MAY 11 1994

June Gibbs Brown
Inspector General

Date

From

Subject

Review of Unfunded Pension Costs of Pennsylvania Blue Shield (A-07-93-00713)

To

Bruce C. Vladeck
Administrator
Health Care Financing Administration

This is to alert you to the issuance on May 12, 1994 of our final audit report. A copy is attached.

Our review showed that as of January 1, 1992, Pennsylvania Blue Shield (PBS) had accumulated $5.5 million in pension costs that are unallowable for Medicare reimbursement.

For Medicare reimbursement, pension costs must be (1) measured, assigned, and allocated in accordance with Cost Accounting Standards (CAS) 412 and 413; and (2) funded as specified by part 31 of the Federal Acquisition Regulations (FAR). Pension cost assigned to an accounting period, but not funded by tax filing deadlines, may not be reassigned to or claimed in subsequent accounting periods. Also, interest on any unfunded costs is an unallowable component of pension costs of future cost accounting periods.

The FAR funding requirement has traditionally been satisfied by trust fund deposits qualifying for tax exemptions under the Employee Retirement Income Security Act (ERISA) of 1974. The ERISA provides for a minimum and a maximum deposit to pension funds as determined each year. The minimum represents a required deposit while the maximum represents the upper limit that can be deducted for income tax purposes for the year for which the deposit is applicable.

Pension costs computed in accordance with CAS represent an assignment of pension costs to specific accounting periods. Historically, CAS pension costs often fell between ERISA minimum and maximum contributions. In addition, before 1986, if CAS pension costs were greater than maximum ERISA contributions, contractors could deposit the CAS amounts in qualified trust funds, claim them as allowable contract costs, and take ERISA maximums as tax deductions. The excess of the CAS amount over the ERISA maximum could be carried forward to future years for tax deductibility. Similarly, if
contractors deposited ERISA maximums that were larger than CAS computed amounts, differences could be carried forward as allowable contract costs for future years.

The Tax Reform Act of 1986 (TRA '86) changed the effect of making pension plan contributions in excess of ERISA maximums. The ERISA maximum was still the tax deductible limit and the excess could still be carried forward to future years for deductibility. However, TRA '86 imposed an excise tax of 10 percent on contributions in excess of ERISA maximums. The excise tax is cumulative from year to year.

With the Omnibus Budget Reconciliation Act of 1987 (OBRA '87), the Congress took additional action affecting contractors' pension plan contributions. The OBRA '87 imposed a second more restrictive test to the full funding limitation. The more restrictive test caused most pension plans that were already in full funding to retain their full funding status longer and pushed additional plans into a full funding status.

The PBS did not make contributions to the pension trust fund for 1986 through 1991. For each of those years, we considered CAS pension costs to be unfunded and unallowable. Considering interest on the deposits not made, PBS has accumulated $5.5 million as of January 1, 1992 that must be separately identified and excluded as future components of Medicare pension costs.

We are recommending that PBS: (1) separately identify $5.5 million as an unallowable component of pension costs as of January 1, 1992, (2) continue a yearly update of unallowable pension cost components related to the unfunded CAS costs for 1986 through 1991, and (3) identify and update unallowable pension costs occurring in later years.

The PBS disagreed with our calculated amount for the unfunded pension cost because it disagreed with our computation of the Medicare segment assets (CIN: A-07-93-00712). The Health Care Financing Administration regional office did not comment on our draft report.

For further information contact:

Vincent R. Imbriani
Regional Inspector General
for Audit Services, Region VII
816-426-3591

Attachment
Department of Health and Human Services

OFFICE OF
INSPECTOR GENERAL

REVIEW OF UNFUNDED PENSION COSTS OF PENNSYLVANIA BLUE SHIELD

JUNE GIBBS BROWN
Inspector General

MAY 1994
A-07-93-00713
Mr. Everett F. Bryant  
Senior Vice President, Government Business Unit  
Pennsylvania Blue Shield  
Post Office Box 632  
Camp Hill, Pennsylvania 17011-0632  

Dear Mr. Bryant:

This report provides you with the results of an Office of Inspector General (OIG), Office of Audit Services (OAS) review titled "REVIEW OF UNFUNDED PENSION COSTS OF PENNSYLVANIA BLUE SHIELD." The purpose of our review was to determine whether pension costs for Plan Years 1986 through 1991 were funded in accordance with the Federal Acquisition Regulations (FAR).

As of January 1, 1992, Pennsylvania Blue Shield (PBS) had accumulated $5,490,995 in pension costs which are unallowable for Medicare reimbursement. Pension costs assigned to an accounting period, but not funded by the tax filing deadlines, may not be reassigned to or claimed in subsequent accounting periods. Also, interest on the portion not funded in a period cannot be a component of pension costs of any future cost accounting periods.

