DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

Memorandum

Date JAN - 7 1999

From June Gibbs Brown
Inspector General

Subject Review of the 1997 Adjusted Community Rate Proposal for a Pennsylvania Risk-Based Managed Care Organization (A-03-98-00022)

To Nancy-Ann Min DeParle
Administrator
Health Care Financing Administration

The attached final report is one in a series of reports that is part of our overall review of the administrative costs planned and incurred by managed care organizations (MCO) relative to their operating a Medicare risk managed care plan. 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.

On July 27, 1998 we issued a report entitled, "Administrative Costs Submitted by Risk-Based Health Maintenance Organizations on the Adjusted Community Rate Proposals Are Highly Inflated" (A-14-97-00202). This report examined the allocation of administrative costs on the adjusted community rate (ACR) proposals for contract years 1994 through 1996. We concluded that the methodology which allowed MCOs to apportion administrative costs to Medicare was flawed and that 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 Pennsylvania 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 pricing an MCO benefit package, computing savings (if any) from Medicare payment amounts, and determining additional benefits that will be provided beneficiaries or reduced premiums that could 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 Pennsylvania 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.

We were unable to complete our review because plan officials did not provide documentation for all sampled costs we wished to review nor did they provide sufficient information pertaining to costs allocated to the plan from a related entity. Due to the plan's impairment to the scope of our review we are unable to conclude on the reasonableness of all administrative costs we selected for review. However, based on audit work completed before the plan ceased to provide information to the audit team, we found that the Medicare administrative cost component on the 1997 ACR proposal exceeded actual Medicare expenditures by approximately $63 million.

Our review found that the cause of this difference of $63 million was the proposed Medicare administrative rate exceeded the plan's actual Medicare administrative rate. In accordance with HCFA guidelines, the plan applied the percentage methodology that was used on its non-Medicare side (about 21 percent of medical premiums were considered by the plan to represent their administrative costs) to the Medicare administrative component on the 1997 ACR proposal. Our review showed actual Medicare administrative costs were about 7 percent of the medical premium, not 21 percent. As a result, the 1997 ACR submission proposed Medicare administration income that was almost 300 percent of the plan's actual Medicare administrative expenses. Income from HCFA to cover the plan's administrative costs for its Medicare contract totaled $95,776,830; however, the plan's accounting records showed that these costs actually totaled only $32,792,397. Therefore, the plan's Medicare income for administration based on the ACR proposal exceeded the plan's 1997 Medicare administrative costs by $62,984,433.

In addition, our review of 1996 administrative costs used as the base of the Plan's ACR for 1997 showed: (1) costs that would not be allowable if existing Medicare regulations were applied to risk-based MCOs, (2) cost allocation errors, (3) unresolved administrative costs, and (4) unresolved related party costs. Specifically, the base data used to develop the plan's ACR submission included:

- $914,429 relating to contributions, lobbying, entertainment, travel, and gifts that would not have been allowed if Medicare cost reimbursement principles were in effect.

- $34,034 in net cost allocation errors related to distributing plan costs among various lines of business.

- $680,037 in unresolved advertising, printing, and other expenses due to insufficient documentation; and

- $39,178,909 in unresolved costs of a related organization that were allocated to the plan. While these types of expenses are allowable under Medicare fee-for-service, Medicare limits the provider's reimbursement to the related party's costs. Moreover, Medicare requires cost-based MCOs to allocate allowable costs of a separate entity or department that performs administrative services in reasonable proportion to the benefits received.

These 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 Pennsylvania plan. In response to our draft report, the Pennsylvania MCO officials disagreed with our use of Medicare's standard of reasonableness and other cost principles not applicable to risk contracts as the basis to evaluate the reasonableness of its administrative costs. The plan, however, did not provide additional information that would cause us to change our reported findings and conclusions.

