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REVIEW OF ADMINISTRATION OF FEDERAL EMPLOYEES' HEALTH BENEFITS PROGRAM

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HEARINGS

BEFORE THE

COMMITTEE ON RETIREMENT, INSURANCE, AND HEALTH BENEFITS

OF THE

COMMITTEE ON

POST OFFICE AND CIVIL SERVICE

HOUSE OF REPRESENTATIVES

NINETY-SECOND CONGRESS

SECOND SESSION

PART III

AUGUST 10; SEPTEMBER 13, 1972

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REVIEW OF ADMINISTRATION OF FEDERAL EMPLOYEES' HEALTH BENEFITS PROGRAM

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REVIEW OF FEDERAL EMPLOYEES' HEALTH BENEFITS PROGRAM

THURSDAY, AUGUST 10, 1972

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON POST OFFICE AND CIVIL SERVICE,
SUBCOMMITTEE ON RETIREMENT, INSURANCE,
AND HEALTH BENEFITS,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room 210, Cannon House Office Building, Hon. Jerome R. Waldie (chairman of the subcommittee) presiding.

Mr. WALDIE. The subcommittee will come to order.

We are continuing our hearings on review of the Federal employees' health benefits program with particular emphasis upon the manner by which the Blues utilize the 4.5-percent maximum of premium that is available to them for administrative charges.

They are using, rather than the total available to them, I think 4.4 percent, somewhat less than the total amount that is available for administrative purposes; and we will also examine the list-charge moneys, which are in excess of \$5 million, as to how those moneys are accounted, as to how they are used, and as to whether they are in fact needed as a cost of the program to the employee and the Government, who pays the premium benefit.

In this inquiry, we will be particularly interested in how closely the Blues have complied with their restraints that are stated in their policies as to the expenditure of funds that are attributable to administration of these programs.

We will also examine how they spend moneys for administration and how closely it complies with other restrictions on Federal contractors. It is not my belief at the present time that there is any violation of the contract that the Blues have with the Civil Service Commission; but it is my opinion at the present time that that contract is so miserably, poorly drafted that there are no restraints that are enforceable if the necessity for restraint exists on the part of the Government, who contracted on behalf of the employees, the restraints that may or may not be in existence in terms of the Blues' administration practices.

So the hearings will essentially cover the question of do the Blues spend their money, which they utilize for administrative purposes, wisely; is there a pattern of restraint that is discernible or is there a pattern of lack of restraint in that portion of the contract. That might give us some indication of what problems exist in this contract.

We will also again examine what they do with the risk charge if the risk charge in fact is being expended for the benefit of the employees, who are paying the premium, and for the benefit of the Federal employees' program. And then we will review, once again, the question of how accurate the Blues have been in their projections of anticipated profit or loss upon which a request for increases has been predicated.

It is my own personal conviction, subject to being disabused of that opinion, that inaccuracy has been extreme and that the inaccuracy on the part of the Blues in projecting loss upon which permanent increases would be predicated has not been checked in any way, or restrained in any way by the Civil Service Commission; and in my view, the Civil Service Commission, if this opinion is correct, has been extremely remiss in being able to exercise any check or restraint on these figures.

The continuing impression is that the Civil Service Commission does not really administer this program but simply accepts all the decisions that the carriers—in this instance, the Blues—make.

When we are concluded with the inquiry involving the Blues—and I might add, I do not want to leave the impression that where problems exist, they exist only in the contracts which the Civil Service Commission has with the Blues—we will then proceed with Aetna, which is the other nationwide carrier, to determine whether their contract and their performance in any way differs significantly from that of the Blues.

I will be asking the representatives of the Blues questions that were prepared by the General Accounting Office to which answers were given in the last hearing, but properly at that time the information that was necessary for full answers was not available, and perhaps it now is.

In that regard, I want to call Mr. Bernard Tresnowski.

Mr. Tresnowski, would all of you gentlemen like to come up together?

Mr. TRESNOWSKI. Yes.

Mr. WALDIE. Mr. Tresnowski is senior vice president of the Blue Cross Association; Mr. Ryan, senior vice president of the National Association of Blue Shield Plans; and Mr. Joseph Harvey, vice president of the Federal employee program.

Gentlemen, I don't know if you have before you the committee hearings, part 2, February 23, April 26 and 27, 1972.

Mr. TRESNOWSKI. I have a copy of it.

Mr. WALDIE. If you will turn to page 201, I will read the question again for the reporter's convenience, that was set forth in this transcript at that page.

I would like to go over several questions that were asked of you at that time, and ask them again on the basis of information you may have acquired.

We noted that the administrative cost for the Blue Shield plan for the Richmond, Va., office seemed to increase quite significantly from calendar years 1966 and 1970.

Examples of such administrative cost increases are—and let me just go over three of them.

(1) Executive operation increased during that period of time from \$2,543 to \$45,220, or a percentage increase of 1,778.

The question that I want to ask on each of these items is, what are the reasons for such large increases, particularly executive operation, data processing, and office service operation.

In data processing it increased in that period of time from \$5,990 to \$129,254, or a 2,057-percent increase; and office service operations an increase from \$6,758 to \$108,171, or a 1,500-percent increase.

These are increases that are paid from the administrative costs that you are permitted to utilize up to 4.5 percent of what the premium has paid. So we are concerned as to why such a tremendous increase in those figures.

Can you tell me what the reason for those increases in that office were?

Mr. TRESNOWSKI. Mr. Waldie, we did have a prepared statement today, which will cover these matters in a direct sense or an indirect sense.

Mr. WALDIE. If you prefer to, you may proceed with that.

Mr. TRESNOWSKI. Well, I can answer this particular one.

Mr. WALDIE. All right.

Mr. TRESNOWSKI. At the time of the last hearing when this question was posed, you will recall we weren't prepared, and we submitted for the record, which is contained on page 205 of that hearing, that we pointed out that the outside audit of the written plan had not been conducted at that time.

Such a review of these administrative expenditures is in process now, but it is not available at this time to explain these differences.

In addition to examining these trends in the Richmond plan, we are examining seven of our large FEP plans. We hope to have that from the General Accounting Office.

Mr. WALDIE. In your answer on page 205, you indicated that a review had not been made by the association, but an audit was recently conducted by the Civil Service Commission and that you were currently evaluating the Civil Service Commission findings. Can you tell us your evaluation of those findings?

Mr. TRESNOWSKI. That is what I am talking about. Those are just now being concluded.

Mr. WALDIE. I would appreciate your supplying us with that information. Could you tell us when we might expect that?

Mr. TRESNOWSKI. Well, that should be within the next week or 10 days.

Mr. WALDIE. Now we will leave off that for a moment and go to your prepared statement.

**STATEMENT OF WILLIAM E. RYAN, SENIOR VICE PRESIDENT,
NATIONAL ASSOCIATION OF BLUE SHIELD PLANS; ACCOMPANIED
BY BERNARD R. TRESNOWSKI, SENIOR VICE PRESIDENT, BLUE
CROSS ASSOCIATION; AND JOSEPH E. HARVEY, VICE PRESIDENT,
FEDERAL EMPLOYEE PROGRAM, BLUE CROSS-BLUE SHIELD**

Mr. RYAN. Thank you, Mr. Chairman.

As you requested in your letter of August 2 to Mr. Harvey, we are here to discuss questions you have asked regarding Blue Cross and Blue Shield's administration of the Federal employee program.

We are committed to the goal of improving administration and we believe our overall performance and strong acceptance by Federal employees bear this out.

Through our testimony today, we wish to accomplish three things: First, to reply directly to your questions; second, to show clearly that Blue Cross and Blue Shield administration of the Federal employee program is being monitored in a reasonable fashion; and, third, to set the administration of the program in the proper perspective so that a realistic evaluation can be made.

The Federal employee health benefits program has been a unique and highly successful program. Participation in Blue Cross and Blue Shield coverage has grown each year as more Federal employees have chosen the service benefits program in competition with programs of other carriers during open enrollment seasons.

Today, more Federal employees and their families have Blue Cross and Blue Shield than are enrolled with the other 37 carriers combined.

Effectiveness of the operation of the program is found in the fact that Blue Cross and Blue Shield administrative costs, which are subject to audit, have stayed under the allowable 4.5 percent of subscription income.

Mr. WALDIE. May I interrupt just occasionally.

Subject to audit under what provisions? Under the contract?

Mr. RYAN. The contract gives certain rights of audit. We also have imposed upon ourselves certain obligations of audit, Mr. Chairman.

Mr. WALDIE. But the independent audits are conducted by whom?

Mr. RYAN. The independent audits are conducted by the plan's certified public accountants.

Mr. WALDIE. Does the contract provide that the Civil Service Commission has the right to conduct audits?

Mr. RYAN. To the best of my knowledge, it does, I believe.

Mr. WALDIE. And how often does the Civil Service Commission conduct audits?

Mr. RYAN. I don't have that information.

Mr. HARVEY?

Mr. HARVEY. The Civil Service Commission, Mr. Chairman, conducts an ongoing audit program which, over the past several years, has involved audits of perhaps 12 to 16 plans per year.

Mr. WALDIE. Do they audit your operation, Mr. Harvey?

Mr. HARVEY. Yes, sir.

Mr. WALDIE. How long have you been audited?

Mr. HARVEY. In terms of the Civil Service Commission's issuing an audit report on the national association's operations, I think there has only been one official report issued.

Mr. WALDIE. When was that?

Mr. HARVEY. My recollection is about 1964.

But in addition to that, the Civil Service Commission auditors are continually involved in examining our records.

Mr. WALDIE. And do they make reports of their results of that audit?

Mr. HARVEY. Whenever any problem situation is encountered, the Civil Service Commission calls it to our attention immediately.

Mr. WALDIE. But do they make a report on what they find that would be available to this committee?

Mr. HARVEY. Well, I would presume, sir, that anything that is called to our attention would be available to the committee.

Mr. WALDIE. Well, I just hope your assumption is correct.

What was the result of the official report in 1964? Is that the last official audit, then, of your operation?

Mr. HARVEY. It was the last time an official report was issued; yes, sir.

Mr. WALDIE. Was it also the first time?

Mr. HARVEY. Yes, sir. To the best of my recollection.

Mr. WALDIE. You can proceed.

Mr. RYAN. We in Blue Cross and Blue Shield return approximately 95 cents of every dollar in benefits—an enviable record.

We believe that the questions you have raised should be considered in the light of these figures. Furthermore, it should be noted that the Federal employee program is a massive program that pays \$700 million annually in claims; that processes 6,700,000 claims a year; that involves 145 Blue Cross and Blue Shield plans across the Nation; and that serves more than 5 million Federal employees and members of their families.

We would also like to point out that Blue Cross and Blue Shield have been in operation together for 35 years. We created this concept of hospital and medical prepayment at a time when many did not believe it was possible.

Since that time, despite increasing competition by commercial health insurance carriers, we have been the leading and most innovative force in this very complex area of financing health care.

We are in daily, face-to-face contact with large, national accounts—such as the motor, steel, and communications industries—all of which are deeply concerned with our administration of their health care dollars.

We have met that competitive test and have responded to their concerns in such a way that seven out of the 10 largest corporations in America have Blue Cross and Blue Shield protection.

We believe that this is testimony of our effectiveness, but we are well aware that the financing and delivery of health care are subject to powerful forces of socioeconomic change. We know we must seek continual improvement of our coverage, our claims administration, our service to subscribers, and our cost containment efforts.

The answers to the question you have posed, we believe, will document our ongoing efforts to merit the confidence shown in us.

To save the time of this committee, we have grouped the questions into five categories and will comment on each of them in the following order: administrative practices, cost control; usual, customary and reasonable charges; corporate expense allocations; and the cost of meetings.

Questions have been raised about the cost of electronic data processing in the Federal employee program claims processing costs in a program as complex as the Blue Cross and Blue Shield Federal employee program must be evaluated in terms of the total program, rather than being related to isolated aspects of processing costs in individual plans.

For example, some plans may be in the process of building up EDP capabilities. Their costs will be higher when compared with a plan that has already gone through a similar effort.

The record shows that the number of total claims increased from 2,730,000 in 1966, to 6,758,000 claims in 1971. Total administrative expense increased from \$10.3 million in 1966, to \$32.1 million in 1971. This represents a 26.1 percent increase in the per unit cost of claims processed during this period.

During the past several years, there have been other significant developments in addition to the increased claims volume which increased our administrative costs. Utilization and peer review activities have been intensified. Cost control programs have been implemented.

The usual, customary and reasonable charge program has required more complex and precise administration. The addition of outpatient X-ray and laboratory, as well as medical emergency benefits, have generated low dollar volume claims that require the same processing costs as more expensive procedures.

A requirement to coordinate benefit payments where duplicate coverage existed has added another administrative task. There is little doubt in our minds that without improved EDP processing capabilities, the administrative cost burden would have been greater.

As far as updating of EDP facilities is concerned, this is required in most large business operations. In EDP technology, the cost-benefit ratio on new equipment has been firmly established. For example, the IBM 370 system does approximately the same job as the IBM 360 system, but does it more reliably, it does it faster, and it does it at a lower cost.

We know of no directly comparable indicators in other sections of the Nation's economy that would provide appropriate comparisons with increases in FEP administration costs.

Mr. WALDIE. May I interrupt you there?

Mr. RYAN. Yes, sir.

Mr. WALDIE. As one possible appropriate comparison and a comparable indicator, has Aetna experienced the same relative increases in administrative costs that the Blues have?

Mr. RYAN. I would think in the overall processing of this kind of claims operation—and remember that our claims operation, dealing directly with physicians, hospitals, and the other facets of it, is somewhat different from commercial; but I would think in the volume of claims, in the increase in machines and mechanized approaches to claims processing—all insurers would have incurred somewhat the same increases.

Mr. WALDIE. We should be able to quickly ascertain that by determining whether their increase in percentage of administrative cost that they use has been the same as yours.

Mr. RYAN. I would only caution, Mr. Chairman, that again our type of claims processing is somewhat different.

Mr. WALDIE. The type is different, but the process you are talking about is the same as—

Mr. RYAN. Not really. I think if we are doing a unique-type job with providers into all of the other aspects of utilization review, peer review, usual and customary determination, I think that would make a significant difference in the type of processing and the volume of individual operations that would be involved.

Mr. WALDIE. Is yours the same as the medicare program?

Mr. RYAN. Not entirely.

Mr. WALDIE. But you say it compares favorably with the medicare program.

Mr. RYAN. Well, I think because it is a comparable program.

Mr. WALDIE. Is it as comparable to medicare as it is to Aetna?

Mr. RYAN. I think it would be more comparable to medicare in terms of the functions that would be performed in claims processing.

Mr. WALDIE. My recollection is—and I don't have the figures before me—that Aetna's administrative costs have increased far less in latitude than has yours.

Mr. RYAN. Well, as I say, I don't think they have had the same change in their claims processing and, frankly, in their product, as we have had over a period of 4 or 5 years; plus the additional burden of the outpatient benefits, the high-volume benefits, and so forth.

Mr. WALDIE. All right. Please proceed.

Mr. RYAN. It is of interest to note, however, that the Federal employee cost-per-claim process increase of 26.1 percent from 1966 to 1971 compares favorably with the medicare program administered by us and commercial carriers.

The increase in EDP costs are the result of efforts to process claims more promptly and more effectively. Had Blue Cross and Blue Shield EDP capacity not kept pace with the increase with the number of claims processed, our claims service to Federal employees would have deteriorated to an unacceptable level. Added EDP costs have been accompanied by improved capabilities to process claims promptly and accurately.

Contracts for claim processing services have been necessary for essentially the same reasons as EDP updating. Software development—that is, EDP programs to process claims—is less expensive when purchased from an EDP consulting firm where the software has already been developed and the cost to additional purchasers is less.

With regard to your question on the use of outside consultants, this occurred in a plan which was undergoing internal reorganization. A management consulting firm, well recognized in its field, was employed to conduct a "total management review" of the plan.

Through June 30, 1972, the cost of the consultation services have totaled approximately \$866,000. These costs have been allocated to the various lines of business conducted by the plan on the same basis as other indirect overhead costs are allocated. Through June 30, 1972, the allocation of the Federal employee program has been \$38,936, some 4.5 percent of the total.

Mr. WALDIE. The 4.5 percent of the total is the cost allocated to various lines of businesses conducted by these plans.

All direct overhead costs are allocated, in terms of the FEP program, at 4.5 percent.

Mr. RYAN. In this individual plan, they allotted responsibility to the Federal employees program based on this percentage of that plan's operation.

Mr. WALDIE. I understand that. But I am referring to the second sentence in that paragraph: "These costs have been allocated to the various lines of business conducted by the plan on the same basis as other indirect overhead costs are allocated."

And the question is, "Are other indirect overhead costs allocated in the FEP program on the basis of 4.5 percent of the total?"

Mr. RYAN. I would only be making a judgment based on premises if I said yes; and I am not that well acquainted with this situation.

Mr. WALDIE. Well, what plan are we talking about? We are not talking about Mr. Harvey's operation.

Mr. RYAN. No. This is an individual Blue Cross and Blue Shield plan.

Mr. WALDIE. And does it differ from time to time as to how they allocate the cost?

Mr. RYAN. Depending upon the overall involvement of FEP as put into comparison with the—we have plans where 30 percent of—

Mr. WALDIE. Well, this 4.5 percent, then, am I able to assume that in this plan, the FEP program comes to the 4.5 percent of their business?

Mr. RYAN. I think it is a logical assumption but it is not one that I can firmly establish for you at this point. This is a logical assumption at least—if they would make a differentiation between—

Mr. WALDIE. Well, perhaps Mr. Harvey can answer that.

Mr. HARVEY?

Mr. HARVEY. No; I cannot.

Mr. WALDIE. You see, one of the basic questions that plagues me is my inability to clarify in my own mind whether the FEP program—because of lack of monitoring on the part of the Civil Service Commission—has been assigned the burden of administrative costs of other plans that are being administered by these particular Blue Cross/Blue Shield. This would be the reason for this series of questions. We have to pick up 4.5 percent of the FEP program, of that management review, and I am questioning two things: Did we want to pick it up—this is a bit of concern. We had to pick it up, I suppose, under the contract. Second, did we pick up our fair share? You can't tell me that now because you don't know what 4.5 percent of the total means.

Mr. RYAN. Well, I think we can assume that they have abided by the accounting diagram. I think Mr. Tresnowski said that there is in progress or has just been completed an audit of this and I would think at that point—

Mr. WALDIE. Well, I don't mean to be cynical. I don't want you to interpret this comment as such. But, my conviction is that there have been too many assumptions that have been made that have not been accurate. We now question the assumptions when we find them being made. And I will get into that on questioning after the statement, as to the assumptions you have made projecting loss; but we ought to now be very careful in accepting your assumptions.

So I would appreciate if you would provide for the committee the manner by which the 4.5 percent allocation of the cost of that management contract was referring to the Federal employees program.

Mr. HARVEY. We would be glad to do that.

Mr. WALDIE. Please proceed.

Mr. RYAN. During 1971, the plan's total administrative expenses were reduced from 1970 levels by more than a million dollars. This reduction was accomplished primarily through adoption of recommendations of the management consultant firm, and Federal employee program is among those who have been benefitted from this saving.

Since the administration of the Federal employee program is integrated with administration of the plans' other lines of business, FEP has benefited in proportion with other lines of business.

With regard to assuring proper benefit payments, Blue Cross and Blue Shield are always concerned with benefit administration in each of our accounts. It is imperative that subscribers receive all the benefits to which they are entitled. At the same time, it is equally as important to all subscribers, for Blue Cross and Blue Shield, to be certain that benefits for any member or participant do not exceed the terms of the contract.

In accomplishing equitable administration in FEP, we have an ongoing program of performance audits intended to assure that correct benefits are being provided at the local plan level.

To be more specific, proper benefit administration under FEP is assured by the following:

No. 1, an administrative manual which all plans are required to follow in claims administration;

Second, advice and counsel from FEP office in Washington which assist plans in interpreting the contract, the manual, and in the adjudication of specific claims;

Third, annual claims workshops held by the associations for the training of plans, claims personnel;

Fourth, annual FEP audits which are required of each plan to guarantee that it has conducted its FEP activities properly; and, No. 5, override audits which are conducted for the national associations by a recognized public accounting firm to verify the findings of the plans' local audits.

MR. WALDIE. Those overriding audits; is that material also on file in your office?

MR. HARVEY. Yes, it is.

MR. WALDIE. And it, too, is available if the subcommittee would desire it?

MR. HARVEY. Yes.

MR. RYAN. In the area of cost control, we are proud of our efforts in this respect but believe we can and must do better. It is important to recognize that our utilization of review and peer review activities only reach the tip of the iceberg in their total impact on costs.

There is a deterrent effect when it is known that these activities are being carried out and the educational efforts of utilization review establish community standards for care that have a long-lasting impact.

We can cite a sample of five representative Blue Shield plans in which savings of over \$3 million were realized last year through utilization review, peer review, and usual, customary, and reasonable charge program administration. These figures represent all lines of business in these plans, and it is difficult to break out the Federal employee savings without spending a significant sum on research.

We have long been the leader in developing ways to reimburse and audit hospitals and other providers, and we are maintaining that leadership.

Prospective reimbursement—which means negotiating a rate of payment in advance and forcing an institution to live within a budget—shows great promise as a way of controlling cost.

Currently, 14 Blue Cross plans are using that approach and the early results are encouraging.

Rhode Island, for example, reports a saving of \$5 million last year. A third of our plans will implement significant changes in reimbursement in one form or another this year.

Blue Cross and Blue Shield are also working in the area of alternative delivery systems. Specifically, we are helping to establish HMO's, and right now, plans offer that approach along with the more traditional benefits, permitting individuals to make a real choice of the kind of care he wants.

The move to new ways of financing and delivering care has come of age. We are conducting a demonstration collaboratively with the Group Health Association of America on how to develop an HMO with minimum resources and time in Rochester, N.Y. Other collaborative efforts are also underway.

In regard to hospital utilization review, several approaches have been implemented. For example, in Pittsburgh, the hospital utilization project has been operating since 1963.

Blue Cross of Western Pennsylvania has been an important participant in this program which provides meaningful data in the form of comparative reports and profiles on hospital use to aid activities in utilization review activities. Numerous other plans are involved in similar programs.

Inspired by this and other local efforts, the Blue Cross Association developed a cost containment package for local use bearing on utilization review, areawide planning linkages, and incentive reimbursement.

In previous testimony before you, we reported on the series of meetings we have held, and are continuing to hold with medical and institutional organizations on the need to contain health care costs.

As a result of these meetings, positive steps have been taken by the medical profession. Specialty organization newsletters, the American Medical News, and medical journals have called for the help of physicians to demonstrate a turnaround in utilization trends.

Dr. McWhorter, in a Presidential memo, published by the College of American Pathologists, expressed concern over the rising volume of laboratory services and urged his colleagues to carefully assess the types and volume of tests being ordered.

The American Society of Internal Medicine conducted an educational campaign to contain the utilization of outpatient X-ray and laboratory services.

The American College of Surgeons carried in its newsletter an article headlined, "Blues Study Cost Squeeze in Federal Employment Program." All physicians, regardless of specialty, were urged to work "to find solutions for rising health care costs by way of cost controls and reasonable utilization."

Finally, the Joint Commission on Accreditation of Hospitals, at our request, took steps to avoid duplication in the hospital of valid diagnostic X-rays and laboratory tests done outside. The Commission issued a statement reiterating its position that valid laboratory tests performed outside the hospital need not be repeated.

It is, of course, difficult to measure specifically the dollar savings of any educational efforts. The impact was definitely favorable and we feel obligated to continue these efforts for the benefit of all our subscribers.

We might add that cost containment is not a late development with Blue Cross and Blue Shield. These efforts have been underway for some time. For more than 5 years, Blue Shield has been involved in the development of utilization review.

In 1969, in response to the need to make maximum use of health care dollars, the National Association of Blue Shield Plans adopted criteria by which utilization review performance can be measured. These criteria are based on four essential elements: Prevention, detection, correction, and accountability.

For Blue Cross, utilization review is the process of examining the efficiency of institutional use, the appropriateness of admission, services ordered and provided, length of stay, and discharge practices on both a current and retrospective basis. Operationally, it is a control system.

Several systems and programs have been developed and plan implementation has begun. These include a health responsibility program, claims and utilization review program, and health data information systems, and educational programs.

We would like to answer your inquiry regarding our usual, customary, and reasonable charge—UCR—program by making three key points:

First, it is true that in the usual, customary, and reasonable charge program there has been an increased cost because we have a different product.

It must be clearly understood that the intent of the usual, customary, and reasonable method of providing payments of benefits is to assure a paid-in-full program for Blue Shield subscribers regardless of income.

This is in direct contrast to the intent of the old service schedule programs where a commitment to paid-in-full was delivered originally to those subscribers using participating physicians and having a family income of \$6,000 or less per year. Later in the program, the income ceiling was raised to \$7,500.

Second, the administration of a usual, customary, and reasonable charge program requires the maintenance of individual physician's profiles, the updating of customary ranges of professional fees by economic area, and a mechanism for evaluating the need for reasonable professional judgments when physicians' fees exceed either of these parameters.

These certainly add to the administrative costs, but they provide the kind of protection which most Federal employees need and are willing to purchase.

Third, the Civil Service Commission itself requested in the mid-sixties a paid-in-full program available to all Federal employees. This paralleled demands by major segments of our industrial market. Therefore, Blue Shield developed the UCR program which would satisfy the needs of our purchasers in all segments of the private market.

Since the inception of usual and customary fee programs, there have been continuing discussions about the advisability of returning to fee schedules.

A key program is to find a fee schedule which will encompass sufficient physicians in varied specialties to have an effective program, neither overpaying some physicians, nor underpaying others.

If we were to return to a \$7,500 service benefits schedule, an undesirable situation would develop for Federal employees in terms of a paid-in-full program. For example, we would be able to assume payment in full only for 31 percent of the nationwide Federal work force. In the Washington, D.C., area, only 24 percent would be eligible.

Mr. WALDIE. Let me interrupt you there.

Mr. RYAN. Yes, Mr. Chairman.

Mr. WALDIE. Obviously, if you returned to a fee schedule you would not return to a \$7,500 income level.

Mr. RYAN. In all probability; that's right.

Mr. WALDIE. Well, that paragraph says "return to a fee schedule." If you return to a fee schedule, you would return to an income level that would reflect the change since—

Mr. RYAN. I think really behind this question is one other comment, Mr. Waldie.

We would probably return to an income schedule that would cover approximately the same percentage of people the \$7,500 may have covered 7 or 8 years ago.

Mr. WALDIE. When you had the \$7,500, what were the percentages that were—

Mr. RYAN. I really don't know; but I—

Mr. WALDIE. Well, they were obviously an awful lot higher than 31 percent.

Mr. RYAN. Obviously.

I think the point I was going to make is, if we got back to a fee schedule that would cover that percentage of people, we would be very close to the total expenditures that you may now be making under usual and customary.

Mr. WALDIE. Let me ask you one more question in that area.

When you talk about prospective reimbursement as a cost control feature, I don't understand how you could have a prospective reimbursement as a usual, customary, and reasonable fee if you were trying to return a limited based upon prospective reimbursement and in fact, your limit is in error.

What happens to the subscriber who finds your error not covering his medical bill?

Mr. RYAN. I think that particular concept applies more to hospital types of coverage; but I will ask Mr. Tresnowski, with the chairman's permission, to comment.

Mr. TRESNOWSKI. When we talk about providers of care, we make a distinction that the institutional provider that we are involved in experimentation on incentive reimbursement; that is, the prospective. You don't negotiate with prospective physicians. You do with the hospitals. You sit down in advance of the fiscal year; you examine the budget; and agree upon prospective payments, within which the hospital agrees to operate.

Mr. WALDIE. Do you have fee schedules for hospitals and institutions?

Mr. TRESNOWSKI. No.

Mr. WALDIE. Do you have reasonable fees for them?

Mr. TRESNOWSKI. No. That is the point. There are a variety of ways of paying a hospital. You can pay them on their other costs, which is the predominant way Blue Cross pays today; or in this new approach which we are talking about, a prospective rating where we sit down in advance of the year and agree with them on the rate, which you could call a fee; but the fee would vary, of course, by the ingredients involved.

Mr. WALDIE. Why could you not do that with the physicians?

Mr. RYAN. I think in effect, Mr. Waldie, what we have said about usual and customary is that we have developed a profile for physicians. That physician then has a fee schedule for himself, if you will.

Mr. WALDIE. But I presume that the hospitals also have a type of program, unless you are talking about the hospitals going on prospective reimbursement.

Mr. RYAN. I think here we are talking about an institutional organization, which is different than dealing with 200,000 physicians.

Mr. WALDIE. Are the institutional organizations easier to deal with?

Mr. RYAN. I wouldn't—

Mr. WALDIE. But would the HMO that has a doctor within it be an institutional organization with the use of prospective reimbursement for the HMO?

Mr. RYAN. Frankly, I had never thought about precisely that point of an HMO.

Mr. TRESNOWSKI. That's right. There are certain bills in the Congress today, and there are a couple of committees that reported more bills; and my knowledge of those is that they encountered the full range of services, institutional and professional; and there are a variety of ways that they can be paid, one of which is a so-called per capita arrangement, which is prospective payment on the basis of the number of enrollees within which everybody lives, institutional and medical. That is one of the devices around the HMO.

Mr. WALDIE. So you don't have to worry about the usual customary fees as you do under an HMO?

Mr. TRESNOWSKI. You would, depending upon the method of payment. Per capita is one method of payment. There are other methods; you can take, for example, the experience of an HMO. I think H.R. 1 has on it for medicare A the area payment, which would be reimbursable to the HMO for the medicare beneficiary.

So there are a variety of ways which you can pay an HMO. All are designed to contain utilization and cost—

Mr. WALDIE. Now, just one further question on the hospitals and institutions.

When you had the fee schedule for that, as you did for the doctors—I presume that's—

Mr. TRESNOWSKI. No, no. We predominantly pay hospitals on an audited cost basis; that is, where they reported a cost to us; we go in and audit and pay them on that basis. We now talk of prospective rates, which is negotiated in advance based on past experience.

Mr. WALDIE. Can you tell me why you cannot take options on an audited basis.

Mr. RYAN. I think when you are talking about professional services Mr. Chairman, it is very difficult to talk about on an audited cost basis.

Mr. WALDIE. Why?

Mr. RYAN. Why? I don't know who has ever put a particular price-tag on professional services in terms of being able to bargain the cost of providing a procedure for a judgment in medical terms.

Mr. TRESNOWSKI. Mr. Chairman, I know less about it, so I probably can answer the question. We are now confronted, for example, with the prospect of a major drug benefit also anticipated in H.R. 1, and there we are talking about 50,000 pharmacies and the possibility of reimbursement of those pharmacies along the cost base reimbursement system which, in the case of physicians, we are talking about upwards of 600,000 practicing physicians.

