STATE OF MINNESOTA

OFFICE OF THE ATTORNEY GENERAL

Compliance Review of Allina Health System and Medica Health Plans

Volume 6

Administrative Expenses,
Administrative Costs of Medica HMO,
Allina Administrative Expenses, and
State Recommendations

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Chapter 6:

ADMINISTRATIVE EXPENSES

6.1 Purpose. The ratio of administrative costs to the premium dollar in an HMO is a controversial subject. Some patient advocates contend that many of the structural changes in health care, such as prior authorization and retrospective review requirements, have increased administrative costs at both the insurer (HMO) and physician levels. HMO executives contend that administrative expense ratios have not increased or, if they have increased, that administrative spending has resulted in more responsible expenditures for health services. Other advocates contend that the administrative costs of the current system render it less efficient than alternative health care systems utilized in other countries.

Chapter Seven reports on the administrative expense ratio for Medica Health Plans ("Medica"), an HMO. Chapter Eight reports on the administrative expense ratio for Allina Health System's hospital and clinic system. The calculations in these chapters are substantially different than the ratios utilized in reports filed by Medica and Allina Health System ("Allina") with the Minnesota Department of Health and the Internal Revenue Service. This in part is because the latter calculations are self-reported by the HMO rather than calculated by an independent party. The differences may also be due to the fact that the health care industry, the Internal Revenue Service, and regulatory agencies have not established specific standards relating to the calculation of administrative expenses. It is apparent that the definition of "administrative expenses" varies widely depending upon whether one refers to the statutory regulatory filings made by Medica and Allina, the financial audit reporting pursuant to generally accepted accounting principles (GAAP), or the Internal Revenue Service rules. The following is a summary of the differences in these reporting requirements.

6.2 Internal Revenue Service Form 990. Allina files an IRS Form 990 as part of its year-end tax process. In the instructions to Form 990, the IRS makes clear that the Form 990 information is an essential and important link to the public, as it provides "the primary or sole source of information about a particular organization." The Form 990 is generally structured to segregate costs into three *functional* categories: "program" services, "management and general" expenses, and fundraising activities. Program expenses are those expenses necessary to carry out the not-for-profit purpose of the organization. The definition of "program" expenses may be loosely interpreted by professionals who are involved in advising non-profit corporations on the standards for appropriate reporting of expenses. For instance, although the IRS specifically does not allow a corporation to classify as "program" expenses items such as fundraising, billing, financial auditing and accounting costs, Allina and its accountants allocated such costs to "program" services as opposed to "management and general" expenses. Indeed, on many occasions the costs related to personnel who are typically thought of as administrative, such as executive and management salaries, certain office and overhead costs, and various maintenance costs, were allocated by Allina as "program" expenditures because they "relate to carrying out the not-for-profit organization's charitable functions."

For instance, Allina reported expenses relating to its billing personnel on a "functional" basis, which means that it allocated a set percentage of each billing employee to an activity such as OB/GYN, cardiovascular surgery, oncology, etc. By using a "functional" or "activity" approach, the billing personnel are eliminated from the administrative allocation and are instead blended into the medical-related activity of the hospital system. By utilizing a "functional" approach and dividing such administrative costs by "activity," Allina effectively masked or buried administrative expenses within the "function" of health-related activities. Because the purpose of a not-for-profit corporation such as Allina is broadly defined, many costs that were deemed administrative by the Attorney General's Office were allocated by Allina as program expenses on the Form 990. For instance, Allina classified expenditures for items in the following categories as being for "program" or health care expenses and not "management and general" in calculating its Form 990: golf games, health club memberships (for executives, not patients), travel, dinners (for executives, not patients), spa services (for executives, not patients), books and gifts, flowers, glassware, wine, company parties, World Perk memberships, valet parking, Timberwolves tickets, groceries, gasoline, car rentals, and the like. Because the purpose of determining administrative expenses is to test the efficiency of management as to the allocation of the health care dollar, the IRS Form 990 has little meaning or value in interpreting the efficiency of a health care organization.

6.3 Generally Accepted Accounting Principles (GAAP). GAAP requires entities under common control to report their statements of income and loss, financial position and cash flows on a consolidated basis. Allina reports the operations of its hospitals, clinics and provider network in a combined financial report with that of Medica, various foundations and other taxable and non-taxable entities. These financial reports are based on *natural* account classifications with no requirement to classify the expenditures between "program" versus "management and general" expenditures.

The GAAP report contains independently audited financial statements that are supposed to provide the user with assurances as to the reliability of a company's finances. Allina's GAAP report, however, is not meaningful in attempting to determine the company's administrative costs. For instance, the company allocated its expenses on a functional basis, and then allocated a percentage ratio for the "general and administrative" expenses allocated to each function.

When the Attorney General's Office requested supporting information for the ratio that was assigned, however, it was only provided documentation prepared in connection with the preparation of the IRS Form 990. While GAAP allows the allocation of administrative expenses to functional areas, it does not specify with great clarity which expenses should be allocated and reflected as program expenses and which as administrative expenses. As noted in section 6.2, the billing personnel in a hospital have a "natural" classification as being administrative in nature. Rather than designating the billing personnel as administrative, however, Allina allocated certain percentages of the cost of the billing personnel's "functions" to "activities" such as the OB/GYN activity, the oncology activity, the cardiovascular activity, etc. By spreading the cost of the billing personnel among each medical activity, the administrative costs were lowered in an artificial manner. Accordingly, the Attorney General's Office allocated the cost of billing personnel directly to administrative costs.

The Attorney General's Office does not dispute that the above classifications may be permitted on a "functional" basis in a GAAP report. It disagrees, however, with the assertion that such an allocation provides meaningful disclosure of the administrative costs of a health care system. Because GAAP reporting standards allow for the grouping of expenses by "function," they permit many administrative expenses to be combined with medical costs and then collectively designated as a "program" expense. Thus, if the goal is to accurately assess administrative expenses, the same deficiencies arise in a GAAP report as exist with the IRS Form 990.

6.4 Department of Health Filings. Medica also reports its financial operations under rules prescribed by the Minnesota Department of Health, which rely heavily on the rules of the National Association of Insurance Commissioners (NAIC). The NAIC standards require an income statement that separates payments for medical and hospital services from those of administration. The NAIC standards are designed to cover a broad range of operating entities, many of which have a far different structure than Medica and Allina. For example, line 9 (entitled "Other Professional Services") of the statutory Statement of Revenue, Expenses and Net Worth is intended to include compensation as well as fringe benefits paid by an HMO to non-physician health providers such as dentists, psychologists, optometrists, nurses or other clinical personnel. The majority of Medica's reporting on this line, however, represents payments to hospitals for "outpatient services." The NAIC instructions are designed for HMOs which own hospitals that employ or contract with physician and non-physician providers. Medica includes all payments to hospitals for physician and non-physician services, administrative services, and overhead on this line. This tends to inflate the medical costs for this type of HMO.

Nevertheless, the clear intent of the Health Department filing requirements is to separate and differentiate the costs associated with the direct provision of patient care (medical expenses) from the administrative costs associated with marketing, operations and administration of an HMO. Expenses are required to be reported on a *natural* classification basis (based on the nature of the expenditure), not on a functional basis (grouping costs by an "activity"). The Department of Health regulations give more clarity than those of the Internal Revenue Service in that they prohibit the grouping and reporting of administrative expenses on a functional basis.

