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September 10, 2008

Ms. Joan Agostinelli
Office Chief
Arizona Department of Health Services
Office for Children with Special Health Care Needs
Children's Rehabilitative Services
150 N. 18th Avenue, Suite #330
Phoenix, AZ 85007-3243

Final and Confidential

Subject: Title XIX, Title XXI and Proposition 204 Capitation Rates for Contract Year 2009

Dear Ms. Agostinelli:

The Arizona Department of Health Services (ADHS), Office for Children with Special Health Care Needs (OCSHCN), Children's Rehabilitative Services (CRS) program contracted with Mercer Government Human Services Consulting (Mercer) to develop capitation rates for the Title XIX, Title XXI and Proposition 204 populations. These rates are used by the Arizona Health Care Cost Containment System (AHCCCS) to compensate CRS and the CRS contractor for CRS members determined Title XIX, Title XXI or Proposition 204 eligible during the Contract Year. For the Contract Year beginning October 1, 2008, and ending September 30, 2009 (CYE 2009), Mercer has developed capitation rates following the process described in this letter.

Background

CRS is primarily a children's program for Arizona residents under the age of twenty-one with chronic and disabling, or potentially disabling, conditions. The program provides services through one statewide contractor. Medical services not related to a child's CRS-eligible condition are provided through the child's AHCCCS health plan.

Three capitation rates are developed for compensating the CRS contractor based upon a member's CRS enrollment diagnosis. The three rates represent compensation for providing services to members with specific diagnoses that have historically represented relatively High, Medium and Low costs to the CRS contractor. The High, Medium and Low capitation risk group structure includes small numbers of the Qualified Medicare Beneficiary (QMB) Plus, Medicaid [non-QMB and non-Specified Low-income Medicare Beneficiary (SLMB)],



Page 2
September 10, 2008
Ms. Joan Agostinelli
Arizona Department of Health Services

and SLMB Plus dual eligible populations. No other dual eligible populations are enrolled in the program. In Mercer's opinion, the High, Medium and Low capitation rate cells most appropriately match payment with risk in the CRS program, and hence provide a greater level of actuarial soundness than other approaches. The three-tier rate structure will continue to be used for CYE 2009.

CYE 2009 Capitation Rate Development Methodology – Overview

CYE 2009 marks the fourth year that contractor encounters have been used as the base data source. The CYE 2009 rates have been re-based.

Base Data

The SFY 2006 and SFY 2007 contractor encounter data were valued using a combination of contractor paid amounts and Medicaid (AHCCCS) fee schedule allowed amounts, incorporating a methodology in conjunction with Third Party Liability (TPL) cost avoidance and any pay-and-chase recoveries. SFY 2006 encounters were trended forward to a "modeled SFY 2007" level, and blended with the actual SFY 2007 encounters to further enhance the credibility of the base data.

With three years of encounter data, SFY 2005 through SFY 2007, CRS Administration and Mercer performed a thorough analysis and re-established High, Medium and Low diagnostic groupings. Per member per month (PMPM) costs were regrouped into the three categories and the base SFY 2006 and SFY 2007 data were adjusted accordingly, increasing the matching of payment to underlying risk. The adjustments were done on a budget-neutral basis, meaning no dollars were gained or lost in the process.

The CRS program falls under Arizona's 1115 waiver. Mercer performed a review of the CRS subcontractor submitted data and determined that the data included a small amount of non-covered services which have been excluded from the base data.

Base Data Adjustments

1. Unpaid Claims Liability

The SFY 2006 and SFY 2007 base data utilizes encounters with dates of service beginning July 1, 2005, and ending June 30, 2007. Encounters were initially analyzed with a run-out period of seven months beyond the June 30, 2007, endpoint, with data extracted in early

Page 3
September 10, 2008
Ms. Joan Agostinelli
Arizona Department of Health Services

February 2008. The next step in the base data analysis process was a review of the CRS contractors' expense component for claims incurred but unpaid, hereinafter called the unpaid claims liability (UCL). The UCL is the sum of claims incurred but not reported, plus those claims reported but not yet paid. Statutory accounting recognizes an incurred medical expense for the period as the result of the sum of claims paid in the period, plus the change in the accrued liability for the UCL between the beginning and the end of the period. This calculation pushes the correction of the estimation error of the beginning UCL into the expense recognized in the current period. However, the expense that should be recognized in base data development is calculated from claims incurred in the SFY 2006 and SFY 2007 experience period, both claims paid in SFY 2006 and SFY 2007 and the accrued liability for the UCL as of the end of SFY 2007.

A review of the contractors' SFY 2007 encounters indicated that there were outstanding claims as of the early February 2008 data extract. The overall adjustment for SFY 2006 and SFY 2007 encounters received beyond the early February 2008 data extract was 0.83 percent.

