MONTANA STATE FUND
2007 BUDGET ANALYSIS

A Report Prepared for the

Legislative Finance Committee

By

Kris Wilkinson

October 9, 2006

Legislative Fiscal Division

www.leg.mt.gov/css/fiscal

INTRODUCTION

The Montana State Fund (MSF) provides Montana employers with an option for workers' compensation and occupational disease insurance and guarantees available coverage for all employers in Montana. The management and control of the state fund is vested solely in the Board of Directors (board).

The Montana State Fund was created by the 1990 Special Legislative Session, it was exempted from the Legislative Finance Act by the 1993 Legislature. This exemption removes MSF from the legislative appropriation process and from legislative oversight conducted by the Legislative Finance Committee through the Legislative Fiscal Division. Statute does, however, require MSF to present its approved budget for review by the Legislative Finance Committee no later than October 1.

The MSF 2007 budget is attached to this document. MSF staff will provide a brief summary of the information contained in their budget. This report discusses LFD analysis of MSF 2007 budget. This report does not attempt to explain workers' compensation insurance and all aspects of the budget. Rather, it concentrates on several segments of the budget for the purpose of providing information on areas of interest or concern to the legislature.

A historical background of the legislative decisions relating to MSF and MSF board decisions is presented in Appendix A.

PREMIUM RATES

Background

MSF charges premium costs to employers based on the payroll of the insured employer's workforce and the type of industry or activity the employer is engaged in. MSF uses the system established by the National Council on Compensation Insurance (NCCI) to classify an employer's type of industry. These classifications are commonly called class codes. The premium rates established for each class code are an estimate of the amount of average future workers' compensation losses associated with the employment and the costs of administering the potential claims.

The premium rates associated with each class code are calculated by NCCI each year through examination of losses, which are costs of benefits paid or to be paid to Montana injured employees, payments to Montana medical and other service providers for injured workers, and the cost of MSF administering claims which are incurred during the policy period. These factors result in loss-costs. For the most part, adjustments to loss-costs are adopted by the board and used to assess premium rates for Montana employers. A loss-cost multiplier is also determined to arrive at the overall premium rate. Loss-cost multipliers are other costs such as the amount of equity MSF maintains, the commissions paid to independent insurance agents, or the amount of additional losses the board thinks MSF will have to cover above what is included in the benefits and claims expenditures.

Premium Rate Assessments

To ensure MSF can meet its obligations, MSF must set premium rates at amounts sufficient to recover costs of all claims for workers' compensation losses and to meet expenses of conducting the business of MSF. This is done by:

- assessing loss-costs for each type of industry
- determining the loss-cost multiplier to recover other costs associated with providing workers' compensation insurance such a general overhead costs.

For FY 2007 the board voted to accept NCCI loss-cost increases, which averaged 2.4 percent, as a basis for rate making. The increase in the loss-cost multiplier was included in the average premium costs.

It should be noted that one of the costs included in the loss-cost multiplier is the payment of commissions to independent insurance agents. Currently, agent represented business is 66.2 percent of MSF premiums. In 2007, commissions are paid at 7.975 percent of gross premiums of agent represented business.

SIGNIFICANCE OF MSF PREMIUM COSTS TO STATE OF MONTANA

In addition to the potential impact on Montana employers, Montana state government paid $19.8 million in premiums to MSF in FY 2006. As stated, the board approved an increase in premiums by an average of 2.4 percent for FY 2007, which equates to $475,000 in additional premium costs for state government. Due to increases associated with individual class codes the actual FY 2007 premiums will be higher.

FISCAL YEAR 2007 ANNUAL BUDGET

Revenues

MSF revenues include both net earned premium and investment income.

Net earned premium primarily result from premiums assessed, partially offset by reductions for reinsurance premiums paid, safety incentive refunds, and volume discounts. Budgeted net earned premiums and the actual amounts of net earned premiums for the last 10 years appear in Figure 1.

Since FY 2002, net earned premiums budget estimates were an average of 20 percent under estimated. FY 2007 net earned premium is calculated on 818 fewer policies than MSF issued in FY 2006. One implication of the under-budgeted net earned premiums is the use of net earned premium as a measurement for employee incentives. See Employee Incentive Plan on page 4 for a discussion of this concern.

In FY 2007 investment income is budgeted at $35.5 million, with an assumption of a 5.09 percent return on investments. Investment income is generated through investments in bonds, equity securities, cash and short-term investments and collateral securities on loan on admitted assets. Investment income is used to offset MSF costs, assisting in stabilizing premium rates for Montana employers.

Figure 1
Montana State Fund
Net Earned Premium
(in millions)

	Budgeted	Actual	% Over Under Estimate
1997	$90.51	$88.15	-2.61%
1998	74.07	76.42	3.17%
1999	66.05	70.17	6.24%
2000	65.42	70.66	8.01%
2001	70.51	74.51	5.67%
2002	78.13	92.97	18.99%
2003	94.70	117.78	24.37%
2004	126.01	139.36	10.59%
2005	146.91	189.38	28.91%
2006*	191.80	$211.90	10.48%
2007	$214.00		

* FY 2006 actuals is estimated at this time

EXPENDITURES

Expenditures for MSF have five major categories:

- New Fund Benefits and Claim Expenditures (68.11 percent of the budgeted expenditures)
- Old Fund Benefits and Claims Expenditures (6.00 percent of budgeted expenditures)
- Allocated Loss Adjustment Expenditures or costs directly associated with managing the cost of a specific claim (2.01 percent of budgeted expenditures,)
- Unallocated Loss Adjustment Expenditures or costs which cannot not readily be identified with a specific claim but are can be identified as a cost of generally managing benefits or claims (7.82 percent of budgeted expenditures,)
- Underwriting Expenditures (16.06 percent of budgeted expenditures)

MSF has varying levels of control over expenditures. For benefits, complexity and severity of the worker's injury, the injured worker's ability to return to work, age of the injured workers, changes in worker's compensation statutes and decisions in both the Worker's Compensation Court and the Montana Supreme Court affect the benefits payment amounts paid out in any given year. Both indemnity and medical benefit payments can be made over a number of years so that estimates on the cost of claims for previous premiums must be included as well as the estimated costs of claims on covered employees in the current year. MSF attempts to

control these costs through programs such as return to work or safety management programs and programs designed to impact direct costs such as its pharmacy benefit program.

New Fund benefits and claim expenditures are paid from current premiums and reserves. Therefore, if any major changes occur in benefits or claim expenditures, the board has the option of increasing premiums to cover the additional costs. There are no revenues generated in the Old fund except for investment income, so any increase needed to cover additional benefits and claim expenditures must come from the general fund. See discussion of Old Fund benefits and claims expenditures on page 4.

The costs of allocated loss adjustment expenditures and unallocated loss adjustment expenditures are, for the most part, a function of the number and severity of the benefits and claims paid in any given year. The board has less control over these costs as a result.

Underwriting expenditures are the costs of administering the worker's compensation insurance program and include the personal services, operating costs and equipment used by MSF. In FY 2007 underwriting expenditures comprise 16.1 percent of total budgeted expenditures. Unlike other expenditures, MSF and the board have significant control over underwriting expenditures. While increasing or decreasing these costs does not have a dollar for dollar impact on premium rates, changes in overall underwriting expenses, particularly as a percentage of total expenditures, impacts loss-costs multipliers, which impact premium rates.

Underwriting Expenditures

Figure 2 shows the MSF agency budget for FY 2007 as compared to the FY 2006 actual expenditures.

