DEPARTMENT OF HEALTH & HUMAN SERVICES OFFICE OF INSPECTOR GENERAL

Office of Audit Services
Region I
John F. Kennedy Federal Building
Room 2425
Boston, MA 02203
(617) 565-2684

SEP 2 0 2005

Report Number: A-01-04-00523

Mr. David Fogerty
Director of Government Operations
Blue Cross & Blue Shield of Rhode Island
444 Westminster St.
Providence, Rhode Island 02903

Dear Mr. Fogerty:

Enclosed are two copies of the U.S. Department of Health and Human Services (HHS), Office of Inspector General report entitled "Review of Medicare Administrative Costs – Parts A and B for Fiscal Years 2000 – 2004 at Blue Cross & Blue Shield of Rhode Island." A copy of this report will be forwarded to the action official noted below for review and any action deemed necessary.

The HHS action official will make final determination as to actions taken on all matters reported. 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, Office of Inspector General reports are made available to members of the press and general public to the extent that information contained therein is not subject to exemptions in the Act that the department chooses to exercise (see 45 CFR Part 5).

Questions on any aspect of the report are welcome. Please refer to report number A-01-04-00523 in all correspondence.

Sincerely,

Michael J. Armstrong
Regional Inspector General
for Audit Services

Enclosures – as stated

Direct Reply to HHS Action Official:

Charlotte S. Yeh, M.D.
Regional Administrator
Centers for Medicare & Medicaid Services – Region I
Department of Health and Human Services
JFK Federal Building, Room 2325
Boston, Massachusetts 02203

Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

REVIEW OF MEDICARE ADMINISTRATIVE COSTS – PART A & B FOR FISCAL YEARS 2000 – 2004

BLUE CROSS & BLUE SHIELD OF RHODE ISLAND

Daniel R. Levinson
Inspector General

SEPTEMBER 2005
A-01-04-00523

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 Inspector General, Office of Audit Services reports are made available to members of the public to the extent the information 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. Authorized officials of the HHS divisions will make final determination on these matters.

EXECUTIVE SUMMARY

BACKGROUND

The Medicare program is administered by the Centers for Medicare & Medicaid Services (CMS). CMS contracts with private organizations, known as intermediaries for Part A and carriers for Part B, to process and pay claims for services provided to eligible beneficiaries. CMS contracted with Blue Cross & Blue Shield of Rhode Island (Rhode Island) to serve as the Part A intermediary and Part B carrier responsible for processing all Rhode Island Part A and Part B claims.

Rhode Island and CMS negotiated an annual budget for all allowable costs related to the administration of these programs. The costs are claimed for reimbursement on the final administrative cost proposal (FACP). The FACP and supporting data serve as the basis for the final settlement of allowable administrative costs. For the period October 1, 1999, through January 31, 2004, Rhode Island claimed administrative costs of $46,060,083.

In June 2003, Rhode Island exercised its contractual option to terminate participation as a Medicare contractor and notified CMS accordingly. Both Rhode Island and CMS agreed this termination would be effective on January 31, 2004.

OBJECTIVE

Our objective was to determine whether the administrative costs that Rhode Island claimed in its cost proposals complied with applicable Federal regulations and contract provisions.

SUMMARY OF FINDINGS

Our review disclosed that Rhode Island claims included costs that were not allowable for Medicare reimbursement as follows:

- $1,383,533 ($487,633 Part A and $895,900 Part B) in excess of the CMS-approved budget awards that was claimed on the Fiscal Year (FY) 2000 FACPs and for which adequate documentation of allowability was not provided;

- $1,103,268 ($607,511 Part A and $495,757 Part B) claimed on the FY 2004 FACPs that exceeded the actual allowable expenses supported by company accounting records and reported on activity reports that contractors submitted with their FACPs; and

- $95,863 in net excess costs ($25,448 underclaimed on Part A and $121,311 overclaimed on Part B) included on the FY 2004 FACPs because of errors in the cost allocation process.

We determined that Rhode Island claimed these unallowable costs because it did not have adequate internal control procedures to ensure that costs were claimed in accordance with the factors for determining the allowability of contract costs included in Part 31.201 and other pertinent sections of FAR. Specifically, the auditee did not maintain records to show how it reconciled Medicare expenses in company books to the amounts claimed on the FACPs. As a result, Rhode Island overstated its claim for Medicare reimbursement by a total of $2,582,664.

RECOMMENDATIONS

We recommend that Rhode Island:

- reduce its FY 2000 FACPs by $1,383,533 ($487,633 Part A and $895,900 Part B) for costs claimed in excess of the approved amounts (see Appendix B), and

- increase its FY 2004 Part A FACP by $25,448 and reduce its FY 2004 Part B FACP by $121,311 to account for errors in the allocation process (see Appendix B).

As a result of our review, Rhode Island has resubmitted the revised FACPs for the $1,103,268 that it claimed in excess of the actual allowable costs. Therefore, we do not have any further recommendations related to this finding. However, CMS should consider these adjustments in the final settlement of these FACPs (see Appendix B).

RHODE ISLAND'S COMMENTS

In its July 19, 2005, written response to our draft report (see Appendix C), Rhode Island agreed with the recommended disallowances of $1,103,268 related to costs claimed in excess of actual expenses and $95,863 related to errors in the allocation process. However, Rhode Island disagreed with our recommendation that the $1,383,533 in costs claimed in excess of CMS-approved amounts should be disallowed.

OFFICE OF INSPECTOR GENERAL'S RESPONSE

After our review of Rhode Island's response and the accompanying documentation, we maintain that our recommended disallowances accurately reflect Rhode Island's failure to comply with applicable Federal regulations and Medicare program criteria. As a result, we continue to believe that the recommended financial adjustment is warranted.

