State of Arizona
Office
of the
Auditor General

PERFORMANCE AUDIT

STATE COMPENSATION FUND

Report to the Arizona Legislature
By Douglas R. Norton
Auditor General

December 1998
Report Number 98-22

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AUDITOR GENERAL

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

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DEPUTY AUDITOR GENERAL

December 18, 1998

Members of the Arizona Legislature

The Honorable Jane Dee Hull, Governor

Mr. Jerry N. LeCompte, President
State Compensation Fund

Transmitted herewith is a report of the Auditor General, A Performance Audit of the State Compensation Fund. This report is in response to a May 27, 1997, resolution of the Joint Legislative Audit Committee. The performance audit was conducted as part of the Sunset review set forth in A.R.S. §§41-2951 through 41-2957.

The report presents information about the State Compensation Fund's efforts to adjust to a highly competitive workers' compensation insurance market. Although the Fund remains the major provider of workers' compensation insurance in Arizona, competition has reduced the Fund's market share and the amount of workers' compensation premiums earned. However, the Fund appears to be operating well and has taken several steps to attract and retain policyholders, including reducing premium rates and developing programs to improve services offered to current policyholders. Because the Fund had implemented, or was in the process of implementing, a number of process improvements and operation changes, no further recommendations are offered in this audit report.

As outlined in its response, the State Compensation Fund agrees with the finding.

My staff and I will be pleased to discuss or clarify items in the report.

This report will be released to the public on December 21, 1998.

Sincerely,

Douglas R. Norton
Auditor General

Enclosure

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Summary

The Office of the Auditor General has conducted a performance audit and Sunset review of the State Compensation Fund pursuant to a May 27, 1997, resolution of the Joint Legislative Audit Committee. The audit was conducted as part of the Sunset review set forth in Arizona Revised Statutes (A.R.S.) §§41-2951 through 41-2957.

Arizona law requires employers to provide workers' compensation insurance for their employees. This insurance provides medical coverage, rehabilitation, and supplemental income for workers who are injured on the job. To help employers obtain this coverage, the State Compensation Fund (the Fund) was established as part of the Industrial Commission in 1925 and became a separate state agency in 1969. In 1997, the Fund reported assets of more than $2 billion. As shown in Figure 1 (see page ii), the Fund, which competes with private insurance carriers, is the major provider of workers' compensation insurance in Arizona. In 1997, the Fund wrote policies for approximately 61 percent of the insured employers in Arizona, and earned approximately 41 percent of all premiums paid to workers' compensation insurers in the State.

After a comprehensive preliminary review, it was determined that the Fund is generally operating well. However, the Fund faces a highly competitive workers' compensation insurance market. Consequently, this report presents information about the Fund's efforts to remain competitive.

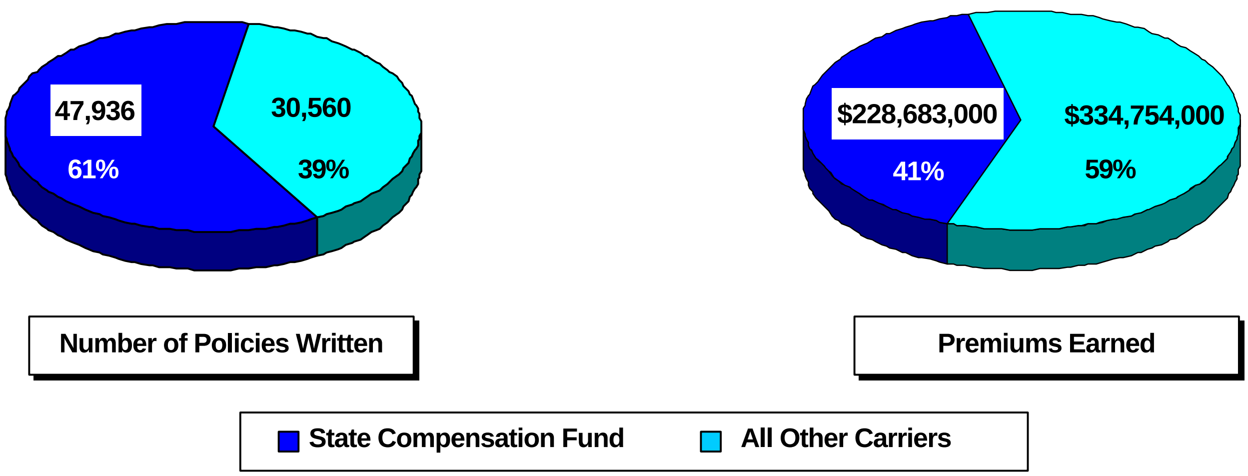
The State Compensation Fund Is Appropriately Adjusting to a Competitive Market (See pages 9 through 14)

To remain competitive in the current workers' compensation insurance market, the Fund is taking steps to retain and attract policyholders, and to improve efficiency. Approximately 275 private insurance carriers are providing workers' compensation insurance in Arizona, and increased competition from these carriers has made it more difficult for the Fund to maintain its income from earned premiums. The Fund's earnings from premiums declined from $348.5 million in 1994 to $240.9 million in 1997. Although much of the reduction is a result of declining premium rates charged by all carriers, the Fund's revenues have been further reduced as a number of major policyholders have left the Fund to obtain insurance elsewhere. Nonetheless, the Fund is still the largest workers' compensation insurer in the State and remains financially strong.

The Fund is taking several steps to attract and retain policyholders. Because the Fund found that larger policyholders that left the Fund often did so to obtain lower rates elsewhere, the Fund reduced its premium rates in July 1998. In addition, the Fund has developed programs to improve services offered to current policyholders. For example, the Fund received feedback that its customer service program was too rigid and did not adequately meet the needs of a variety of policyholders. The Fund has since redesigned its customer service program to allow for more flexibility and more policyholder input.

