

**Memorandum**

Date **JAN 24 2001**
From *Michael Mangano*
Michael Mangano
Acting Inspector General
Subject
To Review of the Adjusted Community Rate Proposal Submitted to the Health Care Financing Administration by a Texas-based Medicare+Choice Managed Care Organization for the 2000 Medicare Contract Year (A-06-00-00052)

Michael McMullan
Acting Principal Deputy Administrator
Health Care Financing Administration

Attached are two copies of the U.S. Department of Health and Human Services, Office of the Inspector General, Office of Audit Services' final report entitled, "Review of the Adjusted Community Rate Proposal Submitted to the Health Care Financing Administration by a Texas-based Medicare+Choice Managed Care Organization for the 2000 Medicare Contract Year."

The attached final report is one in a series of reports that is part of our overall review of the administrative cost component of the adjusted community rate (ACR). The objective of the review was to examine the administrative cost component of the Contract Year 2000 ACR submitted by a Texas managed care organization (MCO), and assess whether the costs were appropriate when compared to the Medicare program's general principle of paying only reasonable costs.

In an Office of Inspector General (OIG) audit report issued in January 2000,¹ we identified \$66.3 million of inappropriate administrative costs that were included in the ACRPs submitted by nine MCOs. These administrative costs would have been unallowable had the MCOs been required to follow Medicare's general principle of paying only reasonable costs. We recommended that the Health Care Financing Administration (HCFA) pursue legislation concerning MCOs' administrative costs which would require risk-based MCOs to follow Medicare's general principle of paying only reasonable costs. In response to our draft report, HCFA did not concur with the recommendation. The HCFA noted that it had recently revised the ACR methodology and that the new procedures will be reviewed to ensure the effectiveness of reducing the administrative burdens on the MCO.

¹Review of the Administrative Cost Component of the Adjusted Community Rate Proposal at Nine Medicare Managed Care Organizations for the 1997 Contract Year (A-03-98-00046)

However, based on the results of our audits at the nine MCOs, HCFA requested OIG examine other MCOs to determine if they were including inappropriate costs in computing their ACRPs under the revised ACRP format. This review is in response to HCFA's request.

The Medicare ACR process is designed for risk-based MCOs 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. Beginning with the Medicare Contract Year 2000, plans were required to use their actual Medicare costs in developing their ACRs.

Under the existing ACR methodology, there is no statutory or regulatory authority governing the costs in the ACR for risk-based MCOs, unlike other areas of the Medicare program. For example, regulations covering cost-based MCOs provide specific parameters delineating allowable administrative costs for enrollment and marketing and prescribe an allocation methodology for apportioning indirect costs. Likewise, Medicare carriers and intermediaries are required to comply with Part 31 of the Federal Acquisition Regulations (FAR). Had the risk-based MCO we reviewed in Texas been required to follow these guidelines, we would have questioned \$10.0 million of \$18.1 million of administrative costs reported as Medicare base year costs on the Contract Year 2000 ACR. As a result of these questioned Medicare base year costs, we determined that the administrative costs reported in the 2000 ACR would have been reduced by \$32.36 per member per month, or \$13.9 million (based on the MCO's projected Medicare enrollment level).

Specifically, the Medicare base year administrative costs within the ACR included:

- \$3.9 million that would have been disallowed had HCFA required risk-based MCOs to follow the MCO cost contract criteria which required that indirect costs be apportioned on the basis of a ratio of Medicare enrollment to total enrollment. By apportioning its indirect costs on the basis of revenue rather than enrollment, the Texas MCO increased its administrative expenses in the ACR from \$14.2 million to \$18.1 million.
- \$2.6 million for costs unallowable under Part 31 of the FAR "Contract Cost Principles and Procedures," which are required to be followed by other organizations that participate in Medicare, but not by risk-based MCOs. The costs related to such items as federal income taxes, entertainment, charitable contributions, auto allowances, legal expenses and settlement expenses associated with a lawsuit filed by the State of Texas, and lobbying.

- \$3.5 million in related party transactions for corporate expenses and royalty fees that were not supported by costs. While these types of expenses are allowed under Medicare fee-for-service, Medicare limits the provider's reimbursement to the related party's costs. The corporate expenses and royalty fees were based on negotiated agreements between related parties, and the MCO was unable to identify the related parties' costs.
- \$11,780 in unsupported costs. The MCO did not provide the necessary documentation to enable us to determine the allowability of five transactions classified as local community relations or entertainment expenses.

Under current regulations, the MCO is not prohibited from using revenue as the basis for allocating its indirect costs. Moreover, the MCO is not prohibited from including items such as entertainment, charitable donations, and certain legal expenses in its administrative rate due to a lack of statutory or regulatory authority governing allowability of costs in the ACR process, unlike other areas of the Medicare program.

We determined that the impact of the \$10.0 million of administrative costs in the Texas MCO's Medicare base year costs resulted in an increase of \$13.9 million in administrative costs (based on the MCO's projected enrollment levels) in the 2000 ACR submitted to HCFA. The effect of including costs in the ACR that exceed actual costs or would be unallowable under Medicare principles is an inflated administration amount that reduces any potential savings from the Medicare payments. In addition, this methodology impacts the amount available to Medicare beneficiaries for additional benefits or reduced premium amounts.

