DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General
Offices of Audit Services

Region VII
601 East 12th Street
Room 284A
Kansas City, Missouri 64106

August 17, 2005

Report Number A-07-04-00166

Donald L. Fisher
Vice President
Compensation, Benefits, HRIS, and Risk Management
Highmark, Inc.
1800 Center Street
P.O. Box 890089
Camp Hill, Pennsylvania 17089-0089

Dear Mr. Fisher:

Enclosed are two copies of the U.S. Department of Health and Human Services (HHS), Office of Inspector General (OIG) report entitled "Review of Postretirement Benefit Costs Claimed by Highmark, Inc." for the period covering fiscal years 1998 through 2002. A copy of this report will be forwarded to the HHS action official noted on the next page for her review and any action deemed necessary.

The action official will make final determination regarding actions taken on all matters in the report. We request that you respond to the action official within 30 days from the date of this letter. Your response should present any comments or additional information that you believe may have a bearing on the final determination.

In accordance with the principles of the Freedom of Information Act (5 U.S.C. § 552, as amended by Public Law 104-231), OIG reports are made available publicly to the extent information contained therein is not subject to exemptions of the Act that the Department chooses to exercise (see 45 CFR part 5).

If you have any questions on this report, please do not hesitate to call me at (816) 426-3591, extension 274, or Jenenne Tambke, Audit Manager, at (573) 893-8338, extension 21, or e-mail her at Jenenne.Tambke@oig.hhs.gov. Please refer to report number A-07-04-00166 in all correspondence.

Sincerely yours,

Patrick J. Cogley
Regional Inspector General
for Audit Services

Enclosures

Direct Reply to HHS Action Official:

Nancy B. O'Connor
Acting Regional Administrator, Region III
Centers for Medicare & Medicaid Services
Public Ledger Building, Suite 216
150 South Independence Mall West
Philadelphia, Pennsylvania 19106

Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

REVIEW OF POSTRETIREMENT BENEFIT COSTS CLAIMED BY HIGHMARK, INC.

Daniel R. Levinson
Inspector General

AUGUST 2005
A-07-04-00166

Office of Inspector General

http://oig.hhs.gov

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OAS FINDINGS AND OPINIONS

The designation of financial or management practices as questionable or a recommendation for the disallowance of costs incurred or claimed as well as other conclusions and recommendations in this report represent the findings and opinions of the HHS/OIG/OAS. Authorized officials of the awarding agency will make final determination on these matters.

EXECUTIVE SUMMARY

BACKGROUND

Highmark, Inc. (Highmark) administers Medicare Part A and B operations under cost reimbursement contracts with the Centers for Medicare & Medicaid Services (CMS). Highmark was formed with the merger of Veritus, Inc. (Veritus) and Pennsylvania Blue Shield (PBS).

Highmark accounted for and claimed Post Retirement Benefit (PRB) costs using accrual accounting, and it established a Voluntary Employee Benefit Association (VEBA) trust for the purpose of funding the accrued costs pursuant to Federal regulations.

CMS reimburses a portion of its contractors' PRB costs. In claiming PRB costs, contractors must follow cost reimbursement principles contained in the Federal Acquisition Regulations (FAR) and applicable Cost Accounting Standards (CAS) as required by their Medicare contracts. Furthermore, the Medicare contract and the Budget Performance Requirements require that any change in accounting practice for PRB costs be submitted to CMS in advance for approval.

OBJECTIVE

Our objective was to determine the allowability of the PRB costs Highmark claimed for Medicare reimbursement on an accrual basis for fiscal years (FY) 1998 through 2002.

SUMMARY OF FINDING

The PRB costs Highmark claimed on an accrual basis for FYs 1998 through 2002 were allowable. However, Highmark did not include in its Final Administrative Cost Proposals (FACPs) all of the PRB costs that were allowable pursuant to Federal regulations. As a result, for FYs 1998 through 2002, Highmark did not claim $2,961,526 of PRB costs that was allowable for Medicare reimbursement.

RECOMMENDATION

Highmark should revise its FACPs for FYs 1998 through 2002 or submit a claim for additional allowable PRB costs of $2,961,526.

OTHER MATTERS

Highmark based its claim for PRB costs on the amount accrued and funded for the cost accounting period with the tax-deductible contribution to its VEBA. Highmark did not calculate the PRB cost to be assigned to the cost accounting period pursuant to the accrual accounting guidelines in FAR 31.205-6(o)(2)(iii). It did not account for the unfunded portion of the PRB cost assigned to the cost accounting period. Highmark accumulated unfunded PRB costs, plus interest, of $65,966,646 as of January 1, 2002.

AUDITEE'S COMMENTS

Highmark's comments are summarized in the following paragraphs and presented in their entirety as Appendix E.

Highmark did not agree with our calculations of allowable PRB pension costs. Highmark stated that we did not use supporting information it sent to us on May 26, 2005, in response to a previous audit. As a result, Highmark stated that we:

- overstated the Medicare segment headcount percentage, which inflated the allowable PRB costs;

- omitted Medicare Allowable PRB Costs from the calculation of the "other segment" PRB costs, which understated allowable PRB costs; and

- utilized the incorrect Medicare A and Medicare B line-of-business (LOB) percentages, which inflated allowable PRB costs.

Highmark also stated that it did not need to seek CMS approval for its change in accounting practice for PRB costs, because it was a continuation of the prior PBS program. Additionally, Highmark disagreed with our statement in the Other Matters section that Highmark should be precluded from including unfunded PRB costs in any future claims to the Federal Government. Highmark believed that "by requiring contractors to use [S]FAS 106 in calculating PRB costs, the FAR irreconcilably conflicts with the [Internal Revenue Service] limitations on VEBA funding."

OFFICE OF INSPECTOR GENERAL'S RESPONSE

We disagree with Highmark's assertions that our calculations of the allowable PRB pension costs were incorrect.

The CAS requires that the allocation of PRB costs to cost objectives be based on the beneficial or causal relationship between the PRB costs and the corresponding cost objectives. Retiree medical insurance benefits, i.e. postretirement benefits, are not determined by salary, but by incurrence of a claim for a covered cost or service by a retiree or beneficiary. The expected cost does not vary upon the salary history of the retiree. The cost for retirees will only vary by the benefit structure and number of dependents. Thus, our position has not changed, and we maintain that the most appropriate methodology for allocating PRB costs to the segments is based upon the headcount of plan participants from each segment.

Our identification of the Medicare segment was in accordance with the Medicare contract. As addressed in the pension segmentation report (A-07-04-03050), we reviewed our identification of the participants and cost centers comprising the Medicare segment with representatives of Highmark and obtained their concurrence. In addition, Highmark did not provide any headcount information in the documentation sent to us on May 26, 2005.

We did not exclude the allowable other segment costs from the allowable PRB costs. The other segment pension costs are calculated and included the Medicare Segment A and Medicare Segment B Allowable PRB Costs. We added an additional sentence to the footnote in Appendix A to explain the calculation of the other segment costs.

Highmark sent us the Medicare Segment A and Medicare Segment B LOB percentages; however, it did not provide us with additional documentation to support the use of these percentages. Therefore, we used the LOB percentages for Medicare Segment A and Medicare Segment B based upon the agreed upon Medicare segment cost centers as determined during our audit.

We recognize the Highmark PRB plan is a continuation of the PBS PRB plan and that PBS sought approval for its change in accounting practice for PRB costs; however, CMS had not granted approval for the PBS PRB plan.