2. Completion for "Omissions"

As part of its 1115 waiver provisions, AHCCCS performs annual data validation studies of encounters. AHCCCS tests for completeness, accuracy and timeliness of encounter submissions based upon statistically valid sampling of both professional and facility encounters, comparing them against medical records. Mercer utilized the results of the most recently completed data validation study to develop factors to apply to the base CRS data to further complete the encounters for these "omissions." Mercer and CRS Administration utilized (with some downward adjustment which lowered the overall impact) the factors shown by AHCCCS, which vary between facility and professional consolidated categories of service (COS). The overall rate impact of this correcting adjustment is 3.09 percent.

3. "Non-encounterable" Costs

In addition, the adjusted base SFY 2006 and SFY 2007 data reflects contractor costs not captured by encounters, but typically considered under medical service expenses rather than administrative expenses. These "non-encounterable" costs include those for such providers as social workers and interpreters, as well as telephone and tele-video interventions, counseling, care coordination activities and member/family education. The overall non-encounterable adjustment is 1.07 percent of the base SFY 2006 and SFY 2007 encounters.



Page 4
September 10, 2008
Ms. Joan Agostinelli
Arizona Department of Health Services

4. Medicare Part D

Under the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (MMA), a prescription drug benefit is provided by Medicare for the Medicare/Medicaid dual eligible population, effective January 1, 2006. Under this program, prescription drug expenditures for dual eligibles by a state Medicaid program will be significantly reduced. To account for this change, Mercer excluded all pharmacy costs for dual eligibles from the base data.

5. AHCCCS Inpatient Outlier Methodology Change

Starting on October 1, 2007, AHCCCS began a three-year phase-in of a new inpatient outlier methodology (specific to the cost-to-charge ratios used to qualify and pay outliers). CYE 2009 marks Year 2 of the phase-in, so the outliers in the base SFY 2006 and SFY 2007 encounters were re-priced using the new methodology. This change reduced the two-year base data by approximately \$3 million.

Trend to CYE 2009

The SFY 2006 trended (modeled SFY 2007) and SFY 2007 encounter cost data were trended forward twenty-seven months to CYE 2009. The trend factors recognize changes in cost-per-service unit and utilization of health care services from the SFY 2006 and SFY 2007 base period to CYE 2009. Unique trends were applied separately for ten COS. Trends ranged from a low of 2.3 percent for Non-Physician Professional (-3.25 percent utilization and 5.75 percent unit cost; $0.9675 \times 1.0575 = 1.023$) to a high of 17.5 percent for Pharmacy (-0.25 percent utilization and 17.75 percent unit cost; $0.9975 \times 1.1775 = 1.175$). The weighted annual trend adjustment for SFY 2006 and SFY 2007 to CYE 2009 was 9.1 percent (3.1 percent utilization and 5.8 percent unit cost).

Mercer relied heavily on historical CRS encounter information as well as its professional experience in working with other state Medicaid programs, outlooks in the commercial marketplace that influence Medicaid programs, regional and national economic indicators, and general price/wage inflation in developing trends. The 9.1 percent weighted trend compares favorably (is lower than) historical experience trend.

Mercer actuaries select COS trend factors from a range of possible values. The final trend figures selected account for the recent Budget Reconciliation Bills (BRB) mandating a one-year freeze to AHCCCS hospital inpatient and outpatient fee schedules. Mercer believes the final trend factors selected to be reasonable and appropriate. The impact of the one-year



Page 5
September 10, 2008
Ms. Joan Agostinelli
Arizona Department of Health Services

freeze on the medical component of the CRS weighted average capitation rate is estimated at negative 1.0 percent.

Service Utilization Increase and Technology Changes from Base Data to CYE 2009

Service utilization increases and technology changes not reflected (or not fully reflected) within the SFY 2006 and SFY 2007 base data will impact the CRS contractor for CYE 2009. Adjustments for CYE 2009 were made for the following items through analyzing data from CRS, the AHCCCS contractors and external sources.

1. Biotech Drugs

Effective CYE 2009, the coverage of the high-cost drugs Aldurazyme, Cerezyme, Elaprase, Fabrazyme and Myozyme will be transferred from AHCCCS to CRS. In addition, Orfadin, another biotech drug, is expected to further increase contractor expenditures beyond normal pharmacy trend. The total impact of these changes is approximately 2.1 percent of the final medical costs.

2. Kuvan

Kuvan, a new drug for the treatment of Phenylketonuria (PKU), was approved by the FDA in late 2007. Kuvan is estimated to have a 0.7 percent impact on the final medical costs.