In responding to our draft report, the Texas MCO concluded that applying cost-based standards to risk-based organizations was counterintuitive. We disagree with the Texas MCO. The Medicare ACR process is designed for MCOs to present to HCFA their estimate of funds needed to cover the costs of providing the Medicare package of covered services. Without specific cost standards and criteria, HCFA cannot properly evaluate the proposals.

Because of the lack of criteria for inclusion of costs in the ACR, there are no recommendations addressed to the Texas MCO. This audit is part of a continuing nationwide review of the ACR process and is being performed at several MCOs. While this review examined only one plan, we believe that our results highlight a continuing 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 will 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.

Page 4 - Michael McMullan

To facilitate identification, please refer to Common Identification Number A-06-00-00052 in all correspondence relating to this report.

Attachments

Department of Health and Human Services

**OFFICE OF
INSPECTOR GENERAL**

**REVIEW OF THE ADJUSTED
COMMUNITY RATE PROPOSAL
SUBMITTED TO THE HEALTH CARE
FINANCING ADMINISTRATION BY A
TEXAS-BASED MEDICARE+CHOICE
MANAGED CARE ORGANIZATION FOR
THE 2000 MEDICARE CONTRACT YEAR**



Inspector General

JANUARY 2001

A-06-00-00052

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From *Michael Mangano*
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Michael McMullan
Acting Principal Deputy Administrator
Health Care Financing Administration

This final report presents the results of our review of the administrative cost component of the adjusted community rate (ACR) submitted to the Health Care Financing Administration (HCFA) by a Texas-based Medicare+Choice managed care organization (MCO) for the 2000 Medicare contract year. This audit was part of a nationwide review of the administrative cost component of the ACR process.

EXECUTIVE SUMMARY**OBJECTIVE**

The objective of the review was to examine the administrative cost component of the Contract Year 2000 ACR submitted by the Texas MCO, and assess whether the costs were appropriate when compared to the Medicare program's general principle of paying only reasonable costs.

BACKGROUND

The Medicare ACR process is designed for risk-based MCOs 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. Beginning with the Medicare Contract Year 2000, plans were required to use their actual Medicare costs in developing their ACRs.

In an Office of Inspector General (OIG) audit report issued in January 2000,¹ we identified \$66.3 million of inappropriate administrative costs that were included in the ACRPs submitted by nine MCOs. These administrative costs would have been unallowable had the MCOs been required to follow Medicare's general principle of paying only reasonable costs. We recommended that HCFA pursue legislation concerning MCOs' administrative costs which would require risk-based MCOs to follow Medicare's general principle of paying only reasonable costs. In response to our draft report, HCFA did not concur with the recommendation. The HCFA noted that it had recently revised the ACR methodology and that the new procedures will be reviewed to ensure the effectiveness of reducing the administrative burdens on the MCO.

However, based on the results of our audits at the nine MCOs, HCFA requested OIG examine other MCOs to determine if they were including inappropriate costs in computing their ACRPs under the revised ACRP format. This review is in response to HCFA's request.

SUMMARY OF FINDINGS AND RECOMMENDATIONS

Under the existing ACR methodology, there is no statutory or regulatory authority governing the costs in the ACR for risk-based MCOs, unlike other areas of the Medicare program. For example, regulations covering cost-based MCOs provide specific parameters delineating allowable administrative costs for enrollment and marketing and prescribe an allocation methodology for apportioning indirect costs. Likewise, Medicare carriers and intermediaries are required to comply with Part 31 of the Federal Acquisition Regulations (FAR). Had the risk-based MCO we reviewed in Texas been required to follow these guidelines, we would have questioned \$10.0 million of \$18.1 million of administrative costs reported as Medicare base year costs on the contract year 2000 ACR. As a result of these questioned Medicare base year costs, we determined that the administrative costs reported in the 2000 ACR would have been reduced by \$32.36 per member per month, or \$13.9 million (based on the MCO's projected Medicare enrollment level).

Specifically, the Medicare base year administrative costs within the ACR included:

- \$3.9 million that would have been disallowed had HCFA required risk-based MCOs to follow the MCO cost contract criteria which required that indirect costs be apportioned on the basis of a ratio of Medicare enrollment to total enrollment. By apportioning its indirect costs on the basis of revenue rather than enrollment,

¹Review of the Administrative Cost Component of the Adjusted Community Rate Proposal at Nine Medicare Managed Care Organizations for the 1997 Contract Year (A-03-98-00046)

the Texas MCO increased its administrative expenses in the ACR from \$14.2 million to \$18.1 million.