Additionally, we are aware that Highmark and CMS are engaged in discussions concerning the unfunded PRB costs addressed in the Other Matters section. However, Highmark did not calculate the PRB costs to be assigned to the cost accounting period pursuant to the accrual accounting guidelines in FAR 31.205-6(o)(2)(iii).

Therefore, we recommend that Highmark revise its FACPs for FYs 1998 through 2002 or submit a claim for additional allowable PRB costs of $2,961,526. After addressing the issues raised under Other Matters, Highmark should seek approval for its change in accounting practice.

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Glossary of Abbreviations and Acronyms

CAS	Cost Accounting Standards
CMS	Centers for Medicare & Medicaid Services
FACP	Final Administrative Cost Proposal
FAR	Federal Acquisition Regulations
FY	fiscal year
HHS	U.S. Department of Health and Human Services
Highmark	Highmark, Inc.
LOB	Line of Business
OIG	Office of the Inspector General
PBS	Pennsylvania Blue Shield
PRB	Post Retirement Benefit
SFAS	Statement of the Financial Accounting Standards Board
VEBA	Voluntary Employee Benefit Association
Veritus	Veritus, Inc. of Pennsylvania

INTRODUCTION

BACKGROUND

Medicare

Highmark, Inc. (Highmark) administered Medicare Part A and B operations under cost reimbursement contracts with the Centers for Medicare & Medicaid Services (CMS). CMS reimburses a portion of its contractors' Post Retirement Benefit (PRB) costs. In claiming PRB costs, contractors must follow cost reimbursement principles contained in the Federal Acquisition Regulations (FAR) and applicable Cost Accounting Standards (CAS) as required by their Medicare contracts.

Highmark accounted for and claimed PRB costs using accrual accounting, and it established a Voluntary Employee Benefit Association (VEBA) trust for the purpose of funding the accrued costs pursuant to Federal regulations.

Regulations

The FAR sets forth the allowability requirements and applicable methods of accounting for PRB costs under a government contract. PRB costs can include, but are not limited to postretirement health care, life insurance provided outside a pension plan, and other welfare benefits, such as tuition assistance, day care, legal services, and housing subsidies provided after retirement. PRBs do not cover retirement income and ancillary benefits, such as life insurance, paid by pension plans during the period following the employees' retirement.

The FAR 31 requires contractors to choose one of three accounting practices (pay-as-you go, accrual, or terminal) for measuring and assigning PRB costs to accounting periods. However, the Medicare contract and the Budget Performance Requirements require that any change in accounting practice for such pension and/or PRB costs must be submitted to CMS in advance for approval.

The FAR further states that to be allowable, costs must be funded by the time set for filing the Federal income tax return or any extension thereof. Furthermore, costs of retiree insurance must comply with the standards promulgated by the CAS Board. The CAS requires that the allocation of PRB costs to cost objectives be based on the beneficial or causal relationship between the PRB costs and the corresponding cost objectives.

In 1990, the issuance of the Statement of Financial Accounting Standards (SFAS) 106 required contractors to report in their financial statements the accrued liability for PRBs for current and retired employees, and set forth specific guidance on the accrual methodology to be used. However, the FAR allows contractors the option of electing accrual accounting following SFAS 106 methodology for funded PRBs or of continuing to recognize PRB costs on a cash basis for government contract purposes if that had been their practice.

OBJECTIVE, SCOPE, AND METHODOLOGY

Objective

Our objective was to determine the allowability of the PRB costs Highmark claimed for Medicare reimbursement on an accrual accounting basis for fiscal years (FY) 1998 through 2002.

Scope

We reviewed PRB costs claimed for Medicare reimbursement on Highmark's Final Administrative Cost Proposals (FACP) for FYs 1998 through 2002. Achieving the objective did not require that we review Highmark's overall internal control structure. However, we did review the controls relating to the PRB costs claimed for Medicare reimbursement to ensure that costs were allowable pursuant to the FAR.

We conducted fieldwork at Highmark's corporate office in Camp Hill, PA.

Methodology

We identified Highmark's PRB costs for the total company and the portion allocable to the Medicare segment. We also determined the extent to which Highmark funded the PRB costs with contributions to the VEBA trust fund or with direct payment of benefits. In performing our review, we used information provided by Highmark's actuarial consulting firm. Because Highmark had not followed SFAS 106 to develop PRB costs as required by the FAR, the CMS Office of the Actuary developed PRB costs for Highmark based on SFAS 106 methodology pursuant to the FAR. Using this information, we calculated the PRB costs that were allowable for Medicare reimbursement for FYs 1998 through 2002. Appendix A contains the details of the PRB costs and contributions.

We performed this review in conjunction with our audits of pension segmentation (A-07-04-03050), pension costs claimed for reimbursement (A-07-04-00163), and unfunded pension costs (A-07-04-00177). We used the information obtained and reviewed during those audits in performing this review.

Our audit was performed in accordance with generally accepted government auditing standards.

FINDING AND RECOMMENDATION

The PRB costs Highmark claimed on an accrual basis for FYs 1998 through 2002 were allowable. However, Highmark did not include in its FACPs all of the PRB costs that were allowable pursuant to Federal regulations. As a result, for FYs 1998 through 2002, Highmark did not claim $2,961,526 of PRB costs that was allowable for Medicare reimbursement.

FAR & CAS

The FAR states that to be allowable, costs must be funded by the time set for filing the Federal income tax return or any extension thereof, and must comply with the applicable standards promulgated by the CAS Board. Additionally, the CAS requires that the allocation of PRB costs to cost objectives be based on the beneficial or causal relationship between the PRB costs and corresponding cost objectives.

MEDICARE CONTRACT & BUDGET AND PERFORMANCE REQUIREMENTS

Since 1993, the Budget and Performance Requirements instructions sent to Medicare contractors by CMS have included a reminder of the special provisions regarding costs of PRB plans. The Budget Performance Requirements specified that any change in accounting practice for PRB costs must be submitted to CMS in advance for approval.

ALLOWABLE PRB COSTS

For FYs 1998 through 2002, Highmark did not claim all of the PRB costs that were allowable for Medicare reimbursement. Highmark failed to claim some of the accrued PRB costs that had been funded through deposits to the VEBA trust. Our calculation showed that Highmark underclaimed PRB costs by $2,961,526. The following schedule provides a comparison of allowable PRB costs as calculated by Highmark and the Office of Inspector General (OIG). Details underlying this schedule may be found in the appendixes to this report.

Highmark Part A PRB Costs Claimed Variance			
FY	**Per OIG**	**Per Highmark**	**Difference**
1998	$159,759	$174,495	($14,736)
1999	206,650	272,081	(65,431)
2000	247,887	289,682	(41,795)
2001	299,507	315,338	(15,831)
2002	333,484	332,814	670
Total	**$1,247,287**	**$1,384,410**	**($137,123)**

Highmark Part B PRB Costs Claimed Variance			
FY	**Per OIG**	**Per Highmark**	**Difference**
1998	$1,182,980	$917,993	$264,987
1999	1,331,405	790,023	541,382
2000	1,291,925	615,670	676,255
2001	1,368,407	610,597	757,810
2002	1,414,562	556,347	858,215
Total	**$6,589,279**	**$3,490,630**	**$3,098,649**

RECOMMENDATION

Highmark should revise its FACPs for FYs 1998 through 2002 or submit a claim for additional allowable PRB costs of $2,961,526.