6.5 Administrative Expense Calculation Utilized by Attorney General's Office. The Attorney General's Office attempted to classify Allina expenditures between "medical" and "administrative" based on a "natural" classification system similar to that adopted by the NAIC and utilized by the Minnesota Department of Health. Accordingly, expenditures that Allina or Medica "grouped" together in a "functional activity" were reversed and reallocated along a "natural" classification basis. Attached as Exhibit 1 is a listing of those *natural* account activities that were allocated by the Attorney General's Office to the administrative function. Allina personnel participated in selecting the account descriptions that are set forth in Exhibit 1 as being administrative in nature.

CHAPTER 7:

ADMINISTRATIVE COSTS OF MEDICA HMO

7.1 Definition of HMO Administrative Costs. The definitions utilized in this Compliance Review are similar to the definitions used by the Minnesota Department of Health. The calculation of administrative costs began with the administrative expense figure reported by Medica and then those categories of expenditures that clearly were not involved in the delivery of health care services were added to that figure. Because the expenses and employees of Medica are commingled with those of Medica Insurance Company, Allina Self Insured, Inc. and Medica Health Plans of Wisconsin, and because any segregation of these expenses and revenues would be artificial, it was determined that the most appropriate calculation of an administrative expense ratio would be to include all of the revenue and all of the expenses of these companies.

7.2 Medica's Administrative Expense Table. Medica is required to report its administrative expenses on the annual financial statement it files with the Minnesota Department of Health. Medica reported administrative expenses of $145,437,088 in 2000, which equal 12.7 percent of its premium revenue. (Exhibit 2). It reported administrative expenses of $143,727,994, or 12.6 percent of its premium revenue, in 1999 (Exhibit 3) and $148,219,092, or 12.5 percent of its premium revenue, in 1998. (Exhibit 4). Medica states that, "At Medica, we voluntarily cap our administrative expenses at around ten percent of revenues." (Exhibit 5).

In contrast, Medica reported in its December 2000 *internal* financial statement that its overall administrative expenses for 2000 were 17.1 percent of revenue. (Exhibit 6). As noted above, Medica has three affiliates that also act as financial intermediaries: Medica Insurance Company ("MIC"), an insurer; Allina Self-Insured, Inc. ("ASI"), a third party administrator

("TPA") and preferred provider organization ("PPO"); and Medica Health Plans of Wisconsin ("Medica-Wisconsin"), a Wisconsin HMO. In its internal financial statements, Medica consolidates its revenue and expenses with those of MIC, ASI and Medica-Wisconsin. *Id.* The State concluded that Medica's administrative expenses in 2000 were approximately 18.7 percent of revenue, in 1999 at least 19.1 percent of revenue, and in 1998 were at least 17.6 percent of revenue.

The following table summarizes the figures utilized in the State's analysis:

MEDICA ADMINISTRATIVE EXPENSES

Section	Administrative Expense	2000 Dollars	2000 Percent of Health Care Revenue (1)	1999 Dollars	1999 Percent of Health Care Revenue (2)	1998 Dollars	1998 Percent of Health Care Revenue (3)
7.3	Amount Reported By Medica As Administrative In Annual Statement	$145,437,088	9.9%	$143,727,994	10.4%	$148,219,092	10.9%
7.4	Intercompany Management Fees	$53,021,790	3.6%	$44,938,874	3.3%	$50,842,597	3.8%
7.5	Amount Reported By MIC As Administrative In Annual Statement (Net of Intercompany Management Fees)	$28,003,330	1.9%	$19,386,329	1.4%	$8,383,944	.6%
7.6	Amount Reported By ASI As Administrative In Financial Statements (Net of Intercompany Management Fees)	$16,946,325	1.2%	$15,481,772	1.1%	$902,389	.1%
7.7	Amount Reported By Medica-Wisconsin As Administrative In Annual Statement (Net of Intercompany Management Fees)	$458,681	.0%	$222,212	.0%	$32,474	.0%
7.8	Administrative Reclassifications	$7,325,226	.5%	$4,563,266	.3%	$10,117,473	.7%

7.9	Allocations For Administrative Expenses Owed To Allina	-	-	$5,021,000	.4%	$4,336,000	.3%
7.10	Premium Tax Assessment Recorded in Error	-	-	$6,000,000	.4%	($6,000,000)	- .4%
7.11	United Behavioral Payments (United HealthGroup)	$9,332,566	.6%	$9,885,736	.7%	$9,983,060	.7%
7.12	Institute For Human Resources Payments (United HealthGroup)	$1,305,641	.1%	$1,173,042	.1%	$1,201,057	.1%
7.13	Termination Fee For NurseLine Agreement (United HealthGroup)	$312,000	.0%	$288,000	.0%	$288,000	.0%
7.14	ChiroCare Payments	$1,713,258	.1%	$1,709,104	.1%	$1,184,458	.1%
7.15	Pharmacy Processing Fees	$274,611	.0%	$422,202	.0%	$969,030	.1%
7.16	Pharmacy Rebates Offsetting Administrative Expenses	$300,000	.0%	$300,000	.0%	$192,000	.0%
7.17	Payments to Clinics For Administrative Services	$418,464	.0%	$144,104	.0%	$681,084	.1%
7.18	Payments to Hutchinson and Brainerd Medical Centers for Non-Health Care Expenses	$170,000	.0%	$170,000	.0%	$669,984	.0%
7.19	Aspen Clinic Payments	$9.649.019	.7%	$9,121,216	.7%	$6,607,464	.5%
7.20	**Total Administrative Expenses**	**$274,667,999**	**18.7%**	**$262,554,851**	**19.1%**	**$238,610,106**	**17.6%**

(1) Total Premium Revenue for Medica. MIC, ASI and Medica-Wisconsin for 2000 was $1,465,337,910. (Exhibit 7)
(2) Total Premium Revenue for Medica. MIC, ASI and Medica-Wisconsin for 1999 was $1,375,913,972. *Id.*
(3) Total Premium Revenue for Medica. MIC, ASI and Medica-Wisconsin for 1998 was $1,355,450,380. *Id.*

The following describes the administrative expenses set forth in this table.

7.3 Medica's Reported Administrative Expenses. Medica reported its administrative expenses to be $145,437,088 in the annual financial statement filed with Minnesota Department of Health for the year 2000. (Exhibit 2). It reported administrative expenses of $143,727,994 in its 1999 annual statement (Exhibit 3) and $148,219,092 in its 1998 annual statement. (Exhibit 4). These figures are therefore included as administrative expenses in Line 7.3 of the Medica Administrative Expenses table.

7.4 Intercompany Management Fees. Medica's three affiliates that also act as financial intermediaries—MIC (the insurer), ASI (the TPA and PPO), and Medica-Wisconsin (the Wisconsin HMO)—do not employ their own staffs. Rather, they have each entered into Administrative Services Agreements with Medica to perform their administrative functions, including provider relations; provider network development; management; contracting; medical management; communications; finance; sales and marketing; member services; human resources; facilities planning; purchasing and services; print and telecommunications services; mail distribution; payroll; accounts payable; controllership functions; underwriting; and cash management. (Exhibits 8-10).

The Administrative Services Agreements do not specify a set price that Medica will charge its affiliates for providing administrative services. *Id.* Rather, the contracts merely state that the fees charged by Medica to the three affiliates "shall be determined in accordance with Medica's standard methodologies for allocation of actual direct and indirect administrative expenses" and "may vary depending upon the department or the class of expense to be allocated." *Id.* Because of the interrelationships between Medica and its affiliates, no arm's-length negotiations occur among them to determine the true value of administrative services rendered. Indeed, in many cases agreements between the entities were signed by officers of the other entity.

As noted above, Medica, in its operations, combines its expenses and revenue with those of MIC, ASI, and Medica-Wisconsin in a single consolidated financial statement. (Exhibit 6).

The State's analysis of Medica's administrative expenses, therefore, similarly combines the administrative expenses and revenue of Medica, MIC, ASI and Medica-Wisconsin.