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-03-98-00022 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 PENNSYLVANIA RISK-BASED MANAGED CARE ORGANIZATION

JUNE GIBBS BROWN
Inspector General

JANUARY 1999
A-03-98-00022

DEPARTMENT OF HEALTH & HUMAN SERVICES | Office of Inspector General

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To Nancy-Ann Min DeParle
Administrator
Health Care Financing Administration

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

The Medicare ACR process is designed for managed care organizations (MCO) to present to HCFA their estimate of the funds needed to cover the costs of providing the Medicare package of covered services to any enrolled Medicare beneficiary. The MCO's anticipated or budgeted funds are calculated to cover medical and administrative costs of the plan for the upcoming year and must be supported by the individual MCO's operating experiences relating to utilization and expenses. All assumptions, cost data, revenue requirements, and other elements used by MCOs in the ACR proposal calculations must be consistent with the calculations used for the premiums charged to non-Medicare enrollees. The ACR process is a key element in the reimbursement methodology for Medicare risk-contracts. The ACR proposal is integral to pricing an MCO's benefit package, computing savings (if any) from Medicare payment amounts, and determining additional benefits or reduced premiums that could be charged to Medicare beneficiaries.

Presently there is no statutory or regulatory authority governing allowability of costs in the ACR process, 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.

We were unable to complete our review because plan officials did not provide documentation for all sampled costs we wished to review nor did they provide sufficient

information pertaining to costs allocated to the plan from a related entity. Due to the plan's impairment to the scope of our review we are unable to conclude on the reasonableness of all administrative costs we selected for review. However, based on audit work completed before the plan ceased to provide information to the audit team, we found that the Medicare administrative cost component on the 1997 ACR proposal exceeded actual Medicare expenditures by approximately $63 million.

Our review found that the cause of this difference of $63 million was the proposed Medicare administrative rate exceeded the plan's actual Medicare administrative rate. The plan applied the percentage methodology that was used on its non-Medicare side (about 21 percent of medical premiums were considered by the plan to represent their administrative costs) to the Medicare administrative component on the 1997 ACR proposal. Our review showed actual Medicare administrative costs were about 7 percent of the medical premium, not 21 percent. As a result, the 1997 ACR submission proposed Medicare administration income that was almost 300 percent of the plan's actual Medicare administrative expenses. Income from HCFA to cover the plan's administrative costs for its Medicare contract totaled $95,776,830; however, the plan's accounting records showed that these costs actually totaled only $32,792,397. Therefore, the plan's Medicare income for administration based on the ACR proposal exceeded the plan's 1997 Medicare administrative costs by $62,984,433.

The percentage methodology is acceptable to HCFA because the only requirement regarding the inclusion of costs on the ACR proposal is that all assumptions, cost data, revenue requirements, and other elements used by MCOs in the ACR proposal calculations must be consistent with the calculations used for the premiums charged to non-Medicare enrollees. Allocating administrative costs based on a percentage computation, however, grossly inflates the plan's administrative needs for Medicare. The reason is that this methodology takes advantage of the effect of medical utilization factors on the administrative component. The result is that the amounts for administration tend to be a product of the medical premium rather than reflecting what is needed to cover administrative costs.

In addition, our review of 1996 administrative costs used as the base of the Plan's ACR for 1997 showed: (1) costs that would not be allowable if existing Medicare regulations were applied to risk-based MCOs, (2) cost allocation errors, (3) unresolved administrative costs, and (4) unresolved related party costs. Specifically, the base data used to develop the plan's ACR submission included:

- $914,429 relating to contributions, lobbying, entertainment, travel, and gifts that would not have been allowed if Medicare cost reimbursement principles were in effect.

- $34,034 in net cost allocation errors related to distributing plan costs among various lines of business.

- $680,037 in unresolved advertising, printing, and other expenses due to insufficient documentation; and

- $39,178,909 in unresolved costs of a related organization that were allocated to the plan. While these types of expenses are allowable under Medicare fee-for-service, Medicare limits the provider's reimbursement to the related party's costs. Moreover, Medicare requires cost-based MCOs to allocate allowable costs of a separate entity or department that performs administrative services in reasonable proportion to the benefits received.

The effect of including these costs in the plan's ACR proposal was 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.