Figure 1

State Compensation Fund
Number of Policies Written and Premiums Earned[1]
by the Fund and Private Insurance Carriers
Year Ended December 31, 1997
(Unaudited)



1 Approximately 275 private carriers were providing workers' compensation insurance in Arizona.

Source: Auditor General staff analysis of premiums earned data obtained from Department of Insurance 1997 Annual Report; and analysis of policy holder numbers obtained from the State Compensation Fund Statement of Operations, 1997, and the National Council on Compensation Insurance.

The Fund is also working to reduce its budget and to improve the efficiency of its operations. This effort has been necessary because the Fund's premium earnings and workload have decreased substantially, but its administrative costs have not. As a result, administrative costs relative to premium earnings increased from 13.6 percent in 1995 to 21.7 percent in

1997. To reduce this ratio, the Fund is working to reduce its budget by 25 percent, or approximately $11.7 million, between 1998 and 2000. The Fund plans to rely mainly on staffing reductions to meet its budget goals. However, the Fund is also undergoing a review of its major functions, which is expected to result in further savings through improved efficiency. To date, the review process, which is expected to be complete in mid-1999, has identified changes that could potentially save the Fund more than $2 million annually.

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INTRODUCTION AND BACKGROUND

The Office of the Auditor General conducted a performance audit and Sunset review of the State Compensation Fund (the Fund) pursuant to a May 27, 1997, resolution of the Joint Legislative Audit Committee. This audit was conducted as part of the Sunset review set forth in Arizona Revised Statutes (A.R.S.) §§41-2951 through 41-2957.

Fund Created to Ensure All Arizona Employers Have Workers' Compensation Insurance Coverage

The 1925 Legislature established, in statute, a requirement that employers purchase or provide workers' compensation insurance for their employees. That same year the Legislature established the State Compensation Fund within the Industrial Commission of Arizona (ICA) to provide employers with a source for this insurance. In 1968, the Legislature removed the Fund from the Industrial Commission and established it as a separate entity, effective January 1, 1969. This separated the regulatory function (ICA) from the insurance function (the Fund). The Fund competes with private insurance companies in the workers' compensation market. The Fund's mission is:

> *To provide a ready market for workers' compensation insurance to Arizona employers at the lowest possible cost, and to return injured workers to full employment at the earliest opportunity.*

Although statutes do not require that the Fund act as the insurer of last resort, it has taken on this responsibility, accepting all employers regardless of claims history, size, or business experience. It accepts employers that cannot obtain workers' compensation insurance coverage from private carriers or that are not fiscally able to self-insure. The Fund is the largest carrier of workers' compensation insurance in the State, insuring approximately 48,000 employers. The Fund's policyholders account for roughly 61 percent of the employers who purchase workers' compensation insurance in Arizona, and approximately 41 percent of the total workers' compensation premium dollars.

Organization and Staffing

The State Compensation Fund is responsible to a 5-member Board of Directors appointed by the Governor to 5-year terms. By law, Board members must be Fund policyholders or employees of policyholders. The Board appoints the Fund's president, who manages the Fund's daily operations.

The Fund, headquartered in downtown Phoenix, operates district offices in Flagstaff, Glendale, Lake Havasu City, Mesa, Phoenix, Prescott, Show Low, Tucson, and Yuma. The Fund currently operates with a total of 617 FTEs, distributed as follows:

- **Administrative and Investments—**This division employs 179 FTEs and includes the Financial Services, Human Resources, Information Technology, and Management Resources departments. All these departments provide administrative support for the rest of the Fund's staff. The division also provides day-to-day management and tracking of the Fund's investment portfolio which, according to the Fund's 1997 annual report, was valued at slightly over $2 billion.

- **Benefits and Legal—**This division employs 206 FTEs and includes the Claims, Rehabilitation, Legal, and Investigation departments. This division manages claims filed by injured workers, coordinates treatment and rehabilitation efforts, and investigates claims to ensure they are valid. The Investigation Department also investigates possible fraud cases and, when appropriate, files them with the State Attorney General for prosecution. The Legal Department represents the Fund in Administrative Hearings over contested claims, attempts to resolve disputes prior to hearings, and provides other legal services to Fund management.

- **Employer Services—**This division employs 220 FTEs and includes the Policy Administration and Insurance Services departments. These departments perform auditing, underwriting, marketing, and loss control activities, which help ensure the Fund's policyholders are paying the appropriate amount for coverage and help policyholders reduce claims and associated costs. The Employer Services Division also supervises the district offices, which are staffed by claims, marketing, and loss control representatives, and auditors.

The Fund president, 5 vice-presidents, internal auditors, and their support staff make up the remaining 12 FTEs. The 5 vice-presidents manage the Administrative, Investments, Benefits, Legal, and Employer Services functions and, with the president, compose the executive staff, which carries out the Board's policy decisions and manages the Fund.

Budget and Financial Position

Because the Fund generates its own operating revenues through premiums paid by policyholders and by investment income, it receives no General Fund appropriations. The Fund operates on a calendar-year basis and submits a biennial budget to the Joint Legislative Budget Committee for review and approval. Since statutes require the Fund to be no more nor less than self- supporting, at the end of each year the Fund returns to its policyholders any revenues in excess of benefit payments, required reserves, and surpluses. According to Fund figures, dividends for 1997 totaled $83 million—the Fund's largest dividend ever. Table 1 (see page 4) shows Fund expenditures for 1995, 1996, and 1997.

