DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

Memorandum

Date JUN 22 1999

From for June Gibbs Brown
Inspector General

Michael Mangano

Subject Review of the 1997 Adjusted Community Rate Proposal for a Missouri Risk-Based Managed Care Organization (A-07-99-01275)

To

Nancy-Ann Min DeParle
Administrator
Health Care Financing Administration

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

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

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

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

We determined the portion of the Missouri Plan's income from Medicare for administrative activities, based on the 1997 ACR proposal, exceeded the Missouri Plan's actual 1997 administrative expenses for their entire operation by approximatelv 200 percent. Income received from HCFA during 1997 to cover administrative costs for the Missouri Plan's Medicare MCO contract totaled $43.6 million. However, the Missouri Plan's financial report to HCFA showed administrative costs (including profits and reinsurance expenses) for their entire operations was almost $22.6 million, a difference of $21 million. Medicare's share of administrative costs should have been around $6.5 million (based on the ratio of Medicare beneficiary member months to the Missouri Plan's total member months), a difference of $37.1 million. Much of this difference was due to the Missouri Plan using an improper administrative load factor on its ACR proposal. Essentially, the Missouri Plan used a factor which was consistent with the handling of non-Medicare insurance policies sold to individuals. Although this inflated proposal was understood by HCFA and approved for use by the Missouri Plan, we have concerns with the financial effect of the Plan's use of an improper administrative load factor.

We also found (1) unsupported costs of $2,131,749 for items such as management fees, commissions, administrative expenses, rental/lease costs, and interest on long-term debt, and (2) costs of $69,594 for items such as entertainment, charitable donations, political contributions, lobbying, and public relations that would not be allowable if existing Medicare regulations were applied to risk-based managed care organizations. We believe these costs were not appropriate when compared to the Medicare program's general principle of paying only reasonable costs.

We believe these administrative costs should not be included in the ACR proposal since this only serves to increase the ACR. An unjustifiably increased ACR adversely impacts the amount available to Medicare beneficiaries for additional benefits or reduced premium amounts.

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

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

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

If you have any questions, please contact me or have your staff contact George M. Reeb, Assistant Inspector General for Health Care Financing Audits, at (410) 786-7104. To facilitate identification, please refer to Common Identification Number A-07-99-01275 in all correspondence relating to this report.

Attachment

Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

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

JUNE GIBBS BROWN
Inspector General

JUNE 1999
A-07-99-01275

DEPARTMENT OF HEALTH & HUMAN SERVICES

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Date JUN 22 1999

Michael Mangano for

From June Gibbs Brown
Inspector General

Subject Review of the 1997 Adjusted Community Rate Proposal for a Missouri Risk-Based Managed Care Organization (A-07-99-01275)

To Nancy-Ann Min DeParle
Administrator
Health Care Financing Administration

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

EXECUTIVE SUMMARY

We determined the Missouri Plan's income from Medicare for administrative activities, based on the 1997 ACR proposal, exceeded actual 1997 administrative expenses for their entire operation (both their Medicare and non-Medicare lines of business). In effect, Medicare funded nearly 200 percent of the Missouri Plan's total administrative costs. Estimated income to be received from HCFA during 1997 to cover administrative costs for the Missouri Plan's Medicare managed care contract totaled $43.6 million. However, the Missouri Plan's financial report to HCFA showed total administrative costs (including profits and reinsurance expenses) for their entire operations were almost $22.6 million, a difference of $21 million. Medicare's share of administrative costs should have been around $6.5 million (based on the ratio of Medicare beneficiary member months to the Missouri Plan's total member months), a difference of $37 million.

A major part of this $37 million difference was due to the administrative load used by the Missouri Plan. We found that the proposed 1997 Medicare administrative rate of 30.7 percent was based on the administrative load for a group size of one, which was not consistent with the Missouri Plan's Medicare enrollment for 1996. A more accurate reflection of the administrative load would have been 16 percent based on the actuarial projection of the Missouri Plan's size.

The Missouri Plan could not provide documentation for the methodology and actuarial calculations used to support their proposed 1997 administrative rate. In addition, the

Missouri Plan could not determine which fiscal year was used in the development of the administrative rate for the 1997 ACR. As a result, the administrative costs used in the development of the 1997 ACR proposal remain unsupported.