Because of the lack of criteria for inclusion of costs on the ACR proposal, there are no recommendations addressed to the Pennsylvania plan. This audit is part of a nationwide review of the ACR process and is being performed at several other MCOs. Based on the results of our reviews, we will be making recommendations to HCFA.

In responding to our draft report, the Pennsylvania MCO officials disagreed with our use of Medicare's standard of reasonableness and other cost principles not applicable to risk based contracts as the basis to evaluate the reasonableness of the plan's administrative costs. Additional MCO response to the draft report and the Office of Inspector General (OIG) comments are included on page 10.

INTRODUCTION

BACKGROUND

Medicare payments to risk-based MCOs are based on a prepaid capitation rate. This rate reflects the estimated costs that would have been incurred by Medicare on behalf of enrollees of the MCO if they received their covered services under fee-for-service Medicare. Risk contractors are required by section 1876 of the Social Security Act to compute an ACR proposal and submit it to HCFA prior to the beginning of the MCO's contract period. The HCFA encourages the plans to support their ACR proposal with the most current data available. The Medicare 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 covered services to any enrolled Medicare beneficiary.

The MCO calculates its ACR, using as a basis, its commercial rates adjusted to account for differences in cost and use of services between Medicare and non-Medicare enrollees. The development of a base rate is the first step of the process. The base rate is the amount that

the MCO will charge its non-Medicare enrollees during the contract period. The next step in the process is to develop adjustments to arrive at the initial rate which is the rate the plan would have charged its commercial members if the commercial package was limited to Medicare coverage. The adjustments eliminate the value of those services not covered by Medicare that were included in the base rate or add the value of covered Medicare services not included in the base rate.

After the calculation of the initial rate, the rate is multiplied by utilization factors to reflect differences between Medicare members and non-Medicare members with regard to volume, intensity, and complexity of services. This last calculation results in the ACR. If the average Medicare payment amount is greater than the ACR, a savings is noted. The MCO was required to use this savings to either improve their benefit package to the Medicare enrollees, reduce the Medicare enrollee's premium, or contribute to a benefit stabilization fund. With regard to the inclusion of costs, according to HCFA's Health Maintenance Organization Manual, all assumptions, cost data, revenue requirements, and other elements used by MCOs in the ACR proposal calculations must be consistent with the calculations used for the premiums charged to non-Medicare enrollees.

The MCO cost data will be especially important due to the changes in the ACR proposal brought about by the Balanced Budget Act of 1997 (Public Law 105-33) which authorizes the Medicare+Choice program. Under HCFA's new format for the ACR proposals, beginning with contract year 2000, administrative costs will be determined using a relative cost ratio based on actual administrative costs incurred for Medicare beneficiaries in a base year (prior year) to actual administrative costs incurred for non-Medicare enrollees in the same base year. However, the HCFA guidelines do not require that MCOs adhere to cost principles that preclude the reporting of unreasonable, unnecessary, and/or unallocable administrative costs.

SCOPE

The objective of our review was to examine the administrative cost component of the ACR proposal submitted by the plan, and assess whether the costs were appropriate under Medicare's principle of reasonableness. Our review concentrated on the administrative cost component of the plan's ACR proposal for the 1997 Medicare contract year. We used the 1996 financial records as support for the 1997 ACR proposal. We also examined the 1997 financial records to determine the plan's actual Medicare administrative expenses.

We reviewed non-Medicare administrative costs because they support the non-Medicare base rate in the ACR proposal, and this rate is used to derive the Medicare ACR. We reviewed Medicare administrative costs because plans will be required as of the 2000 Medicare contract year to record both non-Medicare and Medicare costs actually incurred to establish relative cost ratios which will be used to derive the Medicare ACR. Therefore, it is

important for the plans to screen both non-Medicare and Medicare costs which impact the ACR calculations.

The administrative costs included the non-medical costs associated with: administrative salaries and benefits, advertising and printing, travel and meals, legal, consulting, communication, computer processing, and other administrative costs allocated to the plan from related entities.