TABLE OF CONTENTS

INTRODUCTION

BACKGROUND

Medicare Program

Title XVIII of the Social Security Act (the Act) established the Health Insurance for the Aged and Disabled (Medicare) Program. Medicare is a national health insurance program that provides coverage to eligible beneficiaries age 65 and over, some beneficiaries under 65 with disabilities, and beneficiaries with end-stage renal disease. This program has two distinct parts. Part A is the hospital insurance program, which provides coverage for inpatient hospital care, posthospital extended care, and posthospital home health care. Part B is an optional medical insurance program that covers physician services, hospital outpatient services, home health care, and other health services.

The Medicare program is administered by the Centers for Medicare & Medicaid Services (CMS). CMS contracts with private organizations, known as intermediaries for Part A and carriers for Part B, to process and pay claims for services provided to eligible beneficiaries. The Act provides that intermediaries and carriers are reimbursed for all reasonable and allowable costs incurred in administering the programs.

Blue Cross & Blue Shield of Rhode Island Medicare Contracts

Blue Cross & Blue Shield of Rhode Island (Rhode Island) contracted with CMS to serve as the Part A intermediary and Part B carrier responsible for processing all Medicare Part A and Part B claims in Rhode Island. Rhode Island's administrative costs were reimbursed under the terms of its contracts with CMS. Specifically, Appendix B of the contracts sets forth principles of reimbursement for administrative costs and references Federal regulations, primarily Part 31 of the Federal Acquisition Regulation (FAR), that identify allowable administrative costs.

Rhode Island and CMS negotiated an annual budget for all allowable costs, which are claimed for reimbursement on the final administrative cost proposal (FACP). The FACP and supporting data serve as the basis for the final settlement of allowable administrative costs. From October 1, 1999, through January 31, 2004, Rhode Island claimed administrative costs of $46,060,083 ($17,759,360 for Part A and $28,300,723 for Part B) on its FACPs.

In June 2003, Rhode Island exercised its contractual option to terminate participation as a Medicare contractor and notified CMS accordingly. Both Rhode Island and CMS agreed that this termination would be effective on January 31, 2004. CMS agreed to reimburse costs related to the termination process under a separate agreement. We reviewed the

allowability of these termination costs in a separate audit, the results of which will be included in our audit report number A-01-05-00509.

OBJECTIVE, SCOPE, AND METHODOLOGY

Objective

Our objective was to determine whether the administrative costs that Rhode Island claimed in its cost proposals complied with applicable Federal regulations and contract provisions.

Scope

Our review covered the period from October 1, 1999, through January 31, 2004. We performed a limited review of Rhode Island's internal controls to obtain an understanding of accounting policies and procedures relevant to the audit objectives.

Our fieldwork was performed at the offices of Blue Cross & Blue Shield of Rhode Island in Providence, Rhode Island, from July 2004 through March 2005. In addition, we communicated with CMS officials in the regional office in Boston, Massachusetts, throughout the course of the audit.

Methodology

To accomplish our audit objective, we reconciled the Rhode Island FACPs with the accounting records and reviewed direct charges, payroll documents, and the basis for allocating certain indirect costs.

In reviewing selected costs, we considered whether costs claimed by Rhode Island were allowable, allocable, reasonable, adequately supported, and of benefit to the Medicare program.

Our review was conducted in accordance with generally accepted government auditing standards.

FINDINGS AND RECOMMENDATIONS

From October 1, 1999, through January 31, 2004, Rhode Island claimed the following administrative costs that were not allowable for Medicare reimbursement:

- $1,383,533 ($487,633 Part A and $895,900 Part B) in excess of the CMS-approved budget awards that was claimed on the Fiscal Year (FY) 2000 FACPs and for which adequate documentation of allowability was not provided;

- $1,103,268 ($607,511 Part A and $495,757 Part B) claimed on the FY 2004 FACPs that exceeded actual allowable expenses as documented by company accounting records and activity reports that contractors submit with their FACPs; and

- $95,863 in net excess costs ($25,448 underclaimed on Part A and $121,311 overclaimed on Part B) included on the FY 2004 FACPs because of errors in the cost allocation process.

These unallowable claims were submitted because Rhode Island did not have adequate internal control procedures. Specifically, the auditee did not maintain records to show how it reconciled Medicare expenses in company books with the amounts claimed on the FACPs. As a result, Rhode Island overstated its claim for Medicare reimbursement by a total of $2,582,664.

COSTS CLAIMED IN EXCESS OF APPROVED AMOUNTS

Contract Provisions and Federal Regulations

The Medicare Intermediary and Carrier Manuals, Part 1 Fiscal Administration, sections 1261 and 4261, respectively, state that CMS will issue a Notice of Budget Approval (NOBA) to notify contractors of the amount of funds approved and certified to be available for administrative expenses. Contractors are not authorized to incur expenses that exceed the total certified amount.

Section 4351 of the manuals states that if the budgeted funds are insufficient for the contractor to adequately perform the required functions, the contractor should submit a supplemental budget request that documents the need for additional funds. The Medicare Part A and B contracts also specify that the contractor is required to notify the Secretary of the Department of Health and Human Services 60 calendar days before the estimated date on which the initial funds will be exhausted.

Furthermore, pursuant to FAR Part 31.201-2(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 . . . ."

