HOUSE COMMITTEE ON PENSIONS AND INVESTMENTS
TEXAS HOUSE OF REPRESENTATIVES
INTERIM REPORT 2008

A REPORT TO THE
HOUSE OF REPRESENTATIVES
81ST TEXAS LEGISLATURE

VICKI TRUITT
CHAIR

BLAKE ROCAP
COMMITTEE CLERK

Committee On
Pensions and Investments

January 12, 2009

Vicki Truitt
Chair

P.O. Box 2910
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The Honorable Tom Craddick
Speaker, Texas House of Representatives
Members of the Texas House of Representatives
Texas State Capitol, Rm. 2W.13
Austin, Texas 78701

Dear Mr. Speaker and Fellow Members:

The Committee on Pensions and Investments of the Eighteth Legislature hereby submits its interim report including recommendations and drafted legislation for consideration by the Eighty-first Legislature.

Respectfully submitted,

Vicki Truitt, Chair

Mike Villarreal, Vice-Chair

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INTRODUCTION

In the 80th Legislative session ninety-one bills were referred to the House Committee on Pensions and Investments. The committee approved and sent thirty nine of those bills to a calendars committee for further consideration. The significant legislation approved by the committee included providing for a "thirteenth check" for annuitants of the Teacher Retirement System (TRS), directing the statewide retirement funds to divest in Sudan related investments, expanded investment authority for the Teacher's retirement system, providing for automatic enrollment of state employees in 401(k) plans, allowing governmental entities to report their obligations on their financial statements consistently with the Texas Constitution and the TRS sunset bill.

HOUSE COMMITTEE ON PENSIONS AND INVESTMENTS

INTERIM CHARGES

1. Evaluate the possibility of requiring the state and employee contribution rate to meet the annually required contribution for the statewide retirement funds each biennium in order to prevent unfunded liabilities.

2. Explore options for funding other post-employment benefits, and examine strategies employed by other governmental entities in addressing these obligations.

3. Study the impact of actuaries on public pension plans, and evaluate the need for legislation to ensure appropriate actuarial assumptions, actuarial audits or regulation of actuaries contracting with state pension plans.

4. Analyze the impact of allowing a retiree to return to work in the Texas Municipal Retirement System.

5. Assess the representational proportion of each of the stakeholder groups, eligibility requirements, qualifications, and selection and election procedures of the boards of trustees of the retirement systems.

6. Examine eligibility criteria for membership and possible inclusion of additional employees in the Law Enforcement and Custodial Officers Supplemental Retirement Fund (LECOSRF). Evaluate the effect of diversion of funds from the auto registration fee on the unfunded liability of the LECOSRF, and explore the possibility of creating a similar supplemental retirement program as part of the Teacher Retirement System of Texas for those members performing law enforcement duties.

7. Evaluate and make recommendations, if necessary, regarding state contracts with pharmacy benefit managers. Assess the feasibility of combining prescription drug programs of state health insurance programs. All recommendations should take into consideration any budgetary impacts. (Joint Interim Charge with the House Committee on Government Reform)

8. Examine the operation of the Houston Municipal Employees Pension System, its Board of Trustees and staff. (Joint Interim Charge with the House Committee on Urban Affairs)

9. Monitor the agencies and programs under the committee's jurisdiction.

CHARGE # 1

MANDATORY ARC FUNDING FOR STATEWIDE RETIREMENT SYSTEMS

Evaluate the possibility of requiring the state and employee contribution rate to meet the annually required contribution for the statewide retirement funds each biennium in order to prevent unfunded liabilities.

BACKGROUND

Defined benefit pension plans, like ERS and TRS, often express funding costs of pension plans as a percentage of payroll. The percentage of payroll required to fully fund the pension liabilities is the annually required contribution rate (ARC). If the ARC is contributed, a pension system will have the assets it needs to pay its liabilities within its amortization period and is considered 100 percent funded. Funding the ARC helps pension plans comply with the generally accepted accounting principles set forth by GASB, which are the basic accounting principles part of which prescribes the minimum necessary percent of payroll financing for future pension liabilities, and is recommended by the Government Finance Officers Association.

FINDINGS

Richard DeCleene the Chief Financial Officer of the Illinois Municipal Retirement Fund and a member of the Government Finance Officers Association Committee on Retirement and Benefits Administration suggests several advantages of 100 percent funded pension plans and argues that 100 percent funding is the soundest long-term approach for managing a pension plan's assets and liabilities[1].

A comparison of investment performance for the five years ending in fiscal year 2003 between overfunded and underfunded plans by Fidelity Investments found that overfunded plans earned 5.45 percent while the underfunded plans only earned 4.60 percent. It has been suggested that the lower investment returns by the underfunded plans are caused by a lack of flexibility in asset allocation and a lessened ability to manage investment risk because the underfunded plans have less of a buffer to withstand a declining equities market.[2] However this seems to beg the question: Do the underfunded funds exhibit poor investment performance because they are underfunded, or is the underfunding caused by a history of poor investment performance? In either case it is clear that a well funded plan can more easily recover from poor investment performance.

Funding the ARC of a pension plan every year recognizes the cost of benefits promised to employees in the same time period that services are rendered to the employer. This helps maintain intergenerational equity among taxpayers by not pushing the payment of benefits earned today on the taxpayers of tomorrow. It also provides greater transparency of the true costs of the pension benefit being provided to employees. Full funding also provides employees assurance that the benefits they have earned will be paid when they are due.[3] Additionally fully funding a defined benefit pension plan creates lower contribution rates over the long term because any contribution made today will earn investment income that will offset future liabilities that would otherwise be funded by future contributions.

1 DeCleen, Richard, "IMRF White Paper on 100% Funding" March 23, 2007.
2 *id.*
3 *id.*

The committee heard testimony expressing a concern that requiring the ARC to be funded each biennium would create unpredictability and fluctuation in the contribution rate. Indeed a goal of many defined benefit pension plans is to maintain a consistent funding level from year to year. Maintaining a level funding rate provides predictability to employees and employers and produces intergenerational equity among the plan members and taxpayers. In order to achieve this level funding many plans smooth their investment gains and losses to create a more long term picture of a trust fund's value that is not as affected by the volatility of the investment portfolio.

The funding amount of the statewide retirement systems is subject to change every two years through the biennial appropriations process whether the funding amount is tied to the ARC or not. Additionally once the ARC is met and consistently funded, the ARC should not deviate substantially from the normal cost of the pension plan. A disadvantage of placing undue emphasis on a level funding amount is that if the funding amount is below the normal cost of the plan, the pension plan enters into a situation of negative amortization where the plan's annual funding is less than its annual cost. As a result, each year the plan's unfunded liability grows and the plan gets further away from being fully funded. This is especially important ERS and TRS because of the constitutional provision that requires that the, financing be based on sound actuarial principles[4] and the specific statutory prohibition on providing benefit increases to retirees if the plans are not fully funded.[5] The committee also heard concerns that an unintended consequence of requiring the ARC to be funded each year was the possibility that the ARC amount would become a ceiling for the contributions to the pension funds.

Like all state spending, the funding of the statewide pension plans is subject to Section 6, Article VIII, Texas Constitution, requiring that a withdrawal of money from the treasury is permitted only if the money is specifically appropriated, meaning, as noted above, that the funding for the pension plans is controlled by the appropriations act each legislative session and cannot be proscribed by a statutory change. Section 67, Article XVI of the Texas Constitution provides for a minimum state contribution rate for the ERS and TRS. Therefore the only way to require that the minimum contribution meet the ARC would be through constitutional amendment.

RECOMMENDATIONS

- In order to ensure the long term health of the statewide pension plans, help provide the most cost effective funding, prevent unfunded liabilities from growing, and provide greater opportunity for retiree benefit enhancements, the committee recommends that the legislature remains vigilant in adequately funding the state pension plans and appropriates at a minimum the annually required contribution each biennium.

4 Texas Const. Article XVI, Sec.67 (a)(1)
5 Tex. Gov't Code § 811.006, 821.006

CHARGE # 2

OPEB

Explore options for funding other post-employment benefits, and examine strategies employed by other governmental entities in addressing these obligations.

BACKGROUND

In June 2004, the Governmental Accounting Standards Board (GASB) approved Statement 45, which requires employers to account for employer provided retirement benefits other than pensions on an accrual basis. The stated goal of GASB 45 is to create greater financial statement accuracy by requiring these other post-employment benefits (OPEBs) to be recognized when they are earned by employees rather than when they are ultimately paid by employers. The 80th Legislature recognized that OPEB benefits do not carry the legal enforceability that pension benefits do, and passed HB 2365 which created an "other comprehensive basis of accounting" (OCBOA), allowing Governments in Texas to report their OPEB cost forecast as a note on their financial statements rather than as a liability. After deciding how to report OPEB for accounting purposes governmental entities are faced with the greater policy question of how to manage the cost of retiree healthcare which makes up the bulk of OPEB obligations.

Governments have three basic options for managing OPEB liability and should implement any combination of the three that elected policymakers (city councils, county commissioner's courts, or other governing boards) deem appropriate for their workforce and budget.

1. Do nothing and continue paying for OPEB on a "pay as you go" basis.
2. Make benefit design changes that would decrease OPEB liability.
3. Pre-fund OPEB benefits.

Each option has its own advantages and disadvantages. Continuing on a pay as you go basis allows an employer to manage its health care expenses from budget cycle to budget cycle, but risks reaching a point where the benefits are no longer sustainable and benefit design changes and benefit cuts will have to be made. Additionally, some argue not pre-funding OPEB benefits could affect credit ratings as the accrued OPEB liability will grow greater each year.

There are many ways employers can decrease their OPEB liability by changing the design of their health care plan — from discontinuing any OPEB benefit completely, to changing vesting requirements and eligibility to receive the benefit, and modifying co-pays and deductibles. Savings could also be realized by implementing wellness programs and focusing on preventative care as well as providing education to covered retirees to help them become more knowledgeable health care consumers.

An employer may also choose to begin pre-funding the benefit. Pre-funding allows employers to see the true cost of the benefits their employees have earned, and does not push the payment of this benefit onto future generations of taxpayers. This provides assets to help reduce the OPEB liability but it may divert funds needed today for expenses that will not come due for many years in the future.

FINDINGS

States and experts in the field have undertaken the challenge of studying the issues surrounding GASB 45 and recommending and enacting solutions to governments' OPEB liabilities. While there is not a one size fits all solution, affirmative steps should be taken so that policy makers have a range of options available to them in determining what is most appropriate for their beneficiaries. The Government Finance Officers Association recommends six steps for governments to take to assess their OPEB liability and ensure the sustainability of benefits being provided.[6] These steps should help policy makers make choices to manage OPEB liability and balance fiscal responsibility in plan design and cost containment with the need to provide a competitive benefits and retirement package to employees.

The Center for State & Local Government Excellence has released a comprehensive Issue Brief entitled "After GASB 45: Solving the Unfunded Liability Problem in Retiree Healthcare" In it the authors acknowledge that there is no panacea to cure the issue of OPEB liability because every local and state government exists within a unique and complex economic, political, legal, and policy environment. The solution lies in each government implementing changes and programs that are best for their circumstances and assessing them repeatedly as circumstances change. The legislature can assist by ensuring a statutory framework and legal environment exists in which local policymakers can implement the policies they have chosen for their local government as effectively as possible. The study concludes that because significant unknowns remain relating to the future cost and provision of healthcare that a cautious incremental approach at a measured pace may have distinct advantages over rapidly changing health benefits and their funding.[7]

Currently, cities, counties and other governmental entities that provide retired employees with health insurance generally fund their plans on a pay as you go basis, paying for the expense out of their yearly budgets. They do not have trust funds and could not hold and invest any prefunding they felt was necessary or appropriate for OPEB. Additionally the Texas Public Funds Investment Act[8] limits the type of investments in which these entities can place their money. Legislative authority for OPEB trust funds would be required for these entities to engage in any successful pre-funding.

In addition to providing statutory investment authority for prudent long term investing, some states have created statewide OPEB trust funds to invest money collectively, reduce the administrative burden on local governments, and take advantage of economies of scale that are created when investing a larger portfolio. Florida's Municipal League Trust has a structure where entities select the investment portfolio and the appropriate actuarial assumptions for that investment profile are provided[9]. North Carolina created a local government trust fund administered by the state

6 GFOA's Recommended Practice, "Ensuring the Sustainability of Other Postemployment Benefits" (2007)
7 Center for State and Local Government Excellence, "After GASB 45: Solving the Unfunded Liability Problem in Retiree Healthcare" Sept. 2008
8 Tex. Gov't Code Chap. 2256
9 Florida Municipal Pension Trust Fund www.FloridaOPEB.com

treasurer[10]. Many cities and counties are familiar with similar arrangements through their participation as members of the TMRS or TCDRS. In fact, these pension funds received inquiries regarding the feasibility of providing an OPEB trust under their existing structure and investment authority. Many local governments also place their money in TEX-Pool which is administered by the Texas Treasury Safekeeping Trust Company in the Comptroller's office.

The OPEB statutes in Minnesota[11] and Virginia[12] have been proposed as models for other states to look to in formulating legislation.[13] The same author also suggested that OPEB laws should include three key elements that were included by Minnesota and Virginia: establish a trust structure and governance, provide the trust with broad investment authority, and provide for bonding authority.

There is considerable debate regarding the issuance of bonds to pay for unfunded OPEB liability[14]. The goal behind this debt financing is to secure the capital needed to pay for future OPEB costs by investing the bond revenue in equities with the assumption that the equities investment will provide greater return than the debt service required by the issuance of bonds. While this is an attractive option because it recognizes OPEB liabilities and creates a predictable payment requirement, it is subject to the risk involved in attempting any arbitrage. Additionally it has the disadvantage of converting a discretionary budgetary obligation that can be adjusted each plan year with fixed bond payments. The Government Finance Officers Association has recommended "considerable caution" in evaluating the possibility of issuing OPEB bonds and recommended four practices to follow with regards to OPEB bonds[15]:

1. Allow sufficient time for a public-policy dialogue to occur between the governing body, employee groups, finance officials, and the public they serve regarding the appropriate funded ratio for OPEB. Failure to do so could produce “solutions” that ultimately fail to reflect the desires and considered judgment of constituents.

2. Consider OPEB bonds only upon consultation and advice from a knowledgeable financial advisor who is not also serving, or planning to serve in the future, as an underwriter of the OPEB bonds. As part of their consideration, potential issuers should compare the results of any proposed OPEB bond issuance to both (1) advance funding on the basis of the ARC and (2) pay-as-you-go funding.

3. Refrain from issuing OPEB bonds until all issues concerning the proper establishment of a qualified trust fund, investment procedures, and investment guidelines have been resolved.