Medica has identified the administrative expenses associated with providing support services to MIC, ASI and Medica-Wisconsin to be $53,021,790 in 2000 (Exhibit 11), $44,938,874 in 1999, and $50,842,597 in 1998 (Exhibit 12). Medica has not included these figures as administrative expenses in the financial statements it filed with the Health Department. These intercompany management fees are therefore included as administrative expenses in Line 7.4 of the Medica Administrative Expenses table. Because the commingled expenses of these affiliates are included in this Compliance Review and in Medica's internal financial reports, the revenue of these affiliates are also included as part of the calculation.

7.5 MIC's Reported Administrative Expenses. In addition to the management fees paid to Medica, MIC reports certain direct administrative expenses attributable to its operations. The majority of these relate to administrative fees paid to United Health Group, Inc. ("UHG") which, pursuant to an Administrative Services Agreement with Medica, MIC, ASI and Medica-Wisconsin, performs their core "insurance" functions, including claims processing. (Exhibit 13).

MIC reported in its annual statements filed with the Minnesota Department of Commerce administrative expenses (exclusive of the intercompany management fees described above) of $28,003,330 in 2000, $19,386,329 in 1999, and $8,383,944 in 1998 (Exhibit 14). These administrative expenses are included in Line 7.5 of the Medica Administrative Expenses table.

7.6 ASI's Reported Administrative Expenses. ASI also has administrative expenses in addition to the management fees paid to Medica. Almost all of these represent administrative fees paid to UHG. ASI's internal financial statements show its administrative expenses (exclusive of the intercompany management fees described above) to be $16,946,325 in 2000, $15,481,772 in 1999, and $902,389 in 1998 (Exhibit 15). These administrative expenses are included in Line 7.6 of the Medica Administrative Expenses table.

7.7 Medica-Wisconsin's Administrative Expenses. Medica-Wisconsin's administrative expenses (exclusive of the intercompany management fees described above) were reported in its annual statements to be $458,681 in 2000, $222,212 in 1999, and $32,474 in 1998 (Exhibit 16). These administrative expenses are included in Line 7.7 of the Medica Administrative Expenses table.

7.8 Administrative Reclassifications. Medica provided the State with workpapers utilized to prepare its annual statements filed with the Minnesota Department of Health. Medica reported as medical expenses several million dollars each year that its accountants had originally considered to be administrative expenses.

In 2000 these reclassifications totaled $7,325,226. (Exhibit 17). That figure includes over $4 million dollars of internal expenses incurred for purposes of reviewing health claims. *Id.* It also includes over $1 million paid to UHG as an information systems fee and over $1 million paid to a pharmacy benefit manager ("PBM") that processes Medica's pharmacy claims and provides it with access to a prescription drug formulary. *Id.* Similar reclassifications totaled $4,563,266 in 1999 and $10,117,473 in 1998. *Id.*

These additional administrative expenses are included in Line 7.8 of the Medica Administrative Expenses table.

7.9 Allocations For Administrative Expenses Owed To Allina. Allina, Medica's parent organization, operates a "System Office" that acts as a central business office for Allina's affiliates, including Medica, MIC, ASI and Medica - Wisconsin. The System Office provides centralized support for Allina's affiliates in certain areas such as payroll and computer systems. Allina allocates to its affiliates a portion of the overhead expenses of the System Office.

In 1999 Medica's share of the System Office allocation (according to the company's internal schedules) was $21,818,000, but Medica only paid $16,797,000, for a difference of $5,021,000. (Exhibit 18). In 1998 Medica's share of the allocation was $18,899,000, but Medica only paid $14,563,000, for a difference of $4,336,000. *Id.* Former officers of Medica have stated that such reduced payments were intentional. They state that in 1999 Medica executives stated that the HMO's administrative expenses were so high as to be subject to criticism from regulators and policyholders. Accordingly, the officers were told that the Allina System Office should not bill Medica for the balance due for providing overhead support which would clearly need to be reported as an administrative expense. Instead, they arranged for Medica to make an additional payment to Allina's hospitals, which was then allocated as a medical expense.

To more accurately reflect Medica's administrative costs, the Medica costs subsidized by Allina through the System Office, which were $5,021,000 in 1999 and $4,336,000 in 1998, are included as administrative expenses in Line 7.9 of the Medica Administrative Expenses table.

7.10 Premium Tax Assessment Recorded in Error. In lieu of income taxes, HMOs and insurers pay a gross premium tax. In 1998 HMOs were permitted a deduction from their gross premium tax if they could prove that they passed on to enrollees certain premium savings. Medica officials state that the companies' assumed they would not be able to verify such premium savings. Therefore, Medica officials estimated the Medica 1998 premium tax by $6 million more than was actually incurred. (Exhibit 19). The State, however, credited Medica for its claimed premium savings and as a result Medica had over-accrued its 1998 premium tax by

$6 million. Accordingly, in 1999 Medica simply credited the $6 million overage from 1998 to reduce its 1999 tax obligation. This had the effect of reducing Medica's administrative expenses as shown on its 1999 annual statement. To more accurately reflect administrative costs (which include taxes), the State deducted $6 million of estimated unpaid premium taxes for 1998 administrative expenses and increased the administrative expenses for 1999 by $6 million. These amounts are reflected in Line 7.10 of the Medica Administrative Expenses table.

7.11 United Behavioral Contract. Medica contracts with United Behavioral Systems, Inc. ("UBSI"), an affiliate of UHG, for mental health and substance abuse services. (Exhibit 20). Among other things, UBSI performs utilization review and credentialing functions for Medica in connection with these types of claims. *Id.* Medica has reported its payments to UBSI in its annual statements filed with the Minnesota Department of Health as medical, as opposed to administrative, expenses. (Exhibit 21). Medica advised the Minnesota Department of Health that it pays UBSI on a capitated basis and was "unable to quantify" the amount of the capitation payment that was associated with administrative services. *Id.*

The UBSI contract, however, clearly allocates a specific portion of the capitation fee as being attributable to administrative services. (Exhibit 20). Medica advised the State that it paid $37,703,135 to UBSI in 1999, of which $9,885,736, or 26.2 percent, represented administrative services. (Exhibits 22-23). Medica advised the State that it and its affiliates paid UBSI $38,431,907 in 1998, of which $9,983,060 represented administrative services. (Exhibit 23).

Medica claims that it modified its contract with UBSI for the 2000 contract year and that it no longer identifies a specific portion of its capitation payments to UBSI as being for administrative services. (Exhibit 24). Medica and its affiliates paid UBSI $35,620,479 in 2000. (Exhibit 25). Because some of the capitation fee clearly should be allocated as administrative expenses, the State applied the same administrative figure of 26.2 percent that existed in 1999 to the 2000 payments, resulting in additional administrative expense under the UBSI contract of $9,332,566 for 2000.

These additional administrative expenses, which Medica had reported as medical expenses, are included in Line 7.11 of the Medica Administrative Expenses table.

7.12 Institute For Human Resources Payments. Medica also contracts with UHG, through its Institute For Human Resources ("IHR"), to provide employee assistance services to Medica enrollees. (Exhibit 26). IHR is also obligated under the contract to perform administrative services associated with the employee assistance program in exchange for a capitation payment. *Id.* Medica paid $4,983,363 to IHR in 2000 (Exhibit 27), $4,477,260 in 1999 (Exhibit 28), and $4,584,188 in 1998 (Exhibit 29) in capitation payments. Because the IHR agreement does not delineate the portion of the capitation payment allocated as administrative, and because some portion clearly is administrative, the same administrative fee incurred under the UBSI contract (26.2 percent) was applied to the capitation payments made under the IHR contract. This results in additional administrative expenses of $1,305,641 in 2000, $1,173,042 in 1999, and $1,201,057 in 1998. These figures are included in Line 7.12 of the Medica Administrative Expenses table.