OTHER MATTERS

Highmark based its claim for PRB costs on the amount accrued and funded for the cost accounting period with the tax-deductible contribution to its VEBA. Highmark did not calculate the PRB cost to be assigned to the cost accounting period pursuant to the accrual accounting guidelines in FAR 31.205-6(o)(2)(iii). It did not account for the unfunded portion of the PRB cost assigned to the cost accounting period.

We compared the PRB costs calculated by the CMS Office of the Actuary to actual contributions. We found that Highmark accumulated unfunded PRB costs, plus interest, of $65,966,646 as of January 1, 2002. The following table shows the unfunded amounts and interest, which are unallowable on a cumulative basis. (Details of amounts that were not funded and the accumulation of such unfunded costs may be found in the appendixes to this report.) Highmark should track this amount and ensure that the unfunded PRB costs are not included in any future claims.

Unfunded PRB Costs and Interest

Plan Year	Unfunded PRB Costs	Interest to 12/31/2002	Total as of to 12/31/2002
Pre-1998	$27,851,121	$10,307,329	$38,158,450
1998	10,005,320	3,702,835	13,708,155
1999	10,960,287	3,139,754	14,100,041
2000	0	0	0
2001	0	0	0
2002	0	0	0
Total	**$48,816,728**	**$17,149,918**	**$65,966,646**

AUDITEE'S COMMENTS

Highmark's comments are summarized in the following paragraphs and presented in their entirety as Appendix E.

Highmark did not agree with our calculations of allowable PRB pension costs. It stated that: "The cost allocation method used by Highmark differed from the one used by the auditors in preparing this report." Highmark stated that we did not use supporting information it sent to us on May 26, 2005, in response to a previous audit. As a result, Highmark stated that we:

- overstated the Medicare segment headcount percentage, which inflated the allowable PRB costs;
- omitted Medicare Allowable PRB Costs from the calculation of the "other segment" PRB costs, which understated allowable PRB costs; and
- utilized the incorrect Medicare A and Medicare B line-of-business (LOB) percentages, which inflated allowable PRB costs.

Highmark also stated that it did not need to seek CMS approval for its change in accounting practice for PRB costs, because it was a continuation of the prior PBS program. Highmark stated that it notified CMS of PBS's change in accounting methodology for PRB costs in 1994. It stated that it also notified CMS, in its FY 1998 Budget Request filed in 1997, that it was changing the cost allocation processes in 1998. It further stated that it discussed the changes with CMS Regional Office staff.

Additionally, Highmark disagreed with our statement in the Other Matters section that Highmark should be precluded from including unfunded PRB costs in any future claims to the Federal Government. Highmark believed that "by requiring contractors to use [S]FAS 106 in calculating PRB costs, the FAR irreconcilably conflicts with the [Internal Revenue Service] limitations on VEBA funding." It stated that the FAR provision is inconsistent with the principal of full reimbursement for a contractor's reasonable, allowable, and allocable costs, and that it was discussing these issues with CMS.

OFFICE OF INSPECTOR GENERAL'S RESPONSE

We disagree with Highmark's assertions that our calculations of the allowable PRB pension costs were incorrect.

The CAS requires that the allocation of PRB costs to cost objectives be based on the beneficial or causal relationship between the PRB costs and the corresponding cost objectives. Retiree medical insurance benefits, i.e. postretirement benefits, are not determined by salary, but by incurrence of a claim for a covered cost or service by a retiree or beneficiary. The expected cost does not vary upon the salary history of the retiree. The cost for retirees will only vary by the benefit structure and number of dependents. Thus, our position has not changed, and we maintain that the most appropriate methodology for allocating PRB costs to the segments is based upon the headcount of plan participants from each segment.

Our identification of the Medicare segment was in accordance with the Medicare contract. As addressed in the pension segmentation report (A-07-04-03050), we reviewed our identification of the participants and cost centers comprising the Medicare segment with representatives of Highmark and obtained their concurrence. In addition, Highmark did not provide any headcount information in the documentation sent to us on May 26, 2005.

We did not exclude the allowable other segment costs from the allowable PRB costs. The other segment pension costs are calculated and included the Medicare Segment A and Medicare Segment B Allowable PRB Costs. We added an additional sentence to the footnote in Appendix A to explain the calculation of the other segment costs.

Highmark sent us the Medicare Segment A and Medicare Segment B LOB percentages; however, it did not provide us with additional documentation to support the use of these percentages. Therefore, we used the LOB percentages for Medicare Segment A and Medicare Segment B based upon the agreed upon Medicare segment cost centers as determined during our audit.

We recognize the Highmark PRB plan is a continuation of the PBS PRB plan and that PBS sought approval for its change in accounting practice for PRB costs; however, CMS had not granted approval for the PBS PRB plan.

Additionally, we are aware that Highmark and CMS are engaged in discussions concerning the unfunded PRB costs addressed in the Other Matters section. However, Highmark did not calculate the PRB costs to be assigned to the cost accounting period pursuant to the accrual accounting guidelines in FAR 31.205-6(o)(2)(iii).

Therefore, we recommend that Highmark revise its FACPs for FYs 1998 through 2002 or submit a claim for additional allowable PRB costs of $2,961,526. After addressing the issues raised under Other Matters, Highmark should seek approval for its change in accounting practice.

APPENDIXES

HIGHMARK, INC
STATEMENT OF ALLOWABLE PRB COSTS
FOR FISCAL YEARS 1998 THROUGH 2002
REPORT NUMBER A-07-04-00166

Date	Description		Total Company	Other Segment	Medicare Segment A	Medicare Segment B
1998	Total Contributions to Trust Fund	1/	$8,757,316			
6.50%	Discount for Interest	2/	(370,122)			
1/1/1998	Present Value of Trust Fund Contributions	3/	8,387,194			
1998	Total Direct Benefit Payments	4/	40,535			
6.50%	Discount for Interest	5/	(1,276)			
1/1/1998	Present Value of Direct Benefit Payments	6/	39,259			
1/1/1998	Prepayment Credit Applied	7/	0			
1/1/1998	PV of Direct Benefit Payments Applied	8/	39,259			
1/1/1998	PV of Trust Fund Contributions Applied	9/	8,387,194			
1/1/1998	Funded Net Postretirement Benefit Cost	10/	8,426,453			
1998	Allowable Interest on Direct Benefit Payments	11/	1,276			
1998	Allowable Interest on Contributions	12/	370,122			
1998	**Total Allowable & Allocable PRB Cost**	13/	**8,797,851**			
1998	Headcount Percentages	14/	100.00%	86.32%	1.50%	12.18%
1998	Allocable PRB Costs	15/	8,797,851	$7,594,305	$131,968	$1,071,578
1998	Fiscal Year PRB Costs 20/	16/		7,362,365	130,090	848,644
1998	Medicare Part A LOB Percentage	17/		0.48%	97.00%	0.00%
1998	Medicare Part B LOB Percentage	18/		2.75%	0.00%	99.60%
1998	**Medicare Allowable PRB Costs**	19/	**$1,342,739**		**$159,759**	**$1,182,980**

