GAO

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General Accounting Office
Washington, D.C. 20548

Health, Education and Human Services Division

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August 7, 1995

The Honorable Nancy L. Johnson
House of Representatives

Dear Mrs. Johnson:

The United Mine Workers of America (UMWA) Combined Benefit Fund pays the health benefits of certain retired mine workers and their dependents or survivors. The Fund was established by the Coal Industry Retiree Health Benefit Act of 1992, which merged two existing UMWA health benefit trusts. The Fund, which had a surplus of $114.8 million as of September 30, 1994, is financed mostly by annual premiums assessed to certain companies, called operators, and some operators have claimed that the requirement that they pay the premiums is unfair.

The Subcommittee on Oversight, House Committee on Ways and Means, held a hearing on June 22, 1995, on this issue and other matters affecting the Fund. Among the witnesses at the hearing were representatives of the consulting firms of Ernst & Young and Towers Perrin. These firms did studies of the Fund's financing, and each projected different financial outcomes for the Fund: Ernst & Young projected that the surplus would decrease each year and be eliminated by 2004, while Towers Perrin concluded that the surplus would continue to grow well past the year 2004 (see table 1.1). This letter responds to your May 31, 1995, letter and subsequent discussions with your staff asking us to explain the differences in the two consultants' studies.

BACKGROUND

The Fund's trustees requested the March 1995 Ernst & Young study, which projects the Fund's activities through 2004. A private group requested Towers Perrin's initial study to gauge the effects of certain proposed legislation on the Fund's finances through 2043. Towers Perrin did three analyses: an initial study in early 1994, and updates in May 1994 and January 1995. In May 1995, Towers Perrin also issued a critique of the Ernst & Young study, which supported the estimates reflected in its own January 1995 update.

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Using the Fund's actual financial experience for certain periods, each firm developed a model to estimate the Fund's future financial outlook. Each model used assumptions about how certain factors would change over time: medical cost inflation and the Fund's medical expenses trend; beneficiary mortality; reimbursements from external sources such as Medicare and the Black Lung program; and investment income. The Towers Perrin model is based on the results of the Fund's first period of activity--February 1, 1993, to January 31, 1994. Towers Perrin then adjusted the data in May 1994 and January 1995 to reflect the results of activities in 1994 and 1995. Ernst & Young's model, developed in early calendar year 1995, was primarily based on the Fund's fiscal year 1994 operations. The structure of the models and their assumptions about the Fund's medical expense inflation rate differed significantly, as detailed in table 1.2.

SOURCES OF DIFFERENCES IN THE MODELS' PROJECTIONS

The consultants' models project widely differing financial results for the Fund. A key element in these projections is the amount of the Fund's annual unreimbursed net expenses.[1] Accordingly, we compared the models' unreimbursed net expense estimates through the year 2004 as well as their estimates for 1995 with the Fund's actual annualized net expenses through April 1995 of about $228 million. First, our comparisons showed that the models' expense estimates for 1995 differed from each other by about $16 million and that the differences were greater in 1996 and later years (see table 1.3). Second, we found that Towers Perrin's model underestimated the Fund's 1995 net expenses by about $20 million, whereas Ernst & Young's model underestimated the expenses by approximately $3 million. Our analysis shows that two factors could account for the differences in the models' estimates of net expenses for 1995 and subsequent years: the construction of the basic models and the assumptions of medical inflation.

First, in constructing its basic 1994 model, Towers Perrin may have underestimated net unreimbursed expenses. The model relied mostly on the Fund's 1993 experience, which

[1]Net unreimbursed expenses are the difference between the sum of gross medical and administrative expenses and reimbursements from Medicare and the Department of Labor's Black Lung program.

was somewhat anomalous in that the Fund's Medicare per capita reimbursement rate increased that year, reducing net unreimbursed expenses. In 1994 and 1995, however, the reimbursement rate decreased. This may help explain why the January 1995 update reflected an increase of only about 5 percent in net expenses compared with the May 1994 estimates, even though, on the basis of its experience in prior years, Medicare had reduced the Fund's medical expense reimbursement rate for 1995 by about 27 percent. In contrast, Ernst & Young's model relied mainly on 1994 information and excluded the 1993 data because Ernst & Young believed that the 1993 Medicare reimbursement increase would not recur.