Costs Exceeding Authorized Amounts

In FY 2000, Rhode Island's Part A and B FACPs included costs that exceeded the NOBA amounts by $1,383,533. In June 2004, after its decision to leave the Medicare program, Rhode Island decided to reexamine the FY 2000 FACP claims and seek additional reimbursement from CMS for unclaimed amounts. Rhode Island did not submit

supplemental budget requests for the amounts that exceeded the NOBA amounts, nor did it provide documentation to explain the need for the additional funds. Specifically, we found the following:

Part A Funding

CMS approved Part A administrative funds for Rhode Island totaling $2,928,800 for FY 2000. In its original FY 2000 FACP submission, Rhode Island claimed $210,629 in excess of the CMS Part A NOBA amounts for the Y2K line item. In the June 2004 revised FACP, Rhode Island claimed an additional $277,004 in excess of the CMS Part A NOBA for the Program Management and Medicare Integrity Program line items. These claims are as follows:

FY 2000 – PART A	CMS-Approved NOBA	Original FACP Claim	Revised FACP 6/15/04	Claimed in Excess of NOBA
Program Management	$1,180,300	$1,180,300	$1,282,023	$101,723
Medicare Integrity Program	1,502,600	1,502,600	1,677,881	175,281
Y2K	175,000	385,629	385,629	210,629
Non Renewal Funding	70,900	66,010	66,010	-0-
	$2,928,800	$3,134,539	$3,411,543	$487,633

Part B Funding

CMS approved funding of $4,921,801 for Rhode Island to administer the Medicare Part B program for FY 2000. In the April 25, 2001, FY 2000 FACP submission, Rhode Island claimed the total CMS-approved amounts for all expense line items. However, in its June 15, 2004, revised FACP, Rhode Island claimed additional costs of $895,900 in excess of the Part B NOBA as follows:

FY 2000 – PART B	CMS-Approved NOBA	4/25/01 FACP Claim	Revised FACP 6/15/04	Claimed in Excess of NOBA
Program Management	$3,604,100	$3,508,103	$3,584,450	($19,650)
Medicare Integrity Program	1,142,701	1,142,701	1,461,373	318,672
Y2K	175,000	270,997	771,878	596,878
	$4,921,801	$4,921,801	$5,817,701	$895,900

Inadequate Documentation of Additional Costs Claimed

Rhode Island could not document how it had derived the costs claimed on its original FY 2000 FACPs from the costs allocated to Medicare in its accounting records. Rhode Island officials attempted to reconcile the FACP amounts with the accounting records but were unable to do so. The results of these reconciliation attempts showed that the costs on company books after adjustment exceeded the amount claimed for FY 2000. However, Rhode Island could not provide any documentation to adequately support the additional claims for reimbursement.

With no audit trail to support the additional claims and no CMS approval for the additional funding, we cannot accept Rhode Island's claim for FY 2000 costs in excess of the approved amounts.

COSTS CLAIMED IN EXCESS OF ACTUAL EXPENSES

Regulations Governing Allowable Costs

Pursuant to FAR Part 31.201-2(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 . . . ."

Claims Exceeding Allowable Costs

Rhode Island's FY 2004 Part A and B FACPs included costs of $1,103,268 that were in excess of the actual Medicare allowable costs on the company books and in the accompanying FACP activity reports. These costs were claimed for the period October 1, 2003, through January 31, 2004, when Rhode Island left the Medicare program. The costs claimed on the FACPs exceeded the actual allowable costs as follows:

	Part A	Part B
Costs Claimed per FACP	$1,859,651	$3,358,497
Actual Costs per Company Books	1,252,140	2,862,740
Costs Claimed In Excess of Actual Costs	$ 607,511	$ 495,757

Cause of Overclaim

Rhode Island inadvertently claimed costs that exceeded actual allowable costs because controls were not in place to reconcile Medicare-related costs on the company books with actual allowable Medicare costs.

As a result, Rhode Island claimed $1,103,268 in excess of the actual allowable costs. Rhode Island agreed with our finding and processed the adjustments in revised FACPs submitted to CMS in July 2004.

ERRORS IN THE ALLOCATION PROCESS

Regulations for Determining Allowability

Pursuant to FAR Part 31.201-4, "A cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship."

Cost Allocation Methodology

One of the indirect cost allocation methods that Rhode Island used for claiming FY 2004 Part A and B administrative costs was incorrect. As a result, allocations based on full-time equivalents used for the December 2003 quarter were nearly double those used for the September 2003 quarter. The allocations also applied the hours of temporary employees to cost centers that did not benefit temporary employees, such as postretirement benefits.

The inaccuracies resulted in Part A being allocated $25,448 less than its share of indirect costs and Part B being allocated $121,311 more than its share of indirect costs. As a result, Rhode Island's allocations to Medicare resulted in a net $95,863 in excess of its share of allocable overhead costs in FY 2004.

Computer File Error

Rhode Island agreed that the chief reason for the allocation percentage errors was because the full-time equivalent computer file contained an error that prevented it from accurately retrieving employee hours worked. Using accurate employee hours, Rhode Island recalculated the full-time equivalent percentages to be applied to Medicare for each of the indirect cost allocations.

RECOMMENDATIONS

We recommend that Rhode Island:

- reduce its FY 2000 FACPs by $1,383,533 ($487,633 Part A and $895,900 Part B) for costs claimed in excess of the approved amounts (see Appendix B), and

- increase its FY 2004 Part A FACP by $25,448 and reduce its FY 2004 Part B FACP by $121,311 to account for errors in the allocation process (see Appendix B).

As a result of our review, Rhode Island has resubmitted the revised FACPs for the $1,103,268 that it claimed in excess of the actual allowable costs. Therefore, we do not have any further recommendations related to this finding. However, CMS should consider these adjustments in the final settlement of these FACPs (see Appendix B).

BLUE CROSS & BLUE SHIELD OF RHODE ISLAND'S COMMENTS

In its July 19, 2005, written response to our draft report (see Appendix C), Rhode Island agreed with the recommended disallowances of $1,103,268 related to costs claimed in excess of actual expenses, which it has already repaid, and $95,863 ($25,448 underclaimed on Part A and $121,311 underclaimed on Part B) related to errors in the allocation process. However, Rhode Island disagreed with our recommendation that the $1,383,533 in costs claimed in excess of CMS-approved amounts should be disallowed.