7.13 NurseLine Agreement Termination Fee. Until 1996, Medica contracted with UHG to perform a "NurseLine" function for Medica enrollees. In September, 1996 Medica terminated this agreement with UHG in order to bring the NurseLine services in-house at Allina. (Exhibit 30). Under a termination agreement, Medica was required to pay UHG a termination penalty of $24,000 for each month beginning October 1, 1996 through December 1, 2000. *Id.* Medica expensed a termination fee of $312,000 in 2000 (Exhibit 31) and $288,000 each in 1999 and 1998. (Exhibit 32). Because no service was provided to Medica enrollees for this fee, the State classified the payments as administrative expenses. The figures are reflected in Line 7.13 of the Medica Administrative Expenses table.

7.14 ChiroCare Contract. Medica contracted with Chiropractic Care of Minnesota, Inc. ("ChiroCare") to perform utilization review and credentialing services for Medica enrollees utilizing chiropractic services. (Exhibit 33). Medica made capitation payments to ChiroCare of $6,539,154 in 2000, $6,523,296 in 1999 and $4,520,831 in 1998. (Exhibit 34). Medica reported to the Minnesota Department of Health its capitation payments to ChiroCare as medical expenses rather than administrative expenses. (Exhibit 21). It again claimed that it was "unable to quantify" the amount of the capitation payments attributable to administrative services. *Id.*

In order to more accurately account for Medica's administrative expenses, the State applied the same 26.2 percent administrative figure applicable to the UBSI contract to the capitation payments made to ChiroCare for each year identified above. This results in an additional administrative expense to Medica of $1,713,258 in 2000, $1,709,104 in 1999 and $1,184,458 in 1998. These figures are reflected in Line 7.14 of the Medica Administrative Expenses table.

7.15 Pharmacy Processing Fees. Medica pays several million dollars each year to its pharmaceutical benefit managers ("PBMs") to process pharmacy claims and manage its prescription drug formulary. While Medica has classified some of its payments to its PBMs as administrative expenses, Medica's workpapers show that other pharmacy processing fees were reported by Medica as medical expenses. Medica classified pharmacy processing fees in the following amounts as medical expenses: $274,611 in 2000 (Exhibit 35), $422,202 in 1999 (Exhibit 36), and $969,030 in 1998 (Exhibit 37). The State has reclassified these processing fees as administrative expenses, and they are reflected in Line 7.15 of the Medica Administrative Expenses table.

7.16 Pharmacy Rebates Offsetting Administrative Expenses. Medica states that it receives rebates from pharmacy vendors on products marketed to senior citizens where the HMO assumes no financial risk for paying pharmacy claims. (Exhibit 38). Pharmacy rebates are ordinarily applied by Medica to reduce the amount of pharmacy claims itemized as medical expenses. Medica has advised the State that, because it has no pharmacy claims against which these rebates could be offset, it applied the rebates to offset its administrative costs. *Id.*

Medica reports the amount of these offsets to be $300,000 in both 2000 and 1999 and $192,000 in 1998. *Id.* Because Medica's classification artificially reduces the amount of administrative expenses reported to the State, the State has restored these amounts as administrative expenses. The figures are included in Line 7.16 of the Medica Administrative Expenses table.

7.17 Payments to Clinics For Administrative Management. Medica pays certain primary care clinics a "care management" fee (in addition to patient care fees) for acting as administrative gatekeepers. (Exhibit 39). Medica states that it paid these clinics administrative "gatekeeper" fees totaling $681,084 in 1998, $144,104 in 1999 and $418,464 in 2000. (Exhibit 40). Medica classified these care management fees as medical costs. Because these fees relate to functions that are part of a managed care system, the State allocated these amounts as administrative expenses. These figures are included in Line 7.17 of the Medica Administrative Expenses table.

7.18 Payments to Hutchinson and Brainerd Medical Centers for Non-Health Care Expenses. Medica also paid other administrative fees to clinics that were classified by Medica as health care expenses. For instance, Medica has entered into contracts with various Minnesota clinics where it pays fees above and beyond those required for the care and treatment of patients. For example, Medica entered into a contract with Hutchinson Medical Center ("Hutchinson") in 1995. (Exhibit 41). Hutchinson gave *Allina* a right of first refusal to purchase the clinic in the event it received a purchase offer from a third party. *Id. Medica* paid Hutchinson $170,000 in each year from 1996 to 2000, for a total of $850,000 in exchange for Allina's right of first refusal. (Exhibit 42). Because these amounts are not for patient treatment, they have been allocated by the State as administrative expenses and are included in Line 7.18 of the Medica Administrative Expenses table.

Medica entered into a similar contract with Brainerd Medical Center ("Brainerd") in 1996 where Brainerd granted Allina and Medica the right to participate in "marketing opportunities" with the clinic. (Exhibit 43). It is widely believed that these "marketing opportunities" relate to the referral of Brainerd patients to Allina hospitals. Medica paid Brainerd $500,000 in 1996, 1997 and 1998 for such opportunities. (Exhibit 42). Because these payments do not appear to relate to the care and treatment of patients, the State also included them as administrative expenses in Line 7.18 of the Medica Administrative Expenses table.

7.19 Aspen Clinic. Medica entered into a long-term contract with Aspen Medical Group, P.A. ("Aspen") in 1998 where, in addition to the fees paid by Medica to the clinic for patient care, Medica agreed to make a series of payments to Aspen if it referred all Medica patients only to Allina-owned hospitals. (Exhibit 44). Because these payments appear to be primarily for the purpose of securing referrals to Allina hospitals, the State's analysis allocates them as administrative costs of $9,649,019 in 2000, $9,121,216 in 1999 and $6,607,464 in 1998. These figures are included in Line 7.19 of the Medica Administrative Expenses table.

Medica's additional payments to Aspen were as follows between 1998 and 2000:

1998 ASPEN CLINIC PAYMENTS

Type of Payment	Amount
Care Management Fees	$ 999,998
Infrastructure Payments	$ 500,000
Cash Flow Payments	$ 2,438,546
Consulting Expenses	$ 333,000
Continued Availability Payment	$ 1,200,000
Imputed Interest	$ 400,000
Rental Deduction	$ 735,920
Total	**$ 6,607,464**

1999 ASPEN CLINIC PAYMENTS

Type of Payment	Amount
Care Management Fees	$ 916,663
Infrastructure Payments	$ 500,000
Imputed Interest	$ 500,000
Rental Deduction	$ 724,553
Enhanced Fee Payments	$ 6,480,000
Total	**$ 9,121,216**

2000 ASPEN CLINIC PAYMENTS

Type of Payment	Amount
Care Management Fees	$ 999,996
Infrastructure Payments	$ 500,000
Imputed Interest	$ 100,000
Rental Deduction	$ 708,023
Write-off of Advance	$ 841,000
Enhanced Fee Payments	$ 6,500,000
Total	**$ 9,649,019**

Medica classified these payments as medical expenses, but the State believes they should more appropriately be considered administrative expenses. The payments identified above include the following:

Care Management Fees. Medica's contract with Aspen requires it to pay Aspen a "care management fee" of $83,333 per month for performing case management and utilization management services. (Exhibit 44). Medica paid Aspen care management fees of $999,998 in 1998 and $916,663 in 1999 (Exhibit 45) and $999,996 in 2000 (Exhibit 46).

Infrastructure Payments. Medica's contract with Aspen requires it to pay the clinic $500,000 each year for five years beginning in 1998 to assist Aspen in "maintaining and improving its capital infrastructure." (Exhibit 44). Medica expensed these payments in 1998 and 1999 (Exhibit 47) and 2000 (Exhibit 48).

