for contracting that incorporate effective contract management principles.

We found that some of the consultant contracts lacked clauses that should be included in local government contracts. Specifically, we recommend that the service cooperatives

³³⁶ See, e.g., SCSC's 2002 Operating Agreement at ¶ 3.2.b.

incorporate the following provisions into their contracts: audit, data practices, unilateral termination, and retainage clauses. We recommend that the service cooperatives refrain from including confidentiality provisions that are contrary to Minnesota law in their contracts.

We found that five of the service cooperatives used part of their insurance administrative fees for non-insurance related programs. We recommend that any transfers of insurance funds, including administrative fees, to a service cooperative's general fund be reflected in the service cooperatives' financial statements. We recommend that the administrative fees be used to administer the insurance program, to provide better monitoring of the reserves and renewal rates, and to fully fund insurance reserves.

We found that seven of the service cooperatives receive a service fee from the Blues for "research and development activity," including the development and maintenance of "The Minnesota Provider Network." We found that the Minnesota Provider Network is an LLC. We found that the service fee fund appears to be the LLC's funds, used in part to pay lobbying expenses. We found lobbying contracts entered into by a service cooperative joint powers entity, but payments of the contracts appear to be from the LLC's fund. We question what public entity approved payments to the fund, and expenditures from the fund. We recommend that the service cooperative boards re-examine the LLC, and exercise control over the LLC's funds.

We recommend that a joint powers entity comprised of seven service cooperatives reconsider the provision in its joint powers agreement authorizing the executive directors to enter into contracts and to expend the entity's funds.

We found that many of the insurance reserves maintained by the service cooperatives have been under-funded for some time. We recommend that the service cooperatives fully fund their insurance reserves. We have concerns that some of the service cooperatives may not have been adequately monitoring their reserves, and under-funded reserves may place additional pressure on the service cooperatives to remain with the Blues. We believe the service cooperatives must take steps to monitor the reserves, on an on-going basis, and obtain information from the Blues necessary to monitor the service cooperatives' reserves. We recommend that service cooperatives track claims data and other components of the reserve funds. If a service cooperative is unable to adequately monitor its reserve funds, we recommend that independent outside assistance be obtained.

We are concerned that some of the service cooperatives may have relied too heavily on the Blues' determination of annual rates. We found that, in some cases, premiums may have been set too low, resulting in the under-funded reserves. We believe the service cooperatives must independently evaluate the rates quoted by the Blues at each annual renewal so that accurate premiums are set during the renewal process. We recommend that the service cooperatives preserve and exercise the option of obtaining outside audits to determine accurate renewal rates.

We found that the service cooperatives' accounting and financial reporting practices for the insurance risk plans and the reserves were not consistent. We found that some of the service cooperatives' financial statements did not comply with generally accepted accounting principles. We found an absence of identifiable information regarding the insurance risk pools in some of the service cooperatives' financial statements, raising concerns about the fair presentation of some of the service cooperatives' financial statements.

We believe audit reports regarding the financial statements of government entities are public, whether prepared by the State Auditor, the Legislative Auditor, a CPA in private practice or an internal auditor. We do not believe Minnesota law authorizes service cooperatives to create one audit for "public consumption" and another on their public insurance pools for "internal consumption," hidden from public scrutiny.

We believe that seeking some diversity among service vendors would be beneficial to the service cooperatives and would enhance the service cooperatives' negotiation position on all parts of their health coverage and services packages. We recommend that the service cooperatives avoid providing the Blues with competitive advantages that may preclude other providers from submitting successful proposals. We recommend that the service cooperatives explore methods to make their requests for proposals more attractive to other bidders.

We recommend that the service cooperatives review their relationship with the Blues. Recommended practice for health care cost containment includes periodic re-bidding of the health care plan vendors. Specifically, we recommend that the service cooperatives reserve the right to choose different carriers for different portions of their plans, transition to a limited number of common plan designs to encourage more carriers to provide competing proposals, provide potential vendors with complete and accurate data upon which to base their proposals, and consider using the request for proposal process more frequently as market conditions change.

We recommend that the board of directors for each of the service cooperatives, and for the service cooperatives' joint powers entity, take a more active role in determining how service cooperative funds are expended.

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