In its response, Rhode Island maintained that the auditors were able to reconcile costs claimed in the final revised FY 2000 FACP to supporting documentation in the company's books and records that the auditors had access to and used during their on-site audit.

Rhode Island also asserted that it is entitled to the total costs reasonably incurred, including those costs in excess of the CMS NOBA. Rhode Island stated that the excess costs were solely for the benefit of the Medicare program and pointed out that the auditors did not question the costs on the basis that they were not allocable to Medicare.

Rhode Island further stated that it incurred the excess costs because CMS's NOBA was far too low to cover the work required by the contract. Rhode Island claimed that CMS openly discourages Medicare contractors from claiming or requesting costs over the approved NOBA and that CMS unilaterally sets cost limits on contractors through the NOBA process. As an example, Rhode Island cited the issue of Y2K costs. It stated that CMS had threatened contractors that anything short of full Y2K compliance could subject contractors to termination or nonrenewal of their Medicare contracts. Under these circumstances, Rhode Island maintained it could not reasonably limit its efforts to the arbitrary level that CMS had agreed to fund.

Rhode Island also asserted that, according to principles of contract law, the Medicare contracts are cost reimbursable and, therefore, CMS should bear the risk of any loss not attributable to unreasonable conduct on the part of the contractor. In addition, Rhode Island stated that every contract imposes an implied obligation that neither party will do anything to hinder the other in performance of the contract. It maintained that CMS's

practice of imposing requirements that give rise to increased costs while openly discouraging claims for those costs in excess of the NOBA violates these principles of law and shifts the risk of loss to the contractor. Rhode Island further argued that CMS violated the duty of cooperation both by shifting risk of loss to the contractor and by refusing to reimburse the contractor for costs that the contractor incurred only because of the actions of the agency.

Finally, Rhode Island believed that the costs in excess of the NOBA are recoverable in the context of a termination settlement. It noted that the Board of Contract Appeals has stated that the purpose of a termination settlement is to fairly compensate the contractor for costs incurred in performing the terminated work. Rhode Island concluded that, as a matter of basic fairness, it must recover the costs that it incurred exclusively for the Medicare program because any other results would be inconsistent with the cost reimbursement nature of the Medicare contract and the understanding that Rhode Island was performing under the principle of neither profit nor gain.

For these reasons, Rhode Island maintained that it is entitled to all costs reasonably incurred, including those in excess of the NOBA amounts.

OFFICE OF INSPECTOR GENERAL'S RESPONSE

Rhode Island correctly noted that we were able to reconcile costs claimed in the June 15, 2004, submittal of the final revised FY 2000 FACP to the company's books. In this regard, the company books showed total costs of $3,411,453 for Part A and $5,817,701 for Part B. However, Rhode Island could not provide any reconciliations to show how it had derived the original FACPs. In addition, Rhode Island officials could not show what specific costs not claimed in the original FACP submission were now claimed in the revised FACP. Thus, we concluded that there was no audit trail to identify or support the additional costs claimed.

Rhode Island also did not justify why it had incurred costs in excess of the NOBA. After we received Rhode Island's response, we confirmed that during FY 2000 Rhode Island had submitted supplemental budget requests for additional funds for Y2K (1.4 million for Part A and 1.4 million for Part B) that CMS denied, while other such requests that Rhode Island submitted in FY 2000 were approved for amounts greater than those requested. However, from the time of the initial FACP submissions in December 2000 to June 2004, Rhode Island made only one supplemental budget request, which was submitted in April 2001 for an additional $135,000 in Part B funding. This request was approved by CMS, and the related Part B NOBA was increased to reflect the approval.

As noted in our report, Medicare contractors are not authorized to incur expenses that exceed their approved budgets. If budgeted funds are not sufficient for the contractor to perform the required functions, the contractor must request supplemental funding and document the need for these funds at least 60 days before the estimated date that the initial funds will be exhausted.

However, since the April 2001 supplemental budget request, we found no evidence that Rhode Island had negotiated with CMS to increase the budget, institute additional efficiencies, reduce the contract work functions to be performed, or devise any other solutions that would be agreeable to both parties to compensate for the costs in excess of the NOBA amount.

Finally, we disagree with Rhode Island's comments that the costs in excess of the NOBA amounts are recoverable in the context of a termination settlement. When Rhode Island exercised its contract option to leave the Medicare program, it entered into a separate termination agreement with CMS in which CMS agreed to reimburse Rhode Island for costs that the company incurred in transferring its responsibilities to other contractors. The costs in excess of the NOBA amounts have nothing to do with the termination process and were not included in the termination agreement. Thus, Rhode Island cannot recover these costs as part of its termination expenses.

In summary, we believe that Rhode Island had ample opportunity to request additional funding to cover Medicare expenditures over the approved NOBA amounts. However, it did not follow the appropriate process to request funds in a timely manner and document the need for the additional funding. As a result, we stand by our recommended disallowance of the additional funds that Rhode Island requested 3 years after the fact.

