DEPARTMENT OF HEALTH AND HUMAN SERVICES Office of Inspector General

Office of Audit Services
1100 Commerce, Room 632
Dallas, Texas 75242

April 27, 2004

Report Number: A-06-03-00032

Ms. Marti Mahaffey
Executive Vice President & COO
TrailBlazer Health Enterprises, LLC
8330 LBJ Freeway Executive Center III
Dallas, Texas 75243

Dear Ms. Mahaffey:

Enclosed are two copies of the Department of Health and Human Services (HHS), Office of Inspector General report entitled "Audit of Administrative Costs, Part A and Part B of the Medicare Program for TrailBlazer Health Enterprises, LLC, for the period of October 1, 1999 through September 30, 2002." A copy of this report will be forwarded to the action official noted below for his review and any action deemed necessary.

Final determination as to actions taken on all matters reported will be made by the HHS action official named below. We request that you respond to the HHS action official within 30 days from the date of this letter. Your response should present any comments or additional information that you believe may have a bearing on the final determination.

In accordance with the principles of the Freedom of Information Act (5 U.S.C. 552, as amended by Public Law 104-231), OIG reports issued to the department's grantees and contractors are made available to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act which the department chooses to exercise. (See 45 CFR Part 5.)

We appreciate the overall cooperation given to us by TrailBlazer, Palmetto GBA, LLC and BlueCross BlueShield of South Carolina officials and staff throughout this audit.

If you have any questions or comments about this report, please do not hesitate to contact me at 214-767-8414 or through e-mail at gordon.sato@oig.hhs.gov, or contact Cheryl Blackmon, Audit Manager, at 214-767-9205 or through e-mail at cheryl.blackmon@oig.hhs.gov.

To facilitate identification, please refer to report number A-06-03-00032 in all correspondence relating to this report.

Sincerely,

Gordon L. Sato

Gordon L. Sato
Regional Inspector General
for Audit Services

Enclosures-as stated

Direct Reply to HHS Action Official:

James R. Farris, MD
Regional Administrator
Centers for Medicare and Medicaid Services
1301 Young Street, Room 714
Dallas, Texas 75202-4348

Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

AUDIT OF ADMINISTRATIVE COSTS PART A AND PART B OF THE MEDICARE PROGRAM FOR TRAILBLAZER HEALTH ENTERPRISES, LLC, FOR THE PERIOD OCTOBER 1, 1999 THROUGH SEPTEMBER 30, 2002

APRIL 2004
A-06-03-00032

NOTICES

THIS REPORT IS AVAILABLE TO THE PUBLIC at http://oig.hhs.gov

In accordance with the principles of the Freedom of Information Act, 5 U.S.C. 552, as amended by Public Law 104-231, Office of Audit Services' (OAS) reports are made available to members of the public to the extent information contained therein is not subject to exemptions in the Act. (See 45 CFR Part 5)

OAS FINDINGS AND OPINIONS

The designation of financial or management practices as questionable or a recommendation for the disallowance of costs incurred or claimed as well as other conclusions and recommendations in this report represent the findings and opinions of the HHS OIG OAS. Final determination on these matters will be made by authorized officials of the HHS divisions.

EXECUTIVE SUMMARY

OBJECTIVES

The objectives of our audit were to determine whether: (1) TrailBlazer's Final Administrative Cost Proposals (proposals) fairly present the cost of program administration allowable in accordance with the Federal Acquisition Regulation (FAR), Title 48, Chapter 1, Part 31, as interpreted and modified by the Medicare agreements; and (2) such costs are reasonable, allowable, and allocable to the Medicare program. In addition, we reviewed fiscal year (FY) 1999 forward funding costs approved for the Medicare Division of Blue Cross and Blue Shield of Texas, Inc., which became TrailBlazer Health Enterprises, LLC (TrailBlazer).

TrailBlazer claimed $347,905,248[1] on its proposals during the period of October 1, 1999 through September 30, 2002 (FY 2000-2002). The proposals included pension costs of $8,773,125 and pension-related costs totaling $4,378,233 that are the subject of a separate audit. Therefore, we excluded these pension and pension-related costs from our audit. We also excluded FY 2002 forward funding costs totaling $3,725,043 for expenses that had not been obligated or incurred.

FINDINGS

We are questioning $622,078 in costs relating to:

- $447,161 of executive compensation costs related to annual increases that were not reasonable as they exceeded the Bureau of Labor Statistics' guidelines;
- $167,964 of executive compensation that exceeded established limits;
- $3,077 of unallowable costs related to country club dues and lobbying and political activity costs; and
- $3,876 that was overstated for return on investment.

These questioned costs are not in accordance with FAR as interpreted and modified by the Medicare agreements.

RECOMMENDATIONS

We are recommending that TrailBlazer (1) reduce costs claimed on proposals by $622,078 and (2) take corrective action to address the findings.