Date	Description	Total Company	Other Segment	Medicare Segment A	Medicare Segment B
1999	Total Contributions to Trust Fund	$9,827,136			
6.50%	Discount for Interest	(412,105)			
1/1/1999	Present Value of Trust Fund Contributions	9,415,031			
1999	Total Direct Benefit Payments	146,070			
6.50%	Discount for Interest	(4,598)			
1/1/1999	Present Value of Direct Benefit Payments	141,472			
1/1/1999	Prepayment Credit Applied	0			
1/1/1999	PV of Direct Benefit Payments Applied	141,472			
1/1/1999	PV of Trust Fund Contributions Applied	9,415,031			
1/1/1999	Funded Net Postretirement Benefit Cost	9,556,503			
1999	Allowable Interest on Direct Benefit Payments	4,598			
1999	Allowable Interest on Contributions	412,105			
1999	**Total Allowable & Allocable PRB Cost**	**9,973,206**			
1999	Headcount Percentages	100.00%	85.85%	1.81%	12.34%
1999	Allocable PRB Costs	9,973,206	$8,561,997	$180,515	$1,230,694
1999	Fiscal Year PRB Costs		8,320,074	168,378	1,190,915
1999	Medicare Part A LOB Percentage		0.46%	100.00%	0.00%
1999	Medicare Part B LOB Percentage		1.69%	0.00%	99.99%
1999	**Medicare Allowable PRB Costs**	**$1,538,055**		**$206,650**	**$1,331,405**

HIGHMARK, INC
STATEMENT OF ALLOWABLE PRB COSTS
FOR FISCAL YEARS 1998 THROUGH 2002
REPORT NUMBER A-07-04-00166

Date	Description	Total Company	Other Segment	Medicare Segment A	Medicare Segment B
2000	Total Contributions to Trust Fund	$10,798,948			
6.50%	Discount for Interest	(451,220)			
1/1/2000	Present Value of Trust Fund Contributions	10,347,728			
2000	Total Direct Benefit Payments	81,814			
6.50%	Discount for Interest	(2,575)			
1/1/2000	Present Value of Direct Benefit Payments	79,239			
1/1/2000	Prepayment Credit Applied	0			
1/1/2000	PV of Direct Benefit Payments Applied	79,239			
1/1/2000	PV of Trust Fund Contributions Applied	9,877,669			
1/1/2000	Funded Net Postretirement Benefit Cost	9,956,908			
2000	Allowable Interest on Direct Benefit Payments	2,575			
2000	Allowable Interest on Contributions	430,723			
2000	**Total Allowable & Allocable PRB Cost**	**10,390,206**			
2000	Headcount Percentages	100.00%	86.63%	2.02%	11.35%
2000	Allocable PRB Costs	10,390,206	$9,001,036	$209,882	$1,179,288
2000	Fiscal Year PRB Costs		8,891,276	202,541	1,192,139
2000	Medicare Part A LOB Percentage		0.51%	100.00%	0.00%
2000	Medicare Part B LOB Percentage		1.31%	0.00%	98.60%
2000	**Medicare Allowable PRB Costs**	**$1,539,812**		**$247,887**	**$1,291,925**

Date	Description	Total Company	Other Segment	Medicare Segment A	Medicare Segment B
2001	Total Contributions to Trust Fund	$12,053,016			
6.50%	Discount for Interest	(514,746)			
1/1/2001	Present Value of Trust Fund Contributions	11,538,270			
2001	Total Direct Benefit Payments	81,460			
6.50%	Discount for Interest	(2,564)			
1/1/2001	Present Value of Direct Benefit Payments	78,896			
1/1/2001	Prepayment Credit Applied	500,613			
1/1/2001	PV of Direct Benefit Payments Applied	78,896			
1/1/2001	PV of Trust Fund Contributions Applied	11,029,981			
1/1/2001	Funded Net Postretirement Benefit Cost	11,609,490			
2001	Allowable Interest on Direct Benefit Payments	2,564			
2001	Allowable Interest on Contributions	492,070			
2001	**Total Allowable & Allocable PRB Cost**	**12,104,124**			
2001	Headcount Percentages	100.00%	87.22%	2.15%	10.63%
2001	Allocable PRB Costs	12,104,124	$10,557,217	$260,239	$1,286,668
2001	Fiscal Year PRB Costs		10,168,172	247,649	1,259,823
2001	Medicare Part A LOB Percentage		0.51%	100.00%	0.00%
2001	Medicare Part B LOB Percentage		1.11%	0.00%	99.66%
2001	**Medicare Allowable PRB Costs**	**$1,667,914**		**$299,507**	**$1,368,407**

Date	Description	Total Company	Other Segment	Medicare Segment A	Medicare Segment B
2002	Total Contributions to Trust Fund	$13,478,164			
0.00%	Discount for Interest	(567,380)			
1/1/2002	Present Value of Trust Fund Contributions	12,910,784			
2002	Total Direct Benefit Payments	90,236			
0.00%	Discount for Interest	(2,840)			
1/1/2002	Present Value of Direct Benefit Payments	87,396			
1/1/2002	Prepayment Credit Applied	541,328			
1/1/2002	PV of Direct Benefit Payments Applied	87,396			
1/1/2002	PV of Trust Fund Contributions Applied	12,192,549			
1/1/2002	Funded Net Postretirement Benefit Cost	12,821,273			
2002	Allowable Interest on Direct Benefit Payments	2,840			
2002	Allowable Interest on Contributions	535,816			
2002	**Total Allowable & Allocable PRB Cost**	**13,359,929**			
2002	Headcount Percentages	100.00%	87.72%	2.12%	10.16%
2002	Allocable PRB Costs	13,359,929	$11,719,330	$283,230	$1,357,369
2002	Fiscal Year PRB Costs		11,428,802	277,483	1,339,694
2002	Medicare Part A LOB Percentage		0.49%	100.00%	0.00%
2002	Medicare Part B LOB Percentage		0.92%	0.00%	97.74%
2002	**Medicare Allowable PRB Costs**	**$1,748,046**		**$333,484**	**$1,414,562**

FOOTNOTES

1/ Total contributions to the trust fund are the net deposits made to the Voluntary Employee Benefit Association (VEBA) trust fund. Such contributions can be used to satisfy the funding requirements of Federal Acquisition Regulations (FAR) 31.205-6(o)(2)(iii) and Cost Accounting Standards (CAS) 416-50(a)(1)(v)(A).

2/ Interest is determined using the Statement of Financial Accounting Standards (SFAS) 106 expected long-term rate of return.

3/ The present value of trust fund contributions is the value of the contributions discounted from the date of deposit into the VEBA back to the first day of the plan year.

4/ Direct benefit payments are amounts paid directly to or on behalf of plan beneficiaries. Direct benefit payments must be considered towards the funding of the Post Retirement Benefit (PRB) cost assigned to the period before considering the amount funded by contributions to the trust fund in accordance with CAS 416-50(a)(1)(iv)(C). In effect, the benefit payments that reduce the recognized accumulated postretirement benefit obligation are deemed liquidated on a cash accounting basis pursuant to FAR 31.205-6(o)(2)(i).

5/ Interest is determined using the SFAS 106 expected long-term rate of return.

6/ Direct benefit payments are discounted to the first day of the plan year at the expected long-term rate of return assuming the benefit payments are made evenly throughout the year, that is, on average all payments are assumed to occur in the middle of the year.

7/ Any accumulated value of prepayment credits are applied towards funding the accrued current net postretirement benefit cost, as developed in Appendix D, immediately. The accumulated value of prepayments credits is available as of the first day of the plan year to the cost assigned to the period and FAR 31.205-6(o)(4) states that any increased cost interest due to delayed funded is unallowable. The accumulated value of prepayment credits is developed in Appendix C.