Figure 2
Montana State Fund
Underwriting Expenditures

	Actual FY 2006	Budget FY 2007	% Increase
Personal Services	$19,027,183	$19,410,337	2.01%
Operating Expense	13,143,137	9,732,096	-25.95%
Equipment	$3,134,691	$2,862,494	-8.68%
Total Costs	$35,305,011	$32,004,927	-9.35%

Personal Services

While a comparison of FY 2006 actual personal services compared to FY 2007 budgeted personal services shows only a 2.1 percent increase, the actual expenditures include $1.4 million accrual for employee incentive payments which was not budgeted in FY 2006. MSF was able to stay within their overall personal services budget in FY 2006 even with the incentive payments due to significant vacancy savings. As of June 7, 2006 MSF had 27 vacant positions out of 293.5, or 9.3 percent of all positions vacant. Seven of the positions were vacant for over one year. MSF budgeted vacancies at 3.35 percent in FY 2007.

MSF budgets vacant positions and new positions at 100 percent of the mid-point for the position assigned pay band. According to MSF Pay for Performance Program Information and Employee Compensation Policies, newly hired personnel are compensated between entry (80 percent of the mid-point) and the mid-point. By budgeting all positions which are currently vacant or new at the mid-point when some, if not all positions, begin below the mid-point MSF overstates the amount needed in the personal services budget.

Employee Incentive Plan

The Montana State Fund Board approved an executive incentive plan in FY 1995. The costs of the executive incentive payments are not budgeted. The amount of the incentives is determined through a weighted formula depending on MSF achievement of incentive targets. This was changed to an employee incentive plan in FY 2002. Figure 3 shows the measurement factors used in the calculations of incentive payments.

Figure 3
Montana State Fund
Employee Incentive Plan

Measurment Factor - 1

Probability of Achieving Varying Results
and the Opportunity Payout

For example:

Level of Achievement for President	Probability	Payout Opportunity
Threshold	80%	10%
Target	50%	20%
Outstanding	20%	30%

Measurement Factor 2

Measure	FY 2007 Weight Factor	Threshold	Target	Outstanding
Achieve FY Net Operating Income	30%	$12.8 million	$24.4 million	$40.9 million
Achieve Net Earned Premium	5%	$214.4 million	$217.3million	$220.8 million
Achieve FY Loss Ratio	25%	87.60%	83.50%	77.50%
Achieve Expense Ratio	10%	25.80%	24.90%	23.80%
Achieve Investvent Income	5%	$35.5 million	$36.6 million	$37.8 million
Achieve Enterprise-Wide Initiatives	25%	80%	90%	100%
Payment Amount President		10%	20%	30%
Payment Amount Executive		7.50%	15%	22.50%
Payment Amount Employee		5%	10%	15%

Indicates "Gatekeeper"

One major consideration for any employee incentive plan is whether the financial goals are set at the appropriate amounts to ensure that extra pay is only made for extra achievement. For example, in FY 2007 one of the measurements is achieving net earned premium in the budgeted amount of $214.8 million. As stated, since FY 2002, net earned premium budget estimates were an average of 20 percent under-estimated. See Figure 1 on page 3.

In FY 2006 net earned premium was $211.9 million, $20 million above budget, resulting in incentive payments between 10 to 20 percent for this component of the measurement formula, which is weighted at 5 percent. Estimated incentive payments of $1,364,220 for FY 2006 were considered by the board in October of 2006. Actual payments will be less than the accrual. While these incentive payments were not budgeted, MSF was able to pay them from budgeted expenditures. The overall budget for underwriting expenditures was used to calculate the loss-cost multiplier included in premiums paid by employers in 2006.

If the net earned premium is under-budgeted by 10 percent in FY 2007, the additional net earned premium of $21.4 million will result in achievement of $235.8 million in net earned premium. $235.8 million in net earned premium results in outstanding level of achievement for the incentive payments, which allows this component of the incentive to be calculated at the highest level of incentive payments. Underestimating this component of the incentive formula can result in easier achievement of incentive payment goals.

Dividends

According to 39-71-2316 (h), MCA the state fund may declare dividends if there is an excess of assets over liabilities. However, dividends may not be paid until adequate actuarially determined reserves are set aside. See Appendix A for an explanation on why MSF maintains reserves and what dividends accomplish. MSF has paid dividends for the last eight years, including those years they suffered a net operating loss. See Figure 4 for net operating income/loss and dividend payments.

Figure 4
Montana State Fund
Net Operating Income/Loss
Dividend Payments
(in millions)

	Net Operating Income/Loss	Dividend Declared
1998	$42.65	$7.00
1999	34.53	6.95
2000	12.35	4.99
2001	11.58	2.90
2002	11.79	1.90
2003	-34.51	5.00
2004	-$6.25	$5.00

The board policy is to declare dividends to policyholders 2 years after the policy year ends so that policyholder injury losses for the dividend year can be more accurately determined. Therefore, the $5 million dividend for FY 2004 was approved by the board in March 2006. The board approved $5 million in dividends to policyholders for both FY 2003 and FY 2004, even though net operating losses in those years were $34.5 million and $6.2 million, respectively. MSF equity covered both the net operating losses and the $10 million in dividends.

While excess assets are returned to policyholders as dividends, dividends are not returned to all employers, nor are dividends paid in the same percentages as premiums are paid. Dividends are paid based on the business's loss ratios for the year following payment of premium and on the premium size. For example, in FY 2004 the state of Montana paid $10,777,669 in premiums (12.93 percent of net earned premiums) and received $110,083 in dividends, or about 2 percent of the dividend paid. The small amount of the dividend resulted from the individual state agencies loss ratios. Reducing equity through dividend payments reduces the amount of investment income available for offsetting the costs of premiums to all employers, including those not eligible for dividends.

Even with significant operating losses in FY 2003 and FY 2004, MSF is considered by their actuary to have adequate reserves. However, its actuary recommends increasing MSF equity position to "strong", which would ensure the agency is financially and operationally strong, and may not have to increase premium rates should unexpected developments occur. A strong equity position allows for stable premium rates. MSF actuarial analysis suggests targeting equity between $190 to $230 million based on June 30, 2005 financials. By approving dividends in years MSF suffered net operating losses, the board has extended the time it will take MSF to achieve a strong equity position. Increases to reserves are also a consideration when determining loss cost multipliers, which can result in increased premium costs to Montana employers.

Old Fund Benefits and Claim Expenditures

Benefits and claims expenditures continue to be made for claims of injuries resulting from accidents occurring before July 1, 1990. The Old Fund benefit payments are diminishing as claims are resolved.

When the legislature removed approximately $23 million of the reserve funds for the Old Fund in FY 2002 and FY 2003, it also required in any year the reserves in the Old Fund are insufficient to pay the claims for workers, the general fund must pay the remaining claims. As of June 30, 2005 the estimated unfunded liability associated with the Old Fund is $15.6 million. Using this liability it is estimated Old Fund reserves will be depleted in 2013.

However, this was before the Stavenjord case was decided in relation to retroactivity and common fund status by the Supreme Court and remanded to the Workers' Compensation Court. This case relates to the failure of the Occupational Disease Act to provide the same permanent partial disability benefits for occupational diseases as provided for injuries. As the court requires the case to be applied retroactively to 1987 and the case was granted

common fund status, the Montana State Fund currently estimates the potential estimated benefit costs to be between $5 and $7 million to the Old Fund.