TRAILBLAZER'S COMMENTS

TrailBlazer generally agreed with our conclusions and recommendations, except for the questioned executive compensation costs in excess of the Employment Compensation

[1] This amount consists of total Part A and Part B costs claimed on the proposals as follows: Supplement #02 and #04 (FY 2000), Supplement #03 and #03 (FY 2001), and Supplement #04 and #05 (FY 2002), respectively.

Index (Index). For the remaining questioned costs for the three-year period which resulted from clerical errors, TrailBlazer stated that corrective action has been taken to prevent similar errors in the future. TrailBlazer further stated that they would continue to coordinate and follow-up to ensure that appropriate procedures are properly implemented.

OFFICE OF INSPECTOR GENERAL'S RESPONSE

We continue to maintain the use of the Index is an equitable and relevant measure in determining reasonableness of increases in executive compensation. Further, the FAR does not prohibit the use of the Index as a measurement tool.

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INTRODUCTION

BACKGROUND

Title XVIII of the Social Security Act established the Health Insurance for the Aged and Disabled (Medicare). Hospital Insurance (Part A) provides protection against the costs of hospital inpatient care, post-hospital extended care and post-hospital home health care. Supplemental Health Insurance (Part B) is a voluntary program providing protection against the costs of physician services, hospital outpatient services, home health care services and other health services.

To meet program objectives, Centers for Medicare & Medicaid Services (CMS) enters into contracts with private companies to process and pay claims for services provided by health care providers to eligible beneficiaries. The contracts provide for reimbursement of allowable administrative costs incurred by intermediaries that process Part A hospital claims and carriers that process Part B medical claims. Contractors claim reimbursement of administrative costs through submission of proposals to CMS.

CMS has contracted with TrailBlazer to serve as: (1) Intermediary for Colorado, New Mexico, and Texas; and (2) Carrier for Texas, Maryland, Delaware, Virginia, and the District of Columbia.

TrailBlazer, headquartered in Dallas, Texas, is a wholly owned subsidiary of BlueCross BlueShield of South Carolina (BlueCross). BlueCross provided certain management and other operational support services for TrailBlazer, including accounting and financial, human resources and personnel, and legal and general corporate administration. Palmetto GBA, LLC, also a wholly owned subsidiary of BlueCross, performed some of these services for TrailBlazer, including Medicare cost accounting and financial reporting.

OBJECTIVES, SCOPE AND METHODOLOGY

The objectives of our review were to determine whether: (1) TrailBlazer's proposals fairly present the cost of program administration allowable in accordance with Part 31 of FAR as interpreted and modified by the Medicare agreements; and (2) such costs are reasonable, allowable, and allocable to the Medicare program. In addition, we reviewed FY 1999 forward funding costs approved for the Medicare Division of Blue Cross and Blue Shield of Texas, Inc., which became TrailBlazer.

To accomplish our audit objectives we: (1) examined applicable laws and regulations; (2) held discussions with BlueCross, Palmetto, and TrailBlazer officials regarding their administrative cost procedures and other related issues; (3) obtained an understanding of the accounting policies and procedures relevant to the audit objectives; (4) performed various financial reconciliations; and (5) judgmentally selected invoices to determine whether expenses are reasonable, allowable, and allocable. Our examination also included audit procedures designed to examine pertinent accounting records and supporting documentation. The audit period covered costs reported from October 1, 1999 through September 30, 2002 and FY 1999 forward funding costs.

Our audit was conducted in accordance with generally accepted government auditing standards. Our internal control review was limited to obtaining an understanding of TrailBlazer's administrative cost process. The proposals included pension costs of $8,773,125 and pension-related costs totaling $4,378,233 that are the subject of a separate audit. Therefore, we excluded these pension and pension-related costs from our audit. We also excluded FY 2002 forward funding costs totaling $3,725,043 for expenses that had not been obligated or incurred. We performed our audit field work at TrailBlazer in Dallas, Texas; BlueCross and Palmetto offices in Columbia, South Carolina and the OIG Dallas/Fort Worth Field Office. Audit work was conducted from January 2003 through December 2003.

During the course of our audit, TrailBlazer filed revised proposals for FY 2002. The proposals had net increases in total costs of $5,469 for Part A and $858,972 for Part B. We excluded these costs from the scope of our audit. Accordingly, we did not express an opinion on these costs.

FINDINGS AND RECOMMENDATIONS

We determined that TrailBlazer's administrative costs claimed on its proposals were generally in accordance with Part 31 of FAR and Appendix B of its Medicare agreement with CMS. We also determined that the FY 1999 forward funding costs totaling $4,970,532 approved for the Medicare Division of Blue Cross and Blue Shield of Texas, Inc. were appropriately liquidated. However, we are questioning $622,078 in costs relating to executive compensation, compensation limits, unallowable costs, and return on investment. These questioned costs are not in accordance with FAR as interpreted and modified by the Medicare agreements. We are recommending that TrailBlazer (1) reduce costs claimed on proposals by $622,078 and (2) take corrective action to address the findings.

EXECUTIVE COMPENSATION COSTS

TrailBlazer claimed approximately $447,161 of executive compensation costs related to annual increases that were not reasonable as they exceeded the Bureau of Labor Statistics' guidelines. Specifically, these increases exceeded the average increases for comparable positions when compared to the Index. Executive compensation costs were overstated for both FY 2001 and FY 2002.