APPENDIXES

BLUE CROSS & BLUE SHIELD OF RHODE ISLAND
FINAL ADMINISTRATIVE COST PROPOSALS WITH OIG DISALLOWANCES
Medicare Parts A and B
For the Periods Ending September 30, 2000, 2001, 2002, 2003 and Period Ending January 31, 2004

Cost Category	Part A	Part B	Total Costs Claimed
Salaries/Wages	$9,619,478	$15,192,716	$24,812,194
Fringe Benefits	2,903,069	4,451,177	7,354,246
Facilities or Occupancy	845,152	1,592,880	2,438,032
EDP Equipment	1,216,016	2,592,324	3,808,340
Subcontractors	0	0	0
Outside Prof. Services	1,338,025	3,136,304	4,474,329
Telephone & Telegraph	162,766	442,951	605,717
Postage & Express	399,024	1,989,661	2,388,685
Furniture & Equipment	95,682	339,525	435,207
Materials & Supplies	157,664	412,417	570,081
Travel	118,610	154,535	273,145
Return on Investment	122,223	127,670	249,893
Miscellaneous	546,722	492,917	1,039,639
Other	0	53,710	53,710
Non Renewals	66,010	0	66,010
Forward Funding	499,590	146,066	645,656
Other Adjustments (Credits)	(330,671)	(2,824,130)	(3,154,801)
Total Costs Reported on FACP	$17,759,360	$28,300,723	$46,060,083
OIG Recommended Disallowance	(1,069,696)	(1,512,968)	(2,582,664) *
OIG Recommended for Acceptance	**$16,689,664**	**$26,787,755**	**$43,477,419**

*** See Appendix B**

BLUE CROSS & BLUE SHIELD OF RHODE ISLAND
FINAL ADMINISTRATIVE COST PROPOSALS WITH OIG DISALLOWANCES
Medicare Part A
For the Periods Ending September 30, 2000, 2001, 2002, 2003 and Period Ending January 31, 2004

Cost Category	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004	Total Part A Costs Claimed
Salaries/Wages	$1,867,658	$2,147,038	$2,680,295	$1,997,963	$926,524	$9,619,478
Fringe Benefits	534,696	655,293	796,427	645,821	270,832	$2,903,069
Facilities or Occupancy	180,268	190,900	258,012	138,084	77,888	$845,152
EDP Equipment	246,528	300,231	275,200	324,491	69,566	$1,216,016
Subcontractors	0	0	0	0	0	$0
Outside Prof. Services	247,196	208,052	262,771	264,913	355,093	$1,338,025
Telephone & Telegraph	39,590	30,780	44,625	33,003	14,768	$162,766
Postage & Express	79,359	119,750	127,623	28,372	43,920	$399,024
Furniture & Equipment	32,146	32,124	31,411	1	0	$95,682
Materials & Supplies	32,501	35,164	46,017	27,557	16,425	$157,664
Travel	25,381	30,485	25,715	23,710	13,319	$118,610
Return on Investment	44,019	32,497	34,267	8,440	3,000	$122,223
Miscellaneous	89,408	48,969	222,043	84,826	101,476	$546,722
Other	0	0	0	0	0	$0
Non Renewals	66,010	0	0	0	0	66,010
Forward Funding	0	0	499,590	0	0	499,590
Other Adjustments (Credits)	(73,234)	(70,083)	(65,814)	(88,380)	(33,160)	(330,671)
Total Costs Reported on FACP	$3,411,526	$3,761,200	$5,238,182	$3,488,801	$1,859,651	$17,759,360
OIG Recommended Disallowance	(487,633)	0	0	0	(582,063)	(1,069,696)
OIG Recommended for Acceptance	**$2,923,893**	**$3,761,200**	**$5,238,182**	**$3,488,801**	**$1,277,588**	**$16,689,664**

*** See Appendix B**

BLUE CROSS & BLUE SHIELD OF RHODE ISLAND
FINAL ADMINISTRATIVE COST PROPOSALS WITH OIG DISALLOWANCES
Medicare Part B
For the Periods Ending September 30, 2000, 2001, 2002, 2003 and Period Ending January 31, 2004

Cost Category	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004	Total Part B Costs Claimed
Salaries/Wages	$2,870,847	$3,133,416	$4,355,119	$3,468,071	$1,365,263	$15,192,716
Fringe Benefits	812,982	944,771	1,222,112	1,052,400	418,912	$4,451,177
Facilities or Occupancy	273,015	388,678	489,929	264,821	176,437	$1,592,880
EDP Equipment	1,179,589	487,341	395,471	431,257	98,666	$2,592,324
Subcontractors	0	0	0	0	0	$0
Outside Prof. Services	401,941	347,491	461,956	645,620	1,279,296	$3,136,304
Telephone & Telegraph	116,840	88,984	130,302	69,524	37,301	$442,951
Postage & Express	479,139	506,189	622,077	233,753	148,503	$1,989,661
Furniture & Equipment	56,663	147,860	134,998	4	0	$339,525
Materials & Supplies	61,613	122,621	142,540	48,120	37,523	$412,417
Travel	34,639	30,674	40,914	30,467	17,841	$154,535
Return on Investment	29,231	34,301	22,846	26,118	15,174	$127,670
Miscellaneous	97,927	59,010	219,099	96,394	20,487	$492,917
Other	0	0	0	53,710	0	$53,710
Non Renewals	0	0	0	0	0	0
Forward Funding	0	0	146,066	0	0	146,066
Other Adjustments (Credits)	(596,942)	(634,936)	(698,089)	(637,257)	(256,906)	(2,824,130)
Total Costs Reported on FACP	$5,817,484	$5,656,400	$7,685,340	$5,783,002	$3,358,497	$28,300,723
OIG Recommended Disallowance	(895,900)	0	0	0	(617,068)	(1,512,968)
OIG Recommended for Acceptance	**$4,921,584**	**$5,656,400**	**$7,685,340**	**$5,783,002**	**$2,741,429**	**$26,787,755**

*** See Appendix B**

BLUE CROSS & BLUE SHIELD OF RHODE ISLAND
OFFICE OF INSPECTOR GENERAL'S RECOMMENDED DISALLOWANCES - MEDICARE PARTS A AND B
For the Periods Ending September 30, 2000, 2001, 2002, 2003 and Period Ending January 31, 2004

