

**Memorandum**

AUG 23 2001

Date

From

Thomas D. Roslewicz
Thomas D. Roslewicz
Deputy Inspector General
for Audit Services

Subject

To

Review of the Administrative Cost Component of the Adjusted Community Rate Proposals for a Pennsylvania Plan (A-14-00-00209)

Neil Donovan
Director, Audit Liaison Staff
Centers for Medicare and Medicaid Services

Attached are two copies of our final report entitled, "Review of the Administrative Cost Component of the Adjusted Community Rate Proposals for a Pennsylvania Plan."

We suggest that you share this report with the Centers for Medicare and Medicaid Services (CMS)¹ components involved in the Medicare managed care organization (MCO) operations, particularly the Center for Health Plans and Policy. The report presents the results of our review of the administrative cost component of the adjusted community rate (ACR) proposals submitted to CMS for the contract year (CY) 2000 by a Pennsylvania Medicare+Choice (M+C) managed care contractor (the Plan). The objective of our review was to examine the Plan's administrative cost component of the CY 2000 ACRs and assess whether the costs were appropriate when considered in light of the Medicare program's general principle of paying only reasonable costs. This audit is part of a nationwide review of administrative costs included in the ACR proposals.

In an Office of Inspector General (OIG) audit report issued in January 2000,² we identified \$66.3 million of administrative costs that were included in the ACR proposals 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 CMS 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 report, CMS did not concur with the recommendation. The CMS noted that it had recently revised the ACR methodology and that the new procedures would be reviewed to ensure the effectiveness of reducing the administrative burdens on the MCO.

¹ Formerly known as the Health Care Financing Administration.

² Review 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, CMS requested that OIG examine other MCOs to determine if administrative costs, that would be deemed unallowable under Medicare's reasonable cost principles, were included in the computation of the ACR proposals under the revised format. This review is in response to CMS' request.

The ACR process was designed for Medicare+Choice organizations (M+CO) to present to CMS their estimate of the funds needed to cover the costs of providing the Medicare package of covered services to enrolled Medicare beneficiaries. An M+CO's estimate includes medical and administrative costs for the upcoming year and must be supported by its operating experiences related to utilization and expenses. Beginning in CY 2000, M+COs were required to use their actual Medicare costs (base year) in developing their ACRs. For CY 2000, the base year was 1998.

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 managed care organizations that contract with CMS 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 M+C contracts.

Our review showed that if Part 31 of the Federal Acquisition Regulations³ (FAR) Contract Cost Principles were applied to M+COs, \$37,649 of the Plan's administrative costs should not have been included when computing the ACRs. These potential disallowed administrative costs included donations, gifts, political contributions, memberships, sponsorships, entertainment, parties, alcoholic beverages, brokers commissions, and promotional giveaways. The effect of including these costs in the Plan's ACRs was to increase the amounts needed for administration, thus reducing any potential excess from the Medicare payment amounts. Therefore, this methodology impacts the amount available to Medicare beneficiaries for additional benefits or reduced premium amounts. Using the resultant per member per month rate reduction computed by eliminating these costs from the three ACRs, we estimate that for CY 2000, beneficiaries paid higher premiums/copayments than necessary or were not offered additional benefits totaling \$8,996.

Because of a lack of criteria for inclusion of administrative costs on the ACR proposal, there are no recommendations addressed to the Plan. Instead, based on the results of our nationwide review, we will be making recommendations to CMS concerning the ACR process.

³ The 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.

In other matters, MCO cost contract criteria require that indirect costs be apportioned on the basis of a ratio of Medicare enrollment to total enrollment. Several other M+COs that we reviewed apportioned its indirect costs (mostly administrative expenses) on the basis of revenue rather than enrollment, usually resulting in greater administrative costs being allocated to Medicare. However, the Plan apportioned their administrative expenses on the basis of Medicare enrollment to total enrollment. We believe that this was an appropriate allocation as indicated by the requirement that cost MCOs follow this particular methodology. Therefore, we feel that other M+COs could be required to follow this allocation methodology.

While this review examined only one plan, we believe that our results of this Plan, and others previously issued, continue to highlight a problem – administrative costs deemed unallowable under Medicare’s reasonable cost principles are being paid with Medicare funds. We are continuing our reviews at other M+COs. The results of these reviews will be shared with CMS in the coming months so that appropriate legislative changes can be considered.

In response to our draft report, the Plan stated it understands that it is necessary to have an equitable and adequate allocation of administrative costs so that no one product will indirectly subsidize another. The Plan uses the standard of selecting a reasonable basis to allocate the total administrative costs of each cost center. The Plan also stated that it strives to have an equitable pricing allocation of administrative costs while complying with all laws, and works to maintain a balance to be consistent with the industry, the laws, and to best serve their customers.