Section 31.205-6(b) of the FAR was the regulation governing executive compensation during FY 2001 and 2002. It states:

> *The compensation for personal services paid or accrued to each employee must be reasonable for the work performed…Based on an initial review of the facts, contracting officers or their representatives may challenge the*

> *reasonableness of any individual element or sum of the individual elements of compensation paid or accrued to particular employees or job classes of employees. In such cases, there is no presumption of reasonableness and, upon challenge, the contractor must demonstrate the reasonableness of the compensation item in question….*

The Index measures the rate of change in employee compensation that includes wages, salaries and employers' cost for employee benefits. The Index represents dozens of indices that are calculated for various occupational and industry groups to measure the rate of change in employee compensation. It is a fixed weight index at the occupational level and eliminates the effects of employment shifts among occupations. The Index is distinguished from other surveys because it covers all establishments and occupations in both the private non-farm and public sectors. The Index showed an average annual increase of 3.7 percent for calendar years (CYs) 2000 through 2002.

To assess the reasonableness of the executive compensation increases, we compared total compensation paid to TrailBlazer top executives to the base year compensation adjusted forward using the Index for executive, administrative, and managerial occupations. The compensation amounts that we used included the executive's annual salary, bonus incentives, and other benefits paid to the employee. These benefits included, but were not limited to, Section 401K retirement account matching costs, life and health insurance, and auto allowances. The Index guidelines exclude non-production bonuses, such as discretionary bonuses, from earning calculations. Accordingly, we excluded discretionary bonuses to derive total compensation.

According to a BlueCross official, their policy does not include the use of the Index as a guide for executive compensation. Instead, increases in executive compensation for TrailBlazer executives are based on factors such as job performance and productivity.

A TrailBlazer official stated that they disagree with the use of the Index for determining executive salary increases, because the Index only uses averages and does not take into account other factors. However, we believe the Index is an equitable and relevant measure in determining the reasonableness of increases in executive compensation.

BlueCross's policy resulted in an overpayment of $447,161 for FY 2001 and FY 2002[2] in executive compensation allocated to the Medicare program.[3]

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[2] TrailBlazer reported proposal costs on a FY basis. However, BlueCross calculated compensation on a CY basis. To be consistent with BlueCross compensation calculations, we applied the limitation on a CY basis.

[3] In order to ensure that the overstatements are reimbursed on the proposals in which the costs were generally incurred, we assigned 75 percent of the overstatements to the same FY as the CY (e.g., FY 2000 for CY 2000) and the remaining 25 percent to the following FY. See Appendix C.

RECOMMENDATIONS

We recommend that TrailBlazer:

(1) reduce its proposals for FYs 2001 through 2003 by a total of $447,161 to compensate for these overpayments, and

(2) coordinate and follow up with BlueCross to ensure that it establishes and implements policies and procedures so that executive compensation increases that exceed the Index are not charged to the Medicare program.

TRAILBLAZER'S COMMENTS

With regard to executive compensation costs, TrailBlazer disagreed with OIG's conclusion that these costs were not reasonable. TrailBlazer stated that:

- no statutory, regulatory or contractual basis was cited for the use of this Index,
- the FAR makes no reference to "increases" in compensation, and
- the Index does not take into account company growth.

In addition, TrailBlazer noted that in CMS's response to the August 5, 1994 OIG report entitled "Review of Executive Compensation at Medicare Contractors", CMS stated "extensive contract negotiations, however, will need to take place before CMS can unilaterally place a ceiling on executive salary increases, especially since the Medicare contracts are cost reimbursed agreements". TrailBlazer concluded that its contract does not contain a provision that would limit executive compensation increases to the rate of increase of the Index.

OFFICE OF INSPECTOR GENERAL'S RESPONSE

We continue to maintain the use of the Index is an equitable and relevant measure in determining reasonableness of increases in executive compensation. Further, the FAR does not prohibit the use of the Index as a measurement tool.

In addition, while the OIG 1994 audit report referred to by TrailBlazer did address the requirement for negotiations, it also (1) determined excessive increases occurred in executive compensation for the three Medicare contractors under audit and (2) concluded that the OIG did not believe that increases to compensation that were excessive or unreasonable should have been allocated to Medicare. Further, the report noted that such increases seemed particularly inappropriate at a time when Medicare trust funds were facing financial uncertainty. In addition, in its response to an early alert memorandum related to this audit report, CMS agreed with the OIG challenging the reasonableness of the executive compensation charged to Medicare. CMS also stated that the onus was on the Medicare contractors to show that the compensation paid to its executives is reasonable.

In summary, we still believe that the unreasonable executive compensation claimed by TrailBlazer should not be allocated to Medicare.

COMPENSATION LIMITS

TrailBlazer reported executive compensation costs that exceeded the allowable limits under Section 809 of Public Law 104-201. Specifically, BlueCross and TrailBlazer executives' compensation costs exceeded the statutory limitations by approximately $167,964. BlueCross did not: (1) include all compensation for senior executives, and (2) make an adjusting journal entry to reduce executive compensation within allowable limits.