The plan's total 1996 general ledger administrative costs (which was the basis for developing the 1997 ACR proposal) amounted to $127,469,922 consisting of $26,880,873 for Medicare and $100,589,049 for non-Medicare. Included in total administrative costs was $71,676,231 incurred by the plan--$18,531,904 for Medicare and $53,144,327 for non-Medicare. The remaining $55,793,691 of administrative costs were allocated to the plan from two related entities. Of these related party costs, $8,348,969 was allocated to Medicare and the remaining $47,444,722 was allocated to non-Medicare.

We judgmentally selected for review cost items from the 1996 general ledger totaling $15,370,124. Of the total amount sampled, $7,665,252 was for Medicare and $7,704,872 for non-Medicare. We also requested documentation to support administrative cost allocations for related party costs. Because of the limited scope of our review, our results cannot be considered representative of the universe of administrative costs submitted by the plan. To accomplish our objective, we:

- reviewed applicable laws and regulations;

- discussed with plan officials their ACR proposal process and how their administrative costs were derived and allocated to various lines of business; and

- selected categories of administrative costs from the plan's general ledger which traditionally have been shown to be problematic areas in the Medicare fee-for-service program.

Our review was performed in accordance with generally accepted government auditing standards except that the scope of our audit was impaired due to the lack of cooperation on the part of the plan. Specifically, before the completion of audit field work, the plan ceased providing documentation and other information that we deemed necessary to fully evaluate sampled administrative costs and costs allocated from a related entity. Due to the plan's impairment to the scope of our review, we are unable to conclude on the reasonableness of all administrative costs we selected for review. The objective of our review did not require us to review the internal control structure at the plan. Our work was performed at the plan's offices during Fiscal Year 1998.

FINDINGS AND RECOMMENDATIONS

Income for Administrative Costs Exceeded Actual Expenses

We determined the portion of the plan's income from Medicare for administrative activities, based on the 1997 ACR proposal, exceeded the plan's actual 1997 administrative expenses by almost 300 percent. Income from HCFA during 1997 to cover the plan's administrative costs for its Medicare contract totaled $95,776,830; however, the plan's accounting records showed that these costs totaled only $32,792,397, a difference of $62,984,433, or about 300 percent.

In addition, our review of 1996 administrative costs used as the base of the Plan's ACR for 1997 showed: (1) costs that would not be allowable if existing Medicare regulations were applied to risk-based MCOs, (2) cost allocation errors, (3) unresolved administrative costs, and (4) unresolved related party costs.

Medicare Administrative Percentage

The plan applied the percentage methodology that was used on the non-Medicare side (about 21 percent of medical premiums were considered by the plan to represent their administrative costs) to the Medicare administrative component in the 1997 ACR. Actual Medicare administrative costs were about 7 percent of the Medicare medical premium based on administrative costs recorded in the plan's 1997 general ledger. The percentage methodology is acceptable to HCFA because the only requirement regarding the inclusion of costs on the ACR proposal is that all assumptions, cost data, revenue requirements, and other elements used by MCOs in the ACR proposal calculations must be consistent with the calculations used for the premiums charged to non-Medicare enrollees. Allocating administrative costs based on a percentage computation, however, grossly inflates the plan's administrative needs for Medicare. The reason is that this methodology takes advantage of the effect of medical utilization factors on the administrative component. The result is that the amounts for administration tend to be a product of the medical premium rather than reflecting what is needed to cover administrative costs.

As a result of applying the 21 percent non-Medicare rate to Medicare, the administrative rate increased $67.56 per member per month (PMPM) causing an overall loss[1] on the ACR proposal. Consequently, it appeared to HCFA that the plan would suffer significant losses under its Medicare risk contract and would need additional premium income to cover these losses. The plan waived a portion of the additional premiums. The plan was able to satisfy

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[1] The plan's ACR proposal included three separate Medicare products. The basic package included a loss of $17.82 PMPM, optional package A included a loss of $33.75 PMPM and a $10 beneficiary premium, and optional package B included a loss of $33.41 PMPM.

