



Memorandum

Date AUG 25 1998

From June Gibbs Brown
Inspector General *June G Brown*

Subject Review of the Administrative Cost Component of the Adjusted Community Rate Proposal
(A- 14-97-00205)

To Nancy-Ann Min DeParle
Administrator
Health Care Financing Administration

The attached final report is part of our overall review of the administrative costs planned and incurred by managed care organizations (MCO) relative to their operating a Medicare risk managed care plan. The MCOs, in general, have viewed our audits of their use of administrative funds to be a sensitive matter. Because of this and the fact the Medicare managed care program is essentially a concentrated Health Care Financing Administration (HCFA) central office operation, we want to share these individual MCO reports directly with you.

On July 27, 1998 we issued a report entitled, "Administrative Costs Submitted by Risk-Based Health Maintenance Organizations on the Adjusted Community Rate Proposals Are Highly Inflated" (A- 14-97-00202). This report examined the allocation of administrative costs on the Adjusted Community Rate (ACR) proposals for contract years 1994 through 1996. We concluded that the methodology which allowed MCOs to apportion administrative costs to Medicare was flawed and that Medicare covered a disproportionate amount of the MCOs administrative costs. We believe the attached report on selected administrative costs of a Medicare managed care risk contractor for the Medicare contract year of 1997 provides some insight on where some of the excess administrative costs may be used.

The ACR process is designed for MCOs to present to HCFA their estimate of the funds needed to cover the costs (both medical and administrative) of providing the Medicare package of services to any enrolled Medicare beneficiary. The ACR proposal is integral to pricing an MCO benefit package, computing savings (if any) from Medicare payment amounts, and determining additional benefits that will be provided beneficiaries or reduced premiums that could be charged to the Medicare enrollees. Included as MCO's administrative costs are the non-medical costs of compensation, interest expenses, occupancy (costs), depreciation, marketing expenses, reinsurance expenses, claims processing costs, 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 MCO, and assess whether the costs for judgmentally selected administrative cost items were appropriate when considered in light of the Medicare program's general principle of paying only reasonable costs. Because of the limited scope of our review, our results cannot be considered representative of the universe of administrative costs submitted by the MCO.

Our review of selected categories of administrative costs totaling \$1,962,940 showed \$708,337 (approximately 36 percent) would, in our opinion, be considered improper and unnecessary if they were submitted by MCOs under cost contracts or if submitted by health care providers paid under a Medicare cost reimbursement system. We believe these administrative costs should not be included in the ACR proposal since this only serves to increase the ACR. An unjustifiable 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.

Although we recommended in a draft report to the MCO that they screen their administrative costs and eliminate from the Medicare ACR calculation those administrative costs that would not be allowable under other areas of the Medicare program, there does not appear to be a legal basis to require these adjustments. However, voluntary efforts on the part of the MCOs will help assure the future solvency of the Medicare trust funds until appropriate legislative action is considered. In response to our draft report, the MCO officials did not dispute the facts in our report.

While this review examined only one plan, we believe that our results 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- 14-97-00205 in all correspondence relating to this report.

Attachment

Department of Health and Human Services

**OFFICE OF
INSPECTOR GENERAL**

**REVIEW OF THE
ADMINISTRATIVE COST COMPONENT
OF THE
ADJUSTED COMMUNITY RATE
PROPOSAL**



**JUNE GIBBS BROWN
Inspector General**

**AUGUST 1998
A-14-97-00205**

**Memorandum**

AUG 25 1998

Date

June Gibbs Brown
Inspector General *June G. Brown*

From

Subject Review of the Administrative Cost Component of the Adjusted Community Rate Proposal
(A- 14-97-00205)

To

Nancy-Ann Min DeParle
Administrator
Health Care Financing Administration

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

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

We found certain administrative costs, that would not be allowable if existing Medicare regulations were applied to risk-based MCOs, were not eliminated from the plan's ACR proposal. These administrative costs were questionable when considered in light of Medicare's reimbursement principle of reasonableness. We also questioned those costs relating to political contributions that were not excluded from the ACR proposal despite the article 9, section D provision of the risk contract prohibiting the use of HCFA funds to influence legislation or appropriations.

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.

Our review of selected categories of the plan's administrative costs totaling \$1,962,940 showed costs of \$708,337 (approximately 36 percent) which we believe increased the funds needed to cover the costs under the risk-contract. These were:

- ▶ \$30,607 in political contributions that were questionable under Medicare's MCO contract,
- ▶ \$677,730 in costs relating to travel, meetings, and charitable contributions that would not be allowable if cost reimbursement principles were in effect.

The effect of including these costs in the plan's ACR proposal is to increase the amounts needed for administration, thus reducing any potential savings from the Medicare payment amounts. In addition, this methodology impacts the amount available to Medicare beneficiaries for additional benefits or reduced premium amounts.