I am using the analogy of the pharmacy because there are 50,000 retail pharmacies; there are about 7,000 hospitals in this country. We don't know whether in fact we can do pharmacy reimbursement on a cost basis. The last word I had on H.R. 1 that is sitting in Senate Finance is they are moving away from cost base reimbursement and going to usual, customary, and reasonable fees for reimbursement of retail pharmacies only to get around the very serious administrative problems associated with the prospect of reimbursement.

It is an approach to dealing with the situation.

Mr. WALDIE. All right. You may proceed.

Mr. RYAN. While we continue to develop more sophisticated means of providing benefits under UCR programs, special attention is being given to more factual and justifiable determination of proper levels of payment.

Two of our major plans, Michigan and Pennsylvania, have developed techniques related to economic factors within the area, as well as physician fee charges, in judging proper limits for UCR increases.

At the present time, exclusive of our involvement in medicare part B and other Government-financed programs, we have more than 20 million people enrolled in usual, customary, and reasonable charge programs. It is the fastest growing program in Blue Shield because it meets the needs of the entire employed population, and because we have demonstrated that effective cost constraints in UCR can be applied.

An area of inquiry has been the allocation of corporate overhead to the Federal employee program, based on the ratio of direct Federal employee program salaries to total Blue Cross Association salaries.

It is true that BSA allocates corporate overhead in this manner. It is a generally acceptable accounting procedure based on the standards of the American Institute of Certified Public Accountants—AICPA. However, the Federal employee program is not asked to share in any costs which are not appropriate.

Mr. WALDIE. Now, if you would stop there for just a minute. In other words, the method by which the FEP allocations of appropriate administrative cost or appropriate corporate cost is derived from the percentage of salaries paid to FEP or employees of the association working on the FEP program to other employees?

Mr. TRESNOWSKI. That's correct. That's Blue Cross Association. It is an acceptable accounting allocation procedure of the so-called salary ratio method where you take direct FEP salaries as a percent of overall salaries and that's the basis for allocating those selected overhead costs.

Mr. WALDIE. And that works out to what percent?

Mr. TRESNOWSKI. I don't know precisely; I think it is in the neighborhood of 4 percent—4.5 or 4.7 percent.

Mr. WALDIE. It has nothing to do with, then, the number of subscribers that the FEP program, compared to the number of subscribers of the other programs.

Mr. TRESNOWSKI. No, because the national officers are not dealing in claims-processing environments; we are dealing with an administrative responsibility, and therefore we use the salary ratio method of allocation.

Mr. WALDIE. And that method of allocation costs of FEP is not the method followed?

Mr. TRESNOWSKI. Oh, it may well be; yes. In fact, I think it is in a majority of instances, or in particular allocations. But I can't answer for any particular plan.

Mr. WALDIE. Well, is there a formula that has application to all plans?

Mr. TRESNOWSKI. Yes. It is called GAAP; it is called General Accepted Accounting Practice. That standard is used in industry and it states the standards of the AICPA.

Mr. WALDIE. And those standards permit a different allocation?

Mr. TRESNOWSKI. As long as they are reasonable and equitable; yes.

Mr. WALDIE. Would you be able to provide the committee with a description of the various methods of allocating FEP costs in all the kinds that are administered in the FEP program?

Mr. TRESNOWSKI. Yes; we can supply that.

Mr. RYAN. The six accounts identified in your question are accepted accounts of the corporation. They are: Public Relations Advisory Committee Costs, Travel and Travel Items, Analysis and Programing for Professional Selling, Advertising, Legal and Employee Relations, and Welfare.

However, three of them are not charged as corporate overhead or in any way directly or indirectly charged to FEP. Those three accounts: Public Relations Advisory Committee, Analysis and Programing for Professional Selling, and Advertising.

Mr. WALDIE. Now, do I understand that to mean that though we pay 4.5 percent—or whatever that formula works out—of corporate cost, when the 4.5 percent is computed, the cost of Public Relations Advisory Committee Costs, Analysis and Programing for Professional Selling, and Advertising are excluded?

Mr. TRESNOWSKI. That is correct.

Mr. WALDIE. And why are they excluded?

Mr. TRESNOWSKI. Well, there are a whole set of overhead accounts, and the overhead accounts are selected for allocation to a particular program based upon the applicability of that overhead account for that purpose.

The overhead account is selected because it either has a direct or indirect bearing on that particular program. And in these particular cases, advertising clear exclusion under the contracts of the Civil Service Commission, as well as the marketing activities.

Mr. WALDIE. What about public relations?

Mr. TRESNOWSKI. The Public Relations Advisory Committee is considered by the Blue Cross Association as a responsibility, primarily, of our private-market activities, and, therefore, is not chargeable—

Mr. RYAN. Travel and travel items are allocated to corporate planning accounts, some of which are charged as corporate overhead. The same is true for legal services and employee relations and welfare.

The basis for selecting corporate overhead accounts for charging to FEP is that it is an obligation necessary to sustain the corporation and make it available to serve FEP. Not all corporate overhead is charged to FEP—only those accounts which have a direct or indirect bearing on the activity of the program.

Travel items are restricted to transportation, hotels, meals, and dues in professional organizations.

Mr. WALDIE. May I interrupt for just a moment? There has been some question raised about liquor bills, which we will get into. Do you include liquor bills as part of meals?

Mr. RYAN. I think you were talking about the—

Mr. WALDIE. I am talking about the travel items in terms of—

Mr. TRESNOWSKI. We will get into that later in our statement in relation to receptions and luncheons associated with the Federal employee plan.

Mr. WALDIE. On travel items, liquors are not permitted to be charged?

Mr. TRESNOWSKI. No. Liquor is identified as hospitality on our account, when it is incurred.

Mr. WALDIE. Are travel items restricted to transportation, hotels, meals, and dues in professional organizations?

Mr. TRESNOWSKI. Right.

Mr. WALDIE. Liquor is not part of travel items?

Mr. TRESNOWSKI. Yes; it is. It is, and it is called hospitality.

Mr. WALDIE. OK, so we add another feature in there: hotels, hospitality, meals, and so forth.

Mr. TRESNOWSKI. That's right.

Mr. WALDIE. Did we leave anything else out?

Mr. TRESNOWSKI. No; that's it.

Mr. WALDIE. Now, how are dues, in professional organizations, a travel item?

Mr. TRESNOWSKI. It is just a classification of the expense in a particular account.

Mr. WALDIE. Well, why should it be, is the question I am asking? Why is that a travel item, to belong to a professional organization? The question I am really asking is why should the Federal employee program pay for a portion of the dues in professional organizations? I presume this sentence means they do.

Mr. TRESNOWSKI. Yes, sir.

Mr. RYAN. Right.

Mr. WALDIE. And it does because it is peculiarly under travel items account, which is assessable to the Federal program.

Mr. TRESNOWSKI. No; it is not. It is specifically charged as a dues in a professional organization, and it just happens to be a corporate policy to include this under the financial account. It is called travel and others, as a matter of fact, and it has defined in it the inclusion of expense for dues for professional organizations.

As to your question about why, it is corporate policy to pay for dues in professional organizations.

Mr. WALDIE. Would country clubs be called professional organizations?

Mr. TRESNOWSKI. No.

Mr. WALDIE. Is it corporate policy to permit country club dues to be assessable?

Mr. TRESNOWSKI. No; it is not.

Mr. WALDIE. And so there would be no charge assessable against the Federal employee program involving dues for country clubs?

Mr. TRESNOWSKI. No.

Mr. RYAN. Accepted business practices provide for the payment of meals, transportation, rental of facilities for meetings, and cost incidental thereto when the purpose of such costs is dissemination of technical information.

Employee relations and welfare are allowable costs charged on an overhead basis to Federal employee programs and all line of business served by Blue Cross and Blue Shield. Again, it is common practice to provide for employee morale, health and welfare activities, when these services or benefits are provided to improve working conditions and employer-employee relations.

The Sunshine Fund is an employee-sponsored fund to which each employee of the corporation may donate an annual amount of \$3 and to which the corporation also makes a contribution. These funds are used at the discretion of employees for acknowledgments of births, deaths, and retirements.

Mr. WALDIE. May I interrupt for just a moment? We have a description of your travel items here. The items include, among others, dues and fees of social clubs.

Mr. TRESNOWSKI. I am going to look it up, Mr. Chairman.

Mr. WALDIE. Please do.

Mr. TRESNOWSKI. That is correct.

Mr. WALDIE. So that is not professional organizations.

Mr. TRESNOWSKI. Well, we do include professional organizations.

Mr. WALDIE. But you don't list them.

Mr. TRESNOWSKI. And that is what the dues are. I am not aware of social clubs.

Mr. WALDIE. Well, that's what it says.

Mr. TRESNOWSKI. Yes.

Mr. WALDIE. It doesn't say anything about professional organizations.

Mr. TRESNOWSKI. Well, professional organization dues.

Mr. WALDIE. Well, that isn't included.

Mr. TRESNOWSKI. Well, it says "dues."

Mr. WALDIE. It says "dues and fees of social clubs."

Mr. TRESNOWSKI. But I am saying that included in that area are the dues paid for professional organizations.

Mr. WALDIE. All right. But also included in that are dues and fees of social clubs.

Mr. TRESNOWSKI. If it is what the definition says; yes.

Mr. WALDIE. Well, is that in fact the practice? Are Playboy Club memberships included as travel and travel items?

Mr. TRESNOWSKI. Not to my knowledge, sir.

Mr. WALDIE. Can anyone shed any light on that?

Mr. RYAN. They are not included.

Mr. WALDIE. They are not, Mr. Ryan?

Mr. RYAN. No. I was talking about the Blue Shield Association. They would not be.

Mr. WALDIE. Would not. OK.

Mr. HARVEY. That doesn't mean, Mr. Chairman, that individual members may not maintain their own memberships.

Mr. WALDIE. I can appreciate that. Of course not. But they should not be charged against any of the Federal employee programs or any of the other carriers.

Mr. TRESNOWSKI. Well, there may be costs that may be incurred in connection with their private memberships that they may charge to the program, or with the account. But the membership in those organizations may be private memberships.

Mr. WALDIE. All right. Proceed.

Mr. RYAN. Regarding the Blue Cross Association Telecommunications System, your letter indicated total charges to FEP from 1966 through 1971 of \$3,361,000. The actual charges for the telecommunications system for that period was \$3,149,118, a figure more favorable to FEP.

The telecommunications system is used for eligibility checking for Federal enrollees, as well as for other claim processing and any wire communication among and between Blue Cross and Blue Shield plans. This includes claims verification, administrative messages or other forms of communication.

The wire system is used for medicare, the Blue Cross Inter-Plan Bank System—FEP—and centrally certified accounts. The allocation is on a word-count basis except for the Inter-Plan Bank, which is on a flat charge.

Mr. WALDIE. Now, let me stop you there. What is a word-count basis?

Mr. RYAN. On the basis of the messages and the content that goes through the system.

Mr. WALDIE. Is this a written or verbal communication?

Mr. RYAN. No; it is a telecommunications printed system.

Mr. WALDIE. You allocate the number of words that go out from the FEP account and they pay on that basis?

Mr. RYAN. Yes.

Mr. WALDIE. Do you honestly do it that way?

Mr. RYAN. Well, there is a way in which those accumulations or statistics are put together, which I am sure is electronically done.

Mr. TRESNOWSKI. The telecommunications system is a Blue Cross Association system. It is all automatic and it works on this automatic register.

Well, as our telecommunications people say to me, it is a system untouched by human hands.

Mr. WALDIE. What about the telecommunications system. How do you allocate that?

Mr. TRESNOWSKI. It is on a word-count basis.

What we do is first allocate a flat-rate charge to the Inter-Plan Bank and then, for other uses of the program—

Mr. WALDIE. What does that mean? If they want to use it, they pay by the hour?

Mr. TRESNOWSKI. No. It is a flat amount charged to the Inter-Plan Bank as one user of the system. Beyond that it is a word count for other users.

Mr. WALDIE. What do we get charged for that?

Mr. TRESNOWSKI. On a word-count basis.

Mr. WALDIE. How much a word are we paying for that?

Mr. TRESNOWSKI. I can tell you that.

Mr. WALDIE. How much did the whole system cost?

Mr. TRESNOWSKI. I will tell you that also.

In 1971, the total system cost \$2,454,664, of which the Federal employee program paid \$809,000, which is 32.96 percent of the total, based upon a percentage on words transmitted at 32.96.

They used 309,948,235 words in FEP, for a 32.9 percent total.

Mr. WALDIE. All right.

If you could count that and compute it on a different basis, would that account for 4.5 percent. One count is by word. Which count gives you the different basis in terms of what the FEP put out.

Mr. TRESNOWSKI. Well, it is not the account; it is the function. We are talking here about a telecommunications allocation. What you do is you look for a basis of allocation which fairly and equitably allocates that particular function. On a computer you may be using machine time allocated where you are not dealing with a production function, an executive function, you lean on salary ratio. It depends on the particular natural accounts you are dealing with. You look for the most fair and equitable way.

Mr. RYAN. Finally, we would like to discuss the number of FEP meetings held and their related expenses.

It is a matter of public record that, in the administration of the program, Blue Cross and Blue Shield have conducted meetings, conferences, and training sessions for people administering its many complexities. These people work in 145 Blue Cross and Blue Shield plans.

It is necessary to have frequent local, regional, and national meetings for policy development and continuous training in claims administration functions. Each of the meetings has a specific agenda. Each is necessary for effective administration of the program; and each is well documented as to its program, results, and associated expense.

These meetings are held at locations which minimize the necessary travel of Blue Cross and Blue Shield personnel from local plans. They are held in central locations and in hotels that have indicated they can provide the room accommodations necessary to fulfill the meeting objectives.

The facilities chosen contribute to the effectiveness of the meetings by providing space that is consistent with, and conducive to, a good training environment.

Furthermore, the practice of holding meetings in hotels rather than in much more limited office accommodations is consistent with the accepted practice of industry in general as well as of Government agencies.

When we extend a measure of hospitality to persons attending the meetings, it takes the form of receptions and of group lunches. Those sessions enable personnel from various plans and various disciplines to exchange ideas and acquaint themselves with methods of operation in other locations.

In summary, these meetings are conducted in facilities, and in a manner consistent with accepted business practice. All meetings contribute materially to the successful and effective administration of Blue Cross and Blue Shield Federal employee program.

In conclusion, Mr. Chairman, we have continually worked toward the development and administration of health care prepayment mechanisms that would meet the needs of the public. We have sought to construct and enforce proper administrative practices. We have strengthened and will continue to improve our cost containment efforts in utilization review, and administration of usual, customary and reasonable charge programs, and provider reimbursement systems.

Blue Cross and Blue Shield have served the Federal employees well and have been their predominant choice of carrier since the inception of the program. We will expand benefits and further improve our administrative practices to continue to justify their faith in us.

Thank you, Mr. Chairman.

Mr. WALDIE. Thank you, Mr. Ryan.

Mr. Hillis, do you have any questions?

Mr. HILLIS. I have no questions at this point, Mr. Chairman.

Mr. WALDIE. Gentlemen, let me now go back to the questions that remained unanswered in the last hearing and I presume the responses may remain the same. But for the record, on page 202, let me read question No. 8.

We notice that data processing expenses for the California Physician Service increased about 10 times from 1969-1970 from about \$41,000 to about \$440,000 and the cost of processing claims increased by 55 percent during the same period from \$522,885 to \$815,238. Consequently we have the following question: What were the reasons for this substantial increase in the data processing operations? We understand that a substantial part of the claims processing for the FEP is still performed on a manual basis.

Would you wish to respond to that or would your answer be the same as given in previous hearings?

Mr. RYAN. No. As a matter of fact, Mr. Chairman, I have personally looked into this to some degree.

I think we have to take into consideration what our objectives are; and they are performance to the subscriber, service, and accuracy of our claims payments.

I think also we have to understand the environment that exists in California, and in California Blue Shield in particular. The volume of claims in that plan since just immediately prior to medicare until the present time is something in the difference between 25,000 claims a day and now 180,000 claims a day.

They found themselves in a position 2 or 3 years ago where their performance was going down and the claims cost was going up; so they weren't able to maintain their heads above water.

They brought in an outside consultant on EDP and systems and made a contract with them. As a matter of fact, the first contract was for their medicare and medical business; the second contract was for their private business, which includes the Federal employee program.

They feel that they are not only at a point at this particular point in time able to handle their business; but they are in a developmental process, developing a system called System 72, which will eliminate the manual handling of any of the claims processing that they do at the present time for Federal employees.

Mr. WALDIE. May I interrupt you at that point?

Mr. RYAN. Certainly.

Mr. WALDIE. At the time that they had the problem, they brought in the Ross Perot operation—

Mr. RYAN. That's right. EDS.

Mr. WALDIE. They brought in the Perot operation to do medicare. Now, was that in 1969?

Mr. RYAN. I think it was prior to 1969, because the second contract I believe was in 1969.

Mr. WALDIE. None of that cost was applied to FEP.

Mr. RYAN. No, sir.

Mr. WALDIE. Were they having the same problems of administering the FEP program, or was it just medicare?

Mr. RYAN. No; I think they felt that if they were able to use a facility demanding an organization such as EDS, it would relieve them of that tremendous influx of government programs but, as a matter of fact, then they began to have the increase in volume in the private market and felt that they could probably do better, more effective work.

Mr. WALDIE. But in actuality, did the FEP program break down out there?

Mr. RYAN. I wouldn't say that it broke down. I think we had several complaints from various agencies about subscriber service replies to correspondence, slow claims payments, and so forth.

Mr. WALDIE. Were they more than the usual customary—

Mr. RYAN. Let's say they weren't unique in terms of FEP that California had a problem which we sought in various other accounts and, therefore, were quite interested in seeing—

Mr. WALDIE. Did they break down in their other private claims, as distinct from the medicare and medicaid programs?

Mr. RYAN. Well, if I may, Mr. Chairman, "breakdown," I don't think is fully accurate. They did have serious difficulties in maintaining the volume of claims that were coming in in the private market.

Mr. WALDIE. Do they use the same equipment to process the FEP business as they do the medicare and medicaid?

Mr. RYAN. They have an EDP center, as a matter of fact, which is removed from the main office.

Mr. WALDIE. Did they have to expand it when they executed the private contract the subsequent year after the first public contract?

Mr. RYAN. I am not sure that I can answer the specifics of what expansion took place in terms of the hardware. I do know there were changes in equipment at that time.

Mr. WALDIE. Well, all I know is that in 1969 and 1970 there were increased costs, and those were typical, I presume, to the Ross Perot contract, from \$19,069 to \$141,055. Then another went up to \$209,445.

The questions I want to pose, are: No. 1, did they have to go to the Ross Perot contract to service the FEP contract; and, No. 2, are we in fact picking up some of this medicare and medicaid expense, for which the equipment was installed?

Mr. RYAN. If I might, I might answer your second question: You are not.

The increases which you have experienced in EDP allocation and so forth in California Blue Shield, are not totally due to the increase in the costs of EDP equipment.

Mr. WALDIE. How much of the contract with Perot was assigned to FEP?

Mr. RYAN. I am sorry; I don't have that information. The point I was making, if I might—

Mr. WALDIE. Yes; but before you do, would you provide that for the committee? How much did FEP in 1969 and 1970 increase in cost; how much did FEP pick up in the Ross Perot contract?

Mr. RYAN. I think related to that, Mr. Chairman, would be the observation that in talking with the people in the California Blue Shield program, one of the major changes which is reflected in that increase in cost is the fact that there was a new and more sophisticated system of cost allocation.

As a matter of fact, before the first 9 years of the program, FEP was not paying its proportionate share as the judge appointed in 1969 when they were reviewing it and when the statistics came in whereby we were able to get better data and have more precise allocation. And they said this is a significant variation.

Mr. WALDIE. That could be very easily ascertained.

I really want to know how much did we pick up of the Ross Perot contract for the private business. And I want to know if there was any reduction in Ross Perot's contract for the public business of BCA.

I get the feeling, you see, that they are using the very same equipment that they installed to meet a crisis breakdown in the processing of medicare and medicaid claims; and it was installed for that purpose; and since the equipment was there, it was decided that the private sector could utilize it also; and I would presume the contract said that Ross Perot elected to receive the extra service of the private sector and that would retard the increase in the cost necessary to service the private sector; and that should not be hard to understand.

I can't dispel my present suspicion that we are subsidizing the Ross Perot and EDS people for a problem that involves medicare and medicaid but does not involve in fact the crisis problem.

Mr. RYAN. I can assure you that the private system seems to be—

Mr. WALDIE. We have an analysis done by the General Accounting Office that has a peculiar situation in it.

In 1967 through 1971, claims were dropping off under FEP—\$47,000 in supplementary in 1967.

And in 1971, \$40,000; whereas, during that period of time, costs went up from \$286,906 in processed supplemental claims in 1967 to \$631,667.

Mr. RYAN. That is related only to supplemental claims?

Mr. WALDIE. Only to supplemental. And I understand the supplemental claims were processed manually.

Mr. RYAN. Well, partially processed manually, which is part of what the new system is supposed to correct.

Mr. WALDIE. But most of the processing of the supplemental claims was done manually.

Mr. RYAN. I believe they told me that the system by which they processed the claims is manual; the methods of payment and data retrieval and so forth—at the present time.

Mr. WALDIE. Yes. But we are speaking about Ross Perot's cost in this. Didn't that jump, reflecting Ross Perot's contract? Didn't they process less claims?

Mr. RYAN. I would think you should be able to get an explanation for that. I don't have that detail.

Mr. WALDIE. How much was that increase in processing supplemental claims—from \$286,906 to \$631,667—attributable to Ross Perot's contract?

Mr. RYAN. I will attempt to get that for you.

Mr. WALDIE. Do you have any thoughts on that now, or do you prefer to wait?

Mr. RYAN. Well, I think it is a very complicated process that we are operating. In claims administration, the methods and the systems that you use to process them; the new equipment and the judgments that you make as to how you can better effect accurate claims payments, subscriber satisfaction, better data retrieval, and so forth—I don't happen to be a systems expert; I do and am most interested in the effects that come out of better systems and better subscriber relations, and better accounting.

Mr. WALDIE. I only ask the question, again reflecting my concern that there is no one giving any surveillance or monitoring to the charges assessed against the FEP. We may very well be being ripped off by every program of Blue Cross/Blue Shield. These questions are directed at that possibility.

All right; question 9:

We noted for the Blue Shield plan for San Francisco, California, office, that the professional-hospital relation cost has increased from \$16,221 in calendar year 1966 to \$283,482 in calendar year 1970 for a 1,647 percent increase.

Explain to me, then, the increase of 1,647 percent in the San Francisco office.

Mr. RYAN. The basic reason for that, Mr. Chairman, is the fact that the allocation of expenses within that particular account in that plan was almost nonexistent as far as FEP is concerned. They did not charge, in any realistic relationship, those charges to FEP. When they put in a new systems program they were able to make a more proper allocation, and this is when the increased occurred.

Second, of course, I am sure you realize the size of the State of California and the overall involvement has an effect if you are going to maintain any medical and hospital liaison.

Third, I believe that California has been one of the Blue Shield plans which was a leader in utilization review, peer review, and almost at the county level.

Again, I would reiterate that, in my discussions with the plan, they have laid the majority of that increase to more proper allocation and have said that, prior to the date, FEP was not paying an equitable share.

Mr. WALDIE. I guess it is fair to conclude that the FEP contribution to the installation of this new system has resulted in higher costs to FEP; because the system has been undercut.

Mr. RYAN. Perhaps FEP and perhaps other lines of business that were not getting proper allocation; but, again, it is more effectively administered in the State of California and that is the longer goal.

Mr. WALDIE. You think now FEP is more effectively administered?

Mr. RYAN. Yes, sir.

Mr. WALDIE. That is an interesting conclusion. I was not aware that FEP was not being effectively administered. I knew that medicare and medicaid were not carefully administered. But I was not aware that FEP was not being effectively administered.

Mr. RYAN. I would hope that that would reflect my view that there were difficulties in terms of maintaining subscriber service.

Mr. WALDIE. OK. Now, let's get to another old question, bearing in mind again the reason for these questions is bearing upon the efficiency of your administration of the FEP program.

One of the criteria that determines your efficiency is your accuracy in your actuarial projections upon which premium increases are sought.

I want to review the history of your actuarial projections as you announced them during the last 2 years and bring us up to date, upon which perhaps you can draw substantially or disavow my conclusion that your accuracy is nonexistent.

In December of 1971, Mr. Harvey wrote a letter to all Members of Congress to the effect that the 1970-71 deficit will be \$68 million and that refusal of the increase in premium rates that was then being sought—and that was 34 percent, I believe, at that stage—would put your deficit at \$146 million at the end of 1972.

In a February 22, 1972, hearing of this committee, Mr. Ryan said that he agreed with that deficit amount but that it had now been revised down to a deficit, not of \$68 million but of \$45 million.

In March—a month later—the Blues announced the deficit had actually been only \$16 million.

In the April 26 hearing, before this committee, Mr. Ruddock revised that estimate down to a \$15 million deficit; and now, I understand, the position is that there is not a deficit, but there is a surplus. Is that right?

Mr. RYAN. When you were talking about the deficit figure, you were talking about 1971, Mr. Waldie.

Mr. WALDIE. Yes.

Mr. RYAN. The final accurate figure is, I believe, around \$15 million. We were talking about projected, the position of the program at the end of 1972.

Mr. WALDIE. The deficit is now what for 1971?

Mr. RYAN. \$15,353,000.

Mr. WALDIE. And your estimate of that deficit in December of 1971 was that it would be \$58 million.

Mr. RYAN. I believe that is correct.

I think that during the course of these hearings, we have discussed the question of projections in a particular environment, and that environment was highly out of what we might have expected during the past year in terms of economics, in terms of health care usage, and so forth.

Our actuaries made their projections on the basis of the trends that they read, and what they felt were to be the situations for the rest of 1971, knowing that they were making those projections a year and a half in advance of the final figures.

Mr. WALDIE. And they were terribly wrong.

Mr. RYAN. They were wrong, as I think many people were wrong who happened—

Mr. WALDIE. And at the Civil Service Commission; the people there were wrong who accepted it.

Mr. RYAN. There were a great many other people who accepted that, Mr. Chairman.

Mr. WALDIE. There were a great many that did not. We have figures in the committee that were almost on target.

Mr. RYAN. But there were firms that in substance agreed with the projections as they were made.

Mr. WALDIE. You said you would end up in a deficit position at the end of this year. In what way do you estimate the deficit that you represented to the Price Commission?

Mr. RYAN. I don't remember that we represented a deficit at the end of this year. I think what we talked about was what our position was at that particular time and what we felt we would need in order to bring ourselves back to a zero reserve.

Mr. WALDIE. At that time, the representation to the Commission was that you needed \$60 million or you would go \$50 million in the hole; right?

Mr. RYAN. That is correct.

Mr. TRESNOWSKI. We have prepared for submission to the Civil Service Commission our estimate through the end of 1972.

Now, we prepared these taking into account a couple of key assumptions. I will tell you what our estimate is and then I would like to tell you what our assumptions are.

Mr. WALDIE. Fine. What is your estimate?

Mr. TRESNOWSKI. Our estimate is that the gain for 1972, that is the underwriting gain, would be \$64,225,000.

The assumption that we make—

Mr. WALDIE. Now, just supposing that had been your estimate before the Price Commission of a \$50 million loss.

Mr. TRESNOWSKI. We didn't project a loss through 1972.

Mr. WALDIE. How far did you project the loss?

Mr. TRESNOWSKI. The loss that we were projecting at that time had to do with 1971. The loss in fact was \$15,353,000.

Mr. WALDIE. What were you projecting for 1972?

Mr. TRESNOWSKI. We projected a rate which would break even.

Mr. WALDIE. Mr. Harvey wrote a letter in December 1971, to all Members of Congress that for 1971 deficit would be \$58 million.

Mr. TRESNOWSKI. Right.

Mr. WALDIE. And that refusal of an increase in premium rates—and that was 34 percent—would put them at a deficit of \$146 million at the end of 1972.

Mr. TRESNOWSKI. I don't know the precise calculation, but if there were no rate increase, then we would have obviously lost considerably more.

Mr. WALDIE. Yes.

Mr. TRESNOWSKI. Whether it was \$147 million, I don't know.

Mr. WALDIE. You see, if he said with no rate increase you would lose \$146 million, I am trying to figure out what the deficit projected with a 22 percent rate increase would be.

Mr. TRESNOWSKI. I don't think their deficit projected; I think what we were talking about was a break even.

Mr. WALDIE. But you asked for 34 percent.

Mr. TRESNOWSKI. Right. What we were talking about at that time was the recoupment of our anticipated \$68 million loss.

Mr. WALDIE. Which was \$14 million.

Mr. TRESNOWSKI. \$14,353,000.

Mr. WALDIE. So that you now are \$64 million in the black.

Mr. TRESNOWSKI. Well, no, we are not.

Mr. WALDIE. But your projection is you will be.

Mr. TRESNOWSKI. Yes. And I would like to give you the assumption on which that projection—

Mr. WALDIE. And that was the 22 percent increase.

Mr. TRESNOWSKI. That's right.

Mr. WALDIE. All right. Please give me your assumptions.

Mr. TRESNOWSKI. The assumptions are as follows:

The key consideration was phase 2 of the economic stabilization program. Regardless of whatever actions may be taken in other areas of the economy; that is, if in fact phase 2 is lifted or there are other changes in the economic stabilization program, the controls in delivery and financing of health care would be continued at the present levels through 1973. Should these controls be withdrawn at the end of April 1973—that is the expiration of the statute—the impact on the Federal employee program for 1973, in terms of increased cost, could range as high as \$20 to \$25 million.

Mr. WALDIE. What impact does that have upon the \$64 million figure? That's for 1973; is that right.

Mr. TRESNOWSKI. That's right.

Mr. WALDIE. We are talking about 1972.

Mr. TRESNOWSKI. That's right.

Mr. WALDIE. Whatever happens in 1973 will have no impact on the \$64 million surplus.

Mr. TRESNOWSKI. Yes; but let's keep in mind that we are talking about a set of assumptions associated with a rate for 1973. We are presumably—

Mr. WALDIE. Well, I am not really interested at this time in a rate for 1973. I am interested in the rate that you asked for and received in 1972 that was predicated upon a break-even picture and in fact, you made \$64 million.

Mr. TRESNOWSKI. We didn't make it; we are projecting.

Mr. WALDIE. You are projecting. Now, that is an enormous error, isn't it?