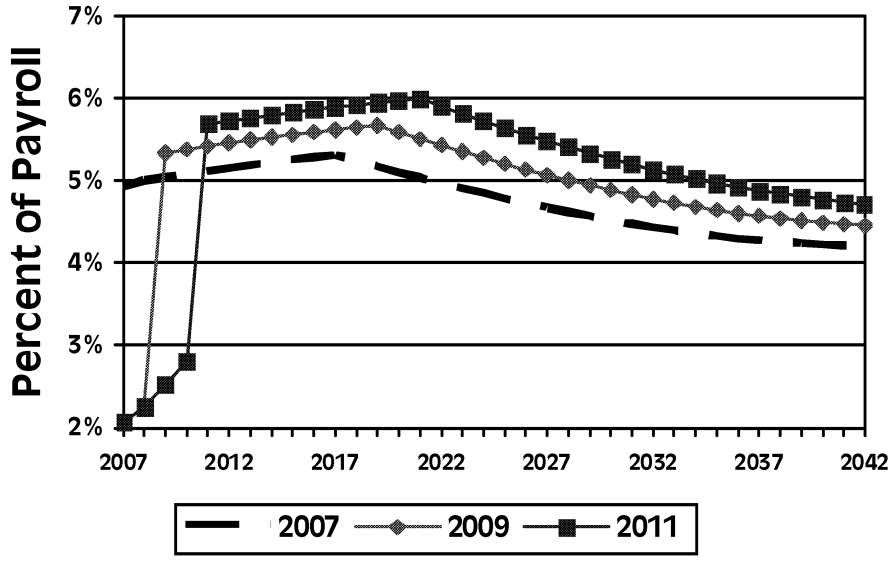
10 N.C. Gen. Stat. § 147-69.4 (2007)
11 Minn. Stat. §471.6175 (2008)
12 Va. Code Ann. § 15.2-1544 (2007)
13 Miller, Girard "Needed: Stronger OPEB Laws" Governing, August 2008
14 *id.* and Center for State and Local government Excellence Issue Brief "
15 GFOA, "Need for Considerable Caution in regard to OPEB Bonds" 2007

4. Consider, upon consultation with actuaries and other experts, limiting the planned funded ratio to an amount suggested by actuarial and other analysis.

Others have expressed similar reservations about the issuance of bonds to pre-fund OPEB's and have suggested a larger economic view be considered so that bonds are issued when the equities market is near its lowest expected value. This will of course make it more likely that a bond issuer would win the arbitrage bet and run less risk of being stuck in a situation of negative arbitrage where they owe more on their debt service then the equities portfolio is making[16].

Texas' OPEB responsibility is concentrated in the health care benefits that are provided to retirees of the Teacher Retirement System, the Employees Retirement System and the UT and Texas A&M University Systems. Each system receives a biennial appropriation and re-evaluates the appropriateness of their health insurance plans at that time. Additionally each system has infrastructure in place as part of their current benefits plan to manage any OPEB pre-funding that the legislature may choose to provide. Initiating prefunding sooner rather than later saves money in the long run and can help keep contribution rates lower than they otherwise would be.

Advanced funding of pension or retiree medical plans becomes more expensive as the process is delayed and active members continue to accrue benefits. The chart below reflects actuarial estimates of the annually required contributions required for funding the TRS-Care health benefit provided to retired teachers. Each year the process is delayed increases the starting contribution requirement by approximately 0.20% and extends the time until the unfunded accrued actuarial liability is funded. While this data is specific to TRS-Care the principle is the same: advanced funding saves money in the long term.



16 Miller, Girard "Bonding with OPEB: Look before you leap" Governing , July 1, 2007.

RECOMMENDATIONS

- Many states have enacted legislation creating trust funds and allowing for long term prudent investment to help facilitate the pre-funding of OPEB[17]. The Legislature should create a statewide OPEB trust fund to invest any prefunding that local governments may decide is necessary for the management of their OPEB liability. This trust fund could be created as a brand new entity with an independent board of trustees, or it could also be created in the office of the Comptroller and held by the Treasury Safekeeping Trust Corporation.

- The state should also consider beginning to prefund future OPEB costs. Any money set aside today will have an opportunity to begin earning investment income and will eventually cost the state less in the long run.

- Local governments should begin the process of assessing their OPEB liabilities and their health benefit plans. They should look for ways to contain costs. Local governments should improve efficiency while being mindful of the importance of the health insurance benefit, both to the individual and to the state as a whole (in terms of the cost of uninsured citizens and uncompensated health care).

- The Legislature should also carefully weigh if it is in local governments', residents', taxpayers' and retirees' best interests for the legislature to provide authority for the issuance of OPEB bonds to the local governments of the state.

17 Snell, Ronald K. "Pensions and Retirement Plan Enactments in 2007 State Legislatures" NCSL, October 2007.

CHARGE # 3

ACTUARIAL PRACTICE

Study the impact of actuaries on public pension plans, and evaluate the need for legislation to ensure appropriate actuarial assumptions, actuarial audits or regulation of actuaries contracting with state pension plans.

BACKGROUND

Actuaries provide pension plans with the underlying assumptions and computations that make the basis for all the decisions a board of trustees must make regarding the funding, benefit design, cost and administration of a plan. Many pension plans that have found themselves in financial trouble can look back to poor actuarial information and advice as a precipitating factor of their crises. It is therefore critically important that actuarial work be consistently reliable and of the highest quality to preserve the integrity and success of pension plans in the state.

FINDINGS

Regulation of Actuaries

Actuaries are not licensed by the state of Texas or registered by any entity in the state of Texas. This absence of state regulation has not led to any uncertainty or inconsistency regarding the qualifications of actuaries because there is robust self-regulation in the field. However, current law does require that an actuary preparing an actuarial valuation must be a Fellow of the Society of Actuaries(FSA), a Member of the American Academy of Actuaries, or an Enrolled Actuary (EA), under the Employee Retirement Income Security Act of 1974[18]. Becoming an Fellow of the Society of Actuaries or an Enrolled Actuary requires the satisfaction of basic education and experience requirements as of the time those designations are attained. But these designations do not, in and of themselves, require the satisfaction of any continuing education relating to public retirement systems.

The American Academy of Actuaries has recently amended its Qualification Standards to include both (a) basic education and experience requirements, such as being a Fellow of the Society of Actuaries or Enrolled Actuary, and (b) continuing education requirements relevant to the actuarial services provided by the actuary. It would be beneficial if the Code were modified to require actuaries complete this specialized continuing education applicable to public retirement systems, such as those of the Academy, rather than merely requiring the basic education and experience requirements such as being a Fellow of the Society of Actuaries or an Enrolled Actuary.

Actuarial Audits

HB 2446 was passed by the 80th legislature and requires that all pension plans with assets of greater than 100 million dollars (currently 22 plans) perform an actuarial audit every five years. This should help these larger plans identify any actuarial work that could lead to trouble in the future. It has been recommend that the statute be more specific in outlining the basic findings that an actuarial audit should make, including whether the actuarial assumptions and methods comply with relevant Actuarial Standards of Practice issued by the Actuarial Standards Board, the potential impact on obligations and contribution rates if future experience deviates from the actuarial assumptions in ways that the auditing actuary believes are likely, and whether the auditing actuary was able to replicate the actuarial values presented in the actuarial valuation. There are an additional 37 plans with assets greater than 10 million that could also benefit from having their actuarial work audited.

18 Tex. Gov't Code § 802.101(d)

Actuarial Assumptions

Overly optimistic actuarial assumptions can lead to underfunding that endangers future benefits. These assumptions can lead to benefit increases being approved without proper funding. Actuarial audits will help identify any unrealistic assumptions and the requirements that actuaries be members of the national professional organizations will encourage the adoption of appropriate assumptions. Another approach to normalizing actuarial assumptions is to compile a survey of the current actuarial assumptions made by the pension plans in the state. This would allow actuaries to defend their proposed actuarial assumptions and deflect any pressure they may feel from members, management or the board of trustees to make unrealistic actuarial assumptions.

RECOMMENDATIONS

- Further state regulation of the actuarial profession is unnecessary in light of the requirements placed on actuaries to be registered with national organizations to contract with public pension plans.

- The requirements of actuarial audits for certain pension plans may be expanded to include plans with assets greater than $10 million. The requirements should be clarified to specify at what point after a plan assets grow greater than $100 million an audit is required.

- A survey of actuarial assumptions would help identify any plans that have adopted assumptions outside the reasonable range and provide information to actuaries, trustees, and beneficiaries on the reasonable actuarial assumptions being made across the state.

CHARGE # 4

TMRS RETURN TO WORK

Analyze the impact of allowing a retiree to return to work in the Texas Municipal Retirement System (TMRS).

BACKGROUND

Debate regarding the prohibition on Texas Municipal Retirement System (TMRS) retirees from returning to work after retirement has persisted for several legislative sessions. Currently, if a TMRS member retires from a member city, that employee cannot return to work for that same city without having his or her annuity suspended. They could however go to work for another TMRS member city without having their annuity suspended. The House Committee on Pensions and Investments of the 78th legislature was charged with studying the risks, benefits, and impact associated with the "retire in place" practice as it related to the four statewide pension systems. That committee's recommendation was to allow TMRS retirees to return to work for the same city without having their benefit suspended. This recommendation was consistent with the practice of the other three statewide retirement systems.

FINDINGS

The Texas Municipal Retirement System is a hybrid pension plan that provides a defined benefit based on the cash balance of a member's and their employer's contributions at the time of retirement, rather than calculating the lifetime monthly annuity based on a formula determined by years of service and average salary. When a retiree returned to work they would start a new account, just as if they were a new employee. This new account and its funding would be completely independent of any prior employment. This plan design and the fact that TMRS does not provide system wide health insurance allows it to avoid many of the issues that have befallen other plans when they see a spike in retirees returning to work.

Those in favor of allowing a retiree to return to work advanced several arguments in support of a change in the statute. Cities claim that they have difficulty retaining talented employees because under current law an employee can retire, begin collecting their annuity, and then go back to work for a different city. Cities have also gone as far as hiring former employees as contractors, at great expense, in order to retain their expertise. There is also a fear that the impending retirement of many members of the "baby boom" generation will lead to a loss of experience that could be mitigated if those retirees were allowed to return to work. Employees who retired and then decided to return to work would be able to do so without the suspension of the retirement benefit that they had earned.

Opponents of allowing retirees to return to work contend that this practice will limit younger employees' opportunity for advancement and adversely affect city succession planning. The financial effect and actuarial effect on the system and its member cities has also been cited as reason for not changing the law. However, allowing return to work will likely have a negligible effect on the system because of the cash-balance nature of the annuity calculation.

Allowing a retiree to return to work to the city from which they retired can provide advantages to both retirees and cities. A retiree who faces a change in their financial situation and desires to return to work would not face any penalty in seeking employment with the city that they retired from, and presumably are most familiar with. Cities will also benefit from more experienced employees applying for positions. Removing the annuity suspension provision for retirees should not be

considered a mandate, instruction, or recommendation to cities to rehire retirees. It is intended to give cities more options in fulfilling there employee needs, and they will continue to retain complete control of their hiring process. In every circumstance a city retains independent authority to hire whomever they wish for their open positions and they should take into consideration their succession planning.

Federal Tax Considerations

TMRS is a qualified pension plan under Section 401(a) of the Internal Revenue Code making it eligible for favorable tax treatment. Most significantly this means that an employee's contribution is made tax free and no income tax is paid on his or her deposits, the city's matching deposits, or the investment income on those funds. This tax qualification also allows an employee to continue this tax deferral by rolling funds into an IRA or other eligible retirement plan if they do not retire from the TMRS system. Failure to meet the requirements of the Internal Revenue Code can result in disqualification by the Internal Revenue Service and a loss of these favorable tax benefits.

One of the requirements of Section 401(a) of the Internal Revenue Code is that pension plans not allow in-service distributions prior to "normal retirement age." An in-service distribution occurs when a distribution from the pension funds is paid before the employee retires while the employee is still working for their employer, or when there is not a bona fide severance from employment. It is clear that a severance from employment will occur if an employee severs his or her employment with their current employer maintaining the plan and becomes employed by an unrelated employer. It is also clear that a prearranged termination and rehire by the same employer will not be considered a bona fide severance from employment. Thus, if an employee of a city resigns, retires from TMRS before reaching normal retirement age and is rehired by the city in a prearranged manner, payment of the TMRS annuity to the employee may be considered to be an impermissible in-service distribution that could disqualify the city's plan, subjecting it and its employees to adverse tax consequences. Any legislation that allows TMRS return to work must take these tax issues into consideration to ensure that no pre-arranged retire and rehire takes place that would endanger the tax benefits the plan currently qualifies for. The Texas County and District Retirement System has set up a system that could be replicated to ensure that no in-service distributions are made in violation of the tax code.

RECOMMENDATIONS

- We concur in the 78th legislature's recommendation that the statue governing TMRS should be amended to allow a retiree to return to work to the city they retired from without suspension of their annuity as long as the tax exempt status of the retirement systems is not jeopardized by such a change.

CHARGE # 5

BOARD GOVERNANCE

Assess the representational proportion of each of the stakeholder groups, eligibility requirements, qualifications, and selection and election procedures of the boards of trustees of the retirement systems.

BACKGROUND

The boards of trustees of pension plans are charged with a fiduciary duty to act solely for the benefit of the members of the pension system. Questions have been raised regarding the selection process for members of the boards of trustees, their qualifications and the potential for conflicts of interest. In the 80th Legislature several bills were referred to the committee that would have modified the qualifications for serving on a board of trustees and/or the procedure for selecting or electing board members. This proposed legislation included a prohibition of a registered lobbyist from serving as a board member, a modification of the hybrid election and appointment procedure for the TRS board and reserving a place on the ERS board for a retiree.

FINDINGS

Each statewide retirement system has different selection procedures for their board of trustees mandated by their enabling statute. The Fire Fighters' Pension commissioner oversees 121 Firefighter pension plans covering 80 volunteer fire departments and 41 paid fire departments. The paid fire department plans all have the same board makeup and selection process. The volunteer fire departments all have the same board makeup and selection process, but their rules differ from the paid departments. There are also many independent public pension plans with varying board member configurations and selection processes based on their respective charters and enabling legislation.

Texas Municipal Retirement System (TMRS)

The TMRS Board of Trustees consists of six members appointed by the Governor with the advice and consent of the Senate. The trustees serve staggered six year terms with two new trustees being appointed in February of each odd numbered year. The Board is evenly divided between three "executive" trustees and three "employee" trustees. Executive trustees must be a chief executive officer, chief finance officer, or other officer, executive, or department head of a participating municipality.[19] An employee trustee must be an employee of a participating municipality. A municipality cannot have more than one employee serve on the board of trustees at a time. The TMRS board is governed by an ethics policy that addresses conflicts of interest as well as a prohibition on "revolving door" employment by trustees and key management staff.

Texas County and District Retirement System (TCDRS)

The TCDRS Board of Trustees consists of nine members appointed by the Governor with the advice and consent of the Senate. The trustees serve staggered six year terms with three terms expiring at the end of each odd numbered year. All of the trustees must be contributing members or retirees of TCDRS. The TCDRS board is governed by an ethics policy that addresses conflicts of interest as well as a prohibition on "revolving door" employment by trustees and key management staff.

19 Tex. Gov. Code 855.003(a)

Employees Retirement System (ERS)

The ERS Board of Trustees consists of six members. Three trustees are appointed, one each by the Governor, the Speaker of the House, and the Chief Justice of the Texas Supreme Court. Three are elected by ERS members and retirees. Both appointed and elected trustees serve staggered six-year terms with the terms of appointees expiring on August 31 of each even-numbered year and those of elected members on August 31 of each odd-number year. Elected members must be active employees and not be employed by an agency or department with which another trustee is employed.

Teacher Retirement System (TRS)

The TRS Board of Trustees consists of nine members who are appointed by the Governor to staggered terms of six years. Three trustees are directly appointed by the Governor and must "…have demonstrated financial expertise, … worked in private business or industry, and … have broad investment experience, preferably in investment of pension funds."[20] Two trustees are appointed by the Governor from a list prepared by the State Board of Education. Two trustees are appointed by the Governor from public school district active member nominees. One trustee is appointed by the Governor from higher education active member nominees. One trustee is appointed by the Governor from the retired member nominees. The TRS board and all employees are governed by a code of ethics that forbid conflicts of interest. Additionally the TRS has a code of ethics for consultants, agents, financial providers and brokers.