FOOTNOTES (continued)

8/ Present value of direct benefit payments are applied towards current period funding up to the amount of the accrued current net postretirement benefit cost assigned to the period reduced for any prepayment credits that have been applied. Such direct payments are considered as funding of the cost assigned to the period before considering the amount funded by contributions (fund deposits) in accordance with CAS 416-50(a)(1)(iv)(C).

9/ Present value of trust fund contributions are applied towards current period funding up to the amount of the accrued current net postretirement benefit cost reduced for any prepayment credits and present value of direct benefit payments that have been applied. Such contributions can be used to satisfy the funding requirements of FAR 31.205-6(o)(2)(iii) and CAS 416-50(a)(1)(v)(A).

10/ The allowable and allocable PRB cost is the sum of the prepayment credits, present value of direct benefit payments, and present value of trust fund contributions that have been applied. This is the value of the allowable and allocable PRB cost for the period as of the first day of the plan year before considering any allowable interest on the direct benefit payments and trust fund contributions. The allowable and allocable PRB cost can not exceed the accrued net postretirement benefit cost for the period

11/ Direct benefit payments are deemed to be paid as the costs are incurred by and behalf of plan beneficiaries, and therefore, no adjustment for delayed funding is necessary. The allowable interest on direct benefit payments is the amount of the discount for interest prorated by the present value of direct benefit payments applied to the present value of direct benefit payments.

12/ The allowable interest on trust fund contributions is the lesser of the actual interest incurred or the maximum allowable interest. The actual interest incurred for trust fund contributions applied is the amount of the discount for interest prorated by the present value of trust fund contributions applied to the present value of total trust fund contributions. FAR 31.205-6(o)(4) disallows interest caused by not funding within 30 days of the end of each quarter. Therefore, the maximum allowable interest is the amount of interest that would be incurred if the total contribution were made in four (4) installments at 4 months, 7 months, 10 months, and 13 months after the first day of the plan year.

13/ The total allowable and allocable PRB cost is the allowable and allocable PRB cost as of the first day of the plan year plus allowable interest on direct benefit payments and trust fund contributions. This is the amount of postretirement benefit costs that may be allocated to final cost objectives, such as Medicare contracts, as an allowable cost.

14/ The headcount percentages used to allocate the total allowable PRB costs are developed from the active and retired plan participant data obtained as part of our audit of pension segmentation (A-07-04-03050).

15/ Total allocable PRB costs are allocated to the Medicare and other segments based on the headcount percentage of these intermediate cost objectives.

16/ We converted the allocable PRB costs determined on a plan year basis to a Federal fiscal year (FY) basis (October 1 through September 30). We calculated the fiscal year PRB costs as 1/4 of the prior plan year's costs plus 3/4 of the current plan year's costs. Costs charged to the Medicare contract should consist of the Medicare segment's direct PRB costs plus PRB costs attributable to indirect Medicare operations. The allocable PRB cost for calendar year 1997, which is used to determine the allocable cost for fiscal year 1998, was obtained from audit reports A-07-05-00185 and A-07-05-00186.

17/ The Medicare Part A line-of-business (LOB) percentage is the portion of each segment's allowable PRB costs that can be allocated to the Medicare Part A contract as a final cost objective. We obtained the percentages from documents provided by

18/ The Medicare Part B LOB percentage is the portion of each segment's allowable PRB costs that can be allocated to the Medicare Part B contract as a final cost objective. We obtained the percentages from documents provided by the contractor.

FOOTNOTES (continued)

19/ We calculated allowable PRB costs to each of the Medicare contracts based on the applicable Medicare LOB percentage for each segment. The allowable portion of the "other segment" PRB costs are included with the allowable PRB costs for both Medicare Segment A and Medicare Segment B.

20/ PRB costs for FY 1995 only cover the period from 01/01 to 09/30/1995. The amounts shown as claimed by Veritus in the audit report also only cover the period from 01/01 to 09/30/1995. PRB costs claimed on a pay-as-you-go basis for the first quarter of FY 1995 (10/01/1994 - 12/31/1995) are outside the scope of this audit.

HIGHMARK, INC
STATEMENT OF ACCUMULATED VALUES OF UNFUNDED ACCRUALS
FOR PLAN YEARS 1998 THROUGH 2002
REPORT NUMBER: A-07-04-00166

Date	Description		Total Company
1/1/1998	Prior Accumulated Value of Unfunded Accruals	1/	$27,851,121
1/1/1998	Value of Current Year Underfunding	2/	10,005,320
1/1/1998	Accumulated Value of Unfunded Accruals		37,856,441
1998	Expected Long-Term Rate of Return	3/	6.50%
	Interest to End of Year at Expected Rate		2,460,669
12/31/1998	**Accumulated Value of Unfunded Accruals**	4/	**$40,317,110**

Date	Description	Total Company
1/1/1999	Prior Accumulated Value of Unfunded Accruals	$40,317,110
1/1/1999	Value of Current Year Underfunding	10,960,287
1/1/1999	Accumulated Value of Unfunded Accruals	51,277,397
1999	Expected Long-Term Rate of Return	6.50%
	Interest to End of Year at Expected Rate	3,333,031
12/31/1999	**Accumulated Value of Unfunded Accruals**	**$54,610,428**

Date	Description	Total Company
1/1/2000	Prior Accumulated Value of Unfunded Accruals	$54,610,428
1/1/2000	Value of Current Year Underfunding	0
1/1/2000	Accumulated Value of Unfunded Accruals	54,610,428
2000	Expected Long-Term Rate of Return	6.50%
	Interest to End of Year at Expected Rate	3,549,678
12/31/2000	**Accumulated Value of Unfunded Accruals**	**$58,160,106**

Date	Description	Total Company
1/1/2001	Prior Accumulated Value of Unfunded Accruals	$58,160,106
1/1/2001	Value of Current Year Underfunding	0
1/1/2001	Accumulated Value of Unfunded Accruals	58,160,106
2001	Expected Long-Term Rate of Return	6.50%
	Interest to End of Year at Expected Rate	3,780,407
12/31/2001	**Accumulated Value of Unfunded Accruals**	**$61,940,513**

Date	Description	Total Company
1/1/2002	Prior Accumulated Value of Unfunded Accruals	$61,940,513
1/1/2002	Value of Current Year Underfunding	0
1/1/2002	Accumulated Value of Unfunded Accruals	61,940,513
2002	Expected Long-Term Rate of Return	6.50%
	Interest to End of Year at Expected Rate	4,026,133
12/31/2002	**Accumulated Value of Unfunded Accruals**	**$65,966,646**

FOOTNOTES

1/ The prior accumulated value of unfunded accruals as of the first day of the current year is the accumulated value of unfunded accruals as of the last day of the prior year. For 1998, the prior accumulated value of unfunded accruals is the sum of accumulated values of unfunded accruals for the predecessor plans sponsored by PBS ($11,426,121) and Veritus ($16,425,000). See audit reports A-07-05-00185 (PBS) and A-07-05-00186 (Veritus).

2/ See Appendix D.

3/ Source: SFAS 106 Valuation reports.

4/ Accumulated value of unfunded accruals is adjusted for interest at the expected long-term rate of return to the end of the plan year. Unfunded accruals, which are unallowable in future periods in accordance with FAR 31.205-6(o)(3), are adjusted for interest to eliminate the unallowable increased cost due to delayed funding as required by FAR 31.205-6(o)(4).