HCFA's insolvency concerns by adding a "Statement of Solvency" to its ACR proposal. In its statement the plan indicated that it believes that it will incur Medicare administrative expenses which are lower than those projected using the ACR methodology. However, neither the plan nor HCFA attempted to reduce the ACR rate to more accurately reflect projected expenses. Accordingly, the inflated ACR adversely impacted the amount available to Medicare beneficiaries for additional benefits or reduced premium amounts.

Administrative Costs Not Traditionally Allowed by Medicare

Administrative costs (incurred by the plan in 1996 and used as a base for the 1997 ACR) were included in the ACR proposal that would not be allowable if existing Medicare regulations applied to risk based MCOs. Administrative costs for 1996 totaled $127,469,922 with $26,880,873 charged as Medicare and $100,589,049 for non-Medicare.

Our review of selected categories of administrative costs showed that the base for the ACR proposal included $914,429 relating to contributions, lobbying, entertainment, travel, and gifts that would not have been allowed if Medicare cost reimbursement principles were in effect. Although many of these costs were recorded as non-Medicare expenses, they impact the Medicare ACR calculation. The following is a breakout of those costs that were questionable when compared to the Medicare principle of reasonableness:

- **Contributions - $492,407:** These expenses include donations to local schools and charitable organizations such as the YMCA, Boy Scouts of America, and the Urban League. These costs were charged to non-Medicare.

- **Government Relations - $326,132:** The plan staff indicated that lobbying costs could be found in this account. Article 9, section D of the MCO contract with HCFA prohibits the use of HCFA funds to influence legislation or appropriation. This contract provision incorporated section 31.205-22 of the Federal Acquisition Regulation which defines unallowable lobbying and political activity costs. Of the $326,132 of government relations costs, $225,163 was for Medicare and $100,969 non-Medicare. Since the plan did not provide us with supporting documentation we are questioning these costs.

- **Entertainment, Travel and Gifts - $95,890:** These costs include social club dues and expenses, catering services, employee entertainment, and alcohol. The plan charged $4,940 to Medicare and the remaining $89,601 to non-Medicare. Other costs include $852 charged to Medicare in excessive hotel costs incurred by a marketing manager while attending a conference at Disney World in Orlando, Florida; and the costs for birthday cakes and flowers for employees - $337 charged to Medicare and $160 to non-Medicare.

Cost Allocation Errors

Our review found $34,034 in net cost allocation errors in 1996 administrative costs related to distributing plan costs among various lines of business. Allocation errors resulted in a $84,454 net undercharge to the plan's Medicare line of business and a $118,488 net overcharge to non-Medicare lines of business. The largest allocation error totaled $177,321. The net effect of the allocation errors was an overcharge of $34,034 to the plan's non-Medicare lines of business.

Allocation errors could have a significant effect when developing the ACR proposal under the new requirements of the Medicare+Choice program. Under the revised methodology for developing ACRs, administrative costs are developed by multiplying the non-Medicare PMPM administrative costs by a relative cost ratio. This ratio divides Medicare costs by non-Medicare costs. Therefore, an allocation error resulting in an overcharge to Medicare and an undercharge to non-Medicare costs will inflate the relative cost ratio and lead to an inflated PMPM administrative cost rate.

Unresolved Administrative Costs

Our review identified $680,037 in unresolved advertising, printing, and other 1996 administrative expenses due to insufficient documentation. The plan did not provide documentation and other information that we deemed necessary to fully evaluate the costs, therefore, we were unable to make a final determination on these costs as follows:

- **Advertising - $250,137:** The plan charged these costs to Medicare for television and newspaper advertising. We were unable to determine if the plan submitted the advertising copy to HCFA for review in accordance with contract terms.

- **Printing - $129,900:** The plan charged these costs to Medicare for the printing of marketing brochures. We were unable to determine if the plan submitted a copy of the brochures to HCFA for review in accordance with contract terms.

- **Other Expenses - $300,000:** The plan charged these costs to Medicare to an account entitled "Other Expenses" through a journal entry transaction. The purpose of the entry was to "support open invoices outstanding at any time." However, the journal entry did not describe the nature of the expenses for these open invoices.