Beginning with 1997, allowable compensation to executives has been limited for purposes of determining government contract cost under the authority of Section 809 of Public Law 104-201. Compensation is defined as total amount of wages, salary, bonuses, deferred compensation, and employer contributions to defined contribution pension plans.

Section 809 of Public Law 104-201 and the Federal Acquisition Regulation 31.205-6 (p)1 states:

> *…(1) Cost incurred after January 1, 1998 for compensation of a senior executive in excess of the benchmark compensation amount determined applicable for the contractor fiscal year by the Administrator, Office of Federal Procurement Policy (OFPP) under Section 39 of the OFPP Act (41 U.S.C. 435) are unallowable. This limitation is the sole statutory limitation on allowable senior executive compensation cost incurred after January 1, 1998…(2)…(ii) "Senior executive" means-…(B) …the five most highly compensated employees in management positions….*

Executive compensation exceeded the statutory limitation allocated to Medicare by a total of approximately $167,964 for BlueCross and TrailBlazer executives during CYs 2000 through 2002. The statutory limitation provision sets the limit of compensation for senior executives at $353,010 for FY 2000, $374,228 for FY 2001, and $387,783 for FY 2002. The percentage of time allocated to Medicare is applied to these limits to determine the amount of compensation eligible for Medicare reimbursement.

According to a BlueCross official, an administrative error caused BlueCross to omit certain categories of compensation for four of its executives during CY 2000. BlueCross excluded compensation totaling approximately $920,270 in the executive compensation totals used to derive executive compensation allocable to Medicare. As a result, BlueCross misallocated executive compensation to Medicare that exceeded the statutory limitation by approximately $154,041.

The amounts totaling $154,041 erroneously charged to Medicare for executive compensation consisted of the following categories:

- ✓ Non-discretionary bonuses allocated to Medicare in the amount of $143,922 for four executives;
- ✓ Taxes related to the non-discretionary bonuses noted above allocated to Medicare in the amount of $4,210 for two executives;
- ✓ Preferred Saving Plan matching funds allocated to Medicare in the amount of $4,544 for four executives;
- ✓ Executive Non-Qualified Plan compensation allocated to Medicare in the amount of $543 for one executive; and
- ✓ Premiums for group term life insurance over $50,000 allocated to Medicare in the amount of $822 for four executives.

For CY 2001, when adjusting the compensation limits, BlueCross: (1) excluded $17,000 related to Section 401K retirement account matching costs from the total senior executive compensation, and (2) made a transposition error on the original journal entry resulting in a $9,000 understatement to the senior executives' compensation. Therefore, BlueCross erroneously allocated $2,131 to the Medicare program.

Executive compensations for BlueCross were adjusted in accordance with the statutory limitation for CY 2002.

TrailBlazer senior executives' compensation met the statutory limitation requirements for CY 2000 and CY 2001. For CY 2002, we determined that compensation for TrailBlazer's senior executives exceeded the limitations by approximately $11,792. BlueCross officials stated that they could not locate a journal entry to support that an adjustment had been made to reduce senior executive compensation below the required limitation.

According to a BlueCross official, they have recently developed and implemented an automated system to ensure that executive compensation costs are calculated and adjusted correctly so that such costs do not exceed established limits.

As a result of the administrative errors, the Medicare program was overcharged $167,964[4] for executive compensation impacting FYs' 2000 through 2003 proposals. [5]

[4] See Footnote 2.
[5] See Footnote 3.

RECOMMENDATIONS

We recommend that TrailBlazer:

(1) reduce its proposals for FYs 2000 through 2003 by a total of $167,964 to correct the overstatement of senior executive compensation, and

(2) coordinate and follow up to ensure that procedures are adequate and applied so that TrailBlazer and BlueCross executive compensation costs do not exceed the established limits.

TRAILBLAZER'S COMMENTS

TrailBlazer generally agreed with the OIG's conclusions and recommendations. They stated that corrective action has been taken to prevent similar errors in the future.

UNALLOWABLE COSTS

TrailBlazer claimed unallowable costs related to country club dues and lobbying and political activity costs totaling $3,077 on its FYs 2000 through 2002 proposals.

Country Club Dues

TrailBlazer claimed unallowable costs related to country club dues on its FY 2001 and 2002 proposals. BlueCross allocated these costs to the Medicare program for two of their senior executives. As a result of this allocation, TrailBlazer's proposals were overstated by $2,399.

These costs are unallowable in accordance with FAR Section 31.205-14, which states:

> ". . . Costs of membership in social, dining, or country clubs or other organizations having the same purpose are also unallowable, regardless of whether the cost is reported as taxable income to the employees."

According to a BlueCross official, this allocation occurred because BlueCross was not aware that country club costs were being allocated to the Medicare program. The official stated that the automated system recently developed and implemented for executive compensation includes a process to preclude country club dues from being allocated to the Medicare program.