HIGHMARK, INC
STATEMENT OF ACCUMULATED VALUES OF PREPAYMENT CREDITS
FOR PLAN YEARS 1998 THROUGH 2002
REPORT NUMBER: A-07-04-00166

Date	Description			Total Company
1/1/1998	Prior Accumulated Value of Prepayment Credits	1/	$	-
1/1/1998	Prepayment Applied to Current PRB Cost	2/		-
1/1/1998	Current Year Prepayment Credit	3/		-
1/1/1998	Accumulated Value of Prepayment Credits		$	-
1998	Expected Long-Term Rate of Return	4/		6.50%
	Interest to End of Year at Expected Rate			-
12/31/1998	**Accumulated Value of Prepayment Credits**	5/	**$**	**-**

Date	Description			Total Company
1/1/1999	Prior Accumulated Value of Prepayment Credits	5/	$	-
1/1/1999	Prepayment Applied to Current PRB Cost			-
1/1/1999	Current Year Prepayment Credit			-
1/1/1999	Accumulated Value of Prepayment Credits		$	-
1999	Expected Long-Term Rate of Return	6/		6.50%
	Interest to End of Year at Expected Rate			-
12/31/1999	**Accumulated Value of Prepayment Credits**		**$**	**-**

Date	Description		Total Company
1/1/2000	Prior Accumulated Value of Prepayment Credits	$	-
1/1/2000	Prepayment Applied to Current PRB Cost		-
1/1/2000	Current Year Prepayment Credit		(470,059)
1/1/2000	Accumulated Value of Prepayment Credits	$	(470,059)
2000	Expected Long-Term Rate of Return		6.50%
	Interest to End of Year at Expected Rate		(30,554)
12/31/2000	**Accumulated Value of Prepayment Credits**	**$**	**(500,613)**

HIGHMARK, INC
STATEMENT OF ACCUMULATED VALUES OF PREPAYMENT CREDITS
FOR PLAN YEARS 1998 THROUGH 2002
REPORT NUMBER: A-07-04-00166

Date	Description		Total Company
1/1/2001	Prior Accumulated Value of Prepayment Credits	$	(500,613)
1/1/2001	Prepayment Applied to Current PRB Cost		500,613
1/1/2001	Current Year Prepayment Credit		(508,289)
1/1/2001	Accumulated Value of Prepayment Credits	$	(508,289)
2001	Expected Long-Term Rate of Return		6.50%
	Interest to End of Year at Expected Rate		(33,039)
12/31/2001	**Accumulated Value of Prepayment Credits**	**$**	**(541,328)**

Date	Description		Total Company
1/1/2002	Prior Accumulated Value of Prepayment Credits	$	(541,328)
1/1/2002	Prepayment Applied to Current PRB Cost		541,328
1/1/2002	Current Year Prepayment Credit		(718,235)
1/1/2002	Accumulated Value of Prepayment Credits	$	(718,235)
2002	Expected Long-Term Rate of Return		6.50%
	Interest to End of Year at Expected Rate		(46,685)
12/31/2002	**Accumulated Value of Prepayment Credits**	**$**	**(764,920)**

FOOTNOTES

1/ The prior accumulated value of prepayment credits as of the first day of the current year is the accumulated value of prepayment credits as of the last day of the prior year. For 1998, the prior accumulated value of prepayments credits is the sum of accumulated values of prepayments credits for the predecessor plans sponsored by PBS ($-0-) and Veritus ($-0-). See audit reports A-07-05-00185 (PBS) and A-07-05-00186 (Veritus).

2/ See Appendix D.

3/ See Appendix D.

4/ Source: SFAS 106 Valuation reports.

5/ Accumulated value of prepayment credits is adjusted for interest at the expected long-term rate of return to the end of the plan year. Prepayment credits may be accumulated and carried forward, with interest, to fund future PRB costs in future periods. Prepayments are shown with a negative sign.

HIGHMARK, INC
STATEMENT OF PRB COST FUNDING
FOR PLAN YEARS 1998 THROUGH 2002
REPORT NUMBER: A-07-04-00166

Date	Description		Total Company
12/31/1998	Service Cost	1/	$8,683,731
12/31/1998	Interest Cost	2/	8,641,828
	Net Return on Adjusted Assets Value		
1998	Expected Return on Plan Assets	3/	(997,617)
1998	Expected Return on Prior Unfunded Accruals	4/	(1,810,323)
1998	Expected Return on Prepayment Credits	5/	0
	Amortization of Unrecognized Balances		
1998	Amortization of Initial Transition Obligation	6/	3,621,039
1998	Amortization of Past Service Cost	7/	1,491,180
1998	Amortization of (Gains) or Losses	8/	0
12/31/1998	**Accrued Current Net Postretirement Benefit Cost**	9/	**19,629,838**
1998	Expected Long-Term Rate of Return	10/	6.50%
	Interest Adjustment to the Beginning of the Year		(1,198,065)
01/01/1998	**Accrued Current Net Postretirement Benefit Cost**	11/	**18,431,773**
01/01/1998	Prepayment Credit Applied	12/	0
01/01/1998	**Current Period Funding Requirement**	13/	**18,431,773**
01/01/1998	Present Value of Current Year Direct Benefit Payments	14/	(39,259)
01/01/1998	Present Value of Current Year Trust Fund Contributions	15/	(8,387,194)
01/01/1998	**Value of Current Year Underfunding (Prepayment)**	16/	**$10,005,320**

Date	Description	Total Company
12/31/1999	Service Cost	$10,810,786
12/31/1999	Interest Cost	9,968,354
	Net Return on Adjusted Assets Value	
1999	Expected Return on Plan Assets	(1,420,366)
1999	Expected Return on Prior Unfunded Accruals	(2,620,612)
1999	Expected Return on Prepayment Credits	0
	Amortization of Unrecognized Balances	
1999	Amortization of Initial Transition Obligation	3,621,039
1999	Amortization of Past Service Cost	1,491,180
1999	Amortization of (Gains) or Losses	0
12/31/1999	**Accrued Current Net Postretirement Benefit Cost**	**21,850,381**
1999	Expected Long-Term Rate of Return	6.50%
	Interest Adjustment to the Beginning of the Year	(1,333,591)
01/01/1999	**Accrued Current Net Postretirement Benefit Cost**	**20,516,790**
01/01/1999	Prepayment Credit Applied	0
01/01/1999	**Current Period Funding Requirement**	**20,516,790**
01/01/1999	Present Value of Current Year Direct Benefit Payments	(141,472)
01/01/1999	Present Value of Current Year Trust Fund Contributions	(9,415,031)
01/01/1999	**Value of Current Year Underfunding (Prepayment)**	**$10,960,287**

Date	Description		Total Company
12/31/2000	Service Cost		$4,455,304
12/31/2000	Interest Cost		8,090,750
	Net Return on Adjusted Assets Value		
2000	Expected Return on Plan Assets		(1,730,625)
2000	Expected Return on Prior Unfunded Accruals		(3,549,678)
2000	Expected Return on Prepayment Credits		0
	Amortization of Unrecognized Balances		
2000	Amortization of Initial Transition Obligation		3,621,039
2000	Amortization of Past Service Cost		1,491,180
2000	Amortization of (Gains) or Losses		(1,773,863)
12/31/2000	**Accrued Current Net Postretirement Benefit Cost**		**10,604,107**
2000	Expected Long-Term Rate of Return		6.50%
	Interest Adjustment to the Beginning of the Year		(647,199)
01/01/2000	**Accrued Current Net Postretirement Benefit Cost**		**9,956,908**
01/01/2000	Prepayment Credit Applied		0
01/01/2000	Current Period Funding Requirement		**9,956,908**
01/01/2000	Present Value of Current Year Direct Benefit Payments		(79,239)
01/01/2000	Present Value of Current Year Trust Fund Contributions		(10,347,728)
01/01/2000	**Value of Current Year Underfunding (Prepayment)**	**18/**	**($470,059)**