Cash Flow Payments. Medica's contract with Aspen required it to pay the clinic up to $4.5 million dollars, or the clinic's net losses for the first quarter of 1998, to assist the clinic with its "cash flow." (Exhibit 44). Medica paid Aspen $2,438,546 in 1998 pursuant to this contractual requirement. (Exhibit 49).

Consulting Expenses. Medica agreed to pay Aspen up to $500,000 to be used to retain Andersen Consulting, L.L.P. to assist the clinic in improving its financial and operational performance. (Exhibit 44). Medica paid Aspen approximately $333,000 for this purpose. (Exhibit 50).

Continued Availability Payment. Medica reports that it paid Aspen an additional $1.2 million in 1998 to "assure Aspen's continued availability to serve Medica patients." (Exhibit 51).

Imputed Interest and Advance Write-offs. Medica made advance payments to Aspen of $9,770,000. (Exhibit 52). While $3.3 million was advanced pursuant to Medica's written agreement with Aspen (Exhibit 44), $6.4 million dollars was advanced without any written contract. (Exhibit 53). The purpose of the advances reportedly was to help Aspen "transition" under its new contract with Medica.

The average outstanding balance on these advances was approximately $4.9 million in 1998, $5.7 million in 1999, and $1.3 million in 2000. (Exhibit 54). These interest-free advances increased Medica's interest expense or reduced the amount of interest that Medica was able to earn on the amounts advanced to Aspen by $400,000 in 1998, $500,000 in 1999, and $100,000 in 2000. (Exhibit 54). The State included this imputed interest as an administrative expense of Medica.

In 2000 Aspen still owed Medica $1.6 million. Medica recognized, however, that it would likely not collect the full amount and so it created a reserve of $841,000. (Exhibit 55). This amount was also included by the State as an administrative expense because it does not appear to be an expense relating to patient treatment.

Rental Deduction. In addition, Medica entered into a capital lease agreement for office space in Bandana Square in St. Paul. (Exhibit 56). Medica, in turn, subleases this space to Aspen at a loss of almost $500,000 per year. *Id.* While Medica recognizes rental income and certain expenses associated with this transaction as an administrative expense, it does not classify the interest as an administrative expense. Instead, Medica uses the $700,000 per year in interest to offset its investment income on its annual statements. In order to accurately account for Medica's administrative costs, this interest expense has been included as an administrative expense in the State's analysis.

Enhanced Fee Payments. Medica's contract with Aspen requires it to pay money in addition to that designated for patient's claims to assist Aspen in "transitioning." (Exhibits 44 and 57). Medica paid Aspen $6,500,000 in 2000 and $6,480,000 in 1999 for this purpose. (Exhibit 58).

7.20 Administrative Expense Ratio for Medica. As noted above, the foregoing allocation of expenses indicates that Medica's administrative expenses were approximately 18.7 percent of revenue in 2000, 19.1 percent in 1999, and 17.6 percent in 1998. While slightly higher than the 17.1 percent administrative expense ratio used in the *internal* records of Medica (Exhibit 6), these figures are considerably higher than the ratio reported by Medica to the Minnesota Department of Health and the Internal Revenue Service. For instance, for the year 2000 the Attorney General's Office calculated an 18.7 percent administrative ratio. For the same year Medica's internal documents indicate a 17.1 percent administrative ratio. The report filed with the Minnesota Department of Health, however, only indicates a 12.7 percent administrative ratio. For the reasons set forth earlier, the Attorney General's Office believes that the calculation utilized in this Compliance Review is the most accurate and meaningful calculation of Medica's administrative expenses.

It should be noted that a 1996 report of Ernst & Young reported that Medica's outsourcing of core insurance functions to UHG resulted in high administrative costs for Medica. (Exhibit 59). An industry reference book (A.M. Best) indicates that Medica's *self-reported* administrative ratio is second highest among not-for-profit HMOs with over $1 billion in assets. (Exhibit 60).

7.21 Self Reported Cost Drivers of Medica Premium. In 1998 the Medica health premium was higher than the national average (Exhibit 61) and over the past three years Minnesota health premiums have increased faster than the national average. (Exhibit 62). Attached as Exhibit 63 is a chart that summarizes Medica's *self-reported* allocation of expenses in financial statements it filed with the Department of Health. The State analyzed the revenue and expenses reported on that chart and reallocated them on an average per member per year basis, which figures are set forth on Exhibit 64. According to these figures, which are based on Medica's *self-reported* figures, its average annual premium was $1,957 in 1997, $2,147 in 1998,

$2,365 in 1999, and $2,531 in 2000. This represents an increase of $575 over the three-year period, or an increase of approximately 29 percent.

Medica's *self-reported* figures, as set forth in Exhibit 64, indicate that the annual fees paid to physicians per member were $647 in 1997, $660 in 1998, $694 in 1999 and $721 in 2000. In other words, physicians' fees went up by $74 per member over the three year period, or 11.5 percent.

Medica's *self-reported* figures, as set forth in Exhibit 64, indicate the annual fees paid for inpatient hospitalization per member were $470 in 1997, $538 in 1998, $559 in 1999 and $648 in 2000. In other words, the dollar increase for inpatient hospitalization over the three-year period was $178 per member, and the percentage increase was approximately 38 percent.

Medica's *self-reported* figures, as set forth in Exhibit 64, indicate the annual fees paid for pharmaceutical costs per member represented the highest increase, with the expenses being $192 in 1997, $221 in 1998, $261 in 1999 and $316 in 2000. This represents an increase of $124 over the three year period, or a 64 percent increase in pharmaceutical costs.

Medica's *self-reported* figures, as calculated on Exhibit 64, also indicate that the annual administrative expenses (not including taxes and management fees for related companies) on a per member basis were $197 in 1997, $228 in 1998, $264 in 1999 and $284 in 2000. This represents an increase of $87 over the three-year period, or a 44 percent increase in administrative costs.

Medica's *self-reported* figures, as calculated on Exhibit 64, indicate that Medica's net income on a per member basis was $22 in 1998, $7.78 in 1999 and $63.18 in 2000.

7.22 Loss Reserves. The biggest expense category in an HMO or insurer is claims. During a policy year an HMO agrees to cover all health treatment that is incurred by the policyholder during the year. Although the HMO might not have yet received a bill by the end of the policy year, it is required to pay the bill if the covered treatment was rendered during the policy year.

Even though an HMO may not have received some bills at year end, for financial purposes it must still estimate the total cost of such bills for purposes of calculating its profit or loss on its financial statement. In the insurance industry this estimated expense category is entitled IBNR, meaning expenses that are "Incurred But Not Reported."

The claims underlying the IBNR for some insurance policies, such as a medical malpractice policy, may not be ultimately resolved for a long period of time. This is because a claim against a physician for malpractice might not be known until years after a policy had been issued. An example would be a physician who, having medical malpractice coverage in 1975, misdiagnoses a disease that was treatable in 1975. Because of the misdiagnosis, the patient's disease does not manifest itself until 1980 when it is too late for the disease to be treated. If the patient files a claim against the physician in 1980, it is the 1975 medical malpractice insurer that must pay the claim.

Because of this long claim period, a medical malpractice policy is known in the industry as a "long tail" policy.

In contrast, an HMO or health insurance policy is known as a "short tail" policy. This is because all claims are generally billed by a health provider within 30 days, and in most cases these bills are sent directly to the HMO. Indeed, as noted in Chapter 2 of this Compliance Review, Medica actually "prefunded" the payment of such claims by Allina at the level of $30 million. Indeed, within 60 days of the policy year almost all IBNR claims of an HMO have manifested themselves by receipt of a bill.