In addition, other cases before either the Worker's Compensation Court or the Supreme Court could negatively impact the Old Fund and increase the amount of the unfunded liability in the Old Fund reserves. One case, titled Satterlee, challenges the constitutionality of terminating permanent total disability and rehabilitation benefits when a claimant receives or becomes eligible to receive full Social Security retirement benefits or an alternative to that plan. Should this case be decided against MSF, settlement payments to the Old Fund could range between $93 and $116 million, further increasing the Old Fund liability.

SUMMARY

Review of the MSF 2007 budget shows several issues. They include:

- Potentially under-budgeting net earned premium revenues
- Budgeting personal services at higher rates than indicated
- Setting incentive payment measurements for net earned premiums at levels below historic averages, with the effect of making it easier to attain the measurements
- Dividend policies which allow for payment of dividends for years when MSF suffered operating losses

Finally, the LFC should be aware that within the next few years, the legislature could be required to offset growing Old Fund liabilities with general fund.

APPENDIX A

BACKGROUND OF LEGISLATIVE DECISIONS RELATING TO MSF AND MSF BOARD DECISIONS

During the 1980s workers compensation was a function of the Department of Labor and Industry. The program experienced significant liabilities, exceeding $400 million. In order to restructure the fund and develop a plan to reduce the debt, the legislature established the fund as a nonprofit, independent public corporation during the 1990 Montana Special Legislative Session. It was also during this session that separate funding and accounts for claims of injuries resulting from accidents occurring before July 1, 1990 (Old Fund) and claims occurring on or after July 1, 1990 (New Fund) were established. As part of the plan to reduce the liability for the Old Fund Montana employers were charged an Old Fund Liability Tax. In 1993 MSF was exempted from the Legislative Finance Act but required to present their budget to the Legislative Finance Committee for review. In 1998 the Old Fund was determined to have adequate reserves to pay claims in part due to a $63.8 million payment from the New Fund. As a result, the Old Fund Liability Tax was eliminated. Transfers of approximately $4 million and $19 million from reserves for Old Fund claims to the general fund were made in FY 2002 and 2003 respectively, because the reserves were determined to be in excess of the funds needed to pay the claims. According to statute, in any year the reserves in the Old Fund are insufficient to pay the claims for workers the general fund must pay the remaining claims. As of June 30, 2005 a liability of $15.6 million exists in the Old Fund. It was estimated the reserves for the Old Fund will be depleted in 2013 at which time general fund will needed.

On July 8, 1995 the Montana State Fund implemented a market based, pay-for-performance compensation program. According to program policies, the goal is to progress employees within the pay range to a competitive range of 90 to 100 percent of the midpoint of the salary range. The policies allow for merit calculations based on job performance. The increases may increase base salary or be made a one-time single payment. Increases amounts range from 1 to 6 percent of annual salary.

The Montana State Fund Board also implemented an Executive Incentive Plan. The board established the program in 1995, initially awarding only executives additional payments. The program was expanded to exempt employees in 1999 and to all employees in 2002. Annual awards are made based on achievement of specific financial goals. As of FY 2006 awards range from 0 to 30 percent of annual salary depending on the level of achievement of the outlined goals and the employee classification.

In FY 1999 MSF began paying commissions to independent insurance agents to sell and service Montana State Fund insurance to employers around the state. The first year of the program agent represented premiums represented 29.5 percent of MSF gross earned premiums. While benefits comprise the largest expenditure in the MSF budget, commissions are the largest component of MSF operating costs. Commissions consist of base commissions, incentive commissions, and other states coverage commissions.

In 2001 the legislature eliminated a requirement in 39-71-2363, MCA which limited administrative expenditures approved by the board to 15 percent of the earned annual premium of the prior fiscal year.

What Dividends Accomplish

According to MSF, policyholder dividends accomplish the following:

- Return a portion of the earnings to some policyholders
- Share positive results with policyholders when underwriting/loss experience is better than expected or investment returns are higher than anticipated
- Reward policyholders with low loss ratios within 2 years
- Provide policyholders with incentives for safety and loss prevention and return to work programs
- Build long term partnership with policy holders that are contributing to stability and financial strength of MSF

Why MSF maintains reserves

MSF maintains reserves to pay loss costs on policies in the years following the injury of an employee. Loss costs represent the costs of benefits paid or to be paid to injured employees, to medical providers for medical and related services, and the costs of administering claims which are incurred during the policy period. The board maintains large reserves to insure the total costs of the claims can be paid over the life of the claim. MSF must pay the full cost of the injured workers claims, both medical bills and wage replacement, even if costs exceed the premiums and investment income received for that year.

S:\Legislative_Fiscal_Division\LFD_Finance_Committee\LFC_Reports\2006\October\MSF_Report.doc

Attachment 1

MONTANA STATE FUND
FISCAL YEAR 2007 ANNUAL BUDGET REQUEST

Montana State Fund operates in a dynamic and competitive environment. Our future success is dependent upon our ability to anticipate changing market conditions and to react in an appropriate manner. Ultimately, we will continue to weather the forces of change by being responsive to the needs of all those we serve. We will utilize all the resources at our disposal to build upon past successes and maintain a strong, viable, and stable workers' compensation market for Montana businesses.

The fiscal year 2007 (FY07) budget request provides the funding that enables Montana State Fund (MSF) to continue our leadership role in the Montana workers' compensation industry, implement our business plan initiatives, and efficiently manage business operations. The FY07 Budget will provide the financial resources to support the FY07 Strategic Business Plan (SBP). The SBP has four enterprise-wide initiatives:

1) Focus on Employee Satisfaction;
2) Focus on Customer Satisfaction;
3) Establish standard as "Best in the Industry" relative to claim resolution;
4) Provide appropriate infrastructure to allow the realization of MSF's vision.

The FY07 SBP provides details on each initiative and expected benefits to customers and MSF's operations.

REVENUE

The premium revenue MSF generates in Montana's competitive workers' compensation insurance market, along with investment income, funds the operating expenses, indemnity and medical claims MSF policyholders incur.

For FY07 we are projecting net earned premium of $214,368,000. The estimate projects 29,775 policies written in FY07 and is based on 27,801 active policies. MSF estimates FY07 investment income to be $35,500,000. This is based on net return on invested assets of 5.09%. The following table displays the revenue, net earned premium and investment income: budgeted for FY07; current projection for fiscal year end 2006 (FYE06); the original FY06 Board approved revenue budget; and, actual FYE05 revenue.

Fiscal Year Revenue for MSF (000's)

		A	B	C	D	E
	Revenue Type	**FY07 Budget Estimate**	**FYE06 – 3rd Qtr Projection**	**FY06 Budget Estimate**	**FYE05 Actual**	**FY05 Budget**
1	Net Earned Premium	$214,368	$211,888	$191,832	$189,379	$146,905
2	Investment Income	35,500	31,640	32,018	$30,167	$23,671
3	**Total Revenue**	**$249,868**	**$243,528**	**$223,850**	**$219,546**	**$170,576**

Source: From the Montana State Fund

EXPENDITURES

The total budget request for FY07 is $199,337,855. The FY07 budget is separated into five primary expenditure categories based on statutory accounting guidelines and is displayed with comparative expenditures from the 5/31/06 projection of FYE06 expenditures and the FY06 budget.