Date	Description	Total Company
12/31/2001	Service Cost	$4,930,153
12/31/2001	Interest Cost	9,236,870
	Net Return on Adjusted Assets Value	
2001	Expected Return on Plan Assets	(2,223,640)
2001	Expected Return on Prior Unfunded Accruals	(3,780,407)
2001	Expected Return on Prepayment Credits	32,540
	Amortization of Unrecognized Balances	
2001	Amortization of Initial Transition Obligation	3,621,039
2001	Amortization of Past Service Cost	1,491,180
2001	Amortization of (Gains) or Losses	(943,629)
12/31/2001	**Accrued Current Net Postretirement Benefit Cost**	**12,364,106**
2001	Expected Long-Term Rate of Return	6.50%
	Interest Adjustment to the Beginning of the Year	(754,616)
01/01/2001	**Accrued Current Net Postretirement Benefit Cost**	**11,609,490**
01/01/2001	Prepayment Credit Applied	(500,613)
01/01/2001	Current Period Funding Requirement	**11,108,877**
01/01/2001	Present Value of Current Year Direct Benefit Payments	(78,896)
01/01/2001	Present Value of Current Year Trust Fund Contributions	(11,538,270)
01/01/2001	**Value of Current Year Underfunding (Prepayment)**	**($508,289.00)**

HIGHMARK, INC
STATEMENT OF PRB COST FUNDING
FOR PLAN YEARS 1998 THROUGH 2002
REPORT NUMBER: A-07-04-00166

Date	Description		Total Company
12/31/2002	Service Cost		$5,619,588
12/31/2002	Interest Cost		9,856,838
	Net Return on Adjusted Assets Value		
2002	Expected Return on Plan Assets		(2,676,053)
2002	Expected Return on Prior Unfunded Accruals		(4,026,133)
2002	Expected Return on Prepayment Credits		35,186
	Amortization of Unrecognized Balances		
2002	Amortization of Initial Transition Obligation		3,621,039
2002	Amortization of Past Service Cost	**19/**	1,224,190
2002	Amortization of (Gains) or Losses		0
12/31/2002	**Accrued Current Net Postretirement Benefit Cost**		**13,654,655**
2002	Expected Long-Term Rate of Return		6.50%
	Interest Adjustment to the Beginning of the Year		(833,382)
01/01/2002	**Accrued Current Net Postretirement Benefit Cost**		**12,821,273**
01/01/2002	Prepayment Credit Applied		(541,328)
01/01/2002	Current Period Funding Requirement		**12,279,945**
01/01/2002	Present Value of Current Year Direct Benefit Payments		(87,396)
01/01/2002	Present Value of Current Year Trust Fund Contributions		(12,910,784)
01/01/2002	**Value of Current Year Underfunding (Prepayment)**		**($718,235.00)**

FOOTNOTES

1/ Source: SFAS 106 valuation reports. SFAS 106 describes the service cost component of net postretirement benefit cost as "the portion of expected postretirement benefit obligation attributed to employee service during that period."

2/ Source: SFAS 106 valuation reports. SFAS 106 measures the interest cost component of net postretirement benefit cost as the accumulated postretirement benefit obligation, adjusted for expected benefit payments, multiplied by the discount rate "to recognize the passage of time."

3/ Source: SFAS 106 valuation reports. SFAS 106, as modified by SFAS 132, measures the expected return on plan assets component of net postretirement benefit cost by applying the expected long-range rate return to the fair value of plan assets at the beginning of the period, adjusted for expected benefit payments and contributions.

4/ Interest due to delayed funding is unallowable under FAR 31.205-6(o)(4). The expected return on plan assets is increased by interest at the assumed expected long-term rate of return on the accumulated value of unfunded accruals to eliminate the effect of the underfunding.

5/ The expected return on plan assets is decreased by interest at the assumed expected long-term rate of return on the accumulated value of prepayment credits to adjust for the effect of the premature funding. This accounting recognition treats prepaid and unfunded postretirement benefit costs on a consistent basis.

FOOTNOTES (Continued)

6/ This is the amortization of the transition obligation component of net postretirement benefit cost that were separately established for the predecessor PBS and Veritus plans. Information on the unrecognized transition obligation of these prior periods was obtained and developed as part of our audits of the costs of these plans. (See audit reports A-07-05-00185 and A-07-05-00186.)

7/ This is the amortization of the unrecognized past service cost. Past service costs were established for the predecessor PRB plans sponsored by PBS and Veritus prior to the merger of the plans into the Highmark plan on January 1, 1998. Information on the past service cost of these prior periods was obtained as part of our audits of the costs of these plans. (See audit reports A-07-05-00185 and A-07-05-00186.) In addition, a past service cost was created by the plan changes that occurred coincidentally with the January 1, 1998, plan merger. Information on the past service cost for the 1998 plan change was obtained from the SFAS 106 valuation report.

8/ As required by FAR 31.205-6(o)(2)(iii), the SFAS 106 methodology for determining the gains or losses is followed. The value of gains and losses are determined based on the unrecognized transition obligation, unrecognized past service cost, and plan assets, adjusted for the accumulated values of unfunded accruals and prepayments, determined for government contract costing purposes.

9/ The accrued current net postretirement benefit cost is the sum of the various components of net postretirement benefit cost, including the expected returns on unfunded accruals and prepayment credits. This is the amount of cost assigned to the period and measured as of the last day of the plan year.

10/ Source: SFAS 106 Valuation reports.

11/ The accrued current net postretirement benefit cost as of the last day of the plan year is discounted to the first day of the plan year at the expected long-term rate of return.

12/ Since the accumulated value of prepayments credits is available as of the first day of the plan year to the cost assigned to the period, any prepayment credits are applied immediately towards the funding the accrued current net postretirement benefit cost. FAR 31.205-6(o)(4) states that any increased cost due to delayed funded is unallowable.

13/ Because FAR 31.205-6(o)(3) requires the cost assigned to the period be funded within the tax-filing deadline for the period to be allowable, any accrued current net postretirement benefit cost remaining after application of the accumulated value of prepayments credits must be funded by deposits to the plan assets or direct payments to plan beneficiaries.

14/ Benefit payments made directly to or on behalf of plan beneficiaries are discounted to the first day of the plan year at the expected long-term rate of return assuming the benefit payments are made evenly throughout the year. Direct benefit payments that reduce the recognized accumulated postretirement benefit obligation are deemed liquidated on a cash accounting basis in accordance with FAR 31.205-6(o)(2)(i).

FOOTNOTES (Continued)

15/ Contributions to the plan assets are discounted from the date of deposit to the first day of the plan year at the expected long-term rate of return. Such contributions can be used to satisfy the funding requirements of FAR 31.205-6(o)(2)(iii) and CAS 416-50(a)(1)(v)(A).

16/ The portion of the accrued current net postretirement benefit cost assigned to the period that is not funded within the tax-filing deadline as required by FAR 31.205-6(o)(3) is unallowable. Unfunded PRB costs are accumulated with interest and are not allowable in any subsequent periods. Underfunding is shown as a positive value.