Insurers generally use "IBNR" as an expense category to "smooth" a financial statement from one year to the next. If an insurer or HMO performs poorly, it will "underestimate" the IBNR claims to make its financial performance appear better than it is. In contrast, an insurer or HMO which is performing well will "over-reserve," or overestimate, the IBNR claims to make its financial profits appear less than what they really are.

Over the past three years Medica has consistently over-reserved its claims. This is particularly the case when one takes into the account the $30 million that Medica prepaid to Allina as described in Chapter 2.

Medica officials acknowledge that the HMO has been "building reserves" over the past few years. For instance, in 1999 Medica estimated that it had $159,446,523 in unpaid claims at year-end 1998. (Exhibit 65). Through 1999 Medica only paid, however, $150,326,844 of claims incurred during the 1998 year. (Exhibit 65). This means that the company over-reserved by $9,119,679, and accordingly it was able to defer the recording of these funds as income until 1999. (Exhibit 65).

Similarly, in 2000 Medica estimated its IBNR at $181,765,822 at year end 1999. (Exhibit 65). During 2000 Medica paid, however, only $155,677,951 in claims incurred in 1999. (Exhibit 65). Thus, the company had $26,870,871 in over-reserved claims, which it then recorded as income in 2000. (Exhibit 65).

Finally, in 2001 Medica estimated that it had $185,884,459 in IBNR at year end 2000. (Exhibit 65). As of June 30, 2001, six months later, Medica had only paid $164,760,307, which indicates a six-month IBNR development with an over-reserve of at least $21,124,152. (Exhibit 65). Indeed, there is some reason to believe this figure may be low and that another $15 million may be over-reserved at this time.

20,000 employees should also adopt a policy regarding payment for "going away" parties.

D. **Executive Compensation.** Chapter Four of this Report discussed in detail the compensation of the Allina and Medica executives. The companies were lavish with regard to their incentive programs, many of which (in the case of Medica) were counterproductive to its members' desire to control the increase of premiums. On several occasions incentive programs were modified when it was discovered that executives would not achieve the performance that was required in the original incentive program. On other occasions existing employees were paid "signing bonuses" amounting to hundreds of thousands of dollars even though they were previous employees of Allina. The boards of Allina and Medica should undertake a review of executive compensation.

E. **Medica's Internal Staff.** In 2000 Medica serviced approximately one million members. Its membership has slightly dropped since 1998. In spite of this drop, the staff of Medica has increased from 694 employees to 855 employees. (Exhibit 87). During this same time period the salaries and benefits of Medica have increased from $39 million in 1998 to $64 million in 2000. (Exhibit 87). In other words, while the number of members serviced by Medica has not increased, the size of its staff has increased by approximately 23 percent and the size of its payroll has increased by approximately 63 percent. While Medica added approximately 20 employees to undertake the underwriting function of the HMO pursuant to a contract change with United Health Care in 1999, it is unclear why the company hired another 141 employees.

is believed that, if the policies attached as Exhibits 76 and 77 are adopted and properly executed, savings in consultant and attorneys' fees and expenses should result.

B. United Health Care. A 1998 report of Arthur Andersen noted that United Health Care's fees for technology services to Medica were about double that which would be charged by EDS of Dallas, Texas. (Exhibit 79). For reasons that are unknown but raise concerns as to the business purpose of its instructions, in 1998 Medica management told its employees that the HMO could not solicit Requests For Proposals ("RFPs") and that it could only do business with United Health Care. (Exhibit 80). The company should be able to substantially reduce its technology costs by seeking RFPs and negotiating the use of alternative systems. (See Exhibit 81).

C. Travel and Entertainment. As noted in Chapter Five of this Report, the travel and entertainment expenditures of Allina and Medica executives were excessive. More important than the total cost of these expenses was the creation of a culture where executives would routinely incur expenses without regard to their business purpose. Indeed, on several occasions invoices were paid twice (Exhibits 82, 83), the same business purpose was attributed to different invoices (Exhibit 84, 85), and the criteria given for payment of an invoice was not its business purpose but rather whether it would draw media attention. (Exhibit 86). At least $2,000 was spent on a "going away" dinner for an employee that simply transferred between Allina divisions. (Exhibit 82). It is extremely important that the company adopt prudent standards concerning business travel and entertainment. A company with

CHAPTER 9:

STATE RECOMMENDATIONS

Section 9.1 Recommendations. The Compliance Review notes that there are a number of areas that should be reviewed by the new boards of Allina and Medica, some of which are discussed in general below:

A. **Consultants.** Chapter Three of the Compliance Review discussed the use of consultants. It pointed out that Allina was very lax with regard to the issuance and monitoring of contracts to consultants. In March of 2001 the Attorney General's Office filed a lawsuit in order to gain access to Allina's records. In that lawsuit the Attorney General's Office filed a brief alleging substantial issues relating to the use of consultants. During the month of April several of these consultants were terminated. Even though the company responded to the lawsuit by spending $700,000 on a group of "war room public relations" consultants, it did manage to start limiting its overall consulting costs. At the first board meeting of the new directors, Medica reported that the administrative costs of the HMO steadily dropped each month since the lawsuit was filed (March of 2001). (Exhibit 75). Attached as Exhibit 76 is a proposed policy to be implemented by Medica and Allina with respect to the use of consultants. Also attached as Exhibit 77 is a policy statement regarding the use of attorneys. While not separately itemized, Allina reports that it expends a substantial sum of money on attorneys' fees. New board members indicate that these fees were billed on invoices as sparse and incomplete as the Deloitte & Touche invoice attached as Exhibit 78. It approximately $497,263,000 is expended on non-patient care costs. Based upon total expenses for the Allina hospital group of $1,251,606,000, this means that Allina hospital group's administrative costs account for approximately 39.7 percent of its expenses. Allina officials point out, however, that $51 million is attributable to bad debt and another $19,498,000 to the Minnesota Care and Medicaid Surcharge taxes. Allina points out that bad debt charges and the Minnesota Care and Medical Surcharge taxes are not controllable by the company. Accordingly, Allina requested that those amounts be separately itemized in connection with the reporting of its total non-patient care costs.

Allina officials also prepared a working paper summarizing non-patient care costs for AMC. This summary is attached as Exhibit 72. Under this calculation AMC expended approximately $254,100,000 in the year 2000, of which $86,778,000 was for non-patient care costs. Allina officials summarize the percent of total non-patient care costs as being 34.2 percent of expenses. Allina points out that approximately 3.8 percent of these costs are attributable to bad debt and the Minnesota Care and Medicaid Surcharge taxes, both of which are not controllable by the company.

Using the figures presented by Allina, the administrative ratio for the Allina hospital group and AMC was approximately 38.8 percent. (Exhibit 73).

Attached as Exhibit 74 is an illustration of the allocation of the Medica/Allina health dollar. It indicates that 18.7 percent of the Medica premium is expended on administrative functions and that, after deduction of the administrative and pharmaceutical expenses, Allina expended 38.8 percent on administrative functions if the patient utilized Allina facilities. This computes to an approximate 46 percent administrative ratio for the integrated health system.

In addition, Allina designated the following gifts on Exhibit 68 as being for health care rather than administrative purposes: golf clubs, spa services, books, glassware, millennium clocks, gift certificates and numerous purchases of flowers.

Other purchases on Exhibit 68 allocated by Allina as health care rather than administrative expenses included executive memberships at health spas, golf clubs, sports and health clubs, World Perks memberships and the like.

Rather than allocating such expenditures to health care categories, the Attorney General's Office allocated them on a "natural" classification basis as administrative expenses.