Mr. TRESNOWSKI. Well, I don't think you can—I don't know—we don't want to call it an error, Mr. Waldie.

Mr. WALDIE. Why not?

Mr. TRESNOWSKI. Because it is an estimate, an estimate based upon—

Mr. WALDIE. Well, if the estimate proved accurate, which would be a rare thing, but if it does prove accurate, it would be an enormous error.

Mr. TRESNOWSKI. If the estimate proved accurate, it would be an error—

Mr. WALDIE. If the estimate proved accurate, that you are going to end up with \$64 million in the black, the enormous error is the estimate that that rate increase would cause you to break even; is that correct?

Mr. TRESNOWSKI. I am not following you.

Mr. WALDIE. You estimated that a 22 percent-rate increase would cause you to break even at the end of 1972. Is that right?

Mr. TRESNOWSKI. Yes; that's right.

Mr. WALDIE. In fact now your projections are that you will make \$68 million; is that right?

Mr. TRESNOWSKI. That's correct.

Mr. WALDIE. If you are accurate in that projection, that in fact we do end up with \$68 million in the black, am I correct in making an assumption that you were wrong when you said 22 percent would cause you just to break even?

Mr. TRESNOWSKI. We were wrong in estimating our terms in cost and utilization; yes.

Mr. WALDIE. And am I correct in saying that you were enormously wrong—\$68 million wrong?

Mr. TRESNOWSKI. I would challenge the word "enormous." I think that \$65 million in a \$750 million program is within—

Mr. WALDIE. Actuarial tolerance?

Mr. TRESNOWSKI. I think it is; yes.

Mr. WALDIE. Do you?

Mr. TRESNOWSKI. Yes; I do.

Mr. WALDIE. A 15-percent error?

Mr. TRESNOWSKI. Is it 15 percent?

Mr. WALDIE. About that.

Mr. RYAN. Eight percent.

Mr. WALDIE. Eight percent, a tolerable error, an estimate?

Mr. TRESNOWSKI. Well, it depends on what kind of environment you are dealing with in terms of tolerance.

We were dealing with a health care environment, which was subject to significant changes in the last year and a half; the economic stabilization being one.

Mr. WALDIE. Will any of this \$64 million, if in fact it is a surplus, be applied to the reduction of the deficit?

Mr. TRESNOWSKI. Well, that particular figure does not take into account any reduction in the deficit that occurred in 1971. It will, of course, remain in the program and be taken into account in the ratings of the subsequent year, under circumstances which include any underwriting gains and any underwriting losses.

Mr. WALDIE. Well, in fact, we will be able then to apply a portion of that \$64 million to the reduction of the \$14 million deficit.

Mr. TRESNOWSKI. Well, to my knowledge, that provision—

Mr. WALDIE. I thought that the Price Commission's action, reducing from 34 to 22 percent, was predicated exactly on that point. They said you couldn't have the 34 percent that you wanted and the Civil Service Commission had agreed, because the 12-percent difference between the 22 percent they gave you and the 34 percent you requested was to be applied to the reduction of an anticipated \$68 million deficit.

Mr. TRESNOWSKI. That information we got from you at the last hearing.

Mr. WALDIE. You didn't understand that?

Mr. TRESNOWSKI. We have no formal or informal information from the Price Commission as to the basis on which they made the judgment on the 22 percent.

Mr. WALDIE. We can find out from the Price Commission as to whether in fact you can apply any of the excess money of the 22 percent to a reduction of your \$14-million deficit, or whether or not that must go against the premium increase.

I think that covers that picture. And I remain convinced that either this industry is taking, or making suggestions upon which premium should be paid for the Blues, and particularly I indicated it in that regard. I don't know, until I track it down, how wrong the other companies have been. My recollection is they have proffered a premium increase. But they may have included an enormous increase, too.

Mr. TRESNOWSKI. I think we would welcome this kind of comparison.

Mr. WALDIE. Yes. I think that is the comparison that is essential, and I am inclined to believe that they may have even a greater wind-fall from the Federal employees than did in fact the Blues. We will find out.

Now, some of these questions you have already answered in your written statement but I want to mention them to you again and perhaps discuss details that were left out.

The questions have been submitted to you. These deal again, by the way, with the restraints that exist or do not exist and the manner by which you spend the moneys that are provided you from the Federal employees plan for administering the FEP program.

Since mid-1971, you have been pursuing a vigorous policy of cost containment—and by the way, I commend you on that—with respect to the payment of medical benefits on behalf of the members of the FEP.

We have received many complaints that the policy has been pursued beyond the bounds of reasonableness. However that may be, payments should not be made beyond the limits of the obligation of the program.

On the other hand, if your service is at the point where it is a part of the administrative operations of Blue Cross/Blue Shield, little cost containment appears to have been practiced. In fact, in many areas, the cost of administrative activity seems to have been performed on an intensive rather than on a peer basis, such as first-class travel by your personnel in situations where it would appear that coach class could have been used, meetings held in expensive locations and some of the related questions of entertainment.

Now, I want to go over a trip that Mr. Harvey made as an illustration, and only as an illustration. And that trip, Mr. Harvey, is one that the GAO has examined in detail that is so illustrative of the problem that we want to discuss here with you.

It was a trip on which you traveled from Washington, to Victoria Canada, to San Francisco, and then to Miami, Fla. Are you familiar with that trip?

Mr. HARVEY. Yes.

Mr. WALDIE. I gather you made a speech in Victoria, Canada. That was a Federal employee program, because at that meeting, you were a representative of the Western Regional FEP program.

Mr. HARVEY. That is correct.

Mr. WALDIE. The entire cost of this trip has been accrued to administrative expenses of the FEP program.

Mr. HARVEY. That is correct.

Mr. WALDIE. And then you went to Miami.

Mr. HARVEY. That is correct.

Mr. WALDIE. And made two speeches in Miami.

Mr. HARVEY. That is correct.

Mr. WALDIE. Again, on the FEP program.

Mr. HARVEY. Yes, sir.

Mr. WALDIE. From Washington, to Toronto, to Victoria, to San Francisco, to Miami, and back to Washington.

Mr. HARVEY. Yes, sir.

Mr. WALDIE. And that was a 7-day trip.

Mr. HARVEY. I don't recall the exact number of days.

Mr. WALDIE. It was a 7-day trip?

All the air travel was first class, and the reason I ask that question is that it involved Blue Cross regulations on air travel:

Air travelers are urged to fly coach when such space is available and to seek a plane with available coach seats on a reasonable schedule.

In general, only coach fare may be billed and on business directly chargeable to Government accounts, but BCA will absorb needed, or added costs for first-class fare properly approved by the Division during evaluation periods.

The first question I have is: Is FEP a Government account?

Mr. HARVEY. In the sense in which you are asking the question, I don't believe it is.

Mr. WALDIE. It is a private, commercial account?

Mr. HARVEY. Yes, sir.

Mr. WALDIE. What makes an account a Government account? The Government pays 40 percent of the premium and the employee pays 60 percent of the premium.

How do we get to become a Government account; there are certain advantages, apparently, that accrue to Government accounts.

Mr. TRESNOWSKI. Well, the Government account cited in the sense of the medicare program and the program under which we operate as an administrative intermediary are found—in the case of medicare to be—

Mr. WALDIE. Well, I understand that. But why are we not a Government account? The contract is the Civil Service Commission.

Mr. TRESNOWSKI. Well, it is not a Government account because it is not an administrative intermediary arrangement; it is an underwritten—

Mr. WALDIE. It has to be an intermediary relationship before it becomes a Government account.

Mr. TRESNOWSKI. That is correct.

Mr. WALDIE. Why are there differences in expenses that are permitted on a Government account? Government accounts seem more stringent.

Mr. TRESNOWSKI. Well, because in the case of medicare, we are bound by the principles of Federal procurement regulations and by the armed services procurement regulations.

Mr. WALDIE. That's the distinction?

Mr. TRESNOWSKI. That is.

Mr. WALDIE. And those are much more stringent than your personal regulations.

Mr. TRESNOWSKI. In the case of first-class travel, yes, they are.

Mr. WALDIE. For example, under those regulations, you cannot account for any liquor bill, can you, of any kind?

Mr. TRESNOWSKI. Entertainment costs are not allowable. But meeting costs are allowable.

Mr. WALDIE. But not liquor for the meeting.

Mr. TRESNOWSKI. Well, I am not sure.

Mr. WALDIE. I am told that by Government auditors.

If the Blue Cross/Blue Shield contract had incorporated in it the regulations that apply to medicare, you would of course be bound by the contract.

Mr. TRESNOWSKI. You mean the contract with the Civil Service Commission?

Mr. WALDIE. Yes.

Mr. TRESNOWSKI. If it is by contract; we would agree with that; yes.

Mr. WALDIE. Would you agree with that?

Mr. TRESNOWSKI. It has never been proposed to us.

Mr. WALDIE. Well, I am proposing it now. Would you agree to it?

Mr. TRESNOWSKI. Well, you are not the contract officer.

Mr. WALDIE. Unhappily, I am not. [Laughter.]

But would you object to such a proposal?

Mr. TRESNOWSKI. I really can't answer that question today. I must say that we have no objection to any constraints that are in accord with the purposes and practices—

Mr. WALDIE. Are the restraints that are connected with the medicare contract in accord with appropriate business practices?

Mr. TRESNOWSKI. Yes, they are, I think.

Mr. WALDIE. So you would have no objection to those restraints in this contract?

Mr. TRESNOWSKI. Well, you see, it depends. The Federal procurement regulation is subject to amendment at any time outside of the control—I mean—

Mr. WALDIE. I am not suggesting it be amended; I am suggesting it specifically be put in the contract.

Mr. TRESNOWSKI. Well, that is something we would have to take into account.

Mr. WALDIE. Is that why you traveled first class, Mr. Harvey, because there is no prohibition against traveling first class?

Mr. HARVEY. Are you referring to this specific trip?

Mr. WALDIE. Yes.

Mr. HARVEY. No. As I recall, Mr. Chairman, that trip was an extremely difficult trip to schedule, extremely difficult to get where I had to be to take part in these particular programs.

As a matter of fact, I believe I recall spending the best part of one night in one of these air waits, trying to make a connection to get to—

Mr. WALDIE. Well, then I assume the response is that this was unique. Normally you would travel by coach.

Mr. HARVEY. No. Normally, I personally travel first class.

Mr. WALDIE. You cannot travel first class when you are dealing with Medicare. Oh, you don't deal with medicare——

Mr. HARVEY. I do not deal with medicare.

Mr. WALDIE. Would you find it objectionable to be constrained from traveling first-class except in those cases when you can't travel coach?

Mr. HARVEY. Yes; it would be very uncomfortable for me. As a matter of fact, I think I should point out here that my practice, in keeping with the Blue Cross Association policy, is to reimburse the Blue Cross Association for the difference between coach and first-class travel rates in most instances.

Mr. WALDIE. I wasn't aware of that.

Mr. HARVEY. That happens to be my practice.

Mr. WALDIE. Was that done in this case?

Mr. HARVEY. Well, no; not in that case, because of the difficulty involved in the travel schedule.

Mr. WALDIE. What do you do, make a check back to them for that?

Mr. HARVEY. Yes. In some instances I make a check back to them, and in others, it is deducted from my salary.

Mr. WALDIE. Is that practice also for people who travel for Blue Cross/Blue Shield?

Mr. HARVEY. I have no idea, Mr. Waldie.

Mr. WALDIE. Why do you return it?

Mr. HARVEY. Because I am endeavoring to follow the policy statements of the Blue Cross Association with respect to air travel.

Mr. WALDIE. You don't consider FEP an exception to this policy statement?

Mr. HARVEY. No, sir.

Mr. WALDIE. Well, then I gather you would certainly have no objection to incorporation of the regulations from the other contract.

Mr. HARVEY. I don't believe I care to answer that question either at this point, Mr. Waldie. I think that deserves some very deep study by our staff, inasmuch as the Federal employee program is an underwritten contract which differs from the intermediary type contract.

Mr. WALDIE. Just one further thing to demonstrate the practice is not unique. This does not involve you, it involves Mr. Woodward, who made four trips from June to September of 1971, on regularly scheduled lines, all first class. I presume that that was virtually impossible in this case to——

Mr. HARVEY. I didn't get the name.

Mr. WALDIE. Mr. Woodward. You don't know who he is? His trips were charged to FEP.

Mr. RYAN. Is that right?

Mr. WALDIE. He went on two trips to Chicago for an FEP review. He went from Chicago to Seattle, Wash., two trips; FEP review—and from Chicago to Jacksonville. He must be from the Chicago office.

Mr. TRESNOWSKI. Yes. He is probably a member of the Chicago staff. The name is not familiar to me.

Mr. WALDIE. Do I gather that your contract with the Civil Service Commission allows that if a fellow out in San Francisco is traveling back here to Washington to meet with you on some problem involving FEP, he can travel first-class without the restraint?

Mr. HARVEY. He can travel in accordance with the travel policies of his own local plan.

Mr. WALDIE. And you have nothing to do with those?

Mr. HARVEY. That is right.

Mr. WALDIE. Now, if he is traveling under medicare business, can he travel under the policies of his local plan?

Mr. HARVEY. No.

Mr. TRESNOWSKI. No.

Mr. WALDIE. He has to abide by the governmental regulation relative to the plan?

Mr. TRESNOWSKI. That's correct.

Mr. WALDIE. OK. Let me just now go on to the entertainment question. Well, I think you have answered that. The question was: Why do you hold meetings in Washington hotels, with your headquarters at 1700 Pennsylvania and another one down at L'Enfant Plaza? Are there no facilities there that would permit you to hold your meetings there?

Mr. RYAN. The facilities are quite limited at our office if there is a meeting of more than seven or eight, or nine days.

Mr. WALDIE. The Hay-Adams Hotel is used when you have a large group.

Mr. RYAN. That and others, as I understand.

Mr. WALDIE. What do you mean "that and others"?

Mr. RYAN. It may not always be at the Hay-Adams Hotel.

Mr. WALDIE. Do these regulations have application to the FEP contract? Again, these are your Blue Cross Association regulations:

Business luncheons or dinners must involve situations in which business purposes cannot reasonably be met under any other circumstances.

The test is not with the business itself, but whether it is necessary to handle business at lunch or dinner rather than in the office.

The luncheons and dinners that you have are all related to a business purpose involving FEP.

Mr. RYAN. That is right.

Mr. WALDIE. What sort of business, for example? Can you give us an example or type that brings people across the country to Washington? It is a matter of discussing problems of the contract?

Mr. RYAN. Well, if we are talking about the meetings that were referred to, these are basically operating claims people who are coming in to a central location as much—for instruction in education and technical knowledge. The individual, an individual meeting, with a person would no doubt be under precise involvement with the plan of the Federal employee program.

Mr. WALDIE. Well, that person could meet there in the office.

Mr. RYAN. He would not be doing it with me, but I would feel—

Mr. WALDIE. Let me just go over one instance here. This is at the Marriott Hotel. A meeting that took place on October 8, 1970. Now, we have a bill from the Marriott Hotel that was billed: Activity, FEP operation, BCA-NABSP plan performance workshop. What is that?

Mr. RYAN. National Association of Blue Shield Plans and Blue Cross Associations both provide personnel or training and performance reviews; and I would presume that—in the course of their being involved in the various plans to go out and evaluate the performances and make suggestions, and so forth—there were educational programs held. We could ask Mr. Harvey to be more definite on it, but that would be my assumption at this point.

Mr. WAIDIE. I am sorry; I don't understand this and I don't want to plague you with my lack of understanding of it.

This one I guess breaks down in a manner in which I can understand.

The same advisory committee, BCA-NABSP actuarial advisory committee, that is the Hay-Adams, on June 2 and 3; 21 people were attending; 11 of those people have their costs attributable to Blue Cross/Blue Shield, FEP.

The luncheon for those 11 people was \$696.57; meals were \$390.05; entertainment was another amount. What would "entertainment" be at that luncheon meeting? Would that be liquor?

Mr. RYAN. It may have been hospitality. When we are talking about 11 people—when you get into lunches and so forth, and here again I am talking personally—you may well have had local staff, however, who were a part of that meeting. In fact, I would be quite sure they would be a part of that meeting. There might be a good number more than the 11 who came from out of town who might be staying at the hotel.

Mr. WALDIE. Would local staff stay at the hotel?

Mr. RYAN. No; I say I believe that while you may have had 11 people staying at the hotel, I believe that the meeting had somewhere near 20. So that the luncheons and things like that might well be on a different basis than the 11 who would be registered.

Mr. WALDIE. Well, according to this, all these costs are attributable to these 11 people.

Mr. TRESNOWSKI. No; that's not true, Mr. Chairman.

The charges that you have recorded there are charges that were recorded by the 11 people; but many of them were on behalf of the entire group.

Mr. WALDIE. But the entire bill, however it was computed was applied to the administrative cost of the FEP program.

Mr. TRESNOWSKI. It was the FEP actuarial advisory committee meeting; and the 11 people charged the costs that was assignable to 21 attendees.

Mr. WALDIE. All right; that may very well explain it. But GAO is not aware of that.

Mr. TRESNOWSKI. Well, yes; they were, because I went over that point with them when they explained this meeting to me and I asked them specifically that question because I knew you would ask it—that 11 people were charging that—and I said is that the impression in fact that the chairman will be given; and they said, no, they will tell him that it was 11 people charging expenses for a large group of people.

Mr. WALDIE. All right. That makes a lot more sense to me. I did not understand that and that is not explained to me; but that is what happened?

Mr. TRESNOWSKI. Yes.

Mr. WALDIE. As to these 11 people, they just signed the bill.

Mr. TRESNOWSKI. That's right.

Mr. WALDIE. OK. I have no further questions, gentlemen. Do you have any questions, Mr. Hillis?

Mr. HILLIS. No.

Mr. WALDIE. Gentlemen, we thank you for your comments.

Mr. RYAN. Thank you, Mr. Chairman.

Mr. WALDIE. The subcommittee is adjourned.

(Whereupon, at 11:30 a.m. the subcommittee adjourned.)

... I don't know what the ...

REVIEW OF FEDERAL EMPLOYEES' HEALTH BENEFITS PROGRAM

WEDNESDAY, SEPTEMBER 13, 1972

HOUSE OF REPRESENTATIVES,
COMMITTEE ON POST OFFICE AND CIVIL SERVICE,
SUBCOMMITTEE ON RETIREMENT, INSURANCE,
AND HEALTH BENEFITS,
Washington, D.C.

The subcommittee met at 9:30 a.m., pursuant to call, in room 210 Cannon House Office Building, Hon. Jerome R. Waldie (chairman of the subcommittee) presiding.

Mr. WALDIE. The subcommittee will come to order. Today we resume our long series of oversight hearings into the administration of the Federal Employees' Health Benefits program.

Our special area of inquiry today will be the "risk charge," now called "public service charge," which is being collected by two of the largest individual carriers of the FEP program, Blue Cross/Blue Shield and Aetna.

These two organizations account for nearly 80 percent of all individual enrollees of the FEP program.

Those of you who have followed the progress of these hearings are well aware of my personal skepticism of the amount of risk borne by the carriers.

I have termed the risk, or public service charge if you will, as being profit—pure and simple.

Given the generous reserves and operating expenses allowed the carriers by the Civil Service Commission, I have questioned the necessity of allowing the carriers to collect this largess in future contracts.

I was pleased to read the recent report of the General Accounting Office in which my criticisms of excess reserves and the risk charge allowances were substantially supported.

Today's witnesses include Mr. Herbert Faey, of the GAO's actuarial staff, and Mr. Daniel Pettengill of Aetna.

The subcommittee also extended an invitation to Blue Cross/Blue Shield to testify as to the "risk charge" and to respond to the contentions held by myself and others that the reserves allowed by the present Civil Service Commission contract are far in excess of the amount needed and do, in fact, constitute an unnecessary expense leading to premiums that are too high.

Blue Cross/Blue Shield has chosen not to participate in these hearings and has chosen not to respond to these questions.

Mr. Joseph Harvey, the Blues' spokesman for the FEP program, indicated to the subcommittee staff that he is too busy with the Civil Service Commission and that the negotiations are "too sensitive" for him to participate in these hearings.

It should be noted that his counterpart in the Civil Service Commission, Andy Ruddock, is not too busy to participate in Senate hearings this very morning.

I am concerned that Mr. Harvey either does not have the interest or the concern to answer questions that are in the very best interest of his consumers.

Before calling our first witness, I think that it would be very instructive to cite a few facts and figures to underline the huge financial stakes involved in these "risk charges" and "reserves":

By the end of this year, Blue Cross/Blue Shield will have received \$50 million in risk charges from the 12-year-old Federal employee program; the smaller Aetna program shall have received in excess of \$17 million in risk charges. Yet, when we asked the Civil Service Commission whether the Blues or Aetna have ever suffered any financial loss from the Federal program which was not subsequently recouped, the answer was an unequivocal "No."

Under these circumstances, to call the risk charge pure profit is perhaps an understatement. A risk charge paid out where no risk really exists is more like a gift.

Equally disturbing is the fact that neither we, nor anyone else but the carriers themselves, know where that \$67 million has gone.

Testimony from prior hearings suggest the possibility that at least one carrier (Blue Cross/Blue Shield) may be using the risk charge as an end run for expenses which are either disallowed by the Civil Service Commission, or which should be charged to administrative costs and the Civil Service Commission exercises no oversight function over their use.

But we intend to find out where the \$67 million paid out in risk charges for a nonexistent risk, have gone.

Finally, we come to the reserves which are maintained by the carriers and the Civil Service Commission to guard against possible losses to the insurers.

Here we find, in my view, an absolutely intolerable situation. In the midst of a wage-price freeze and control, most Federal employees have been paying sharply increased premiums. Those increases have in great part served to simply drive up those largely unnecessary reserves to near record heights.

It is projected that as of December 31, 1972, Blue Cross/Blue Shield will have a total of \$144.9 million available to it in reserves to guard against the day which will almost undoubtedly never come.

Meanwhile smaller Aetna, whose premiums did not increase during 1972, but who is projecting a \$22 million increase in reserves, has to content itself with a mere \$80.6 million in available reserves, which represents fully 39.7 percent of its annual premiums.

The Civil Service Commission has indicated in past testimony, that in regard to Blue Cross/Blue Shield it wished to abolish, or at least drastically reduce, its risk charge.

But, Blue Cross/Blue Shield has absolutely refused, and the Civil Service Commission maintains that it had little choice but to acquiesce.

Well, I think that it is time that the Federal employee and taxpayer had someone to push for him.

Perhaps Blue Cross/Blue Shield and Aetna thought that we would lay down after they euphemistically changed the name from "risk charge" to "service charge," and reduced their profit somewhat.

But we will continue.

We do not think that it is unreasonable to demand that a charge justified primarily by a nonexistent risk, and totaling more than \$67 million over 12 years should be dropped.

We certainly do not think that it is unreasonable to demand that at least a substantial proportion of the \$225.5 million held in reserve for Blue Cross/Blue Shield and Aetna should be used to offset and reduce the current high premiums which have produced those same unneeded levels of reserves.

It seems to us that the only people being "insured" now are the carriers who are ensured of a profit, come what may.

We would hope that the Federal employee soon starts to receive equal consideration.

Mr. Hillis, do you have any statement you would care to make?

Mr. HILLIS. No; not at this time.

Mr. WALDIE. Out first witness is Mr. Feay, from the General Accounting Office. Mr. Feay, would you come forward, please? We are glad to have you with us, again, Mr. Feay. Mr. Feay, we have in our hands the report dated May 22, 1972, from the General Accounting Office entitled, "Opportunities for Improving Administration of Government-wide Indemnity Benefit Plan of Health Insurance for Federal Employees and Annuitants."

Was this report made in the normal course of your office business or at the behest of some Member of Congress or committee?

STATEMENT OF HERBERT FEAY, ACTUARY, GENERAL ACCOUNTING OFFICE

Mr. FEAY. That was made in the normal course of business by the GAO. There was no special request by a member or a committee of the Congress.

Mr. WALDIE. Can you tell me what the results of that audit and of that report indicate to you relative to the extent of the risk charge and the reserves presently allowed Aetna? I presume this report only dealt with Aetna?

Mr. FEAY. That is correct.

Mr. WALDIE. Can you respond to that question?

Mr. FEAY. On the question of reserves, the conclusions which are on pages 44 and 45 were as follows:

We believe that the combined total of the Special Reserve of the Plan held by Aetna and the contingency reserve of the Plan held by the Commission has been higher than needed to protect against adverse change variations in benefit claims. We believe that combined contingency reserves equal to about five percent of annual subscription charges would be adequate to cover adverse chance variations, provided that subscription rates were established in such a manner as to give more specific consideration to the Plan's claims experience for various underwriting factors, such as—

Mr. WALDIE. Excuse me, Mr. Feay, I cannot find where you are reading.

Mr. FEAY. On pages 44 and 45.

Mr. WALDIE. I see.

Mr. FEAY (continuing). Different age, sex, and geographical groupings of its participants.

In our opinion, if the plan's premium rates were computed as stated above, the total premiums would be more closely related to the actual claims experience than they were in the past. Also this method of computation would enable appropriate determinations of the amounts of contingency reserves required to cover adverse chance variations in claims and would tend to minimize wide fluctuations in premium rates, such as the large increase which occurred in 1969, to cover prior operating losses.

Mr. WALDIE. Mr. Feay, when you state, "We believe that combined contingency reserves equal to about 5 percent of annual subscription charges would be adequate," are you combining contingency reserves as the FEP plan discusses them, those reserves held by the Civil Service Commission along with special reserves which are held by the carriers?

Mr. FEAY. Correct.

Mr. WALDIE. Are you including risk charges as reserves at all?

Mr. FEAY. No.

Mr. WALDIE. So, risk charges are out of the situation at the time you are speaking?

Mr. FEAY. The special reserve of Aetna came from the excess of income over disbursements. Since the risk charges are part of income, some of the special reserves could have come from these risk charges.

Mr. WALDIE. In your examination of Aetna, can you tell me how it came about that a special reserve was set up by the companies? The statute, as I read it, only required that a contingency reserve be set up. Is there anything in the law which requires a special reserve to be set up in the company, too?

Mr. FEAY. That was under the contract with the Commission which allowed them to set up a special reserve.

Mr. WALDIE. In their special contingency reserve?

Mr. FEAY. I was commenting on the special reserve of the Aetna.

Mr. WALDIE. What is the amount of the contingency reserve?

Mr. FEAY. The Civil Service Commission maintains a contingency reserve for the plan. As provided by law, the Commission annually adds to this reserve an amount equal to 4 percent of the premiums for the current year less expenses not exceeding 1 percent of those premiums.

Mr. WALDIE. Is there any maximum defined as to what that cumulative reserve in the contingency reserve is, accumulated in increments of 3 percent? What is the maximum percentage of premiums that that can attain?

Mr. FEAY. As far as I know there isn't any.

Mr. WALDIE. Do you have any range in fluctuations that indicates the experience of Aetna? What has that contingency reserve ranged from in percentage of premium? Has there been any figure that will give us some indication?

Mr. FEAY. Yes; our report contains figures for the contingency reserves expressed as percentages of the premiums for 1 year. I will look for them.

Mr. WALDIE. On page 42, that may have the answer.

From inception of the Plan in 1960 through December 31, 1971, the totals of the Commission's contingency reserve for the Plan and the Special Reserve held by Aetna (combined contingency reserves) at the end of each contract period ranged from a low of 6.2 percent to a high of 32.3 percent of the period's subscription charges.

That is not a specific answer. This figure deals with the combined reserve. I want the contingency reserve figure.

The high of 32.3 percent has now been exceeded under the projections for 1972?

Mr. FEAY. Yes.

Mr. WALDIE. That high will not be 39.7 percent; is that your understanding?

Mr. FEAY. My understanding is that the estimated contingency reserves for the end of 1972 will exceed 32.3 percent and could be as high as 39.7 percent figure you cite.

Mr. WALDIE. A more appropriate reading would be the combined range from a low of 6.2 to a high of 39.7.

Do you believe that the combined reserve, the contingency held by the Commission and the special reserve held by the carrier should not exceed 5 percent of the total subscription premium?

Mr. FEAY. This is correct for the Aetna plan with numbers of participants and the amounts of benefits now in force for that plan.

Mr. WALDIE. I am talking about Aetna. These figures only deal with Aetna?

Mr. FEAY. Yes.

Mr. WALDIE. There is a major discrepancy in your view of what the reserve should amount to and what the Commission and carriers' view is. Will you explain to me how you concluded that only 5 percent of subscription premium is necessary to keep the fund for the carrier in a substantially stable position?

Mr. FEAY. In the first place, I assumed that they would make an adequate and accurate study of their experience so that they could project the next year's claims costs accurately. We could make the projection by a hack saw method, but of course, you will have greater variations.

However, if you analyze the experience and use model projections as is done by systems analyses people you can greatly increase the accuracy of your projections.

Mr. WALDIE. Have you done that, Mr. Feay?

Mr. FEAY. We made a study to the best of our ability using the information available. We did not carry out detailed calculations as far as we would have like to have gone but these calculations are much more exact than those made to establish previous premium rates.

We believe that for the Aetna Plan we can predict the claims within this 5 percent.

Mr. WALDIE. Can you tell me the difference in millions that we are talking about, a 5 percent reserve versus using your figure, a 30.1 percent reserve which was the highest as of the date you wrote your report. What are the differences in millions that would be required for Aetna's plan? A 30.1 percent reserve totals \$57.8 million. What does a 5 percent reserve total?

Mr. FEAY. I have to look it up in the table of reserves. Mr. Collins, do you know where that figure is; how many millions are involved?

Mr. COLLINS. We would have to supply that.

Mr. TERRY. That would be \$10 million.

Mr. WALDIE. So the difference there, as of December 31, was \$47.8 million more in the Aetna plan than was necessary?

Mr. FEAY. On the basis of my studies, that is correct.

Mr. WALDIE. That figure is higher now because the combined reserve has increased to 39.7 percent?

Mr. FEAY. We have extensive calculations backing this up, using the theory of risk as we call it.

Mr. WALDIE. Would you explain the theory of risk? Is it a risk theory that is commonly accepted in practice?

Mr. FEAY. Yes, in fact the Society of Actuaries now has a publication issued at irregular intervals devoted exclusively to this subject. Risk theory is one of the subjects covered by the examinations of this society.

The study of risk theory has a long history. One of the early papers on the subject was submitted to the International Congress of Actuaries in about 1904. The initial studies of probability and risk theory actually started before 1900 in connection with gambling. The gamblers wanted to know their chance of gain if they loaded the decks in a certain way. An operator of a gambling location desired information on what were the probable variations in the variations from his operations from day to day.

Mr. WALDIE. I see in your report you recommended that which the Commission did. You recommended that the contingency reserves held in the Commission's hands be available on termination of the program to pick up any deficits that the carriers may have incurred.

