

APPENDIX 1

EMPLOYEE BENEFITS REVIEW

October 16, 2007



Auditor General's Office

**Jeffrey Griffiths, C.A., C.F.E.
Auditor General
City of Toronto**

TABLE OF CONTENTS

EXECUTIVE SUMMARY	1
BACKGROUND	3
AUDIT OBJECTIVES, SCOPE AND METHODOLOGY	4
AUDIT RESULTS	5
THE ADMINISTRATION OF EMPLOYEE BENEFITS IS WELL MANAGED	5
BENEFIT COSTS ARE INCREASING AT RATES SIGNIFICANTLY IN EXCESS OF INFLATION ALTHOUGH SUCH INCREASES ARE GENERALLY WITHIN INDUSTRY STANDARDS	6
REASONS FOR INCREASING BENEFIT COSTS	8
OPPORTUNITIES TO REDUCE COSTS.....	10
CONCLUSION	13
EXHIBIT 1: Benefit Cost Comparison – Public Sector Benefit Plans	14

EXECUTIVE SUMMARY

Since amalgamation, the Auditor General has issued a number of reports relating to the administration and processing of payroll at the City. The annual follow-up by the Auditor General on outstanding recommendations has indicated that management has implemented all payroll related recommendations. Our review of the administration of employee benefits is the first such review of this particular area.

Benefit Administration is well managed

The purpose of our review of employee benefits initially was to evaluate the administrative controls in order to ensure that claims for employee benefits were being processed efficiently and effectively. It became evident very early on during the review that this particular function was well managed by staff from the Benefits and Employee Services Section of the Pension Payroll and Employee Benefits Division. In addition, we are satisfied that the controls in place at the City's insurance carrier, Manulife Financial (Manulife) are such that benefit claims are processed promptly, accurately and in compliance with the provisions of the City's various benefit plans. Consequently, this report does not contain any recommendations relating to the day to day administration of employee benefits either from a City management perspective or from the perspective of Manulife. During the course of our review, however, we identified a few minor administrative issues which require attention. These concerns have been communicated separately to management.

Employee benefits costs are increasing significantly

Throughout our research and ongoing discussions with management it became evident that the major area of concern in relation to the management of employee benefits related to the continuing yearly escalation of employee benefit costs. These significant increase in costs are not however, unusual. For example, industry standards for health cost increases in Canada over the past few years has been in the range of 16 per cent for health and 10 per cent for dental. In this context, the City's increasing costs are within these ranges.

The cost of providing benefits to City employees has risen from approximately \$146 million in 2005 to a level of almost \$162 million in 2006. This amount represents an increase in the range of 11 per cent and does not include the cost of employee benefits relating to the City's Agencies, Boards and Commissions. Further, the budget for 2007 employee benefits is anticipated to increase a further \$24 million to \$183 million or almost 13 per cent. Such increases are unsustainable in the long term.

Employee benefits are a part of employees compensation and should therefore be managed as effectively and prudently as possible while continuing to follow industry standards.

The majority of the contents of this report include information relating to the level of the increase of employee benefits, as well as our perspective on the drivers contributing to the increases. The containment of employee benefit increases represents a major challenge to management.

Our report contains three high level recommendations relating to the administration of benefits. These recommendations generally, are long term in nature and while having relevance to the management of employee benefits, will not have a significant financial impact in the containment of employee benefit costs particularly when considered in the context of the significant funds expended on employee benefits. These recommendations centre on:

- the need to review the pooling of purchasing power with other City entities;
- the need to continue to review cost containment initiatives such as the use of drug dispensing fee caps; and
- the need to review and document the annual evaluation of Manulife's performance

Increasing employee benefit costs is a major concern at the City as well as many public and private organizations world wide. The aging of the "baby boomer" population is contributing to this increase. The use of many benefit programs by the "baby boomer" generation will increase significantly as this segment of the population reaches retirement age.

Management is very much aware of the challenges facing them in this regard and have undertaken a number of initiatives to reduce employee benefit costs. These efforts must continue if the level of current benefits provided to City employees is to be sustainable in the future.

BACKGROUND

In 2007, the City and its Agencies, Boards and Commissions will spend an estimated \$259 million in employee benefit costs

The City of Toronto provides benefits to approximately 71,000 employees, dependents and retirees with budgeted 2007 employee benefit expenditures of \$183 million for employees of the City of Toronto and those Agencies, Boards and Commissions included under the City's benefit plan. These include the Sony Centre, the Board of Governors of Exhibition Place, Toronto Zoo, Toronto Public Library and Board operated Community Centres and Arenas.