		A	B	C	D	E
	Categories	**FY07 Budget**	**FYE06 – 5/31 Proj.**	**FY06 Budget**	**FYE05 Actuals**	**FY05 Budget**
1	MSF - Benefits and Claim Expenditures	$135,773,935	$114,346,249	$113,412,453	$98,105,072	$126,239,953
2	Old Fund - Benefits and Claim Expenditures	11,936,942	11,323,667	12,130,610	10,219,654	14,069,239
3	Allocated Loss Adjustment Expenditures	4,050,157	2,785,811	3,398,119	2,222,391	2,497,481
4	Unallocated Loss Adjustment Expenditures	15,571,894	15,723,096	16,436,287	17,115,345	15,993,457
5	Underwriting Expenditures	32,004,927	29,870,918	29,080,986	27,444,262	25,645,328
6	**Total Expenditures**	**$199,337,855**	**$174,049,741**	**$174,458,455**	**$155,106,724**	**$184,445,458**

Statutory Operating Expense Ratio

The statutory operating expense ratio is total statutory operating expenses as a percentage of net earned premiums. MSF estimates our financial statement results based on the proposed budget and including adjustments for Generally Accepted Accounting Principals (GAAP). GAAP adjustments include capitalization of equipment and intangible assets, depreciation, amortization, Loss Adjustment Expense (LAE) reserve adjustments, and contingent commission on re-insurance.

The proposed FY07 Budget anticipates a 21.85% statutory operating expense ratio (see FY07 Statutory Operating Expense Ratio attachment). The FY06 projected statutory operating expense ratio based on actual expenditures through the 3rd quarter FY06 is 19.53%. These estimated expense ratios include an estimate of contingent commissions on reinsurance programs.

The FY06 expense ratio approved with the budget was 26.38% and did not include contingent commission on reinsurance. The comparable FY07 statutory expense ratio, excluding contingent commission on re-insurance, is 25.78%. The 3rd quarter projected FY06 expense ratio excluding contingent commission on re-insurance is 23.51%.

Benefits and Claim Expenditures
The FY07 total MSF budget includes funding for $147,710,877 in estimated benefit payments to injured employees. Benefit payments comprise 74.1% of the total FY07 MSF budget.

In comparison, the FY06 - 5/31/06 projection estimates total MSF expenditures of $174,049,741, including $125,669,916 in benefit payments. Benefit payments are projected to comprise 72.2% of FY06 expenditures.

In May of FY06 the State Fund completed implementation of our new claim management system, Claim Center; a medical bill payment process; and, a medical bill audit function. These systems will enable MSF to manage claims with increased efficiency and enhance cost containment practices.

MSF also proposes adding 6.00 FTE for Claim Examiner positions in FY07 and continuing our Claim Examiner training program which is expected to graduate six new Claim Examiners in early FY07 and train six additional Claim Examiner-Trainees during the course of FY07. This additional staff will further enable MSF to effectively manage claims. New positions are explained in a latter section, 'MSF Staffing'.

FY07 benefit payments are separated by New Fund and Old Fund and compared to the FY06 – 5/31/06 projection and FY05 actual expenditure levels below.

		Benefit Payments (000's)				
		A	B	C	D	E
		FY07 Budget	**FY06 – 5/31 Projection**	**FY05 Actual**	**$ Change FY07 from FY06 Proj.**	**% Change FY07 from FY06 Proj.**
1	New Fund	$135,774	$114,346	$98,105	$21,428	18.73%
2	Old Fund	11,937	11,324	10,220	613	5.41%
3	**Total**	**$147,711**	**$125,670**	**$108,325**	**$22,041**	**17.53%**

New Fund Benefit Payments
$135,773,935 is budgeted in the New Fund for payment of benefits to individuals in compliance with the statutes governing claim payments. The following table reflects the FY07 New Fund benefit payments, FY06 – 5/31/06 projected benefit payments, and six years of prior actual payments.

Fiscal Year	Benefit Payments	Percent Increase from Prior Year
FY07 Budget	$135,773,935	18.73%
FY06-5/31 Projection	114,346,249	16.55%
FY05 Actual	98,105,072	(2.2%)
FY04 Actual	100,271,014	20.3%
FY03 Actual	83,319,729	22.7%
FY02 Actual	67,899,056	9.4%
FY01 Actual	62,068,055	12.2%
FY00 Actual	55,329,633	

Source: From the Montana State Fund

The FY07 New Fund benefit payments were estimated as follows:

- Prior fiscal years (1991 – 2005) actual benefits paid by accident year were established in a benefit payments 'triangle'. The 3rd quarter projection of New Fund benefit payments was used for FY06.
- The FY07 expected benefit payments were separated into estimated indemnity (44.27%) and medical (55.73%) benefit payment categories based on the ratio of FY06 actual expenditures to indemnity and medical payments.
- The payout pattern by individual accident year was analyzed. Each accident year's expected FY07 benefit payments were estimated based on the percentage change from the two most recent accident years. The FY07 New Fund benefit payment budget estimate was heavily weighted on the data from FY05 to current.
- Benefit payments associated with Other States Coverage (OSC) were estimated independently and added into the total New Fund benefit payments. The FY07 OSC budget is based on FY06 policies and estimated program participation for FY07. The total amount of benefit payments budgeted for OSC is $1,290,685.
- The State Fund is not expecting any benefit payments associated with the Employer's Liability program in FY07.

Old Fund Benefit Payments

$11,936,942 is budgeted for benefits and claim payments in the Old Fund. The Old Fund is in a claim run-off situation. No new claims are impacting the Old Fund. When estimating FY07 Old Fund benefit payments the diminishing level of payment is conservatively weighed to ensure adequate funds are available for payment of statutorily required benefits. The budget for Old Fund benefit payments was estimated as follows.

- Benefit payments were estimated after analyzing prior year's benefits paid by month. FY05 Actual and FY06 3rd quarter projected benefits payments were the most heavily weighted data used for estimating the FY07 budget.
- As of FY06 3rd quarter year to date actuals, indemnity benefits are 33.45% of total benefits paid and medical is 66.55%. For FY07, it is estimated the ratio of indemnity to medical payments will remain the same.
- Old Fund benefit payments have been relatively stable for the past 6 complete fiscal years as illustrated below with the FY06 Projection and FY07 Budget.

Fiscal Year	Benefit Payments	Percent Change from Prior Year
FY07 Budget	$11,936,942	(5.4%)
FY06-5/31 Projection	11,323,667	10.8%
FY05 Actual	10,219,653	(19.7%)
FY04 Actual	12,730,836	(10.1%)
FY03 Actual	14,165,534	12.1%
FY02 Actual	12,636,229	(7.5%)
FY01 Actual	13,663,892	4.1%
FY00 Actual	13,130,302	

Source: From the Montana State Fund

Allocated Loss Adjustment Expense (ALAE)
ALAE are costs directly associated with managing the cost of a specific claim, i.e., an independent medical examination to analyze a prescribed treatment of an injured employee.

$4,050,157 is budgeted to the New Fund and the Old Fund for ALAE:

- New Fund - $3,731,526
- Old Fund – $318,631

ALAE is expected to increase by $1,226,257 or 43.4% from the FY06 – 5/31 projection of $2,785,811. The primary increase in this expense is associated with the new medical invoice processing system.