Section 8.2 Allina's Administrative Expense Calculation. As part of the Compliance Review the State compiled a list of "natural" categories to which Allina should allocate administrative expenditures. (Exhibit 1). It then requested Allina's financial executives to object to those categories that they believed should be classified as expenses directly related to patient care. (Exhibit 69). Attached as Exhibit 70 is the response of Allina executives to the request.

Allina was then requested to produce workpapers to calculate the percentage ratio of the expenses it classified to the categories set forth in Exhibit 70 for Abbott Northwestern Hospital, United Hospital and the Allina Medical Clinic ("AMC"). Abbott Northwestern Hospital is the largest hospital in Minneapolis, and United Hospital is the largest hospital in St. Paul. AMC is one of the largest physician clinics in Minnesota, employing over 500 physicians throughout the State.

Section 8.3 Administrative Expense Ratio for Allina. Based upon Allina's budgetary assumptions set forth in Exhibit 70, Allina prepared Exhibit 71 as a breakdown of the non-patient care cost summary for the Allina Form 990 filing group. The summary essentially states that program-related (health-related). The Attorney General's Office, however, allocated each of the expenditures of Exhibit 68 as being administrative in nature. These expenses include dinners at restaurants such as Campiello, Steamers Seafood and Raw Bar, Kincaid's, Ruth's Chris Steakhouse, Anchorage Inn, The Four Seasons in New York, Palomino's Restaurant, The Pelican Club in New Orleans, The Alpen Rose in Vail, Francos in Scottsdale, Café Terra Cotta in Scottsdale, Il Forno Ristorante in Phoenix, Los Amigos in Vail, The St. Paul Grill, Hotel Sofitel, Northland Inn, Dancing Crab Restaurant in Washington, Adam's Mark Hotel, Stacy's Sea Grille, Sherlock's Home, Anchorage, Madden's, The Omni Hotel (Chicago), The Lodge at Cordillera (Edwards, Colorado), Lord Fletcher's, Nicollet Island Inn, Bravo Restaurant, Peabody Hotel (Orlando), The Capital Grille, Pronto, Loring Café, Ivories Restaurant, D'Amico Cucina, W.A. Frost, Oceanaire, Sydney's, La Grill (Orlando), La Belle Vie, Lowell Inn, Figlio's, Palmer House (Chicago), Benihana, Lauren Restaurant, Ciatti's, The Coyote Cafe, Rosen's Bar and Grill, Giannis Steakhouse, Zelo's, The Sardine Factory, Club XIX (Monterey, California) and Fandango's.

Other expenditures on Exhibit 68 that were attributed as health care expenditures by Allina, but classified as administrative by the Attorney General's Office, include golf games at Arrowwood Resort, Raven Golf South, The Phoenician Inn, Majestic Oaks Golf Club, Minneapolis Golf Club and the Minikahda Club.

In addition, Allina designated the following airplane tickets on Exhibit 68 to destinations such as the following as being for health care rather than for administrative purposes: Phoenix, Arizona; Fort Smith, Arkansas; Chicago, Illinois; Aspen, Colorado; New Orleans, Louisiana; Seattle, Washington; San Diego, California; Detroit, Michigan; Orlando, Florida; Grand Rapids, Michigan; Reno, Nevada; Washington, D.C. and Pebble Beach, California.

CHAPTER 8:

ALLINA ADMINISTRATIVE EXPENSES

8.1 Administrative Expenses In General. As discussed in Section 6.5, the Attorney General's Office undertook a "natural" classification approach in determining administrative costs. Sections 6.2 and 6.3 highlight the differences between a "natural" classification approach and a "functional" approach in allocating the health care dollar. In a hospital system, a natural classification approach allocates the cost of billing personnel to the administrative function. In contrast, Allina utilized a "functional" approach in preparing reports pursuant to GAAP. The GAAP interpretation of administrative expenses is arguably broad enough to permit such a "functional" allocation. Similarly, Allina utilized such a "functional" approach in reporting "management and general" expenses on its Form 990. Once again, the IRS rules are arguably broad enough to permit some of this functional allocation to occur.

In order to meaningfully calculate administrative costs, the Attorney General's Office categorized all of the items set forth in Exhibit 1 as being administrative in nature. Allina personnel were involved in the process of selecting which of the accounting classifications would be listed in Exhibit 1. While there were differences of opinion between the Attorney General's Office and Allina concerning the allocation, the impact was minimal in terms of the overall calculation of Allina's administrative expense ratio.

Because of the size of Allina, it was impossible for the Attorney General's Office to examine each and every expenditure made by Allina. Rather, a sample of expenditures was reviewed in order to calculate and allocate certain administrative costs. For instance, attached as Exhibit 68 is a list of certain expenses that were designated by Allina to be in whole or in part

Based upon the above conclusions, in 2000 Medica may have avoided approximately 10 percent of its premium or in excess of $100 million if it had a 13 percent administrative ratio instead of an 18.7 percent ratio, if it did not over-reserve its claims by at least 1.9 percent, and if it did not record a profit of 2.5 percent. It should be noted that Medica's net worth will likely be at its maximum limit at year-end, in which case it would be prohibited by law from booking any more profit.

As noted above, Medica also over-reserves its claims (Section 7.22), which represents an unnecessary burden to the annual premium. The Compliance Review estimates that Medica over-reserved its claims by $9 million in 1998, $26 million in 1999 and by at least $21 million in 2000. (Exhibit 65). These funds will never be used to pay incurred claims and, accordingly, are eventually designated as profit in a succeeding year. For instance, in the year 2000, at least 1.9 percent of the Medica premium may be attributable to over-reserved claims. Medica should not be reserving for claims that will never be paid.

Finally, Medica's profit over the past three years has steadily increased and, as a nonprofit corporation, is subject to question. As noted above, under Minnesota law an HMO may not accumulate net worth in excess of 25 percent of its annual reported expenses. Minn. Stat. § 62D.042, subd. 2(b). As of June 30, 2001, Medica's total expenses for six months (medical costs plus administrative costs) were $552 million (Exhibit 66), which means that its maximum net worth may not exceed $276 million. As of June 30, 2001 Medica states that its net worth is $238 million (Exhibit 67) and that it may earn at least another $22 million by year end, giving it a net worth of $260 million.

The State believes that Medica could record up to an additional $15 million in income by year end 2001 due to additional over-reserved claims. (See Section 7.22). Further, the State believes that Medica's practice of over-reserving claims is continuing in 2001, which will result in more income and a higher net worth. As a result, Medica will likely reach the maximum net worth permitted by law within six months and will not be able to earn a further profit.

According to Exhibit 63, the company earned $28,574,337 in 2000, which is approximately 2.5 percent of its premium.

At an annual premium of $1.1 billion, at least 1.9 percent of the 2000 premium is attributable to Medica's practice of over-reserving claims.

The Minnesota Legislature established the maximum net worth for an HMO as being 25 percent of its annual expenses. Minn. Stat. § 62D.042, subd. 2(b). Medica's practice of over-reserving its IBNR and claims defers profits to subsequent years. The State assumes that this practice of over-reserving claims continues in 2001 and could result in Medica violating Minnesota law in 2002 by having a net worth higher than that legally permitted.

7.23 Potential Reduction of Medica Premium. The chart in Chapter 7 of the Compliance Review sets forth a number of expenses that Medica allocated to physician, hospital or "other" service categories which the State believes should be allocated to administrative costs. If these expenses are reallocated to the administrative category and removed from the physician, hospital and "other" categories, one of the leading cost drivers of the Medica premium appears to be administrative costs.