Best Practices in Board Governance

The Stanford Institutional Investors' Forum created a Committee on Fund Governance which released a report on Best Practice Principles in May of 2007. These principles included recommendations that trustees be selected in way that provides accountability to plan beneficiaries; ensures that trustees have relevant expertise; and, once selected, ensures that trustees endeavor to acquire the skills and knowledge to serve as fiduciaries.[21]

Currently the only board members who are required to have special experience and expertise are the independent trustees appointed by the Governor to the TRS board. Retirement systems have however established advisory committees to their boards to provide this expertise. The ERS has an Investment Advisory Committee; the TMRS has an advisory committee on retirement and a newly formed Legislative Stakeholder Committee.

There is currently no educational requirement to serve on a pension system's board of trustees like there is for managing other public money under the Public Funds Investment Act.

20 Tex. Gov't Code 825.002(b)

21 Committee on Fund Governance: Best Practice Principles, The Stanford Institutional Investors' Forum, May 31, 2007.

However all of the statewide systems provide training for their board members and the Office of the Firefighter's Pension Commissioner provides educational opportunities for board members of the plans it oversees.

RECOMMENDATIONS

- Requiring trustees to have particular knowledge or experience does not assure positive results, nor does the absence of such requirements lead to inferior results. A board's ultimate success depends largely on factors that are difficult, if not impossible, to legislate, e.g., judgment, integrity, and commitment. However the committee believes that pension plans can be strengthened by providing a more direct voice for members and beneficiaries on the boards of trustees.

- During the 80th legislative session the committee on Pensions and Investments favorably reported HB 1689 that provided for direct election of trustees to the TRS board by active members and retired members of the system. The committee continues to be supportive of such legislation and recommend that it be enacted.

- The committee finds that the ineligibility of a retiree serving on the ERS board should be re-examined and either retirees should be eligible to serve in the three elected positions, or one of the three elected positions should be reserved for a retired member of the system.

CHARGE # 6

LECOSRF

Examine eligibility criteria for membership and possible inclusion of additional employees in the Law Enforcement and Custodial Officers Supplemental Retirement Fund (LECOSRF). Evaluate the effect of diversion of funds from the auto registration fee on the unfunded liability of the LECOSRF, and explore the possibility of creating a similar supplemental retirement program as part of the Teacher Retirement System (TRS) of Texas for those members performing law enforcement duties.

BACKGROUND

The Law Enforcement and Custodial Officers Special Retirement Fund (LECOSRF) is a special retirement fund administered by the Employees Retirement System (ERS) that provides an additional pension benefit that is roughly 18% greater than the regular state employee pension benefit provided by ERS. Additionally members of the LECOSRF are eligible for earlier retirement. This financial incentive makes employees want to become members of the LECOSRF fund and makes employers want to be able offer such a great benefit to help hire and retain employees.

There are currently three types of employees included in the LECOSRF:

1. A "law enforcement officer" who has been commissioned by the Texas Department of Public Safety, Texas Alcoholic Beverage Commission, Texas Parks and Wildlife Department, or the Office of Inspector General at the Texas Youth Commission, and whose commission is recognized by the Texas Commission on Law Enforcement Officers Standards and Education.

2. A "custodial officer" for the Texas Department of Criminal Justice – Institutional Division (TDCJ), certified as having normal duties that require you to have direct contact with inmates.

3. A "parole officer or caseworker" employed and certified by the Board of Pardons and Paroles or the TDCJ.

In the 80th legislative session, five bills were filed in the Texas House and referred to the Committee on Pensions and Investments seeking to add various groups to the LECOSRF fund including: parole support employees of the TDCJ, law enforcement officers employed by the Attorney General; Juvenile Correctional Officers (JCO) employed by the Texas Youth Commission; law enforcement officers employed by institutions of higher education; and rescue specialist firefighters employed by the adjutant general at national guard facilities.

FINDINGS

The LECOSRF fund was established in recognition of the difficult and dangerous job that law enforcement officers and custodial officers at our state prison facilities have. It was originally funded by dedicating a portion of motor vehicle registration fees to the fund. When the statutory funding direction to the ERS was first enacted in 1981, the original language declared that 75 cents from each vehicle registration fee was to be put into the law enforcement and custodial officer retirement fund. In 1983, when the section was amended, the language that put 75 cents into the fund still remained on the books. In 1989, the statute was re-codified into the Government Code and the language did not call for the fund to be supplemented with vehicle registration fees. In 1991, language was put back in that called for the funds to be supplemented with vehicle registration fees and other appropriations made by the Legislature. Finally, in 1993, this section was again amended to its current version to remove any language that called for the fund to be supplemented with vehicle registration fees.[22] The vehicle registration fee is still collected and provided net revenue of

22 Tex. Gov't Code Sec. 815.317

$ 1,000,671,687.95 in fiscal year 2007.[23] The LECOSRF fund was appropriated $21,441,463 for fiscal year 2008, and $21,655,877 for fiscal year 2009. These appropriated amounts were less than the annually required contribution and not enough to keep the LECOSRF fund actuarially sound. Prior to the past biennium the LECOSRF fund had only received dedicated funds from the vehicle registration fee and had accumulated enough reserves to be actuarially sound and pay for its actuarially accrued liabilities. The diversion of these previously dedicated funds has caused this to be the first time the fund has been below 100 percent funded.

State law prohibits a pension benefits increase and an increase in actuarial liability to a pension system unless the system is actuarially sound. Adding employees to the membership group of LECOSRF would break this safeguard provision that forbids unsupportable benefits. Not only would adding employees to the LECOSRF group violate this law because the LECSORF fund is actuarially unsound, the addition of employees in the LECOSRF fund also allows them to retire earlier which would increase the actuarial liability of the main ERS fund which is also less than 100 percent funded and actuarially unsound.

There is no doubt that the licensed peace officers that are members of the Teacher Retirement System by virtue of their employment by a local school district or by an institute of higher education face many of the same risks as the officers in the fund. Additionally school districts and universities are in competition to retain qualified officers and allow officers to retire before they become too old to be effective. The evidence is also clear that Junior Correctional Officers, by virtue of their close contact with offenders in the TYC, suffer injuries at a higher rate than all other state employees. No one denies the dangerous nature of their job and the service they provide the state.

There is currently no reliable census of the Peace Officers that are members of the Teacher Retirement System (TRS), making it difficult to estimate the cost of providing them an increased benefit or a retirement at 20 years of service, either through the LECOSRF fund or in a separate fund that could be created and managed by the pension plan that they are currently members of, the TRS. Additionally, while the salaries of the current members of LECOSRF are set by the legislature, the salaries of officers working for school districts and universities are set locally by school boards or boards of regents. If there is a difficulty in retaining experienced officers, these local bodies are better positioned than the legislature to adjust salary and benefits, including defined contribution retirement benefits that could supplement the defined benefit being earned through TRS, much like the LECOSRF supplements the ERS benefit.

RECOMMENDATIONS

- Any adjustment to the benefits provided JCO's should come as part of a larger effort to reform the TYC and professionalize the position of JCO. Prospective adjustments should be made in the context of the needs of that agency with proper considerations about funding. Additionally, an increase in salary would automatically have the effect of increasing pension benefits because ERS' defined benefit is based on salary.

23 Office of the Comptroller of Public Accounts "Texas Annual Cash Report Fiscal Year 2007" revenue object 3014.

- The LECOSRF fund and the ERS fund as a whole are actuarially unsound at this time. Therefore it would be illegal to increase their liabilities without making an appropriation to pay for it. If funds are not specifically re-dedicated from the motor vehicle registration fee as they were originally intended, the Appropriations Committee should, at a minimum, provide the actuarially required contribution (as recommended in Charge 1 of this report) to the LECOSRF fund and the ERS fund in order to correctly follow "level percent of payroll" financing.

CHARGE # 7

PHARMACY BENEFIT MANAGEMENT CONTRACTS

(Joint charge with House Committee on Government Reform)

Evaluate and make recommendations, if necessary, regarding state contracts with pharmacy benefit managers. Assess the feasibility of combining prescription drug programs of state health insurance programs. All recommendations should take into consideration any budgetary impacts.

Background: Pharmacy Benefit Managers (PBMs) explained.

Over the last 30 years, as the costs of prescription drugs have grown, many public and private health benefit plan sponsors have turned to pharmacy benefit managers, or PBMs, to control these costs. PBMs are companies that offer a set of core administrative and clinical services to contain drug expenditures while improving the quality of drug benefits.[24] Some of the administrative services provided by PBMs include establishing a network of participating retail pharmacies and negotiating discounts for drugs purchased in that network; negotiating drug discounts and rebates from pharmaceutical manufacturers; and providing high volume, automated mail order pharmacy services for maintenance medications. Some of the clinical benefits provided by PBMs include the development of drug formularies, a list of approved prescription drugs, for use by a plan's beneficiaries; promoting the use of generic drugs over more expensive brand drugs; and providing disease management services to reduce the overall costs for patients with chronic illnesses such as asthma, diabetes, and hypertension. In addition to these activities, PBMs also provide their clients with claims administration for their prescription drug plans.

PBMs are generally credited for lowering their clients' prescription drug costs. Several studies, including ones by the Government Accountability Office[25], Congressional Budget Office[26], and Federal Trade Commission[27], have concluded that PBMs help lower clients' prescription drug costs. In 2005 in Texas, $9 billion in prescription drug expenditures covering nearly 12.8 million individuals were managed by PBMs.[28] According to a study conducted by the Perryman Group, PBMs helped Texans save nearly $3.04 billion in prescription costs in 2005, and another estimated $4.8 billion in 2006.[29]

Approximately 60 PBMs operate in the United States. The majority of market share is consumed by three publicly-traded companies. These companies are Medco Health Solutions (NYSE: MHS), CVS Caremark (NYSE: CVS), and Express Scripts Incorporated (NASDAQ: ESRX). Each of these companies does business in Texas.

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24 Health Policy Alternatives., Inc., *Pharmacy Benefit Managers (PBMs): Tools for Managing Drug Benefit Costs, Quality, and Safety*, August 2003, page 3.

25 "The three PBMs we examined achieved savings for FEHBP (Federal Employees' Health Benefit Plan) - participating health plans by using three key approaches: obtaining drug price discounts from retail pharmacies and dispensing drugs at lower costs through their mail-order pharmacies; passing on certain manufacturer rebates to the plans; and using intervention techniques that reduce utilization of certain drugs or substitute other, less costly drugs." United States General Accounting Office, *Federal Employees' Health Benefits: Effects of Using Pharmacy Benefit Managers on Health Plans, Enrollees, and Pharmacies*, January 2003, page 4.

26 "The degree to which PBMs could effectively control Medicare drug costs would depend on their being allowed to and encouraged to aggressively use the various tools at their disposal." Congressional Budget Office, *Issues in Designing a Precription Drug Benefit for Medicare*, October 2002, page xiii.

27 "To date, empirical evidence suggests that PBMs have saved costs for payors." U.S. Federal Trade Commission and U.S. Department of Justice, *Improving Health Care: A Dose of Competition*, July 2004, page 20.

28 The Perryman Group, *The Impact of Pharmacy Benefit Managers (PBMs) on the Texas Economy: An Assessment of Current and Projected Benefits and the Consequences of Various Potential Regulations*, October 2006, page 10.

29 The Perryman Group, pages ii, 10.

Background: State of Texas contracts with PBMs.

The Employees Retirement System (ERS), Teacher Retirement System (TRS), University of Texas System, and Texas A&M University System, each sponsor PBM contracts. ERS recently signed a contract with CVS Caremark that began on 1 September 2008. Before then, ERS contracted with Medco Health Solutions. TRS has two PBM contacts, one with Medco for active teachers (TRS - Active Care), the other with CVS Caremark for retired teachers (TRS - Care). The University of Texas and the Texas A&M University systems each have contracts with Medco and CVS Caremark respectively. The chart, *Stat PBM Contracts*, highlights the contracts maintained by each agency, how many individuals are covered, and the associated costs.

State PBM Contracts, FY 2008

Agency	PBM	Number of Members	Plan Cost
Employees Retirement System	CVS Caremark	450,542	$375,412,136
Teacher Retirement System - Active Care	Medco	252,739	$163,265,434
Teacher Retirement System - Care	CVS Caremark	158,945	$334,409,273
University of Texas System	Medco	147,614	
Texas A&M System	CVS Caremark	34,092	$35,272,843

All agencies procure their pharmacy benefit manager contracts through a competitive bidding process. Each agency issues a request for proposal (RFP) that specifies the types of service and coverage required. PBMs, in turn, submit their bids to the agencies' RFPs. Once received, the agencies evaluate the PBM's bids to select those that best meet the evaluation criteria specified in the RFP, including cost savings relative to other proposals.

Over the past year two agencies, TRS and ERS, have issued requests for proposals for their pharmacy benefit manager contracts. In 2007 TRS received nine bids to its RFP for the Active Care contract. Of the nine bids received, two, Medco and Caremark, were selected as the finalists. The board recommended that the contract be awarded to the incumbent PBM, Medco. Also in 2007, ERS issued an RFP for its PBM contract. The agency received four bids. Two of the bids were selected as finalists. In the end, the ERS board approved a contract with CVS/Caremark starting 1 September 2008. The A&M System is in the process of drafting an RFP for issuance within the next year. The UT System has recently renegotiated its PBM contract effective 1 September 2008.

Background: Policy Issues and Questions Surrounding State PBM Contracts.

Pharmacy benefit managers are not without controversy. Over the past decade several groups have criticized PBMs for engaging in unfair, deceitful, or otherwise deceptive trade practices. Some have alleged that PBMs pocketed rebate revenues without informing clients, or reclassified, and thereby retained, rebates as alternative fees for services provided.[30] PBMs have also been accused of

30 National Community Pharmacy Association, "10 Questions that Benefits Managers Should Ask Their PBM," 14

engaging in the practice of "differential or spread pricing", where the manager charges a plan a higher amount for a drug, but reimburses a pharmacy a lesser amount for that drug, thereby making a profit on the difference, or spread, between the two prices paid.[31] In addition to these practices, PBMs have also been accused of directing clients towards expensive brand drugs over cheaper generic alternatives. Critics maintain that these types of misleading practices "resulted in higher costs to plan sponsors and significant profits for some PBMs, while payers struggled to manage costs and plan members coped with rising out-of-pocket expenses."[32]

Against the backdrop of allegations regarding pharmacy benefit manager practices, several states attorneys general have filed lawsuits against PBMs. The State of Texas has been involved in four separate actions against PBMs.

Texas Attorney General PBM Cases

State of Texas v. CaremarkRx, LLC, Caremark LLC and Caremark PCS, LLC. Settled in 2008. The Attorney General's office entered into a multi-state settlement with Caremark regarding the company's practice of drug switching, where the company switched patients to different brand-name cholesterol drugs. The settlement requires Caremark to inform patients and doctors about the effects a drug switch will have on the patient's co-payment, and the financial payments, if any, Caremark may realize for initiating the switch. Under the terms of this agreement, Caremark will pay Texas $2.5 million to promote lower drug costs for low-income, elderly or disabled individuals, and provide consumer education.