The PBS did not make contributions to the pension trust fund for Plan Years 1986 through 1991. As a result, PBS accumulated unfunded pension costs of $5,490,995 as of January 1, 1992. The PBS must separately identify and eliminate this amount from the amortization components of future pension costs.

The PBS disagreed with our calculated amount for the unfunded pension costs because they had disagreed with our computation of the Medicare segment assets (CIN: A-07-93-00712). Their response to our draft report is included as Appendix B.

INTRODUCTION

BACKGROUND

For Medicare reimbursement, pension costs must be (1) measured, assigned, and allocated in accordance with Cost Accounting Standards (CAS) 412 and 413, and (2) funded as specified by part 31 of the FAR. The CAS deals with stability between
contract periods and requires that pension costs be consistently measured and assigned to contract periods. The FAR addresses the allowability of pension costs and requires that pension costs assigned to contract periods be substantiated by funding.

The FAR funding requirement has traditionally been satisfied by trust fund deposits qualifying for tax-exemptions under the Employees Retirement Income Security Act of 1974 (ERISA). The ERISA provided for a minimum and a maximum deposit to pension funds as determined each year. The minimum represented a required deposit while the maximum represented the upper limit that could be deducted for income tax purposes for the year for which the deposit was applicable.

Pension costs computed in accordance with CAS represent an assignment of pension costs to specific accounting periods. The CAS pension costs often fell between ERISA minimum and maximum contributions. If contractors deposited the minimum ERISA contribution in their qualified trust funds, and the CAS pension costs exceeded the ERISA minimum, the contractors could only claim the funded portion of the CAS amount as allowable contract costs. Additionally, the excess of the CAS costs over the ERISA minimum contribution could not be carried forward as a component of future CAS pension costs.

In contrast, before 1986, if CAS pension costs were greater than maximum ERISA contributions, contractors could deposit the CAS amounts in qualified trust funds, claim them as allowable contract costs, and take ERISA maximums as tax deductions. The excess of the CAS amount over the ERISA maximum could be carried forward to future years for tax deductibility. Similarly, if contractors deposited ERISA maximums that were larger than CAS computed amounts, differences could be carried forward to fund allowable contract costs for future years.

The Tax Reform Act of 1986 (TRA 86) changed the effect of making pension plan contributions in excess of ERISA maximums. The ERISA maximum was still the tax deductible limit and the excess could still be carried forward to future years for deductibility. However, TRA 86 imposed an excise tax of 10 percent on contributions in excess of ERISA maximums. The excise tax is cumulative from year to year and applied on a first-in/first-out basis considering carry-forwards and current year contributions.

With the Omnibus Budget Reconciliation Act of 1987 (OBRA 87), the Congress took additional action affecting contractors' pension plan contributions to qualified trust funds. Prior to OBRA 87, ERISA's full funding limitation traditionally considered accumulated assets and the actuarial liability. If assets equalled or exceeded the actuarial liability, the tax deductible amount was limited to zero.
The OBRA 87 imposes a second more restrictive test to the full funding limitation. It considers the accumulated assets and 150 percent of the amount designated "current liability." The actuarial liability under the pre-OBRA 87 test was based on projected benefits and conservative valuation assumptions. The current liability test of OBRA 87 considers only currently accrued benefits and values the liability using interest rates based on Treasury rates. The effect was that most pension plans that were already in full funding would remain there longer. Also, the same effect would push additional plans into full funding.

**SCOPE**

We made our examination in accordance with generally accepted government auditing standards. Our objective was to identify unfunded CAS costs, plus appreciation on the unfunded costs, from January 1, 1986 to January 1, 1992. Achieving our objective did not require that we review the internal control structure of PBS.

This review was done in conjunction with our audit of PBS regarding pension segmentation (CIN: A-07-93-00712). The information obtained and reviewed during that audit was also used in performing this review.

The Health Care Financing Administration (HCFA) Office of the Actuary developed the methodology used for computing the CAS pension costs based on PBS' historical practices.

We performed site work during June and July 1993 at PBS' corporate offices in Camp Hill, Pennsylvania. Subsequently, we performed audit work in the OIG, OAS, Jefferson City, Missouri Office.

**FINDING AND RECOMMENDATIONS**

As of January 1, 1992, PBS had accumulated $5,490,995 in unallowable direct pension costs related to its Medicare segment. These costs are unallowable because the pension costs were not funded within specific time periods set by regulation. Imputed interest on the unfunded costs is also unallowable. These costs represent unfunded pension costs and imputed interest for Plan Years 1986 through 1991. The PBS cannot claim any of these unfunded costs in future cost accounting periods.