Second, Towers Perrin's medical cost inflation assumptions for the Fund were considerably lower than Ernst & Young's assumptions, and thus the expenses in Towers Perrin's model grew more slowly. Towers Perrin based its assumptions on (1) the assumptions used in current actuarial practice for estimating future health expenditures for private corporations' current employees and retirees in the long term and (2) the Fund's past and current efforts to contain cost growth in areas such as prescription drugs, which it estimated were 60 percent of net medical expenses. Also, Towers Perrin referred to the lower expenses the Fund experienced in 1993 as an example of the Fund's success in controlling costs.

In contrast, Ernst & Young essentially relied on the Medicare trust fund's projections of medical inflation and adjusted these estimates to reflect the Fund's past experience. Given that the Fund population's average age is 73 and about 89 percent are Medicare-eligible, Ernst & Young's assumptions may be more appropriate. Also, in developing its inflation assumptions, Towers Perrin may have overestimated the effects of the Fund's cost- control efforts. Further, if Towers Perrin's inflation assumptions were applied to the whole economy, the health expenditure share of the gross domestic product would decrease by the year 2004. We are not aware of any other study that makes such an optimistic assumption.

Overall, Ernst & Young's assumptions may be more reasonable and thus its model may be more accurate in predicting the Fund's financial status beyond 1995.

I hope that this letter is responsive to your request. As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this letter until 30 days from its date. At that time we will send copies to interested parties and make copies available to others upon request.

If you have any questions about this correspondence, please call me on (202' 512-7215 or Donald Snyder, Assistant Director, on (202) 512-7204.

Sincerely yours,

Jane L. Ross

Jane L. Ross
Director, Income Security Issues

Enclosure

Table 1.1: Consultants' Projections of Fund's Financial Status, 1995-2004

Dollars in thousands

	Accumulated surplus or (deficit)	
Year	Towers Perrin[a]	Ernst & Young
1995	$133,925	$111,367
1996	155,722	109,516
1997	181,848	105,153
1998	207,247	97,397
1999	231,970	86,527
2000	250,623	71,783
2001	249,062	51,963
2002	246,457	26,868
2003	242,950	(3,529)
2004	240,843	(38,929)

[a]Data are from the January 1995 update.

Table 1.2: Differences in the Basic Elements of the Consultants' Models

Element	Towers Perrin	Ernst & Young
Model basis	Net per capita unreimbursed medical and administrative expenses, by sex and age group, for entire population	Gross per capita medical and administrative expenses for Medicare and non-Medicare population, by sex and age group
Fund's medical inflation trend	1995-96 4%[a] 1997-99 8% 2000-02 6% 2003-43 4%	1995 6.6% 1996 8.1% 1997-98 8.4% 1999 8.3% 2000 8.7% 2001 9.2% 2002 9.5% 2003 9.7% 2004 9.9%

[a]Data are from the January 1995 update. The May 1994 update assumed inflation at 8% for these years. Towers Perrin reduced it to reflect the Fund's "current and pending cost management initiatives," including a new capitated prescription drug contract that the Fund entered into, noting that prescription drugs accounted for 60 percent of the Fund's net benefit cost.

Table 1.3: Consultants' Projections of Fund's Net Unreimbursed Expenses, 1995-2004

Dollars in thousands

Year	Towers Perrin	Ernst & Young
1995	208,104	224,826
1996	204,006	236,321
1997	199,116	238,572
1998	200,511	238,883
1999	201,236	236,688
2000	203,089	233,871
2001	200,893	230,307
2002	198,157	225,027
2003	194,877	218,265
2004	187,694	216,111

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