- In the 3rd quarter of FY06 the State Fund began the new medical invoice processing system and in May the new process was fully implemented. CorVel is the vendor who reviews and processes medical invoices for MSF. FY06 expenditures for CorVel's services are only for partial year. The total annual FY07 budget for this service is $1,601,381. The New Fund budget for this expense is $1,417,526 and the Old Fund budget is $183,855.
- The benefits of using CorVel to process medical invoices will be integrated with Claim Center, and additional services of medical bill review, advanced nurse review, bill payment, bill review management reports and Explanation of Benefits (EOB) generation. It is expected that the services provided by CorVel will generate approximately 2% cost savings on medical benefit payments. At the beginning of FY07 the State Fund will have eliminated its Medical Payments Unit.
- Most other ALAE expenses, $2,448,776, are budgeted to remain flat as compared to FY06 – 5/31 projected expense of $2,443,422. Private investigative service expenditures are budgeted to increase in FY07 by $112,280 due to contract changes providing for increase surveillance hours. This change took effect in FY06. The total FY07 budget for private investigative services is $689,259.

MSF Staffing
The State Fund is requesting approval of 296.5 FTE for FY07. This equates to 301 positions, nine of these positions are half FTE positions. The FY06 approved FTE level is 293.5 FTE.

The Board approved 292.50 FTE for FY06. During FY06, 1.00 FTE was added though no additional budget was requested. The new position was added within the guidelines and authority designated by the Board to the Chief Executive Officer and as business needs mandated.

For FY07 the State Fund is requesting a net of 3.00 FTE for new positions. This includes 10.00 FTE for new positions and is offset by the elimination of 7.00 FTE.

The FY07 FTE increase equates to a 1% increase in FTE from FY06.

FY07 budgeted net earned premium is increasing $2.48 million or 1.2% from the FY06 projected net earned premium. The increase in net earned premium from FY04 through the FY07 estimate is expected to be over 50%. The increase in net earned premium going back to FY02 is 130%.

		Net Earned Premium	% Increase from Prior FYE	
		A	B	
1	FY07 Budget	$214,367,873	Compared to FY06 Proj.	1.2%
2	FYE06 Projected	211,887,872	Compared to FYE05	11.9%
3	FYE06 Budget	191,832,000	Compared to FYE05	1.3%
4	FYE05	189,378,858		35.9%
5	FYE04	139,360,612		18.3%
6	FYE03	117,776,580		26.7%
7	FYE02	92,971,868		

New Fund benefits and claim payments are expected to increase by 35% from FY04 through the FY07 estimate.

FTE increase from 267.50 for FY04 to 296.50 in FY07. This is a 10.8% increase in FTE over four years. MSF prudently uses consultants and temporary staff when circumstances are appropriate and only adds permanent staff as business needs mandate.

The following table reflects MSF staffing by department for the FY07 budget, the FY06 Projection, FY05 and FY04.

MSF Staffing (FTE)

		A	B	C	D
	Department	**FY07 Budget**	**FY06 Projection**	**FYE05**	**FYE04**
1	Corporate Support	36.00	35.00	37.00	38.00
2	Executive Offices	5.00	5.00	7.00	6.50
3	General Counsel	3.00	3.00	3.25	3.25
4	Human Resources*	5.00	5.00	0.00	0.00
5	Information Technology	51.00	51.00	47.50	38.00
3	Operations	145.00	137.00	132.00	127.00
4	Operations Support	51.50	57.50	57.75	54.75
7	**MSF Total**	**296.50**	**293.50**	**284.50**	**267.50**

*Human Resources were under the Executive Offices in FY04 and FY05.

MSF continually re-aligns our staffing to meet the changing work processes developed to most effectively and efficiently service our customers. The net increases in staffing are necessary to service the growth in business that has occurred during recent years, and will have on-going impacts on workloads through FY07.

An attachment titled ‘State Fund Staffing Changes’ details the FTE additions and deletions that are expected for FY07 and the changes of prior years. The following details the changes to staffing from the FY06 budgeted level.

Corporate Support Staffing
At the outset of FY06 the Communications Team (2.00 FTE) was moved from Corporate Support to the Executive Offices. This shifting of teams enhances the cohesiveness between the President's Office and the Communications Team.

For FY07 1.00 FTE for an Accountant position is requested. This position will be used to coordinate reconciliation activities resulting from implementation of Claim Center. The Accountant position will ensure appropriate accounting standards are adhered to for MSF's financial reporting.

Operations Department Staffing
Currently, Operations has staff of 137.00 FTE. The FY07 Budget request is for 145.00 FTE.

The original FY06 budget approved 136.00 FTE in Operations. During the course of FY06, Operations added 1.00 FTE for a Customer Service Specialist position on one of the Operation's business teams.

For FY07 Operations is requesting 8.00 FTE for new positions. The new positions will address workload issues with the teams assigned. The positions being added are:

6.00 FTE - Claim Examiners – one to each team
1.00 FTE - Administrative Support
1.00 FTE - Customer Service Specialist

The new Claim Examiner positions will be filled in early FY07. There are currently six MSF employees participating in the Claim Examiner Trainee program directed by Operations Support. These employees are expected to graduate and transition into the new Claim Examiner positions in early FY07.

Operations Support Department Staffing
Operations Support is requesting a FY07 staffing level of 51.50 FTE. This is a net decrease of 6.00 FTE from the current FY06 staffing of 57.50 FTE.

With the implementation of Claim Center during FY06, Operations Support will be eliminating the Medical Payments Unit moving forward into FY07. This has provided for the reduction of 3.50 Medical Payment Technician FTE.

Currently in FY06 there are 6.00 Claim Examiner-Trainee positions. This will be reduced to 3.00 FTE in FY07. The Claim Examiner Trainee program will graduate six Claim Examiners in early FY07. During FY07, MSF expects to continue this program using 3.00 FTE Claim Examiners-Trainee positions. This will provide positions for three trainees in two FY07 sessions for a total of six trainees in all.

The Safety Intern position was initially budgeted for FY06 at 0.50 FTE. During the course of the year this position was increased to 1.00 FTE by transferring FTE from a vacant Medical Payment Technician position as approved by the President through the end of FY06. This position will revert back to a 0.50 FTE position in FY07.

A new 1.00 FTE Safety Coordinator position is requested for FY07. The Safety Coordinator will:

- Implement the MSF loss control safety action plan;
- Provide in-house safety services for policyholders on Teams 1 and 2;
- Track internal MSF safety recommendations and safety action plan follow-ups to assure timely follow through.
- Assist with Safety Management Consultant quality assurance, MSF Safety Plan and Guideline development and, safety support services including development of MSF policyholder safety programs, materials, and measurements.

Personal Services

To support the necessary staff of 296.50 FTE, MSF requests funds of $19,410,337 for the FY07 personal services budget. This budget is comprised of:

- Regular salaries, differential pay, and overtime/comp time - $14,484,694
- Merit base and lump sum salary adjustments - $430,050
- Personal leave program payouts - $50,866
- Employee taxes and benefits - $4,444,727

The following table compares the FY07 budget request to the FY06 Projection and FY06 Budget on FTE and personal services.

	FY07 Budget	FY06-5/31 Projection	FY06 Budget
FTE	296.50	293.50	292.50
Personal Services	$19,410,337	$19,088,546	19,120,773

No Gain Sharing payments have been included in the FY07 personal services budget. The FY06 5/31 projection does include an estimate for Gain Sharing expense to be accrued. No executive incentives have been budgeted. No salary adjustments to the President's compensation have been included in the FY07 budget.

Regular Salaries, Differential Pay, and Overtime/Comp Time - $14,484,694

Regular salaries were based on current staff hourly wages for all employees hired through 2/16/06. Vacant positions and new positions were based on the compensation at 100% of mid-point for the pay band slotted as estimated by the team leader, department vice president, and Human Resources.