Follow-up to Previous Auditor General Report

As part of the current audit, concerns previously identified in the Auditor General's 1988 performance audit of the State Compensation Fund were reviewed. A brief summary and current status for each of the six findings identified in 1988 follows:

- **The State Compensation Fund's status as a state agency and its relationship with the State—**The 1988 report found that as a state agency in competition with private insurance carriers, the Fund had an unfair advantage due to state support in areas such as purchasing and personnel. The report recommended that the Legislature consider requiring the Fund to reimburse state agencies for the cost of services received.

  Follow-up: Following the 1988 audit, several statutory changes were enacted, essentially eliminating any unfair competitive advantage. Specifically, in 1990, the Legislature revised A.R.S. §23-986, exempting the Fund from using state personnel services, the state salary schedule, state purchasing, risk management, motor pool, property management, and telecommunications services. Revisions also removed the Fund from the State's public finance and budgetary accounting, public records, and archives requirements. Also, amendments to A.R.S. §23-982 removed the requirement that the State Treasurer "be custodian of the state compensation fund." In addition, revisions to A.R.S. §23-981(C) eliminated the State's fiscal liability for the Fund. The Fund remains subject to Joint Legislative Budget Committee budget review and approval, the legislative Sunset review, and the Governor's appointment of board members.

- **Claims Management—**The 1988 report recommended the Fund ensure that claims receive appropriate oversight by medical staff; claims are assigned based on the expertise of the claims representatives; a clear policy is developed for supervisory review of claims; and specific guidelines are established to ensure that claims receive a minimal level of investigation.

Table 1

State Compensation Fund
Statutory-Basis Statement of Operations[1]
Years Ended December 31, 1995, 1996, and 1997
(in thousands)

	1995	1996	1997
Premiums earned	$343,627	$294,696	$240,855
Compensation and medical benefits incurred	329,943	231,245	226,050
Loss expenses incurred	40,293	83,331	38,598
Underwriting and administrative expenses	17,093	18,655	19,352
Taxes and fees	4,258	2,784	3,827
	391,587	336,015	287,827
Net underwriting loss	(47,960)	(41,319)	(46,972)
Investment income	133,290	147,558	153,903
Investment expenses	(4,511)	(4,554)	(4,959)
Net investment income	128,779	143,004	148,944
Other income (expense)	996	(1,388)	(216)
NCCI assigned risk pool income (expense)[2]	1,673	1,598	(1,016)
Net income before provisions for policyholders' dividends	83,488	101,895	100,740
Provision for policyholders' dividends[3]	(67,600)	(48,650)	(83,000)
Net income	$ 15,888	$ 53,245	$ 17,740

[1] The financial statements are prepared on a statutory basis in accordance with accounting practices prescribed or permitted by the Arizona Department of Insurance. Prescribed statutory accounting practices include a variety of practices described in the National Association of Insurance Commissioners' publications, as well as state laws, regulations, and general administrative rules. Permitted statutory accounting practices encompass all accounting practices not so prescribed.

[2] The State Compensation Fund is assigned certain policyholders that participate in the National Council on Compensation Insurance (NCCI) assigned risk pool. The assigned risk pool consists of employers whom two or more insurance carriers and the State Fund refuse to cover. These employers are distributed among the insurance carriers in the State in proportion to the carriers' share of the total net workers' compensation insurance in the State. All premiums collected on such policies are transferred to NCCI. All losses incurred on such policies are recoverable from NCCI. In addition, the Fund is assigned a pro rata allocation of the liability for loss and loss expenses incurred by all NCCI policyholders in the State of Arizona. By Board resolution, since January 1, 1998, the Fund does not refuse coverage to any employer, effectively eliminating any new additions to the risk pool.

[3] The Fund's Board of Directors makes provisions for dividends to policyholders based on the Fund's overall experience. Dividends are paid to policyholders that meet premium volume and loss experience criteria established by the Board. This is a permitted statutory accounting practice.

Source: The State Compensation Fund *Statutory-Basis Financial Statements* for years ended December 31, 1997 and 1996, and years ended December 31, 1995 and 1994, audited by Deloitte & Touche LLP.

Follow-up: The Fund has fully implemented one of these recommendations and has partially implemented the rest:

- ➲ The Fund now employs medical personnel and has guidelines for referring files for medical review.
- ➲ During 1996, the Fund studied methods of assigning claims to representatives. Following the study the Fund began assigning claims geographically by zip code to a team of Fund representatives. This reduced the geographic area of responsibility and increased the Fund employees' knowledge of the employers and providers. It also reduced the number of Fund staff with whom the employers and providers must deal.
- ➲ The Fund also established policies identifying specific instances that require supervisory file review. However, the Fund has not fully implemented the policy. Auditors reviewed 34 cases meeting the criterion for supervisory review and found only 2 contained appropriate documentation of such review.
- ➲ In addition, although the Fund has established guidelines requiring claims representatives to contact the employer, medical provider, and claimant before accepting a claim, this policy has not been fully implemented. Auditors reviewed 30 claim files and found only 13 contained documentation that the 3 contacts called for in the guidelines were completed.

The Fund is currently reviewing its claims management processes and management indicates these issues will be included as part of that review.

- **Computer systems—**The 1988 audit recommended the Fund improve and enforce security controls over computer access, develop an audit plan for the computer system, and develop a written disaster recovery plan.

  Follow-up: The Fund has improved security by locking the computer room doors and requiring passwords to access the computer system. Although it has no formal audit plan, the Fund monitors computer activity and generates reports concerning computer transactions for management review. Finally, the Fund has developed a Disaster Recovery Plan and is building an off-site backup location for the system in its new Mesa office.

- **Fiscal Responsibility—**The 1988 report recommended that the Fund management ensure compliance with laws regarding real property acquisitions, discontinue providing employee awards, and revise its employee training and education policy to be consistent with other state agency policies. Of specific concern was the fact that the Fund paid for food served during training sessions and employee meetings.