The City pays an additional \$76 million in benefits for employees of other City Agencies, Boards and Commissions, who while not included in the City employee benefit plan are part of the City's 2007 gross operating budget of \$7.8 billion. These include the Toronto Police Service, Toronto Public Health and the Toronto Transit Commission among others. Employee benefits for these organizations are administered under separate employee benefit plans and contracts.

The City is self-insured and uses Manulife to administer its claims

Similar to most employers who manage benefit programs for a large number of employees, the City of Toronto is self-insured and uses an insurance carrier to process and adjudicate employee benefit claims. In these circumstances, the City reimburses the insurance carrier for the actual benefit claims paid to employees and pays an administration fee for their processing and adjudication services. The City's insurance carrier is Manulife Financial (Manulife).

Manulife has been the benefit administrator for claim processing services since June 1, 2000. The contract with Manulife expired June 1, 2005 and following a six-month extension to allow staff sufficient time to assess proposals received through the Request for Proposal process, a further five-year contract with Manulife was executed. The current contract expires December 31, 2010.

Why did we conduct this audit?

The Auditor General's 2007 Audit Work Plan included a review of the City's administration of the employee benefits program. This review was selected based on the complexity involved in the administration of benefits, risks related to the inadequacy of internal controls and the extent of expenditures.

The purpose of this review was to review procedures in place to manage and control services provided under the benefit administrator's contract and to determine if opportunities exist for improving future benefit administrator contracts.

AUDIT OBJECTIVES, SCOPE AND METHODOLOGY

What were the objectives of this audit?

The objectives of this audit were to assess whether cost containment opportunities exist in City sponsored employee benefit plans, to review procedures in place to manage and control services provided under the benefit administrator's contract and to determine if opportunities exist for improving future benefit administrator contracts.

What did the audit include?

Our audit included a review of employee benefit related practices and procedures in place during the period January 1, 2005 to June 30, 2007 for active and retired employees of the City (excluding the Agencies, Boards and Commissions). We focused on cost containment strategies related to employee benefit costs and claims analysis, claims processing, quality assurance and improvements in monitoring the benefit administrator's performance.

How did we conduct this audit?

Our audit methodology included the following:

- review of policies, procedures and current divisional practices;
- interviews with relevant City staff;
- examination of relevant documents;
- review of records and management reports;
- evaluation of current management control processes;
- review of relevant Council, Standing Committee and audit reports;
- analysis of data;
- review of benchmarking information with comparable governmental organizations; and
- other procedures deemed appropriate.

We also interviewed Manulife's management staff and reviewed the report of an independent auditor on the benefit administrator's description of administrative internal controls.

The audit was conducted in accordance with generally accepted government auditing standards

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

AUDIT RESULTS

THE ADMINISTRATION OF EMPLOYEE BENEFITS IS WELL MANAGED

Benefits Administration is well managed

The Benefits and Employee Services Section of the Pension, Payroll and Employee Benefits Division administer employee benefit plans with diligence and in an organized manner. The Benefits and Employee Services staff maintain a good working relationship with the employee benefit administrator. Both parties work together to provide a high level of service to City staff. In addition, we are satisfied that the controls in place at Manulife are such that benefit claims are processed promptly, accurately and in compliance with the provisions of the City's various benefit plans.

Current claims monitoring process provides adequate oversight

Our review indicates that the current monitoring process provides adequate oversight and assurance as to claims adjudication and processing. We noted a few minor issues for which we had some suggestions related to benefit administration procedures and discussed these with management.

Management has undertaken initiatives to control benefits costs

In the past five years, management has undertaken initiatives to control employee benefit costs. These initiatives include:

- consolidation of benefit plan administration from over 10 insurance carriers to one;
- use of a generic drug plan;
- providing a maximum cost on private duty nursing coverage;
- revising the dental recall period for Fire Services; and
- revising paramedical practitioner coverage.

BENEFIT COSTS ARE INCREASING AT RATES SIGNIFICANTLY IN EXCESS OF INFLATION ALTHOUGH SUCH INCREASES ARE GENERALLY WITHIN INDUSTRY STANDARDS

In 2002, the City spent \$113 million to provide employer sponsored benefit plans. Costs for 2006 increased to \$162 million. The budget for 2007 was \$183 million

Employee benefit costs include extended health care, dental care, drugs, long term disability and life insurance. Costs for these benefits have grown an average of six per cent per year over the past five years. In 2002, the City of Toronto spent \$113 million to provide employer sponsored benefit plans to its employees and retirees. The 2006 cost of providing health care benefits to employees and retirees is \$162 million, and 2007 budgeted employee benefit costs are \$183 million excluding Agencies, Boards and Commissions.