The hourly wage for each FTE was multiplied by total annual payroll hours in FY07. There are 2,080 payroll hours for each FTE in FY07. Partial FTE salaries are prorated accordingly.

Net Regular Salaries budget is $14,415,924. Regular Salaries are estimated to be $14,915,934 assuming all positions are filled the entire year. This amount was reduced by a vacancy savings factor of 3.35% or $500,010. Position vacancies are a regular and normal occurrence resulting from employee turnover. To start FY07, MSF recognizes we will have existing position vacancies. The reduction to Regular Salaries more accurately reflects the funding required for compensation.

Differential Pay of $14,230 is budgeted to begin a Claim Examiner career progression program in January 2007.

$54,540 is budgeted for Overtime in FY07. This is primarily driven by the needs of the Finance team ($5,000) to be incurred during the quarterly and fiscal year end close processes, and, payment of exempt employee call out time in the Information Technology Department.

Merit Based Salary Adjustments - $430,050
The merit salary adjustments are paid after the final STAR (Skills, Talents and Results) Process Reviews are completed in July. For the FY07 budget an average merit adjustment of 3.7% was assumed and applied to the salaries of all eligible employees.

The merit salary adjustment includes two components:

1) Lump Sum Payments; and,
2) Base Salary Adjustments.

All merit adjustments were assumed to be effective 9/15/06. Lump sum amounts will be based on annual salary and paid out in full in FY07. Base pay adjustments are included in hourly wages estimated to be paid after 9/16/06 through the end of the fiscal year.

Personal Leave Program Payout - $50,866
The Personal Leave Program requires payment of unused personal leave for eligible employees within established program guidelines. The FY07 budget was based on FY06 actual payments.

Employee Benefits - $4,444,727
Employee Benefits are payments / contributions MSF makes on behalf of our employees, as a tax, or as worker's compensation premium. The following list each employee tax and benefit category and the dollars budgeted.

- FICA / Medicare - $1,157,704
- Retirement - $1,053,320
- Workers' Compensation Premium - $282,339
- State Unemployment Tax (SUT) - $37,756
- Group Insurance - $1,913,608

FICA / Medicare, Retirement, SUT, and Group Insurance are set in law. A MSF Underwriter estimated the Workers' Compensation Premium rate.

HB13 enacted by the 2005 Legislature increased group insurance contributions for MSF from $5,796 per employee in FY06 to $6,378 per employee in FY07. This is an annual increase from FY06 of $582 or 10% per eligible employee. In FY07, it is estimated MSF will have a maximum of 301 employees eligible for a MSF contribution. The total increased cost resulting from the increase in Group Insurance from FY06 to FY07 is $175,182.

Operating Expenses
The total budgeted operating expenses are $25,303,990 and include funding as reflected in the following table. This does not include personal services or equipment and intangible assets (explained later).

OPERATING EXPENSES					
		A	B	C	D
	Category	**FY07 Budget**	**FY06-5/31 Projection**	**Variance $**	**Variance %**
1	Other Services	$20,102,651	$17,796,159	$2,306,492	12.96%
2	Supplies & Materials	635,145	1,112,917	(477,772)	(42.92%)
3	Communications	1,262,819	1,212,229	50,590	4.17%
4	Travel	308,626	223,347	85,279	38.18%
5	Rent	329,094	379,924	(50,830)	(13.37%)
6	Utilities	116,234	119,503	(3,269)	(2.81%)
7	Repairs & Maintenance	1,152,842	1,054,940	97,902	9.28%
8	Other Expenses	1,396,580	1,364,083	32,497	2.38%
9	**Total Operating Expenses**	**$25,303,990**	**$23,263,102**	**$2,040,888**	**8.77%**

Other Services

- **Commissions -** $14,949,123 – This is an increase of $1,753,240 over the FY06 – 5/31 commissions projection of $13,195,883. This includes base, incentive and Other States Coverage commissions.

  Commissions are the largest operating expense for MSF and are directly and proportionately related to gross premiums. The payment of commissions increases our service and distribution capabilities with our agent partners.

  Commission payments are generated when MSF receives a premium payment regardless of the policy year with which the payment is associated. In FY07 we are expecting $235.2 million in gross earned premiums.

  Base Commissions:
  In aggregate, MSF current (5/1/06) agent held business is 66.2% with an average base commission rate of 7.975% though this varies by Operations team. This correlates to $12,415,134 in base commission payments on $235.2 million in FY07 gross earned premiums.

  Incentive Commissions:
  Incentive commissions are determined after reviewing how an agent's overall book of MSF represented policyholders' losses develops. The average agent incentive commission rate is expected to be 1.5% though not all agents may qualify for the incentive commission. $2,336,372 is budgeted for the FY07 agents' incentive commission.

  Other States Coverage (OSC) Commissions:
  $197,617 is budgeted for commissions associated with OSC policies. The total FY07 premium estimated for OSC is $2,448,967. The average commission is 8%.

- **Consulting and Professional Services** - $3,347,896 – This is an increase of $878,966 or 35.6% from the FY06 – 5/31 projection of $2,468,930. The FY06 budget is $4,404,762. The following are the areas of contractor expense in FY07. These expenses are needed to complete Strategic Business Plan initiatives.

  There are six projects / initiatives with a budget of over $150,000 highlighted in the table below. These six items comprise 63% of the Consulting and Professional services budget. Additional detail on these and other items follow the table.

Consulting and Professional Services			
	A	B	C
	FY07 Budget	**Team**	**Item / Description**
1	$844,112	Operations Administration	NCCI Membership Fee Agreement and transaction based charges
2	$535,662	Teams 3-6	Others States Coverage Fronting Fees, Letters of Credit, and loss adjustment expense
3	$195,000	Corporate Support	General Ledger Initiative
5	$170,000	Board of Directors	Independent Actuary
6	$163,800	Executive Office	Building Project
6	$155,000	IT – Insurance Applications	Policyholder System – System Change Request Support

  - ✓ **National Council on Compensation Insurance** (NCCI) – $844,112 – This is an increase of $54,348 or 6.9% from the FY06 – 5/31 projection of $789,764. The budget is based on the current MSF and NCCI contract which became effective 1/1/05 and will be in force throughout FY07. Payments under this contract were budgeted as follows:
    - Affiliation / Licenses / Service Cost - $375,860 - - The NCCI affiliation fees are based on a percentage of net direct written premium. As premium increases the membership fee will continue to increase. Premiums used to calculate the membership fee increased from $154.2 million in FY06 to $198.3 million for FY07, or $44.1 million.
    - Transaction based fees - $468,252 - MSF provides NCCI with eMods, unit reporting statistics, proof of coverage, and additional data. MSF is charged a transaction fee when providing this data to NCCI.
    - No Credits were budgeted – NCCI has a program to provide members with credits, similar to a dividend program, based on NCCI's financial results. In FY06 through three quarters MSF has received $36,000 in credits, which are included in the FY06 – 5/31 projection. As the credits are not guaranteed and not in the control of MSF, we did not budget for the credits.

- ✓ **Other States Coverage** (OSC) – $535,662 - Per OSC contracts MSF pays Argonaut 13% of the written premium as a fronting fee and US Bank letter of credit fees. The budget is based on total revenues of $2,448,967 for OSC. Per contract MSF pays Argonaut 12% of incurred losses for loss adjustment expense for the cost of providing claims adjusting and supervision services required to support the classes of business reinsured under our agreement. Incurred losses are estimated to be $1,358,616 in FY07. The Budget has been distributed to Operations' teams 3-6 based on premium revenue by team expected for FY07.