Follow-up: The Fund currently meets legal requirements for property acquisition. Although the Fund has not changed its training and award policies, it has reduced its expenditures for employee awards and training sessions. The State Constitution prohibits gifts except when the gifts are for a public purpose and the value of the gift approximates the benefit to the public. However, this constitutional requirement applies to tax revenue, and it is unclear whether it applies to an enterprise like the Fund, whose expenditures do not derive from taxes. Consequently, it is not clear whether providing food at Fund award and training functions violates the Constitution.

- **Board Membership—**The 1988 audit expressed concerns about the Board of Director's size and composition. The Board consisted of three members, which limited representation and potentially caused violations of the Open Meeting Law, since two board members meeting together constituted a quorum. The report recommended that the Legislature amend A.R.S. §23-981.01 to increase the size of the Board to at least five members.

  Follow-up: In 1990, the Legislature increased the size of the Board to five members, all of whom must be policyholders or employees of policyholders.

Scope and Methodology

Audit work focused on the State Compensation Fund's overall management and position in the workers' compensation market. This report presents one finding regarding the State Compensation Fund's continued efforts to adjust to a competitive market (see pages 9 through 14). Several methods were used to study the issues addressed in this audit, including:

- State Fund management and staff were interviewed to obtain an understanding of the Fund's operations. Also, management and staff of the Industrial Commission of Arizona and the Department of Insurance, both of which regulate the Fund, were interviewed and expressed no major concerns related to the Fund. In addition, five former policyholders were interviewed to determine their reasons for leaving the Fund. Auditors also reviewed two years' worth of board meeting minutes and attended two Board meetings to help review the Board's role in managing the Fund and its compliance with the Open Meeting Law.

- Other competitive state funds were surveyed to determine how Arizona's Fund compares with them regarding status as a state agency, level of legislative oversight, claims management, advertising, and market share. A total of 13 of the 18 other states with workers' compensation funds that compete with the private sector responded to the survey.

- Fund files, documents, and reports were reviewed to determine such things as the Fund's status in the market, reasons for loss of business, financial status, and compliance with policies and procedures. Specifically, 34 claim files were examined for documentation of supervisory review and an additional 30 claim files were reviewed for documentation of initial investigative contacts.

After a comprehensive preliminary review of the Fund's operations, auditors determined that overall, the Fund appears to be operating effectively. Specifically:

- The Fund is proactively addressing various management and operational issues, and it continues to review and revise procedures addressed in the 1988 audit report (see Finding I, pages 9 through 14).

- The Fund has improved claims management technology by using document imaging and computers to facilitate the process, which has resulted in a reduction in FTEs and an increase in efficiency.

- Fund managers are reviewing processes relating to claims management, including activities such as case assignment, claims processing, medical review, and provider payment, to identify potential improvements.

This audit was conducted in accordance with government auditing standards.

The Auditor General and staff express appreciation to the Board of Directors and the President, Vice-presidents, and staff of the State Compensation Fund for their cooperation and assistance throughout the audit.

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FINDING I

THE STATE COMPENSATION FUND IS ADJUSTING APPROPRIATELY TO A COMPETITIVE MARKET

The State Compensation Fund is currently operating in a highly competitive workers' compensation market, requiring it to continually assess its position and make adjustments to remain competitive. Competition has reduced the Fund's market share and the amount of workers' compensation premiums earned. This decline in premiums has resulted in increased administrative costs relative to the Fund's total earnings. However, the Fund remains financially strong and is taking appropriate steps to attract and retain policyholders by reducing its premium rates, improving customer service, and modifying its marketing methods. In addition, the Fund is currently reducing its budget to improve its administrative expense ratio and is streamlining its processes to improve efficiency.

Current Workers' Compensation Market Is Competitive

While the Fund is the largest carrier of workers' compensation insurance in Arizona, it is facing a highly competitive market. In 1997, approximately 275 private carriers provided workers' compensation insurance for over 78,000 Arizona businesses.[1] Competition among these carriers has resulted in an overall reduction in the total amount of workers' compensation premiums paid in Arizona and in the total amount paid to the Fund. In addition, the Fund's earnings from premiums have been further reduced as private carriers have become increasingly successful in marketing to the Fund's large and mid-sized policyholders. As the Fund's income from premiums has declined, its administrative costs have increased relative to earnings.

Premium rates have declined—As shown in Figure 2 (see page 10), over the last 10 years, workers' compensation insurance premiums peaked in 1994, when insurers earned approximately $711 million in premiums. That year, the Fund earned approximately $338 million in premiums, or approximately 48 percent, of the total. Since then, premium rates have steadily declined, lowering the total premiums earned by all workers' compensation carriers

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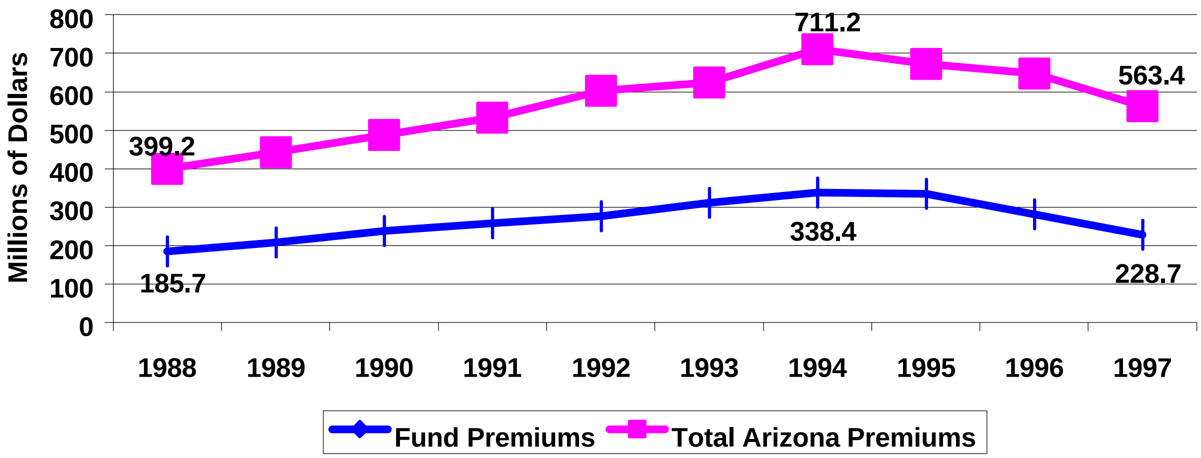
1 Total policyholder numbers for 1997 provided by the National Council on Compensation Insurance.