Current claim costs for an aging workforce and retirees, rising health care costs and other related issues are expected to drive costs even higher.

Stability in the number of plan enrolments

The City provides benefit coverage to approximately 71,000 employees, dependents and retirees. The number of eligible employees, dependents and retirees has remained relatively stable over the past several years.

While enrolments have been relatively stable, benefit costs and claims have increased

While the total number of employees and retirees enrolled in City benefit plans has remained relatively stable, both the cost and number of benefit claims have increased.

Tables 1 and 2 below show how benefit costs and claims have increased from 2004 to 2006.

Table 1:

**City Benefit Costs from 2004 to 2006
(Excludes Agencies, Boards and Commissions)**

Benefit Type	City Costs		
	2006 \$	2005 \$	2004 \$
Extended Health	33,080,793	25,583,792	23,673,509
Drugs	49,425,232	46,353,129	43,835,204
Dental	44,325,397	41,763,287	40,000,708
Long Term Disability	22,755,216	21,032,083	19,638,862
Life Insurance	<u>12,716,333</u>	<u>11,420,350</u>	<u>10,949,163</u>
Total	<u>\$162,302,971</u>	<u>\$146,152,641</u>	<u>\$138,097,446</u>
Annual Percentage Increase	11.1%	5.8%	

Significant increase in costs in 2006

Table 1 shows that based on the City’s 2006 actual experience the increase in costs from 2005 to 2006 was over 11 per cent. In particular, the increase for extended health care compared to 2005 was 29 per cent.

Significant increase in claims in 2006

Table 2 shows how the total number of benefit claims has also increased significantly. The number of total claims has increased from 1,428,770 to 1,526,365 from 2005 to 2006.

Table 2:

**Benefit Claims for Employees and Retirees
(Excludes Agencies, Boards and Commissions)**

Benefit Type	2006		2005		2004
	Number of Claims	Annual Percentage Change %	Number of Claims	Annual Percentage Change %	Number of Claims
Extended Health	202,597	27	159,791	20	133,076
Drugs	726,151	5	692,850	3	672,627
Dental	597,617	4	576,129	1	569,676
Total Claims	<u>1,526,365</u>	7	<u>1,428,770</u>	4	<u>1,375,379</u>

Increases in the average annual cost per plan member for drug prescriptions

The average annual claim cost for prescription drugs during 2004-2005 was \$438. For the same 12 months in 2005-2006 the average annual prescription claim cost increased to \$458. This represents an increase of five per cent in annual prescription drug claim costs. At this rate of increase per year, claims for prescription drugs alone would cost the City over \$286 million over the next five years.

Benefit costs increase annually due to various factors

Benefit costs increase annually due to inflation, increases in the use of employee benefits, technological advances involving new services, new drugs and drug therapies and changes in the mix of services. For example, dental claim trends are shifting to more restorative treatments as opposed to basic treatments.

For 2007, industry average cost increases for extended health care and drugs are 16 per cent and 10 per cent for dental costs. For 2006, industry average increases were 15 per cent for extended health care and drugs, and 10 per cent for dental costs.

REASONS FOR INCREASING BENEFIT COSTS

The City's workforce is aging

One significant factor affecting City benefit costs is the relatively advanced age of City employees.

In 2006, the average age of a City employee was 45

A review of the City's workforce age distribution indicates a significantly high percentage of older workers. In a study done by the City's Human Resources Division "baby boomers" (those born between 1946 and 1964) represented 62 per cent of the City's current workforce. Combined with this age factor is the City's low turnover rate. In 2006, the turnover rate was seven per cent. In 2006 the average age and tenure for City employees was 45 years and 14 years service.

Benefit costs rise with age

Benefit costs generally rise with employee age and the increase in the need for health care service. In addition, employees are no longer required to retire at age 65. As a result, claim costs will likely increase as a larger number of older employees will remain eligible for full benefits.

Demographics are a long-term cost driver

Industry information indicates that the amount spent per claimant between 56 and 65 years of age for drugs are double that of the 36 to 45 age group. Drug plans with an older employee population, will experience increases in claim costs and higher annual drug costs. A comparison between the average prescription drug claim cost for active City benefit plan members in 2005-2006 and retired members (includes individuals age 55 and older) illustrates this benefit cost factor. The average total claim cost per active member was \$458 and \$927 for retiree members.

With the end of mandatory retirement, City benefit costs will increase

In 2006, the Province ended mandatory retirement at age 65. City employees who turn 65 after December 12, 2006 can choose to continue working. Employees working beyond age 65 will further continue to be eligible for certain benefits with each union/association.