- ✓ **General Ledger upgrade** - $195,000 – This will fund a consultant to support the process of reviewing and coordinating MSF's business requirements in implementing a general ledger package.

- ✓ **Independent Actuary** - $200,000 – The New Fund expense for services related to reserves, loss estimation, dividends and other items is $170,000 in FY07. MSF is required by law to use the services of an independent actuary when estimating losses, dividends, and other areas of business. $30,000 is budgeted in the Old Fund for reserve analysis.

- ✓ **MSF Building Project** - $163,800 – This will fund a consultant who will provide MSF with expert knowledge in office building construction and will assist with the oversight and advisory services involved in new construction.

- ✓ **Policyholder System (PHS) system change request support** - $155,000 – This consultant will support in the ongoing process of updating the PHS system as needed.

- ✓ **IT Annual Change Requests -** $138,000 – This will allow for consultants review and assist with annual change requests such as: 1099's, retro plan payments, dividends, agent incentive calculation, and annual statement preparation.

- ✓ **Pacific Institute Investment in Excellence** - $123,000 – This will allow for the ongoing Investment in Excellence training offered to all employees on a yearly basis.

- ✓ **Human Resources** - $120,000 – The budget will fund the following projects to be completed by contractors: compensation review and market analysis; employee opinion survey; college career fairs; and, executive succession planning.

- ✓ **President's Management Consulting** - $100,000 - Consulting services as deemed necessary by the President during FY07 for events and costs that arise during the course of the fiscal year.

- ✓ **IT – Administration Consulting Services** - $78,000 – The consulting services are for strategic planning, audits, and operational improvements in the information Technology Department.

- ✓ **Other Consulting and Professional Services Items -** $648,125
  - $88,400 – Continued support of automated regression test scripting;
  - $85,500 – Claims Center upgrade;
  - $75,000 – Development of architectural plan for MSF;
  - $75,000 – Data Center design consultant;
  - $62,000 – External audit of medical payments by CorVel;
  - $57,225 – External audit of Pharmacy Benefit Manager;
  - $55,000 – IT consulting support;
  - $52,000 – MS project and budget report development;
  - $25,000 – Palmer & Cay reserve review follow up audit;
  - $22,000 – Fraud Indexing Service;
  - $20,000 – Underwriting survey reports;
  - $16,000 – Best in Claims professional consultant;
  - $15,000 – CommCore communication training for leaders.

- **Legal Fees and Court Cost -** $175,000
  - $5,000 for wage and hour issues;
  - $20,000 for declaratory judgment action in a current litigation matter;
  - $5,000 for employer liability coverage opinions;
  - $2,000 for bankruptcy issues;
  - $48,000 for arbitration of human resource issues;
  - $10,000 for Schmill case;
  - $30,000 for Hiett case;
  - $25,000 for Hogenson – scope of coverage lawsuit;
  - $30,000 for potential unknown common fund cases.

- **Fraud Investigation and Prosecution from Dept. of Justice -** $262,880 – this is a decrease of $5,471 or 2% from the FY06 – 5/31 projection of $268,351. MSF uses the services of the Department of Justice to complete investigations submitted to them by MSF and prosecutes workers' compensation fraud cases. The Department of Justice has police powers that enable them to more thoroughly complete fraud investigations and prosecutions.

- **Policyholder Audits** - $690,000 – this is an increase of $80,502 or 13.2% from the FY06 – 5/31 projection of $609,498. MSF audits specific governing class codes to maximize return on audit investment where there is the possibility of under reported payroll. All teams will focus on increasing audits of certain industries, i.e. construction, logging, and mining.

- **Consultants – Training -** $276,000 – this is an increase of $134,947 or 96% from the FY06 – 5/31 projection of $141,053. The budget will enable MSF to bring trainers on-site and provide for a larger number of employees to participate in the training rather than sending a limited number of employees to external locations to receive training. The more significant items are for: Websphere, J2EE Web, XML Programming, Data Warehouse, General Ledger, Oracle 10g, and Claim Center, $170,000.

- **Computer and Network Services provided by the Dept. of Administration** - $424,148 – this is a decrease of $92,938 or 18% from the FY06 – 5/31 projection of $517,086 and is driven by decreased use of State systems and associated network fees. These expenses are paid to the Department of Administration for information technology services.

- **SABHRS Administrative Costs** - $146,104 – this is a minor increase from the FY06 payment of $146,100. This expense is paid to the Department of Administration MSF's portion of the expense for maintaining the state's accounting system, SABHRS. The Office of Budget and Program Planning determines MSF's share of this expense.

- **Insurance and Bonds** - $273,157 – this is a minor decrease from the FY06 payment of $275,958. All MSF insurance is provided through the State's division of Risk Management and Tort Claims. The State is self-insured.

- **Temporary Services** - $81,058 – this is a decrease of $612,630 or 88.3% from the FY06 – 5/31 projection of $693,688. MSF used temporary staff to fill in for incumbents reassigned to the Claim Center and other projects in FY06. Temporary staff was used in the Medical Payments Unit until the implementation of Claim Center. MSF expects a significant reduction of temporary staff due to the final implementation of Claims Center.

- **Financial and Legislative Audits** - $73,912 – this is an increase of $20,354 or 38% from the FY06 – 5/31 projection of $53,558. $35,412 is for the Financial Compliance audit performed by the Legislative Audit Division (LAD) of the MSF Governmental Financial Statements. $23,500 is for an independent accounting firm to audit our annual statutory financial statements and conduct a premium audit.

- **Warrant Writing** - $47,815 – this is a decrease of $24,688 or 34% from the FY06 – 5/31 projection of $72,503. The majority of the decrease is the result of MSF contracting out medical bill review and payment for injured employees to CorVel. MSF relies on the State of Montana for issuance of all other warrants. The estimate is based on the Office of Budget and Program Planning' estimate of MSF expense.

- **Printing** - $77,924 – this is a decrease of $33,508 or 30% from the FY06 – 5/31 projection of $111,432. This is a variety of small printing jobs for brochures, business cards, forms, envelopes, safety handouts, and other informational materials.

Supplies and Materials

- **Minor Office Equipment** - $75,528 - this is a decrease of $207,406 or 73.3% from the FY06 – 5/31 projection of $282,934. The decrease in budget is due to the completion of workstation additions with wall extensions to the 2nd floor and MSF Annex in FY06.

- **Computer Hardware** – $248,838 – this is a decrease of $70,123 or 22% from the FY06 – 5/31 Projection of $318,961. A majority of this expense, $199,930, is for personal computer, laptops, and printer replacements, per our planned maintenance schedule, and a variety of IT specific items.

Communications

- **Advertising** (excluding recruitment advertising) - $515,212 – this is an increase of $19,126 or 3.9% from the FY06 – 5/31 projection of $496,086. This will provide funding for all advertising campaigns to occur in FY07; media placement, newspapers, billboards, brochures and inserts, web design, direct mail, and opportunity marketing.

- **Communications** (excluding all advertising) - $676,687 – this is a minor decrease from the FY06 – 5/31 projection of $634,959. This expense covers postage, cell phones, phone equipment, long-distance and '800' line services.

Travel

- $308,626 – this is an increase of $85,279 or 38.2% from the FY06 – 5/31 projection of $223,347. MSF staff will be attending increased levels of training at off site locations to gain expertise in operating new systems, i.e., Claim Center, PeopleSoft. Staff, including the Safety Management Consultants and Premium Auditors, will be increasing visits to policyholders in FY07 to provide services. This also includes travel by safety management, claim examiners, and underwriters to customers.