The allocation of country club dues to the Medicare program resulted in overstatements of the FY 2001, 2002 and 2003 proposals. [6]

[6] See Footnote 3.

Recommendations

We recommend that TrailBlazer:

(1) reduce its proposals for FYs 2001 through 2003 by a total of $2,399 to compensate for overstatement of charges, and

(2) coordinate and follow up with BlueCross to ensure that procedures are adequate and applied so that country club dues are not allocated to the Medicare program.

Lobbying and Political Activity Costs

TrailBlazer claimed unallowable costs related to lobbying and political activity costs on its FY 2000 proposal. Specifically, BlueCross allocated costs to the Medicare program related to its annual membership in a political education committee. As a result of this allocation, TrailBlazer overstated its FY 2000 proposal by $678.

Lobbying and political activity costs are unallowable in accordance with FAR Section 31.205-22(a), which states:

> *Costs associated with the following activities are unallowable… Establishing, administering, contributing to, or paying the expenses of a political party, campaign, political action committee, or other organization established for the purpose of influencing the outcomes of elections.*

BlueCross allocated lobbying and political activity costs for its annual membership in a political education committee whose stated intentions were to "maintain our reputation as the political analysis and candidate recruitment organization of South Carolina business".

According to a BlueCross official, an administrative error occurred during an update of its allocation tables in December 1999. He/she further stated that BlueCross revised the tables in the next quarter to prevent lobbying and political activity costs from being allocated to Medicare. This error resulted in an overstatement of the FY 2000 proposal by $678.

Recommendation

We recommend that TrailBlazer reduce its FY 2000 proposal by a total of $678 to compensate for overstatement of charges.

TRAILBLAZER'S COMMENTS

TrailBlazer generally agreed with the OIG's conclusions and recommendations. They stated that corrective action has been taken to prevent similar errors in the future.

RETURN ON INVESTMENT

In two instances, BlueCross used incorrect rates of return to calculate the return on investment. This resulted in TrailBlazer claiming $3,876 for investment expenses in excess of the allowable amounts claimed on the proposals for FYs 2000 and 2001. BlueCross did not have adequate procedures in place to ensure that proper rates were used to calculate the return on investments.

Paragraph X.A. of Appendix B of the Medicare agreement states that:

> *To the extent that land and tangible depreciable assets, such as buildings, equipment, and leasehold improvements, owned by the contractor are used for Medicare purposes, the cost of investment will be determined by multiplying the average undepreciated balance of such assets for the contract period by the actual rate of return of the contractor's investment portfolio for the contract period, or a lower rate if the contractor so chooses.*

Total return on investment costs for TrailBlazer consisted of the sum of return on investment costs (1) related to TrailBlazer-owned assets and (2) allocated to TrailBlazer for BlueCross-owned assets used by TrailBlazer for Medicare purposes. According to a BlueCross official, costs were allocated to TrailBlazer on a monthly basis, therefore, return on investment calculations also had to be performed on a monthly basis using the current month's undepreciated balances. In addition, the official stated that due to timing differences, BlueCross's policy was to use the previous month's investment rate to calculate the return on investment for the current month. We believe this methodology used by BlueCross for calculating return on investment met the intent of the Medicare agreement.

However, for the months of February 2000 and April 2001, BlueCross used incorrect rates of return to calculate the return on investment as follows:

BLUECROSS RETURN ON INVESTMENT RATES

Month and Year	Incorrect Return on Investment Percentage	Return on Investment Rate shown on Yield on Investment Schedule
February 2000	5.53%	5.05%
April 2001	6.53%	6.47%

BlueCross did not have adequate procedures to ensure that proper rates were used to calculate return on investment. Therefore, TrailBlazer claimed $3,876 for investment expenses in excess of the allowable amounts claimed on the proposals for FYs 2000 and 2001.

A BlueCross official stated that he/she was aware prior to the audit that incorrect rates had been used to calculate return on investment. Therefore, BlueCross had already taken action to strengthen their procedures to ensure proper rates are used to calculate return on investment.

RECOMMENDATIONS

We recommend that TrailBlazer:

(1) reduce its proposals for FYs 2000 and 2001 by a total of $3,876 to compensate for these overpayments, and

(2) coordinate with BlueCross to ensure that such procedures are adequate and applied so proper rates are used to calculate return on investment.

TRAILBLAZER'S COMMENTS

TrailBlazer generally agreed with the OIG's conclusions and recommendations. They stated that corrective action has been taken to prevent similar errors in the future.

OTHER MATTERS

CONTRACTOR INFORMATION REQUESTED BY CMS

<u>CMS has requested comments concerning:</u>

1. Significant Data Processing – TrailBlazer processes Medicare claims using two CMS designated standard systems: (1) Part A uses the Fiscal Intermediary Shared System (FISS) and (2) Part B uses the Multi-Carrier System (MCS). According to TrailBlazer officials, TrailBlazer does not make modifications to these systems. Modifications and enhancements are made to FISS and MCS by the standard system maintainers, Arkansas Blue Cross and Blue Shield and Electronic Data Systems, respectively, at the direction of CMS. FISS and MCS upgrade releases are provided to TrailBlazer by the standard system maintainers. TrailBlazer installs the releases and performs acceptance testing before moving them into a production status. Therefore, TrailBlazer does not incur costs for change analysis and modification of the systems.