In re. Express Scripts, Inc. Settled in 2008. Texas, along with 28 other states, entered into an assurance of voluntary compliance agreement with Express Scripts regarding the company's practice of drug switching and its communications with clients. The settlement requires Express Scripts to inform patients and doctors about the effects such switches will have on the patient's co-payments, and the financial incentives the PBM may realize for initiating the switch. Express Scripts agreed to pay Texas $728,000 as part of this agreement.

U.S. & State of Texas, et al. ex rel. Janaki Ramadoss v. Caremark Inc., et. al. Filed in 2005. The Attorney General's Office entered into a lawsuit against Caremark along with several other states and the federal government alleging that the company avoided reimbursing Medicaid for prescription drug payments for individuals who were insured by its prescription drug plan. If an individual were covered by Medicaid and Caremark, and Medicaid paid for that individual's prescription, then federal and state law require Caremark to reimburse Medicaid for that expense. This case is still in litigation.

State of Texas v. Medco Health Solutions, Inc. Settled in 2004. Texas Joined 19 other states in a settlement with Medco for falsely representing to patients, health care plans, and doctors that cost savings would be realized if the doctors switched some patients to different prescription drugs. The switches resulted in greater profits to Medco, and increased costs to patients and plans due to follow-up doctor visits and laboratory tests when the patients used the new drugs. Texas received $2.5 million of the $29 million settlement.

Sources: Attorney General of Texas, Pending Cases Against Pharmacy Benefit Managers as of February 13, 2008; Attorney General of Texas, Company to Pay $9.3 million, offer restitution program for certain consumers, Press Release, 28 May 2008.

The text box, *Texas Attorney General PBM Cases*, describes each case in detail. Although the State of Texas has participated in several multi-state settlements or cases against PBMs, none of the cases

July 2004, www.ncpanet.org/media/releases/2004/10_questions_that_benefits_managers_should_07-14-2004.php.
31 National Community Pharmacy Association, "10 Questions that Benefits Managers Should Ask Their PBM."
32 John D. Jones, "The Truth About Transparency", *Pharmacy Benefit Insider Newsletter*, September 2004, www.rxsolutions.com/c/pbi/pbi_view.asp?docid=492, accessed 3 April 2007.

involved a specific PBM contract maintained by ERS, TRS, or the university systems. Furthermore, the State of Texas has not taken any legal action against a pharmacy benefit manager under contract with a state agency or university system for any breaches of contract, or other malfeasances.

Critics of state PBM contracts point towards the state's settlements as an indication of a pattern and practice of PBM malfeasance, and justification for the regulation of agencies' contracting practices. During the 80th Legislative Session, three bills were introduced to regulate the State of Texas' PBM contracts.[33] None passed. During the joint hearing between the House Committees on Government Reform and Pensions and Investments, several key questions were raised regarding the state's PBM contracts. Those questions were as follows:

1. Should state agencies be required, by statute, to engage in certain types of contracts with pharmacy benefit managers?
2. Should the State consider consolidating the procurement of pharmacy benefit management services into a single contract?
3. Should the Legislature require that all rebate revenues received by pharmacy benefit managers be remitted to the contracting agency?
4. Do agencies' contracts include sufficient provisions to allow for the appropriate audits to ensure PBMs' compliance, including terms regarding rebates?
5. Do the state's contracts allow the PBMs to steer clients towards more expensive drugs, and towards mail order facilities operated by the PBM?
6. Should the state's contracts include provisions requiring that the PBM serve as a fiduciary?
7. Do the agencies' have the expertise necessary to develop and draft PBM contracts that best reflect the state's interest?

Each of these questions are addressed in the subsequent issues.

Issue 1: Requiring, by statute, the use of certain contracting standards for state PBM contracts may unnecessarily limit agencies' flexibility to leverage competition within the PBM market to the state's advantage.

Background:

PBMs are commonly faulted for lacking transparency. Opaque business practices coupled with a profit incentive, give rise to concerns regarding how -- or even if -- a PBM may satisfy a clients' interest in maximizing savings for their prescription drug plans. The perceived lack of transparency creates two potential problems for the client. First, the client may not know if they are receiving all of the discounts and rebates pledged in their PBM contract. Second, the lack of transparency precludes the client from being able to make cost comparisons--commonly referred to as "apples-to-

33 These bills included HB 3280, relating to treatment of pharmaceutical services provided through specialty and mail order pharmacy services operated under contracts between governmental entities and pharmacy benefit managers; HB 3454, relating to contracts between governmental entities and pharmacy benefit managers; and SB 1834, relating to treatment of pharmaceutical services provided through specialty and mail order pharmacy services operated under contracts between governmental entities and pharmacy benefit managers.

apples" -- when shopping for PBM plans. Consequently, in the absence of full, consistent disclosure of some PBMs' business practices, some clients may be unable to find the truly lowest cost plan available.

In an effort to bring more transparency to PBM contracts the Pharmaceutical Coalition of the Human Resource Policy Association, a group of 58 private sector employers within the 250-member strong Association, created the Transparency in Pharmaceutical Purchasing Solutions (TIPPS) standards in 2005.[34] These standards require greater disclosures from PBMs regarding drug acquisition costs, disclosure and sharing of rebate revenues from pharmaceutical manufacturers, and the right to engage in a full audit of the PBM. The text box, *2008 TIPPS Standards*, describes the standards in detail.

The TIPPS were created by the Pharmaceutical Coalition to provide a uniform set of cost-effective, transparency standards for PBMs to meet when providing services to Coalition members.[35] Since 2005, those PBMs willing to meet these standards may be certified by the Coalition.[36]

2008 TIPPS Standards

1. Acquisition Cost for Retail Payments: Charge a Coalition member no more than the amount that it pays the pharmacies in its retail network for brand and generic drugs.

2. Acquisition-Based Pricing for Mail Service Claims: Charge a Coalition member the acquisition cost of drugs at mail order pharmacies, plus a dispensing fee, based on actual inventory cost (AAC) or wholesale acquisition cost (WAC).

3. Pass Through of Pharmaceutical Revenue: Pass through any and all pharmaceutical manufacturer revenue that the Coalition member's utilization enables the PBM to earn.

4. Specialty Pharmacy: Provide all transparency standards as described above for specialty pharmacy products.

5. Plan Management and Consumer Engagement: Provide decision support tools, including online formulary tools, price comparison functionality, and agree to apply all credits including rebates at the point of sale.

6. Right to Audit: Grant a Coalition member full rights to audit their claims, the PBM's pharmacy contracts, utilization management clinical criteria, and any and all pharmaceutical manufacturer contracts and mail service purchasing invoices related to the Coalition member's contract to ensure compliance.

Source: Pharmaceutical Coalition of the HR Policy Association, http://www.pharmacoalition.org/TIPPS_Transparency.aspx

34 The Human Resource Policy Association is an association for chief human resources officers for over 250 large corporations. The Association does not deal exclusively with the issue of pharmacy benefit manager contracts. Other issues of concern to the Association include immigration reform, changes in federal employment and discrimination laws, and, among others, reform of the health care system. (See: www.hrpolicy.org)

35 Transparency in Pharmaceutical Purchasing Solutions (TIPPS) Certification, Pharmaceutical Coalition of the HR Policy Association, www.pharmacoalition.org/TIPPS_Certficiation.aspx, accessed on 3 September 2008.

36 The Pharmaceutical Coalition of the HR Policy Association is not the only organization that certifies PBMs willing to engage in certain practices. The Utilization Accreditation Review Commission, or URAC, is an independent, non-profit organization that accredits health care plans, networks, and, among other health care-related entities, pharmacy benefit managers. URAC's accreditation process requires that PBMs have policies and procedures in place that ensure the disclosure of rebates and pricing structures, and provide for audit arrangements and formulary decision making by the purchaser. URAC's accreditation also requires that PBMs have policies and procedures in place to ensure the protection of customer's health information, accessibility and reliability of information to consumers, and safeguards to ensure that certain financial incentives do not create conflicts of interest. (See: http://www.urac.org/accreditation/faq.aspx#pbm, accessed 4 September 2008)

The certification process allows Coalition members to work with a pre-screened group of PBMs that are willing to adhere to these standards. Participating PBMs are certified on an annual basis by agreeing to comply with the TIPPS standards and to rigorous audit rights to ensure compliance with those standards.[37] In 2008 thirteen PBMs were certified by the Coalition in meeting the TIPPS standards. Both Medco and CVS Caremark, the only PBMs with State of Texas contracts, are TIPPS certified for 2008.

Since their inception in 2005, the TIPPS standards put forth by the Pharmaceutical Coalition of the HR Policy Association have changed. In 2006 additional standards were added. Since then, the TIPPS standards have been streamlined from nine requirements to six.[38] Although the TIPPS standards are recognized as best practices, they are not uniformly employed throughout the private sector. Of the 58 members of the Pharmacy Coalition of the HR Policy Association, only a handful have entered into contracts with PBMs that include all of the TIPPS standards.[39] Although TIPPS were initially designed to assist Coalition members, they are recognized by professionals outside of the HR Policy Association as useful guidelines towards ensuring greater transparency in PBM contracts.

During the 80th Regular Session two bills were introduced that attempted to codify certain TIPPS standards for state PBM contracts. Advocates for these bills claimed that implementing TIPPS standards in statute could save upwards of $100 million per year.[40] Another pointed out that the legislation could save the state between $60 million and $100 million per year for TRS and ERS.[41] Despite these claims, the Legislative Budget Board's fiscal notes for the bills anticipated no fiscal implication to the state.[42]

Findings:

- Increased competition within the PBM industry has improved state sponsors' access to better, more cost-effective prescription drug plans. In an effort to become more competitive, PBMs are willing to offer greater discounts, services, and contract terms that meet the sponsors' interests, including greater transparency. The history of ERS', TRS', and the university systems' use of their competitive bid processes over the past five years indicates that each have leveraged competition within the industry to the state's advantage. Through their respective competitive bidding processes, agencies have secured newer PBM contracts that

37 Background, Pharmaceutical Coalition of the HR Policy Association, www.pharmacoalition.org/background.aspx, accessed on 3 September 2008.
38 http://www.pharmacoalition.org/docs/April%2010%202008%20Mtg%20Presentation.ppt, accessed 3 September 2008.
39 Telephone interview with Marisa Milton, Executive Director of the Pharmaceutical Coalition of the HR Policy Association, 2 September 2008.
40 American Pharmacies, House Must Hear PBM Contract Transparency Bill to Save State As Much as $100 Million Per Year, Press Release, 3 May 2007.
41 Written testimony of Richard Beck, American Pharmacies, to the House Committee on Government Reform, Monday, April 2, 2007.
42 Legislative Budget Board, Fiscal Note for HB 3454, 80th Legislative Session; Legislative Budget Board, Fiscal Note for SB 1834, 80th Legislative Session.

offer deeper discounts, and preferable contract terms, with some including all or most TIPPS standards.

The recent history of ERS' PBM contracts illustrates how agencies have leveraged market competition to the state's advantage. Before September 2008, ERS' prescription drug program was administered by Medco Health Solutions. When ERS entered into this contract with Medco, ERS leveraged its buying power in a competitive market to garner uniquely advantageous contract provisions favorable to the state, [43] and an estimated savings of nearly $50 million.[44] In 2007 ERS re-bid its PBM contract. The agency awarded its contract to CVS Caremark, whose bid included deeper discounts compared to those offered by the incumbent PBM, Medco. The new contract will save ERS and its members $265 million over the next four years. These savings will accrue through greater discounts for retail and mail order drugs, and larger guaranteed rebates.[45] In addition, the terms of the new contract include all of the preferential provisions from the previous contract, including provisions that "equal or exceed the requirements of the RFP."[46] ERS' new contract also incorporates all of the TIPPS transparency standards.

Like ERS, TRS has leveraged competition within the PBM market to its members' advantage. Before 2006, both of the agency's PBM contracts were administered by Medco Health Solutions. In 2006, the agency solicited competitive bids for its retired teacher PBM program, and awarded the contract to CVS Caremark. Medco, concerned for having lost this contract, subsequently offered TRS better terms, including an estimated $13 million in discounts over the next two years, for its active teacher prescription drug program.[47] In late 2007, TRS re-bid its active teacher PBM contract. The agency awarded the contract to Medco, the incumbent PBM. The discounts and rebates offered under this new contract are projected to save TRS' members approximately $65 million between 2009 and 2010.[48]

The Texas A&M System, too, has leveraged market competition to its own advantage. Compared to its previous contract, the System's current contract includes reduced administrative and dispensing fees, and greater discounts for brand and generic drugs.

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43 These provisions included: a prohibition of therapeutic substitution (a form of drug switching); a "most favored nations" clause requiring that the PBM provide ERS with the same terms provided to any similar clients that are more favorable than those provided to ERS; a requirement that members be allowed to choose between retail and mail order pharmacies for the distribution of their prescription drugs; and a requirement ERS reimburse the PBM for only the amount that the PBM pays the retail pharmacy. Employees Retirement System, *Briefing on Prescription Drug Program Prepared for the Honorable William "Bill" Callegari, Chairman House Committee on Government Reform*, 14 September 2007.

44 Legislative Budget Board, *Texas State Government Effectiveness and Efficiency, Selected Issues and Recommendations*, January 2007, pages 114 - 115.

45 Employees Retirement System, *Public Agenda Item: Review of and Action on the Selection of a Vendor to Administer the Prescription Drug Program Under HealthSelect of Texas*, 26 February 2008, page 10.

46 Employees Retirement System, *Public Agenda Item: Review of and Action on the Selection of a Vendor to Administer the Prescription Drug Program Under HealthSelect of Texas*, page 11.

47 Interview with Ronnie Jung, Executive Director, Teacher Retirement System of Texas; Ray Spivey, Governmental Relations, TRS; Betsey Jones, fiscal analyst, TRS, (Hereafter TRS Interview) 1 October 2007.

48 E-mail from Ray Spivey, Governmental Relations, Teacher Retirement System of Texas, to Jeremy Mazur, Office of Representative Callegari, 16 September 2008.

These new contract terms saved the System approximately $3.5 million in FY 2007.[49]

The experience of Texas' agencies indicates that savings are readily realized by leveraging a competitive PBM market. In fact, the new contracts approved by ERS and TRS will save nearly $100 million a year for the next two years.[50] This amount equals the annual savings claimed by advocates for the legislation filed during the 80th Session. In addition, in 2008 the UT System took advantage of the competitive market to renegotiate its PBM contract to achieve savings of over $20 million per year for the next three years. All of the savings were accrued in the absence of legislative direction, and without the implementation of any particular contracting standard. This highlights the importance of allowing agencies the flexibility to adjust to market conditions.

- Most agencies have already considered incorporating some, or all, of the TIPPS standards into their contracts. The table, *State Agency Compliance with 2008 TIPPS Standards*, depicts the extent towards which state agencies have incorporated TIPPS standards into their contracts. ERS' new 2008 contract with CVS Caremark incorporates every applicable TIPPS standard.[51] The agency's previous contract with Medco incorporated a majority of the TIPPS standards as well. In its recent RFP for the Active Care contract, TRS required bidders to explain their compliance with the TIPPS standards. The new TRS - Active Care contract includes four of the TIPPS standards. While the University of Texas System's contract incorporates all of the standards, the Texas A&M System's does not. The reason for this is that when Texas A&M bid for a PBM contract in 2006, one year after the TIPPS standards were introduced in the private sector, it selected a traditional contract arrangement rather than a transparent one because of the greater costs associated with the transparent bids.

49 Legislative Budget Board, *Texas State Government Effectiveness and Efficiency, Selected Issues and Recommendations*, pages 114.