Currently there is not a statutory basis for requiring plans to eliminate these costs from their ACR calculation. However, we believe the use of Medicare trust funds in paying monthly MCO capitation payments should not exceed an amount that would be incurred using existing regulations applied in other areas of the Medicare program that include prudent and cost-conscious management concepts. Plan officials did not dispute the facts in our report.

While this review examined only one plan, we believe that our results 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.

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

After the calculation of the initial rate, the rate is multiplied by utilization factors to reflect differences between Medicare members and non-Medicare members with regard to volume, intensity, and complexity of services. This last calculation results in the ACR. If the average Medicare payment amount is greater than the ACR, a savings is noted. During the period of our audit, 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 the MCO 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. This information will be used as the basis for calculating the amount HCFA will allow an MCO to charge Medicare enrollees for a benefit package.

SCOPE

The objective of our review was to examine the administrative cost component of the ACR proposal submitted by the plan, and assess whether the costs were appropriate under Medicare's principle of reasonableness. Our review concentrated on the administrative cost component of the plan's ACR proposal for the 1997 Medicare contract year. We used the 1996 financial records as support for the 1997 ACR proposal. The administrative costs included the non-medical costs associated with: facilities, marketing, taxes, depreciation, reinsurance, interest, non-medical compensation, and profit. However, most of our selections were from four categories in the general ledger: travel and meetings, miscellaneous, charitable contributions, and political contributions.

We judgmentally selected approximately 120 administrative cost items from the general ledger totaling \$1,962,940. The total plan's administrative expenses for 1996 were approximately \$59 million. Because of the limited scope of our review, our results cannot be considered representative of the universe of administrative costs submitted by the plan.

To accomplish our objective, we:

- ▶ reviewed applicable laws and regulations;
- ▶ discussed with plan officials their ACR proposal process and how their administrative costs were derived; and
- ▶ selected categories of administrative costs which traditionally have been shown to be problematic areas in the Medicare fee-for-service program.

Our review was performed in accordance with generally accepted government auditing standards. The objective of our review did not require us to review the internal control structure at the plan. Our work was performed at the plan's headquarters and HCFA headquarters in Baltimore, Maryland between August 1997 and February 1998.

FINDINGS AND RECOMMENDATIONS

Political Contributions

We examined those administrative costs recorded as political contributions. According to article 9, section D of the MCO contract, there was a prohibition against the use of HCFA funds to influence legislation or appropriations. This contract provision incorporated section 3 1.205-22 of the Federal Acquisition Regulation (FAR) which defined unallowable

“Lobbying and political activity costs.” The FAR stated that costs incurred for contributing to a political party, campaign, or political action committee are unallowable.

We identified \$30,607 recorded as contributions that were made directly to a politician or to a political association and therefore should have been eliminated by the plan when computing the ACR proposal.

Other Administrative Costs

We examined administrative costs associated with travel and meetings and identified \$652,810 in costs that cause us concern because these costs would be unallowable under both an MCO cost reimbursement contract and a Medicare fee-for-service reimbursement arrangement. These costs related to expenses incurred for the benefit of the employees and for meetings at offsite locations for managers, supervisors and/or board members. Examples of some of these costs were:

- \$108,058 for an annual awards banquet for the employees,
- \$190,417 for a sales award meeting in Puerto Rico for top producing sales personnel,
- \$84,080 for a business planning meeting at a resort for senior staff and board members,
- \$16,585 for a holiday party for managers and,
- \$25,087 for a company picnic for employees.

Other administrative costs reported as charitable contributions totaling \$24,920 would also be identified as unallowable under Medicare cost reimbursement principles. We found charitable contributions included \$15,850 for various golf tournament sponsorships and \$2,750 claimed for the purchase of tickets to a charity ball.

Summary

Our review showed that certain administrative costs, which would not be allowable if existing Medicare regulations were applied to risk-based MCOs, were not eliminated from the ACR proposal. These administrative costs were questioned because they did not appear to be a reasonable estimate of funds needed as they apply to the ACR process to cover the costs under the managed care contract. We question whether many of these administrative

costs should be included in the plan's ACR proposal, since this only serves to increase the ACR. This affects the computation of potential savings from the Medicare payment amounts, and ultimately adversely impacts the amount available to Medicare beneficiaries for additional benefits or reduced premium amounts. However, we recognize that presently there is no statutory or regulatory authority governing allowability of costs in the ACR process, unlike other areas of the Medicare program. For example, regulations covering MCOs that contract with HCFA on a cost reimbursement basis provide specific parameters delineating allowable administrative costs for enrollment and marketing. These same guidelines, however, are not used in administering the MCO risk contracts.

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