- \$2.6 million for costs unallowable under Part 31 of the FAR “Contract Cost Principles and Procedures,” which are required to be followed by other organizations that participate in Medicare, but not by risk-based MCOs.² The costs related to such items as federal income taxes, entertainment, charitable contributions, auto allowances, legal expenses and settlement expenses associated with a lawsuit filed by the State of Texas, and lobbying.
- \$3.5 million in related party transactions for corporate expenses and royalty fees that were not supported by costs. While these types of expenses are allowed under Medicare fee-for-service, Medicare limits the provider’s reimbursement to the related party’s costs. The corporate expenses and royalty fees were based on negotiated agreements between related parties, and the MCO was unable to identify the related parties’ costs.
- \$11,780 in unsupported costs. The MCO did not provide the necessary documentation to enable us to determine the allowability of five transactions classified as local community relations or entertainment expenses.

Under current regulations, the MCO is not prohibited from using revenue as the basis for allocating its indirect costs. Moreover, the MCO is not prohibited from including items such as entertainment, charitable donations, and certain legal expenses in its administrative rate due to a lack of statutory or regulatory authority governing allowability of costs in the ACR process, unlike other areas of the Medicare program.

We determined that the impact of the \$10.0 million of administrative costs in the Texas MCO’s Medicare base year costs resulted in an increase of \$13.9 million in administrative costs (based on the MCO’s projected Medicare enrollment level) in the 2000 ACR submitted to HCFA. The effect of including costs in the ACR that exceed actual costs or would be unallowable under Medicare principles is an inflated administration amount that reduces any potential savings from the Medicare payments. Consequently, this methodology impacts the amount available to Medicare beneficiaries for additional benefits or reduced premium amounts.

In responding to our draft report, the Texas MCO concluded that applying cost-based standards to risk-based organizations was counterintuitive. We disagree with the Texas MCO. The Medicare ACR process is designed for MCOs to present to HCFA their estimate of funds needed

²The FAR is the primary regulation for use by all Federal Executive agencies in their acquisition of supplies and services with appropriated funds. Part 31 contains cost principles and procedures for (a) the pricing of contracts, subcontracts, and modifications to contracts and subcontracts whenever cost analysis is performed and (b) the determination, negotiation, or allowance of costs when required by a contract clause.

to cover the costs of providing the Medicare package of covered services. Without specific cost standards and criteria, HCFA cannot properly evaluate the proposals.

The Texas MCO's comments are included in their entirety as Appendix A to this report. We summarized the MCO's comments and our response to those comments in the Findings and Recommendations section of the report. Modifications were made to the final report to take into consideration the MCO's comments.

Because of the lack of criteria for inclusion of costs in the ACR, there are no recommendations addressed to the Texas MCO. This audit is part of a continuing nationwide review of the ACR process and is being performed at several MCOs. Based on the results of our reviews, we will be making recommendations to HCFA so that appropriate legislative changes can be considered.

INTRODUCTION

Background

Risk contractors are required by section 1854 of the Social Security Act to compute an ACR and submit it to HCFA prior to the beginning of the MCO's contract period. The HCFA encourages each plan to support its ACR with the most current data available. At HCFA central office, the Health Plan Administration Group reviews the ACR for correctness. The ACR is designed to help both the MCO and HCFA recognize and evaluate the revenue requirements needed to cover the proposed costs. The ACR is intended to ensure that Medicare beneficiaries are not overcharged for the benefit package offered.

Beginning with the 2000 ACR, MCOs were required to use actual Medicare administrative costs in the ACR. Administrative costs are determined using a "relative cost ratio" based on actual administrative costs incurred for Medicare beneficiaries in a base year relative to actual administrative costs incurred for commercial enrollees in the same base year. For the Contract Year 2000 ACR, the base year was 1998. The "relative cost ratio" is applied to estimated commercial administrative costs for the year being reported upon to arrive at the Medicare administrative costs.

Scope

The objective of our review was to examine the administrative cost component of the 2000 ACR submitted by the Texas-based MCO, and assess whether the costs were appropriate under Medicare's principle of reasonableness. To accomplish our objective, we:

- ▶ reviewed applicable laws and regulations;
- ▶ discussed with MCO officials their ACR process and how their administrative costs were derived;

- ▶ compared proposed costs included in the ACR to the costs reported on the MCO's accounting records for the base year (1998);
- ▶ tested selected categories of Medicare administrative costs which traditionally have been shown to be problematic areas in the Medicare fee-for-service program by evaluating the selected costs against the cost principles of Part 31 of the FAR;
- ▶ recomputed indirect overhead allocations using the principles of overhead allocation mandated by 42 CFR 417.564(a), which is applicable to cost MCO contractors; and
- ▶ recomputed the administrative costs on the ACR using the revised base year costs.

We reviewed the auditee's financial records for the 12-month period ending December 31, 1998, which were used as support for the 2000 ACR. The Medicare administrative costs included the non-medical costs associated with salaries, fringe benefits, travel, entertainment, marketing, taxes, and legal fees.