50 ERS' contract will save $265 million over the next four years, which is $66.25 million per year. TRS' contract will save $65 million for FY 2009 and 2010, which is $32.5 million per year. Combined, the new plans will save $98.75 ($66.25 + $32.5) million per year.

51 Letter from Ann Fuelberg, Executive Director, Employees Retirement System, to the Honorable Chuck Hopson, Texas House of Representatives, 8 April 2008, page 2.

State Agency Compliance with 2008 TIPPS Standards

TIPPS Standard (2008)	ERS	TRS - Care	TRS - Active	UT	A&M(1)
Acquisition Cost for Retail Payments: Charge agency no more than the amount that it pays the pharmacies in its retail network for brand and generic drugs.	✓	X	✓	✓	X
Acquisition-Based Pricing for Mail Service Claims: Charge agency the acquisition cost of drugs at mail order pharmacies, plus a dispensing fee, based on actual inventory cost (AAC) or wholesale acquisition cost (WAC).	✓	X	X	✓	X
Pass Through of Pharmaceutical Revenue: Pass through any and all pharmaceutical manufacturer revenue that the agency's utilization enables the PBM to earn.	✓	X	✓(2)	✓	X
Specialty Pharmacy: Provide all transparency standards as described above for specialty pharmacy products.	✓	X	X	✓	X
Plan Management and Consumer Engagement: Provide decision support tools, including online formulary tools, price comparison functionality, and agree to apply all credits including rebates at the point of sale.	✓(3)	✓(3)	✓(3)	✓(3)	✓(3)
Right to Audit: Grant a agency full rights to audit their claims, the PBM's pharmacy contracts, utilization management clinical criteria, and any and all pharmaceutical manufacturer contracts and mail service purchasing invoices related to the Coalition member's contract to ensure compliance.	✓	✓	✓	✓	X(4)

(1) A&M System requested both transparent and traditional bids in its 2006 RFP, but selected a traditional model because it offered greater savings to the plan and its members.
(2) TRS has a revenue sharing agreement with PBM, along with a minimum guarantee.
(3) Provision applies, except rebates are not credited at point of sale.
(4) The A&M System is entitled to audit PBM records that relate directly and primarily to the PBM's obligations as undertaken pursuant to the contract.

Although some agencies have incorporated some, or all of the TIPPS in their contracts, the adoption of these standards alone does not appear to guarantee savings. In fact, as is discussed in detail in Issue 3 of this Charge, requiring full transparency potentially incurs certain risks that may cost the state and the plans' beneficiaries. ERS, TRS, and the university systems have, however, realized and documented actual savings to the state and their beneficiaries through their leveraging of the PBM market.

- Regulating state PBM contracts to require implementation of transparency standards similar to the TIPPS may not ensure savings to the state, and could limit the competitive PBM market already available to state agencies. Experiences of other states suggests that regulating PBM contracts may limit the number of PBMs willing to participate in local markets, thereby limiting the competitive environment. The states of Maine, South Dakota, North Dakota and the District of Columbia have all implemented laws requiring greater

transparency in PBM contracts.[52] As a result of the regulations adopted, several PBMs have withdrawn or withheld their business from these markets. Since Maine adopted its regulations in 2003, one major PBM, Medco, has declined to participate in state RFPs on grounds of the presence of regulation.[53] After South Dakota passed its law in 2004, Advance PCS, now CVS Caremark, cancelled its contract with that state.[54]

Recommendations:

1.1 State agencies and higher education systems should continue to leverage the competitive PBM market for bids that are cost effective for the state and their members. Agencies' bids for future contracts should continue to consider, but not be statutorily required to incorporate, contemporary private sector best practices. If the State of Texas is to continue to enjoy the benefits offered by a competitive, changing PBM market, then ERS, TRS, and the university systems should maintain the flexibility to adjust their contracts to prevailing market conditions. Requiring, by statute, that agencies incorporate certain standards into their PBM contracts may impair their ability to leverage a competitive market.

Issue 2: Consolidating procurement of state PBM contracts into a single state contract may erode agencies' leverage in a competitive PBM market.

Background:

Currently, ERS, TRS, and the UT and A&M systems have their own, separate PBM contracts. As depicted in the table, *Lives Covered Through State PBM Contracts*, over one million individuals receive their prescriptions drug benefits through a state-sponsored PBM contract.

Lives Covered Through State PBM Contracts

Agency	Number of Lives Covered
Employees Retirement System	450,542
Teacher Retirement System	383,679
University of Texas System	147,614
Texas A&M System	34,092
Total:	**1,015,049**

The large number of lives covered through each PBM contract provides each agency and systems with a significant amount of buying power. Already, the agencies have leveraged that purchasing power to secure contract terms that are beneficial to the state. Given that over one million individuals are covered under state PBM contracts, consolidating the state's purchasing of PBM services could, in theory, enhance the state's buying power and ability to secure better discounts.

52 Richard Cauchi, State Legislation Affecting Pharmaceutical Benefit Managers, National Conference of State Legislatures Background Brief - 2007, 5 February 2007.
53 E-mail from David Root, Medco Government Affairs, to Jonathan Mathers, Committee Clerk, House Committee on Government Reform, 4 December 2008.
54 E-mail from Allen Horne, Vice President, Government Affairs, CVS Caremark Corporation, to Jeremy Mazur, Office of Representative Bill Callegari, 4 September 2008.

Other states have entered into purchasing pools, or consolidated their PBM contract procurement in an effort to enhance their buying power. In 2002 the states of Delaware, Missouri, New Mexico, and West Virginia formed a coalition to issue an RFP for a single PBM to service each state's employee health benefit plan's prescription drug program.[55] In 2004 Ohio joined this coalition, making it the provider for over 675,000 beneficiaries. Under the contract approved by this coalition, each state received 100 percent of rebate revenues where the PBM guaranteed a minimum rebate to each state that, in turn, paid an administrative fee per prescription.[56] Although the states participating in this coalition claimed savings, the program was discontinued in 2005 after participants' interest in it dissipated.

The State of Georgia has had experience with a single PBM contract for several of its health benefit programs. In 2000, the Georgia Department of Community Health entered into a single contract for the state's Medicaid, PeachCare for Kids (CHIP), higher education systems, and state employee's health benefit programs.[57] This combined contract initially serviced two million Georgians. Officials with the Department of Community Health believed that a consolidated contract would help the state save money by augmenting its purchasing leverage while decreasing duplicative staff functions.[58] Several years later Georgia split up its PBM contracts, primarily to accommodate the unique requirements of its Medicaid and PeachCare programs. At the time that this split occurred, the higher educational system also splintered off to establish its own PBM contract. Now, the State of Georgia maintains several, separate PBM contracts.

Findings:

- Allowing each agency and higher education system to purchase their own PBM services broadens the opportunity to leverage competition within the PBM market -- particularly for larger state contracts -- to the state's advantage. Moreover, the agencies have leveraged the competition among PBMs for their respective contracts towards their own advantage. For example, before 2005, Medco administered TRS' Care and Active Care programs. TRS awarded the contract for its Care program to CVS Caremark in 2005. In an effort to ensure its continued service for the Active Care contract, Medco offered newer, better terms that included approximately $13 million discounts for TRS over the next two years.[59] Similarly, in its 2007 bid for the Active Care program, although TRS awarded the contract to Medco, CVS Caremark, which administers the TRS - Care program, offered the Care program an estimated savings of upwards of $90 million over the next two years. Although TRS' experience is unique, in that the agency administers two, separate PBM contracts, the agency's bidding history illustrates how a competitive market yields savings advantages for

55 Brendan Krause, State Purchasing Pools for Prescription Drugs: What's Happening and How Do They Work?, NGA (National Governors Association) Center for Best Practices Issue Brief, August 2004, page 5.
56 Krause, State Purchasing Pools for Prescription Drugs: What's Happening and How Do They Work?, page 6.
57 Sharon Solow-Carroll and Tanya Alteras, "Stretching State Health Care Dollars: Pooled and Evidence-Based Pharmaceutical Purchasing", The Commonwealth Fund, October 2004, page 20.
58 Telephone interview with Lori Garner, Pharmacy Department, Division of Medical Assistance, Georgia Department of Community Health, 23 September 2008.
59 TRS interview, 1 October 2007.

each contract. As another example of this phenomenon, in 2008, after ERS finalized its new PBM contract, the UT System decided to approach its incumbent PBM to see if it would be willing to renegotiate its existing contact to include more favorable terms. The UT System was successful in renegotiating its contract to generate significant savings over the next three years.

- Consolidating the state's pharmacy benefit manager contracts may not guarantee long term savings. A single contract would limit the state's participation in the competitive PBM market to once every three to four years, or for the length of the contract. This would depart from the current structure where, by having several agencies issuing bids for PBM contracts on a more frequent basis, the state gains greater exposure to a competitive market that continues to offer better savings and contract terms, such as the "most favored nations" clause in ERS' contract.[60] In addition to limiting the state's exposure to participating in the competitive market, a consolidated contract would limit the number of PBMs capable of bidding on the state's contact. While larger companies such as Medco, CVS Caremark, and Express Scripts may have the capitalization and other infrastructure necessary to meet the state's needs, medium to smaller sized PBMs may not. A single contract approach could limit the state to selecting from a smaller pool of PBMs. Furthermore, the consolidated approach would lock the state into a contract with a single provider for the duration of the contract. This could allow the selected PBM to serve as a monopoly where, even though the rest of the PBM market may be offering more progressive, or cost effective contract terms, the PBM may not be under any obligation to provide the state with any of those benefits. Lastly, establishing a single contract raises logistical concerns with regard to its funding and administration. While the state's current prescription drug plans are administered through existing resources, establishing a consolidated contract could require the creation of a new state agency that may require the extra appropriation of state resources.

- The prescription drug plans administered by ERS, TRS, and the university systems are part of the larger group benefit plans provided by these entities. Although the health and pharmacy benefits may appear as separate, they are integrated as part of a broader, comprehensive health plan. The established integration of pharmacy and health benefits allows for more effective cost containment programs, customer service, in addition to disease management and wellness efforts.[61] Consolidating the administration of the prescription drug plans from the broader health services offered may detract from providers' salutary plan objectives for their employees.

60 The "most favored nations" clause requires the PBM to provide ERS with pricing terms that are equivalent to those of any other contract that the PBM enters into with a similar client during the term of the ERS contract that are more generous than those included in the ERS contract.

61 Employees Retirement System, Combining Prescription Drug Programs of State Health Insurance Programs, ERS Executive Summary, 15 February 2008.

Recommendations:

2.1 ERS, TRS, and the University of Texas and Texas A&M systems should continue to administer their own pharmacy benefit manager contracts. The State of Texas should not consolidate these existing plans into a single state contract. At some point, however, the agencies and university systems may wish to consider a collective, non-binding bid where each agency may have the option to enter into their own contract. This suggestion does not require any change in statute.

Issue 3: Requiring, by statute, that agencies receive all rebate revenues provided to a PBM by pharmaceutical companies, may limit agencies' flexibility in soliciting competitive bids.

Background:

Each PBM contract includes a list of preferred drugs, otherwise known as a formulary, for use by each plan sponsors' clients. ERS', TRS', and university systems' employees are encouraged to use those drugs listed on their respective plans' formularies through the use of lower co-payments. Non formulary drugs may be prescribed, however a member must pay more to use them. Invariably, a drug's placement on a PBM's formulary increases the likelihood for its use. Pharmaceutical companies will offer PBMs incentives, commonly known as rebates, to have their drugs placed on a formulary list.[62]

Precisely how a PBM uses their rebate revenue is subject to debate. Over the past decade, pharmacy groups and benefits sponsors, such as those members of the HR Policy Association, have faulted PBMs for pocketing rebate revenues as profit. These groups further contend that if a PBM earns rebate revenue through a sponsor's members' use of formulary drugs, then the sponsor should receive those rebates. PBMs counter that the rebates are based in part off of their entire book of business, not any certain sponsors' participation within their program. PBMs also point out that while rebate revenues contribute to their profitability, they also fund the services provided. Those PBMs that retain a portion of the rebate revenues received sometimes forgo charging their clients an administrative fee to cover the costs of services provided. If, however, a client requests that all rebate revenues be refunded back to the client, the PBM may assess an administrative fee to cover service costs. Typically, fully transparent contracts where 100 percent of rebate revenues are passed through to the plan sponsor include an administrative fee.

Findings:

- All state agencies have provision in their current PBM contracts addressing the disposition of rebate revenues. The table, State PBM Contracts and Rebates, depicts how each agency and higher education system's contract addresses the use of rebate revenues. The table also indicates whether each contract includes an administrative fee. Only ERS and the UT System, with contracts that require the 100 percent pass through of rebate revenues, are

62 Federal Trade Commission, *Pharmacy Benefit Managers: Ownership of Mail-Order Pharmacies*, August 2005, pg. i.

assessed administrative fees. The other contracts do not require the 100 percent pass through of rebate revenues, and are not assessed an administrative fee.[63]

- All agencies have used the competitive bidding process to solicit different types of bids, where varying amounts of rebate revenues are returned to the state. The agencies have employed this approach to broaden choices for proposals that may maximize savings. For example, ERS' 2007 bid requested that all vendors submit two types of bids.[64] One bid, would be a "traditional" bid, where the PBM would pay a guaranteed fixed rebate for each prescription dispensed and not charge an administrative fee. The other bid would be a transparent bid, where the PBM pays ERS 100 percent of all pharmaceutical manufacturer revenue received subject to a guaranteed minimum rebate. Under the transparent structure, the PBM would be permitted to charge ERS an administrative fee. ERS ultimately selected a transparent bid.[65]

State PBM Contracts and Rebates

Agency Contract	Rebate Clause	Administrative Fee
ERS	PBM agrees to pass through to ERS 100 percent of all manufacturer revenue generated by prescription drug utilization of plan members, subject to a guaranteed minimum rebate for each prescription dispensed -- whether generic, brand or specialty, through retail or mail channels -- under the plan.	Yes
TRS - Active Care	TRS has a revenue sharing agreement where the agency receives 90 percent of rebate revenues. The PBM retains a percentage as a management fee. This agreement includes a minimum guarantee.	No
TRS - Care	TRS is guaranteed a uniform flat rebate amount for each rebatable prescription dispensed.	No (except for Medicare D services)
University of Texas	Based on the new contract effective 1 September 2008, PBM agrees to pass through to ERS 100 percent of all manufacturer revenue generated by prescription drug utilization of plan members, subject to a guaranteed minimum rebate for each prescription dispensed -- whether generic, brand or specialty, through retail or mail channels -- under the plan.	Yes
Texas A&M System	System receives a fixed rebate amount for each rebate-eligible claim, with the amount of rebate differing between retail and mail.	No

Sources: Employees Retirement System, Teacher Retirement System, University of Texas System, Texas A&M System.

63 TRS - Care pays a per member per month administrative fee for Medicare eligible retirees only to administer Medicaid. Both TRS program pay administrative fees for certain services such as prior authorization and processing paper claims.

64 Employee Retirement System, *Public Agenda Item: Review of and Action on the Selection of a Vendor to Administer the Prescription Drug Program Under HealthSelect of Texas*, page 6.

65 ERS' RFP required that the cost of the traditional bids supplied must equal that of the transparent bids where 100 percent of all rebate revenues were provided to the agency. This requirement in the RFP forced the PBMs to structure their traditional bids so that they would have the financial equivalence of the terms of the transparent bids, under which the PBMs were required to pass through to ERS any and all rebates generated by the drug utilization of

In 2007 TRS issued a similar bid for its Active Care contract. In it, TRS asked that respondents submit three different types of bids: a traditional bid, a full transparency bid with 100 percent pass-through of rebate revenue and an administrative fee, and a "revenue sharing" transparent bid with a percentage pass through of rebate revenue and no fee. TRS selected the revenue sharing bid.