Figure 2

State Compensation Fund
Premiums Earned by the Fund Compared to All Premiums Earned by Workers' Compensation Carriers in Arizona [1]
Years Ended December 31, 1988 through 1997
(Unaudited)



[1] Earnings do not include premiums paid by self-insured, or self-rater, companies for services such as claims management. For the State Compensation Fund, these self-rater premiums totaled approximately $12.3 million in 1997.

Source: Auditor General staff analysis of information contained in Department of Insurance Annual Reports for 1988 through 1997.

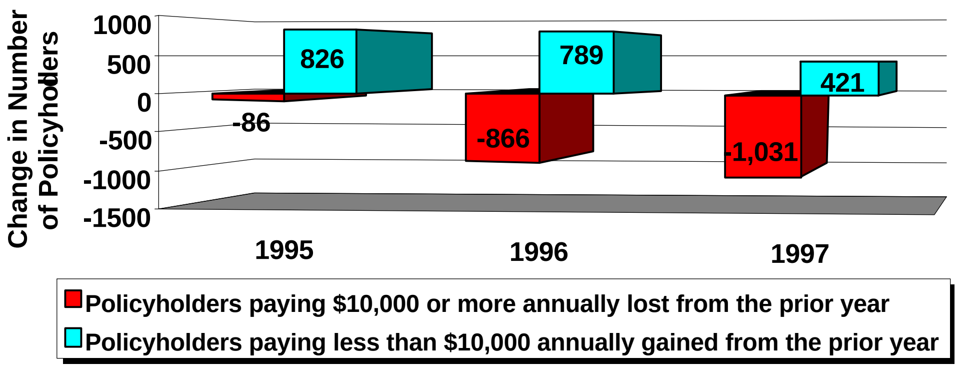
in the State. In 1997 all workers' compensation insurers in the State earned premiums of approximately $563 million. Of that total, the Fund earned approximately $228.7 million, or 40 percent. [1]

Some larger policyholders have left the Fund—Although declining premium rates have had the greatest impact on the Fund's revenues, premium earnings have been further reduced as the number of Fund policyholders has declined and the Fund's policyholder profile has changed. The Fund reported a total net loss of 77 policyholders in 1996 and 610 policyholders in 1997. In 1998, the Fund estimates it will again lose more than 600 policyholders. Although the total losses in 1996 and 1997 represent less than 2 percent of the Fund's approximately 48,000 policyholders, those losses consist mainly of policyholders that were

[1] Premium earnings were obtained from the *Eighty-fifth Annual Report of the Director of Insurance*, for the year ending December 31, 1997. The earnings do not include premiums paid by self-insured, or self-rater, companies for services such as claims management. For the State Compensation Fund, these self-rater premiums totaled approximately $12.3 million in 1997.

Figure 3

State Compensation Fund
Change in the Number of Policyholders
by Annual Premium Category
Years Ended December 31, 1995 through 1997
(Unaudited)



Source: Auditor General staff analysis of policyholder data obtained from the State Compensation Fund.

paying more than $10,000 in annual premiums. As shown in Figure 3, the Fund continues to gain smaller policyholders while losing larger policyholders. Consequently, the percentage of Fund policyholders paying more than $10,000 in annual premiums declined from approximately 12.5 percent in 1994 to approximately 8 percent in 1997.

The Fund's administrative expense ratio has increased**—**As premium earnings and workload have declined, the Fund's administrative expenses have not decreased accordingly. According to Fund officials, the number of reported claims declined to approximately 44,000 in 1997, down from 68,000 in 1994. The Fund projects claims numbers will decline further, to an estimated 39,000, in 1998. Meanwhile, administrative costs have not declined. Consequently, administrative costs relative to premium earnings have increased from 13.6 percent in 1995 to 21.7 percent in 1997.

The State Compensation Fund Is Reducing Premiums and Improving Service

Despite the current competitive market, the Fund remains strong and is taking appropriate steps to attract and retain policyholders. It has recently reduced its premium rates, developed several programs designed to improve customer service and retain its current policyholders, and is considering other methods to attract new policyholders and increase its revenue.

The Fund remains strong—Despite the current competitive market, the Fund remains strong and is by far the largest carrier of workers' compensation insurance in Arizona. Its 40 percent share of the total premiums earned is about 10 times the share of the next largest competitor. The Fund's investment portfolio has increased from approximately $580 million in 1987 to over $2 billion in 1997. Its policyholder dividends for 1997 totaled $83 million—the highest amount ever.

Rate reduction makes Fund more competitive—The Fund recently established more competitive premium rates in an attempt to maintain its market share. In surveying policyholders that paid annual premiums of $10,000 or more and that left the Fund between January and June 1998, the Fund found that more than half cited price as the primary reason. In response, the Fund filed in July 1998 to reduce its premium rates with the Department of Insurance, which regulates rates for all workers' compensation insurance carriers in Arizona. Carriers must notify the Department when they begin charging rates above or below the base rates set by the National Council on Compensation Insurance (NCCI), an insurance rating bureau. Without objection from the Department, the Fund began offering a 35 percent discount off NCCI base rates on July 1, 1998. Prior to the rate reduction, the Fund's discount was 25 percent and as many as 21 carriers offered lower rates. When the Fund's new rates took effect, only 4 carriers offered lower rates. Only 1 of those companies is among the 25 largest.