2. Interim Expenditure Reports – To determine the accuracy of the expenditure reports filed by TrailBlazer, we judgmentally reviewed the final report for FY

2002 and compared it to the submitted proposals and approved budget amounts. Our limited review did not disclose any material inaccuracies, inconsistencies, or weaknesses other than those included in the findings and recommendations noted in this report.

3. Complementary Insurance Credits – TrailBlazer furnished complementary insurance credits only to outside organizations. Our test work included verification that: (1) agreements exist between the Medicare contractor and the complementary insurer, (2) the charges by the contractor were the approved rates as specified by CMS, and (3) the amounts billed were properly credited to Medicare. Based on our test work, we concluded that TrailBlazer complied with complementary insurance policies during the audit period.

RECONCILIATION PROCESS

During much of the audit, Palmetto did not provide complete financial data needed to perform the required financial reconciliation of the proposals to the subsidiary records of expenses. The incomplete financial data resulted in the audit team having to spend an inordinate amount of time working on the reconciliation. We suggest that TrailBlazer and Palmetto work together to improve the financial reconciliation process. However, we noted that the accounting department reconciled the financial statements to the Interim Expenditure Reports in a timely manner.

APPENDICES

TRAILBLAZER HEALTH ENTERPRISES, LLC
FINAL ADMINISTRATIVE COST PROPOSALS
AND THE OIG RECOMMENDED REDUCTIONS
FOR THE FISCAL YEAR 2000
(OCTOBER 1, 1999 – SEPTEMBER 30, 2000)

OPERATION	PART A ADMINISTRATIVE COSTS FACP #02	PART B ADMINISTRATIVE COSTS FACP #04	TOTAL ADMINISTRATIVE COSTS
Bills/Claims Payment	$5,644,073	$40,444,351	$46,088,424
Appeals/Reviews	1,122,571	7,052,921	8,175,492
Inquiries	2,030,948	18,066,740	20,097,688
Provider Education and Training	869,554	2,886,989	3,756,543
Participating Physician	-	734,814	734,814
Reimbursement	2,590,837	-	2,590,837
Productivity Investment	96,727	123,051	219,778
Medical Review	2,829,318	7,849,828	10,679,146
Medicare Secondary Payer	1,159,811	3,349,623	4,509,434
Benefits Integrity	703,003	2,606,757	3,309,760
MIP Provider Education and Training	256,645	1,612,465	1,869,110
Audit	8,105,751	-	8,105,751
Non-Renewals	1,126,942	3,796,580	4,923,522
Credits	(428,191)	(11,847,185)	(12,275,376)
Total Administrative Costs Claimed	**$26,107,989**	**$76,676,934**	**$102,784,923**
Costs Not Reviewed:			
Pension Costs	$784,828	$2,122,640	$2,907,468
Pension-Related Costs	283,008	807,027	1,090,035
Total Costs Not Reviewed	**$1,067,836**	**$2,929,667**	**$3,997,503**
Recommended Reductions:			
Executive Compensation (Index)	$ -	$ -	$ -
Compensation Limits	28,213	87,318	115,531
Country Club Dues	-	-	-
Lobbying and Political Activity	164	514	678
Return on Investment	650	2,845	3,495
Total Recommended Reductions	**$29,027**	**$90,677**	**$119,704**

TRAILBLAZER HEALTH ENTERPRISES, LLC
FINAL ADMINISTRATIVE COST PROPOSALS
AND THE OIG RECOMMENDED REDUCTIONS
FOR THE FISCAL YEAR 2001
(OCTOBER 1, 2000 – SEPTEMBER 30, 2001)

OPERATION	PART A ADMINISTRATIVE COSTS FACP #03	PART B ADMINISTRATIVE COSTS FACP #03	TOTAL ADMINISTRATIVE COSTS
Bills/Claims Payment	$6,899,868	$50,613,116	$57,512,984
Appeals/Reviews	1,520,017	8,931,003	10,451,020
Inquiries	799,079	13,732,062	14,531,141
Provider Education and Training	908,396	2,856,471	3,764,867
Participating Physician	-	1,037,219	1,037,219
Reimbursement	2,481,869	-	2,481,869
Productivity Investment	314,956	494,031	808,987
Provider Telephone Inquiries	1,842,772	5,539,514	7,382,286
Medical Review	3,134,956	10,635,407	13,770,363
Medicare Secondary Payer	1,347,001	3,560,826	4,907,827
Benefits Integrity	794,886	3,620,208	4,415,094
MIP Provider Education and Training	314,811	1,750,480	2,065,291
Audit	9,763,752	-	9,763,752
Non-Renewals	-	-	-
Credits	(522,449)	(16,049,084)	(16,571,533)
Total Administrative Costs Claimed	**$29,599,914**	**$86,721,253**	**$116,321,167**
Costs Not Reviewed:			
Pension Costs	$741,355	$2,102,506	$2,843,861
Pension-Related Costs	325,833	1,020,014	1,345,847
Total Costs Not Reviewed	**$1,067,188**	**$3,122,520**	**$4,189,708**
Recommended Reductions:			
Executive Compensation (Index)	$30,858	$124,384	$155,242
Compensation Limits	9,793	30,315	40,108
Country Club Dues	235	755	990
Lobbying and Political Activity	-	-	-
Return on Investment	68	313	381
Total Recommended Reductions	**$40,954**	**$155,767**	**$196,721**