Requests for proposals issued by the University of Texas and Texas A&M University systems also solicited different bids from participants. In 2006 A&M System issued an RFP

that requested PBMs submit two bids: a traditional bid where the PBM retained a portion of the rebate revenues and did not charge the System an administrative fee, the other being a transparent bid, where the PBM passed through all rebate revenues to the System and assessed an administrative fee. In its analysis of the bids provided, A&M found that the transparent bids were more expensive. Although the transparent bids required the PBM to give the system all of the rebate revenues received, they came at a cost of higher dispensing and administrative fees and greater drug costs. The contract selected by A&M allows the PBM to retain a portion of the rebate revenue, while also providing the System with a fixed rebate for each rebate-eligible claim.[66]

- Transparent contracts requiring the 100 percent pass through of rebate revenues do not guarantee long term savings. Rebates are based on the pharmaceutical companies' strategies to ensure market share for their brand drugs. To be sure, pharmaceutical rebates are a function of the marketplace: lesser sales of rebate-eligible brand drugs, particularly with the growth in generic drug utilization, may diminish the amount of rebate revenues that a PBM receives. By extension, plan sponsors that require a transparent arrangement where 100 percent of rebate revenues are provided, risk the reduction of those revenues, particularly when a brand drug moves to generic during the term of the contract.[67] In this scenario, even though rebate revenues decline, the administrative fees commonly associated with 100 percent pass through arrangements remain fixed. Here, the plan sponsor's costs remain fixed as their rebate revenues decline, potentially obviating any savings benefits intended under the transparent arrangement.

  While each agency and university system has contemplated transparent PBM bids, all have approved agreements that, in their analysis, ensure savings while avoiding certain risks. ERS' new contract requires a minimum, guaranteed rebate for each brand and generic drug dispensed. Although ERS' contract includes an administrative fee, the promised rebate savings are protected by the contractual guarantee. TRS, in its new Active Care contract, mitigates the risks associated with rebates through a revenue sharing arrangement where the

ERS' participants.

66 Interview with Paul Bozeman, Office of System Risk Management and Benefits Administration, Texas A&M System; David Rejino, Government Relations, Texas A&M System (Hereafter: A&M System Interview), 26 September 2007.

67 Letter from Ann Fuelberg, Executive Director, Employees Retirement System, to the Honorable Chuck Hopson, Texas House of Representatives, 8 April 2008, page 3.

agency receives 90 percent of rebate revenues and is not assessed an administrative fee. When Texas A&M University System evaluated traditional and transparent bids for its PBM contract, the System found that the transparent bids were more expensive than the traditional ones provided.[68] The UT System, finding the risks involved with a transparent contract too large, selected a traditional contract.[69]

Requiring, by statute, that all state agencies secure the 100 percent pass through of rebate revenues in their PBM, essentially requires that they absorb greater risks associated with rebates. Although rebate revenues may be available in the short term, in the long run, particularly as the patents for brand drugs expire and generic utilization continues to proliferate, the certainty of such revenues is not guaranteed.

Recommendations:

3.1 Agencies should retain the ability to secure PBM rebates in a manner that best serves the interests of their members and the state. Requiring, by statute, that certain amounts of rebate revenues be refunded to the state may unnecessarily lock agencies into contract requirements that may, given certain market assumptions, cost the state and the agencies' beneficiaries in the long term.

Issue 4: Agencies contracting with PBMs must have sufficient audit rights to ensure PBMs' compliance with contract agreements, including rebate pledges.

Background:

Critics of PBMs frequently claim that the companies operate under a "layer of fog"[70] with largely "secretive"[71] practices and "hidden"[72] costs that effectively preclude any buyer from understanding the true costs of drugs and services provided. Critics further claim that PBMs' use their secretive practices to obscure certain profit margins, retain larger portions of rebate revenues, and restrict a sponsor's members to drugs that are more profitable to the PBM.[73] Although a PBM may pledge certain pricing and rebate revenue-sharing schemes, the plan sponsor may have little recourse with which to verify that the PBM is honoring those terms.

In an effort to ensure that they are being treated fairly by their PBMs, some companies are including comprehensive audit and disclosure rights in their contracts. The Pharmaceutical Coalition of the

68 A&M System Interview, 26 September 2008.
69 Roger Starkey, Assistant Vice Chancellor of Government Relations, The University of Texas System (UT System); Daniel Stewart, Assistant Vice Chancellor of Employee Benefits, UT System; James Sarver, Director of Employee Benefits, UT System; Laura Chambers, Manager of Insurance Benefits, UT System; (Hereafter: UT System Interview) 3 October 2007.
70 Testimony of Sharon Treat, executive Director, National Legislative Association on Prescription Drug Prices, Hearing on State's Role Regulating Pharmacy Benefit Managers, Joint Senate Health and Human Services Committee and Senate State Affairs Committee, Texas Senate, 17 October 2006.
71 Gerry Purcell, "State of Texas: Moving Towards PBM Transparency", 15 February 2008, Power Point Presentation, slide 6.
72 Purcell, slide 20.
73 Purcell, slide 6.

HR Policy Association TIPPS require that a PBM agree to provide full audit rights to claims and utilization data, retail network contracts, and rebate arrangements.[74] The standard also requires that the auditor be chosen by the sponsor, not the PBM. Allowing for an independent audit would allow for the verification of costs and discounts claimed by the PBM.

In light of the importance of being able to audit a PBM's compliance with a contract, recent attention has been focused on the extent that state PBM contracts include appropriate audit rights. One critique of ERS' 2007 RFP claimed that the agency sought audit rights for "[o]nly claims and certain performance standards, but not actual rebates or mail and specialty acquisition costs."[75] The same critique found that TRS' recent RFP for its Active Care program incorporated "[f]ull audit rights including rebates."

In August 2008 the State Auditor's Office released a report with the finding that, in general, state PBM contracts include provisions that limit the agencies' and university systems' "ability to conduct the audits necessary to verify prescription drug costs and the PBM contractor's compliance with their contracts."[76] The Auditor's report also noted that the right to audit should include rebate audits in order to verify the "(1) the amount of rebates a PBM contractor receives from drug manufacturers and (2) the amount of rebates that are passed back to agencies of higher education institution's prescription drug plan."[77] Although the Auditor's report generally assessed the state contracts as lacking the appropriate audit standards, three of the four management responses provided indicated compliance with the recommendation. In particular, the management responses furnished by ERS, TRS, and the University of Texas System stated that each entity's contract includes the provisions necessary to conduct audits to ensure compliance with the contract.[78] The response furnished by the A&M System agreed on the necessity for comprehensive audit rights, and would take the SAO's recommendation into consideration for a contract starting next year.[79] The actual terms of the audit provisions of each agency's and higher education system's are summarized in the findings below.

Findings:

- Despite the State Auditor's Office broad conclusions, and other critiques leveled regarding certain contracts, those PBM contracts maintained by ERS, TRS, and the University of Texas System include comprehensive audit right provisions, including the right to audit rebate data.

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74 http://www.pharmacoalition.org/docs/April%2010%202008%20Mtg%20Presentation.ppt, accessed 3 September 2008.

75 Gerry Purcell, "State of Texas: Moving Towards PBM Transparency", 15 February 2008, Power Point Presentation, slide 31.

76 State Auditor's Office, "Pharmacy Benefit Manager Contracts at Selected State Agencies and Higher Education Institutions", August 2008, page 2.

77 Ibid.

78 Letter from Ronnie Jung, Teacher Retirement System, to John Keel, State Auditor, 7 August 2008, found in SAO, page 35; Letter from Ann S. Fuelberg, Executive Director, Employees Retirement System, to John Keel, State Auditor, 5 August 2008, found in SAO, page 40. Letter from Scott C. Kelley, Executive Vice Chancellor for Business Affairs, University of Texas System, to Willie J. Hicks, Project Manager, State Auditor's Office, 5 August 2008, found in SAO, page 43.

79 Letter from Michael D. McKinney, Chancellor, Texas A&M System, to The State Auditor of Texas, 4 August 2008, found in SAO, page 53.

The sub-points below summarize the audit rights provisions within each agency's PBM contract.

Employees Retirement System. ERS' contract provides the agency with "an absolute right to conduct audits of PBM in connection with the PBM's duties and obligations under the Contract, and that all ERS-related records may be audited by ERS."[80] ERS, or its designee, may "audit and inspect PBM's business practices in connection with the Contract" if the agency determines that the PBM does not satisfy the contract's requirements.[81] ERS also reserves the right to hire a third party auditor to review agreements between the PBM and pharmaceutical manufacturers "to ensure PBM's compliance with the Contract with respect to Rebates."[82]

Teacher Retirement System - Care. The TRS - Care contract authorizes the agency, or its representative to audit the PBM's "records and books relevant to all services provided" under the contract.[83]

Teacher Retirement System - Active Care. The TRS - Active Care contract provides TRS with the full audit rights to confirm the PBM's compliance with its contractual obligations. TRS may also audit the guaranteed rebates.

University of Texas System. The audit provision in the System's contract permits the System to audit claims and formulary information, as well as "other audits of the vendor as it [UT System] deems necessary." The UT System's contract also permits for "representatives of [the] System to audit and examine records and accounts which pertain, directly or indirectly to the Plan at such reasonable times as may be requested by [the] System for purposes of confirming its contractual obligations under this Contract."[84]

Texas A&M University System. A&M's contract entitles the system to audit the PBM's records that relate directly and primarily to the PBM's obligations under its contract with the A&M System.[85] With regard to rebates, A&M's contract authorizes the system to request information from the PBM in order to ascertain that the monies paid to A&M are in accordance with the contract. But for certain claim-specific data, the A&M System has yet to fully exercise its audit rights.

- Executing a comprehensive audit of a PBM contract may cost agencies more than it could save. Although TRS, ERS, and UT have full audit rights, each has expressed concern regarding the cost-effectiveness of exercising those rights on account of the potential audit

80 ERS Contract with CVS Caremark, effective 1 September 2008, Section 15.3.
81 ERS Contract with CVS Caremark, effective 1 September 2008, Section 10.1.
82 ERS Contract with CVS Caremark, effective 1 September 2008, Section 15.6.
83 TRS Contract with CVS Caremark, Section 5 Audit Right.
84 E-mail from James Sarver, Director, Office of Employee Benefits, University of Texas System, to Jeremy Mazur, Office of Representative Callegari, 16 September 2008.
85 A&M PBM Contract (see e-mail with David Rejino).

costs.[86] Furthermore, the costs of a full rebate audit -- upwards of $100,000 -- could likely outstrip any potential savings identified. In its management response to the August 2008 SAO audit, A&M System also noted that a cost-benefit analysis of conducting such an audit could prove that it is more costly than necessary.[87]

- No change in statute is necessary to ensure that state agencies and higher education systems are capable to including appropriate audit rights in their PBM contracts. All entities issuing RFPs have the authority to contract for the desired audit rights that best reflect the state's interest, and to modify future bids to require more stringent audit rights. Furthermore, no agency or higher education system has been challenged on including such contractual provisions on grounds that they are not authorized or otherwise required by statute.

Recommendations:

4.1 Agencies and higher education systems should continue to include appropriate audit provisions in future PBM contracts. Each agency should also maintain the discretion to execute their audit rights. At some point in time, however, an agency should consider exercising its audit right to verify a PBM's compliance with the contract, particularly with regard to promised rebate revenues. Although such an audit may be costly to the state, verifying PBM's compliance may justify this expenditure. This suggestion does not require any change in statute.

Issue 5: Agencies should maintain the flexibility necessary to ensure the provision of cost-effective, efficient pharmaceutical services for their members.

Background:

Critics contend that PBM's profit incentives do not align with their clients' interest in saving money. Common criticisms of PBM contracts point to two alleged practices where PBMs may encourage certain utilization and distribution patterns that are profitable to themselves, while potentially costly to the client. The first alleged practice is that PBMs push expensive brand drugs over cheaper generics, especially in light of the rebate incentives that PBMs may receive for greater brand drug utilization. The second alleged practice is that PBMs steer clients towards using their mail order services, which are more lucrative for the PBM, and actually less cost advantageous for the client.

The issue of steering clients to more expensive, brand drugs is best encapsulated in the debate surrounding the use of Nexium, a brand name drug used for heartburn and acid reflux. Nexium is included on all state contract formularies. In fiscal year 2005 ERS, TRS, and the university systems spent $31 million for Nexium.[88] In fact, in 2005, spending on Nexium was the second largest drug expenditure after that for Lipitor, a cholesterol-lowering medication. Comments from pharmacist

86 TRS Interview, 1 October 2007; Interview with Robert Kukla, Employee Retirement System; Shack Nail, ERS; Phil Dial, Rudd & Wisdom, (Hereafter ERS Interview) 17 December 2007; UT System Interview, 3 October 2007.
87 SAO, page 53,
88 Legislative Budget Board, *Texas State Government Effectiveness and Efficiency, Selected Issues and Recommendations*, page 112.

representatives point to the significant amount of state spending on Nexium as evidence of PBMs' using formularies to steer state employees towards brand drugs that benefit PBM profit margins because of the rebates associated with the use of this brand drug. They also contend that the emphasis on Nexium to the exclusion of other over the counter and generic alternative results in higher expenses.[89] One pharmacist representative noted that the State of Arkansas saved $2 million by paying pharmacists $25 to call prescribing physicians and suggest that they change prescriptions for Nexium to other heartburn medications.[90]

A similar critique was echoed in the State Auditor's August 2008 report on state PBM contracts. The report stated that agencies' and university systems' contracts do not consistently address the use of therapeutic interchange for brand or generic drugs.[91] The report highlighted the fact that several lawsuits have been filed involving charges that PBMs use therapeutic interchange to promote the use of more expensive, rebate-generating brand drugs over less expensive generic drugs. The report added that the "promotion of expensive drugs may lead to higher overall costs to a plan."[92] Although this was not noted in the SAO's report, the State of Texas never took legal action against a PBM contracting with a state agency or university system over similar drug switching practices. Nor did

the SAO's report document that any agency's or university system's plan empirically suffered from the promotion of expensive brand drugs to the exclusion of cheaper alternatives.

In addition to promoting more expensive drugs, PBMs are also criticized for promoting the use of their mail order pharmacy services. Each PBM doing business with the State of Texas owns its own mail order operation where it purchases pharmaceutical products in bulk, and dispenses prescriptions through an automated process. The bulk purchasing coupled with the automated processing lowers the cost of prescriptions filled though this channel. According to one study financed by the PBM industry, mail order pharmacies cut drug costs 27 percent for brand drugs and 53 percent for generic drugs when compared to retail pharmacies' prices.[93] Critics claim, however, that a conflict of interest arises when a PBM serves as a plan administrator and also markets drugs through its mail order program.[94] This arrangement allows PBMs to sell generic drugs at a greater profit,[95] and a greater opportunity to push clients towards drugs that pay higher rebates.[96]

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89 Observations by nationally known PBM expert Gerry Purcell on Previous Testimony and comments by PBMs on Transparency legislation (on file with committee); E-mail from Richard Beck, Vice President of Pharmacy Affairs, American Pharmacies, to Jonathan Mathers, Committee Clerk, House Committee on Government Reform, 5 October 2007 (on file with committee).