3. Cochlear Implants

Effective CYE 2009, the coverage of cochlear implants and related services will be transferred from AHCCCS to CRS. The total impact of this change is \$1.65 million over the two-year base period.

4. Motorized Wheelchairs

Effective CYE 2009, the coverage of motorized wheelchairs related to CRS eligible conditions will be transferred from AHCCCS to CRS. The total impact of this change is \$241,000 over the two-year base period.



Page 6
September 10, 2008
Ms. Joan Agostinelli
Arizona Department of Health Services

5. CRS Related Conditions

Effective CYE 2009, the coverage of conditions related to or caused by CRS conditions (e.g., diabetes caused by cystic fibrosis and failure to thrive caused by Cerebral Palsy) will be transferred from AHCCCS to CRS. The total impact of this change is \$102,000 over the two-year base period.

6. Therapies

Effective CYE 2009, the CRS limit of twenty-four therapy sessions will be lifted. The total impact of lifting the limit is \$5,000 over the two-year base period.

7. Emergency Services

The new CRS contractor will have a significantly expanded hospital network as compared to the previous contractors. As a result of this, the Contractor will be financially responsible for coverage of the related emergency services in those facilities effective CYE 2009, previously covered by AHCCCS non-CRS Contractors. The total impact of this change is \$1.23 million over the two-year base period.

Loading for Contractor Administration and Underwriting Profit/Risk/Contingency

The overall CYE 2009 administrative expense load is 10.2 percent. This is down significantly from the comparable SFY 2008 figure of 14.8 percent due to moving from four regional contractors to one statewide contractor and going through a competitive bid process, including the administrative expense component of the capitation rate.

An underwriting profit/risk/contingency loading of 2.0 percent was applied uniformly to all rates. There should be an assumed margin for contribution to entity surplus and adverse claim risk contingency. The 2.0 percent is consistent with that used for the AHCCCS acute care contractors.

CRS Administration

AHCCCS has placed CRS Administration at risk for the provision of CRS-covered services for CYE 2009. Accordingly, the capitation rates were developed to include compensation to CRS for the cost of ensuring the delivery of all CRS covered services. The capitation rates paid to CRS include an 8.4 percent administrative load. This is down from the 9.8 percent load for SFY 2008. The administrative load represents the CRS costs of ensuring the

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Page 7
September 10, 2008
Ms. Joan Agostinelli
Arizona Department of Health Services

efficient delivery of services in a managed care environment, and is based upon historical CRS costs and accounts for continued regulatory oversight cost expectations for CYE 2009.

Reinsurance Offset

CRS Administration has negotiated a reinsurance arrangement with AHCCCS for CYE 2009. The arrangement covers inpatient claims exceeding \$75,000 at 75 percent reimbursement. It also covers the high-cost biotech drugs Aldurazyme, Cerezyme, Elaprase, Fabrazyme, Kuvan, Myozyme and Orfadin at 85 percent reimbursement. Mercer estimated the value of the reinsurance through analyzing data from CRS, the AHCCCS contractors and external sources. Reimbursement amounts were estimated for the High, Medium and Low risk groups for SFY 2006 and SFY 2007 and each was trended forward to the CYE 2009 time period. These totals were then blended using a one-third weight on projected SFY 2006 and two-thirds weight on projected SFY 2007.

Certification of Rates

Mercer certifies that the Title XIX, Title XXI and Proposition 204 CRS capitation rates for CYE 2009 presented below and in the attachments to this letter, were developed in accordance with generally accepted actuarial practices and principles by actuaries meeting the qualification standards of the American Academy of Actuaries for the Medicaid covered populations and services under the managed care contract. Rates developed by Mercer are actuarial projections of future contingent events. Actual contractor costs will differ from these projections. Mercer has developed these rates on behalf of CRS to demonstrate compliance with the Centers for Medicare and Medicaid Services (CMS) requirements under 42 CFR 438.6(c) and are in accordance with applicable laws and regulations.

Risk Category

	High	Medium	Low
Statewide Rates	\$1,342.38	\$502.82	\$222.99
AHCCCS Reinsurance	\$291.22	\$29.92	\$3.02
Net Rates After Reinsurance	\$1,051.16	\$472.90	\$219.97

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Page 8
September 10, 2008
Ms. Joan Agostinelli
Arizona Department of Health Services

If you have any questions or would like to discuss this information further, please call me at 602 522 6510.

Sincerely,

A handwritten signature in blue ink that reads "Michael E. Nordstrom ASA, MAAA".

Michael E. Nordstrom, ASA, MAAA

MEN/AC/lgm

Copy:
Cynthia Layne, ADHS
David Reese, ADHS
Branch McNeal, Mercer
Gerry Smedinghoff, Mercer
Adam Carney, Mercer
Austin Hackett, Mercer

Attachments