TRAILBLAZER HEALTH ENTERPRISES, LLC
FINAL ADMINISTRATIVE COST PROPOSALS
AND THE OIG RECOMMENDED REDUCTIONS
FOR THE FISCAL YEAR 2002
(OCTOBER 1, 2001 – SEPTEMBER 30, 2002)

OPERATION	PART A ADMINISTRATIVE COSTS FACP #04	PART B ADMINISTRATIVE COSTS FACP #05	TOTAL ADMINISTRATIVE COSTS
Bills/Claims Payment	$7,633,673	$57,358,975	$64,992,648
Appeals/Reviews	1,633,872	10,444,538	12,078,410
Inquiries	844,028	14,128,524	14,972,552
Provider Education and Training	1,031,172	2,990,342	4,021,514
Participating Physician	-	856,941	856,941
Reimbursement	2,939,788	-	2,939,788
Productivity Investment	200,227	1,451,497	1,651,724
Provider Telephone Inquiries	1,518,138	6,400,725	7,918,863
Medical Review	3,208,217	9,964,801	13,173,018
Medicare Secondary Payer	1,472,244	4,490,942	5,963,186
Benefits Integrity	885,138	4,991,712	5,876,850
MIP Provider Education and Training	353,655	2,104,860	2,458,515
Audit	9,996,446	-	9,996,446
Smoking Cessation Project	-	1,789,666	1,789,666
Non-Renewals	-	-	-
Credits	(839,397)	(19,051,566)	(19,890,963)
Total Administrative Costs Claimed	**$30,877,201**	**$97,921,957**	**$128,799,158**
Costs Not Reviewed:			
Pension Costs	$798,300	$2,223,496	$3,021,796
Pension-Related Costs	453,865	1,488,485	1,942,350
Forward Funding Costs	44,976	3,680,067	3,725,043
Net Increases Total Costs (for Revised Proposals)	5,469	858,972	864,441
Total Costs Not Reviewed	**$1,302,610**	**$8,251,020**	**$9,553,630**
Recommended Reductions:			
Executive Compensation (Index)	$42,274	$189,602	$231,876
Compensation Limits	1,931	7,446	9,377
Country Club Dues	275	865	1,140
Lobbying and Political Activity	-	-	-
Return on Investment	-	-	-
Total Recommended Reductions	**$44,480**	**$197,913**	**$242,393**

TRAILBLAZER HEALTH ENTERPRISES, LLC
OIG RECOMMENDED REDUCTIONS
FOR THE FISCAL YEAR 2003
(OCTOBER 1, 2002 – SEPTEMBER 30, 2003)

Recommended Reductions:			
Executive Compensation (Index)	$10,663	$49,380	$60,043
Compensation Limits	600	2,348	2,948
Country Club Dues	65	204	269
Lobbying and Political Activity	-	-	-
Return on Investment	-	-	-
Total Recommended Reductions	**$11,328**	**$51,932**	**$63,260**

TRAILBLAZER HEALTH ENTERPRISES, LLC
OIG RECOMMENDED REDUCTIONS
SUMMARY SCHEDULE FOR THE FISCAL YEARS 2000 -2003
(OCTOBER 1, 1999 – SEPTEMBER 30, 2003)

RECOMMENDED REDUCTIONS:	FY 2000			FY 2001			FY 2002			FY 2003			GRAND TOTAL		
	Part A	Part B	Total	Part A	Part B	Total	Part A	Part B	Total	Part A	Part B	Total	Part A	Part B	Total
Executive Compensation (Index) *	$ --	$ --	$ --	$ 30,858	$124,384	$155,242	$42,274	$189,602	$231,876	$10,663	$49,380	$60,043	$83,795	$363,366	$447,161
Compensation Limits *	28,213	87,318	115,531	9,793	30,315	40,108	1,931	7,446	9,377	600	2,348	2,948	40,537	127,427	167,964
Country Club Dues *	--	--	--	235	755	990	275	865	1,140	65	204	269	575	1,824	2,399
Lobbying and Political Activity	164	514	678	-	-	-	-	-	-	-	-	-	164	514	678
Return on Investment	650	2,845	3,495	68	313	381	-	-	-	-	-	-	718	3,158	3,876
TOTAL RECOMMENDED REDUCTIONS	**$29,027**	**$90,677**	**$119,704**	**$40,954**	**$155,767**	**$196,721**	**$44,480**	**$197,913**	**$242,393**	**$11,328**	**$51,932**	**$63,260**	**$125,789**	**$496,289**	**$622,078**

* Note: As indicated in Footnote 3 of the audit report, in order to ensure that the overstatements are reimbursed on the proposals in which the costs were generally incurred, we assigned 75 percent of the overstatements to the same FY as the CY (e.g., FY 2000 for CY 2000) and the remaining 25 percent to the following FY.