Rent

- $329,094 – this is a decrease of $50,830 or 13.4% from the FY06 – 5/31 projection of $379,924. The primary factor driving this decrease is MSF is now renting one space in the Arcade Building in Helena for the entire IT staff. MSF was previously renting two spaces in another building and will save $60,000 with this change. This budget includes parking expenses, photocopier leases, and rent for the MSF Annex and field office locations.

Repairs and Maintenance

- $1,152,842 – this is an increase of $97,902 or 9.3% from the FY06 – 5/31 projection of $1,054,940. The bulk of this expense is due to maintenance agreements in IT ($904,773) for hardware such as servers, routers and associated peripherals, and application software. Facilities has a significant budget for maintenance agreements ($190,435) for janitorial services, heating, air conditioning and ventilation (HVAC), snow removal and other items.

Other Services

- **Taxes and Assessments** - $413,057 – is a decrease of $17,971 or 4.2% from the FY06 – 5/31 projection of $431,028. This budget is comprised of three pieces; Old Fund Assessments, Other States Coverage (OSC) premium taxes, and property assessments on the Peg Condon Building.

- ✓ Old Fund Administrative Assessment and Subsequent Injury Fund Assessment - $181,170 – this is a decrease of $16,806 or 8.5% from the FY06 payment of $197,976. These are regulatory assessments from the Department of Labor and Industry as provided in law. The budget is based on the invoice provided by the Department of Labor and Industry's Employment Relations Division for FY06. The Administration Assessment is $181,170. There is no Subsequent Injury Assessment for FY07. There will be no expense for the Rehabilitation Assessment in FY07.
- ✓ OSC Premium Taxes - $228,267 – this is a decrease of $1,552 or less than 1% from the FY06 – 5/31 projection of $229,819. The budget is based on rates charged by the OSC vendor.
- ✓ Property Tax on Peg Condon Building - $3,620.

- **Education and Training** - $243,651 – this is a decrease of $102,783 or 29.7% from the FY06 – 5/31 projection of $346,434. MSF maintains a philosophy to provide training to employees in necessary aspects of the business to ensure corporate success. Training is necessary to ensure MSF employees are knowledgeable in best practices associated with claim management, safety management and underwriting of risk.

- **Recruitment Expenses** - $293,047 – this is a increase of $91,042 or 45.1% from the FY06 – 5/31 projection of $202,005. Recruitment expenses comprise the following accounts:

  Employment Ads - Out-of-State – $37,584
  Employment Ads - In-State – $33,336
  Relocation – Taxable – $17,765
  Recruiting – Non-Advertising - $1,610
  Job Candidate Expense – $142,376
  Relocation – Non-Taxable – $60,376

  MSF anticipates 63 recruitments during FY07 based on new positions requested, existing vacancies, and historical turnover. Any amount over the budget will be offset from personal services savings generated by vacancy savings during the candidate search.

- **Charitable Contributions / Scholarships** - $72,575 – this is a decrease of $20,478 or 22% from the FY06 – 5/31 projection of $93,053. Charitable Contributions are budgeted to be $43,875 and MSF estimates 14 scholarships will be awarded in FY07 for a total budget of $28,700. Each scholarship is estimated to be $2,000 with an additional $50 administrative fee each.

- **Fee Collection Expense** - $125,000 – this is a minor increase from the FY06 – 5/31 projection of $119,808. This budget will fund the expense of using collection agencies to collect unpaid debts to the State Fund.

Equipment and Intangible Assets
The total FY07 budget for equipment and intangible assets is $2,862,494. This is a $379,872 or 11.72% decrease from the FY06 – 5/31 projection of $3,242,366. The budget includes funds for:

Equipment

- **Autos & Trucks** - $140,400 - Replacement vehicles as recommended by Fleet Manager. Vehicles being replaced have reached the mileage specified in MSF's Fleet Management Policy as the replacement threshold. The budget will replace seven vehicles in FY07.

- **Multi-User Computers and Terminals** - $672,795.
  - ✓ $300,000 – Hardware to support Data Warehouse upgrade;
  - ✓ $80,000 – Hardware to support Claims Center upgrade;
  - ✓ $19,200 – Storage Area Network (SAN) capacity upgrade;
  - ✓ $69,200 – Additional tape drives for tape library;
  - ✓ $71,895 – Replace APC battery backup with UPS;
  - ✓ $59,500 – Replace ten Intel servers;
  - ✓ $48,000 – Additional disk space for Storage Area Network (SAN);
  - ✓ $25,000 – Scanner redundancy and testing hardware.

- **Office Equipment** - $44,400.
  - ✓ $44,400 is budgeted for replacement of Insertamax mailing machine. The postage meter on this machine will become obsolete in September of 2006 and will not be maintained by Pitney Bowes. Also, the post office will no longer add postage to the machine.

Intangible Assets

- **Multi-User Software** - $2,004,900.
  - ✓ $1,120,600 – Business Intelligence (Data Warehouse) upgrade – This upgrade supports the SBP Infrastructure Initiative and will provide MSF staff the appropriate working environment and necessary technology to most effectively and efficiently service their customers.

  - ✓ $508,300 – General Ledger Upgrade – MSF is currently using MS Excel for our financial reporting which, for financial reporting, is time consuming and increases the potential for errors. Automated reporting will allow MSF more time to analyze the financial data and ensure the quality of the reporting. The new general ledger package will allow MSF to accurately prepare, report, and analyze financial statements.

  - ✓ $288,000 – Claims Center Upgrade - This upgrade is a component of the SBP "Best in Industry" Initiative.

  - ✓ $88,000 - Configuration Management Database software – This will assist in the ongoing maintenance and support of the current infrastructure.

FY07 Budget Recap
Based on the FY07 Annual Budget request and estimated FY07 Net Earned Premium the estimated statutory expense ratio for Montana State Fund is 25.78% before adjusting for contingent commissions on reinsurance programs.

Based on the FY06 – 5/31 projection, our estimated statutory expense ratio for FY06 will be 24.04% before adjusting for contingent commissions on reinsurance programs. The initial FY06 expense ratio was 26.38% based on expenses of $50.6 million and net earned premium of $191.8 million.

Costs not included in the Proposed Budget
The FY07 budget includes all known and expected costs for the fiscal year. The budget does not include:

- Merit and management incentives plan adjustments for the President. This is a separate Board action to be taken in October 2006.
- Court decisions which may significantly and adversely impact the State Fund. No such decisions are currently anticipated.
- Employee Incentive Program (Gain Sharing) payments.

Should the Board takes action on these items, we will include the adjustments in the budget as appropriate.

Future Budgets
Future annual budgets will continue to reflect the initiatives determined by Montana State Fund's management team that will be necessary to remain competitive in Montana's workers' compensation market. MSF will continue to develop efficient processes that will allow us to provide the highest quality customer service to our customers and maintain fiscally sound and competitive rates.

Additional Supporting Documents
The following pages present a summary of the FY07 budget.

- Department and team reference list;
- FY07 Statutory Expense Ratio;
- State Fund Staffing Changes;
- FY07 MSF budget request summary formatted by department;
- FY07 MSF budget request summary formatted with actual prior year expenditures, FY06 budget, FY06 year-to-date expenditures, FY06-5/31 projected expenditures, and the FY07 budget request.