

**Memorandum**

Date DEC 22 1998
For *Michael Mangano*
From June Gibbs Brown
Inspector General

Subject Review of the 1997 Adjusted Community Rate Proposal For a New York Risk-Based Managed Care Organization (A-02-98-01004)

To Nancy-Ann Min DeParle
Administrator
Health Care Financing Administration

The attached final report is part of our series of reviews of the administrative costs planned and incurred by managed care organizations (MCO) relative to their operating a Medicare risk managed care plan. These reviews are being conducted in each region in order to determine if the conditions found are pervasive throughout the nation. Because MCOs view the use of administrative funds to be a sensitive matter and the Medicare managed care program is essentially a concentrated Health Care Financing Administration (HCFA) central office operation, we want to share these individual MCO reports directly with you.

We issued a report on July 27, 1998 which examined the allocation of administrative costs on the Adjusted Community Rate (ACR) proposals for contract years 1994 through 1996. This report entitled, "Administrative Costs Submitted by Risk-Based Health Maintenance Organizations on the Adjusted Community Rate Proposals Are Highly Inflated" (A-14-97-00202) concluded that the methodology which allowed MCOs to apportion administrative costs to Medicare was flawed and that these administrative costs allocated to Medicare covered a disproportionate amount of the MCO's administrative costs. The attached report on selected administrative costs of a Medicare managed care risk contractor located in New York provides some insight on where some of the excess administrative costs may be used.

The ACR process is designed for MCOs to present to HCFA their estimate of the funds needed to cover the costs (both medical and administrative) of providing the Medicare package of services to any enrolled Medicare beneficiary. The ACR proposal is integral to developing an MCO's benefit package, computing savings (if any) from Medicare payment amounts, and determining additional benefits that may be provided to beneficiaries or reducing premiums that may be charged to the Medicare enrollees. Included as MCO's administrative costs are the non-medical costs of compensation, interest, occupancy, depreciation, marketing, reinsurance, claims processing, and other costs incurred for the general management and administration of the business unit.

The objective of this review was to examine the plan's administrative cost component of the 1997 ACR proposal submitted by the New York MCO, and assess whether the costs for judgmentally selected administrative cost items were appropriate when considered in light of the Medicare program's general principle of paying only reasonable costs. Because of the limited scope of our review, our results cannot be projected to the universe of administrative costs submitted by the MCO.

Our review of administrative costs on the New York's MCO's ACR for 1997 showed that \$688,723 were not appropriate when compared to the Medicare program's general principle of paying only reasonable costs. The majority of these costs were for entertainment and the opening of an office by the MCO outside of the service area covered by the MCO's Medicare risk contract.

The \$688,723 of costs would not be allowable if they were submitted by MCOs under cost contracts or if submitted by health care providers paid under a Medicare cost reimbursement system. We believe these administrative costs should not be included in the ACR proposal since this only serves to increase the ACR. An unjustifiably increased ACR adversely impacts the amount available to Medicare beneficiaries for additional benefits or reduced premium amounts.

Presently, there is no statutory or regulatory authority governing allowability of costs in the ACR process for risk MCO contracts unlike other areas of the Medicare program. For example, regulations covering MCOs that contract with HCFA on a cost reimbursement basis provide specific parameters delineating allowable administrative costs for enrollment and marketing. These same guidelines, however, are not used in administering the MCO risk contracts.

Because of the lack of criteria for inclusion of costs on the ACR proposal, there are no recommendations addressed to the New York plan. However, in response to our draft report, the New York MCO officials did not dispute the facts presented in our report.

While this review examined only one plan, we believe that our results of this plan and others previously issued highlight a significant problem. Additional reviews are underway and preliminary results show there are similar findings at other MCOs. The results of these reviews will be shared with HCFA in the coming months so that appropriate legislative changes can be considered. We invite HCFA comments on our review as it proceeds.

If you have any questions, please contact me or have your staff contact George M. Reeb, Assistant Inspector General for Health Care Financing Audits, at (410) 786-7104. To facilitate identification, please refer to Common Identification Number A-02-98-01004 in all correspondence relating to this report.