For instance, the addition of the figures set forth in the chart in Section 7.2 regarding administrative expenses results in the total administrative expenses for 2000 being increased from $145,437,088 to $274,667,998, or 18.7 percent of revenue, for Medica, Medica - Wisconsin, ASI and MIC.

Medica *self-reported* to A.M. Best, an industry resource manual, that its administrative ratio is 13 percent of premium, which ratio appears to be higher than the administrative ratio of comparably sized HMOs. (Exhibit 60). Thus, Medica's 18.7 percent adjusted administrative ratio, in comparison to the ratios of other HMOs on Exhibit 60, is very high, with the excess administrative costs appearing to be approximately 6 percent of premium.

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Allina was then requested to produce workpapers to calculate the percentage ratio of the expenses it classified to the categories set forth in Exhibit 70 for Abbott Northwestern Hospital, United Hospital and the Allina Medical Clinic ("AMC"). Abbott Northwestern Hospital is the largest hospital in Minneapolis, and United Hospital is the largest hospital in St. Paul. AMC is one of the largest physician clinics in Minnesota, employing over 500 physicians throughout the State.

Section 8.3 Administrative Expense Ratio for Allina. Based upon Allina's budgetary assumptions set forth in Exhibit 70, Allina prepared Exhibit 71 as a breakdown of the non-patient care cost summary for the Allina Form 990 filing group. The summary essentially states that approximately $497,263,000 is expended on non-patient care costs. Based upon total expenses for the Allina hospital group of $1,251,606,000, this means that Allina hospital group's administrative costs account for approximately 39.7 percent of its expenses. Allina officials point out, however, that $51 million is attributable to bad debt and another $19,498,000 to the Minnesota Care and Medicaid Surcharge taxes. Allina points out that bad debt charges and the Minnesota Care and Medical Surcharge taxes are not controllable by the company. Accordingly, Allina requested that those amounts be separately itemized in connection with the reporting of its total non-patient care costs.

Allina officials also prepared a working paper summarizing non-patient care costs for AMC. This summary is attached as Exhibit 72. Under this calculation AMC expended approximately $254,100,000 in the year 2000, of which $86,778,000 was for non-patient care costs. Allina officials summarize the percent of total non-patient care costs as being 34.2 percent of expenses. Allina points out that approximately 3.8 percent of these costs are attributable to bad debt and the Minnesota Care and Medicaid Surcharge taxes, both of which are not controllable by the company.

Using the figures presented by Allina, the administrative ratio for the Allina hospital group and AMC was approximately 38.8 percent. (Exhibit 73).

Attached as Exhibit 74 is an illustration of the allocation of the Medica/Allina health dollar. It indicates that 18.7 percent of the Medica premium is expended on administrative functions and that, after deduction of the administrative and pharmaceutical expenses, Allina expended 38.8 percent on administrative functions if the patient utilized Allina facilities. This computes to an approximate 46 percent administrative ratio for the integrated health system.

CHAPTER 9:

STATE RECOMMENDATIONS

Section 9.1 Recommendations. The Compliance Review notes that there are a number of areas that should be reviewed by the new boards of Allina and Medica, some of which are discussed in general below:

A. **Consultants.** Chapter Three of the Compliance Review discussed the use of consultants. It pointed out that Allina was very lax with regard to the issuance and monitoring of contracts to consultants. In March of 2001 the Attorney General's Office filed a lawsuit in order to gain access to Allina's records. In that lawsuit the Attorney General's Office filed a brief alleging substantial issues relating to the use of consultants. During the month of April several of these consultants were terminated. Even though the company responded to the lawsuit by spending $700,000 on a group of "war room public relations" consultants, it did manage to start limiting its overall consulting costs. At the first board meeting of the new directors, Medica reported that the administrative costs of the HMO steadily dropped each month since the lawsuit was filed (March of 2001). (Exhibit 75). Attached as Exhibit 76 is a proposed policy to be implemented by Medica and Allina with respect to the use of consultants. Also attached as Exhibit 77 is a policy statement regarding the use of attorneys. While not separately itemized, Allina reports that it expends a substantial sum of money on attorneys' fees. New board members indicate that these fees were billed on invoices as sparse and incomplete as the Deloitte & Touche invoice attached as Exhibit 78. It is believed that, if the policies attached as Exhibits 76 and 77 are adopted and properly executed, savings in consultant and attorneys' fees and expenses should result.

B. **United Health Care.** A 1998 report of Arthur Andersen noted that United Health Care's fees for technology services to Medica were about double that which would be charged by EDS of Dallas, Texas. (Exhibit 79). For reasons that are unknown but raise concerns as to the business purpose of its instructions, in 1998 Medica management told its employees that the HMO could not solicit Requests For Proposals ("RFPs") and that it could only do business with United Health Care. (Exhibit 80). The company should be able to substantially reduce its technology costs by seeking RFPs and negotiating the use of alternative systems. (See Exhibit 81).

C. **Travel and Entertainment.** As noted in Chapter Five of this Report, the travel and entertainment expenditures of Allina and Medica executives were excessive. More important than the total cost of these expenses was the creation of a culture where executives would routinely incur expenses without regard to their business purpose. Indeed, on several occasions invoices were paid twice (Exhibits 82, 83), the same business purpose was attributed to different invoices (Exhibit 84, 85), and the criteria given for payment of an invoice was not its business purpose but rather whether it would draw media attention. (Exhibit 86). At least $2,000 was spent on a "going away" dinner for an employee that simply transferred between Allina divisions. (Exhibit 82). It is extremely important that the company adopt prudent standards concerning business travel and entertainment. A company with

20,000 employees should also adopt a policy regarding payment for "going away" parties.

D. **Executive Compensation.** Chapter Four of this Report discussed in detail the compensation of the Allina and Medica executives. The companies were lavish with regard to their incentive programs, many of which (in the case of Medica) were counterproductive to its members' desire to control the increase of premiums. On several occasions incentive programs were modified when it was discovered that executives would not achieve the performance that was required in the original incentive program. On other occasions existing employees were paid "signing bonuses" amounting to hundreds of thousands of dollars even though they were previous employees of Allina. The boards of Allina and Medica should undertake a review of executive compensation.

E. **Medica's Internal Staff.** In 2000 Medica serviced approximately one million members. Its membership has slightly dropped since 1998. In spite of this drop, the staff of Medica has increased from 694 employees to 855 employees. (Exhibit 87). During this same time period the salaries and benefits of Medica have increased from $39 million in 1998 to $64 million in 2000. (Exhibit 87). In other words, while the number of members serviced by Medica has not increased, the size of its staff has increased by approximately 23 percent and the size of its payroll has increased by approximately 63 percent. While Medica added approximately 20 employees to undertake the underwriting function of the HMO pursuant to a contract change with United Health Care in 1999, it is unclear why the company hired another 141 employees.

F. **Allina's Internal Staff.** Allina executives indicate that there has been substantial growth in personnel at the holding company level at Allina. It is apparent, however, that the hospitals within the system still appear to exist as independent and autonomous companies and on many occasions use their own name brand identity with patients.

Rather than develop specialty hospitals within a single system, the Allina hospitals clearly compete with each other. Perhaps the most obvious example is the efforts by both Abbott Northwestern and United to form independent heart centers. Several Allina executives have voiced the opinion that it would be more efficient for the holding company to accept the decentralized approach and recognize the autonomy of subsidiary companies and hospitals. Under such a "push down" structure, the central office of Allina would not be redundant to the hospital staff but would act more as a true strategic and oversight operation for the health system.

Section 9.2 Memoranda of Understanding. Attached as Exhibit 88 is a copy of a Memorandum of Understanding between Allina and the State of Minnesota. Attached as Exhibit 89 is a Memorandum of Understanding between Medica and the State of Minnesota.

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