Mr. FEAY. Let us make that clear. They do get it now. Whenever they have a deficit or the special reserve is below on amount developed by formula they get money from the Commission.

Mr. WALDIE. Wait a minute. Explain what they get.

Mr. FEAY. If the special reserve held by Aetna goes below 2 months, I believe.

Mr. WALDIE. It is 5 months, isn't it?

Mr. FEAY. This needs an explanation. The arrangements are that if the total of Aetna's liability for incurred but unpaid claims plus the Aetna's special reserve is less than the premiums for 5 months a payment can be obtained from the Commission. The Aetna's liability for unpaid claims is approximately equivalent to total premiums for 3 months. This leaves approximately 2 months premiums as the minimum amount of the Aetna's special reserve. The Aetna has received payments from the Commission's contingency reserve for each of the years of operation from 1965 through 1971.

Mr. WALDIE. The contract was amended, was it not, and did it not implement the elimination of the risk charge? Did you recommend the elimination of the risk charge?

Mr. FEAY. You have to look at our report here. One of the chapters in this report is on risk charges. On page 49 we have a discussion of risk charges. That is chapter 6. In the second paragraph on page 5, the statements is made " * * * we believe that no significant risk has been involved from adverse chance variations". I think this is an indication that risk charges could be eliminated.

Mr. WALDIE. Is that your recommendation?

Mr. FEAY. We recommended that the Commission reassess the reasonableness of amounts allowed Aetna and reinsurers for risk charges and insurers expense allowances.

Mr. WALDIE. Is it your opinion that the risk charge is no longer required?

Mr. FEAY. I can read you another man's opinion on the Blue Cross. "We believe that the 1 percent (risk charge) should be eliminated or sharply reduced." "We would suggest a smaller goal for the special reserve for the service benefit plan." "A reserve of 2 to 3 percent would seem sufficient as their goal."

Mr. WALDIE. Who said that?

Mr. FEAY. That was in a report by the Wyatt Co. dated August 20, 1971.

Mr. WALDIE. On page 56 of this report you say, in the second paragraph from the bottom of the page, "In our opinion, the Commission's actions in reducing the risk charge (service charge) allowances under the plan do not fully satisfy the objectives of our recommendation." Who did you mean by that?

Mr. FEAY. I am explaining that.

Mr. WALDIE. What would have fully satisfied the objectives of your recommendation?

Mr. FEAY. My original recommendation?

Mr. WALDIE. Whatever recommendation you have made reference to, Mr. Feay.

Mr. FEAY. We recommended that to the Commission in its negotiations for a future contract period.

Mr. WALDIE. Can you explain again to me what the objectives of your recommendations were that would have been satisfied had the Commission acted in accordance with those objectives? What should the Commission have done?

Mr. FEAY. They should have made a study similar to the one that I made.

Mr. WALDIE. It is your belief that that study would have proved what?

Mr. FEAY. That with a surplus of 5 percent or higher there was no significant risk.

Mr. WALDIE. It is your belief that such a survey would indicate that to be the case?

Mr. FEAY. Yes.

Mr. WALDIE. Why did the Civil Service Commission reject that recommendation of conducting such a survey, do you know?

Mr. FEAY. I understand that they have not yet made the study necessary to establish what the risk charges should be.

Mr. WALDIE. I know they have not but do you know why they have not? Did they respond to these recommendations?

Mr. FEAY. We discussed it with an actuary over at Civil Service. He was asked what studies they had made to determine the limits that should be put on contingency reserves.

His reply was that they hadn't made any studies; that they assumed since the Aetna could always call on the Commission for extra reserves or extra money; that it really didn't need to be made.

Mr. WALDIE. That was their response to your recommendation?

Mr. FEAY. That was their response to my inquiry on the telephone as to what studies they had made to determine the limits on surplus.

Mr. WALDIE. I understand that GAO has never done studies to determine what proper reserve requirements should be.

Mr. FEAY. Do you mean for the Aetna?

Mr. WALDIE. I mean the Civil Service Commission.

Mr. FEAY. That is my understanding. However, now I think they are making a study. They have come over to us and we have helped them to start.

Mr. WALDIE. The study now under process is to determine what the extent of the reserves should be?

Mr. FEAY. That I would not know. They wanted to know what we had done.

Mr. WALDIE. In terms of reserve studies?

Mr. FEAY. And risk charge studies.

Mr. WALDIE. Do you have any idea how they established the total rate without having done a study?

Mr. FEAY. I think they used their opinions.

Mr. WALDIE. Whose opinions?

Mr. FEAY. Their own and those of the insurance companies.

Mr. WALDIE. What is your personal opinion as to whose opinion carried the most weight?

Mr. FEAY. I would not know. I just came into this picture 3 years ago.

Mr. WALDIE. To summarize your report, it is my understanding that you believe that reserves are widely excessive and that 5 percent ought to be the top provided for the carriers.

Mr. FEAY. Provided they determine their premiums by proper procedures.

Mr. WALDIE. Your belief is that 5 percent is all that is required for the Aetna plan and your further opinion is that the risk charge is no longer necessary at all?

Mr. FEAY. It is insignificant. I might give them \$10 a year for it.

Mr. WALDIE. But you feel that beyond that it is not necessary.

Mr. Hillis?

Mr. HILLIS. Thank you, Mr. Chairman. Mr. Feay, I found your testimony here and your statement to be very enlightening. I know this is certainly a complex and a complicated field.

However, as I understand it as a new member of the committee, the risk charge is completely separate from the special contingency and the other reserves; is that correct?

Mr. FEAY. No. We have attempted to explain the relationship on pages 42 and 43 of our report.

Mr. HILLIS. The risk charge is then based on risk, if there were such a risk; is that correct?

Mr. FEAY. That is right.

Mr. HILLIS. I also see a reference in your report to page 57, to reinsurance and reinsurers. This is a common practice in the insurance industry, is it not, to reinsure a risk?

Mr. FEAY. Not as it is done in the Aetna case.

Mr. HILLIS. Doesn't this further spread any risk, if there is a risk?

Mr. FEAY. Yes, the risk, which is insignificant, is divided among approximately 120 companies.

Mr. HILLIS. Is it a fair statement that this payment of risk in addition to the administrative costs is legally—as the chairman contends it is—more likely a profit if there is no risk?

Mr. FEAY. My answer is yes, because the risk charges distributed to reinsurers or added to their surplus earnings.

Mr. HILLIS. Referring to page 49, do you have that?

Mr. FEAY. Yes.

Mr. HILLIS. At the bottom of the first paragraph, I want to read this into the record:

The contract provided also for payments to certain reinsurers of additional allowances to compensate for Federal income taxes payable by these reinsurers on their risk charge allowances.

What does that mean?

Mr. FEAY. Certain casualty companies pay a Federal income tax based on their premium income. Each of these reinsurers secures an extra payment from Aetna equal to the amount of Federal income tax assigned by the reinsurer to the Federal group health insurance.

Mr. HILLIS. Does this mean we are reimbursing these companies for their Federal income tax?

Mr. FEAY. That is correct.

Mr. HILLIS. That is very interesting.

Mr. FEAY. As I understand the situation, each reinsurer assigns a portion of his total income tax to the Government health plan but that its total income taxes are based on the total business of the company.

Mr. WALDIE. Do I gather what you are saying is that the contribution to the carrier that is reinsuring for repayment of its income taxes includes taxes that he has paid for all his business?

Mr. FEAY. The total income tax is paid on total business and a portion of the total tax is assigned to the Government health plan. The larger the total tax of the reinsurer, the larger is the assignment to the Government plan by the insurer.

Mr. WALDIE. So that in this respect we are picking up on a portion of the burden?

Mr. FEAY. If a reinsurer made more profit on other business than on the reinsurance of the Government plan, the Government plan is sharing in the tax paid on more profitable business.

Mr. WALDIE. I suppose we pick up the losses by not paying, don't we?

Mr. FEAY. If there is a loss on total business, but a profit on the Government plan reinsurance, the Government plan is not charged for an income tax.

Mr. WALDIE. Should they be paying anything to these people if there is no risk to reinsure? According to your testimony there is no risk here. I don't know if that is so. We will ask Aetna to explain their view on this.

You tell me there is no risk worth more than \$10 a year. Why should we pay them as reinsurance companies to spread a risk that is nonexistent?

Mr. FEAY. That was the policy adopted by Congress when the law was enacted. The desire was to give some of the risk to each of the companies.

Mr. WALDIE. Your view of it is that it is not necessary, in fact, to share the risk. It is a matter of sharing the pie among all the carriers Congress can find?

Mr. FEAY. I would rather trust the Aetna with the entire contract because the risk for the case does not justify reinsurance.

Mr. WALDIE. Mr. Hillis?

Mr. HILLIS. No questions.

Mr. WALDIE. Mr. Hogan?

Mr. HOGAN. I have no questions.

Mr. WALDIE. Mr. Pettengill is our next witness. He is the vice president of the Group Division of Aetna Life & Casualty. Will you come forward, Mr. Pettengill, and introduce the gentleman accompanying you?

STATEMENT OF DANIEL W. PETTENGILL, VICE PRESIDENT, GROUP DIVISION OF AETNA LIFE & CASUALTY

Mr. PETTENGILL. Mr. Chairman and members of the subcommittee, as you have indicated my name is Daniel W. Pettengill, vice president of the Group Division of Aetna Life & Casualty, the insurer that administers the Governmentwide indemnity benefit plan on behalf of the health insurance companies of the United States.

I am accompanied on my left by Mr. Malcolm McIntyre, the Washington coordinator of the program, and on my right by Mr. Willard P. Yeats, counsel, Aetna Life & Casualty.

Mr. WALDIE. May I interrupt you, Mr. Pettengill? May I start off with a question while the subject is fresh in our minds? Will you tell me what the cost of reinsuring the risk that Aetna assumes in its contract with the Federal Government on the Federal employees' health program is? What is the cost of reinsuring if you were to bear that risk entirely on your own? How much would be saved in terms of the premium costs?

Mr. PETTENGILL. I am sorry, I have not examined that figure in recent years. However, on the basis of general experience I would say it is probably between ten one-hundredths and fifteen one-hundredths percent of the premium.

Mr. WALDIE. I have a figure here and your percentages seem quite accurate. The total that has been paid as reinsurers expense allowances over an 11-year period is about \$2,700,000. I think that would come pretty close to your percentage.

Mr. PETTENGILL. Correct.

Mr. WALDIE. According to Mr. Feay, if we can pursue this further, there is really no risk that requires reinsurance but that Congress has mandated it. Would you comment on that inclusion?

Mr. PETTENGILL. I think it would have been helpful had I read my statement.

Mr. WALDIE. If you would prefer, you may read your statement and then comment on it when you conclude your statement.

Mr. PETTENGILL. My purpose this morning is to respond to your inquiry concerning the risk charge under the Governmentwide indemnity benefit plan.

First, we would like to point out that the term "risk charge" normally refers to the theoretical amount of money required by an insurance company to cover the following two areas: (a) The risk of loss on the carrier's block of business as a whole, and (b) the amount the carrier desires to add to its surplus by reason of the services it will have provided.

These two theoretical amounts are usually lumped together for accounting purposes because of the fact that the theoretical charges for the risk of loss seldom precisely equals the losses suffered, and, to the extent possible, the difference is made up out of the theoretical contributions to surplus that were collected for a particular year.

The second point we would make is that the risk charges that have been made under the Governmentwide indemnity benefit plan have been reasonable in our judgment. During 6 of the first 11 policy years, the risk charge was 1.3 percent of premiums and during the other 5 it was 1 percent.

Commencing with the current policy year, the plan has been amended to provide for access to the Commission's contingency reserve, not only while the contract is in force but also in the event that the contract is canceled. This amendment substantially reduces the element of risk under this plan as long as the Commission holds a significant contingency reserve, such as it now does. Accordingly, we have dropped the use of the term "risk charge" and have substituted for it the term "service charge," which connotes the fact that most of this charge represents the desired contribution to surplus for services rendered. The amount of the service charge for this 12th policy year is a flat \$1,300,000 regardless of the size of the premium. Inasmuch as we expect the premium for the year to aggregate about \$200 million, it is evident that the expected contribution to surplus will be approximately 0.65 percent of premiums.

We shall be glad to answer any questions with respect to the risk charges made under the "Governmentwide Indemnity Benefit Plan."

Getting back to your questions I think this indicates that in the early years of this contract there was a substantial risk. In more recent years that risk has, admittedly, become primarily the risk of loss upon cancellation.

Now that we have an amendment which permits us to draw on the reserve in the event of cancellation, I certainly concur with Mr. Feay that the risk under this plan is quite nominal. The risk could arise again if the Civil Service Commission were to divest itself of its contingency reserve.

Mr. WALDIE. You list two purposes to which the theoretical amounts of money required by insurance companies could follow two areas.

The second area is the amount the carrier desires to add to its surplus by reason of the services it will have provided. Is that profit we are talking about there?

Mr. PETTENGILL. Precisely.

Mr. WALDIE. Is this the only profit available to you?

Mr. PETTENGILL. Absolutely the only profit.

Mr. WALDIE. Everything else is at cost, so that you are making no more than 1 percent profit?

Mr. PETTENGILL. That is precisely correct.

Mr. WALDIE. That is not much profit, is it?

Mr. PETTENGILL. It certainly is not.

Mr. WALDIE. Is that a similar amount of profit to the one made on your private policies?

Mr. PETTENGILL. No, it is less. Under our normal business we intend to make somewhere between 1.5 and 2 percent on our health insurance premiums.

Mr. WALDIE. In this, you are making what?

Mr. PETTENGILL. As of the current year, it will be 0.65 of 1 percent.

Mr. WALDIE. That seems to me to be a very reasonable profit.

Mr. PETTENGILL. I think so, sir.

Mr. WALDIE. I am puzzled as to how a similar profit can be given to a nonprofit organization such as the Blues.

Mr. PETTENGILL. That is not my problem, sir.

Mr. WALDIE. No, it is mine and the Congress and the taxpayers'. In your experience in the health field, I presume you would be willing to comment as to why a nonprofit organization ought to receive this profit?

Mr. PETTENGILL. I would say—because I hold no malice toward the plan—that I do not see how any concern, be it for profit or not for profit, will long survive unless it has a means of making additions to its surplus.

I firmly believe that if I were operating the Blue Cross/Blue Shield plan, I would demand a contribution to surplus as a condition to underwriting the contract.

Mr. WALDIE. Is it your view that what you do with that contribution is nobody's business but your own and the income tax people?

Mr. PETTENGILL. That is correct.

Mr. WALDIE. It is not your view that it is any business of the Civil Service Commission?

Mr. PETTENGILL. Correct.

Mr. WALDIE. When it is called a public service charge that is a euphemistic charge because we are not permitted to know that.

Mr. PETTENGILL. I would point out that it is called a service charge and not a public service charge.

Mr. WALDIE. I was not aware of that. It really should be called a profit, should it not?

Mr. PETTENGILL. I have no objection to your calling it that.

Mr. WALDIE. In the Blue Cross/Blue Shield plan it is called a public service charge but it is not the same in your contract?

I guess it serves no purpose. It might serve a purpose since the contract has been changed.

You seem to imply that prior to the Civil Service Commission giving you the right to draw on the contingency reserve there was a considerable risk.

That leads me to another subject. Apparently this comes prior to that change in contract. Most of it went to the first part of your two-part description of how that money was spent. It was the risk of loss of the carriers business as well?

Mr. PETTENGILL. Correct. I believe that the present amount which we are asking was roughly what was intended in the prior years.

Mr. WALDIE. In prior years you were getting 1 percent of premiums. Now, you are getting what for premiums?

Mr. PETTENGILL. 0.65 percent, it equates to approximately 0.65 percent.

Mr. WALDIE. How much of that in prior years was attributable to the risk of loss?

Mr. PETTENGILL. I would say that in most of the years when we had a 1 percent risk charge, the part (a), in the statement was approximately 0.3 percent and the contribution to surplus was 0.7 percent.

Mr. WALDIE. Now you are getting a contribution to surplus of 0.65 percent and there is no risk at all?

Mr. PETTENGILL. Very nominal.

Mr. WALDIE. It is a \$10-a-year risk. I guess you will agree with Mr. Feay on that?

Mr. PETTENGILL. Correct.

Mr. WALDIE. In fact you are telling me that you have taken a reduction in profit as a result of that change in contract. You used to get 0.7 percent profit. Now you get 0.65 percent.

Mr. PETTENGILL. When the contract was originally negotiated, sir, the premiums were \$75 million. Now, they are \$200 million.

In my judgment that increase would call for a slight reduction in the rate of profit.

Mr. WALDIE. The dollar figure is so much higher?

Mr. PETTENGILL. Correct.

Mr. WALDIE. How did we determine when we can get you to concede an even smaller figure of profit? What figure would we have to arrive at before you could drop back to a smaller figure?

Mr. PETTENGILL. I did not bring our formulas with us but I can assure you that it would not drop appreciably even if you doubled the premium.

Mr. WALDIE. Will you address yourself to the extent of your reserves? You will have at the end of the year 39.7 percent of subscription premiums held in reserves contingency. Is that excessive?

Mr. PETTENGILL. First of all, sir, we have not reached the end of the year.

Mr. WALDIE. Project it. That is what you project, is it not?

Mr. PETTENGILL. I doubt that is what you project.

Mr. WALDIE. That is what the Civil Service Commission projects.

Mr. PETTENGILL. I am not quarreling. We will have a substantial reserve at the end of the year.

Mr. WALDIE. Then the lines are drawn. Is the reserve excessive?

Mr. PETTENGILL. If we were to continue to hold it, I would agree with you but we are proposing to make a number of improvements in benefits for the 1973 contract year. Therefore, I believe that there would be some reduction in this figure.

Mr. WALDIE. What is your projection in the reduction in the reserves at the end of 1973?

Mr. PETTENGILL. I think our feeling is that these reserves would be in the neighborhood of 30 percent. We would then plan on a further reduction in 1974 which would bring them to about 25 percent.

Mr. WALDIE. You think 25 percent is a reasonable figure?

Mr. PETTENGILL. Correct.

Mr. WALDIE. There are two ways to bring this down. You could increase benefits or you could return premiums, is that right?

Mr. PETTENGILL. It is difficult to return a premium. We could reduce it for the next year.

Mr. WALDIE. Has any consideration been given to that probability?

Mr. PETTENGILL. Yes, we have had discussions with the Commission on this. In view of the benefit changes which we propose to make this seems like a better method or procedure.

Mr. WALDIE. Has your contract been executed?

Mr. PETTENGILL. No, sir.

Mr. WALDIE. You are not asking for an increase by the way of risk charge, are you?

Mr. PETTENGILL. That is correct.

Mr. WALDIE. Is the Civil Service Commission proposing a reduction?

Mr. PETTENGILL. This was discussed at considerable length and the tentative agreement is that it would remain unchanged.

Mr. WALDIE. You are proposing an increase in benefits which will reduce your reserve from 40 percent to 30 percent. Then, another year, you will reduce it to what it should be, 25 percent? How long has it been over 25 percent?

Mr. PETTENGILL. The very first year it got over 25 percent, I believe; this is the first time it has ever been over 25 percent.

Mr. WALDIE. In 1971 I am advised it was over 30 percent.

Mr. PETTENGILL. I beg your pardon. In other words, 1971, as that year concluded, was the first year it went over 25 percent. It will again be over at the end of 1972.

Mr. WALDIE. In 1971, what did you propose as a means of reducing this?

Mr. PETTENGILL. We proposed some changes in the 1972 contract. The Civil Service Commission approved them and then we had the price-wage freeze and the Civil Service Commission simply said there would be no changes.

Mr. WALDIE. Also, you did not require a reduction in premiums?

Mr. PETTENGILL. That is correct.

Mr. WALDIE. Did you propose a reduction in premium to reduce the reserves?

Mr. PETTENGILL. I think you should be aware, sir, that we are obligated to propose our benefit changes to the Civil Service Commission in April of the year preceding the contract year and to come up with contract rates in June of the year preceding. You will recall that both of those dates were prior to the President's control over which I did not have any control or knowledge whatsoever.

Mr. WALDIE. Any knowledge of what?

Mr. PETTENGILL. That there was going to be a system of national controls.

Mr. WALDIE. Why did they reject your benefit increases?

Mr. PETTENGILL. This was done at the last minute.

Mr. WALDIE. At the last minute could they not have accepted the fact that you have had too much surplus?

Mr. PETTENGILL. At that point in time, we had no knowledge.

Mr. WALDIE. You had enough knowledge to propose an increase in benefits.

Mr. PETTENGILL. Excuse me, sir. Virtually all of this large increase in the special reserve which occurred in 1971 occurred in the last 3 months of the year as a result of the wage-price increase.

Mr. WALDIE. Did you not propose a plan to reduce?

Mr. PETTENGILL. We had proposed some increase in benefits.

Mr. WALDIE. To reduce reserves?

Mr. PETTENGILL. We believed there was going to be a margin in this year, yes, but that it was going to be relatively moderate.

Mr. WALDIE. The Commission rejected it because of the wage-price freeze?

Mr. PETTENGILL. Yes.

Mr. WALDIE. Did they reduce the premiums?

Mr. PETTENGILL. Neither they nor we had any idea of what would happen. I believe that is why they did not request the reduction.

Mr. WALDIE. What did happen was that the people who have to pay the premiums had to pay 15 percent higher.

Your reserve should have been 25 percent. As a result they were 40 percent. That is a fair description; is it not?

Mr. PETTENGILL. It is very difficult, sir, to anticipate these things in advance.

Mr. WALDIE. It always seems strange to me that all decisions on reserves are in favor of the carrier. I am not criticizing you. My criticism is directed at the Civil Service Commission.

Mr. PETTENGILL. The Civil Service Commission was charged with running this program on a sound basis. If they had wild fluctuations in the rates they had to charge to the Federal employees of the Government, I think they would be chastised for that also.

Mr. WALDIE. If the fluctuations were downward I doubt that you would have been criticized. You did not seek an increase last year and I commend you for that. However, your competitor did and he was granted it.

Tell me why you arrived at 25 percent as a reserve that is necessary for stability?

Mr. PETTENGILL. I have been in group health insurance for over 25 years. On the basis of my experience 25 percent of the year's premium is essential if you are going to say that there is essentially no risk for a case of this size.

Mr. WALDIE. Is that what you have for your other programs?

Mr. PETTENGILL. Correct.

Mr. WALDIE. They are required to have a 25-percent reserve?

Mr. PETTENGILL. In a good many instances, sir, there is no buildup under those cases but we endeavor to get 25 percent.

Mr. WALDIE. Do you get it?

Mr. PETTENGILL. In some cases, yes.

Mr. WALDIE. In most cases do you get it?

Mr. PETTENGILL. I would point out to you that New York State recognizes the desirability of building to a 50-percent reserve. We are encouraged to set aside 2 percent a year to build a 50-percent contingency reserve. This is recognized by the Internal Revenue Service for income tax purposes.

Mr. WALDIE. In the majority of your other plans, do you require and do you maintain a 25-percent reserve?

Mr. PETTENGILL. What we do is to offer the policyholder a choice as to whether he will build that special reserve at which time his risk charge will be reduced. If he elects not to, we maintain a higher risk charge.

Mr. WALDIE. Has your risk charge ever exceeded 3 percent?

Mr. PETTENGILL. In some instances.

Mr. WALDIE. Do they not then have a reserve of 25 percent?

Mr. PETTENGILL. They do not.

Mr. WALDIE. For example, what is your largest contract other than your Federal contract? With what business is that?

Mr. PETTENGILL. I don't recall at this time. We have International Harvester and we have Chrysler.

Mr. WALDIE. Let us take Chrysler, what is their risk charge?

Mr. PETTENGILL. I am sorry, I don't know.

Mr. WALDIE. Do any of these big ones have a 2-percent risk charge?

Mr. PETTENGILL. I doubt it because most of them accept the idea of having a special reserve.

Mr. WALDIE. Do they have a 25-percent special reserve?

Mr. PETTENGILL. I am not familiar with that.

Mr. WALDIE. You will provide the committee with the answer to this question. Please tell me the risk charge for Chrysler, Boeing, and International Harvester?

Mr. PETTENGILL. Sir, I am sorry, that information is confidential. If you would care to send your counsel to Hartford, perhaps that would be helpful.

Our risk charge is the only competitive weapon we have. That is, it is the only weapon we have to compete with.

Our offer to have your counsel come to Hartford stands, sir.

Mr. WALDIE. Do I understand that that offer is contingent on this committee's not revealing what those figures are?

Mr. PETTENGILL. That is correct.

Mr. WALDIE. We cannot accept that offer. I do not understand that. I guess we are not competitive. When you are dealing with the Government you are not competing with anybody except Blue Cross/Blue Shield and you are not really competing with them.

Mr. PETTENGILL. In all of our other private contracts there is no statement in advance as to what the charge will be.

Mr. WALDIE. It is negotiated, isn't it?

Mr. PETTENGILL. No, it is set by us.

Mr. WALDIE. You cannot tell us whether you have offered the Federal employees an equal deal to these other purchasers?

Mr. PETTENGILL. We have been extremely careful to be fair to the Federal Government.

Mr. WALDIE. Is our deal an equal or a better deal?

Mr. PETTENGILL. As far as I am concerned, it is a better deal.

Mr. WALDIE. We will seek to find out that information to find out if your testimony is correct. However, we will not do it via the way that you have suggested because I think the public is entitled to know whether or not this essential point, which the committee seeks to get straight, is true or not, that the Civil Service Commission does not legally negotiate, they ratify.

I cannot come to that conclusion totally, although, I am pretty near to that conclusion as to how well we fare when you are dealing with the private sector of the economy versus the taxpayer and the Federal employee.

In your private contracts, are there provisions that in the event you have a loss in 1 year the next year the premium is automatically increased to cover that loss?

Mr. PETTENGILL. The contracts are for 1 year.

Mr. WALDIE. There is no provision covering it?

Mr. PETTENGILL. The answer to your question is "No."

Mr. WALDIE. But there is in our contract, why is that? Our contract is for 1 year but there is a provision saying that if you lose money you automatically get an increase in premium the next year.

Mr. PETTENGILL. There has been no provision to that effect until this year.

Mr. WALDIE. There is in this year's contract?

Mr. PETTENGILL. That is correct.

Mr. WALDIE. But not in any of your other contracts?

Mr. PETTENGILL. That is correct.

Mr. WALDIE. It is your testimony that this is the first time that it has ever been in your contract?

Mr. PETTENGILL. Correct, sir.

Mr. WALDIE. But the practice has been that you do receive an increase in premium automatically to recover any losses from the previous year?

Mr. PETTENGILL. We have had a transfer from the Civil Service Commission's contingency reserve to our reserve and that transfer has been exempt from the risk charge.

Mr. WALDIE. That is not the question I asked. When you incur a loss in a year, is it not true that your loss is immediately covered in the next year by an increase in premium?

Mr. PETTENGILL. Only if we are successful in negotiating.

Mr. WALDIE. Have you ever been unsuccessful in negotiating in the 11 years of this contract?

Mr. PETTENGILL. No, sir.

Mr. WALDIE. So I suggest that you have an increase to cover that, is that a fair statement?

Mr. PETTENGILL. I believe the reason for that is that our losses have been held to a modest level and they are reasonable to permit us to recover in the next year.

Mr. WALDIE. If you have always been able to recover in the next year, it is fair to say there has never been any risk in this contract, isn't it?

Mr. PETTENGILL. You are overlooking, sir; that this contract is participating in our total business. We are, as I said in my testimony, endeavoring to extricate a charge which is both related to the risk of the case and related to the fact that we must accumulate enough risk charges on our business to compensate for the losses we sustain on some cases.

Mr. WALDIE. If you have a contract provision that said if you lose money in 1 year your premium is automatically increased in the next year, why are you required to hold 25-percent reserves?

Mr. PETTENGILL. The 25-percent reserve rate, sir; is the figure we agreed which would reduce the element of risk to virtually zero.

Mr. WALDIE. There is no element of risk if you have an automatic increase to recoup your loss?

Mr. PETTENGILL. Yes, sir.

Mr. WALDIE. What is it?

Mr. PETTENGILL. The contract could be terminated.

Mr. WALDIE. If it is terminated you get an automatic increase.

Mr. PETTENGILL. For the first time.

Mr. WALDIE. But that is what the situation is now. Does that merit a 25-percent reserve given those risks as we have defined them in your contract?

Mr. PETTENGILL. Between the Civil Service Commission and ourselves there should be a 25-percent reserve. Who holds it is a relatively academic matter.

Mr. WALDIE. I am interested in who is paying it and that is the Federal Government and the Federal employees. Why should they be paying a premium to pay a 25-percent reserve that permits you to have an increase in premium in any year in which you have had a loss. What then is the risk?

Mr. PETTENGILL. If we were to lose this contract and there was no reserve.

Mr. WALDIE. I am not saying no reserve.

Mr. PETTENGILL. If there is no increased premium for the next year, how do we recoup the loss?

Mr. WALDIE. If we put a phrase in the contract which would provide that on termination the loss would be paid by the Government, would you need any reserve at all?

Mr. PETTENGILL. No, sir; provided the Government has the funds to do so.

Mr. WALDIE. Neither would you need any risk charges, right?

Mr. PETTENGILL. Correct.

Mr. WALDIE. Would you continue to do business with the Federal Government?

Mr. PETTENGILL. Probably.

Mr. WALDIE. Would .65 be reasonable?

Mr. PETTENGILL. For the present level of the premium.

Mr. WALDIE. Mr. Hillis?

Mr. HILLIS. Thank you, Mr. Chairman.

I want to begin by congratulating you on the fact that there was no premium increase this last year. What is the size of your organization in the health field, in the industry of health field?

Mr. PETTENGILL. We are the largest underwriter of health insurance in the United States and, I believe, in the world.

Mr. HILLIS. Are you larger than Blue Cross/Blue Shield?

Mr. PETTENGILL. We are larger than any one of them. If you aggregate all of them, they are larger.

Mr. HILLIS. What is your administrative cost percentage?

Mr. PETTENGILL. I believe 2.6 at minimum.

Mr. HILLIS. That seems, I think, very good and reasonable. I noticed in referring to the report that Mr. Feay was going over earlier, that in the period from July 1, 1960 up to April 16, 1972, it has had substantial increases in premiums.

The high-self only began at \$3.12 and in 1971 it was \$200. The high-self and family was a 201-percent increase. I guess this normally reflects the costs of health care over the period, does it not?

Mr. PETTENGILL. As the report points out, a substantial portion of that increase has been due to benefit liberalizations. On the other hand, you are perfectly correct that health care costs have doubled in that period of time.