* Attachment

Department of Health and Human Services

**OFFICE OF
INSPECTOR GENERAL**

**REVIEW OF THE
1997 ADJUSTED COMMUNITY RATE PROPOSAL
FOR A NEW YORK RISK-BASED
MANAGED CARE ORGANIZATION**



JUNE GIBBS BROWN
Inspector General

DECEMBER 1998
A-02-98-01004

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Date *Michael Mangano*
From *for* June Gibbs Brown
Inspector General

Subject Review of the 1997 Adjusted Community Rate Proposal for a New York Risk-Based Managed Care Organization (A-02-98-01004)

To Nancy-Ann Min DeParle
Administrator
Health Care Financing Administration

This final report presents the results of our audit of the adjusted community rate (ACR) proposal submitted to the Health Care Financing Administration (HCFA) by a Medicare managed care risk contractor located in New York for the 1997 contract year. The objective of the review was to examine the administrative cost component of the ACR proposal, and assess whether the costs were appropriate when compared to the Medicare program's general principle of paying only reasonable costs.

Managed Care Organizations (MCO) receive a predetermined monthly payment from HCFA for each of their Medicare enrollees. An ACR proposal compares this payment to the premium amounts needed to furnish Medicare-covered services to Medicare enrollees. If the anticipated HCFA funding exceeds the estimated cost of providing the medical services covered under Medicare's fee-for-service program, the MCO must indicate the intended uses of the excess amount (known as savings) in its ACR proposal.

The review identified \$688,723 of costs in the 1997 ACR proposal that were not appropriate when compared to the Medicare program's general principle of paying only reasonable costs. We used the guidelines HCFA applies to cost-based MCOs and Medicare fee-for-service carriers, intermediaries, and providers, since HCFA guidance does not specify which administrative costs may be included in an ACR proposal. We found that the administrative cost component of the 1997 ACR proposal included the following inappropriate costs: (1) expenses not related to the plan's service area, (2) expenses for entertainment, (3) inflated reinsurance costs, (4) corporate administration costs, (5) IRS penalties and interest, (6) political contribution and lobbying costs, (7) employee morale expenses, (8) contributions, (9) travel costs, and (10) interest expense.

The effect of including these costs in the proposal is to increase the amounts needed for administration, thus reducing any potential savings from the Medicare payment amounts. In addition, this methodology impacts the amount available to Medicare beneficiaries for additional benefits or reduced premium amounts.

Since the MCO is not prohibited from including such items in its ACR proposal, there are no recommendations addressed to the New York MCO. This audit is part of a nationwide review of the ACR process and is being performed at several other MCOs. The results of these reviews will be shared with HCFA in the coming months so that appropriate legislative changes can be considered.

In responding to our draft report, the New York MCO took no exceptions to the facts presented in the report.

INTRODUCTION

BACKGROUND

MCOs with risk-based contracts enter into agreements with HCFA to provide prepaid health services to enrolled Medicare members. The HCFA pays predetermined monthly amounts for each beneficiary enrolled in the MCO's Medicare plan. These payments are based on 95 percent of HCFA's actuarial estimate of what Medicare would expect to pay if enrollees received their medical services in the Medicare fee-for-service sector.

Section 1876 of the Social Security Act requires each risk-based MCO to submit an annual ACR proposal to HCFA prior to the beginning of each contract period. The cost data, assumptions, and revenue requirements an MCO uses in an ACR proposal must be consistent with the information used for developing the premiums charged to non-Medicare enrollees. Therefore, an ACR proposal first identifies the average monthly premium an MCO charges its non-Medicare members. An MCO then calculates the premium that would be required to provide its non-Medicare members with a benefit package consisting entirely of services covered by the Medicare fee-for-service program. This premium is then adjusted to reflect presumed differences in the volume, complexity and intensity of services required by Medicare enrollees as compared to the MCO's non-Medicare enrollees. The resulting premium, the ACR, represents the proposed monthly cost of providing Medicare-covered services to the Medicare enrollees, including any estimated profits. Any excess of HCFA's payment over the ACR amount is known as savings. An MCO is required to use any savings to provide additional benefits, reduce premiums charged to its Medicare members, or return the difference to a fund to be managed by HCFA on the MCO's behalf.

OBJECTIVE, SCOPE AND METHODOLOGY

The objective of our review was to examine the administrative cost component of the 1997 ACR proposal submitted by the New York plan, and assess whether the costs were appropriate under Medicare's general principle of reasonableness. To accomplish our objective, we:

- * reviewed applicable laws and regulations.