We believe the use of Medicare trust funds to pay monthly M+CO capitation payments should not exceed an amount that would be allowed using existing regulations applied in other areas of the Medicare program that include prudent and cost-conscious management concepts. Notwithstanding the lack of specific guidelines for M+CO contracts, we believe that those costs that would not be allowable under other areas of the Medicare program should be eliminated from the ACR calculation.

Please advise us within 60 days on actions taken or planned on our recommendations. 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-14-00-00209 in all correspondence relating to this report.

Attachments

Department of Health and Human Services

**OFFICE OF
INSPECTOR GENERAL**

**REVIEW OF THE ADMINISTRATIVE
COST COMPONENT OF THE ADJUSTED
COMMUNITY RATE PROPOSALS FOR A
PENNSYLVANIA PLAN**



**AUGUST 2001
A-14-00-00209**

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Date **AUG 23 2001**
From *[Signature]* Thomas D. Roslewicz
Deputy Inspector General
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To Review of the Administrative Cost Component of the Adjusted Community Rate Proposals for a Pennsylvania Plan (A-14-00-00209)

Neil Donovan
Director, Audit Liaison Staff
Centers for Medicare and Medicaid Services

This final report presents the results of our review of the administrative cost component of the adjusted community rate (ACR) proposals submitted to the Centers for Medicare and Medicaid Services (CMS)¹ for the contract year (CY) 2000 by a Pennsylvania Medicare+Choice (M+C) managed care contractor (the Plan). We suggest that you distribute this report to CMS components involved in the Medicare managed care organization (MCO) operations, particularly the Center for Health Plans and Policy. This audit is part of a nationwide review of administrative costs included in the ACR proposals.

The objective of our review was to examine the Plan's administrative cost component of the CY 2000 ACRs and assess whether the costs were appropriate when considered in light of the Medicare program's general principle of paying only reasonable costs.

In an Office of Inspector General (OIG) audit report issued in January 2000,² we identified \$66.3 million of administrative costs that were included in the ACR proposals 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 CMS 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 report, CMS did not concur with the recommendation. The CMS noted that it had recently revised the ACR methodology and that the new procedures would 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, CMS requested that OIG examine other MCOs to determine if administrative costs, that would be deemed

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The ACR process was designed for Medicare+Choice organizations (M+CO) to present to CMS their estimate of the funds needed to cover the costs of providing the Medicare package of covered services to enrolled Medicare beneficiaries. An M+CO's estimate includes medical and administrative costs for the upcoming year and must be supported by its operating experiences related to utilization and expenses. Beginning in CY 2000, M+COs were required to use their actual Medicare costs (base year) in developing their ACRs. For CY 2000, the base year was 1998.

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 managed care organizations that contract with CMS 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 M+C contracts.

Our review showed that if Part 31 of the Federal Acquisition Regulations³ (FAR) Contract Cost Principles were applied to M+COs, \$37,649 of the Plan's administrative costs should not have been included when computing the ACRs. These potential disallowed administrative costs included donations, gifts, political contributions, memberships, sponsorships, entertainment, parties, alcoholic beverages, brokers commissions, and promotional giveaways. The effect of including these costs in the Plan's ACRs was to increase the amounts needed for administration, thus reducing any potential excess from the Medicare payment amounts. Therefore, this methodology impacts the amount available to Medicare beneficiaries for additional benefits or reduced premium amounts. Using the resultant per member per month (PMPM) rate reduction computed by eliminating these costs from the three ACRs, we estimate that for CY 2000, beneficiaries paid higher premiums/copayments than necessary or were not offered additional benefits totaling \$8,996.

Because of a lack of criteria for inclusion of administrative costs on the ACR proposal, there are no recommendations addressed to the Plan. Instead, based on the results of our nationwide review, we will be making recommendations to CMS concerning the ACR process.

In other matters, MCO cost contract criteria require that indirect costs be apportioned on the basis of a ratio of Medicare enrollment to total enrollment. Several other M+COs that we

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On July 20, 2001, the Plan responded to a draft of this report. The Plan stated that it understands that it is necessary to have an equitable and adequate allocation of administrative costs so that no one product will indirectly subsidize another. The Plan uses the standard of selecting a reasonable basis to allocate the total administrative costs of each cost center. The Plan stated that it strives to have an equitable pricing allocation of administrative costs while complying with all laws. The Plan works to maintain a balance to be consistent with the industry, the laws, and to best serve their customers.