90 E-mail from Richard Beck, Vice President of Pharmacy Affairs, American Pharmacies, to Jonathan Mathers, Committee Clerk, Committee on Government Reform, 5 October 2007 (on file with committee).

91 State Auditor's Office, Pharmacy Benefit Manager Contracts at Selected State Agencies and Higher Education Institutions, page 8.

92 SAO, page 8.

93 Pharmaceutical Care Management Association (PCMA), "How Pharmacy Benefit Managers Help Employers Provide Safer, More Affordable Prescription Drug Benefits", page 2.

94 James Langenfeld and Robert Maness, The Cost of PBM "Self-Dealing" Under a Medicare Prescriptions Drug Benefit, 9 September 2003, page 1.

95 Barbara Martinez, "Selling generic drugs by mail is lucrative business," *The Wall Street Journal*, 9 May 2006.

96 Langenfeld and Maness, The Cost of PBM "Self-Dealing" Under a Medicare Prescriptions Drug Benefit, page 5.

Although PBMs claim that the utilization of mail order services helps curb client's prescription drug costs, one study of the ERS and TRS 2004 plans concluded that the use of mail order channels did not translate into significant cost reductions for either agency.[97] Although this conclusion is correct, this study overlooks the policy reasons that led to the development of the reimbursement arrangement for retail maintenance drugs and the savings that arrangement generated for the ERS prescription drug plan. In 2003, as the 79th Legislature explored options to account for a $10 billion budget shortfall, it considered a proposal to require that all maintenance drugs for the ERS prescription drug plan be dispensed through mail order, and not retail pharmacies. This proposal would have resulted in a 12.5 percent reduction in the cost of maintenance drugs.[98] In response to an appeal from the retail pharmacy industry concerned over the potential loss in customers, the Legislature approved a budget rider that required ERS to implement a prescription drug plan "allowing participants to choose retail pharmacies for maintenance medications with the participant paying the extra cost."[99] In response to this directive, ERS adopted a policy that would effectively allow the agency to pay the same amount for maintenance drugs obtained through a retail pharmacy that it would have paid for those drugs through mail order. This arrangement allowed ERS' members to access retail pharmacies for their maintenance scripts, but required that they pay a retail maintenance fee in addition to their regular co-pay when using a retail pharmacy. Under this arrangement, ERS experiences the same cost regardless of whether the member obtains the script at mail or retail.[100] TRS had a similar policy in place requiring that it pay the lesser amount for a drug to either the mail order or the retail pharmacies; neither gets paid more than the other.[101] While the aforementioned study was correct to observe that mail order did not translate into significant cost reductions, it failed to demonstrate any understanding of the policy considerations behind the benefit structure. The same study did, however, find that the use of mail order benefitted the agencies' members. In particular, the study noted that when compared to retail pharmacies, PBM mail order services saved the plans' members an estimated 48 percent.[102] While the plans may effectively pay the same rates for maintenance drugs through mail order and retail pharmacy channels, the cost benefits of mail order are passed through to the plans' members.

Findings:

- All state PBM contracts require the emphasis of cheaper generic drugs over brand drugs. The ERS and TRS plan designs encourage the use of generic drugs through lower co-pays and a "member pay the difference" requirement where, if a member wants a brand drug where chemically-equivalent generic alternative is available, then they must pay the difference between the brand and generic drug. If a member is prescribed a brand drug,

97 Michael Johnsrud, Kenneth Lawson, and Marvin Shepherd, "Comparison of Mail-Order with Community Pharmacy in Plan sponsor Cost and Member Cost in Two Large Pharmacy Benefit Plans", *Journal of Managed Care Pharmacy*, March 2007, page 122.

98 ERS Memorandum, Follow-Up Questions for ERS Interview - Representative Callegari's Office, December 2007 (on file with committee).

99 House Bill 1, 79th Regular Session, I-44.

100 ERS Memorandum, Follow-Up Questions for ERS Interview - Representative Callegari's Office, December 2007 (on file with committee).

101 TRS Interview, 29 January 2008.

102 Johnsrud, Lawson, and Shepherd, "Comparison of Mail-Order with Community Pharmacy in Plan sponsor Cost and Member Cost in Two Large Pharmacy Benefit Plans", *Journal of Managed Care Pharmacy*, page 133.

and no equivalent generic is available, then the member is only required to pay the co-pay. The University of Texas and Texas A&M systems' contract also encourage the use of generics using plan designs similar to ERS and TRS.

Over the past four years all state prescription drug plans have experienced significant growth in generic utilization. The table, *Rates of State Generic Utilization, FY 2005-2008*, illustrates this trend. Between fiscal years 2005 and 2008, the generic utilization rate for all entities grew by an average of 13.2 percent. This trend, coupled with the fact that generic drugs account for the majority of drugs utilized by all state prescription drug plans, underscores the fact that generics, and not brand drugs, are promoted as a matter of contract policy.

Rates of State Generic Utilization, FY 2005-2008

Agency	2005	2006	2007	2008
ERS	50%	53%	58%	62%
TRS - Care	46%	49%	54%	59%
TRS - Active Care	50%	55%	59%	63%
UT System	46%	49%	54%	59%
A&M System	45%	48%	53%	58%

Sources: Employees Retirement System, Teacher Retirement System, University of Texas System, Texas A&M System.

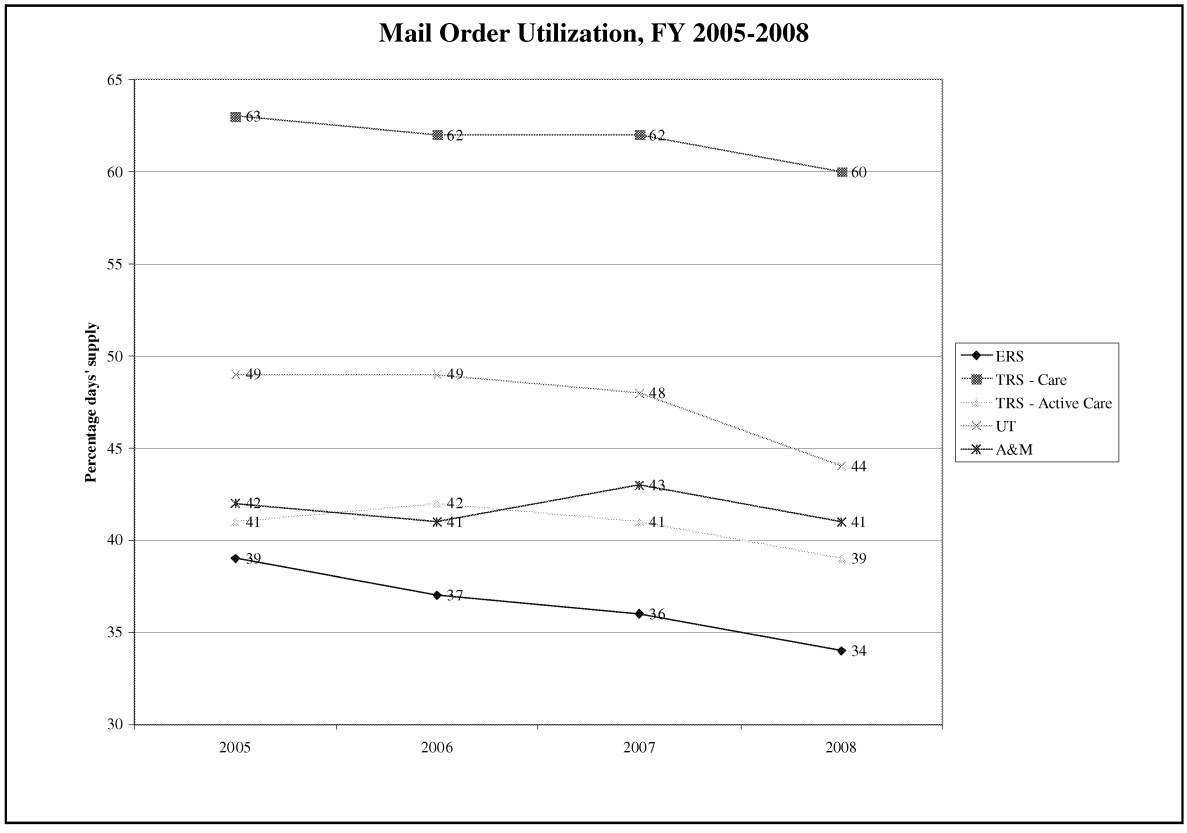
- All state PBM contracts prohibit drug switching practices. ERS prohibits the use of therapeutic interchange, the practice of switching generic for brand, or brand for brand, drugs. Although ERS has contemplated authorizing therapeutic interchange as a cost saving measure, the agency believes that, as a matter of policy, allowing such interchange would interfere with physicians' decisions.[103] Under the current contract a PBM cannot substitute a generic drug for a brand, if that brand is prescribed by a physician. The PBM may, however, substitute a generic drug for a brand drug if that substitution is authorized by that physician. Furthermore, the terms of ERS' 2008 contract prohibit the PBM from using therapeutic substitution to steer members towards using expensive brand drugs. With regard to ERS' members use of any brand drug such as Nexium, although the drug is included on the agency's formulary, since all rebate revenues are returned to ERS, the PBM has no incentive to promote the use of this high-cost brand drug. In addition, ERS' prohibition of therapeutic interchange precludes the PBM's encouragement of that drug's use.[104] TRS' and the university systems' contract include similar prohibitions regarding therapeutic interchange. As an example, UT System's plan prohibits brand to brand interchanges, as well as low cost to high cost drug interchanges.[105]

103 "Although ERS has considered using therapeutic substitution as a cost saving measure for the prescription drug program, we have found that it is the subject of much controversy and debate. It raises the question of whether or not ERS is practicing medicine by second guessing the physician, and leads to speculation about whether or not the PBM is acting in the best interest of the patient when the substitute happens to be a drug that the PBM manufactures. Letter from Robert Kukla, Director of Benefit Contracts, Employees Retirement System, to Representative William Callegari and Representative Vicki Truitt, 18 March 2008, page 2.

104 ERS Memorandum, Follow-Up Questions for ERS Interview - Representative Callegari's Office, December 2007 (on file with committee).

105 E-mail from James Sarver, Director, Office of Employee Benefits, University of Texas System, to Jeremy Mazur, Office of Representative Callegari, 16 September 2008.

- Although each state PBM contract includes the provision of pharmacy mail services, the majority of drugs for most state prescription drug plans are supplied through retail pharmacies. The chart, *Mail Order Utilization, FY 2005-2008*, depicts that, over the past four years for most state-sponsored prescription drug plans mail order pharmacy services account for less than half of all drugs dispensed. Only the TRS - Care plan received a majority of drugs through mail order. The rate of mail order utilization has declined for all plans over the past four years. In fact, between FY 2005 and FY 2008, the amount of days supply provided through mail order to ERS members decreased from 39 percent to 34 percent. Just as the amount of days supply provided through mail order to ERS' beneficiaries decreased, so, too, did the number of scripts filled and the amount paid by ERS for mail order services.106 During that same time, the amount of supply furnished through retail pharmacies to ERS' members increased from 61 to 66 percent.[107] According to TRS, 84 percent of the prescriptions for the Active Care program are filled at retail pharmacies.[108]



106 Between FY 2005 and 2008, the proportion of ERS members' prescriptions filled through mail order decreased from 15% to 13%. During that same period the amount ERS paid for mail order services declined from 34% to 31%.
107 Employees Retirement System, Retail and Mail Order Usage of ERS Pharmacy Benefit, 14 April 2008.
108 Interview with Ronnie Jung, Executive Director, Teacher Retirement System; Betsey Jones, TRS; Ray Spivey, Governmental Relations, TRS; (Hereafter TRS Interview) 29 January 2008.

- Although retail pharmacies account for the majority of drugs supplied to state plans' members, the plans' co-pay and supply restrictions favor use of mail order pharmacy over retail pharmacies. The table, *ERS' Co-Pays and Days Supply Requirements*, depicts the co-pays and days supply restrictions for certain drugs purchased through retail pharmacies or mail order. The prescription drug plans administered by TRS and the university systems offer similar co-pay and supply restrictions, although the Texas A&M plan allows for 90 days supplies through certain retail pharmacies, albeit at higher co-payments relative to mail order and greater discounts than 30-days at retail prescriptions.[109] According to the table, ERS members obtaining non-maintenance drugs from a retail pharmacy will pay the same amount for those drugs as they would through mail order. Retail pharmacies are limited to providing only 30 days supply however, less than the 90 days supply available through mail order. ERS members obtaining maintenance drugs retail pharmacies must pay more than they would through mail order. For example, a member receiving Tier 2 maintenance drugs from a retail pharmacy over 90 days must pay $105.[110] That member could receive the same amount of days supply from the mail order pharmacy for $75, which is $30 less than what would be paid to the retail pharmacy. Under the current plan design, members using mail order services may enjoy the convenience of longer supplies and, with regard to maintenance drugs, lower co-pays. In an effort to establish parity between mail order and retail pharmacies, the Texas Pharmacy Association has suggested allowing beneficiaries to choose between mail order or retail pharmacies without co-pay or supply restriction.[111] Although retail pharmacies already account for well over the majority of drugs dispensed under each prescription drug plan, this recommendation would expand plans' members' options when looking for convenient, more cost effective points of sale for their prescription drugs.

ERS' Co-Pays and Days Supply Requirements

	Tier 1 **Generic**	**Tier 2** **Formulary Brand**	**Tier 3** **Non-Formulary Brand**
Retail pharmacy non-maintenance drugs (1)	$10 co-pay, 30 day supply	$25 co-pay, 30 day supply	$40 co-pay, 30 day supply
Retail pharmacy maintenance drugs (2)	$15 co-pay, 30 day supply	$35 co-pay, 30 day supply	$55 co-pay, 30 day supply
Mail order pharmacy	$30 co-pay, 90 day supply	$75 co-pay, 90 day supply	$120 co-pay, 90 day supply

Source: Employees Retirement System of Texas.

(1) A non-maintenance drug, such as an antibiotic, is used to treat short term illnesses or conditions.

(2) A maintenance drug is medication taken over an extended period of time to treat a chronic disease or condition.

109 Legislative Budget Board, Texas State Government Effectiveness and Efficiency, page 116.

110 ($35 co-pay for 30 day supply) * 3 = $105 co-pay for 90 days supply.

111 Letter from Jim Martin, Executive Director/Chief Executive Officer, Texas Pharmacy Association, to John Keel, State Auditor, 6 March 2008, page 2.

Recommendations:

5.1 State agencies and university systems should continue to pursue plan designs that best meet members' pharmacological needs while ensuring cost effectiveness. This recommendation does not require any change in statute.

5.2 State contracts should provide all beneficiaries the option to obtain prescription drugs from a retail community pharmacy in lieu of the mail order pharmacy at no additional co-pay and without supply restrictions, provided the retail community pharmacy agrees to dispense the prescription drug for the same total reimbursement that would be applicable if the prescription drug was dispensed through mail order. This policy should be cost neutral to the state, and should not require an additional appropriation.

Issue 6: Agencies should retain the discretion with regard to the contractual requirement that the PBM serve as the agencies fiduciary.

Background:

All of the pharmacy benefit manager companies that have contracts with state agencies or higher education systems are publicly-held, for-profit companies. Each company employs a business plan to both expand its market share and provide a rate of return -- or profit -- to its shareholders. Critics of state PBM contracts point to the PBM's inherent profit motive as inconsistent with the state's interest in saving taxpayers' dollars. In particular, critics allege that PBMs retain rebate revenues earned through clients' utilization of formulary drugs, manipulate drug pricing to create pricing "spreads" that benefit the PBM, and, among other charges, channel clients towards using drugs that ensure greater revenues for the PBM.[112] If accurate, each of these activities may ultimately cost the state more than what it should be paying for its prescription drug plans.