The Fund has established programs to improve customer service—In addition to reducing its rates, the Fund has developed new customer service programs to better serve policyholders. These programs include a call center, a redesigned service program, and a team management concept for customer service.

- **Call Center**—In order to resolve policyholders' concerns more quickly and to ease the burden that telephone inquiries were placing on claims representatives, the Fund created the Call Center in 1995. The Center is staffed by senior Fund representatives who have access to policy information on computer, which enables them to respond to questions from both policyholders and claimants. The Call Center reports that in 1998 (through August 31) representatives were able to process approximately 80 percent of the 107,532 calls received without further staff involvement or repeat calls.

- **Redesigned service program**—In January 1998, the Fund began implementing a redesigned policyholder service program called the Exceptional Service Plan (ESP) which provides safety consulting, policy auditing, and claims management. The Fund had received feedback from policyholders that its previous service plans were too rigid to adequately address the needs of all policyholders. ESP is an attempt to emphasize the needs of the policyholder and to provide an individualized and flexible plan. Policyholders that pay premiums of at least $35,000 annually, or smaller policyholders that have had more than two compensation claims per year, can participate in ESP.

- **Team Management Concept**—The Fund is currently implementing a team management concept designed to simplify the policyholders' relationship with the Fund. The Fund has begun assigning policyholders to a team of representatives who work from local district offices to provide services such as loss control, claims management, and marketing. Previously, policyholders worked with a number of different Fund personnel, both at the district offices as well as at the Phoenix home office. Now, local service teams are being used to provide policyholders with more consistent service, and a single point of contact, and to enable Fund employees to become familiar with policyholders' particular needs.

Other methods being considered to attract new customers—In addition to an increased emphasis on better serving its current customers, the Fund is considering other methods to attract new policyholders and increase its revenue. Specifically, the Fund is discussing the possibility of using independent agents to sell Fund policies. Other state workers' compensation funds have used a combination of independent agents and their own marketing representatives. Although using agents could increase the Fund's exposure to potential policyholders, commissions could prove costly. The Fund is also considering using more aggressive advertising techniques. The Fund's advertising efforts have generally been limited to print advertisements in trade journals, press releases, direct mailings, and attendance at trade shows. The Fund did experiment with radio advertising in 1997, but has yet to utilize other mass media advertising.

The Fund Is Working to Improve Efficiency and Effectiveness

In addition to efforts aimed at maintaining its market share and improving customer service, the Fund is undertaking several other efforts to improve its operations. The Fund is adjusting to its reduced workload by cutting its operating budget. Additionally, the Fund is in the process of reviewing its major functions in an effort to streamline processes and improve efficiency.

The Fund is reducing its operating budget—The Fund is taking steps to reduce its administrative expenses to bring its costs more in line with its reduced workload. To decrease these expenses, the Fund plans to reduce its administrative budget by 25 percent, or approximately $11.7 million, over a 3-year period. The planned reductions include a decrease of 5 percent in administrative expenses in 1998, 10 percent in 1999, and 10 percent in 2000. The Fund has mainly relied, and will continue to rely, on staffing reductions to accomplish this goal. Currently, the Fund has 617 full-time employees, although it is budgeted for up to 736 employees. The Fund has identified an additional 60 to 70 current positions that could be eliminated. Most of the staff reductions to date have been accomplished through attrition.

The Fund is reviewing its processes**—**The Fund is currently reviewing its major functions to streamline processes and improve efficiency. In July 1997, with the assistance of a consultant, the Fund started a project it calls "Fundamental Change." Through this process, the Fund is examining all its major functions, including claims processing, billing, and its organizational structure.

The Fund anticipates completing the initial stages of Fundamental Change by the end of 1998, and expects to have recommendations fully implemented by mid-1999. Although Fundamental Change has not been completed, the process has already identified ways to improve efficiency and reduce the Fund's administrative costs. Specifically:

- The review of the Employer Services Section has identified changes that could potentially save the Fund as much as $2 million annually. The review also identified changes to the Fund's billing process to improve customer service; and,

- The review of the Information Technology Section resulted in projected savings of approximately $131,000. Changes included restructuring the section, developing more efficient ways of prioritizing projects, eliminating some functions, and reducing staff size.

Recommendation

This finding provides information only. Therefore, no recommendations are presented.

SUNSET FACTORS

In accordance with A.R.S. §41-2954, the Legislature should consider the following 12 factors in determining whether the Arizona State Compensation Fund should be continued or terminated.

1. Objective and purpose in establishing the Fund.

Arizona law requires employers to provide workers' compensation coverage to pay medical costs and some compensation for lost wages resulting from job-related injuries. Employers may provide this coverage through self-insurance, a private insurance carrier, or the State Compensation Fund. The Fund's mission is:

> *To provide a ready market for workers' compensation insurance to Arizona employers at the lowest possible cost and to return injured workers to full employment at the earliest opportunity.*