INTRODUCTION

BACKGROUND

Medicare Overview

Under Title XVIII of the Social Security Act, the Medicare program provides health insurance to 39 million Americans age 65 and over, those who have permanent kidney failure, and certain people with disabilities. Within the Department of Health and Human Services, the Medicare program is administered by CMS.

Medicare includes two related health insurance programs, hospital insurance, or Part A, and supplementary medical insurance, or Part B. Part A includes inpatient hospital, skilled nursing, rehabilitation, home health, and hospice services. Part B includes physician and outpatient hospital services and durable medical equipment.

The Balanced Budget Act of 1997 (P.L. 105-33) established Part C of the Medicare M+C program. Starting in November 1999, the M+C program began offering Medicare beneficiaries a variety of health delivery models, including M+COs such as health maintenance organizations, preferred provider organizations, and provider sponsored organizations.

Adjusted Community Rate Proposal

The M+COs are required by section 1854 of the Social Security Act to compute an ACR proposal and submit it to CMS prior to the beginning of the M+CO's contract period. The ACR proposal is prepared by an M+CO to justify its pricing structure for a benefit package

offered to beneficiaries. The ACR proposal itemizes the costs for the benefit package provided by the M+CO, including administrative costs. The ACR requirement is designed to ensure that Medicare beneficiaries are not overcharged for the benefit package being offered.

The CMS introduced revised instructions for completing the ACR in February 1998. One ACR proposal must be submitted for each health plan the organization intends to market. The ACR incorporates the revenue requirements of all its plans. The CMS believes that the revised ACR will more accurately reflect the actual costs in pricing a benefit package. The CY 2000 ACRs were based on 1998 actual costs for both non-Medicare and Medicare enrollees.

SCOPE

The objective of our review was to examine the administrative cost component of the CY 2000 ACRs submitted by the Plan and assess whether the costs were appropriate under Medicare's principle of reasonableness. Our review concentrated on the administrative cost component of the Plan's ACRs for the CY 2000. We used the 1998 (base year) financial records as support for the CY 2000 ACR proposals.

To accomplish our objective, we:

- reviewed applicable laws and regulations;
- discussed with the Plan officials their ACR process and the calculation of administrative costs in the CY 2000 ACRs; and
- selected categories of administrative costs from the Plan's 1998 general ledger. The selected cost categories have historically been problematic areas in the Medicare fee-for-service program.

We judgmentally selected approximately 243 administrative cost items from the general ledger totaling \$2,452,942 (\$242,997, Medicare share). Administrative expenses for 1998 (base year) for the entire Plan were approximately \$111 million. We then reviewed each of these items using the guidelines CMS applies to cost MCOs and Medicare fee-for-service carriers, intermediaries, and providers, since CMS guidance does not specify which administrative costs may be included in an ACR.

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 of the Plan. Because we reviewed a judgmental sample, our findings cannot be projected to the universe of administrative costs submitted by the Plan. Our work was performed at the Plan's headquarters and CMS headquarters in Baltimore, Maryland.

RESULTS OF REVIEW

Of the \$242,997 Medicare administrative costs selected for review, we identified costs of \$37,649 recorded on the Plan's books which were not appropriate when compared to the Medicare program's general principle of paying only reasonable costs. We reviewed each of the selected costs using the guidelines CMS applies to cost MCOs and Medicare fee-for-service carriers, intermediaries, and providers. If reasonable cost principles were applied to M+COs, we believe the costs noted below and recorded in the Plan's books would not be allowable.

These costs represent expenditures that we feel were not reasonable or would have been disallowed under Medicare fee-for-service.

Promotional Giveaways - \$22,092--Charges for promotional giveaway items such as logo pens (\$7,008), pharmacy bags (\$15,000), and golf packets (\$84).

Entertainment/Alcoholic Beverages/Parties/Gifts - \$6,429--Entertainment amounts included: (1) \$2,802 for tickets to professional sporting events, including \$1,955 for a lounge box at a major sports complex; (2) \$49 in membership dues; (3) \$17 for alcoholic beverages at professional sporting events; (4) \$670 for gifts, including \$222 in Disney trips given to employees for performance achievements and \$7 for wine gift baskets; (5) \$2,891 for meals and entertainment, including \$404 for golf outings, \$595 for three holiday parties, and \$215 for banquets and luncheons which included approximately \$43 in alcoholic beverages.

Donations/Contributions/Sponsorships - \$2,370--These costs included the following: (1) \$500 for golf sponsorships; (2) \$1,034 for charitable contributions; (3) \$226 in contributions, including a \$205 contribution to a Founder's Wall; and (4) \$610 in sponsorships, including \$110 for sponsorship of a women's symposium.