Unresolved Related Party Costs

Our review identified $39,178,909 in unresolved charges of a related entity--the plan's parent organization--that were allocated to the plan in 1996. Of the total amount, $5,413,367 was allocated to Medicare and $33,765,542 to non-Medicare. Prior to completion of audit field work, the plan ceased providing documentation that we deemed

necessary to fully evaluate the related party costs, therefore, we were unable to make a final determination on these costs.

While these types of expenses are allowable under Medicare fee-for-service, Medicare limits the provider's reimbursement to the related party's costs. Moreover, Medicare requires cost-based MCOs to allocate allowable costs of a separate entity or department that performs administrative services in reasonable proportion to the benefits received. Due to the lack of cooperation on the part of the plan, we were unable to determine whether the allocated costs: (1) represented actual cost to the related party, (2) were distributed on the basis of benefits received or other reasonable allocation methodology, and (3) included costs that would not be allowable if existing Medicare regulations applied to risk based MCOs.

CONCLUSION AND RECOMMENDATIONS

In spite of the limitations to our audit scope imposed by the plan, our review showed that certain administrative costs, which would not be allowable if existing Medicare regulations were applied to risk-based MCOs, were not eliminated from the costs used to develop the ACR proposal. These administrative costs were questioned because they did not appear to be a reasonable estimate of funds needed as they apply to the ACR process to cover the costs under the managed care contract. We question whether many of these administrative costs should be included in the plan's ACR proposal, since this only serves to increase the ACR. This affects the computation of potential savings from the Medicare payment amounts, and ultimately adversely impacts the amount available to Medicare beneficiaries for additional benefits or reduced premium amounts. However, we recognize that presently there is no statutory or regulatory authority governing allowability of costs in the ACR process, 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.

Notwithstanding the lack of specific guidelines for MCO risk contracts, we believe that those costs that would not be allowable under other areas of the Medicare program for the administration of their Medicare contract should be eliminated from the Medicare ACR calculation. We also believe that lobbying costs should be eliminated when constructing the plan's ACR proposal. Although, as of now, there is not a statutory basis for requiring this cost exclusion. The use of Medicare trust funds in paying monthly MCO capitation payments should not exceed an amount that would be incurred using existing regulations applied in other areas of the Medicare program that we believe include prudent and cost-conscious management concepts.

Because of the lack of criteria for inclusion of costs on the ACR proposal, there are no recommendations addressed to the Pennsylvania 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 PENNSYLVANIA MCO RESPONSE AND OIG COMMENTS

In response to our draft report, the Pennsylvania MCO officials disagreed with our use of Medicare's standard of reasonableness and other cost principles not applicable to risk based contracts as the basis to evaluate the reasonableness of the plan's administrative costs. Further, the plan believes we did not balance our finding of $63 million in excessive administrative costs by reporting that the plan had provided $65.8 million ($60.50 PMPM) in additional benefits not provided as part of the basic Medicare package. The plan also commented that it was able to verify as correct, some but not all, of the costs cited in the report. For example, the plan stated that the government relations cost center had a broader scope than just lobbying but did not specify how much was incurred for activities that did not violate lobbying restrictions. Finally, the plan indicated that subsequent to the audit it implemented procedures aimed at reducing cost allocation errors.

The objective of our review was to examine the administrative cost component of the ACR proposal and assess whether the costs were appropriate under Medicare's principle of reasonableness. We recognize that risk based MCOs are not bound by Medicare's standard of reasonableness and our report does not make recommendations for financial adjustments.

We are aware that the plan provided additional benefits not provided under traditional fee-for-service Medicare. However, we disagree with the plan's comment that the costs of the additional services provided should be offset against our finding that the plan received excessive reimbursement for its administrative costs. Moreover, according to its 1997 ACR, the plan proposed and received $93.07 PMPM for these additional benefits.

Although the plan disagreed with some of the amounts of our findings, it did not provide additional documentation or information that would cause us to change our reported findings and conclusions. Finally, we are pleased that the plan recently implemented procedures to reduce cost allocation errors. Under HCFA's revised ACR proposal requirements, proper accounting and cost allocation procedures will be essential in determining the cost of the plan's Medicare managed care contract.