The Texas MCO's financial records for 1998 included \$18.1 million in Medicare administrative costs. Of this \$18.1 million, a total of \$13.1 million, or nearly 73 percent of total administrative costs, were indirect costs. This \$13.1 million of indirect costs was comprised of the following³:

- ▶ \$7.6 million were indirect costs allocated from a pool of \$43.6 million in costs at the regional level to 10 plans (including 4 other Medicare contracts).
- ▶ \$2.1 million were indirect costs allocated from a pool of \$3.6 million in costs at the plan level between Medicare and commercial.
- ▶ \$2.8 million were indirect costs allocated from the corporate office for corporate expenses.
- ▶ \$0.7 million were indirect costs allocated for royalty fees.

We judgmentally selected cost items from the administrative costs reported in the ACR that have been found to be problematic under Medicare fee-for-service to determine the allowability of the costs. Costs selected for review totaled \$3.7 million. In addition, we reviewed the allocation methodology for the \$13.1 million in indirect costs. Because of the judgmental selection, our results cannot be projected to the universe of costs submitted by the plan.

³The Texas MCO's indirect costs totaled \$13.1 million; however, the individual indirect cost categories in the report total \$13.2 million due to rounding.

Our review was performed in accordance with generally accepted government auditing standards. The objective of our review did not require us to review the auditee's internal control structure.

Our audit work was performed at the MCO's regional headquarters and in our Dallas, Texas, field office.

FINDINGS AND RECOMMENDATIONS

Our review of the 2000 ACR submission showed that Medicare base year costs totaling \$10.0 million would have been recommended for disallowance had the MCO been required to follow Medicare's general principle of paying only reasonable costs. For example, regulations covering cost-based MCOs provide specific parameters delineating allowable administrative costs for enrollment and marketing and prescribe an allocation methodology for apportioning indirect costs. Likewise, Medicare carriers and intermediaries are required to comply with Part 31 of the FAR. Because there is no statutory or regulatory authority governing allowability of costs in the ACR, or specific criteria for apportionment of indirect costs, the MCO was not required to adhere to these principles.

These questioned Medicare costs included:

- \$3.9 million that would have been disallowed had HCFA required risk-based MCOs to follow the cost contract requirements which mandate that indirect costs be apportioned on the basis of a ratio of Medicare enrollment to total enrollment. By apportioning its indirect costs on the basis of revenue rather than enrollment, the Texas MCO increased its administrative expenses from \$14.2 million to \$18.1 million.
- \$2.6 million for costs unallowable under Part 31 of the FAR "Contract Cost Principles and Procedures," which are required to be followed by other organizations that participate in Medicare, but not by risk-based MCOs. The costs related to such items as federal income taxes, entertainment, charitable contributions, auto allowances, legal and settlement expenses associated with a lawsuit filed by the State of Texas, and lobbying.
- \$3.5 million in related party transactions for corporate expenses and royalty fees that were not supported by actual costs. While these types of expenses may be allowable under Medicare fee-for-service, Medicare limits the provider's reimbursement to the related party's costs. The corporate expenses and royalty fees were based on negotiated agreements between related parties, and the MCO was unable to identify the related parties' costs.

- \$11,780 in unsupported costs. The MCO did not provide the necessary documentation to enable us to determine the allowability of five transactions classified as local community relations or entertainment expenses.

As a result, we showed that the \$10.0 million in adjustments to the Medicare base year costs would have reduced the administrative costs reported in the 2000 ACR by \$32.36 per member per month, or \$13.9 million (based on the MCO's projected Medicare enrollment level).

INDIRECT COST ALLOCATION

A total of \$3.9 million of administrative costs would have been disallowed had HCFA required risk-based MCOs to follow the cost contract requirements which apportion indirect costs on the basis of a ratio of Medicare enrollment to total enrollment. By apportioning its indirect costs on the basis of revenue rather than enrollment, the Texas MCO increased its administrative expenses from \$14.2 million to \$18.1 million. In addition, the Texas MCO made a calculation error that understated its administrative expenses by \$1.7 million and included \$44,972 in its administrative expenses that should not have been allocated to the Medicare ACR.

Apportionment of Indirect Costs

By using revenue as a basis of indirect cost apportionment in lieu of enrollment, the Texas MCO increased its administrative expenses by \$3.9 million. While there are specific criteria for apportioning indirect costs⁴ for cost contractors, no similar criteria exists for risk contractors. Specifically, according to 42 CFR 417.564(a), cost contractors must apportion administrative costs that benefit the total enrollment of the MCO on the basis of a ratio of Medicare enrollees to total MCO enrollment. The purpose of apportionment is to ensure that the cost of services furnished to Medicare enrollees is not borne by others and that the cost of services furnished to others is not borne by Medicare.

Beginning with the Medicare Contract Year 2000 ACR, MCOs are required to use their actual Medicare costs in developing their administrative costs in the ACR. Most of the MCO's costs were indirect costs that benefitted commercial and Medicare enrollees.⁵ In addition, a large portion of administrative costs are fixed and are not a function of, nor have a direct relationship to, the volume or complexity of medical services being provided to either Medicare or non-

⁴Indirect costs are costs that are identified with two or more cost objectives and thus cannot be directly assigned to a specific contract or market. An example is a rent expense for an office building. The building houses MCO staff who support Medicare and commercial contracts. The MCO uses an apportionment or allocation formula to assign part of the costs to the Medicare business and part of the costs to the commercial business.