Benchmarking of benefits identify differing levels of benefits

During our audit we reviewed benchmark information provided by staff to comparable governmental organizations. The following are two examples of differences in benefit service coverage between the City and three other major public sector employers:

- Pharmacy dispensing fee cap in health care benefit plan. The City of Toronto has none, two of the comparative organizations have a cap of \$7.00 per prescription; and
- Dental care plan and major restorative services. The City of Toronto reimburses between 60 and 80 per cent of claim costs to an annual maximum between \$2,000 and \$5,000 per person. Two of the comparative organizations reimburse 50 per cent of claim costs with annual maximum of \$1,200 and \$1,500 respectively.

Other benefit plan comparisons are shown in Exhibit 1 of this report.

Plan design changes can result from negotiated and legislative changes

Changes in plan design can result from negotiated improvements or legislative changes. Examples of recently negotiated improvements for City plans include increases in coverage for vision care, paramedic and private duty nursing services. These changes resulted from recent Provincial legislative changes involving the delisting of eye exams, chiropractic care and physiotherapy services, all formerly covered by the Provincial Ontario Health Insurance Plan. Each of these delisted services has resulted in an increase in benefit claims for City benefit plans yet originate from reductions in health care coverage by the Province. Legislative cost shifting is a trend that is expected to continue in the future. To date the City has absorbed the costs of these benefit shifts.

Legislative cost shifting has impacted costs

City employees do not share in benefit costs and have little or no financial stake in benefit decisions

City employees currently have little or no financial stake in their benefit service decisions. While there are limits and standard pricing on a few health services such as chiropractors, massage therapists and dentists, the City pays the cost of employee benefit decisions. The current design of City benefit plans provides limited incentive to plan members to obtain the best value when seeking a benefit service provider.

OPPORTUNITIES TO REDUCE COSTS

Benefit staff has implemented several cost containment initiatives

Benefits and Employee Services has implemented several initiatives since amalgamation to control the escalating costs of providing and administering benefits including:

- consolidation of administration in benefit plans from over 10 insurance carriers to one to reduce administrative overhead and administrative costs;
- negotiating similar benefits of collective agreements to reduce the complexity and cost of providing benefits;
- harmonizing the use of customary and reasonable fee schedules;
- lowest cost generic drugs and medicines;
- maximum on private duty nursing coverage;
- change in dental recall period for Fire Services; and
- revising paramedical practitioner coverage.

Benefit staff work closely with the Benefit Administrator, Human Resources, union and association representatives

In managing benefit plans, staff work closely with the benefit administrator. Benefit staff also work closely with Human Resources, including Employee and Labour Relations, to address collective bargaining requirements, including an agreed upon benefit strategy, best practices and cost containment initiatives. Through the Benefits Monitoring Committee, established to encourage ongoing dialogue with unions and associations as required under collective agreements, the Director, Pension, Payroll and Employee Benefits along with union and association representatives address issues of concern arising out of the administration of the benefit plan. City benefit staff also ensure ongoing employee education and communication.

Enhanced economies of scale through pooling purchasing power with the Agencies, Boards and Commission

1. Pooling Purchasing Power With Other City Entities

The City currently provides benefit coverage to its employees and those Agencies, Boards and Commissions which fall under its current benefits umbrella. Other City Agencies, Boards and Commissions, including the Toronto Police Service and the Toronto Transit Commission are not part of the City's benefits umbrella. In 2006 these other Agencies, Boards and Commissions spent \$76 million to provide employee benefits to staff.

We have been advised by management that the current administrative rates charged by Manulife are extremely competitive. In these circumstances, there may be limited opportunities to reduce these costs even further if the Toronto Police Service and the Toronto Transit Commission were included in the City's benefit contract with Manulife. It may be possible, however, that each one of these entities could take advantage of the City's current fee arrangement. We have not reviewed the level of fees being charged to these entities but never-the-less is an option worth considering further.

2. Other Opportunities

Staff follow a continuous process of reviewing cost containment opportunities in relation to employee benefit plans. Opportunities for savings, for example include the imposition of caps on drug dispensing fees and the potential use of deductibles and co-insurance.

Caps on drug dispensing fees

In the case of dispensing fees, no limitation or deductible exists as to the amount reimbursed for drug dispensing fees charged by pharmacies. We reviewed 2007 claims data to determine the range in pharmacy dispensing fees and the impact of these costs on City drug plans. Drug dispensing fees varied from \$4.12 to \$14.00. Assuming a cap of \$8.50 on drug dispensing fees, the City could realize an annual plan savings of approximately \$1.2 million if it imposed a cap at this level.