Political Contributions - \$20--Cost of two tables for a Congressman's fund raiser.

Broker Commissions - \$6,738--Service fees paid to agents for soliciting and securing enrollees in the M+CO for its commercial line of business.

CONCLUSIONS

The effect of including these costs in the Plan's ACRs was to increase administrative costs for CY 2000. Using the resultant PMPM rate reduction computed by eliminating these costs from the Plan's three ACRs, we estimate that for CY 2000 beneficiaries paid higher premiums/copayments than necessary or were not offered additional benefits totaling \$8,996.

Our review showed that certain costs included in the Plan's administrative cost component of the ACRs were inconsistent with the Medicare program's general principle of paying only reasonable costs. While we recognize that, unlike other areas of the Medicare program, there is currently no statutory or regulatory authority governing the allowability of administrative costs in the ACR process, we question the equity of including costs in the ACR process that are unallowable in other facets of the Medicare program.

RECOMMENDATIONS

Because the elimination of unallowable administrative costs from the ACR computation is not currently a requirement applicable to M+COs, we have made no recommendations to the Plan. The results of this review, along with similar reviews at other M+COs, will be shared with CMS so that appropriate legislative changes can be considered.

OTHER MATTERS

The MCO cost contract criteria requires that indirect costs be apportioned on the basis of a ratio of Medicare enrollment to total enrollment. Several other M+COs that we reviewed apportioned its indirect costs (mostly administrative expenses) on the basis of revenue rather than enrollment, usually resulting in greater administrative costs being allocated to Medicare. However, the Plan apportioned their administrative expenses on the basis of Medicare enrollment to total enrollment. We believe that this was an appropriate allocation as indicated by the requirement that cost MCOs follow this particular methodology. Therefore, we feel that other M+COs could be required to follow this allocation methodology.

The Pennsylvania Plan's Comments

The Plan stated that it understands that it is necessary to have an equitable and adequate allocation of administrative costs so that no one product will indirectly subsidize another. The Plan uses the standard of selecting a reasonable basis to allocate the total administrative costs of each cost center. The Plan stated that it strives to have an equitable pricing allocation of administrative costs while complying with all laws. The Plan works to maintain a balance to be consistent with the industry, the laws, and to best serve their customers.

The full text of the Plan's comments are included as an Attachment to this report. Names, addresses, and other material in the response that would identify the Plan have been excluded to protect the Plan's anonymity.

OIG's Response

We believe the use of Medicare trust funds to pay monthly M+CO capitation payments should not exceed an amount that would be allowed using existing regulations applied in

other areas of the Medicare program that include prudent and cost-conscious management concepts. Notwithstanding the lack of specific guidelines for M+CO contracts, we believe that those costs that would not be allowable under other areas of the Medicare program should be eliminated from the Medicare ACR calculation.

OIG NOTE: All Information Identifying The Name and Address Of
The Pennsylvania Plan Was Deleted From The M+COs
Response.

July 20, 2001

George M. Reeb
Assistant Inspector General
for Health Care Financing Audits
Office of Inspector General
Department of Health & Human Services
Washington D.C., 20201

Dear Mr. Reeb:

We are in receipt of the draft report entitled "Review of the Administrative Cost Component of the Adjusted Community Rate Proposals for a Pennsylvania Plan" and greatly appreciate the opportunity to review and comment prior to your final submission to HCFA.

 maintains many cost centers to which all administrative expenditures are coded. These costs are reported in aggregate on our financial statements and are not reported separately by line of business. Cost center expenses are allocated to lines of business as we price each product we offer.

We recognize it is important to have an equitable and adequate allocation of administrative costs so that no one product will indirectly subsidize another. We also recognize that, due to laws and regulations associated with different customers, certain expenses cannot be allocated to lines of business such as a medicare cost contract. For this reason, great effort goes into the decisions on which to allocate the costs within each cost center.

As is standard in the industry, historical costs for each cost center are allocated to line of business in order to understand the administrative cost structure to price each product. A reasonable basis is selected to allocate the total costs of each cost center. Because, as you recognize in your report, the law doesn't require a "Medicare cost type approach" to allocation, we used our standard.

[REDACTED] strives to have an equitable pricing allocation of all administrative costs while complying with all laws. There are practical constraints for which the monitoring of expenditures must be limited. We work to maintain a balance of these contradicting forces so to be consistent with the industry, the laws and to best serve our customers.

Thank you, again, for the opportunity to comment on the draft report provided. If you would like further information or discussion, please contact me.

Sincerely,