

RxQUEST™ 3.0

Forensic Audit



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Quest Analytics Group



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Introduction

Quest Analytics Group (Quest) was recently selected by (Client) to evaluate its pharmaceutical benefit sourcing structure, in conjunction with the team at Brokerage. In that regard, we obtained and reviewed the following information:

- A. The in-force administrative service agreement the Client has with Payer.
- B. The Client's paid claims data for the experience period of 1/1/10 – 2/20/11.
- C. Payer's estimation of the financial value of new pricing terms effective 1/1/11.

Regarding item B above, the data was supplied by Payer (pursuant to a non-disclosure agreement), but they chose not to provide the following data points (despite the reality that the Client owns this data):

- Average Whole Price (i.e., the billed charge rate on each claim)
- Pharmacy I.D.
- Indication on which drugs Payer classified (and paid) as a specialty drug.
- Indication on which drugs Payer classified (and paid) as a compound drug.

It should be noted that Payer's refusal to provide the noted data points is inconsistent with industry standards...Quest has previously obtained this information from the following payers:

- | | | |
|---------------------|--------------------------|--------------|
| • Aetna | • BCBS of Texas | • CatalystRx |
| • United Healthcare | • BCBS of South Carolina | • Humana |
| • CIGNA | • Express Scripts | • Walgreens |
| • BCBS of Alabama | • Caremark | |
| • BCBS of Illinois | • Medco | |

In total, the Payer's file contained 238,700 scripts/claims. 17,661 scripts were excluded from our analysis as they contained zero drug quantity and zero dollars. Also, a small subset of scripts with a pre-2010 fill date was excluded.

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Administrative Service Agreement Commentary

The Payer's administrative service agreement is an integrated contract for processing of both medical and pharmaceutical claims, and we find nothing unusual or problematic with this structure. However, we find several very fundamental issues related to Rx administration and claim payment:

- A. The administration agreement does not entitle the Client to discounts on drugs, nor a defined dispensing fee. As with reinsurance, payers maintain a profit center on drugs. The absence of specific pricing terms is akin to purchasing a reinsurance contract without identifying the premium rate.
- B. The lack of definition on guaranteed discount rates and dispense fees fundamentally precludes the Client from conducting any form of competitive benchmarking.
- C. The Payer's position that they will not release the data points as previously noted makes it impossible to audit the accuracy of Rx claim payment.

Exception Process Requirements

Given the lack of information provided by the Payer, the Quest team executed the following workarounds:

- A. Using a nationally recognized AWP reporting vendor as a pricing source, we created the AWP that applied to 220,615 scripts, given the national drug code and fill date noted by the Payer. This exercise provided a methodology by which we evaluated the Payer's discount rates.
- B. Using a "typical" industry specialty drug roster (roughly 1,300 NDCs), we over-laid the alternate payer specialty definition to establish a proxy for which scripts that the Payer adjudicated as a specialty drug.
- C. Using the AWP vendor as a coding source, Quest screened the data using three filters: a) NDCs designated as 999999999; b) NDCs where an AWP was 10x or greater than ingredient cost; c) invalid NDCs. As with item A above, this required analysis of 220,615 lines of claims coding.

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We believe that the exception processes noted are reasonable and consistent with industry standards. That said, this exercise should not have been necessary...i.e., the Client owns the claims data at issue here.

Audit Findings & Benchmarks

The following table details the key audit metrics resulting from the exception process as earlier described, along with a financial sizing indicator (i.e., Variance to Benchmark).

Deal Term Category	\$ Spend / Claim Count	CLIENT Actual	AWP Adjustment	Benchmark	Variance to Benchmark
Retail Brand Rate	\$8.5M	14.1%	13.0%	15.5%	~ \$212,000
Retail Brand Fee	55,064	\$1.22	n/a	\$1.10	~\$6,600
Retail Generic Rate	\$9.4M	71.0%	n/a	73.0%	~\$188,000
Retail Generic Fee	160,708	\$1.38	n/a	\$1.10	~\$45,000
Mail Brand Rate	\$943,000	21.8%	20.8%	25.0%	~\$39,000
Mail Generic Rate	\$527,000	69.1%	n/a	76.0%	~\$36,000
Retail Brand Rebate	55,064	\$xxxx PEPM	n/a	\$13.00	Sub Total
Mail Brand Rebate	1,753	\$xxxx PEPM	n/a	\$39.50	~(180,000)
Composite	n/a	n/a	n/a	n/a	~\$346,000

Footnotes:

1. Variance to benchmarks is an annual valuation.
2. For conservatism, specialty and compounds are excluded in the benchmark valuations.
3. Assumes that the \$XXXX PEPM buy down in medical administration fee will apply moving forward, despite major patent expirations over the next 2.5 years.
4. The AWP adjustment section is explained in this report.
5. The \$346,000 composite variation is a CY 2010 metric. For purposes of future year valuation, a reasonable trend rate should be applied to index this number for the effect of drug price inflation.

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AWP Commentary

Via the AWP price lookup process previously identified, Quest established a validated average general drug AWP per day of \$46,747. Separately, in the Payer's evaluation of the financial impact of new pricing effective 1/1/11, they identified an AWP level that would result in an average AWP per day of \$50,122.

Since the Payer did not provide the actual AWP for each adjudicated claim, the comments in the preceding paragraph are a "straw man problem statement". That said, we routinely find errors in AWP when that data is provided and audited. In the significant majority of instances, the defects in AWP result in a claim over-price...and it uniformly applies to brand drugs. As noted in the data table, we have inserted one point of conservatism to the brand discount rates as calculated.

Trend Rate Sizing & Commentary

In consultation with the Brokerage, we understand that a 12.5% average annual growth rate assumption has been experience and utilized for planning purposes. This rate is on the high side of the typical norms ranging between 8-11%.

That said, the Quest sourcing process would directly seek to transfer a significant slice of the drivers behind drug trend from the Client to the Payer. This is accomplished via a contracting mechanism based upon a guaranteed average script price (ASP), versus the now two-decade-old discount and rebate approach. The clarity of the ASP bid process creates a significant level of bidder competition that is not obtainable via discounts and rebates. As a result, we have routinely seen fully guaranteed ASP proposals that link to year over year drug trend in the 4-5% range.

Of note, one point of reduced Client trend is worth ~\$100,000 per year.

Given the rigor and specificity of the ASP guarantee (it operates like aggregate reinsurance), we believe it can facilitate a write-down in retiree healthcare reserves and/or a reduction in premium equivalency rates (and COBRA rates).

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Summary

In conclusion, the analysis herein highlights a number of strategic/controllership/legal considerations for the Client, in addition to various market competitiveness and sourcing considerations.

The RxQuest process is well suited to address and resolve the issues outlined in this document...key steps/deliverables are as follows:

1. A request for proposal exercise has been released. This process will provide for an expanded array of competitive benchmarks to supplement those in the data table (which is part of this report).
2. The sourcing process will definitively establish that the Client owns its claims data, and will contractually preclude any Payer from withholding data.
3. The sourcing process is also linked to a definitive downstream audit process which will eliminate financial self-reporting by the selected Payer.
4. The sourcing process is designed to transfer the risk of drug price inflation from the Client to the selected Payer...via the average script price guarantee contracting mechanism.
5. The RxQuest process develops a predictive model on what each bidder's average script price guarantee rate should be...based upon underlying pricing terms offered (and applied to the Client's historical data). This exercise provides a qualitative look a bid quality, and is specifically intended to identify bidder's who may be attempting to "buy business" and/or bidder's who are using too much conservatism in their rate guarantee.

This report is accompanied by a detailed description of each phase of the RxQuest process.

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