

**Memorandum**

Date MAY 7 1999

From June Gibbs Brown
Inspector General *June G. Brown*

Subject Review of the 1997 Adjusted Community Rate Proposal for a California Risk-Based Managed Care Organization (A-09-98-00093)

To Nancy-Ann Min DeParle
Administrator
Health Care Financing Administration

The attached final report is one in a series of reports that is part of our overall review of the administrative costs planned and incurred by managed care organizations (MCOs) relative to their operating a Medicare risk managed care plan. 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.

In a previous audit (A-14-97-00202), we examined on a national basis 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 MCO's administrative costs. The attached report on selected administrative costs of a Medicare managed care risk contractor located in California (the Plan) 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 an 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 to beneficiaries or reduced premiums that could be charged to the Medicare enrollees. Included as MCOs' administrative costs are the non-medical costs of compensation, interest, occupancy, depreciation, reinsurance, contractual obligations, taxes, reserves, and other costs incurred for the general management and administration of the business unit.

The objective of this review was to examine the administrative cost component of the 1997 ACR proposal submitted by the 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 considered representative of the universe of administrative costs submitted by the Plan.

We found that the Medicare administrative cost component on the Plan's 1997 ACR proposal exceeded the Plan's actual Medicare administrative expenditures by approximately \$20.1 million. This resulted from the Plan's use of its non-Medicare (i.e., commercial line of business) administrative rate in accordance with HCFA requirements.

Of the Plan's \$70 million total administrative expenses, we reviewed about \$8.8 million in costs from selected categories which traditionally have been shown to be problematic areas in the Medicare fee-for-service program. We found \$4.2 million of administrative costs allocated to the Plan's commercial line of business, that were included in its 1997 ACR proposal, which would not be allowable if existing Medicare regulations, applicable to other parts of the Medicare program, were applied to risk-based MCOs. The unallowable costs included entertainment; charitable contributions; lobbying; and related-party, reinsurance, and other costs for which the Plan did not provide supporting documentation. While these administrative costs were allocated to the commercial, not the Medicare, line of business in Fiscal Year 1996, they were used to develop the Plan's 1997 ACR proposal. However, beginning with Medicare contract year 2000, the costs allocated to the Medicare line of business will become an important factor in the ACR process.

Of the \$8.8 million in administrative costs reviewed, we found an additional \$905,787 allocated to the Plan's Medicare line of business which, if included in the Plan's future ACR proposals, would not be allowable if existing Medicare regulations, applicable to other parts of the Medicare program, were applied to risk-based MCOs. These unallowable costs were similar to those we found allocated to the Plan's commercial line of business.

The effect of including costs in the ACR that exceed actual costs or would be unallowable under Medicare's reimbursement principle of reasonableness serves to increase administrative costs thereby reducing any potential savings from the Medicare payment amounts. In addition, this impacts the amount available to the Plan's Medicare beneficiaries for additional benefits or for reduction in premium amounts.

Presently, there is no statutory or regulatory authority governing allowability of costs in the ACR process for risk-based 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. Thus, as part of this audit, no recommendations were addressed to the Plan.

In response to our draft report, the Plan generally agreed with our findings and conclusion. The Plan disagreed that lobbying and political activity costs were inappropriately included in the 1997 ACR and stated that there are no regulations or ACR instructions which exclude

these costs. The text of the Plan's comments can be found in the APPENDIX to the attached report.

While this review examined only one MCO, we believe that the results of our audit of this MCO's 1997 ACR and others previously issued highlight a significant problem. Additional audits are underway and preliminary results show there are similar findings in those reviews. 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-09-98-00093 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
CALIFORNIA RISK-BASED MANAGED
CARE ORGANIZATION**



**JUNE GIBBS BROWN
Inspector General**

**MAY 1999
A-09-98-00093**

**Memorandum**

Date MAY 7 1999

From June Gibbs Brown
Inspector General *June G Brown*

Subject Review of the 1997 Adjusted Community Rate Proposal for a California Risk-Based
Managed Care Organization (A-09-98-00093)

To Nancy-Ann Min DeParle
Administrator
Health Care Financing Administration

This final report presents the results of our review of the administrative cost component of the adjusted community rate (ACR) proposal submitted to the Health Care Financing Administration (HCFA) by a California Managed Care Organization (the Plan) for the 1997 Medicare contract year ended December 31, 1997. This audit is part of a nationwide review of the ACR process.