Therefore, we evaluated the 1996 financial records as support for the 1997 ACR proposal. In evaluating actual 1996 costs for the administrative component, we found unsupported costs and costs that would not be allowable if existing Medicare cost reimbursement principles were applied to risk-based managed care organizations (MCOs). Specifically, we noted the following:

- $2,131,749 in unsupported administrative costs for management fees, commissions, administrative expenses, rental/lease costs, interest on long-term debt, and other miscellaneous items. The reasonableness of these costs could not be established.

- $69,594 relating to such items as entertainment, charitable donations, political contributions and lobbying costs, public relations, and other miscellaneous costs that would not have been allowed.

If these costs were included in the proposal, they would have increased the amounts needed for administration, thus reducing any potential savings from the Medicare payment amounts, further impacting the amount available to Medicare beneficiaries for additional benefits or reduced premium amounts.

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

Because of the lack of criteria for inclusion of costs on the ACR proposal, there are no recommendations addressed to the Missouri Plan. This audit is part of a nationwide review of the ACR process and is being performed at several other MCOs. The results of these reviews will be shared with HCFA in the coming months so that appropriate legislative changes can be considered.

The Missouri Plan commented that they believed waiver of premium and profit margin should have been considered in evaluating the administrative load factor. We believe our calculations adequately accounted for both of these factors. The Missouri Plan's response and our comments are discussed in more detail in the body of the report.

INTRODUCTION

Background

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

The MCO calculates its ACR, using as a basis, its commercial rates adjusted to account for differences in cost and use of services between Medicare and non-Medicare enrollees. The development of a base rate is the first step of the process. The base rate is the amount that the MCO will charge its non-Medicare enrollees during the contract period. The next step in the process is to develop adjustments to arrive at the initial rate which is the rate the plan would have charged its commercial members if the commercial package was limited to Medicare coverage. The adjustments eliminate the value of those services not covered by Medicare that were included in the base rate or add value of covered Medicare services not included in the base rate.

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

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

Scope

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

- reviewed applicable laws and regulations;
- discussed with the Missouri Plan officials their ACR proposal process and the calculation of administrative costs in the 1997 ACR proposal;
- reviewed the National Data Reporting Requirements (NDRR) reports;
- selected categories of administrative costs from the Missouri Plan's 1996 general ledger which traditionally have been shown to be problematic areas in the Medicare fee-for-service program.

We judgmentally selected 88 administrative cost items totaling $2,336,434 from the total administrative cost component of the Missouri Plan's 1996 financial statements of $26,377,680. We then reviewed each of these items using the guidelines HCFA applies to cost-based MCOs and Medicare fee-for-service carriers, intermediaries, and providers, since HCFA guidance does not specify which administrative costs may be included in an ACR proposal.

The Missouri Plan could not provide adequate documentation to support the administrative costs used in determining their proposed administrative rate. In addition, the Missouri Plan could not determine which fiscal year was used in the development of the administrative rate used for the 1997 ACR. Because administrative costs used in the development of the 1997 ACR could not be supported, we reviewed administrative costs included in the Missouri Plan's financial records for the 1996 calendar year. We also reviewed the Missouri Plan's financial records for 1997.

Our review was performed in accordance with generally accepted government auditing standards. The objective of our review did not require us to review the internal control structure at the Missouri Plan. Because we reviewed a judgmental sample, our findings cannot be projected to the universe of administrative costs submitted by the Missouri Plan. Field work was performed at the plan office in the Missouri Plan, at the Plan's headquarters office in Kentucky, and at HCFA's headquarters in Baltimore from August 29, 1998 to January 28, 1999.

FINDINGS AND RECOMMENDATIONS

We determined the portion of the Missouri Plan's income from Medicare for administrative activities, based on the 1997 ACR proposal, exceeded the Missouri Plan's actual 1997 administrative expenses for their entire operation by approximately 200 percent. Income received from HCFA during 1997 to cover administrative costs for the Missouri Plan's Medicare MCO contract totaled $43.6 million. However, the Missouri Plan's financial report to HCFA showed administrative costs (including profits and reinsurance expenses) for their entire operations was almost $22.6 million, a difference of $21 million. Medicare's share of administrative costs should have been around $6.5 million (based on the ratio of Medicare beneficiary member months to the Missouri Plan's total member months), a difference of $37.1 million. Much of this difference was due to the Missouri Plan using an improper administrative load factor on its ACR proposal.