Mr. HILLIS. Does your organization, as the largest health care provider in the industry today, try to hold down health care costs? Do you have any studies? What programs do you have, sir?

Mr. PETTENGILL. We have a number of programs, sir. First of all, we participate in the local comprehensive health planning agencies, set up under Public Law 89-749.

Our company contributes to the budgets of those agencies. In addition our people serve on their boards. Second, we are active in working with medical societies. We try to get the physicians and dentists to do a more effective job of policing their own work so that services are really necessary and charges are reasonable.

In this regard we do maintain an extensive computer system of profiles so that we don't have to rely on the physician's word for it. In most instances we have got our own facts.

You may have noticed that we are having difficulties with some of the physicians because we do have our own facts. Our claims organization is, we think, one of the largest. It operates on a regionalized basis so that we have the advantage of local knowledge to the maximum extent possible. We think we are doing a reasonably effective job. However, we have no authority to walk in and say to a hospital, you cannot spend this money.

Mr. HILLIS. I want to change and go in a little different direction here in the line of questioning.

With my first exposure in this committee, this last year, there was a lot of talk about what would happen when the open season came, whether there would be a substantial switch between a company who has raised a premium to 34 percent.

Have you made any study of what did occur in the past open season, the most recent one in this regard?

Mr. PETTENGILL. We did come out with a plus instead of a minus for the first time in several years. I must confess it would have made me happier if the plus had been larger than it was.

In the past month we have received permission from the Civil Service Commission to do a study with respect to the reasons why enrollees transferred from our plan to other plans. I hope that by this time next year we will have information that will be advantageous to both of us.

Mr. HILLIS. Can you comment briefly also on this apparent practice under the contract of reimbursement of, or allowance for Federal income tax paid; why is this necessary?

Mr. PETTENGILL. It is not necessary. It was considered desirable because at the time this law was enacted, Congress apparently in its wisdom desired that the business be spread as widely as possible. It, therefore, made it mandatory that the Aetna cede insurance to any licensed company who requested same. In discussing with the Civil Service Commission what would happen with respect to the risk

charge for a casualty company which is subject to a different income tax law than is a life company, we pointed out that the casualty companies felt they would be discriminated against because, although they would receive the same gross percent, their net risk charge would be less because of the difference in the tax.

The Civil Service Commission, therefore, agreed to this paying of the portion of the income tax that resulted from their receipt of the risk charge.

Mr. HILLIS. I want to deal with another area of taxation here in concluding my questions. Again, in going over the report I was interested in finding out about premium taxes that your company and other companies for profit are required to pay in various States.

The report shows that from 1960 through 1971 the cost of these previous taxes was some \$32 million. Again, this cost is tacked on or recovered through subscription charges, is that correct?

Mr. PETTENGILL. Correct.

Mr. HILLIS. There is pending in this committee H.R. 21, a bill introduced by Chairman Dulski, which would exempt life and health programs from State taxes, would you comment on that?

Mr. PETTENGILL. As I believe I testified, we certainly would support such a program.

Mr. HILLIS. Would this permit a lowering or a reduction of premiums to Federal employees?

Mr. PETTENGILL. Yes, the entire reduction would be passed on to the Government.

Mr. HILLIS. Not just as a greater profit to the company?

Mr. PETTENGILL. No, the only profit we have is from the service charge.

Mr. HILLIS. Thank you, that is all.

Mr. WALDIE. Mr. Hogan?

Mr. HOGAN. I would like to ask a totally different question to start with. I am sure you are aware that this subcommittee worked on and passed a bill which would increase the share of the premium paid by the Federal Government under the Federal employee's contract.

As you also know, this is tied up now in conference. However, just as a matter of curiosity, since most of the members of the committee feel that the Government ought to pay a larger share—my own personal view is that the Government ought to pay 100 percent of the total—can you tell us what a big company such as Boeing, Harvester, or Chrysler pays? What percentage of premium they pay for their employees?

Mr. PETTENGILL. It depends on their labor agreement. I would say that most of the larger employers pay the entire cost of employee coverage, and anywhere from 50 to 100 percent of the dependents' coverage.

Mr. HOGAN. That is interesting to the members of this committee because we have faced some reluctance on the part of the Federal Government to assume more of that burden.

I am very grateful for your comments on that, now, back to the subject matter of this hearing. You indicated in your testimony that because of the increased volume that you have done, there has been a slight reduction in your costs and that you are able to improve the benefits because of the increased volume.

Every time we have a hearing with the Civil Service Commission on this subject, I always bring up one of my pet subjects and that is, if the Civil Service Commission amassed all of the premiums of Government employees and said to competing carriers, "Here is the total volume of premiums of all Government employees, submit a competitive bid on what rate of premium you charge."

It would seem to me that, in view of what you have said, the Federal employee would be able to get a tremendous break in premiums if that could be done. Could you comment on that?

Mr. PETTENGILL. I question that it is a tremendous break. I think if you look at all of the plans or virtually all of them, there are returns of at least 90 cents on the dollar.

I like to think that we do a fairly good job of paying claims. However, even the less efficient carriers are probably not so bad. But that most of the claims they are paying are proper claims.

Therefore, what you want in the way of benefits is most of what the Government is going to have to pay for. The difference between carriers is going to be in the efficiency of their operation.

In other words, whether the expense rate is 4 percent or our 2.6 percent, that is the nature of the savings that would come about. If you put in a provision, such as the chairman has mentioned, that the Government would assure a carrier, that if there were a loss it would be paid for by the Federal Government, then there would be no need for a risk charge. The only charge you would have would be the service charge.

There would be some advantage to having just one plan but it is not a tremendous advantage. I think that what the Congress originally felt was that it desired a pluralistic approach to the benefits.

I think you might make some argument that where you have a large number of employees, some pluralism is highly desirable.

Mr. HOGAN. You indicated that because of the tremendous increase in the buying of premiums you had a choice of increasing benefits or reducing premiums. You chose the first.

Mr. PETTENGILL. As I tried to indicate to an earlier question of the chairman, doubling our present premium would not significantly reduce the percentage service charge that we would want in relation to that premium.

In other words, it is just a question of how small a profit will I take for doing this business. Even if you gave me the entire business of the Federal employees, I would want a half of a percent.

Mr. HOGAN. Going to another subject, would you tell us what kind of salesmanship your company uses in trying to get people to convert from other plans to yours?

Mr. PETTENGILL. Unfortunately, we are not allowed to contact the Federal employees.

Mr. HOGAN. That is a serious constraint on your ability to operate?

Mr. PETTENGILL. Very definitely.

Mr. HOGAN. Would you like to see that removed?

Mr. PETTENGILL. I think so. Although, you have to realize that with as many plans as the Government offers you have to consider the effect on the employee of having a host of people badgering him.

Mr. HOGAN. The thing that concerns me is that we all get into ruts. The day that an employee comes into the Federal service, he signs up

for one of the health insurance benefit plans. Unless something stimulates him to take some action or he gets mad at the company, he will stay in that plan until he retires from Federal service.

I represent a tremendous number of Federal employees. I am willing to say that they don't know that your rates are lower than Blue Cross' rates.

If you had the opportunity to make a mailing or in other ways go to every one of them and say you can save x number of dollars by signing up with our company rather than Blue Cross, I think you would get a number of converts, and Blue Cross would find ways to make its operations more efficient. Even though we strive for the ideal of competitiveness between you and other carriers, we don't really have it. We don't have the benefits of competition.

We have the appearance of competition without the real benefits of competition. That troubles me very much because I think, if we could create an atmosphere where all the other carriers were forced to produce the best possible benefits for the lowest possible premiums, then Federal employees would be a lot better off.

Mr. PETTENGILL. I would agree with you.

Mr. HOGAN. In that connection, from a competitive point of view, if you had this ability to let them know about your lower rates, don't you think that lowering premiums would be a better competitive edge for you than improving benefits?

Mr. PETTENGILL. This is a real tough problem. The weight of evidence appears to be that in general, they prefer the better benefits.

Mr. HOGAN. Thank you. In closing I would like to say that I have always considered it paradoxical and confusing that the carrier for profit is able to operate at a lower rate and give employees a lower premium than the nonprofit company is able to do. There ought to be a lesson in that. Thank you, very much.

Mr. WALDIE. I would like to expand a bit on Mr. Hogan's last comment. What are the reasons that your administrative charges are so much less than Blue Cross/Blue Shield's? Do you have an opinion on that?

Mr. PETTENGILL. I think there are two reasons. One, as Mr. Hogan implied, is that we are aware of the need to provide the best benefits for the lowest price.

The second is that Blue Cross/Blue Shield is a federation of a number of plans. Consequently, they have a disadvantage in that they are trying to drive a large team of horses whereas we are a one-horse team.

Mr. WALDIE. You have some other disadvantages. If you will recall previous testimony, they involved the fact that you may pay taxes and hold reserves in States that are larger than the Blues. What is the story on those efforts?

Mr. PETTENGILL. We certainly concur that we have a tremendous disadvantage in our having to pay premium taxes, whereas the Blue Cross plans do not.

The second disadvantage which I mentioned in 1971, was the fact that the Blues do have contracts with hospitals which, in many instances permit them to pay less than the hospital's established charges. In this area the American Hospital Association has realized that the end result of that inequity is to the disadvantage of the public and the hospitals. It has now come out in favor of the system whereby the rates

of a hospital would be reviewed in advance and, assuming they were approved by the appropriate Government agency, the rates would then apply to all third party carriers so that this discrimination would be abolished. We urge that such prospective rate review be adopted.

The final disadvantage, which is something quite different, is the fact that our program does appeal to the elderly Federal employee. We have a larger percentage of annuitants than the service plan and this means that the active employee pays a larger burden.

Since everyone knows that the cost of health care increases with age, our suggestion here was that the Federal Government should establish its contribution for active employees and then pay an additional contribution which would pick up the excess cost of the annuitant over and above the active employee.

Mr. WALDIE. What about the State reserves, are you required to have higher reserves than the Blues?

Mr. PETTENGILL. I think in general, no.

Mr. WALDIE. Do they differ?

Mr. PETTENGILL. Yes, I believe they do and I think it varies considerably from State to State. As a practical matter the key reserve is the reserve for incurred but unrecorded claims. This reserve can be verified after the fact; that is, you can demonstrate what it should have been. Thus, you can examine whether a carrier has been setting this reserve properly.

If it has been doing a poor job of estimating, you can get after it. Basically, the type of carrier makes no difference. The carrier has to have an adequate claim reserve. If you have any reserves above that, that is where you get the variations.

Mr. WALDIE. Do States require a different reserve for profitmaking organizations than for nonprofit organizations?

Mr. PETTENGILL. Most Blue Cross plans are organized under a special law, and are not subject to the normal regulations that an insurance company is. We think this is wrong.

Mr. WALDIE. Is their reserve requirement less than yours?

Mr. PETTENGILL. There may be a few States in which theirs is higher than ours. But, in general, theirs is no more or no less.

Mr. WALDIE. What is your reserve requirement in California?

Mr. PETTENGILL. We are not required to have any additional reserve.

Mr. WALDIE. What percentage of that subscription income is that reserve?

Mr. PETTENGILL. I would say that it varies depending upon the benefits. As a rough rule of thumb, 3 months' premium is held.

Mr. WALDIE. I get the feeling that I have not been able to confirm yet that there is a distinct competitive disadvantage that you confront in the State when you compete with Blue Cross/Blue Shield, with the latter getting more generous requirements from the States than do the profitmaking companies.

Does your experience confirm that?

Mr. PETTENGILL. No, sir; let me give you an example. Basically, we are saying that under group health insurance we return 90 cents on the dollar in claims; we have 10 percent left over for everything else.

Mr. WALDIE. The Blues make a big point of saying that they return a lot more than you do.

Mr. PETTENGILL. You can if you do not have to pay a 2.3-percent premium tax, which we do and they do not. Therefore they should be able to return 92.3 percent of benefits instead of our 90 percent.

Second, they are able to buy hospital benefits at a discount and in some States they also get a discount from the doctors. On an average, they get about 5 percent off on hospital costs which are about 60 percent of their total. So right there is another 3 percent savings. Thus they ought to return 95.3 percent in benefits.

Mr. WALDIE. I think that is about what they say they do return.

As I understood your statement, the discount given the Blues by the hospitals and doctors is contrary to public interest?

Mr. PETTENGILL. To my knowledge, yes, because the only excuse for a discount is if you are giving a valid extra service.

In other words, I would have no quarrel with a hospital having a rule that if you don't pay your bill within 30 days you would be charged a service charge on top of that bill.

This is exactly what the department store does to me. I see no reason why the hospital should not do it.

This discount arises from the fact that Blue Cross goes in and says we will not pay for this or that kind of expense in our reimbursement.

There is nothing to stop the hospitals at this time from acceding to these discounts. They simply raise the charges to the remaining public.

Mr. WALDIE. Your conclusion is that the public will benefit if that discount practice is terminated?

Mr. PETTENGILL. Correct and the American Hospital Association concurs.

Mr. WALDIE. They would benefit by lower hospital costs?

Mr. PETTENGILL. There, presumably, would be some bookkeeping savings which would produce savings.

Also hopefully, under this prospective rate review, hospitals would be required to demonstrate a greater degree of efficiency than they do now.

Mr. WALDIE. I have a letter that we wrote the committee clarifying some testimony that we had in the past. It involved the interest that you lost on the deficit year though you recouped the deficit the next year by an increase in premium. It was your belief that you lost the interest on that but, in fact, you did receive the interest, too?

Mr. PETTENGILL. My apologies for my lapse of memory.

Mr. WALDIE. Of course, I understand that.

I asked a question in that letter which says: "The information which is confidential is that concerning our risk charges. The only thing I can give you in writing is my assurance that we have not charged the Civil Service Commission a higher risk charge for the indemnity plan than we have charged any of our other group policy holders." I presume that still remains the case?

Mr. PETTENGILL. Yes, sir.

Mr. WALDIE. Would I be equally correct in my presumption that this information would be true if I reworded it to: "The only thing I can give you in writing is my assurance we have not charged the Civil Service Commission a higher reserve requirement for the Gov-

ernment wide indemnity benefit plan than we have charged any of our other group medical holders?

Mr. PETTENGILL. As far as the special reserves, there was never any charge for that. It only occurs, under normal circumstances, if the rate turns up a margin.

Let us face it, it is almost impossible to predict 18 months in advance precisely the rate you are going to need. You try to make rates so that the breakage is on the positive side.

Under those circumstances, there is a margin over and above your estimate.

Mr. WALDIE. All I am trying to do is ascertain whether the margin is given to us the same as the margin is given to your other holders.

Mr. PETTENGILL. Under normal circumstances the rate margin is less because of the fact that under the Federal employee's plan there is the agreement that refunds are not paid back to the policyholder. They are put into the special reserve account and held to increase benefit in the future or to offset rate increases.

Mr. WALDIE. I appreciate that. Am I correct in my assumption that the reserves required for the Federal employee program are not higher than those that are required for your other group medical expense policyholders?

Mr. PETTENGILL. Talking about comparable situations, that is correct.

Mr. WALDIE. I am talking about the reserves set. Are they higher than, less than, or equal to your other medical policyholders'?

Mr. PETTENGILL. I think the answer to that has to be yes because, under normal circumstances, the policyholder takes those refunds in cash.

In this instance, the Civil Service Commission has told us, no, we don't want refunds in cash, put them in the special reserve. Because we have had this provision, the accumulations in the special account have been less than the total of the refunds that we would have paid if this had been a normal case.

Mr. WALDIE. Does this mean that less reserves are required for the Federal employees than for others?

Mr. PETTENGILL. No other policyholder charges his employees an extra amount and puts it into a contingency reserve.

Mr. WALDIE. We are the only ones who do that?

Mr. PETTENGILL. Correct.

Mr. WALDIE. What would be your view if we eliminated that contingency reserve?

Mr. PETTENGILL. I see no reason why it should not be eliminated.

Mr. WALDIE. That is a very fair response.

Mr. PETTENGILL. I have not read the law recently, but up to 4 percent is to take care of the Commission's expenses and then the balance is for contingencies. I don't remember the precise wording.

Mr. WALDIE. The law says they may set aside up to 3 percent in the contingency reserve. In your view, is it an extraordinary thing that is not present in other plans?

Mr. PETTENGILL. That is correct.

Mr. WALDIE. If your special reserve were less than 25 percent, would you ask for an increase?

Mr. PETTENGILL. Right.

Mr. WALDIE. So, really you are not recommending anything but a bookkeeping change. No benefit would be acquired by the policyholder by elimination if you still insist on the 25-percent reserve, would it?

Mr. PETTENGILL. No.

Mr. WALDIE. Do you mean your special reserve is over 25 percent?

Mr. PETTENGILL. No, you are right at 25 percent.

Mr. WALDIE. Your recommendation to eliminate contingency reserve means get it out of their hands and into ours?

Mr. PETTENGILL. Depending upon the times that could be good or bad for the Government. In general, it would be good.

Mr. WALDIE. There are two issues involved in this. The first one is, is 25 percent an excessive reserve given the risk involved in this contract?

The second issue is, if it is not excessive, why do we persist in taking years to get down from over 25 percent to 25 percent?

As I understand your program, you anticipate getting down to about 25 percent by the end of 1973?

Mr. PETTENGILL. Correct.

Mr. WALDIE. Tell me why we don't get down to 25 percent this year? Why don't you call for an improvement in benefits or a reduction in premiums to get you down to 25 percent this year? What is wrong with that?

Mr. PETTENGILL. This is a matter of judgment, sir. In my judgment you approach a problem of this sort on a conservative basis which means you don't attempt to make it all in one year because you might overcorrect.

Mr. WALDIE. If you did overcorrect, what would occur of jeopardy to you? What if you get down to 15 percent? Who would suffer from that overcorrection? Nobody would except you would not have that 10 percent.

Mr. PETTENGILL. The following year, we would ask for a substantial rate increase. We would also ask for an increase in the risk charge.

This means, therefore, in terms of the net cost to the Federal Government, there would be a greater increase.

Mr. WALDIE. That would occur if you had overcorrected. The employee would have the money that is rightfully his and the Government would have the money that is rightfully theirs. The plan would not be jeopardized if you got down to 25 percent, would it?

Mr. PETTENGILL. I think I am failing to make clear to you, sir, that one piece of my program is a charge in that year to the Government and hence, to the Federal employees. This is the service charge which, in the old days, was the risk charge.

If you are to set a combination of contingency reserve and special reserve which is below 25 percent, then we will want to increase the present service charge.

How much we would add to the service charge would depend on what total reserve was available. The risk charge charged in a given year is lost and gone forever as far as the Federal employees are concerned.

Mr. WALDIE. Your job is to minimize that risk charge?

Mr. PETTENGILL. If we could minimize it more than we have I don't know what we would do.

The fact that you have a slightly higher special reserve in 1 year versus another might produce a slight difference.

Mr. WALDIE. We are not talking about a slight difference; we are talking about 25 percent versus 40 percent.

Mr. PETTENGILL. As I said, we are taking action to get that 40 percent down.

Mr. WALDIE. What is that action, as increase in benefits? That will reduce it by what, 10 percent?

Mr. PETTENGILL. Yes, sir; I am hopeful.

Mr. WALDIE. So that the reserve will be 30 percent?

Mr. PETTENGILL. Then, next year, we will take further action to reduce it another 5 more.

Mr. WALDIE. One final question on the 25 percent. I presume you concluded that 25-percent reserves plus the present contract has eliminated risk?

Mr. PETTENGILL. The only risk is what is mine.

Mr. WALDIE. Is that a necessary part of the elimination of that risk, the 25 percent?

Mr. PETTENGILL. Yes.

Mr. WALDIE. How do you arrive at the 25 percent figure?

Mr. PETTENGILL. This is our judgment on the basis of many years of operating in this business.

Mr. WALDIE. Can you give me more than that? Is it just your judgment being confirmed by other companies that 25 percent is a reasonable reserve in programs of this nature?

Mr. PETTENGILL. I have not conducted a survey of the other companies but I would think that they would be close to my judgment because of the general manner in which they operate.

I am not going to sit here and say they are precisely the same.

Mr. WALDIE. It would be fair for me to conclude that this judgment has applied to other contracts with other insurers, that 25 percent would be required of them, too?

Mr. PETTENGILL. For us to reduce the risk charge—

Mr. WALDIE. Their risk is the same as our risk, of this contract, isn't it?

Mr. PETTENGILL. Some of them have lower.

Mr. WALDIE. Do any of them have less risk?

Mr. PETTENGILL. Not at the present time.

Mr. WALDIE. I would assume that our reserve would be the least high of all the reserves that you write. Am I correct on that; doesn't that follow?

Mr. PETTENGILL. We would have to have higher reserves on a case if we had no assurance such as we have here.

Mr. WALDIE. I am saying this is the least risky contract you have, isn't it?

Mr. PETTENGILL. Yes, this is.

Mr. WALDIE. You have no other contract where you require a lesser reserve than 25 percent, is that right?

Mr. PETTENGILL. Excuse me, sir. We are perfectly willing to operate a contract without a reserve. In most contracts, this is the case.

Mr. WALDIE. I would like you to just address this. We have established that you have no contract with less risk.

Am I fair if I conclude that there is no contract you write that has a lesser reserve requirement than the Federal Government contract?

Mr. PETTENGILL. If we had a comparable situation——

Mr. WALDIE. Do you have a comparable situation?

Mr. PETTENGILL. We do not. We have no contract under which the employer has agreed to pay us our losses in the event the contract is terminated.

Mr. WALDIE. So, this is the least risky contract you have?

Mr. PETTENGILL. Right.

Mr. WALDIE. Then the reserves are only there to take care of risk, are they not? There is no other purpose for a reserve is there?

Mr. PETTENGILL. In this instance, the reserves are there to cover our elimination of part of the risk charge.

Mr. WALDIE. The reserves are there to take care of risk, are they?

Mr. PETTENGILL. Right.

Mr. WALDIE. If this is the least risky contract you have is that the the case?

Mr. PETTENGILL. For a comparable case of benefits.

Mr. WALDIE. Ever if there is no such provision in their contract that they will pick up your losses?

Mr. PETTENGILL. We are going around in circles.

Mr. WALDIE. I don't intend to.

Mr. PETTENGILL. You are correct that what we have here is a situation of virtually almost the ideal where our risk has been minimized and hence, the size of the reserves we need are less.

Mr. WALDIE. Therefore, you would not take advantage of the Federal Government and our reserve if it is less than all of your contracts, is that correct?

Mr. PETTENGILL. Correct.

Mr. WALDIE. If we were to make an examination and find that, in fact, you have less reserve rates for other people would that concern you that this testimony may be in need of correction?

Mr. PETTENGILL. I have endeavored to give you the best and most precise information that I know of. I firmly believe that it is correct. I certainly would want it exposed to the public if it were incorrect.

Mr. WALDIE. I would like to have you write a letter confirming that in writing. To use your language here, "none of your other group medical expense policyholders have less reserve requirement than does the Federal Government."

Would you please confirm that in writing to me?

Mr. PETTENGILL. I will write you a letter, sir.

Mr. WALDIE. Can you confirm it in writing?

Mr. PETTENGILL. You have to realize that the two are precisely related. We have no other contract where the risk has been reduced to this level. Therefore, there is no other contract where the reserve requirements would be comparable.

Mr. WALDIE. In any other contract the reserve requirement would be less?

Mr. PETTENGILL. Because the risk charges aren't.

Mr. WALDIE. That doesn't matter. There is no risk even comparable to this in any other contract, so your reserves would be less——

Mr. PETTENGILL. Under this contract.

Mr. WALDIE. Yes, under this contract. Mr. Hillis?

Mr. HILLIS. I have noticed that at the time this report was being made, GAO raised some question about your company's practice in computing income. It states here that in most instances Aetna agreed with the conclusions and promised to make appropriate adjustments, has this bene done?

Mr. PETTENGILL. I believe it has, sir. If not, it will be done in the accounting this year.

Mr. HILLIS. I know you said that it might be better for you to hold the money rather than the Government. For what we hold we get a net interest, don't we?

Mr. PETTENGILL. The only problem has been that it has never been clear as to what is the Federal income tax on this case.

Mr. HILLIS. In the premium structure when you do this survey, will you make available to the committee the breakdown in all of the premium groups where there has been a shift from high to low option?

Mr. PETTENGILL. I did not catch that question.

Mr. HILLIS. In your earlier testimony you said you were going to make a survey on the last open season to see what happened between you and Blue Cross.

Mr. PETTENGILL. It will be with respect to this upcoming 1972 season. The Commission thought it would be difficult to do it with respect to the last open season.

Mr. HILLIS. When that is done will it also include whether there has been a shift within options?

I am interested in whether people are giving up high-self coverage for low-self coverage because of premium increases.

Mr. PETTENGILL. I believe that could be included.

Mr. HILLIS. I also take it that each premium is structured on the low-self covered persons, is that correct?

Mr. PETTENGILL. To begin with, yes, but then each of the two options bears its proportionate share of any overall losses.

Mr. HILLIS. I am not sure I understand that answer.

Mr. PETTENGILL. You have inherent in this case the fact that employees are permitted to choose between a high and a low option. By definition, the poor risk will choose the high and the good risk will choose the low. All other things being equal, if you have an overall loss on the combined plan, high and low, then under a normal group plan all employees share in that loss.

This is because the basic nature of a group plan is that it is a social insurance device that everybody is participating in. So that, under this situation, if we did not do that you could drive the rates between the high and the low options miles apart and way out of line with respect to the benefits provided.

Mr. HILLIS. That answers my question.

Mr. WALDIE. I have no further questions. Mr. Pettengill, despite the nature of the questions that I asked you, I want you to know that I personally think that Aetna has done a good job. I was impressed that you did not seek a premium increase.

I am somewhat unhappy that you did not seek a premium decrease, however, given the nature of your reserves.

Mr. HILLIS. Another question occurred to me in relation to Mr. Hogan's line of questions. Do you advertise your plan? Do you run newspaper advertisements directed at the public for Government employees?

Mr. PETTENGILL. No. At the last year's open season, we did run a few newspaper adds to see whether they would be of use to get information to the Federal employees. Our problem is that the Federal employees are spread all over these entire United States.

In general, if we were to pay the price for a newspaper ad for every newspaper in these United States, we would incur a tremendous cost which we do not feel would be of value to the Federal employees.

Mr. WALDIE. In conclusion, let me tell you that I appreciate your testimony before the committee and the knowledge that you have on the subject which we have in mind.

Hopefully, we will be asking the Blue Cross/Blue Shield people the same questions. I assume, ultimately, they will come before us.

Do you have anything further that you desire to add?

Mr. PETTENGILL. No. We thank the committee very much.

Mr. WALDIE. Thank you, Mr. Pettengill and gentlemen.

The last witness we have is Mr. Ernest Fitzgerald, who is a consultant to our committee. Mr. Fitzgerald will discuss for the record the risk charge and the reserves.

STATEMENT OF A. ERNEST FITZGERALD, MANAGEMENT CONSULTANT

Mr. FITZGERALD. Thank you, Mr. Chairman and Congressman Hillis. My primary purpose is to summarize the inquiry into the risk charge for the Federal employees health insurance carriers with particular emphasis on the Blue Cross/Blue Shield situations.

First, as to background, the risk charge was an annual payment made—until 1971 in the case of Blue Cross/Blue Shield and Aetna—by the Civil Service Commission to underwriters of certain health plans within the Federal health benefits program (FEP).

The records of hearings before this subcommittee and inquiries by the General Accounting Office (GAO) indicate that the payment was to compensate the underwriters for the risk of having to make up any deficit of the plans and to provide a fee or profit for carrier services.

I might explain at this point, for the record, the role of the General Accounting Office in the subcommittee's hearings. The Comptroller General is very helpful in assigning some of his experienced people in this area to submit to the subcommittee some data.

Many of the reports or submission of data to the subcommittee have not gone through the normal review process in the General Accounting Office. This is why they will not be found in the usual formal reports.

As I say, I think the relationship has been very helpful. In fact, it has been invaluable. The subcommittee could not have possibly done as much without the assistance of these experts.

Mr. WALDIE. I want to interrupt simply to affirm your assessment of the value of the consideration that the General Accounting Office has made to this inquiry. We are very appreciative of their diligence and their expertise.

Mr. FITZGERALD. To the present time, so far as is known, no plans have been terminated by the Civil Service Commission, although since inception of FEP in 1960 seven plans have been discontinued. In the case of the major plans—Blue Cross/Blue Shield and Aetna—the risk charges paid over the years apparently represent profits to the plans because they have been reimbursed for all allowable administrative costs incurred and benefit payments made by these plans.

Premiums have been increased several times to cover increases in health costs and benefit coverage when it appeared that subscription income, premiums, at existing rates would be insufficient to pay health benefits and administrative expenses, and thus lead to a deficit condition.

The risk charge was renamed a public service charge in the 1971 Blue Cross/Blue Shield contract, apparently as a result of criticism by the subcommittee that there was little, if any, risk involved in carrying out contractual commitments, and therefore no basis for the payment of such a charge.

Just to emphasize this point, I would like to read at this point an excerpt from a letter dated May 26, 1971, from Mr. Andrew Ruddock of the Civil Service Commission to Mr. Joseph E. Harvey, vice president of Blue Cross Association.

We suggest for your consideration changing the contract description of the risk charge, using different terminology like profit service charge or something similar.

We would also like your reaction to adopting a flat amount for the risk charge. For example, \$1 per enrollee instead of the percentage of premium now used. Of course we want to keep the risk charges as low as possible.

Mr. WALDIE. May I interrupt a moment. Does that compute out that they, in fact, adopted the \$1 per enrollee as the nature of the risk charge?

Mr. FITZGERALD. Apparently so, Mr. Chairman. We have no access to the negotiation memoranda of the Civil Service Commission but it would appear that that is what they did in this year's contract.

Mr. WALDIE. Do we know the number of enrollees?

Mr. FITZGERALD. Yes; I believe that is what gives rise to the conjectures.

Mr. WALDIE. Is that true of Aetna, also?

Mr. FITZGERALD. That I don't know.

Mr. WALDIE. You might make a note with Mr. Hillis' consent; we will address a letter to Mr. Ruddock asking if \$1 per enrollee was the means whereby they established the public service charge for Blue Cross and profit for Aetna.

Mr. FITZGERALD. There may have been some remote basis up to the time the risk charge was converted to a public service charge for justifying some provision for risk.

Blue Cross/Blue Shield have cited one point in time where termination of the contract for the service benefit plan would have left the corporation with a deficit of about \$8 million. But since the time of the conversion from a risk charge to a public service charge the likelihood of a deficit situation having to be met by the insurance companies practically is nonexistent.