Finding Categories	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004	Total Recommended Disallowance	See Page
COSTS CLAIMED IN EXCESS OF APPROVED AMOUNTS	$1,383,533	$0	$0	$0	$0	$1,383,533	3
COSTS CLAIMED IN EXCESS OF ACTUAL EXPENSES	0	0	0	0	1,103,268	1,103,268	5
ERRORS IN THE ALLOCATION PROCESS	0	0	0	0	95,863	95,863	6
TOTAL OIG RECOMMENDED DISALLOWANCE	**$1,383,533**	**$0**	**$0**	**$0**	**$1,199,131**	**$2,582,664**	

BLUE CROSS & BLUE SHIELD OF RHODE ISLAND
OFFICE OF INSPECTOR GENERAL'S RECOMMENDED DISALLOWANCES - MEDICARE PART A
For the Periods Ending September 30, 2000, 2001, 2002, 2003 and Period Ending January 31, 2004

Finding Categories	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004	Total Part A Disallowance	See Page
COSTS CLAIMED IN EXCESS OF APPROVED AMOUNTS	$487,633	$0	$0	$0	$0	$487,633	3
COSTS CLAIMED IN EXCESS OF ACTUAL EXPENSES	0	0	0	0	607,511	607,511	5
ERRORS IN THE ALLOCATION PROCESS	0	0	0	0	(25,448)	(25,448)	6
TOTAL OIG RECOMMENDED DISALLOWANCE	**$487,633**	**$0**	**$0**	**$0**	**$582,063**	**$1,069,696**	

BLUE CROSS & BLUE SHIELD OF RHODE ISLAND
OFFICE OF INSPECTOR GENERAL'S RECOMMENDED DISALLOWANCES - MEDICARE PART B
For the Periods Ending September 30, 2000, 2001, 2002, 2003 and January 31, 2004

Finding Categories	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004	Total Part B Disallowance	See Page
COSTS CLAIMED IN EXCESS OF APPROVED AMOUNTS	$895,900	$0	$0	$0	$0	$895,900	
COSTS CLAIMED IN EXCESS OF ACTUAL EXPENSES	0	0	0	0	495,757	$495,757	5
ERRORS IN THE ALLOCATION PROCESS	0	0	0	0	121,311	$121,311	6
TOTAL OIG RECOMMENDED DISALLOWANCE	**$895,900**	**$0**	**$0**	**$0**	**$617,068**	**$1,512,968**	

Blue Cross Blue Shield of Rhode Island

July 19, 2005

Mr. Michael Armstrong
Office of Audit Services
Region I
John F. Kennedy Federal Building
Room 2425
Boston, MA 02203

Mr. Armstrong,

Enclosed is Blue Cross & Blue Shield of Rhode Island's response to report number A-01-04-00523 entitled "Audit of Administrative Costs at Rhode Island Blue Cross Blue Shield – Medicare Parts A and B – October 1999 through January 2004".

We disagree with the finding that $1,383,533 of costs claimed on the FY 2000 FACP lacked adequate documentation as to their allowability. Reasons for our disagreement are set forth in the body of the response.

I would be happy to discuss any aspect of our response. I can be reached at (401) 459-1956.

Sincerely,

David F. Fogerty Jr.

David F. Fogerty Jr.
Asst. Vice President, Budgets & Cost Analysis

* An additional binder of data was provided by Blue Cross Blue Shield of Rhode Island. It was too voluminous to be included in Appendix C. This information is stored in hard copy and it can be provided for review upon request.

Blue Cross Blue Shield of Rhode Island

I. Introduction

This letter provides Blue Cross & Blue Shield of Rhode Island's ("BCBSRI") response to the Department of Health and Human Services, Office of Inspector General's ("OIG") draft audit report entitled "Audit of Administrative Costs at Rhode Island Blue Cross Blue Shield – Medicare Parts A and B – October 1999 through January 2004" (hereafter referred to as the "Draft Report").

BCBSRI agrees with the OIG's finding that it inadvertently claimed FY 2004 costs of $1,103,268 that exceeded actual allowable costs and notes it had filed adjustments correcting this claim in revised Final Administrative Cost Proposals (FACPs) submitted to CMS in July 2004. (Draft Report, at 3) BCBSRI also agrees with the OIG's finding that it used an incorrect allocation methodology in calculating overhead costs claimed on its FY 2004 FACP. (Draft Report, at 6-7) BCBSRI agrees to submit revised FACPs to increase its FY 2004 Part A FACP by $25,448 and reduce its FY 2003 Part B FACP by $121,311.

In the Draft Report, the OIG recommends disallowance of FY 2000 costs claimed over NOBA in the amount of $1,383,533. (Draft Report, at 5) BCBSRI disagrees with the OIG's finding that it did not employ adequate internal controls and failed to maintain adequate records to show how it reconciled Medicare expenses to the costs claimed on the FACPs. Further, BCBSRI disagrees with the OIG's position that these over NOBA costs should be disallowed.

II. BCBSRI Did Not Lack Internal Controls or Fail To Maintain Records

The OIG incorrectly asserts that, with regard to $1,383,533 in costs claimed on the FY 2000 FACPs, BCBSRI did not employ adequate internal controls and failed to maintain adequate records to show how it reconciled Medicare expenses to the costs claimed. In the Draft Report the OIG states:

> We found that for FY 2000 Rhode Island Blue Cross Blue Shield did not maintain any reconciliation or other supporting documents to demonstrate how it arrived at the costs claimed on its FY 2000 FACP from the costs allocated to Medicare in its accounting records. Rhode Island Blue Cross Blue Shield officials attempted to reconcile the FACP amounts but were unable to do so. According to its reconciliation attempts, the costs on company books after adjustment exceeded the amount claimed for FY2000. However, it could not provide any documentation to adequately support the additional claims for reimbursement.

Draft Report, at 5.