⁵The allocation methodology is crucial because the majority of administrative costs were indirect costs. To illustrate, \$13.1 million (or 73 percent) of the Texas MCO's administrative costs were indirect costs that were allocated to the Medicare proposal while \$5.0 million were direct costs.

Medicare enrollees. Because Medicare premiums are significantly higher than commercial premiums, we believe that allowing the plans to allocate indirect costs on the basis of revenue grossly inflates the plans' administration needs for Medicare. To illustrate, the Texas MCO allocated 58 percent of its administrative costs to the Medicare ACR and 42 percent to its commercial business for indirect overhead related to this market. However, only 37 percent of the enrollees in this market were Medicare beneficiaries and 63 percent of the enrollees were members of the commercial plan. Consequently, Medicare incurred 58 percent of the indirect costs, even though Medicare accounted for only 37 percent of the enrollees.

Misallocated Costs

For part of the base year, the Texas MCO used an incorrect formula in allocating indirect costs to the Medicare ACR which understated the amount of administrative expenses the Texas MCO intended to record in the ACR. In addition, the Texas MCO included items in administrative expenses that should have been allocated to different contracts.

To establish a formula for allocating indirect costs to the various plans, the Texas MCO generally used historical revenue figures from the months preceding the period being allocated. The Texas MCO updated its formula for allocating indirect costs several times a year. For the period September 1998 through November 1998, the Texas MCO used September 1998 actual revenue. However, due to a calculation error by the MCO, the Medicare revenue and commercial revenue figures were reversed for this 3-month period. As a result, the Texas MCO staff allocated \$1,701,078 less to the Medicare plan than they intended.⁶

In addition, the Texas MCO's ACR included \$44,972 in administrative costs which would be unallowable under FAR, such as a commercial expense and an expense that related to another Medicare contract. According to 31 FAR 201-4, a cost is allocable to a Government contract if it: (a) is incurred specifically for the contract; (b) benefits both the contract and other work, and can be distributed in reasonable proportion to the benefit received; or (c) is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown. For example,

- An expense for \$33,150 was allocated to the Medicare ACR for reinsurance. This expense was related to commercial business, but was included on the Medicare proposal because of an MCO data entry error.

⁶Without this error, total Medicare administrative base year costs which would have been reported in the ACR would have increased from \$18.1 million to \$19.8 million. Had the Texas MCO allocated the additional \$1.7 million in administrative costs to the Medicare ACR, the amount we reported as excessive allocation costs would have increased from \$3.9 million to \$5.6 million as a result of using revenue rather than enrollment as the allocation basis.

- An expense for \$11,614 was charged to the Medicare ACR for television advertising. However, the expense should have been charged to another MCO Medicare proposal because the advertising benefitted this other Medicare contract. It was erroneously charged to the audited Medicare ACR because of a data entry error.

**ADMINISTRATIVE COSTS
UNALLOWABLE UNDER THE FAR**

Administrative costs were included in the ACR that would not have been allowable if existing Medicare regulations were applied to risk-based MCOs. For example, Medicare carriers and intermediaries are prohibited

from claiming these types of costs as prescribed by Part 31 of the FAR. A review of selected categories of the MCO's administrative costs totaling \$3.7 million showed that the ACR included \$2.6 million in expenses, such as taxes, alcoholic beverages, entertainment, employee morale, lobbying, contributions, and legal and settlement expenses associated with a lawsuit filed by the State of Texas that would not have been allowed under provisions of Part 31 of the FAR.⁷ The following categories describe these costs.

Taxes

The Texas MCO's ACR included \$2.4 million in federal income tax expense. The 31 FAR 205-41 states that federal income taxes are not allowable.

Entertainment, Alcohol, and Employee Morale Costs

The Texas MCO's ACR included \$10,949 in costs associated with entertainment, alcohol, and employee morale. To illustrate, the following costs were included as administrative costs in the ACR:

- ▶ \$3,851 in holiday parties and picnic expenses,
- ▶ \$1,995 for sporting events and golf,
- ▶ \$3,767 for dues to sport and social clubs, and
- ▶ \$739 for alcoholic beverages.

⁷The Texas MCO allocated its indirect regional costs to 10 of its plans (5 commercial and 5 Medicare). Our testing of the regional costs allocated to the audited Medicare ACR disclosed expenses totaling \$114,109 which would not be allowable under Part 31 of the FAR. Although we did not audit the remaining four Medicare contracts, we noted that an additional \$301,908 of indirect regional costs allocated to those contracts would also have been unallowable under Part 31 of the FAR. These costs included charitable contributions, legal and settlement expenses associated with a lawsuit filed by the State of Texas, and lobbying.

According to 31 FAR 205-13(b) and (c), costs of employee gifts and recreation are unallowable. Section 205-14 states that costs of amusement, diversions, social activities, and any directly related costs, such as tickets to shows or sporting events, meals, lodging, rentals, transportation, and gratuities, are unallowable. Costs of membership in social, dining, or country clubs or other organizations having the same purpose are unallowable. Section 205-51 states that costs of alcoholic beverages are unallowable.