This is because substantial contingency reserves, held for each plan by the Civil Service Commission, were made available, from the time

the conversion was made to pay off liabilities of a plan in the event of termination. For example, the GAO investigators assigned to assist the subcommittee informed us that as of December 31, 1971, the contingency reserve of over \$80 million for the service benefit plan became available, in the event of termination of the contract between the Civil Service Commission and Blue Cross/Blue Shield, to pay off liabilities.

Previously, contingency reserve moneys were not contractually available for this purpose. As of December 31, 1971, the contingency reserve for this plan—slightly over \$80 million—was more than twice the estimated liabilities.

With the change in the name of the risk charge to public service charge—

Mr. WALDIE. May I interrupt you a moment? The contingency reserve was twice the estimated liabilities, that doesn't even take into account at all the special reserve held by the plan?

Mr. FITZGERALD. That is my understanding.

Mr. WALDIE. What was the special reserve held by the plan? I think the \$80 million is a combination of the contingency and the reserve.

Mr. FITZGERALD. That is possible. I will check that and supply the answer to that for the record.

I am speaking now of Blue Cross/Blue Shield.

Mr. WALDIE. I know you are speaking of Blue Cross and Blue Shield. Please check that because that \$80 million in the contingency reserve would seem to be a figure that probably is included in special reserve.

Mr. FITZGERALD. As I say, I will check that.

Mr. WALDIE. Staff tells me that the projection for 1972 of the combined contingency and reserve is \$144.9 million. So, \$80 million may very well be the contingency reserve.

Mr. FITZGERALD. The only figures I had were projections. As you have observed they were somewhat untrustworthy. I will check that and correct it if it is incorrect.

With the change in the name of the risk charge to public service charge, explanations of the intended use of the moneys also shifted. In response to questions from this subcommittee in April of 1972 the Blue Cross and Blue Shield Federal employee benefit program administrators submitted a list of major areas where the risk charge (public service charge) funds were purportedly used: One, support of FEP Non-Group conversion; two, stabilization of reserves (risks); three, contribution to State Mandatory Statutory Reserves (where applicable); four, research and development; and community services.

Working through the GAO investigators assigned to assist in data gathering, the subcommittee staff attempted to determine the distribution of risk charge (public service charge) funds to the areas listed by the Blue Cross and Blue Shield officials.

In response to GAO inquiries, Blue Cross/Blue Shield officials furnished recommended accounting procedures for handling the accrual of risk charges payable to the various local plans and for recording the flow and disposition of payments. They also furnished a number of verbal explanations of how the money was used.

The combination of the review of the accounting procedures and the analysis of the explanations given left all of us somewhat in confusion. On the one hand we had a rather elaborate explanation of where the money went from the Blue Cross/Blue Shield officials.

On the other hand, the individual plans in some cases indicated that the money lost its identity once it was distributed to the few.

In one case the local plan officials reported, "cash received is deposited in the general fund and is used for general operating expenditures."

In another the officials stated that, "the risk being charged becomes a part of the company's general reserve and is available in support of any of the company's programs."

This confused us all because it raised the possibility that money not intended to be spent under the Federal employes program could be covered by risk charge funds. Therefore, the subcommittee staff requested that the General Accounting Office attempt to trace a sample of actual risk charge transactions to determine whether ultimate use of the funds could be factually determined and whether adequate controls existed in the local plans to protect against unintended use of the risk charge monies.

On July 24, 1972, the GAO asked Mr. Joseph Harvey, Blue Cross Association vice president, to grant permission for the GAO auditors to trace the actual flow of risk charge transactions. On July 26, 1972, Mr. Harvey denied the GAO request, stating that the risk charge transactions were not subject to Government audit.

Mr. WALDIE. In this regard, we submitted a list of interrogatories to Mr. Ruddock. His response is dated September 12, 1972, which we will offer for inclusion in the record.

(The letter follows:)

U.S. CIVIL SERVICE COMMISSION,
BUREAU OF RETIREMENT, INSURANCE, AND OCCUPATIONAL HEALTH,
Washington, D.C., September 12, 1972.

HON. JEROME R. WALDIE,
Chairman, Subcommittee on Retirement,
Insurance, and Health Benefits.

DEAR MR. WALDIE: Following are my answers to your September 11, 1972, interrogatories.

1. Question. What has been the total amount of money paid out in "risk charges" to BC/BS and Aetna during the history of the Federal employes health benefits program?

Answer. During the twelve years since inception of the program (July 1, 1960 to June 30, 1972) amounts paid for risk charges and service charges were as follows:

	Blue Cross and Blue Shield	Aetna
Amount of charge.....	\$47,345,059	\$16,684,288
Total premium.....	\$4,478,349.374	\$1,495,527,090
Charge as a percent of premium.....	1.06	1.12

2. Question. Has either BC/BS or Aetna ever suffered any financial loss from the Federal program which was not subsequently recouped?

Answer. No.

Question. If yes, please give a history of those losses.

Answer. Not applicable.

3. Question. Does the Federal Health Benefits Act allow for Federal contribution to programs to cover costs of conversion and community services?

Answer. With respect to conversions, the Federal Employees Health Benefits law (5 U.S.C. 8902 (g)) provides that each plan must offer a conversion option and that "an employee or annuitant who exercises this option shall pay the full periodic charges of the nongroup contract." The law is silent with respect to community services.

4. Question. Can BC/BS and Aetna use "risk charge" funds for any purpose they wish?

Answer Yes.

Question. Does the Civil Service Commission have any oversight or monitoring function over the use of the "risk charge"?

Answer. No.

5. Question. What are the differences in rates between the Federal group insurance premium, and that which is paid by individuals upon conversion?

Answer. The conversion premium rates are generally higher because, among other reasons, they involve individual premium billings and collections. An employee in the Blue Cross-Blue Shield plan may convert to the standard contract offered by his local Blue Cross-Blue Shield plan. These standard contracts differ from one local plan to another and so do their premium rates. The Aetna offers four different conversion options to Federal employees at differing premium rates. A copy of the Aetna and Blue Cross-Blue Shield Washington, D.C. area conversion plans are enclosed.

6. Question. What is the projected 12/31/72 level of the special reserve fund held by Blue Cross-Blue Shield? What percentage of their annual federal program premium does their reserve constitute?

Answer. On June 30, 1972, Blue Cross-Blue Shield estimated that the special reserve would be \$48.9 million on December 31, 1972, including \$23.9 million estimated to be paid from contingency reserve in 1973. This is 5.8% of their estimated 1972 subscription income. Using data through July 31, 1972, we believe that this estimate of reserve level is low. However, we are currently studying August experience which has been unusually high.

7. Question. What is the projected level for 12/31/72 of the special reserve fund held by Aetna? What percentage of their federal program premium does this reserve constitute?

Answer. On June 20, 1972, Aetna estimated that the special reserve, at the end of 1972, will be \$52.0 million. This is 25.6% of the estimated 1972 subscription income. We believe that this estimate is high, but there should be a positive reserve in the neighborhood of 20% of income.

8. Question. Do the other federal health programs all have special reserves? If some do, what is the range of their reserves as a percentage of annual premium?

Answer. At December 31, 1971, there were 26 experience-rated plans besides the Blue Cross-Blue Shield and Aetna Plans, that had special reserves (cumulative gains or losses) belonging to the Federal Employee Program. There were twelve community-rated plans whose reserves did not belong to the Federal Employee Program. The reserves for experience-rated plans, as a percent of annual premiums, ranged from a negative 29.5% to a positive 30.0%.

9. Question. What is the level projected for 12/31/72 of the contingency reserve held by the Civil Service Commission?

Answer. We estimate that the total reserve held by the Civil Service Commission for all plans will be \$152.9 million. Of this amount, \$96.0 million will be in the Blue Cross-Blue Shield account and \$28.6 million in the Aetna account.

10. Question. Under what circumstances can Blue Cross-Blue Shield or Aetna draw on the contingency reserve fund? What is the history of the use of the contingency reserve?

Answer. There are two provisions governing Blue Cross-Blue Shield's and Aetna's drawing on their contingency reserves. The first is regulatory (5 C.F.R. 890.503 (c) (2)). It provides that when, as of the end of a contract period, the total of all reserves held by and for a plan amounts to less than the total of the last five month's subscription charges paid to the plan, it is entitled to payment from the contingency reserve of the lesser of: (1) the amount equal to the difference between the total of the last five months' premium and the total of the reserves held by and for the plan, or (2) an amount equal to the excess, if any, of the plan's contingency reserves over an amount which is equal to the average monthly premium paid the plan during the most recent contract period. The second provision governing the draw on contingency reserves is in the contracts with Blue

Cross-Blue Shield and Aetna. The effect of this provision is to permit use of their respective contingency reserves to discharge their liabilities under the contract after the contract has been terminated if the reserves held by the plan prove insufficient for this purpose. This second provision has never been used. Payments have been made to the plans in accord with the first provision from time to time, as follows:

Year	Blue Cross and Blue Shield	Aetna	Year	Blue Cross and Blue Shield	Aetna
1965.....	\$2,543,532	\$3,152,857	1969.....	\$17,543,576	\$4,531,330
1966.....	15,835,959	7,278,999	1970.....	38,861,116	4,456,906
1967.....	0	3,939,065	1971.....	22,050,826	7,381,272
1968.....	0	4,865,840	1972.....	22,361,792	4,109,989

11. Question. As of December 31, 1972, what percentage of their annual federal program premium will Blue Cross-Blue Shield and Aetna each have available to them to draw against any current deficit (special reserves and contingency reserve)?

Answer. Using the Blue Cross-Blue Shield estimate of a \$48.9 special reserve, the total, including contingency reserve will be \$144.9 million which is 17.1% of premium. Using the Aetna estimate of \$52.0 million special reserve, the total, including contingency reserve will be \$80.6 million or 39.7% of subscription income. These total amounts would be available only if the contracts were terminated.

12. Question. How does this percentage of reserve compare to those of private national health insurance programs?

Answer. The Commission has not made a study of the reserves held by carriers for insurance programs they underwrite for private national firms. We cannot, therefore, respond to this question.

13. Question. Does the Federal Government mandate any specific level of reserves?

Answer. The Federal Employees Health Benefits law (5 U.S.C. chapter 89) contains no such mandate. The health benefits regulations (5 C.F.R. 890.503(c) (1)) state that "The preferred minimum balance for the contingency reserve is one month's subscription charges at the average monthly rate paid from the Employees Health Benefits Fund for the plan during the most recent contract period," but this is less than a mandate. A new plan, for example, would have less than the preferred minimum balance in its contingency reserve until it had been in the Program long enough to build up its contingency reserve to one month's premium.

14. Question. What is the percentage of annual premiums that is generally required for large, established health insurance programs by state governments? Provide a range, if necessary.

Answer. We have not made any study of the level of reserves which states require in the exercise of their function of regulating insurance carriers, and I do not have the information you request. In 1971 we received a letter from the Insurance Commissioner of the State of Wisconsin, in which he questioned the low reserves of one of our carriers in the following terms: "In general it is my experience that prudent management of an accident and health insurance company will write a premium volume that is not in excess of approximately 3 to 4 times its capital and surplus funds. In other words, capital and surplus should be approximately 25% to 30% of premium volume. At year end the surplus of this company was approximately 3% of premium volume without consideration of the probable inadequacy in claim reserve and without consideration of the market value of assets. The financial condition of this company is not only serious, it is critical."

15. Question. In order to clarify previous testimony, are the funds from the special reserves and the contingency reserve invested? If yes, how and where are the contingency funds invested by the Civil Service Commission?

Answer. Funds in both the special reserve and the contingency reserves are invested. Funds in the contingency reserve are invested by the Secretary of the Treasury in interest bearing obligations of the United States as prescribed by law (5 U.S.C. 8909), and interest is credited to the Fund.

16. *Question. How are the proceeds from the investment of the special carrier reserve and the contingency reserve used?*

Answer. Interest earned on the special reserve of a plan is credited to the special reserve of that plan. It is used to pay plan claims and expenses. Interest earned on the contingency reserve of a plan becomes part of the contingency reserve of that plan and is eventually paid and included as part of premium income.

17. *Question. If the total reserves of BC/BS and Aetna were to be drawn down from current levels to the level of reserves generally required by state governments and the money used to offset premiums, what would be the effect on premiums paid by federal employees and the federal taxpayer?*

Answer. As stated in answer to question 14, I do not have information as to a level of reserves generally required by state governments.

Sincerely yours,

ANDREW E. RUDDOCK, *Director.*

Mr. WALDIE. Among the questions asked was whether or not the Civil Service Commission had any oversight function regarding the risk charge. They answered "No." Mr. Harvey, then, was relating exactly Civil Service Commission concept and their responsibilities.

Mr. FITZGERALD. He said that it is profit and they can use it for anything they please.

Mr. WALDIE. I suspect that is true. In a nonprofit organization where it is a public service charge, the use of it for the public's benefit would seem to me to be implicit. The Commission says they have no authority in that regard.

Mr. FITZGERALD. As a result of the Blue Cross/Blue Shield denying the General Accounting Office access to their records, the subcommittee staff requested that the GAO auditors present themselves at the local plan offices in Washington, D.C., Virginia, and Pennsylvania, which they did on July 28, 1972, and requested access to records pertaining to risk charge transactions. Reportedly acting on instructions from Mr. Harvey's office, the local plans denied GAO access to their records.

Mr. WALDIE. I suspect they were acting under the mandate of the Civil Service Commission which is the only one which has any authority.

Mr. FITZGERALD. They say they don't monitor and they can spend it for any purpose they see fit. It is of no concern to the Government.

The Civil Service Commission Audit Division has told this subcommittee staff that they do periodically conduct audits and have done so in cases in the past.

Mr. WALDIE. The handicap this committee labors under is that the concerns we share are not shared by the Civil Service Commission which, apparently, is the only body under present law who has the authority to do something in these regards on behalf of the Government and the Federal employees.

It is simply another little break in the structure that seems to be built here that the Civil Service Commission has no concept of its responsibilities. This adds further configuration to my own belief, that the Civil Service Commission is so far removed from understanding their responsibilities, that administration of these programs ought to be removed from the Commission.

Mr. FITZGERALD. I would like to address the degree of helplessness with which we are confronted in a moment. But, to summarize the situation with respect to what we really know about the use of the risk charge moneys as a result of the Blue Cross/Blue Shield officials and now as I learn supported by the Civil Service Commission, we have no quantitative evidence of any sort on the ultimate use of the risk charge payments.

When faced with similar situations, Government contracting officers often suspend payment on questionable items until complete facts are available to support a decision on propriety of payments. If contracting officers fail to detect or to act on questionable items, the powers of the Comptroller General can sometimes be invoked to suspend items in an account in order to obtain further evidence or explanation necessary to their settlement.

I recommend to the subcommittee that legal advice be sought to determine what might be done to resolve unanswered questions regarding use of risk charge (public service charge) funds. In other words, I suggest that we assess the Government's legal right to discontinue payment of the risk charge until unanswered questions regarding its use are resolved.

Mr. WALDIE. Do you think there are any unanswered questions with regard to Aetna?

Mr. FITZGERALD. With respect to Aetna to the extent that the Civil Service Commission regards and accepts the payment as pure profit, and if that indeed is the case, I would think that that probably would settle the matter.

Mr. WALDIE. I was not aware that it went from risk to all service. According to Aetna that is all service charge and therefore, all profit.

I suspect what the company does with its profit is of no one's concern except the Internal Revenue Service as far as the Federal Government is concerned.

I don't think it is the same with the Blue Cross/Blue Shield where the public service charge is the nomenclature. I think there is a responsibility on their part to account for the expenditure of those funds.

Mr. FITZGERALD. I would think so, particularly, since the associations have written to the subcommittee—and I suppose others—that the funds are being used for certain purposes. Many of the things they say they are using it for are already reimbursed by the Federal Government.

In both cases, the intent of the parties should be examined and it might be found that the service charge is, in fact, a reimbursement for expenses not considered allowable by the parties to the contract. I would think this would be a much more clear-cut possibility in the case of the Blue Cross/Blue Shield Associations.

The neatest solution, of course, would be to eliminate the payment altogether, and I would hope that the Civil Service Commission is already considering this.

As a general rule, Government contracting officers place the burden of justification for items proposed in negotiated contract on the contractor. Unless the Civil Service Commission has information on risk charge (public service charge) use which has not been made available

to this subcommittee, it would appear that they would have great difficulty justifying the continuance of this outlay of Federal employees' and taxpayer's money.

As a final suggestion, I would urge that whatever costs or contingencies are intended to be covered by risk charge (public service charge) be identified and dealt with separately within their proper generic categories. To the extent that risk charge funds support proper levels of allowable items of cost, provision should be made for them in basic operating cost projections.

Again it is difficult to us to see what is not already covered under the case of claims reimbursement and operating expenses.

However, perhaps there is something. Nonallowable items of cost and excessive costs of allowable items should, of course, be denied, and the reduction reflected in premium levels. If it is determined that risk charge payments are used as reserves, the actual amounts involved should be identified and considered together with other contingency accounts in determining needed overall reserve levels. If overall reserve levels are found to be excessive, I would suggest that insurance premiums be reduced or services expanded if desired though I would like to draw down the reserves as fast as possible, preferably within one year. It is an unfortunate aspect of human nature that the availability of excessive funds has an adverse effect on cost consciousness.

That is why I would like to qualify the suggestion that services be expanded.

I think it would be an invitation to increase the level of prices for one thing, to the extent that they are not inhibited by the Price Commission.

This is an area of inquiry that the subcommittee has not approached but just as a general rule, I think it would be much safer and you would have much more assurance of getting value received for a drawdown of reserves with a premium reduction than with a negotiation of increased services at this time.

Mr. WALDIE. One of the questions that I asked the Aetna people was if all risks had been eliminated. There apparently is not much risk here.

If it was just made a blanket policy that the Federal Government will assure that nobody incurred any loss in the termination of the contract, I think that would solve all our problems.

However, could that not run counter to the theory you express that when there are a lot of funds available cost consciousness is not present?

In a contract that has no risk, there is not much question about expenditure of funds. If you are guaranteed all your losses, there is not much incentive to spend the money.

If the Government flatly guaranteed all those losses—although again I don't see how we can guarantee them any more than we have—there would be no cost consciousness, would there?

Mr. FITZGERALD. We can't know the motivations of the individuals involved. I think we have seen a lot of that already. This has been illustrated by some of the excessive entertainment costs that has been discovered.

Mr. WALDIE. I think this subcommittee is going to have to ask Blue Cross a few questions about their reserves. Although, we know the

situation on reserves is even more disturbing than the situation Aetna described today.

Apparently nobody can tell us, or is willing to tell us, because it is confidential. It would be interesting for this subcommittee to ask Chrysler, Boeing, and International Harvester to supply the committee with information on their contracts which would bear upon the main thrust of this inquiry.

Are the carriers riding very high on the Federal taxpayer as well as the Federal employee because of insufficient and inadequate representation on the other side of the bargaining table as represented by the Civil Service Commission?

I think we will conclude these hearings after you have concluded your remarks until Tuesday next when we will ask the Civil Service Commission and the "Blues" to again favor us with their presence so that we can go over the things that we went over with the Aetna today.

Do you have any other comments?

MR. FITZGERALD. I have one further observation. I was somewhat puzzled by the wide discrepancy between the reserve levels represented by Mr. Feay of the General Accounting Office and the level developed by Mr. Pettengill.

I think it might be useful to make certain that we are addressing the same kinds and categories of reserves in each of these cases. I note, in some of the projection of the Blue Cross and Blue Shield that they have more than one category of reserves.

For example, they have a category called accrued claims reserves, which the General Accounting Office representatives tell me is really the accounts payable on claims. This, in effect, would be operating capital requirements. The special reserves are over and above these.

Yet, on the other hand, when the Blue Cross/Blue Shield add together their total reserves they include in the operating projections. The accrued claims reserves, which are really not in the same nature as the contingency amounts in the special reserves, it is really operating capital rather than a paid-for contingency.

MR. WALDIE. I get more and more of the opinion that since we have a contract here as to which no risk is involved—the best they have from their standpoint—that we really ought to just wrap it up in a package and say we will pick up all losses and eliminate all reserves.

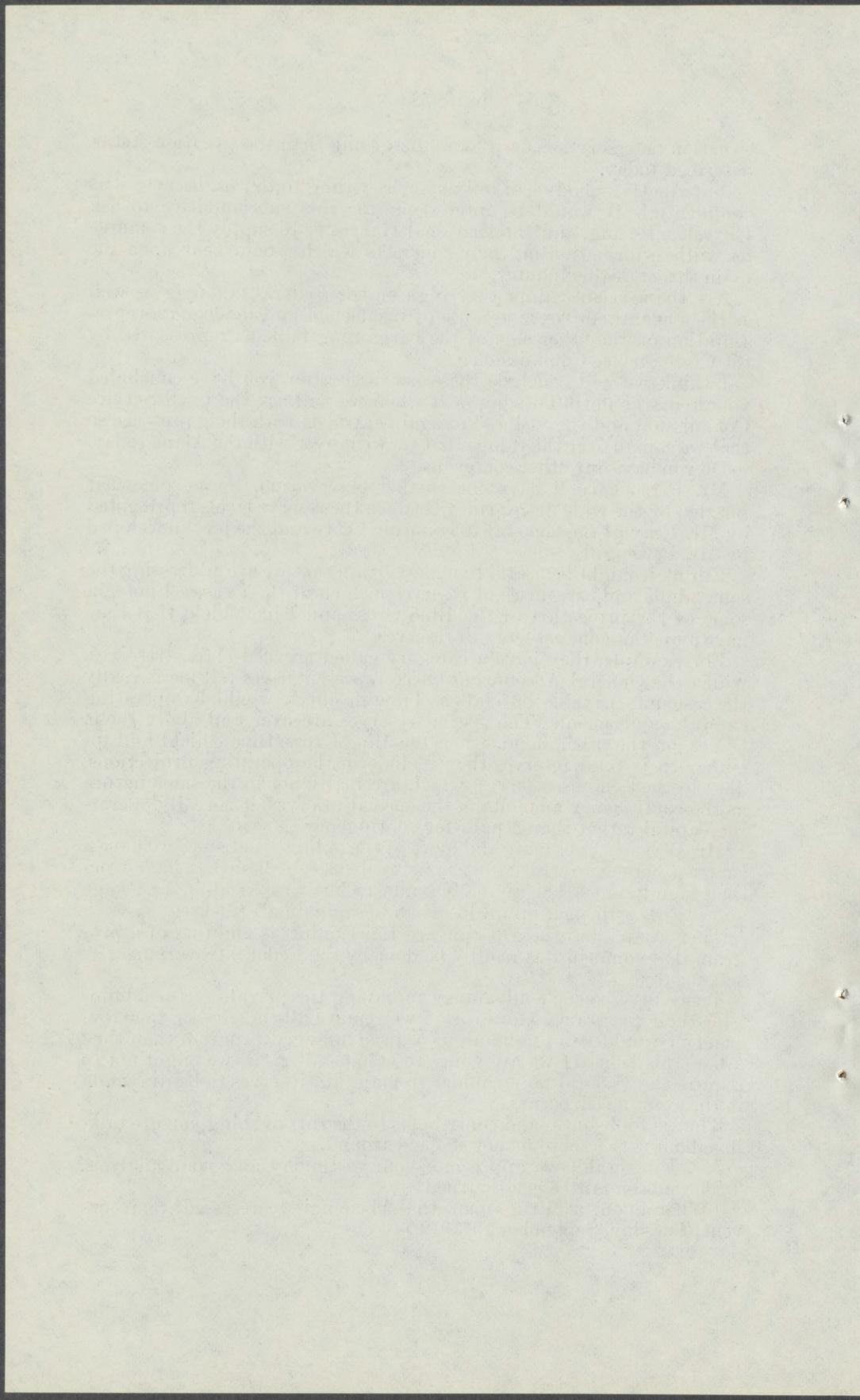
Then Aetna and these people are functioning as auditors of a program that could just as readily be done by the Federal Government as self-insured.

There may be some advantage to having the private sector administer these programs. However, if we remove all these risks, the Government would be in no more of a disadvantaged program than they are at this time. If we are going to assume all risks, we ought not to require the Federal policyholder to maintain reserves to be drawn on in the event a risk occurs.

That is foolishness and contributes to the sort of thing you are talking about with a lot of money stacked around.

Mr. Fitzgerald, we appreciate your testimony and your analysis. The subcommittee is adjourned.

(Whereupon, at 12:15 p.m., the subcommittee recessed, to reconvene, Tuesday, September 19, 1972.)



REVIEW OF FEDERAL EMPLOYEES' HEALTH BENEFITS PROGRAM

TUESDAY, SEPTEMBER 19, 1972

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON POST OFFICE AND CIVIL SERVICE,
SUBCOMMITTEE ON RETIREMENT, INSURANCE,
AND HEALTH BENEFITS,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:15 a.m., in room 210, Cannon House Office Building, Hon. Jerome R. Waldie (chairman of the subcommittee) presiding.

Mr. WALDIE. The subcommittee will come to order.

Today, we continue our long series of oversight hearings into the administration of the Federal employees' health benefits program.

We have held hearings on this matter for more than 18 months, and it seems that we are getting deeper and deeper into a morass of incredibly inaccurate forecasting and ratemaking by the carriers, and quiet acquiescence by the Civil Service Commission.

Nowhere is this situation more evident than in the levels of "reserves," or premium surplus, that have been made available to the carriers to guard against what appears to be no risk at all.

Our inquiry today will be concerned with what the proper level of reserves should be; and if they are determined to be presently excessive, what should be done to lower these unnecessary reserves.

A shocking example of our concern over the administration of this program is chronicled in the history of the 1972 Blue Cross/Blue Shield rate increase.

Last summer Blue Cross/Blue Shield was projecting a \$60 million operating loss for 1971, and a cumulative deficit of \$68 million as of December 31, 1971. The Blues requested a 53.2 percent across-the-board increase to recoup their projected deficit, and to build up their reserves to 1 month's premiums.

In September, the Civil Service Commission agreed to a 39.9 percent rate increase (high option only) which was intended to recoup the loss, but would only return the carrier reserve to a zero position.

In October the increase was dropped to 34.1 percent to comply with phase I guidelines.

In December, after testimony before this subcommittee, and despite the objections of the Civil Service Commission and Blue Cross/Blue Shield, the Price Commission intervened. Its staff recommended a 16.9 percent increase based on a policy decision to cover 1972 operating expenses, but to disallow any recoupment of prior deficits. Because

of dire forecasts of financial ruin by the Blues, the Price Commission finally allowed a 22 percent increase to cover 1972 operating expenses only.

During this period I continually maintained that Blue Cross/Blue Shield was overstating its losses for 1971, and as a third-party intervenor before the Price Commission, insisted that only a 9.4-percent increase be granted.

Unknown to the Price Commission, to the Civil Service Commission, and to me, Blue Cross/Blue Shield had issued a directive during June 1971 designed to cut back on services, and surely to lower any projected losses.

Shortly after the Price Commission granted the 22 percent increase, Blue Cross/Blue Shield started to dramatically reduce its loss estimates for 1971. In testimony before this subcommittee, on February 22, 1972, the figures became a \$37 million loss for 1971 (\$45 million cumulative): by April it was an \$8 million loss for 1971, and finally it was \$7 million (\$15 million cumulative deficit).

Accordingly, as the Price Commission had approved increases predicated on erroneous information, in May I requested that the case be reopened, and a rollback of premiums ordered. The Price Commission refused, citing among other factors, great administrative difficulty in ordering a rollback in the middle of the year.

Present projections indicate that the Blues will have increased their available reserves by \$102 million during 1972. Coincidentally enough, the objectives that Blue Cross/Blue Shield set out to meet with its original request of a 53.2 percent across-the-board have been satisfied: recoupment of all losses during 1972 (despite Price Commission policy) and a buildup to approximately 1 month's premiums as a reserve (despite Civil Service Commission policy to hold to zero reserve).

I wish that Blue Cross/Blue Shield were here today to answer our questions, but they have again refused to testify until after the 1973 contract negotiations with the Civil Service Commission are completed. I just hope that the Blues' projections are more accurate this year, and that the Civil Service Commission is negotiating with a new found skepticism which seems to have been lacking in the past.

We do have Mr. Andrew Ruddock of the Civil Service Commission with us today, and I will be quite interested in his assessment of what 1973 premiums should be in view of the 1972 history, and especially in view of Chairman Hampton's statement of April 7, 1972: "* * * If the experience in the latter part of 1971 holds throughout 1972, this will favorably affect the premiums Federal employees will pay in 1973."

In addition, although it is not part of the written opening statement, it is worthy of comment that in the case of Aetna—we have been talking about the Blues essentially—the other nationwide carrier, without any increase in premiums their cumulative reserves now represent 39.7 percent of premiums.

One of their vice presidents, Mr. Pettengill, testified that in his view 25-percent reserves would be adequate, and in my own personal view I lean more closely toward the suggestion of the representative of the General Accounting Office, that a 5-percent reserve would be adequate

given Mr. Pettengill's description of the Aetna contract with the Federal Government as being the least risk contract of all they write. The 39.7 percent reserves, even given his generous assessment of what reserves should be, is far excessive.

Therefore we are interested in what the Commission proposes to do with the Aetna situation of excessive reserves, and we are also interested in what the Commission proposes to do with the risk charge on all these contracts, including the Blues and Aetna as well as comment on the reserves that have built up in the Blues and Aetna. Mr. Ruddock, we are interested in what you people believe would be an adequate reserve.

With those general opening remarks, do you have a statement, or shall I just go into questions?

STATEMENT OF ANDREW RUDDOCK, DIRECTOR, BUREAU OF RETIREMENT, INSURANCE AND OCCUPATIONAL HEALTH, U.S. CIVIL SERVICE COMMISSION

Mr. RUDDOCK. Mr. Waldie, I do not have a prepared statement. I would like to, if I may, comment on your press release of September 14.

Mr. WALDIE. You certainly may.

Mr. RUDDOCK. The first paragraph says:

Congressman Jerome Waldie, Democrat, California, said today that some \$225 million in excess reserves held by Blue Cross/Blue Shield and Aetna Life and Casualty should be returned to the Federal Employees' Health Benefits Program.

I think I know the context in which you mean that, and a reading of the entire press release would indicate that you are talking about a change in policy, which would use up the reserves in lieu of premiums in a given year, 1973 or future years.

Mr. WALDIE. Yes.

Mr. RUDDOCK. I think unfortunately the first sentence may be misunderstood by some people as implying that somebody has taken \$225 million and walked off with it somewhere, and it is going to be kind of hard to get back.

Mr. WALDIE. Let me quickly clarify that. That was not the intention of that comment. The intention was, as you have described, my own conviction that reserves are enormously high, given the non risk that now exists in this contract, particularly with the concession on the reserves paid to the carriers in last year's amended contract, removing what minimal risk there was.