Deductibles, co-insurance payments and maximum caps reduce overall costs

In addition, current industry best practice for containing employee benefit costs include the use of deductibles, co-insurance and maximum caps on certain products and services. The absence of any structured level of deductible, co-insurance payments and limited use of maximum cap levels is not in accordance with industry best practice. Current industry practices provide employees with a personal financial involvement in health and benefit decisions and create an incentive to contain costs.

Any measure to address issues relating to deductibles, co-insurance and maximum caps requires discussions and negotiations with the City bargaining units. In this context, such negotiations relating to this matter would not take place in isolation and presumably would be part of a more complete negotiation process.

Recommendations:

- 1. The Director, Pension, Payroll and Employee Benefits, in consultation with senior management representatives of the City's Agencies, Boards and Commissions, review and consider the cost-effectiveness of expanding the current City of Toronto benefits umbrella to include other City of Toronto Agencies, Boards and Commissions.**
- 2. The Director, Pension, Payroll and Employee Benefits, continue to review cost containment initiatives for the purpose of identifying potential cost reduction opportunities related to employee and retiree benefit costs. The review should include the use of drug dispensing fee caps as well as the potential for deductible and co-insurance provisions.**

Good contract management enhances decision making, accountability and stewardship

Generally accepted contract management practices and the City's procurement process require divisions to maintain documentation on vendor performance on all contracts.

Management could strengthen the evaluation process for determining the efficiency and effectiveness of the benefit administrator by assessing the extent to which the benefit administrator meets City needs and determining whether overall value is received for fees paid.

Establishing a mechanism for documenting performance allows the City to make an objective assessment of the benefit administrator's service delivery over the term of the contract. This assessment provides information allowing the ability to derive better value from the contract with the benefit administrator. Decisions related to higher potential contract service levels and contract renewals can be based on an informed and documented basis.

Recommendation:

- 3. The Director, Pension, Payroll and Employee Benefits, give consideration to the formal documentation of an annual evaluation of benefit administrator performance.**

CONCLUSION

This review identified a number of issues related to rising employee benefit costs and provides general information related to future benefit costs. While the number of plan members has remained relatively stable over the past number of years, employee benefit costs are rising and are expected to continue to increase at rate in excess of inflation into the foreseeable future even though such increase are in accordance with industry standards.

Our review indicates that the City Benefits and Employee Services Section of the Pension, Payroll and Employee Benefits Division administers benefit plans in a diligent, effective and efficient manner.

In this report, we have provided these high level recommendations related to cost reduction and containment, and management of the contract with the third party administrator. The implementation of these recommendations are generally long term in nature and while the financial impact of these recommendations are not particularly significant in the context of the large amount of funds expended on employee benefits, their relevance to the improved management of employee benefits is important.

EXHIBIT 1

Benefit Cost Comparison – Public Sector Benefit Plans

Benefit	City of Toronto	Province of Ontario	City of Ottawa	City of Hamilton
<u>HEALTH</u>				
Reimbursement	100%	100%	Various	100%
Deductible	No	\$3.00 a prescription	\$25.00 per year	No
Drug Coverage	100%	90%	90%	100%
Dispensing Fee Cap	None	None	\$7.00 per prescription	\$7.00 per prescription
Vision Benefit	\$450/24 months	\$340/24 months	\$300/24 months	\$250/24 months
Co-insurance	None	\$10 single/\$20 family	None	None
Emergency Out of Country Medical	Yes	No (Out of Province – Yes)	Yes	Yes
<u>DENTAL</u>				
Deductible	None	\$100 annually	None	None
Dental Fee Guide*	Current	Lag of one year	Lag of one year	Current
Basic Coverage	100%,	85%	90%	100%
Annual Maximum	Unlimited	Unlimited	Maximum \$1,500	Unlimited
Major Coverage	80%	50%	80%	50%
Annual Maximum	\$5,000 per person	\$1,200 per person	\$1,500 per person	\$1,000 per person
Orthodontic Coverage	50%	50%	50%	50%
Lifetime Maximum	\$5,000 per person (includes adults)	\$3,000 per child (age 6-18 years only)	\$3,000 per person (includes adults)	\$1,500 per child (under age 18 years only)
Premium Payment	100% Employer	100% Employer	Employer 75%, Employee 25%	100% Employer
<u>LONG-TERM DISABILITY</u>				
Coverage	75% of earnings	66 2/3% of earnings	75% of earnings to maximum \$14,000	66 2/3% of earnings
Premium Payment	Employer 100%	Employer 100%	Employer 100%	Employer 100%

*Most Provinces fix rates using the fee guide of their provincial dental associations. For Ontario the dental fee guide increase for 2006 was 3.70 per cent (overall change as costs vary by procedural code).