Lobbying Costs

The Texas MCO's ACR included \$23,721 in lobbying costs. To illustrate, the Texas MCO:

- ▶ paid trade associations \$11,148 in dues that were used by the trade associations on lobbying activities and
- ▶ paid a contractor \$12,153 to lobby on behalf of the MCO.

According to 31 FAR 205-22, costs associated with lobbying and political activity are unallowable.

Contributions and Sponsorship Costs

The Texas MCO's ACR included \$35,285 in costs related to contributions and sponsorships. Of this amount, \$24,155 was incurred for health care premium waivers on behalf of a local sports foundation. The 31 FAR 205-8 prohibits such costs. Specifically, contributions or donations, including cash, property and services, regardless of recipient, are unallowable.

Auto Expenses

The Texas MCO's ACR included \$10,510 in car allowance expenses for its executives. According to 31 FAR 205-6, the portion of the cost of company-furnished autos that relates to personal use by employees is unallowable. The Texas MCO did not track business use of the automobiles versus personal use. Further, they recorded all of the auto allowance as income to the employees for income tax purposes. Because the company did not document the business use of the automobiles, all of the auto allowance expense would be unallowable under the FAR.

Legal Expenses

The Texas MCO's ACR included \$88,840 associated with legal expenses in a lawsuit filed by the State of Texas.

- ▶ \$16,564 in costs were recorded for attorneys' fees in defense of the state's lawsuit.
- ▶ \$72,276 in costs were accrued for a future settlement to resolve the state's lawsuit.

The 31 FAR 205-47 prohibits such costs. Specifically, costs incurred in connection with any proceeding brought by a Federal, State, local, or foreign government for violation of, or failure to comply with, law or regulation by the contractor are unallowable if the result is:

(1) a finding of contractor liability, (2) imposition of a monetary penalty, or (3) disposition of the matter by consent or compromise if the proceeding could have led to a finding of contractor liability or imposition of a monetary penalty. Costs which may be unallowable under 31 FAR 205-47 should be segregated and accounted for by the contractor separately. During the pendency of any legal proceeding, the contracting officer should generally withhold payment of such costs.

Other Expenses

The Texas MCO's ACR included \$3,275 in other costs that would not be allowable under the FAR. For example, the Texas MCO accrued \$2,027 for an expected expense to a leasing company for a lost computer. Under 31 FAR 205-19, actual losses are unallowable unless expressly provided for in the contract.

RELATED PARTY COSTS

Unsupported related party administrative costs totaling about \$3.5 million for corporate expenses and royalty fees were included in the ACR. While related party costs are allowable Medicare expenses under fee-for-service, Medicare limits the provider's reimbursement to the related party's costs [42 CFR 413.17]. The plan did not provide the costs of the related organizations for these expenses. Accordingly, no determination could be made on the allowability of these amounts.

- ▶ Corporate expenses of \$2.8 million represented charges for corporate services, including payroll processing, compensation, finance, government relations, internal audit, tax accounting, health services, market research, advertising, and management oversight and review. The corporate office (a related party) charged the Texas MCO 1.75 percent of net operating revenue for corporate expenses. However, the Texas MCO did not have support that would allow us to determine whether the 1.75 percent rate was reasonable.

- ▶ The royalty or franchise fee of \$672,000 was charged beginning in the latter part of 1998 to the Texas MCO by another subsidiary of the Texas MCO's parent company (a related party) for the use of a trademark. The related party charged the Texas MCO 1.75 percent of net operating revenue. (This fee was a separate charge from the 1.75 percent corporate expense.) However, the Texas MCO did not have support that would allow us to determine whether the 1.75 percent rate was reasonable. According to a Texas MCO official, the royalty fee was subsequently reversed from the 1998 financials because the Texas Department of Insurance did not approve it.

UNSUPPORTED COSTS

The MCO did not provide the necessary documentation to enable us to determine the allowability of five transactions totaling \$11,780 that were included as administrative costs in the ACR. According to 31 FAR 201-2(d), a contractor is responsible for accounting for costs appropriately and for maintaining records, including supporting documentation, adequate to demonstrate that costs claimed have been incurred, are allocable to the contract, and comply with applicable cost principles.

Although we were unable to review the documentation supporting these expenses, they appeared to be unallowable under FAR based on the account descriptions. All of these unsupported expenses were classified by the MCO as local community relations or entertainment expenses. These types of expenses would be unallowable under 31 FAR 205-8 or 205-14.

IMPACT ON THE ACR

Our review of the 2000 ACR submission showed that \$10.0 million in Medicare base year costs would have been unallowable or unsupported had the MCO been required to follow Medicare's general principle of paying only reasonable costs. As a result, we calculated that these adjustments would have reduced the administrative costs reported in the 2000 ACR by \$32.36 per member per month, or \$13.9 million (based on the MCO's projected Medicare enrollment level).