For Medicare reimbursement, pension costs must be (1) measured, assigned, and allocated in accordance with CAS 412 and 413 and (2) funded as specified by part 31 of the FAR. The CAS deals with stability between contract periods and requires that pension costs be consistently measured and assigned to contract periods. The FAR addresses the allowability of pension costs and requires
that pension costs assigned to contract periods be substantiated by funding.

The FAR, 48 CFR 31.205-6(j)(3)(i) and (iii), states:

"**costs of pension plans not funded in the year incurred, and all other components of pension costs** assignable to the current accounting period but not funded during it, shall not be allowable in subsequent years**."

"Increased pension costs caused by delay in funding beyond 30 days after each quarter of the year to which they are assignable are unallowable."

Furthermore, the CAS within 48 CFR 30.412-50(a)(7) states:

"If any portion of the pension costs computed for a cost accounting period is not funded in that period, no amount for interest on the portion not funded in that period shall be a component of pension cost of any future cost accounting period."

In addition, the CAS within 48 CFR 30.412-50(a)(2) states:

"Pension costs applicable to prior years that were specifically unallowable in accordance with then existing Government contractual provisions shall be separately identified and eliminated from any unfunded actuarial liability being amortized***."

We compared CAS pension costs for the Medicare segment, computed by HCFA Office of the Actuary, to actual contributions to the Medicare segment and found the following:

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<tr>
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<th>1/1/86</th>
<th>1/1/87</th>
<th>1/1/88</th>
<th>1/1/89</th>
<th>1/1/90</th>
<th>1/1/91</th>
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<td>$490,881</td>
<td>$705,509</td>
<td>$988,773</td>
<td>$1,185,707</td>
<td>$411,491</td>
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<td>Interest to End of Year</td>
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<td>74,158</td>
<td>88,928</td>
<td>34,977</td>
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<tr>
<td>Less: Actual Contribution</td>
<td>-0-</td>
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<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
</tr>
<tr>
<td>Interest to End of Year</td>
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<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
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<td>-0-</td>
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<td>Under (Over) funding</td>
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<td>$527,697</td>
<td>$758,422</td>
<td>$1,062,931</td>
<td>$1,274,635</td>
<td>$446,468</td>
</tr>
</tbody>
</table>

Appendix A provides additional information on the CAS pension costs.

For Plan Years 1986 through 1991, PBS had not funded the CAS pension costs within the required time periods. The PBS did not make a contribution to the pension trust fund during this period because the pension plan was fully funded.

The CAS pension costs not funded are unallowable as a component of pension costs for any future years. Interest related to these
unfunded costs is also unallowable as a component of future years' pension costs.

The following table shows the unfunded amounts, plus interest, which are unallowable on a cumulative basis. We computed the unfunded amounts for each year as shown on the previous schedule. We increased the unfunded amounts by the assumed rate of interest used in the valuation reports. Our computation of the unfunded amounts plus interest considers those costs which should have been funded for the applicable years. In other words, if PBS funded the costs, the assets of the Medicare segment would have been greater at the specified time periods.

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
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<td>$524,190</td>
<td>$0</td>
<td>$0</td>
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<td>$524,190</td>
</tr>
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<tr>
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<td>0</td>
<td>1,931,463</td>
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<td>655,557</td>
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<td>1/1/92</td>
<td>759,543</td>
<td>711,279</td>
<td>950,959</td>
<td>1,239,776</td>
<td>1,382,979</td>
<td>446,468</td>
<td>5,490,995</td>
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**Recommendations**

We recommend that PBS:

- Identify $5,490,995 as an unallowable component of direct pension costs as of January 1, 1992.
- Update annually the unallowable pension cost component related to the unfunded CAS costs for Plan Years 1986 through 1991.
- Identify and update unfunded pension costs for any later years in a similar manner.

**Auditee Comments**

"Pennsylvania Blue Shield disagrees with the auditor's calculation of $5,490,995 as the unallowable component of direct pension cost***. Because we disagree with the Medicare segment assets*** we also disagree with the $5,490,995 of unallowable direct pension cost."

"The audit report*** also seems to imply that Pennsylvania Blue Shield charged $5,490,995 in unallowable direct pension costs related to its Medicare segment during the period covered by the audit."
The PBS also stated that its representatives and staff from the HCFA Central Office were discussing a waiver concerning the allowability of the unfunded pension costs.

OIG Response

We disagreed with PBS' comments on our pension segmentation report, and we did not revise our computation of the Medicare segment's pension assets. Therefore, we disagree with PBS's comments on our computation of the unfunded pension costs.

There is no implication that $5,490,995 was claimed by PBS for Medicare reimbursement. Simply, this amount is the accumulated unfunded pension cost as of January 1, 1992, which under current regulations, must be removed from components of future pension costs.