TrailBlazer[SM]
HEALTH ENTERPRISES, LLC

8330 LBJ Freeway
Executive Center III
Dallas, Texas 75243-1213

Marti Mahaffey
Executive Vice President and
Chief Operating Officer

April 14, 2004

Ms. Cheryl Blackmon
Audit Manager
Office of Inspector General, Office of Audit Services
1100 Commerce, Room 632
Dallas, TX 75242

Subject: Response to Draft Report "*Audit of Administrative Costs, Part A and Part B of the Medicare Program for TrailBlazer Health Enterprises, LLC for the period of October 1, 1999 through September 30, 2002*" (Report # A-06-03-00032)

Dear Ms. Blackmon:

Thank you for the recommendations resulting from your audit of administrative costs of the Medicare program as presented on Final Administrative Cost Proposals (FACPs) of TrailBlazer Health Enterprises, LLC (TrailBlazer) for the three fiscal years ended September 30, 2000, 2001, and 2002 and the opportunity to provide comments. TrailBlazer places a high priority on ensuring the accuracy of FACPs and that costs they include are reasonable, allowable, and allocable to the Medicare program.

Except for the $447,161 of questioned executive compensation costs in excess of the Employment Compensation Index (ECI), we generally agree with your conclusions and recommendations. As noted in your draft report, the remaining $174,917 of questioned costs for the three year period resulted from clerical errors and steps have already been taken to prevent similar errors in the future. Nonetheless, as recommended in the report, we will continue to coordinate and follow up to ensure that appropriate procedures are properly implemented.

With regard to the executive compensation costs in excess of the ECI, we disagree with the OIG's conclusion that annual increases in these costs were not reasonable. First, absolutely no statutory, regulatory or contractual basis was cited for the use of this index as the test of reasonableness of executive compensation. In fact, the FAR 31.205-(6)(b)(1) makes no reference to "increases" in compensation. Instead, it prescribes testing "the reasonableness of any individual element or the sum of the individual elements of compensation."

Not only is there no statutory, regulatory or contractual basis for its use, the ECI index does not take into account company growth. Further, the ECI does not provide any information as to the reasonableness of compensation at the beginning of the period under evaluation or the reasonableness of compensation at the end of the compensation period. The use of a single factor to evaluate only increases in compensation is an inadequate and arbitrary methodology to evaluate the reasonableness of compensation. In addition, it would make the presumption that the starting salary for the year was already set at a reasonable level. While we would be willing to provide additional information should it be requested, we continue to believe we can meet the burden of introducing "any circumstances surrounding the compensation item challenged" (Section 31.205-6 (b) (1) of the FAR).

We believe the tremendous growth and success of our organization is the best test of the reasonableness of the **sum** of executive compensation. We offer the following statistics in support of the compensation paid:

Year	FTE'S	% Increase	Claims Processed	% Increase	Revenue ($thousands)	% Increase
1999	1,128		63,897,000		$104,591	
2000	1,407	24.7	70,798,000	10.8	$117,507	12.3
2001	1,479	5.1	88,471,000	25.0	$125,233	6.6
2002	1,519	2.7	95,860,000	8.4	$130,102	3.9
3 Year Average		**8.33**		**14.7**		**7.6**

The above statistics represent the increased human resources, workload and dollars that require the expert management skills of our executive team. We believe this growth provides the unique circumstances surrounding the compensation paid. Section 31.205-6 (b) (1) of the FAR, which has been incorporated by specific reference into our Medicare contract, states, in part:

> "...the contractor may introduce, **and the contracting officer will consider**, not only any circumstances surrounding the compensation item challenged, but also the magnitude of other compensation elements which may be lower than would be considered reasonable in themselves." (Emphasis Added)

In this regard, while the report provides a description of the ECI, it does not provide sufficient analysis or justification to render our policy of basing executive compensation on factors such as job performance and productivity unreasonable.

Finally, in its response to the August 5, 1994 OIG report entitled "Review of Executive Compensation at Medicare Contractors", CMS (then HCFA) stated "extensive contract negotiations, however, will need to take place before HCFA can unilaterally place a ceiling on executive salary increases, especially since the Medicare contracts are cost reimbursed agreements." As stated previously, our contract does <u>not</u> contain a provision that would limit executive compensation increases to the rate of increase of the ECI.

In summary, we are committed to ensuring the appropriateness of the administrative costs of the Medicare program included on our FACPs and will work with CMS to address the reasonableness of executive compensation increases as well as the other findings presented in this draft report. Finally, we appreciate the feedback received from your staff during the course of this audit and the opportunity to provide our comments for your consideration.

Sincerely,

Marti Mahaffey,
Executive Vice President & COO

MM