17/ The SFAS 106 expense components and the contract cost accounting is based on the actuarial assumptions originally used to value the plan for 1999. Any changes due to November 23, 1999, remeasurement using different assumptions are recognized in the gain or loss established for 2000.

18/ A prepayment credit is created when the funding by prepayment credits, direct benefit payments, and contributions exceeds the cost assigned to the current period. Prepayment credits may be accumulated and carried forward, with interest, to fund future PRB costs in future periods. Prepayments are shown with a negative sign.

19/ For 2002, a past service cost was established for the Rule of 90 and bringing the Erie portion of the plan into compliance with the Highmark plan. Information was obtained from the SFAS 106 valuation report.

HIGHMARK

July 25, 2005

Mr. James P. Aasmundstad
Regional Inspector General for Audit Services
DHHS, OIG
601 East 12th Street
Room 284A
Kansas City, Missouri 64106

RE: A-07-04-00166 "Review of Postretirement Benefit Costs Claimed by Highmark Inc."

Dear Mr. Aasmundstad:

Attached is our response to your letter dated June 27, 2005, requesting comments on your draft report A-07-04-00166 entitled, "Review of Postretirement Benefit Costs Claimed by Highmark Inc.," for the period covering fiscal years 1998 through 2002.

If you have any questions, please feel free to contact me at 717-302-4175.

Sincerely,

Donald L. Fisher

Donald L. Fisher, Vice President
Compensation, Benefits, HRIS &
Risk Management

DLF/per

Enclosure:

cc: Elizabeth Farbacher
Thomas Hinkson
Patrick Kiley

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Review of Postretirement Benefit Costs

Claimed by Highmark Inc.

Fiscal Years 1998 through 2002

Highmark's Comments to OIG Draft Report A07-04-00166

Highmark's Comments on the Report Number A-07-04-00166

The draft audit report states that Highmark did not include in its FACPs all of the PRB costs that were allowable pursuant to Federal regulations and did not claim $2,961,526 of PRB costs that were allowable for Medicare reimbursement. Highmark reviewed the Part A and Part B Claimed Variance Tables listed on page 3 of the draft report, as well as the calculation steps listed in the tables and corresponding notes on pages 1 – 5 of Appendix A. The cost allocation method used by Highmark differed from the one used by the auditors in preparing this report. We did confirm that the data input in the "Per PBS" column on page 3 are correct. However, this column should be labeled "Per Highmark."

Beginning in 1998, Highmark prepared one PRB valuation that included the parent company and the subsidiaries that participated in Highmark's Retiree Welfare Plan. As such, subsidiary data was included in performing the Highmark (parent company) cost allocation processes of PRB expense. The Highmark PRB funded amount was allocated to the Highmark and participating subsidiary cost centers using Highmark and subsidiary salary dollars as a basis of allocation. Once allocated to cost centers, the PRB funded amount was allocated to product (line of business) using the cost allocation methodology of the cost pool for that cost center.

We have designed our PRB allocation consistent with CAS 9904.403-40 – Allocation of home office expenses to segments / Fundamental requirements (b) (4) (Central payments or accruals). Per the CAS, "payments or accruals which cannot be identified specifically with individual segments shall be allocated to benefited segments using an allocation base representative of the factors on which payment is based." As identified in section 9904.403-60 Illustrations (c) section of the CAS, salary dollars are a fair and reasonable basis to be used for allocation of central payment type expenses such as pension and group insurance expense. At Highmark, we treat PRB costs, as well as pension and group insurance expenses, as central payments and allocate these expenses to cost center based on salaries.

In reviewing the auditor calculations of Medicare Allowable PRB costs on pages 1 – 5 of Appendix A, we noted the following:

- Based on the OIG footnotes in Appendix A of this draft audit report, headcount percentages appear to be based on data contained in the OIG audit of pension segmentation at Highmark (A-07-04-03050). In our response to that audit, Highmark identified concerns with the segment assignment of numerous participants. The headcount percentages used by OIG within this draft audit report significantly overstate the Medicare segment's portion of PRB costs, thus inflating Highmark's Allowable PRB costs. Highmark provided additional supporting information within Schedule B of the package we sent to the OIG on May 26, 2005 for use within this PRB draft audit. It does not appear that the OIG used the segmentation split percentages we provided in that package.

- Within the draft audit report, Appendix A calculations, it appears the OIG inadvertently omitted Medicare Allowable PRB Costs from its calculation of "Other Segment" PRB Costs. This has understated Highmark's Allowable PRB Costs. The Part A and Part B LOB Percentages shown in the "Other Segment" calculation tie, in total, to the percentages provided to OIG within Schedule B of the package Highmark sent to OIG on May 26, 2005.

- Within the draft audit report, Appendix A calculations, both the "Medicare Segment A" and "Medicare Segment B" columns, contain Medicare Part A and Part B LOB Percentages that differ from the information Highmark sent to OIG within Schedule B of the May 26, 2005 package that contained summary data for use within this PRB draft audit. Instead, OIG has utilized Medicare A and B LOB Percentages based on data contained in the OIG audit of pension segmentation at Highmark (A-07-04-03050). In our response to that audit, Highmark identified concerns with the segment assignment of numerous participants. The headcount percentages, which included retired and term vested participants, used by OIG within this draft audit report significantly overstate the Medicare segment's portion of PRB costs, thus inflating Highmark's Allowable PRB costs.

Another finding stated in this draft audit report notes that Highmark did not receive CMS approval for its change in accounting methodology for PRB costs. In Highmark's response to the draft audit report "Review of Postretirement Benefit Costs Claimed by PBS" (A-07-05-00185), we attached a copy of a cover letter from PBS dated August 18, 1994 that was sent with a package of PRB information and data notifying CMS of PBS' change in accounting method for PRB. The package of information was sent to Patricia Britt Volk, Chief, Financial Management and Program Safeguards Branch within the Division of Medicare of CMS. We also included another cover letter dated October 25, 1995, responding to a follow-up request by CMS for additional PRB data. The Highmark PRB program is a continuation of the prior PBS program, and as such, should not have required additional notification.

In addition, Highmark also notified CMS of our change in the allocation process within our FY 1998 Budget Request filed in July of 1997. Within the budget narrative, we identified to CMS that our cost allocation processes were changing, effective 1998. In addition, we met with CMS Financial staff from the Regional Office prior to and during 1998 to discuss Highmark's change in allocation processes, including how we planned to allocate PRB costs.

In the "Other Matters" section of the draft audit report, OIG identifies $65,966,646 in unfunded PRB costs and interest as of January 1, 2002, that Highmark did not calculate in accordance with the "accrual accounting guidelines in FAR 31.205-6(o)(2)(iii)" (i.e., FAS 106). OIG recommends that Highmark should be precluded from including these unfunded PRB costs in any future claims to the Government.

Highmark disagrees with OIG's recommendation on the ground that by requiring contractors to use FAS 106 in calculating PRB costs, the FAR irreconcilably conflicts with the IRS limitations on VEBA funding. This FAR provision, therefore, is inconsistent with the fundamental principle underlying cost-reimbursement contacts generally and Medicare contracts specifically – full reimbursement of a contractor's reasonable, allowable and allocable costs.

Highmark and CMS currently are engaged in discussions concerning this issue, and Highmark will provide a written submission directly to CMS, setting forth its position and its recommendations to mitigate or resolve the conflict.