INSTRUCTIONS FOR AUDITEE RESPONSE

Final determinations as to actions to be taken on all matters reported will be made by the HHS action official identified below. We request that you respond to each of the recommendations in this report to the HHS action official, presenting 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 (Public Law 90-231), OIG, OAS reports issued to the Department's grantees and contractors are made available, if requested, to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act which the Department chooses to exercise. (See 45 CFR part 5.)

Sincerely,

Vincent R. Imbriani
Regional Inspector General for Audit Services, Region VII

Enclosures

HHS Action Official:

Mr. Maurice Hartman
Regional Administrator, Region III
Health Care Financing Administration
3535 Market Street
Room 3100
Philadelphia, Pennsylvania 19101-3363
<table>
<thead>
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<th>Date</th>
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<td>Contribution</td>
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<td>01/01/87</td>
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<td>Amortization Payment</td>
<td>CAS Pension Cost</td>
<td>Interest to 12/31</td>
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<td>----------------------</td>
<td>------------------</td>
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</tr>
<tr>
<td>01/01/89</td>
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**Total**  
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<td>$4,480,072</td>
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**APPENDIX A**

**STATEMENT OF CAS PENSION COSTS AND FUNDING**

**FOR THE PERIOD**

**JANUARY 1, 1986 TO JANUARY 1, 1992**
FOOTNOTES

1/ We obtained the total company normal costs from PBS' actuarial valuation reports. Starting in 1988, we obtained the Medicare segment's normal cost from the Medicare segment's separate valuation reports.

2/ We based the amortization payment on a CAS amortization schedule, developed from information obtained from PBS' valuation reports and IRS Form 5500 reports. We developed a separate CAS amortization schedule for the Medicare segment starting in 1988.

3/ The CAS pension cost represents the sum of the normal cost and amortization payment. We allocated the CAS pension cost to the Medicare segment based on the ratio of the segment's covered payroll to the total company covered payroll. We separately calculated CAS pension costs for years 1988 through 1991. The amounts shown for the "other segment" represent the difference between the total company and the Medicare segment.

4/ We applied one year's interest at the assumed rate reported in the actuarial valuation reports. For years 1986 through 1990, the interest rate is 7.5 percent. For 1991, the interest rate is 8.5 percent.

5/ The annual CAS pension cost, adjusted with interest to the end of the year, must be funded by current and prepaid contributions to satisfy the allowability criteria of FAR section 31.205-6(j).

6/ We obtained total company contributions from IRS Form 5500 reports. The PBS did not make contributions to the pension plan for Plan Years 1986 through 1991.

7/ We applied interest on the contributions at the assumed rate from the date of deposit to the end of the year.

8/ We computed the unfunded pension cost by subtracting the value of contributions and interest at year-end from the CAS funding target.
February 15, 1994

Mr. Vincent R. Imbriani
Regional Inspector General of Audit Services
Department of Health and Human Services
Region III
601 East 12th Street, Room 284A
Kansas City, MO 64106

RE: CIN A-07-93-007103

Dear Mr. Imbriani:

This is in reply to your January 18, 1994 draft audit report entitled "Review of Unfunded Pension Costs of Pennsylvania Blue Shield."

Pennsylvania Blue Shield disagrees with the auditors' calculation of $5,490,995 as the unallowable component of direct pension cost as found on page 5 of the report. The calculation of CAS Pension Cost would have utilized the Medicare segment assets as determined in the "Review of Medicare Contractor's Pension Segmentation Pennsylvania Blue Shield," CIN A-07-93-00712. Because we disagree with the Medicare segment assets identified in that audit, we also disagree with the $5,490,995 of unallowable direct pension cost.

The audit report on page 5 also seems to imply that Pennsylvania Blue Shield charged $5,490,995 in unallowable direct pension costs related to its Medicare segment during the period covered by the audit. Effective with the 1988 contract and forward, no pension costs were allocated to the Medicare segment and no pension costs were included in the Final Administrative Cost Proposals for the segment.

Notwithstanding CAS 412 and 413 and part 31 of the FAR, we believe that these costs are reimbursable under the terms of the Medicare contract. Representatives from Pennsylvania Blue Shield and staff from the HCFA Central Office are discussing a waiver of certain FAR and CAS provisions that govern pension costs. In addition, we understand that the CAS Board is currently considering amendments to the CAS which may permit such costs to be charged to Government contracts at the time they are actually funded. We believe the issue of accumulated unfunded pension costs related to the Medicare segment is an integral part of the waiver discussions between Pennsylvania Blue Shield and HCFA. Hopefully, we can reach a mutually-acceptable agreement which will quickly allow us to close this issue.
Should you have any questions or need additional information, please contact Ray Eichelberger at (717) 763-3167 or Donald Fisher at (717) 763-3292.

Sincerely,

Everett F. Bryant
Senior Vice President
Government Business

EFB/RRE/DLF/mak