- discussed with the New York MCO officials their ACR proposal process and the calculation of administrative costs in the 1997 ACR proposal.
- judgmentally selected and reviewed 966 administrative cost items (invoices and journal entries) totaling \$19,006,047 supporting the administrative cost data submitted with the plan's 1997 ACR proposal.

We reviewed the non-Medicare costs because they support the base rate in the ACR proposal that is used to determine the Medicare ACR. Since we used judgmental sampling techniques, we could not project our results to the total universe of administrative costs of \$40,488,770, which consisted of \$7,652,004 in Medicare costs and \$32,836,766 in non-Medicare costs.

Our review was performed in accordance with generally accepted government auditing standards. The objective of our review did not require us to review the internal control structure at the MCO. Field work was performed at the plan's office in New York from November 1997 through July 1998.

FINDINGS AND RECOMMENDATIONS

Administrative costs totaling \$688,723 were included in the ACR proposal that were not appropriate when compared to the Medicare program's general principle of paying only reasonable costs.

We judgmentally selected 966 administrative cost items (invoices and journal entries) totaling \$19,006,047 from the total administrative cost component of the ACR proposal of \$40,488,770. We then reviewed each of these items using the guidelines HCFA applies to cost-based MCOs and Medicare fee-for-service carriers, intermediaries, and providers, since HCFA guidance does not specify which administrative costs may be included in an ACR proposal.

The review showed that the ACR proposal included the following costs which would not be allowable if existing Medicare regulations were applied to risk-based MCOs:

- Out of Service Area (\$213,572). These were costs related to the opening of an office by the MCO in another state which is outside the service area covered by the New York MCO's Medicare risk contract.
- Entertainment (\$199,222). The largest entertainment cost included \$157,688 for an anniversary party for the parent company of the New York MCO. This amounted to approximately \$3,600 for each New York MCO delegate. Charges for the party included the cost of meeting rooms and meals at the Waldorf Astoria Hotel, conferences at

Rockefeller Plaza and Radio City Music Hall, a reception at Madison Square Garden, and chartering a yacht for a fireworks cruise and dinner. The remaining charges, totaling \$39,806, represent the costs of music, dinner and liquor at a holiday party and other parties, and \$1,728 for employee meals and tickets to sporting events and theater performances.

- Reinsurance (\$90,997). Section 5200.14 of the HMO/CMP Manual requires risk-based MCOs to list the cost of reinsurance under the administrative and general category of expenses in the ACR proposal. The plan, however, initially included the cost of reinsurance in the medical cost base to determine its administrative cost rate. When the cost of reinsurance was subsequently moved from the medical cost base to the administrative cost rate, the plan restated the cost at an inflated amount.
- Corporate Administration (\$48,285). These costs were for the 15 percent corporate administration fees charged to the New York MCO by the plan's corporate offices. This amount represents 15 percent of the other expenses identified in this report to the extent that the reported items are included in the expense pool used to calculate corporate administration charges.
- IRS Penalties and Interest (\$47,533). The plan included costs for penalties and interest assessed by the Internal Revenue Service.
- Political Contribution and Lobbying (\$32,613). Article IX, Section D of HCFA's risk contract with the MCO prohibits the use of HCFA funds to influence legislation or appropriations. The contract also refers to Section 31.205-22 of the Federal Acquisition Regulations which specifies that costs for political activity and lobbying are unallowable.
- Employee Morale (\$32,104). These costs were for food and beverages provided for the benefit of employees.
- Contributions (\$19,667). These costs were for contributions and other payments to charitable and other organizations including \$5,000 for a memorial fund raiser road race, and \$1,425 for golf tournament sponsorships.
- Other Costs (\$4,730). These costs included \$3,278 for travel, meals and lodging that exceeded Federal per diem rates, and \$1,452 for interest expense.

The effect of including these costs in the proposal is to increase the amounts needed for administration, thus reducing any potential savings from the Medicare payment amounts. In addition, this impacts the amount available to Medicare beneficiaries for additional benefits or reduced premium amounts.

Recommendations

Since the MCO is not prohibited from including such items in its ACR proposal, there are no recommendations addressed to the New York MCO. This audit is part of a nationwide review of the ACR process and is being performed at several other MCOs. The results of these reviews will be shared with HCFA in the coming months so that appropriate legislative changes can be considered.

The New York MCO Comments

On October 19, 1998, the New York MCO responded to a draft of this audit report. The MCO took no exceptions to the facts presented in the report.