BCBSRI disagrees with this finding. During the time that the OIG's auditors were on site at BCBSRI's offices from July 2003 to April 2004, they were able to reconcile the costs claimed (whether over NOBA or not) in the final revised FY 2000 FACP to supporting documentation in the company's books and records. The auditor's own workpapers demonstrate this to be the case. The workpaper for Medicare Part A, for example, entitled "FY 2000 Part A Cost Reconciliation" has a column "E" entitled "Amounts Used by Med Finance FACP 03" under which the auditors entered the amount for the total costs claimed and the adjustments made related to costs claimed on the last revised FY 2000 FACP submitted by BCBSRI, by line item. The same workpaper has a column "B" entitled "Amounts used by OIG" under which the auditors entered by line item. the amount found in the company's books and records for each of the costs claimed.[1] A similar workpaper exists for Medicare Part B.

The FACPs were created based on the following information developed during the ordinary course of business:

1. A mainframe based cost allocation report entitled "Blue Cross & Blue Shield of Rhode Island, Cost Center/Department Account Classification Report"
2. A series of adjustments to the cost allocation results that are maintained in excel spreadsheets. These adjustments were supported by additional detail that are maintained in binders at BCBSRI's corporate offices in Providence, Rhode Island.

The auditors had access to and utilized this information during their on-site audit. A comparison of columns B and E of the auditor's reconciliation workpaper for Medicare Part A and of columns B and C of the auditors reconciliation workpaper for Medicare Part B established that the auditors were able to locate and reconcile the claimed amounts and adjustments to the company's books and records. (Attachment 1).

The tables at Attachment 2 provide a reconciliation of costs claimed on the FACPs. The reconciliation starts with the costs allocation reports and provides a summary of the adjustments. The tabs following the reconciliation provides additional information to support the adjustments.

(Note: In looking at the data you will note that the costs for fiscal year 2000 are split between the nine months of calendar year 2000 and three months of fiscal year 1999. BCBSRI's cost allocation process is run on a cumulative calendar basis (consistent with the Cost Accounting Standards); thus, the October through December component of the fiscal year is derived by subtracting the September allocation from the calendar year allocation.)

As illustrated in the tables at Attachment 2, BCBSRI maintains sufficient documentation to supports its costs and maintains that all its costs are allowable.

[1] A dash instead of a number next to one of the line item costs on the auditor's reconciliation spreadsheet means that the auditors did not attempt to check the company books and records for that item.

III. BCBSRI Is Entitled To The Total Costs Reasonably Incurred By The Company Including Those Costs In Excess Of CMS's NOBA Approvals

BCBSRI disagrees with the OIG's recommendation that the company reduce its FY2000 FACPs by $1,383,533 for costs claimed in excess of NOBA approvals. BCBSRI is entitled to be reimbursed for these costs. The questioned costs were reasonably incurred and incurred solely for the benefit of the Medicare program. As discussed in the previous section, the OIG had available to it and was able to audit all costs incurred by BCBSRI on behalf of the Medicare program for FY 2000. The OIG has not questioned these costs on the basis that such costs were *not* allocable to Medicare or otherwise unreasonably incurred.

BCBSRI incurred costs in excess of NOBA approvals for FY2000 – and other years – because the work required such expenditures. CMS's NOBA approvals were often far too low to cover Medicare's initial requirements for a fiscal year and only rarely adjusted to reimburse contractors for new and/or changed requirements. Moreover, CMS would attempt to "have it both ways" by openly discouraging its Medicare Contractors from claiming or requesting over NOBA costs by way of the FACP and/or the SBR process. See, e.g. Budget and Performance Requirements for Fiscal Year 2005 dated June 24, 2005, ¶ VI.D. ("It is the responsibility of the contractor to fully document and justify the level of funding required for each function and to document compliance with the BPRs. Failure to do so could result in funding not being provided. DO NOT assume from the above that funding will be provided at the current Notice of Budget Approval (NOBA) level"); E-mail from Christopher Kerr, Health Care Financing Administration, to John Lauzon and Carol Marrocco, Blue Cross & Blue Shield of Rhode Island Regarding FY 1999 Contractor Performance Evaluation (Nov. 3, 1999, 10:41:51 AM) ("I will cite these areas [where a certain expense report allegedly exceeded NOBA] as Program Deficiencies and request Program Improvement Plans if no action is taken.").

A pertinent example of CMS's practice of unjustifiably attempting to shift cost responsibility to BCBSRI is in the area of Y2K costs.[2] At the time that Medicare Contractors were directed to perform this work, CMS unilaterally set cost "limits" on BCBSRI and other contractors in the form of NOBA approvals. CMS initially threatened contractors that anything short of full Y2K compliance could subject such contractors to termination or non-renewal of their contracts, as well as "denial of other Medicare business." See, e.g., Proposed Amendment of Agreement between Health Care Financing Administration and Blue Cross and Blue Shield Association regarding Year 2000 Compliance dated October 1, 1987 ("Successful completion and testing of the systems changes to make systems Year 2000 complaint by no later than December 31, 1998, in accordance with the above definition is necessary for a finding that the intermediary/carrier is carrying out this agreement/contract in an effective and efficient manner.") (Attachment 3). Under these circumstances, and given the obvious repercussions that may have resulted from Medicare Y2K system failure, BCBSRI could

[2] Notably, Y2K costs amount to $807,507 of the total $1,383,533 of BCBSRI's FY2000 costs recommended for disallowance by the OIG. .

not reasonably limit its efforts to the arbitrary level that CMS had agreed to fund.[3] See generally Medicare Computer Systems – Year 2000 Challenges Put Benefits and Services in Jeopardy, United States General Accounting Office Report to Congressional Requesters, GAO/AIMD-98-284 (Sept. 1998).