So I do not suggest that anybody has acted contrary to law. I do suggest that the action that is permitted accumulation of reserves of that amount has been unwise and not in the best interests of either the Government or the employees.

Mr. RUDDOCK. These reserves, as you know, are very much a part of the program. The reserves which exist are within the framework of the law, the framework of the Commission's regulations, and existing policy.

Over half of this amount is held by Treasury, and is invested in interest-bearing securities of the United States. Over half of this is not held by Blue Cross/Blue Shield and Aetna. I thought it might be well to clear the record on this point.

Mr. WALDIE. It is fair to conclude when it is held by the Commission it is not held for the benefit of the employees but for the benefit of the carriers, and I suppose you could argue there is a benefit to the employees because of this, but the carriers are the only ones that have the right to draw on the contingency reserve held by the Commission; are they not?

Mr. RUDDOCK. Payments are made from the contingency reserve to the carrier, but in lieu of additional premium collected from employees and Government contributions.

In other words, if you calculate the premium which is required for year *x*, then you can either accumulate all of that in the form of premiums from employees and agency contributions, or you can have a lesser amount coming from employees and Government contributions by making a payment from the contingency reserve.

We have done that consistently. The payment from contingency reserve is strictly a payment of subscription charge from that source.

Mr. WALDIE. But everything you say is predicated upon an assumption which I personally am not convinced of that the reserves that you require are justifiable. If the reserves are not justifiable, there would be no reason to pay any of that money over to the carriers to keep up their special reserves, and the basic question that I want to ask today is the manner by which you determine the amount of reserves that are held in the contingency fund and the amount of reserves that are held in the special reserves in the carrier's hands.

The reason I make that request is that Mr. Pettengill says that 25-percent accumulative reserves, that is special and contingency, are sufficient. The General Accounting Office suggests that 5 percent is sufficient, and the Wyatt report suggests that roughly 5 percent or less is sufficient.

The Commission has apparently determined that a considerable amount more than that is necessary because of the risk of its program. That is what I want to analyze today, and I would like to analyze it within this context. Is the risk as a result of the amendments to the contract last year less or greater than it was prior to that amendment for the carrier?

Mr. RUDDOCK. For both Blue Cross and Aetna the risk is less because the contingency reserve is now available to pay off claims in the event of termination of contract.

Mr. WALDIE. Is it fair to assume when the risk is less there would be a reduction in reserves which is designed to cover risk?

Mr. RUDDOCK. I believe just the opposite, Mr. Waldie.

Mr. WALDIE. If the risk gets less, you need higher reserves?

Mr. RUDDOCK. If you have minimized the risk by pledging contingency reserve in payment of claims, obviously if you reduce that contingency reserve—and I use the extreme—to zero, then you are right back in the same risk position that you were in before.

Mr. WALDIE. So your feeling is the only way to reduce the risk is to increase the reserves?

Mr. RUDDOCK. Yes, sir. I think the reduction in risk occurred by reason of the pledge of reserve to pay off claims in the event of termination of contract.

Mr. WALDIE. Aetna tells us this is the least risk contract of all they write. Can you tell me—because they would not tell me—whether the reserves required under the Federal contract reflect the fact that it is the least risk contract of all they write compared to other contracts they write.

Mr. RUDDOCK. Mr. Waldie, I think if you do not mind I would like to go back and trace just a little bit historically because I do not propose this morning to say that we need these reserves, higher reserves or lesser reserves, as a protection against the risk.

Mr. WALDIE. Why not? Why do you not propose to say that?

Mr. RUDDOCK. We have a continuing program. We are not anticipating going out of business although it is conceivable that could happen. Something, for example, like national health insurance could supersede a program of this type. Fluctuations can occur in any given year, but with our experience-rated contracts, as we have discussed before, in ordinary times, we would anticipate recouping any temporary losses from future premium.

May I have, Mr. Waldie, 5 minutes to trace this thing historically?

Mr. WALDIE. Please.

Mr. RUDDOCK. It may not take me that long.

In the original law there is a provision—and it is still there—which says that in addition to the payments that are to be made to the carriers, in premium, that the Commission may set an amount not to exceed 3 percent which will be collected from employee deductions and agency contributions and put into a contingency reserve.

The legislative history would make it clear that that 3 percent set-aside was either a hybrid or it really had not too much meaning.

It started off with the idea of setting aside reserves which would prepay for the higher morbidity of employees and annuitants as they got older, and at that time they were talking about setting aside 15 percent of premium to go into a reserve to prepay for that purpose.

There were others at the time who thought that there should be no contingency reserve established, no set-aside. The ultimate compromise was the 3 percent which obviously is not enough to prepay anything. The law said in effect that this 3 percent would be available to defer or minimize premium increases or to provide additional benefits.

Mr. WALDIE. Did the law say that the fund that would be set up by the contribution of 3 percent should never be more than 3 percent of premiums, or is that the annual contribution?

Mr. RUDDOCK. That set the annual contribution. The law specified in no way the amount to which that contingency reserve should build up.

Mr. WALDIE. So the size of it could be any size the Commission determined to be in the words of the statute reasonably adequate; is that correct?

Mr. RUDDOCK. Yes. The Commission decides the level of the contingency reserves.

Mr. WALDIE. So the Commission in effect decides to what purpose the contingency reserves should be established?

Mr. RUDDOCK. Well, I think the law—

Mr. WALDIE. It does not say reasonably adequate for what; it just says the law shall be determined by the Commission to be reasonably adequate to provide a contingency reserve.

So it gives you the authority to decide for what purpose the contingency reserve is to be established.

Mr. RUDDOCK. Yes, within the roadmap established by the law to defer or minimize premium increases or to provide additional benefits.

Mr. WALDIE. What did you determine?

Mr. RUDDOCK. The Commission determined that the preferred minimum balance in the contingency reserve of each plan would be the equivalent of 1 month's premium. This was decided and was put into the regulations originally in 1963. In 1964 the Commission in order to—

Mr. WALDIE. I am sorry. Before you get onto that, this is really why I am puzzled. What would be the parameters that led you to the conclusion that a contingency reserve minimum balance should be 1 month's subscription charge?

What theory were you applying to say that that has some measure of the risk, that any reserve has to be applied to this?

Mr. RUDDOCK. I am relying primarily on memory here, but I believe the objective of the Commission's regulation at that time was in effect to limit the growth of the contingency reserves and to provide a method, a formula, if you will, by which amounts would be paid out of that contingency reserve.

Mr. WALDIE. But I presume in any insurance program they do not vary just because it is a governmental program from a private. Is there some formula that I can apply that would give me some idea as to whether the reserves that are set up in the Federal program are comparable to those set up in private programs, or are excessive?

Mr. RUDDOCK. In 1964 the Civil Service Commission, wanting to get some independent outside advice on this very point, contracted with the firm of Milliman & Robertson to make a study which included a request that they make a study and express their opinion on what should be the reserve levels.

This is obviously a very well established actuarial consulting firm. The president of the firm is past president of the American Society of Actuaries.

In the report which they gave us—and by the way this is no stranger to this committee; I have here a committee print of December 1964, in which this committee printed for the use of the committee this report from Milliman & Robertson.

If I may, I will just read very briefly from this.

Mr. WALDIE. Yes, please do.

Mr. RUDDOCK (reading).

Guidelines have been established in the management of these reserves. First the Commission seeks to maintain a minimum contingency reserve for each carrier equal to at least one month's premium. When the contingency reserve is in excess of this amount, the excess is available under certain conditions to be paid to the carrier to make up deficiencies in the reserves which it has accumulated from past operation of its plan.

I am skipping.

In practice therefore the Commission has in essence established an objective of about three months premium—a contingency reserve equal to one month's premium, plus a special reserve equal to two months premium—as a desired minimum prudent amount of surplus funds for each health benefit plan. Such a level is consistent with actuarial theory and good industry practice.

Mr. WALDIE. May I just quote another of your experts which is of a contrary opinion, and that is the Wyatt report:

We would suggest a smaller goal for the special reserve for the service benefit plan. For a program of this size, even classical ruin theory would not support a reserve equal to one month's subscription income with the Federal Government as customer, and in fact the special reserve has two month's subscription income as its reserve.

Is that contrary?

Mr. RUDDOCK. That is later advice, and it is certainly not consistent with the advice we received in 1964.

Mr. WALDIE. I gather you reject this in favor of the Milliman & Robertson.

Mr. RUDDOCK. No, sir; I do not.

Mr. WALDIE. All right. How do we resolve this?

Mr. RUDDOCK. Give me a few more moments.

The original preferred minimum balance of 1 month in the contingency reserve and a reserve objective of 2 months premium for special reserve was not arrived at in a vacuum. I am sure you knew that.

Mr. WALDIE. No, I did not know that, and I am not convinced.

Mr. RUDDOCK. In 1968 we had some more experience with this program under our belts, and we were getting into the period of runaway health care costs. We once again contracted with the firm of Milliman & Robertson, and one of the items we asked them to review and on which we asked them to give us objective advice was adequacy of reserves.

In effect—and I will paraphrase this—they said the reserve objective should be modified; that the special reserve should be 1 month's average subscription income as compared with the older two, but they said also in recommending a new and somewhat lower reserve guideline:

We urge both the plans and the Commission to regard the guideline more as a requirement, a requirement for total reserves that we believe essential to prudent handling of the risk inherent in the government-employee program of this magnitude and importance.

One of the concepts of the program in the early years, and as long as we were able to do it, was the idea that premiums would not be changed every year. It was hoped that premiums could be established, and that they would go for a period of 2, 3 or 4 years without having to be changed.

In the second report, the 1968 report, from Milliman & Robertson, they suggested we strive for a 2-year premium, and that the premium be fixed with a reserve objective of having at least as the minimum 1 month in the special reserve at the end of the 2-year period, and of course with the 1 month in the contingency reserve.

Now, moving on from that we have the Wyatt report which indicated that perhaps a lower level of reserve is now in order. We have, as you know, a report from the Comptroller General dated May 22, 1972, in which again there is a recommendation that the Commission study the adequacy of the reserve levels, and an opinion expressed by the actuary here that 5 percent in toto would be enough to protect against classical ruin theory.

We are committed to make that kind of a study. I intend that we do this just as soon as we are through with this year's contract negotiations and open season, and that this be a matter which the Commission will consider for activities in 1973. We will consider whether any change should be made in the regulation which fixes 1 month's premium as the preferred minimum balance and contingency reserve, and also reconsider whether 1 month in special reserve is a desirable and prudent level, or whether it should be something less.

Mr. WALDIE. Do I gather from that that there will be no reduction in the reserve requirement during this negotiating period?

Mr. RUDDOCK. We have published in the Federal Register a proposed change in the regulation, but it is not directed specifically to what you have in mind. This is a recognition that at the beginning of 1972 we used contingency reserves to make it possible to defer premium increases until we got through with the application of the Price Commission guidelines. This regulation which has been published as a proposal and on which the Commission will act after receiving comment would permit the Commission to make additional payments from the contingency reserve, dropping it below that 1 month preferred minimum balance when the Commission decided that was in the best interests of the employees participating in the program.

But the Commission at this point has not made the study and does not have pending any proposed reduction in the preferred minimum balance of the contingency reserve.

Mr. WALDIE. Am I incorrect, Mr. Ruddock, in my understanding that both you and the Blues assume that the premium increase sought and granted by you, but denied by the Price Commission, the 34.1 percent would result in a zero reserve balance at the end of 1972?

Mr. RUDDOCK. That was the estimate at that point. Experience indicates that there is going to be a positive reserve.

Mr. WALDIE. Actually that experience is not based on the 34.1 percent raise.

Mr. RUDDOCK. It is based on the 22 percent high option increase; yes, sir.

Mr. WALDIE. The zero balance objective was not obtained. Reserves then were increased. Do the reserves at the present time exceed even these generous guidelines of 1 month in contingency and 2 months in special?

Mr. RUDDOCK. I do not believe they will, Mr. Waldie.

Mr. WALDIE. They will for Aetna?

Mr. RUDDOCK. Yes. The Aetna experience indicates that there will be 1 month which is $8\frac{1}{3}$ plus roughly 3 percent in the contingency reserve, and I anticipate a special reserve. Of course we will not know precisely what amount is in that special reserve until we have the benefit of the rest of the experience for this year.

Mr. WALDIE. Their projections say they will have 39.7 percent I think. Are you aware of that?

Mr. RUDDOCK. Of the contingency reserve total plus the special?

Mr. WALDIE. That is what we are talking about.

Mr. RUDDOCK. Yes, sir.

Mr. WALDIE. That compares to what you believe should be 1 month which is $8\frac{1}{3}$ and 2 months in the special which is 16%.

Mr. RUDDOCK. After 1968 we hoped to keep 1 month as the minimum special reserve.

Mr. WALDIE. So they are really only required to keep 2 months in total accumulated reserves, and you consider that adequate? Your contingency reserve of 1, and the special reserve of 1 month?

Mr. RUDDOCK. In today's climate I think that certainly will protect against any contingencies.

Mr. WALDIE. That would be less than 17 percent total reserves.

Mr. RUDDOCK. Yes.

Mr. WALDIE. Instead they have 39.7 percent?

Mr. RUDDOCK. I believe that is the figure.

Mr. WALDIE. Let us start with that base to begin with. Obviously the reserves are more than double what they should be. What do you propose as a solution to that with the Aetna contract?

Mr. RUDDOCK. Mr. Waldie, there are two ways obviously—at least two ways—in which you can go. One way is in the interests of having stability of the program, recognizing that health care costs and utilization are still increasing. You can hold to the premium knowing full well that this reserve will be used up within the next year, within the next 1½, 2 years. I will not attempt to pin that down with that preciseness.

Another alternative is that you can abandon any concept of stability of premium, stability of the program. You can try to adjust premiums upward or downward each year so that, in effect, you are definitely planning on a premium change each year, and that you are fixing that as nearly as possible to the actual costs anticipated or experienced in that year.

Let me mention a third possibility, and I am only throwing these out to indicate that it is not strictly only one way in which you can go. You could conceivably have a program in which you would fix your premium only after the experience, so that, in effect, you would be collecting premiums say, in 1974, to pay your actual costs in 1973.

I do not know of anyone who operates that way, but that is the only way in which I think you could fix with preciseness and right down to the penny the premium which is charged.

Mr. WALDIE. I am not asking anyone, especially the Civil Service Commission or the carriers to project. I have given up on that. There is apparently no possibility or anticipating accuracy in terms of projections in this contract.

However we are not projecting now. We know there is twice the amount of reserves that in the most generous of attitudes is required under the Aetna contract, and the question being your negotiating on behalf of the Government employees who have to contribute their premiums to keep those reserves in a reasonable basis of stability.

My question is, given those facts which are not projected as speculative, what do you suppose you will be doing with the Aetna contract in this new contract period?

Mr. RUDDOCK. First let me say that there is indeed some estimate and some projection in these figures. The estimate which I provided in the interrogatory last week gave you the figure projected by Aetna in June of 1972. At that time they would have paid claims experienced through May.

They would have had accrued experience through probably March. So they were indeed projecting what was going to happen in the rest of 1972.

I do not think really that changes things. The basic question here is: What should be done given the assumption of reserves at this estimated level, assuming experienced pans out as projected.

If I remember your question, it was: What does the Commission intend to do about this in 1973?

Mr. WALDIE. There are really three courses of action, I presume. One, you could return excess reserves to the policyholder by a reduction in premium; two, you could say the reserves were too small, and we like them this high; three, you could return the reserves to the policyholder by increase in benefits, the cost of which would be paid by the application of reserve without increase in premium.

But in every instance except the second one, the policyholder benefits.

This is my question to you: is the policyholder going to benefit other than in the hypothetical case that the contract is more secure because the risk is less?

Will he benefit by a return to many of these excess reserves in some form this coming year?

Mr. RUDDOCK. I think I need to add a fourth alternative. We can say we believe these reserves are higher than they need be, and as a matter of policy we will reduce them because of increase costs and utilization over the next few years. We will do it without any immediate reduction in the premium.

Mr. WALDIE. Yes, you can say what you are saying if the reserves are high now, but we may have a worse period in the future, so we better keep them.

I thought I presupposed when I said you could conclude that the reserves presently are too low, and you better keep them for possibly things that might happen in the future. That is really what you would say if you kept the reserves. Though they are high, increased utilization and all sorts of things in the next couple of years may make these reserves inadequate, so we better keep them.

Mr. RUDDOCK. Let me say it another way. I think you can decide to not reduce the premium without doing so for the reason you mentioned. I think you do it if you make a policy decision that it is in the best interests of the employees to maintain the premium level into the future rather than reduce it now and increase it a year from now.

Mr. WALDIE. Yes; that is a possible course of action.

Mr. RUDDOCK. That's a possible course of action.

Mr. WALDIE. I gather that is one you are contemplating.

Mr. RUDDOCK. Let me assure you that I have not been trying to avoid your question of what is going to happen in 1973.

Mr. WALDIE. I know. Is that the one you prefer, the one you have just outlined, as the alternative of the alternatives available?

Mr. RUDDOCK. Mr. Waldie, I think at this point I have to repeat what amounts to a conversation we had just about a year ago, and that is that this very decision is a part of the current negotiations between the Civil Service Commission and the carrier, and I am not authorized to discuss those negotiations.

Mr. WALDIE. All right. I thought that would be the response, and that is precisely why I was holding the hearings, because we do not believe the negotiations in the past have been subject to sufficient scrutiny, and we have to live with the results.

We are attempting to encourage you as negotiating on behalf of the employees of the Government to have a stiffer back in the future than has been demonstrated, and I understand that you are not able to state what your position will be.

The Wyatt report on this point of excess premiums which would reflect a charge for excess reserves says:

This aberration suggests that subscription rates for the governmentwide service benefit plan may be instituted so far in advance of its effective date that increase in hospital and surgical charges can be planned to use up the extra money. In short, there may be a kind of Parkinson's law operating here, such that health costs tend to rise to the level of contemplated subscription income.

But what your consultant tells you there—and I thoroughly concur—if you have all this extra money lying around, that is not, in fact, needed, costs will rise so that that which you have just said you fear will inevitably occur, that the increase in premium will ultimately be due a couple of years from now because they are going to spend that money.

The point your consultant makes, if you run a lean plan and do not give these carriers this extra money that they do not need under any reasonable guidelines, they will keep costs down.

Do you concur in that general theory?

Mr. RUDDOCK. I think they may very well refer to that.

Mr. WALDIE. I think this particular hearing is serving a very useful purpose. As I have indicated, we are committed to make this study of the reserve level. We have the advice from the Wyatt Co. We have the advice from the General Accounting Office. Let me assure you that your advice will very definitely be taken into consideration by the Commission in establishing whatever its future policy is to be.

Mr. WALDIE. I want to go into the amount of the reserves that the Blues have, Aetna aside for the time being, because theirs seems to be so demonstrably excessive. The Blues do not seem to be as demonstrably excessive.

What is the total cumulative reserves of the contingency and special reserves for the Blues at the present time, and what is projected for the end of the contract year percentage wise?

Do we have 1 month in contingency reserve? Do we have 1 month in special reserve with the Blues?

Mr. RUDDOCK. I am looking to my answer to your interrogatory. "On June 30, 1972, Blue Cross/Blue Shield estimated that the special reserve would be \$48.9 million on December 31, 1972, including \$23.9 million estimated to be paid from the contingency reserve in 1973", and these two figures combined are 5.8 percent of the 1973 estimated subscription income; so even on that projection it is less than 1 month.

If I may, I think we have a somewhat different situation.

Mr. WALDIE. If I may interrupt you, counsel reminds me of something in your answers to interrogatories. Your conclusion was that a low projection—

Mr. RUDDOCK. I am inclined to think it will be. As I indicated in the answer there—I am trying to be just as candid as I can—the average experience for pay claims for 1972 was running along fairly smoothly. August is unusually high. August is \$13 million higher than the average of the first 7 months.

Now, you have to be careful when you do anything on the basis of paid claims for 1 month, particularly since it is about 3 months after the fact before you learn what your accrual was.

But at the moment—and we are still I assure you working on this problem—I believe their estimate may be low.

Mr. WALDIE. Do you believe at the end then of the contract they will have more than 1 month's reserve in contingency and 1 month in the special?

Mr. RUDDOCK. Let me recognize that as a possibility. I certainly do not know what is going to happen in September, October, November, or December.

Mr. WALDIE. The same options are open to you in the Aetna. The Aetna is far more demonstrably improper, and your response I presume would be in essence the same as that to the Blues.

If they have too much in reserves, you have certain options open to you.

Mr. RUDDOCK. Yes. I think there is another factor that is involved here, and that is the effect of economic controls, the Price Commission. Since the economic stabilization program went into effect in August of 1971, there has as you know been no premium increase in the Aetna plan. You as well as anyone are aware of the premium increase for Blue Cross/Blue Shield and how that came about.

To the extent that there has been a premium increase within the Price Commission guidelines and regulations, and in which it looks as if the experience is more favorable—in other words, if we and the Price Commission had known in 1971 what we know now—the premium increase would probably have been smaller.

So that, I think, raises the distinct possibility of do you attempt to correct for the inaccurate estimate projections made in 1971?

On that question of error or inaccuracy, I am sure when Mr. Petten-gill testified he indicated that they too had had a favorable experience in the last part of 1971. There seems to have been some definite effect from the economic stabilization program.

Mr. WALDIE. Fine. The point I guess that I am trying to make is that object that you set forth, and that the Blues set forth in their petition, a copy of which I have presented to you. Your objective is to reach a zero balance in reserves in 1972, and you are holding down premiums because that was your objective which was lost track of.

You clearly do not reach a zero balance in reserves. You went way over zero in reserves.

Mr. RUDDOCK. You are suggesting—and I quite agree—that your objective for 1973 could once again be a zero balance.

Mr. WALDIE. That is part of my suggestion. My other suggestion is that you could return to the Government and the employees the money that they need for their own purposes, rather than keep it in that reserve in case something might happen.

Mr. RUDDOCK. I think that it saying the same thing another way.

Mr. WALDIE. Yes, perhaps. I hope so.

The zero reserve objective I understand means whatever the premium was for this year, no portion of that premium was to be attributed to increase of either contingency or special reserves. Is that a fair description?

Mr. RUDDOCK. No. The law of course authorizes the 3 percent set aside, and the Commission has used the 3 percent so that in every year 3 percent of employee deductions and agency contributions will go into the contingency reserve.

Mr. WALDIE. It does not have to set it aside?

Mr. RUDDOCK. It would have to unless—

Mr. WALDIE. The law does not say it has to.

Mr. RUDDOCK. No. Two things could happen. One, the Commission could reduce the set aside to something less than 3 percent. Now, I do not believe the Commission could reduce it to zero, because the law says there will be a set-aside, and I do not think zero is—

Mr. WALDIE. But the Commission did not reduce it at all. They set aside the maximum they may set aside.

Mr. RUDDOCK. That is right. Under the Commission regulations the carrier is paid from the contingency reserve the amount by which that reserve exceeds 1 month, so in effect it is a revolving fund, and we will make a payment from the contingency reserve to each of the carriers.

Mr. WALDIE. That contingency reserve has no other use except for the carrier's benefit, has it?

Mr. RUDDOCK. It was very much to the benefit of employees in the early part of 1972. If a carrier needed an additional \$12 in premium, what we did in effect was to pay that additional premium for January, February, March, and 15 days in April out of the contingency reserve, and then increase the employee's premium and the Government's contribution only from and after April 15 for the rest of the year.

If we had not used the contingency reserve for what I consider to be the employees' benefit in that case, the premium increase beginning April 15 would have to be enough to raise the \$12 in what was left of the year.

Mr. WALDIE. It would not make any difference. It was his money anyway that you were paying out.

Mr. RUDDOCK. Money collected from the prior years.

Mr. WALDIE. For him?

Mr. RUDDOCK. Oh, yes.

Mr. WALDIE. So it was of no net benefit to him by reason of that bookkeeping entry. You took the money. He paid it to you, and you gave it to the carrier.

Mr. RUDDOCK. I do not mean to imply we found a magic source of funds here. The take home pay of the individual was higher for January, February, March, and 15 days in April.

Mr. WALDIE. But it was lower all the time you were collecting those 3 percent reserves from him.

Mr. RUDDOCK. Yes, sir. If we abolished the 3 percent set-aside, and if we eliminated the contingency reserve, which we would do by paying the subscription charges in future years so that we had a contingency reserve of zero and nothing going into it, we can only use that contingency reserve once.

In other words, it would not be a continuous gain into the future of that much each year for employees.

Mr. WALDIE. I ask Mr. Pettengill this: "In view of your contention that this is the least risk contract you write, in examining how much our reserves should be, what would you do if you had a provision in there that the Government guarantees you no less, as I think we do now?" If they have a loss, we have an increase. If they go out of business, we pay the losses out of everything available.

He said, "We would not need any reserves."

Would you agree with that?

Mr. RUDDOCK. Oh, absolutely, if the Government is the guarantor for payment of all benefits.

Mr. WALDIE. Tell me where the Government is not the guarantor under the contract written. In what speculative contingency is the Government not the guarantor? What is the disaster ruin theory that could occur?

Mr. RUDDOCK. The only disaster would be if either a contract with an individual carrier or the program as a whole were terminated at a time when there was not even enough in the reserves to pay off all the claims.

Mr. WALDIE. That is the risk that we set aside the reserves to cover?

Mr. RUDDOCK. Partly, yes.

Mr. WALDIE. If it is only partly, what else is there?

Mr. RUDDOCK. The other is the thing I mentioned, the objective of stabilizing the program so that you do not have premium increases every year. A fairly common method of doing that I understand is to try to establish a 3-year premium. You establish it at a level that during the first year would accumulate a reserve, an accounting figure, if you will. During the second year you would desirably exactly meet the cost incurred in that year, and in the 3d year you would use up the reserve accumulated in the first year. Then you would have another 3-year contract.

Mr. WALDIE. Is that the policy we operate on?

Mr. RUDDOCK. No, sir.

Mr. WALDIE. Then that is not part of the risk or objective, is it, since that is not the policy we operate under.

Mr. RUDDOCK. For many years we followed the policy of trying to have a premium that would last 2 years. That has not generally speaking been possible in recent years.

Mr. WALDIE. The contract is executed every year, is it not? If that is the policy, why do we not execute a 2- or 3-year contract and hold them to it?

We set a policy I gather to have premiums that will last 3 years, but we leave it open in case we are wrong and they would suffer.

Mr. RUDDOCK. We never tried to establish a 3-year.

Mr. WALDIE. But we leave the contract open in case we are wrong.

Mr. RUDDOCK. For minor adjustment in the intervening year.

Mr. WALDIE. To their detriment? There is nothing that protects us. The contract is not executed for 2 years even though the premium is projected to be a 2-year premium.

Mr. RUDDOCK. You are quite right.

Mr. WALDIE. It is only a 1-year contract in case we make a mistake it would hurt them.

Mr. RUDDOCK. But, getting back to your question, the carriers would suffer a loss only in the event of termination of the program or of the individual contract at a time when the reserve was negative.

Mr. WALDIE. Is that a risk in your view that warrants the keeping of reserve in the amount that are presently required?

I guess your answer is, "I do not know; I have not studied that"?

Mr. RUDDOCK. Let me try to prejudge the study. I think that is something that very definitely needs to be looked into. I would think just as competent actuarial advice in 1964 suggested to us that 3 months was the proper level, and in 1968 suggested with this additional experience probably 2 months would do it, now with the advice of the Wyatt Co. and the actuaries from General Accounting Office, it suggests a much lower level, and I think it is entirely possible that these levels can be lower than they are currently.

Mr. WALDIE. Would you care to comment on the proposal that since there really is not great risk the Government could simply put in a clause that anybody who goes out of business with losses we will cover. Would that be objectionable to you?

Mr. RUDDOCK. I think that is a very definite possibility.

Mr. WALDIE. At which time no reserves at all will be required.

Mr. RUDDOCK. It seems to me that that ends the insurance concept.

Mr. WALDIE. It seems to me we ended the insurance concept a long time ago. I am not being over critical of the policy. Aetna was very impressive when it said, this is really a great contract. Of all the contracts we have, this is the least risk.

Mr. RUDDOCK. Would you favor a provision for a Government guarantee in the event of termination of contract?

Mr. WALDIE. No. I would favor reducing the risk to about \$10 a year, which I suspect it is.

Mr. RUDDOCK. May I comment on that.

Mr. WALDIE. Yes.

Mr. RUDDOCK. I have here a report to the Congress from the Comptroller General, Survey of the Application of the Government's Policy on Self Insurance. This one is dated June 14, 1972. I will read only one sentence.

The premiums paid into the fund—

He is talking about insurance generally—

must normally be sufficient in the long run not only to cover the losses of the participants but also to cover the selling, administrative and other expenses of the fund, and to provide a reasonable profit to the insurer for his risk and services in administering the fund.

As we have indicated in the past, when we began this program in 1960, the risk charge in the Blue Cross/Blue Shield contract was 1½ percent. The risk charge for the contract with Aetna was 1¼₁₀ percent.

Mr. WALDIE. Was that designed to take care of risks?

Mr. RUDDOCK. It was intended to cover risks.

Mr. WALDIE. So that portion at least designed for the risk is part of reserves. You meet the problem of risk in insurance by setting up reserves, do you not?

Mr. RUDDOCK. A company establishes surplus to enable it to meet its risk.

Mr. WALDIE. Does it not establish reserves to meet risk?

Mr. RUDDOCK. But the risk charges, as originally set here, were payment to the carriers not only for risk but for services, a fee for doing business.

Mr. WALDIE. But the portion that is set aside for risk is an addition to the reserves that were set aside for risk. It makes it less likely the reserves would be called on if that portion were applied to losses, but it was never applied to losses, was it?

Mr. RUDDOCK. No, sir.

Mr. WALDIE. So in fact it is not a reserve having to do with risk.

Mr. RUDDOCK. No, sir. It was never established as a reserve.

Mr. WALDIE. So the statement of the Comptroller General that the risk charge has some relation to risk really does not seem to apply.

Mr. RUDDOCK. In the years which have intervened since 1960, we have reduced the payment. We have reduced it until it is now in the neighborhood of a half percent; I think 0.6 or whatever.

Mr. WALDIE. Why should there be any payment?

Mr. RUDDOCK. Why should there be any payment?

Mr. WALDIE. Do they not have an administrative charge that pays them?

Mr. RUDDOCK. For their actual expenses.

Mr. WALDIE. Do they not have a reserve setup to take care of losses?

Mr. RUDDOCK. This is not a payment for losses.

Mr. WALDIE. Then what is it a payment for?

Mr. RUDDOCK. Services; profit.

Mr. WALDIE. What services are not permitted to be paid as administrative charges?

Mr. RUDDOCK. This is strictly the profit for doing business.