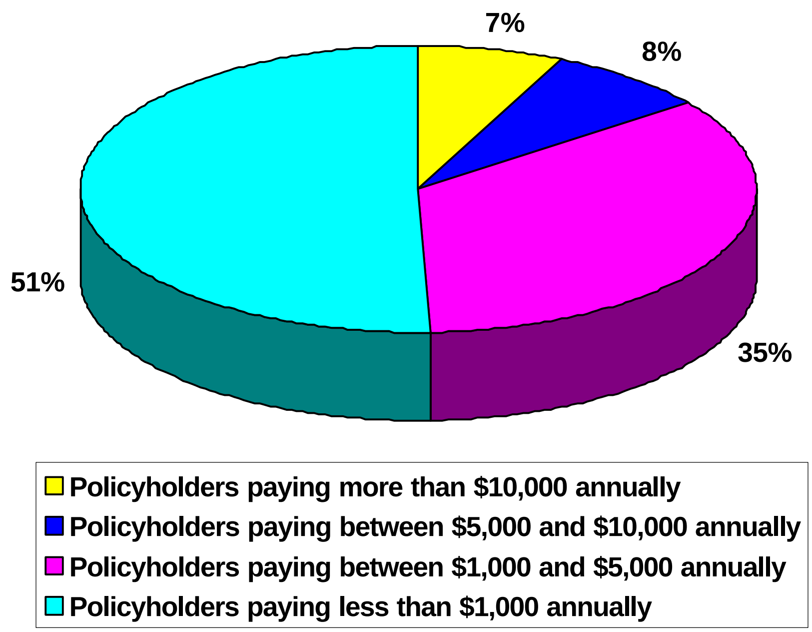
The Fund is the largest provider of workers' compensation insurance in the State, insuring approximately 48,000, or approximately 61 percent, of all insured Arizona employers. Among the employers insured by the Fund are a large number of small businesses. As shown in Figure 4 (see page 16), as of August 31, 1998, about 86 percent of the Fund's policyholders had estimated annual premiums of $5,000 or less, and about 51 percent had estimated annual premiums of $1,000 or less.

2. The effectiveness with which the Fund has met its objective and purpose and the efficiency with which the Fund has operated.

The Fund seems to be effective in meeting its goal of providing a ready market for workers' compensation insurance to all employers at a low cost. In keeping with its mission, the Fund insures all businesses, regardless of size or risk. It accepts businesses that cannot obtain workers' compensation insurance coverage from private carriers or that are not fiscally able to self-insure. The Fund charges a competitive rate and has returned dividends to its insured employers each year. According to its 1997 annual report, since 1969 the Fund has returned over $1.5 billion to its insured employers in the form of dividends and premium reductions.

Figure 4

State Compensation Fund
Percentage of Policyholders by Annual Premium Size[1]
As of August 31, 1998
(Unaudited)



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1 Percentages do not add to 100 due to rounding.

Source: Auditor General staff analysis of policyholder data obtained from the State Compensation Fund.

The Fund has also initiated several programs to improve efficiency, such as a call center, a redesigned service program, and a team management concept of servicing policyholders to improve efficiency and reduce costs. (See Finding I, pages 9 through 14).

The Fund has also established procedures to help it meet its mission to return injured workers to full employment at the earliest opportunity. Medical reviews by Fund medical staff and other medical consultants help ensure medical treatments and procedures are necessary and appropriate. In addition, the Fund also emphasizes rehabilitation. Counselors the Fund employs assist workers in obtaining proper treatment to prepare them to return to their original jobs or be retrained for different occupations. The Fund encourages employers to provide light-duty jobs for injured workers until they can return to their original jobs.

3. The extent to which the Fund has operated within the public interest.

The Fund generally operates both directly and indirectly in the public's interest. The Fund provides direct benefits to those employers and employees it insures, particularly to those who could not obtain coverage or would be required to pay higher rates for coverage if not accepted by the Fund. The Fund also serves the public interest on a broader scale by investing in Arizona. In 1993, the Fund's Board of Directors approved a change in the Fund's investment policy, allowing it to invest up to 10 percent of its portfolio in first mortgage loans on Arizona business real estate. To date, the Fund has loaned over $70 million to Arizona businesses to purchase or construct business real estate properties or improve existing properties.

4. The extent to which rules and regulations promulgated by the Fund are consistent with the legislative mandate.

Although the Fund Manager and the Board of Directors both have statutory authority to promulgate administrative rules and regulations, neither has done so.

5. The extent to which the Fund has encouraged input from the public before promulgating rules and regulations and the extent to which it has informed the public as to its actions and their expected impact on the public.

While the Fund has not had to inform the public regarding promulgation of rules and regulations, it does comply with the Open Meeting Law. Additionally, our review found that the Fund keeps its policyholders informed of its activities through various publications and seminars. Specifically, it publishes a quarterly magazine and an annual report that provides an overview of its general operation and financial status. A number of other pamphlets and publications provide information about various phases of workers' compensation insurance, job and workplace safety, rehabilitation, and other related subjects. Finally, Fund staff conducts seminars for policyholders and providers to acquaint them with the Fund and its operations.

6. The extent to which the Fund has been able to investigate and resolve complaints that are within its jurisdiction.

Although this factor generally does not apply to the Fund, since it is not a regulatory agency, it does receive some complaints from injured workers, insured employers, and medical providers. Questions and potential complaints are usually resolved informally by staff in the Call Center, or by claims or marketing representatives. Formal complaints are filed with the Department of Insurance, which forwards them to the Fund. The Fund's ombudsman, who is a member of the Executive Staff, resolves most of these complaints. The Fund received 19 formal complaints in 1996 and 9 in 1997, and has received 9 through August 1998. Some complaints concerning the approval of claims or amount of compensation benefits paid result in hearings before an Administrative Law Judge. The Fund's legal department is responsible for processing these complaints.

7. The extent to which the Attorney General or any other applicable agency of state government has the authority to prosecute actions under enabling legislation.