Administrative costs for the ACR are determined using a "relative cost ratio" based on actual administrative costs incurred for Medicare beneficiaries in a base year relative to actual administrative costs incurred for commercial enrollees in the same base year. For the Contract Year 2000 ACR, the base year was 1998. The "relative cost ratio" is applied to estimated commercial administrative costs (the initial rate) for the year being reported upon to arrive at the Medicare administrative costs. Reducing the base year administrative costs by \$10.0 million changed the relative cost ratios. By multiplying these adjusted relative cost ratios by the initial rate, we determined that the administrative costs in the 2000 ACR would have been reduced by \$32.36 per member per month, or \$13.9 million.

OTHER MATTERS

On January 1, 1999, the Texas MCO entered into a Management and Administrative Service Agreement with an affiliate of its parent company. As a result, the Texas MCO began paying the affiliate to provide the management and administrative services such as general management, legal and regulatory affairs, accounting, customer service, claims administration, provider information management, finance, real estate, human resources, health care services, marketing, and information services and telecommunications. Previously, most of these services were recorded as actual costs in the Texas MCO's financial system. In 1999, the MCO began

paying for these services based on a predetermined percentage of revenue as opposed to actual costs.

As a result, future ACRs (beginning with the 2001 submission) submitted by the Texas MCO will include a negotiated related party management expense that will represent the vast majority of administrative expenses, in lieu of recording actual administrative expenses incurred. Without establishing criteria for limiting related party transactions to actual costs, HCFA will not have assurance that this expense is reasonable.

RECOMMENDATIONS

Because of the lack of criteria for inclusion of costs in the ACR, there are no recommendations addressed to the plan. This audit is part of a continuing nationwide review of the ACR process and is being performed at several MCOs. Based on the results of our reviews, we will be making recommendations to HCFA so that appropriate legislative changes can be considered.

TEXAS MCO COMMENTS

In responding to our draft report, the Texas MCO concluded that applying cost-based standards to risk-based organizations was counterintuitive.

Regarding our first finding, the Texas MCO stated that requiring indirect costs to be apportioned on the basis of the ratio of Medicare to commercial enrollment ignored important facts. Specifically, the fact that Medicare enrollees consume more health care than commercial members results in higher Medicare costs for a myriad of administrative activities ranging from processing claims to responding to member inquiries and complaints.

Regarding our second finding, the Texas MCO's comments to the draft report are no longer relevant because we changed the order of the expense items in the finding to address their comments.

Regarding our third finding, the Texas MCO stated that the related party transactions for corporate expenses and royalty fees were supported by costs incurred at the parent company.

ADDITIONAL OIG COMMENTS

We disagree with the Texas MCO's conclusion. The Medicare ACR process is designed for MCOs to present to HCFA their estimate of funds needed to cover the costs of providing the Medicare package of covered services. Without specific cost standards and criteria, HCFA cannot properly evaluate the proposals.

We do not disagree with the Texas MCO's position that certain administrative costs such as claims processing are higher for Medicare enrollees versus commercial enrollees. However, the

Texas MCO did not provide any detailed documentation to support the reasonableness of its revenue-based indirect cost allocation that resulted in 58 percent of indirect costs for this market being allocated to the Medicare ACR, even though Medicare accounted for only 37 percent of the enrollees in this market. Moreover, if not for a computation error that reversed Medicare and commercial revenue for 3 months in its revenue-based calculation, approximately 69 percent of indirect costs for this market would have been allocated to the Medicare ACR. Although we agree with the Texas MCO's premise that certain indirect costs are higher for Medicare enrollees versus commercial enrollees, we believe that the revenue-based allocation formula resulted in a disproportionate share of indirect costs being allocated to Medicare.

In its response to our third finding, the Texas MCO indicated that related party costs were supported by costs incurred at the parent company. However, these costs were allocated from the parent company to the Texas MCO based on a percentage of revenue, and the Texas MCO did not identify the related parties' costs. If risk-based MCOs were required to follow related party reimbursement regulations employed in other areas of the Medicare program, the Texas MCO would have been required to identify the actual costs incurred at the parent company and support the allocation method for apportioning the parent's costs to the Texas MCO. Without providing the actual costs of the parent company, no determination could be made on the allowability of the related parties' costs.

To address the Texas MCO's comments concerning the HCFA capitated payments to MCOs, we deleted two sentences that were included in the background section of the draft report.

OIG Note: All information identifying the name and address of the Texas MCO was deleted from the MCO's response.

See OIG Note.

October 23, 2000

See OIG Note.

Mr. Donald L. Dille
Regional Inspector General for Audit Services
Office of the Inspector General
1100 Commerce, Room 6B6
Dallas, TX 75242

RE: Common Identification Number A-06-00-00052

Dear Mr. Dille:

Thank you for the opportunity to respond to the draft report prepared by your office entitled "Review of the Adjusted Community Rate Proposal (ACRP) Submitted to the Health Care Financing Administration (HCFA) by a Texas-based Medicare+Choice Managed Care Organization (M+CO) for the 2000 Medicare Contract Year." We anticipate that our response will be included in the final report that is issued to HCFA.

First, we are pleased that the OIG's review acknowledged that the M+CO's ACRP was prepared in substantial compliance with current governing standards and regulations.