Mr. WALDIE. Then we are not paying for services, because we pay administrative charges for services, do we not?

Mr. RUDDOCK. I think the Comptroller General clearly indicates that the premium has to cover the administrative and other expenses, and to provide a reasonable profit to the insurer for his risk and services.

In other words, I do not know of anybody, profit or nonprofit, who handles business for someone else where all he expects is to be reimbursed for his actual out-of-pocket expenses.

There is contribution to capital. There is some hope of growth. With the Aetna I think this is easily understandable. It is a stock company. They have stockholders who expect to receive a profit.

Mr. WALDIE. I fully understand that. That is pure profit, and we are giving them a profit for running the program for us. I presume we are giving Blue Cross—we are paying them for all the expenses of running it, and then giving them a little extra for having done it for us.

Mr. RUDDOCK. For a profit.

Mr. WALDIE. Yes. So I gather now from what you have said Aetna says it is not a public service charge; it is a service charge in their contract.

Mr. RUDDOCK. It is profit.

Mr. WALDIE. They say it is profit. The Blues say, and their contract says, it is a public service charge. Why the difference in the Aetna between the words "service charge" and the Blues contract "public service charge"?

Mr. RUDDOCK. Because I think—and you will not find me defending Blue Cross/Blue Shield on this point—Blue Cross has in the past justified its collection of a fee from everybody it does business with on the grounds that they use this money for public service purposes.

Mr. WALDIE. That is what you acceded to in the contract, that it was a public service charge. That is why you had to pay the Blues this money. Do you say it is not a public service that they are rendering with this money?

Mr. RUDDOCK. I will let them justify it if they can.

Mr. WALDIE. But you are the one who agreed to pay it to them. I presume you agreed to pay it to them because you thought the public services they were rendering were valid and proper.

Mr. RUDDOCK. No sir.

Mr. WALDIE. Why did you agree to pay it to them?

Mr. RUDDOCK. We agreed to pay it to them because when the Congress in 1960 said in effect to the Civil Service Commission, You will contract for a service benefit plan and with specifications under which Blue Cross/Blue Shield was the only carrier that could possibly meet the intent of Congress, and when we found that Blue Cross/Blue Shield applied, by whatever term, something over and above expenses with everybody it does business with—and this is true today in everyone of its national insurance contracts—we agreed that we would do as any other large employer contracting with the Blues.

We would not say, Well, so far as we are concerned you will have to get your profit, risk, public service charge, contribution to capital, whatever you want to call it—you will have to get that from somebody else; we are not playing that way.

Mr. WALDIE. You changed the name from risk charge to public service charge after the committee started inquiring into this. How did you pick the nomenclature of public service charge for the Blues versus service charge for Aetna?

Mr. RUDDOCK. Blue Cross picked the word "public." We did not pick that.

Mr. WALDIE. You acceded to it.

Mr. RUDDOCK. Yes, we did, and I do not really care what we call it in the contract.

Mr. WALDIE. Do you care how they spend it?

Mr. RUDDOCK. No, sir.

Mr. WALDIE. Do you care whether they spend it for liquor bills?

Mr. RUDDOCK. Is that a question involving my responsibility for administering this contract, or is this questioning their morals?

Mr. WALDIE. No; I do not have any question about their morals. The question is liquor bills, as I understand the news report, are not acceptable charges under administrative expenses.

Mr. RUDDOCK. That is right. That is not a necessary reasonable charge for administering this contract.

Mr. WALDIE. But as far as you are concerned, as administrator of this contract, if they use the public service charge for those expenses that are not acceptable under administrative charges, you have no objection?

Mr. RUDDOCK. If I took that position, it would seem to me that I would have to assume responsibility for how they spend every dollar of their profits.

Mr. WALDIE. I do not say that at all. I say you have another responsibility, and that is: Are the Federal employees getting ripped off by permitting the Blues to use the moneys the Federal employees are contributing for purposes which you would not grant them under administrative expense costs?

Your view of the public service charge is the Blues selected the name. You think it is pure profit, and you do not care what they do with it.

Mr. RUDDOCK. I do not think that is my responsibility.

Mr. WALDIE. That is their business.

Mr. RUDDOCK. That is their money.

Mr. WALDIE. Not the contractor's?

Mr. RUDDOCK. That is right.

Mr. WALDIE. Why did you reduce it if it is none of your concern?

Mr. RUDDOCK. Mr. Waldie, I think our history from 1960 until the present time would indicate that we have constantly been interested in reducing that.

Mr. WALDIE. Because we have been paying too much for the service they rendered?

Mr. RUDDOCK. I do not think that necessarily follows. I testified before I am interested in getting these contracts at the lowest profit for which we are able to contract. I have assured the committee, on numerous occasions, if Blue Cross/Blue Shield is willing to administer this contract, and with no service charge profit, that is fine with me.

Mr. WALDIE. Why did the Blues want the terminology changed from risk charge to public service charge, or was that your suggestion?

Mr. RUDDOCK. We suggested that we stop using the term "risk charge," because while we clearly understood that the term "risk charge" included all of the purposes for which this was paid, people not quite so familiar with the program constantly kept referring to this as being solely and exclusively a rate that was payment for risk which should be related to the amount of risk.

Mr. WALDIE. Do you think it is more descriptive as a public service charge, as what it is actually used for?

Mr. RUDDOCK. Again I am not going to defend the Blues.

Mr. WALDIE. I am not asking you to defend the Blues. You were the one who executes the Government contracts on behalf of the employees. Is it more descriptive of what the charge is?

Mr. RUDDOCK. I would hope that is more descriptive of the way most of their money is used, but I really do not know.

Mr. WALDIE. Do you feel you have any responsibility to find out?

Mr. RUDDOCK. How they use it?

Mr. WALDIE. Yes.

Mr. RUDDOCK. No, sir.

Mr. WALDIE. Why do you hope that is the way they use it? Because if they do not use it that way, it would not be fair to the employees that are paying it?

Mr. RUDDOCK. No, sir.

Mr. WALDIE. Then why do you hope that they use it for public service?

Mr. RUDDOCK. I would hope when an organization holds itself out as performing public services, it would be doing them.

Mr. WALDIE. They do not really hold themselves out as performing public services, or they would not be charging us for it. A public service you are not charged for; are you?

This is a private service, they want a profit from rendering it. It is not a public service; is it?

Mr. RUDDOCK. No; but I am sure you are as familiar as I with some of what they say they do with this charge.

Mr. WALDIE. I do not have any idea what they do with it, and they will not let us know. My guess is they use it for those very costs you would disallow as not being fair to the public employee.

That is my guess, and it is unhappy that I have to guess, and it is unhappy that you do not have a provision in the contract saying if this is a public service charge, as contractor on behalf of the public, I want to guarantee that it is being used for public benefit.

You do not believe that is any of your responsibility?

Mr. RUDDOCK. No, sir.

Mr. WALDIE. Do you not believe they are trying to put a big facade upon this money by listing it as public service?

Mr. RUDDOCK. Yes, sir.

Mr. WALDIE. You do?

Mr. RUDDOCK. Yes.

Mr. WALDIE. I do, too. Does that not disturb you?

Mr. RUDDOCK. Morally; yes, sir. In my responsibility for administering this contract, it does not bother me.

Mr. WALDIE. What do you think the amount paid to them over and above their actual costs should be? Zero?

Mr. WALDIE. I personally believe that their actual costs have built into them a great profit. The 4.3—is that what we are now paying in administrative charges?

Mr. RUDDOCK. Actual expenses not to exceed 4.5 percent.

Mr. WALDIE. That is what they get, is it not?

Mr. RUDDOCK. For 1971, as I remember, it was 4.3.

Mr. WALDIE. You do not know how they stand. Just in a cursory examination by GAO, at our request, we found all sorts of unauthorized expenditures that you yourself agreed were unauthorized; right?

Mr. RUDDOCK. Are you referring, Mr. Waldie, to entertainment expenses, for example?

Mr. WALDIE. I am referring to liquor bills which you say are not authorized.

Mr. RUDDOCK. That is right.

Mr. WALDIE. But they were charging us for them.

Mr. RUDDOCK. They were running them through that account.

Mr. WALDIE. That is charging us for them, is it not?

Mr. RUDDOCK. They had, as I understand, given instructions to their own audit firm to identify each one of those and to reimburse that account, so that it would not end up being a charge as an administrative expense against our contract.

Mr. WALDIE. When did they tell you that? They never told us that. Is that what was done?

Mr. RUDDOCK. Mr. Waldie, I think that is clearly indicated in the GAO audit papers which you made available to us.

Mr. WALDIE. So it is your understanding—and perhaps I have misread it—that they just used this as a convenient vehicle to pay these bills, but they reimbursed us so we are not charged for those bills?

Mr. RUDDOCK. Yes, sir.

Mr. WALDIE. Have you ever audited their administrative expense account?

Mr. RUDDOCK. Yes, sir.

Mr. WALDIE. How often?

Mr. RUDDOCK. Let me indicate.

Mr. WALDIE. Did you ever come across this runthrough of liquor bills in your audit?

Mr. RUDDOCK. We have just in this recent experience. Let me back up a little bit.

Mr. WALDIE. All right.

Mr. RUDDOCK. We completed our last audit of the Office of the Administrator of the Federal employee program here in Washington which includes the expenses of these regional meetings and the like, and we gave them a closeout report in early 1970.

That included GAO and the Commission having been through their accounts up through mid-1968.

We disallowed in entertainment expenses—I do not remember the exact figure—something in excess of \$10,000, and we had an agreement with them that they would immediately have their own audit firm go through the balance of 1968 and all of 1969, and do exactly what we had done, in that they would relieve the administrative expense account of the Federal program of that amount.

Mr. WALDIE. Have they done that?

Mr. RUDDOCK. They had done it.

Mr. WALDIE. How much were we relieved of in 1968 and 1969?

Mr. RUDDOCK. I do not have that figure in my mind.

Mr. WALDIE. Did their auditor find any such expenses?

Mr. RUDDOCK. Yes; and in effect reversed that charge in the account.

Mr. WALDIE. Were the figures as high as the ones you found or was it a lesser figure?

Mr. RUDDOCK. I do not know the number.

Mr. WALDIE. Provide that for the committee.

(The information referred to follows:)

For the period August 1, 1968, through December 31, 1969, the amount was \$9,562.29.

Mr. RUDDOCK. When the General Accounting Office auditors were here within the past few months went in and took a look at the accounts beyond the point at which our auditors had been through them, they found these expenses being entered in the accounts, and they also found that the audit firm retained by the office of the director of Federal employee program had overlooked some of those nonallowable items.

We have given a letter of disallowance to the director of the Federal employee program for the amount entered in the account, and not relieved on the basis of their own audit.

We also have their assurance in writing that beginning I believe July 1 they stopped running these unallowable items through this account.

Mr. WALDIE. How much did you require them to reverse?

Mr. RUDDOCK. Over and above what had been identified by their own audit firm, I believe the figure is \$12,000 something.

Mr. WALDIE. For just the Washington office?

Mr. RUDDOCK. And the charges made to this program through the regional meetings.

Mr. WALDIE. Which year did that cover?

Mr. RUDDOCK. That would cover up through 1971 I think.

Mr. WALDIE. It would cover all the years back through 1971?

Mr. RUDDOCK. Beginning with the middle of 1968; yes.

Mr. WALDIE. What about the preceding years, if that was their practice, in an effort to get back to the preceding years?

Mr. RUDDOCK. You see, our disallowance in early 1970 would have included the disallowance of all of these items up through the middle of 1968.

Mr. WALDIE. Then your view is that you have audited the administrative account charges sufficiently frequently so that you do not think the Blues were playing games with us during those years when they received more money than they were entitled to? Is that correct?

Mr. RUDDOCK. Let me answer your first question as to whether we have audited them frequently enough. Let me say "No."

Mr. WALDIE. Why not?

Mr. RUDDOCK. You mean why has our audit staff not been large enough to do that?

Mr. WALDIE. Right.

Mr. RUDDOCK. For a wide variety of reasons.

Mr. WALDIE. Name one. The money is there, is it not? Does the statute not permit you to take 1 percent of premiums for purposes exactly such as that?

Mr. RUDDOCK. Within such limitations as fixed annually by the Congress.

Mr. WALDIE. Have you ever asked Congress for moneys for this purpose that have been denied?

Mr. RUDDOCK. Specifically for the purpose of audit?

Mr. WALDIE. No. Specifically for purposes of administering the program?

Mr. RUDDOCK. Yes.

Mr. WALDIE. When?

Mr. RUDDOCK. Do not let me overemphasize this.

Mr. WALDIE. Please do not.

Mr. RUDDOCK. For 1973—and as you know we asked for an expense limitation which includes the administration of retirement, life insurance and health insurance, and so that is fixed as limitation—there is an estimate made of the amount which is required to be taken from each of the trust funds.

For fiscal 1973 our request was reduced by \$411,000.

Mr. WALDIE. Rather than go into the history, is it your view you have not asked for more staff to do these things because you are afraid Congress will not give it to you?

Mr. RUDDOCK. No.

Mr. WALDIE. Then why have you not asked? You are entitled to 1 percent of the premiums paid for that purpose.

Mr. RUDDOCK. May I answer that by indicating these hearings have served a very valuable purpose of bringing sharply to our attention a need for improvement in our audit program.

Mr. WALDIE. I think that is clearly true, and I hope that is the case, but we are really on the issue that you brought up as why should they not be paid a profit.

My suggestion is they should not be paid a profit because in my belief they have already taken it.

Should the contract require that access to how they spend this money on behalf of the public service be permitted you or the Congress or both?

Mr. RUDDOCK. Would you mind repeating your question.

Mr. WALDIE. Should the contract require that access to how they spend this money on behalf of the public service be permitted you or the Congress or both?

They deny us access—the Blues do—to their books and how they spend their public service charge, and say that is not our business as representatives of the public. You say that they are right.

They are right only because there is no statutory compulsion or no contract compulsion. Would you deem it advisable to amend the Blues' contract to require audits on your part as contracting party on behalf of the Government of the manner in which they spend their public service charge?

Mr. RUDDOCK. No, sir.

Mr. WALDIE. Why would you not, because you do not think that is the public's business?

Mr. RUDDOCK. I think that is a part of the internal affairs of Blue Cross/Blue Shield.

Mr. WALDIE. And therefore not the public business?

Mr. RUDDOCK. It may very well be the public business, but I would distinguish that from administration of a contract in which the Civil Service Commission representing a large employer deals with Blue Cross/Blue Shield in much the same manner as many other employers throughout the country.

Mr. WALDIE. I wish you did deal with them in the manner of other employers who are permitted to express criticism. If we had dealt with them in the manner of other employers, we would have access to a great deal of information, and they would not have the generous contract they have.

However, in short, your view is you are not willing, or you do not believe it proper, to provide access on your part to how they spend their public service moneys?

Mr. RUDDOCK. I will repeat that. May I benefit from your advice and opinion, Mr. Waldie. Do you think that any other employer dealing with Blue Cross/Blue Shield has the right to audit what Blue Cross/Blue Shield does with similar service charge, risk charge, profit, or whatever, that it is paying the Blue Cross/Blue Shield?

Mr. WALDIE. It is not whatever. It is, as the contract describes it, and the contract describes it as public service charge. Therefore it is to be expended on behalf of the public, not on behalf of Blue Cross.

If it is to be expended—and you are the one who agreed with the nomenclature—on behalf of the public, the public has a right to know if it is in fact being spent on their behalf.

Mr. RUDDOCK. Would your advice be the same if the contract used the term "profit"?

Mr. WALDIE. I do not see how you can pay a nonprofit corporation a profit. How do you get over that hurdle?

I presume that is why they listed it as public service charge, and prior to that as a risk charge, because they would not dare charge it as a profit, because IRS would start taxing them.

Mr. RUDDOCK. But in that context would the prohibition be against paying a profit to a nonprofit organization, or would the restriction be against the nonprofit organization accepting a profit?

Mr. WALDIE. You mean that it is not against the law to accept a profit if you are a nonprofit organization, but it is against the law for us to pay them a profit?

Mr. RUDDOCK. No; I think the other way.

Mr. WALDIE. If it is against the law for them to accept, but not against the law for—

Mr. RUDDOCK. If there is any restriction that deals with a nonprofit organization receiving a profit, I would think it would be a restriction on the receipt rather than on a restriction imposed on the person paying it. But this is semantics.

Mr. WALDIE. I do not know that it is semantics. What disturbs me is you agree that they are playing games with people, using the name public service charge, trying to put up a facade of being a great corporation attempting to help out people.

You agree that it is nonsense, but you consented to the change "risk charge" to "public service charge" because you thought risk charge was confusing the public.

But the public service charge you say does not confuse the public, though you say it is not really a public service charge. I do not understand that evolution of thought.

Mr. RUDDOCK. Again, I think we are dealing in semantics.

Mr. WALDIE. No. If it is not a risk charge, we ought not to have paid it. If it is truly a public service charge, it ought not to get paid. If it is something else, they ought to tell us what it is, and then ask if we are willing to pay it.

You tell me it is profit. I do not see how we can pay a profit to a nonprofit organization. It is something else?

If it is for the expense of running the contract, it is an administrative expense. The contract provides what the administrative charges are, and they are to be paid a cost of doing business. But we pay them everything they put out in this contract—everything.

We assure they do not have any losses, and there are no real restrictions on what we put out. It is a cost-plus contract.

Then we give them a plus which we designate as risk charge because we did not say we were giving them a plus.

Mr. RUDDOCK. I would like very much to see the Congress consider an amendment to the health benefits law which, in effect, would say that no amount over and above actual costs would be paid to any carrier organized not for profit. I say that I would like to see the Congress consider it.

I doubt very much that Congress would enact it. I do not believe the majority of the Members of Congress would put that kind of provision in the health benefits law. But this is clearly an area where the will of Congress will be done.

Mr. WALDIE. How is this item, whether it is risk charge, profit or public service charge, computed? What is the formula whereby you determine what it will be? Is it the best you negotiate?

Or is there, as I have been told—and as the figures would seem to indicate—a dollar a head on all subscribers, the formula by which you arrive at the charge?

Mr. RUDDOCK. The agreement, Mr. Waldie, is on the flat amount.

Mr. WALDIE. I know, but how do you write the flat amount? Is it a dollar a head?

Mr. RUDDOCK. It very generally approximates a dollar a head. Let me put it in other terms.

When the General Accounting Office recommended that the risk charge be reduced—and of course they were aware that it included a lot of things over and above risk—we asked them in effect what they thought would be a reasonable fee or service charge. For reasons I can well understand, they declined to give us any estimate of what it should be.

We have indicated that the present \$5,100,000, which is a big sum of money, is approximately a dollar a head, but it is not arrived at by counting heads and saying, well, gee whiz, there are five million one hundred thousand, and so we will increase it this amount, or we will reduce it. It is a flat amount. It amounts to slightly less than 2 cents per week for each Federal employee and family member who is covered under this contract.

Mr. WALDIE. That is one way of putting it. But it is a dollar a head. That is the real way of computing it.

Mr. RUDDOCK. It is roughly \$1 per year per head.

Mr. WALDIE. On what basis did you determine the \$1 per year per head was a reasonable profit to make from administering this contract?

Mr. RUDDOCK. On no basis. We were negotiating from a position in which the contract said they would get the equivalent of 1 percent of premium. As you know, for this current year that would have been somewhere between \$8 million and \$9 million, and we negotiated it down to \$5 million, which is obviously a reduction.

The coincidence of a dollar a head I think is more that than any rationale that it should be a dollar a head or \$1.10 a head, or \$.90 a head.

Mr. WALDIE. Is there any theory as to what profit for running these programs ought to be? Do you have any idea? Is it just whatever they will agree to?

Mr. RUDDOCK. Provided it is less than what they are receiving from other national contracts.

Mr. WALDIE. Is that the criterion?

Mr. RUDDOCK. That is one of the criteria. The other criterion is the lowest we can get.

Mr. WALDIE. Has that criterion been met, that we pay less for profit on this contract than any other comparable contract of this size in the Nation?

Mr. RUDDOCK. They have assured me of that in writing. I have had that assurance from both Blue Cross/Blue Shield and Aetna.

Mr. WALDIE. That this is the lowest profit they charge?

Mr. RUDDOCK. For any nationally insured contract.

Mr. WALDIE. Are there any other nationally insured contracts?

Mr. RUDDOCK. Oh, yes.

Mr. WALDIE. What would be an example?

Mr. RUDDOCK. Steel; auto workers.

Mr. WALDIE. They charge them a higher profit for administering their programs?

Mr. RUDDOCK. Yes, sir.

Mr. WALDIE. Is there any effort, or are you at liberty to say, to reduce that from a dollar a head to any other figure this contract period?

Mr. RUDDOCK. Without violating any of the specifics of the current negotiations, it is my constant objective to get that figure as low as possible, as near zero as possible.

Mr. WALDIE. Interestingly enough, there are, what, 43 carriers in this program?

Mr. RUDDOCK. Yes. I usually say approximately 40.

Mr. WALDIE. Do they all get this dollar a head fee?

Mr. RUDDOCK. No, sir.

Mr. WALDIE. Why do they not?

Mr. RUDDOCK. We do not pay a fee of this kind to community related plans.

Mr. WALDIE. Why?

Mr. RUDDOCK. Because in fixing their community rates they build in the same kind of contribution to capital, or whatever you want to call it, so that we do not do it again after determining the premium to be paid.

Mr. WALDIE. Your assumption is they have already got their dollar a head profit?

Mr. RUDDOCK. They are getting whatever they are getting from the rest of the community.

Mr. WALDIE. The dollar a head I assume you agree is a fair profit to make for administering this contract?

Mr. RUDDOCK. I have no brief for a dollar a head.

Mr. WALDIE. You agreed to it, and I presume you would not agree to an unfair profit.

Mr. RUDDOCK. I agreed to \$5,100,000 for Blue Cross/Blue Shield and \$1,300,000 for Aetna.

Mr. WALDIE. Which you said approximates—

Mr. RUDDOCK. It approximates a dollar a head. If we could cut those figures in half, then we would be roughly the equivalent of 50 cents a head. I do not believe we could do that by saying there is a rationale for 50 cents a head, and so we want you to bring it down to that basis.

Mr. WALDIE. Your view is they would not contract with you?

Mr. RUDDOCK. I do not know of any rationale for 50 cents a head or for a dollar a head.

Mr. WALDIE. Why do you agree to a dollar a head if there is no rationale? Why did we not take \$50 a head which is equally irrational or 50 cents a head?

Mr. RUDDOCK. Because we were interested in getting the lowest total, and we agreed on the total.

Mr. WALDIE. The lowest total is the one they would agree to conduct the business for, I suppose. Is that not fair?

Mr. RUDDOCK. I would not try to mislead you into saying we brought that right down to "it is this or no contract."

Mr. WALDIE. Other than the community based programs, which I assume you say have a profit built into them, of all the other programs are there any that have the same type program that the Blues or Aetna do that do not get their dollar a head charge?

Mr. RUDDOCK. In the employee organization plans, most of them are underwritten by an insurance carrier, and we pay a profit item which goes to the insurance carrier, just the same as we do in the Aetna contract.

Mr. WALDIE. Is that listed as a service charge in their contracts? Do they get service charges, the employer organization plans, when they contract with you?

Mr. RUDDOCK. The ones that are underwritten by the insurance companies.

Mr. WALDIE. Do?

Mr. RUDDOCK. Yes. There are four that are not underwritten by insurance companies. There are four that are self-underwritten where the services are performed not by an insurance company but by the union itself, and in the four self-insured union contracts we do not pay a service charge or risk charge.

Mr. WALDIE. Are they entitled to it for all the problems in administering the program?

Mr. RUDDOCK. I think you could look at that in two different ways. One way, of course, would be the question of whether the union derives that kind of money from the dues it charges its members as union members, or whether it comes about as an addition to the premium of health insurance contract.

Mr. WALDIE. Forty percent of it would be paid by the Government for every one of these.

Mr. RUDDOCK. That is true.

Mr. WALDIE. If they were to ask for the dollar a head, would you have any objection to it as contracting officer?

Mr. RUDDOCK. I would have to give that some more consideration, Mr. Waldie. It would seem to me that if any one of the four self-insured were to ask, it would certainly have to be given serious consideration.

Mr. WALDIE. Just one final question. You recall the incident where the Blues revealed that they had in fact started tightening up benefit delivery services by their memo that they sent around to their providers.

Mr. RUDDOCK. Yes, sir.

Mr. WALDIE. And they had not notified you that was the case, and the first revelation was before this committee, and you felt that you were surprised at it.

Mr. RUDDOCK. Mr. Waldie, my surprise was when you read the instruction from one of the local Blue Cross plans to, as I remember it, a local hospital.

Mr. WALDIE. Right.

Mr. RUDDOCK. As I think we have indicated, and as the Price Commission has indicated, we were aware that they were trying to tighten up on claims policy. I was not aware of the existence of that particular 16 point memorandum until the day of the hearing here before this committee.

Mr. WALDIE. Have you taken steps now to be aware of action of that nature that would have impact upon the people you represent?

Mr. RUDDOCK. Yes, sir.

Mr. WALDIE. Let me strike that. We went through this.

You do not consider that the Civil Service Commission is representing the Government or employees in its negotiations with the carriers, do you? You do not perceive that as your role?

Mr. RUDDOCK. I think we are representing both the employees—

Mr. WALDIE. The carriers?

Mr. RUDDOCK. No, not the carriers. The employees and the Government.

Mr. WALDIE. Then you do represent the employees and the Government?

Mr. RUDDOCK. Yes, sir.

Mr. WALDIE. And not with the carriers?

Mr. RUDDOCK. Yes.

Mr. WALDIE. But you are not interested in their problem. You are interested in the employees and the Government's problem.

Mr. RUDDOCK. I am interested in the employees' problems collectively.

Mr. WALDIE. But when the employees' problems are in conflict with the carriers, your brief is on behalf of the employees?

Mr. RUDDOCK. Yes, sir. When that is in conflict with the contract, absolutely.

Mr. WALDIE. I am talking about negotiating a contract. You construe yourself as the attorney, if you will, the agent.

Mr. RUDDOCK. Yes, trying to get the best deal we can for the employees.

Mr. WALDIE. And the Government?

Mr. RUDDOCK. Yes, sir.

Mr. WALDIE. In your view you have gotten the best deal you can get on this contract?

Mr. RUDDOCK. I have to be a little careful in answering that. I do not think we are perfect.

Mr. WALDIE. No, but you think it is a good contract that you negotiated last June?

Mr. RUDDOCK. I think there is a lot of room for improvement, and I think we will see that kind of improvement.

Mr. WALDIE. Then the final question. I recall in the last contract we opened up the contingency reserve to the carriers upon abandonment of their contract or going out of business.

Mr. RUDDOCK. Yes, to pay off claims existing at that point.

Mr. WALDIE. That was a quid pro quo to them, an increase in their position, an improvement in their position, that you concede, and you got something for it.

Mr. RUDDOCK. We got a reduction in the profit.

Mr. WALDIE. Is that why the reduction was given to you, because you opened up the contingency reserve?

Mr. RUDDOCK. This was a part of the consideration, yes.

Mr. WALDIE. What other consideration was there? In other words, what he said in effect I gather, once you opened up the contingency reserve, you reduced the risk, so we will give you a reduction in risk charge.

Was that not the argument that was presented to the committee?

Mr. RUDDOCK. Yes, but the record should not indicate that this was a precise measurement of the amount of risk.

Mr. WALDIE. No. It was very imprecise, but your explanation to the committee when I asked you what did you give up on behalf of the Government, and did you lessen the risk? Prior to the execution of that contract the risk was at a higher level. You gave them x amount of contingency fund that they did not have, and your answer was: But in return for that I got a reduction in risk charge because the risk was less.

This was a correlation between the amount reduced and the amount lessened by giving them access to the contingency reserve.

Mr. RUDDOCK. No, sir. We wanted a reduction of a service charge, and they wanted the pledge of a contingency reserve which by the way had been recommended by the General Accounting Office, and when two parties to a contract each want something, they get together, and it is, we will make this concession and you will make that concession.

Mr. WALDIE. But they were separate and completely different. The fact that the risk of the carrier was reduced had nothing to do with the fact that the item called risk charge was reduced.

Mr. RUDDOCK. It had something to do with it, but not in terms of putting the dollar value on the risk and saying: We will reduce the risk by this many dollars because this is the amount by which we have reduced the risk.

Mr. WALDIE. So in effect you gave on behalf of the Government and the employees a benefit that heretofore they had, and the Blues gave us a benefit that heretofore we had not. They reduced their profit.

Mr. RUDDOCK. Yes.

Mr. WALDIE. Of course there is no logic under your theory. They did not reduce their profit because the program became easier to administer. They reduced their profit in exchange for getting rid of a risk that they had.

Mr. RUDDOCK. Well, I think in all fairness we would have to say that they reduced it through the same process by which we had come from $1\frac{1}{2}$ percent at the beginning of the contract down to 1 percent, and that was by reason of—

Mr. WALDIE. So why did you give them anything when you were in the process? Why did you not make them hold the risk that they had prior to last year? If they went out of business, they would lose money. Why did you give them that, because you did not get anything for it?

You had been undergoing the process of forcing them to reduce profit over the years, and that was a continuing, ongoing thing, so in effect you did not give them anything, you just conceded.

Mr. RUDDOCK. No, Mr. Waldie. That was a judgment exercised by the Civil Service Commission at that time. I knew then and I know now you do not agree with it. Let me take your advice for the future.

Mr. WALDIE. All right. That will be very good. That is all.

Again, as I have said publicly, and I tell you now, there is no representative of the Commission in whom I have greater confidence. I have great confidence in your integrity, Mr. Ruddock. I have never believed that any testimony you have ever presented to this committee has been in any way designed to make a picture that is less troubling other than by telling the committee what you believe the facts to be and not editorializing. I always appreciate that sort of cooperation.

Mr. RUDDOCK. Thank you, sir.

Mr. WALDIE. I wish you could persuade the carriers, particularly the Blues, to indicate the same cooperation with this committee that the Commission has, provided it would be helpful to the public, and it would be helpful to you as the man who has to deal with these titans, and we do appreciate it.

(Thereupon at 11:55 a.m., the hearing was adjourned.)



...and I have said publicly, and I tell you now, there is no person
...of the Commission in about a year or so. I have never
...in your integrity. This, I think, I have never
...but his testimony was not presented to this committee
...was designed to make a picture that is less than
...the committee was to believe the facts
...I always appreciate the sort of
...cooperation.

Thank you, sir.

...with you could provide the carrier, particularly
...to indicate the same cooperation with this committee that
...has provided it would be helpful to the public, and
...as the man who has to deal with these things
...I would appreciate it.

(The report at 14 is now the hearing was adjourned.)