In addition, our review of 1996 costs included in the administrative cost component identified unsupported administrative costs, and costs that would not be allowable if existing Medicare regulations were applied to risk-based MCOs.

Income for Administrative Costs Exceeded Actual Expenses

Income received from HCFA during 1997 to cover administrative costs for the Missouri Plan's Medicare MCO contract totaled $43,622,815. However, the Missouri Plan's financial report to HCFA showed administrative costs (including profits and reinsurance expenses) for their entire operations was $22,554,274, a difference of $21,068,541. Thus, based on the 1997 ACR proposal, the Missouri Plan's Medicare income for administrative activities exceeded the Missouri Plan's actual 1997 administrative expenses for their entire operation (both the Medicare and non-Medicare lines of business) by approximately 200 percent. Medicare's share of administrative costs should have been around $6,500,978 (based on the ratio of Medicare beneficiary member months to the Missouri Plan's total member months), a difference of $37,121,837.

A major part of this $37.1 million difference was due to the administrative load used by the Missouri Plan. The Missouri Plan applied the percentage methodology that was used on the non-Medicare side to the Medicare administrative component in their 1997 ACR proposal. The Missouri Plan listed the administrative load for employer groups by number of covered members in the group. The Missouri Plan was not able to provide adequate support for their actuarial calculations supporting the various administrative loads. For ACR proposal purposes, the Missouri Plan considered the Medicare risk product to be an employer group of **one**, consistent with the handling of non-Medicare insurance policies sold to **individuals**. According to the Missouri Plan, the administrative load for a group size of one was 30.7 percent.

The 1996 NDRR and Annual Statement indicated the Missouri Plan had 16,739 members enrolled in the risk plan. According to the ACR proposal, the administrative load for an employer group consisting of 2,000 members plus, was 16 percent. We believe that the 16 percent is a more accurate reflection of the administrative load for the Missouri Plan's Medicare risk plan.

The Missouri Plan stated to us that HCFA knew of and approved the methodology for computing the administrative cost rate. Due to these statements, we asked HCFA officials to comment. They agreed with our conclusion concerning the Missouri Plan's methodology for computing the rate. They agreed with our conclusion concerning the accuracy of the rate. (To explain their current position, after approving the ACR proposal, they indicated that the time available for the approval process had limited its effectiveness.)

Unsupported Administrative Costs

We judgmentally selected 88 administrative cost items totaling $2,336,434 from the total administrative cost component of the Missouri Plan's 1996 financial statements of $26,377,680. Administrative costs totaling $2,131,749 for management fees, commissions, administrative expenses, rental/lease costs, interest on long-term debt, and other miscellaneous items could not be adequately documented or supported. Therefore, the reasonableness of these costs could not be established.

Administrative Costs Not Typically Allowed by Medicare

Administrative costs totaling $69,594 were included in the 1996 financial statements that were not appropriate when compared to the Medicare program's general principle of paying only reasonable costs. The review included the following costs which would not be allowable if existing Medicare regulations were applied to risk-based MCOs:

- **Entertainment** ($18,074) Charges included such items as football, rodeo, and horse show season tickets, an employee retirement party, employee dining at exclusive restaurants, and weekly sales luncheons.

- **Charitable Donations** ($23,860) These costs were for contributions and other payments to charitable and other organizations including $10,000 to a research foundation for sponsoring a candlelight ball and $5,000 for sponsoring a marathon.

- **Political Contributions and Lobbying** ($2,900) Article IX, section D of HCFA's risk contract with the MCO prohibits the use of HCFA funds to influence legislation or appropriations. The contract also refers to section 31.205-22 of the Federal Acquisition Regulations (FAR) which specifies that costs for political activity and lobbying are unallowable.

- **Public Relations** ($23,028) These costs include the cost for giveaways to potential enrollees at enrollment meetings. Section 31.205-1 of the FAR disallows such promotional material.

- **Other Costs** ($1,732) These costs included child and elder care for the benefit of the employee, and travel costs in which meals and lodging exceeded Federal per diem rates.