The OIG's mechanical comparison of costs incurred to NOBA limits fails to take such CMS strong-arm tactics into account. Two principles of contract law underlie the relevance of the fact of CMS strong-arm tactics to any determination of the allowability of the costs in question. First, BCBSRI's Medicare contracts were pure cost reimbursement contracts with no fee and CMS bears the risk of any loss including of any loss arising from the actions of the agency. "At the heart of this type of contract is the implicit understanding that the Government, in consideration of the contractor's undertaking to perform without fee or profit, will assume the risk of losses not attributable to unreasonable conduct on the part of the contractor, an understanding in keeping with the basic principle that risk of loss should be commensurate with opportunity for profit." *Wyman-Gordon Company*, ASBCA 5100, 59 BCA ¶ 2344. Second, it is well- established that "[e]very contract, as an aspect of the duty of good faith and fair dealing, imposes an implied obligation that neither party will do anything that will hinder or delay the other party in performance of the contract." *Tecom, Inc. v. United States*, 2005 WL 1515902 (Fed. Cl. June 27, 2005), *citing Essex Electro Engineers, Inc. v. Danzig*, 224 F.3d 1283, 1291 (Fed. Cir. 2000). CMS's practice of unilaterally imposing requirements that give rise to increased costs while openly discouraging claims for those costs in excess of the approved NOBAs violates both of the above established principles of contract law. First, the practice represents a policy of shifting the risk of loss to the contractor that is on its face a violation of the principle that the Government assumes the risk of loss under cost-reimbursement type contracts. And the practice violates the duty of cooperation both by its effort to shift the risk of loss to the contractor and by refusing reimbursement for costs that, but for the actions of the agency, the contractor would not have incurred.

[3] The OIG also recommended the disallowance of $493,953 in Medicare Integrity Program (MIP) and $82,073 in Program Management costs for FY2000. Like the Y2K costs discussed above, these costs were incurred solely for the benefit of Medicare. Notably, BCBSRI incurred less than it initially proposed in these areas in an attempt to perform under the agency's arbitrarily set NOBA "limits."

For these reasons, BCBSRI is entitled to all costs reasonably incurred by the company including those costs in excess of CMS's NOBA approvals.[4]

IV. BCBSRI's over NOBA Costs Are Recoverable In the Context Of A Termination Settlement

In any event, BCBSRI's over NOBA costs should be reimbursed to the Company in the context of the termination of BCBSRI's Medicare contracts. It is well established that that the guiding principle in the termination settlement of a Government contract is to be based on business judgment standard rather than the formulaic cost principles. *Codex Corp. v. United States*, 226 Ct. Cl. 693, 696 (1981) ("The application of standards of business judgment, as distinguished from strict accounting principles, is the heart of a settlement."). Similarly, the Boards of Contract Appeals have stated that the purpose of a termination settlement is to fairly compensate the contractor and make it whole for the costs it incurred in performing the terminated work. *Appeal of Freedom Elevator Corp.*, GSBCA 7259, 85-2 BCA 17964 (1985), citing *Appeal of Tera Advanced Services Corp.*, GSBCA 6713-NRC, 85-2 BCA 17940 (1985) ("A settlement should compensate the contractor fairly for the work done and the preparations for the terminated portions of the contract. . . . Fair compensation is a matter of judgment . . . various methods may be equally appropriate for arriving at fair compensation.") In short, fair compensation and business judgment rather than the imposition of strict accounting principles will control. *Appeal of Arctic Corner, Inc.*, VABCA 2392, 86-3 BCA 19278 (1986) ("We will likewise approach the various disputed cost levels in this appeal with an eye toward fair compensation rather than imposing strict accounting principles upon the Appellant . . ."); *Appeal of Tagarelli Brothers Construction Co.*, ASBCA 34793, 88-1 BCA 20363 (1987), *aff'd on reconsideration*, 88-2 BCA 20546 (1988) ("Federal regulators contemplate settlement of termination for convenience purposes by agreement, with business judgment, as distinguished from strict accounting purposes, as the heart of the settlement.").

In the instant matter, the business equities clearly favor BCBSRI's recovery of its over NOBA costs. Such costs were incurred to the exclusive benefit of the Medicare program. As a matter of basic fairness, BCBSRI must be made whole for these costs. Any other result would be inconsistent with the cost reimbursable nature of BCBSRI's contract and the understanding of the parties that BCBSRI was performing "*under the*

[4] In June 2005, BCBSRI amended its FACPs for FY 2001, will amend its and FY 2003 in July 2005 to reflect additional over-NOBA costs that were not previously reported. These over-NOBA costs were not included in the year-end FACPs for these years for the same reason the FY 2000 were not reported at the time. By its amended FY 2001 FACP, BCBSRI is claiming $71,876 in system security costs that were required by CMS pursuant to the FY 2001 BPR; $270,023 in unreimbursed program management costs; and, $191,013 in unreimbursed Medicare Integrity Program costs. By its amended FY 2003 FACP, BCBSRI is claiming $43,897 in FISS conversion costs, which costs were forward funded in 1999 and 2002 (and for which CMS provided no mechanism for claiming excess costs at the time such work was ultimately performed in FY 2003); $212,412 in HIPPA EDI transaction costs, which funded work necessary to comply with HIPPA requirements; and $588,917 in MCS conversion costs, which costs were reasonably incurred and necessary in performing CMS's directed conversion from EDS to the MCS system.

principle of neither profit nor loss . . . ." Model Medicare Part A Commercial Intermediary Contract, Art. XII.A.; Model Medicare Part B Carrier Contract, Art. XV.A.

V. Conclusion

For the forgoing reasons, BCBSRI respectfully objects to the OIG's draft audit report entitled "Audit of Administrative Costs at Rhode Island Blue Cross Blue Shield – Medicare Parts A and B – October 1999 through January 2004."