In an effort to better align a PBM's interests with those of the state, some have advocated implementing a fiduciary duty requirement for all contracts. This provision would require the contracted PBM to serve its client's interest, rather than its own, in securing lower drug prices and rebate revenues. Under this arrangement, the PBMs "will be less able the siphon money away for themselves that could go instead towards lower drug prices for the client."[113] In addition to the potential financial benefits to the state, proponents of the fiduciary duty requirement point out that the fiduciary concept is a readily enforceable, basic principle of common law, and would serve as a "catch-all standard" that could address PBM practices not otherwise addressed through contractual or statutory provisions.[114]

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112 Testimony of Sharon Treat, executive Director, National Legislative Association on Prescription Drug Prices, Hearing on State's Role Regulating Pharmacy Benefit Managers, Joint Senate Health and Human Services Committee and Senate State Affairs Committee, Texas Senate, 17 October 2006; Gerry Purcell, "State of Texas: Moving Towards PBM Transparency", 15 February 2008, Power Point Presentation, slide 6.

113 Testimony of Sharon Treat, page 3.

114 Testimony of Sharon Treat, page 4.

Findings:

- Only ERS' 2008 contract includes the requirement that the PBM serve as a fiduciary. This contract specifically includes the word "fiduciary" to reinforce the duties and responsibilities of the PBM, and includes other language requiring that the PBM "act with the utmost good faith, loyalty, candor, care, skill, diligence and prudence in discharging its duties."[115] Although the PBM is a fiduciary in connection with the performance of its obligations under the ERS contract, the PBM is not a fiduciary for ERS in connection with the PBM's pharmaceutical manufacturer contracts. Furthermore, ERS retains exclusive authority over all aspects of the plan.

- The University of Texas and Texas A&M university systems' and TRS' contracts do not include the fiduciary duty requirements. The UT System prefers to maintain that duty, pointing out that they are accountable to the legislature, the UT System, and UT employees; as such they would not want to transfer that responsibility.[116] Similarly, the Teacher Retirement System's Board of Trustees prefers that the agency maintain its fiduciary duty.[117] The Texas A&M System's contract does not include a fiduciary duty requirement.

- Private sector best practices guidelines do not require that pharmacy benefit managers serve as a fiduciary. In particular, the TIPPS standards for PBM accreditation promulgated by the Pharmaceutical Coalition of the HR Policy Association do not specifically require that a PBM serve as a client's fiduciary.[118] In addition, the PBM accreditation standards put forth by the Utilization Accreditation Review Commission (URAC), a private organization that certifies health care providers that meet certain standards, does not require PBMs to serve as a fiduciary.[119]

Recommendations:

6.1 Agencies should retain the discretion to establish the fiduciary duty requirement for their PBM contracts.

Issue 7: Agencies should maintain the expertise necessary to continue to identify market trends in the PBM market, and design RFPs that best leverage the state's interest and purchasing power in a competitive market.

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115 Letter from Ann Fuelberg, Executive Director, Employees Retirement System, to Representative William Callegari, Chair, House Committee on Government Reform and Representative Vicki Truitt, Chair, House Committee on Pensions and Investment, 25 June 2008.

116 UT System Interview, 3 October 2007.

117 TRS Interview, 1 October 2007.

118 Pharmaceutical Coalition of the HR Policy Association, 2008 Transparency in Pharmaceutical Purchasing Solutions (TIPPS[SM]) Standards, http://www.pharmacoalition.org/TIPPS_Transparency.aspx, accessed 3 September 2008.

119 Utilization Accreditation Review Commission, Pharmacy Benefit Management Standards -For Commercial Use- Version 1.0, 2007.

Background:

Some agencies have used third party consultants to assist with the drawing of their PBM contracts. The efficacy and value added by these consultants has been called into question. In its August 2008 report on state PBM contracts, the State Auditor's office found that the agencies and higher education institutions "have limited guidance in developing contract provisions for PBM services."[120] Another critique of the state's PBM contracting practices alleged that "outside consultants used by the agencies in the past had insufficient expertise or experience in PBM operations and contracting."[121] Neither the Auditor's report or the other criticism of the agencies' use of consultants identified any specific limitations in the guidance provided to the agencies or other material defects in the expertise provided.

The alleged lack of expertise ties into another, broader argument, that the state's PBM contracts are predicated on terms and conditions defined by the PBM. Here, the argument points out that the types of drugs used by a plan's members, the prices paid for those drugs, and the amount of rebate revenues generated through their utilization are all directed by the contracting pharmacy benefit manager. Consequently, the contract better reflects the interests of the PBM over those of the contracting state agency. In the absence of transparency regarding a PBM's pricing and revenue schemes, the state's RFP writers may not know if they are receiving the best deal for their PBM contracts.[122]

Findings:

- Three out of the four state entities with PBM contracts obtain outside consulting services for their contracts. ERS and the University of Texas System contract with an actuarial consulting firm to assist with their PBM RFP processes. In addition to assisting these agencies in developing their RFPs, the firm also provides UT and ERS technical advice and analysis on proposed contracts and helps identify a customized PBM contract product for UT's and ERS's needs. [123] The consultants used by ERS and UT have 30 years of knowledge and expertise on the state's health plan.[124] TRS also contracts with a private health care consultant to advise and consult in the analysis of proposals.[125] The agency's contracts are further reviewed by the Texas Office of Attorney General. A&M System did not use a consultant when evaluating PBM contract bids in 2005. For its upcoming bid in 2009, however, the A&M System plans to use a consultant for evaluating traditional versus

120 State Auditors Office, Pharmacy Benefit Manager Contracts at Selected State Agencies and Higher Education Institutions, page 13.

121 Letter from Jim Martin, Executive Director/Chief Executive Officer, Texas Pharmacy Association, to John Keel, State Auditor, State Auditor's Office, 6 March 2008, page 2.

122 Interview with Richard Beck, America's Pharmacies; Rusty Word, America's Pharmacies; Gerry Purcell, PBM consultant (via telephone); David Balto, attorney, former Federal Trade Commission attorney (via telephone); Sharon Treat, Maine State Representative (via telephone); Michael Shepherd, Professor, UT School of Pharmaeconomics (via telephone), 4 December 2007.

123 Interview with Phil Dial, actuarial consultant, Rudd and Wisdom, Inc., 18 October 2007.

124 Letter from Ann Fuelberg, Executive Director, Employees Retirement System, to the Honorable Chuck Hopson, Texas House of Representatives, 8 April 2008, page 2.

125 Teacher Retirement System of Texas, Power Point Presentation Before the House Committees on Government Reform and Pensions & Investments, Pharmacy Benefit Managers, 15 February 2008, slide 11.

transparent bids provided by PBMs.

- Several agencies enter into PBM contracts of their own design; they do not use a contract furnished by the PBM. TRS dictates the terms of its contracts for its Care and Active Care prescription drug plans. ERS requires the PBM to sign a contract developed by the ERS legal staff, not by the PBM. The contract receives input from ERS' Benefit Contracts Division, and further review of the Office of the Attorney General.[126] This contract includes several unique provisions that differentiate the ERS contract from the typical PBM contract. Some of those unique provisions include: a "most favored nation" clause that requires the PBM to provide ERS with pricing terms that are equivalent to those provided in any other contract entered into by the PBM that are more generous than those included in the ERS contract, a clause that allows ERS to reimburse the PBM for the exact amount that the PBM pays a retail pharmacy, and a clause that the PBM must indemnify and hold ERS harmless for errors and omissions made by the PBM and any of its contracting pharmacies.[127] Like ERS and TRS, the University of Texas System's contract is designed and drafted by the System, not the contracting pharmacy benefit manager. The System's contract includes unique provisions, including ones allowing the System to terminate its contract at any time for any reason, as well as performance guarantees enforced with momentary penalties.[128] The current contract maintained by the Texas A&M System was drafted by the PBM, with modifications made by System Office of Risk Management and Benefits Administration and System Office of General Counsel staff when the contract was approved in 2006. The A&M System plans to incorporate a sample contract in the RFP that it plans to issue later this year.[129]

- Each state PBM contract does use the formulary provided by the contracting pharmacy benefit manager. These formularies are, however, reviewed by experts employed by the contracting agencies. TRS had its PBM formularies reviewed by a licensed pharmacist in order to ensure that the included drugs are appropriate.[130] The University of Texas System receives input from its very own School of Pharmacy.[131] ERS had used a licensed pharmacist on staff.

Recommendations:

7.1 Agencies and university systems should continue to secure the internal and external expertise necessary to draft and design pharmacy benefit manager contracts that best address the interest of the State of Texas and the respective plans' members. Any consultants or auditors used by a state agency

126 Letter from Ann Fuelberg, Executive Director, Employees Retirement System, to the Honorable Chuck Hopson, Texas House of Representatives, 8 April 2008, page 2.
127 Employees Retirement System, follow-up Questions for ERS Interview - Representative Callegari's Office, 17 December 2007 (on file with Committee).
128 UT System Interview, 3 October 2007.
129 E-mail from Paul Bozeman, Benefits Administration, Texas A&M University System, to Jeremy Mazur, Office of Representative Callegari, 11 September 2008.
130 TRS Interview, 29 January 2008.
131 UT System Interview, 3 October 2007.

or university system should serve as an un-biased, independent contractor, that does not receive any direct or indirect compensation from the pharmacy benefit manager, pharmaceutical manufacturer, or retail pharmacy industries or trade or advocacy organizations associated with those industries. Each agency using a consultant should periodically evaluate the services provided to ensure that they possess the depth of knowledge and experience necessary to design effective PBM contracts.

7.2 All agencies with PBM contracts, including the university systems, should meet periodically to discuss their PBM contracts and current contracting trends. Each agency should routinely communicate with other contracting agencies regarding contracting issues, particularly with regard to RFP and contract documents.

CHARGE # 8

HOUSTON MUNICIPAL EMPLOYEES PENSION SYSTEM

(Joint charge with House Committee on Urban Affairs)

Examine the operation of the Houston Municipal Employees Pension System, its Board of Trustees and staff.

BACKGROUND

At the request of the House Committee on Urban Affairs no interim study was undertaken on this charge.

CHARGE # 9

AGENCY OVERSIGHT

Monitor the agencies and programs under the committee's jurisdiction.

BACKGROUND

The House Committee on Pensions and Investments has jurisdiction over all matters pertaining to:

(1) benefits or participation in benefits of a public retirement system and the financial obligations of a public retirement system;

(2) the regulation of securities and investments; and

(3) the following state agencies: the Office of Fire Fighters' Pension Commissioner, the Board of Trustees of the Teacher Retirement System of Texas, the Board of Trustees of the Employees Retirement System of Texas, the Board of Trustees of the Texas County and District Retirement System, the Board of Trustees of the Texas Municipal Retirement System, the State Pension Review Board, and the State Securities Board.

FINDINGS

Office of Fire Fighters' Pension Commissioner

The Office of the Fire Fighters' Pension Commissioner (FFPC) is a small agency whose mission is to provide effective and sound benefits to volunteer departments under Texas Emergency Services Retirement System (TESRS), as well as to volunteer and paid departments under Texas Local Fire Fighters' Retirement Act (TLFFRA). Lisa Ivie-Miller is the Fire Fighter's Pension Commissioner and was recently re-appointed by the Governor to a second, four-year term.

The agency administers the TESRS and the TESRS Fund. The Fund provides a cost-effective means for small volunteer departments to belong to a professionally managed fund for the benefit of their local volunteer fire and EMS personnel. As the administrator of the Fund, the FFPC collects contributions of participating department members, invests the proceeds, calculates benefits, and issues payments to retirees and their beneficiaries.

The agency's staff provides investment and legal guidance for local boards; provides opinions; hears appeals of local board decisions; maintains all personnel records for fire fighter members and departments; classifies and coordinates annual reports; verifies all benefit amounts; provides education and training seminars; and assists in providing guidance in the professional management of the local funds. The agency has set up a peer-to-peer training system for trustees to train each other in order to ensure greater competence in managing the plans.

Teacher Retirement System

The Teacher Retirement System (TRS) has undergone several significant changes during the interim and continues to implement new policies. TRS is expanding its investment staff and adopted an incentive compensation plan to help attract and retain qualified investment professionals to seek out the best private equity and alternative investment opportunities as part of a new investment strategy to move a greater piece of the fund's portfolio into alternative investments so the trust will be less at the mercy of the equities market than it has been in the past. This new staff will require office space and TRS is in the process of leasing space for it. It remains to be seen what the result of these changes will be. To date, the System has done well by further diversifying its portfolio and has lost less money than it would have had it not implemented the new investment strategy.

The TRS Board of Trustees has a new chair, James Lee, who was appointed March 7, 2008. The Board of Trustees filled the position of deputy director that had been vacant for several years with former member of the governor's staff, Brian Guthrie. The TRS board sought new fiduciary counsel upon the expiration of the previous contract.

Employees Retirement System

The Employees Retirement System (ERS) completed its five year experience study and readjusted several actuarial assumptions to more accurately reflect the reality of the plan participants' actions, their longevity, and provide a more accurate picture of the population being served. These new assumptions increased actuarial liability and, as a result, decreased the funding ratio and increased the amortization period.

ERS entered into a new pharmaceutical benefits manager (PBM) contract that went into effect September 1, 2008. The new contract is expected to save over $277 million when compared to the previous contract. ERS was also able to continue to provide healthcare to employees and retirees without an increase in premiums.

Texas County and District Retirement System

The Texas County and District Retirement System (TCDRS) provided the promised 7% interest credit on employee accounts and has built a reserve that should serve it well in the coming uncertain times in the economy. The interim saw the departure of TCDRS Deputy Director and General Counsel Tom Harrison who will be missed.

Texas Municipal Retirement System

The Texas Municipal Retirement System (TMRS) was facing a crises brought on by falling interest rates, a lack of investment diversification and actuarial methodology that failed to account for the true cost of benefit increases approved by city councils. The board has taken several steps to reverse course and push the system onto a path of good health for the future. They have changed investment strategy and are moving the portfolio from all bonds and cash into equities. They have changed

actuarial methodology to provide a more accurate forecast of future costs and have chartered a stakeholders group to reach consensus on the future distribution of investment revenue. In order to be effective and produce positive results for the system some legislative changes are required. If these legislative changes are not passed the system will be back on the road to crisis and the hard work of the board and the staff to improve the system's health and future stability will be wasted.

- ❖ In order to continue to provide the benefits promised to municipal employees and retirees, the system will need statutory changes and the Committee recommends that the legislature approve the agreed to legislation that resulted from the stakeholders work in the interim.

State Pension Review Board

In the last two years the Pension Review Board (PRB) has seen the departure of two executive directors and the replacement of the chair of the board of trustees. It has increased its staff from eight employees to 13, and has begun conducting regional training seminars. It continues to have difficulty with the timeliness of submissions to the quarterly reporting system that came online in the fourth quarter of 2007. The agency intends to return to its core mission of providing information to its board members so they can direct agency resources to help the pension plans that need it the most.

State Securities Board

The State Securities Board (SSB) continues to work effectively hand-in-hand with other law enforcement agencies and the Attorney General's office to enforce the securities regulations of the state with a focus on preventing fraud and illegal investment schemes.