As previously stated, we could not determine which fiscal year financial data was used to develop the 1997 ACR proposal. However, if these inappropriate costs were included in the proposal, the effect would be to increase the amounts needed for administration, thus reducing any potential savings from the Medicare payment amounts. In addition, this would impact the amount available to Medicare beneficiaries for additional benefits or reduced premium amounts.

Summary

Our review showed that the Missouri Plan's proposed Medicare administrative rate of 30.7 percent was based on the administrative load for a group size which was not consistent with the Missouri Plan's Medicare enrollment for 1996. A more accurate reflection of the administrative load would have been 16 percent. We believe that the use of an inappropriate administrative rate served to increase the ACR. This affected the computation of potential savings from the Medicare payment amounts, and ultimately adversely impacted the amount available to Medicare beneficiaries for additional benefits or reduced premium amounts.

Certain administrative costs, which would not be allowable if existing Medicare regulations were applied to risk-based MCOs, were not eliminated from the administrative cost component of the 1996 financial statements. These administrative costs do not appear to be a reasonable estimate of funds needed as they apply to the ACR process to cover the costs under the managed care contract. We believe that if these administrative costs were included in the Missouri Plan's administrative cost component, it would only serve to increase the ACR. This would affect the computation of potential savings from the Medicare payment amounts, and ultimately adversely impact the amount available to Medicare beneficiaries for additional benefits or reduced premium amounts.

We believe that those costs that would not be allowable under other areas of the Medicare program for the administration of their Medicare contract should be eliminated from the Medicare ACR calculation. We also believe that lobbying costs should be eliminated when constructing the Missouri Plan's ACR proposal.

Recommendations

Because HCFA approved the administrative rate proposed in the ACR proposal, and because of the lack of criteria for inclusion of costs on the ACR proposal, there are no recommendations addressed to the Missouri Plan. This audit is part of a nationwide review of the ACR process and is being performed at several other MCOs. The result of these reviews will be shared with HCFA in the coming months so that appropriate legislative changes can be considered.

The Missouri Plan MCO Comments

The Missouri Plan MCO made the following comments concerning our draft report:

> *"The structure and formulas on the ACR are determined by HCFA. Contractor followed the HCFA specified rules for administrative charges in our submission of the ACR for 1997. Partly because of this formula for administrative costs, the ACR formula allowed a maximum premium of 85.14 on the low plan and 171.70 on the high plan. Contractor waived 85.14 of the low plan premium and 96.70 of the high plan premium resulting in a net charged premium in 1997 of zero for the low plan and 75.00 for the high plan.*
>
> *When this premium waiver is taken into account, the net administrative charge is only 98.16 per member per month (PMPM). This is equivalent to 22.5% of premium. According to this draft OIG audit report, an administrative charge of 16% of premium is a "more accurate reflection of the administrative load." The gap between the 16% charge state by OIG and the 22.5% is 6.5% of premium. Although Contractor does not dispute the 16% determined by the OIG we would like to point out that HCFA regulations for the 1997 ACR allowed the profit margin to be included in the administrative charge. A profit margin of 6.5 % of premium would be reasonable and could be considered the reason for the 6.5 % gap.* (Contractor's actual name replaced with word "Contractor")."

OIG Comments

The Missouri Plan's response indicated that it did "not dispute" our recommended administrative cost rate of 16 percent. However, the Missouri Plan implied that the use of the 30.7 percent proposed administrative cost rate for 1997 was acceptable if the premium waiver was "taken into account". We disagree with this analysis.

Based on the Missouri Plan's method of adjusting for the premium waiver, the net administrative charge of $98.16 would still result with the Medicare 1997 premium payments covering more than 100 percent of the Missouri Plan's total administrative costs.

Regarding other points in the Missouri Plan's response, the Missouri Plan said that our recommended 16 percent administrative cost rate did not include a profit margin. Our rate did include a profit. We obtained the rate, which included a margin for profit, from a document prepared by the Contractor's actuaries.

The Missouri Plan stated they were merely following HCFA rules for computing the administrative cost rate. However, the Missouri Plan did not use an accurate administrative cost rate for 1997 according to their own actuarial assumptions for group consisting of 2,000 members plus.