Separate and apart from assessing whether or not the Texas M+CO complied with current ACRP standards, the OIG's stated objective in this particular review was "...to examine the administrative cost component of the contract year 2000 ACRP, ...and assess whether the costs were appropriate when compared to the Medicare program's general principle of paying only reasonable costs." However, as the report concedes, there is no statutory or regulatory authority to suggest that the Texas M+CO overstated its administrative costs or otherwise prepared its ACRP in a manner that would violate Medicare rules. Nevertheless, the OIG concludes that the M+CO's overall administrative costs would have been overstated if the M+CO was otherwise obligated to adhere to guidelines outlined in Part 31 of the Federal Acquisition Regulations (FAR).

Summary of Major Findings:

Specifically, the OIG's draft report identifies three primary categories of administrative expenses that are justifiable under current standards and regulations governing ACRPs but that would not be allowable under FAR:

1. According to the OIG, the M+CO reported \$3.9 million in indirect costs that would have been disallowed under FAR cost contract rules. If FAR were applicable, it would require these indirect costs to be apportioned on the basis of the ratio of Medicare to Commercial enrollment.

Re: Common Identification Number A-06-00-00052
October 23, 2000
Page 2

M+CO Response: To suggest that indirect costs should be apportioned on the basis of membership ratios ignores important facts. Ironically, as stated by the OIG draft report authors, "*The purpose of apportionment is to ensure that the cost of services furnished to Medicare enrollees is not borne by others and that the cost of services furnished to others is not borne by Medicare.*" Significant per capita revenue differences between Medicare and commercial enrollees are reflective of corresponding differences in the costs required to provide health care for these two different populations. For example, the fact that Medicare enrollees consume more health care than commercial members results in higher Medicare costs for a myriad of administrative activities ranging from processing claims to responding to member inquiries or complaints. In sum, it is reasonable that a M+CO's common systems and personnel are disproportionately focused on Medicare.

Moreover, while both the Medicare and commercial business is more or less equally regulated at the state level, the Medicare business is much more heavily regulated at the federal level. Consequently, M+COs must support expensive mandates that apply only to its Medicare business such as supporting encounter data reporting or maintaining duplicative quality assurance structures and systems, just to name two.

2. Some \$2.6 million in costs not allowable under Part 31 of FAR were claimed by the M+CO as administrative expenses. The draft report acknowledges that these expenses are allowed under current ACRP regulations and guidelines.

M+CO Response: The OIG's observations and its draft report presentation, while perhaps technically correct, is misleading with regard to the true scope and nature of these "administrative" costs. Actually, a full 92% of these costs (or some \$2.4 million) were taxes paid to the federal government; however, the OIG's draft report cites taxes last - almost as an afterthought - presumably to emphasize the much smaller scope of other items in this category.

3. The OIG draft report cites some \$3.5 million in related party transactions for corporate expenses and royalty fees that "*...were not supported by costs*" or "*...the MCO was unable to identify the related parties' costs.*" The OIG acknowledges that these costs may be appropriate, even under strict FAR principles, if identified and supported.

M+CO Response: In reality, these expenses are supported by costs incurred at the parent company. To achieve economies of scale, many functions supporting our Medicare and commercial business are centralized. Our members, providers and employees benefit from these common services and systems; in fact, they serve to lower overall administrative costs.

Re: Common Identification Number A-06-00-00052
October 23, 2000
Page 3

Conclusion

In a previous OIG report released in January 2000, the OIG recommended that HCFA introduce legislation that caps M+CO administrative costs at 15%. HCFA correctly dismissed this proposal as undesirable and unreasonable. We concurred with HCFA's opinion in this regard because capping administrative costs at an arbitrary level would unjustly penalize organizations with "higher" administrative costs and potentially disincentive other organizations from striving to maximize their overall efficiencies to achieve lower total administrative costs.

In this draft report, the OIG is now recommending that M+COs should be governed by the "reasonable cost" rules set forth in the Federal Acquisition Regulations. However, applying "cost-based" standards to "risk-based" organizations is counterintuitive. It is not reasonable for the federal government to encourage M+COs to accept a fully capitated payment rate that is lower¹ than estimated fee for service costs while at the same time, requiring that same organization to incur actual costs as currently defined under Medicare fee-for-service. There has to be some reward for assuming significant risk. To appropriately raise the capital that is required to run a M+C business, there has to be an opportunity to provide a reasonable return on that investment.

We appreciate the opportunity to comment on the draft and hope that the final report will reflect our response. Please feel free to contact me if you have any questions regarding the foregoing.

Sincerely,

See OIG Note.

¹ The draft OIG report incorrectly states "Medicare payments to risk-based MCOs are based on a prepaid capitation rate with no retroactive adjustments. 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-services Medicare." In reality, the M+CO pre-BBA rates were reduced from county fee-for-service per capita payments; post-BBA plan rates are "delinked" from fee-for-service and, in either case, the methodologies used to calculate the rates include the opportunity for HCFA to retroactively change the payment baseline which can reduce county payments prospectively.