Although this factor does not specifically apply, since the Fund is not a regulatory or enforcement agency, the Fund does investigate claims to identify possible fraud. The Fund's investigative division consists of 14 investigators who help to ensure claims are legitimate. Two of these 14 FTEs (one full-time and two half-time) investigate fraud cases. In addition, the Fund contracts with the Attorney General for a special investigator to assist with fraud investigations. Assistant Attorneys General process search warrants and subpoenas for the Fund's investigators and prosecute fraud cases filed by the Fund. In 1997, the Fund obtained 11 criminal convictions for fraud, and $86,348 in court-ordered restitution, and recovered $31,609 through civil court actions.

8. The extent to which the Fund has addressed deficiencies in its enabling statutes which prevent it from fulfilling its statutory mandates.

In 1990, the Legislature amended statutes, removing the Fund's ability to access such services as the State Treasurer, State Personnel Board, and State Purchasing. The Legislature made these changes to remove advantages the Fund had over private insurance carriers as identified in the Auditor General's 1988 review. (See the Introduction and Background, pages 1 through 7, for further information relating to statutory changes affecting the Fund.)

9. The extent to which changes are necessary in the laws of the Fund to adequately comply with the factors listed in the Sunset Law.

There are no statutory changes necessary for the Fund to comply with the factors listed in the Sunset Law.

10. The extent to which the termination of the Fund would significantly harm the public health, safety or welfare.

Terminating the Fund could significantly harm the public health, safety, or welfare, as it could have a significant negative impact on workers' compensation insurance in Arizona. Although there are approximately 275 private carriers providing workers' compensation insurance in Arizona, the State Fund serves approximately 61 percent of all insured employers. Although not statutorily mandated, the Fund is the insurer of last resort, accepting all employers regardless of risk factor, claims history, size, or business experience. Therefore, terminating the Fund could cause a large void in workers' compensation coverage until all current policyholders obtained insurance elsewhere.

Since workers' compensation insurance is mandatory, terminating the Fund would also cause the high-risk policyholders to be distributed among the other carriers. Moreover, companies in higher-risk industries and smaller companies would likely pay higher premiums for their workers' compensation insurance, and could pass those costs on to consumers. Another possibility is that these companies could drop workers' compensation coverage completely, leaving their workers unprotected in the case of an on-the-job injury.

11. The extent to which the level of regulation exercised by the Fund is appropriate and whether less or more stringent levels of regulation would be appropriate.

This factor does not apply since the Fund is not a regulatory agency.

12. The extent to which the Fund has used private contractors in the performance of its duties and how effective use of private contractors could be accomplished.

The Fund uses private contractors on a limited basis to assist in the performance of its activities. The Fund purchases legal, investigative, payroll audit, and collection services as necessary. It also contracts with various firms to assist in claims cost containment efforts, including rehabilitation and in-house surgery review and approval. The Fund also retains consultants such as public accounting and actuarial firms and investment advisors.

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Agency Response

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December 14, 1998

Mr. Douglas R. Norton
Auditor General
2910 North 44th Street, Suite 410
Phoenix, Arizona 85018

Dear Mr. Norton:

We have reviewed the draft of the performance audit of the State Compensation Fund. We have no substantial issues or concerns with the information contained in the report. We believe the auditors have generally provided an accurate representation of the operations of the Fund and the mission of service that it carries out for the benefit of Arizona and its citizens. The report contains only one informational finding, with which we generally concur. No recommendations are offered relative to this finding. As a result, there are no implementation issues to be addressed.

We would like to take the opportunity to clarify a few of the comments reflected in the report, to complement what is generally an accurate representation of the organization.

Administrative Costs

Reference is made in the Summary and in the body of the report to the fact that the Fund's administrative expenses as a percentage of premium have increased from 13.6% in 1995 to 21.7% in 1997. To the extent that a portion of this change is due to reductions in workers' compensation rates, the increases in administrative expenses in relationship to premium are not unique to the State Fund. Private insurers are experiencing similar increases in administrative expense ratios and the Fund's expenses as a percentage of premium continue to be significantly lower than those of private insurers.

Follow-up to Previous Auditor General Report

Page 5 of the report discusses follow-up of recommendations pertaining to claims management and observes that the Fund has established policies pertaining to supervisory review but that such policies have not been fully implemented. The report also observes that policies pertaining to contact with employers, providers and claimants have not been fully implemented. It should be clarified that the referenced policies are in place and have been fully implemented. The extent to which they may not be followed is an issue of performance or lack thereof on the part of employees, and will be addressed accordingly.

The Fund has been provided with information on the specific cases or claims files which were reviewed by the auditors in reaching the above-referenced conclusions relative to claims management. Adherence to policies is monitored on a continuing basis by staff internal auditors and the results of those reviews reflect a significantly higher degree of compliance with the policies in question than is implied by the report. With the information provided by the audit, the compliance program related to these issues will be reassessed.

Page 6 of the report states that the Fund has not changed its training and award policies, although expenditures have been reduced. We do not believe our policies are in violation of any statutes, nor are they in violation of any Constitutional provisions.

Methods to Attract New Customers

Page 13 of the report indicates that the Fund is considering using more aggressive advertising techniques. Advertising in varying forms has been considered; however, it is unlikely that the Fund will significantly modify its current limited advertising practices.

Sunset Factors

We agree with the opinion of the auditors as reflected in Sunset Factor 10 on page 19, that termination of the Fund could significantly harm the public health, safety and welfare, for the reasons stated therein.

We compliment the auditors for their professionalism during the review and for their efforts in understanding and reporting on the unique position and role of the State Fund, and the mission it serves for Arizona. Too often, there are those who would categorize the Fund as “just another state agency”. It is true that we are a creature of statute, but for all intents and purposes, we operate or attempt to operate as a business, through application of sound business principles and practices. We believe the auditors recognized those efforts and we appreciate such recognition.

If further information can be provided, please advise.

Sincerely,

Bruce C. Thoeny	Jerry N. LeCompte, CPCU
Chairman, Board of Directors	President & General Manager

JNL/cma