EXECUTIVE SUMMARY**OBJECTIVE**

The objective of the review was to examine the administrative cost component of the ACR proposal and assess whether the costs were appropriate when compared to the Medicare program's general principle of paying only reasonable costs.

BACKGROUND

The Medicare ACR process is designed for risk-based managed care organizations (MCOs) to present to HCFA their estimate of the funds needed to cover the costs of providing the Medicare package of covered services to an enrolled Medicare beneficiary. An MCO's anticipated or budgeted funds are calculated to cover medical and administrative costs of the Plan for the upcoming year and must be supported by the individual MCO's operating experiences related to utilization and expenses.

SUMMARY OF FINDINGS AND CONCLUSION

The 1997 ACR proposal included \$20.1 million in administrative costs that exceeded the Plan's actual Medicare administrative expenses. This resulted from the Plan's use of its non-Medicare (i.e., commercial line of business) administrative rate in accordance with HCFA requirements.

We also found that, based on our review of about \$5.7 million in selected general and administrative costs allocated to the Plan's commercial line of business, the administrative cost component of the Plan's 1997 ACR included:

- \$389,506 relating to such items as entertainment, charitable contributions, gifts, and other costs that would not have been allowed if Medicare cost reimbursement principles were in effect;
- \$51,568 in lobbying costs which are prohibited under the Plan's Medicare risk contract; and
- \$3.8 million in related-party transactions, reinsurance, and other costs for which the Plan did not provide supporting documentation.

Administrative costs allocated to the commercial, not the Medicare, line of business in Fiscal Year (FY) 1996 were used to develop the Plan's 1997 ACR. However, beginning with Medicare contract year 2000, the costs allocated to the Medicare line of business will become an important factor in the ACR process of determining the estimated funds needed to cover the costs of providing the package of covered services to an enrolled Medicare beneficiary.

Based on a review of about \$3.1 million in selected general and administrative costs allocated to the Plan's Medicare line of business in FY 1996, we found:

- \$425,335 relating to such items as entertainment, charitable contributions, gifts, and other costs that would not have been allowed if Medicare cost reimbursement principles were in effect;
- \$41,288 in lobbying costs which are prohibited under the Plan's Medicare risk contract; and
- \$439,164 in reinsurance and other costs for which the Plan did not provide supporting documentation.

The effect of including costs in the ACR proposal that exceed actual costs or would be unallowable under Medicare's principle of reasonableness serves to increase administrative costs thereby reducing any potential savings from the Medicare payment amounts. In addition, this methodology impacts the amount available to Medicare beneficiaries for additional benefits or for reduction in 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. Thus, no recommendations were addressed to the Plan. Instead, we are sharing the results of this review with HCFA so that appropriate legislative changes can be considered.

In response to our draft report, the Plan agreed with our findings and conclusion with a few exceptions. The Plan disagreed that lobbying and political activity costs were inappropriately included in the 1997 ACR. The Plan stated that: (1) there is no directive in the regulations or HCFA's ACR instructions to exclude these costs, and (2) the inclusion of such costs in the base rate of the ACR calculation would be irrelevant to the overall calculation based on the amount of the premium waived in the Plan's ACR proposal.

The Plan noted in its response that the inability to provide supporting documentation for related-party transactions and reinsurance was because the former parent company did not furnish the documents requested for the audit. The Plan also commented on the recent and proposed revisions to the ACR methodology.

We disagree with the Plan's inclusion of lobbying and political activity costs in the 1997 ACR based on the terms of the managed care contract between the Plan and the Department of Health and Human Services (HHS) which prohibits use of Medicare funds for this activity. We also disagree that the costs associated with these activities are irrelevant to the Medicare premium calculation when compared to the amount of the premium waived in the Plan's ACR proposal. The effect of including costs deemed unallowable or unreasonable, regardless of their significance, in the ACR calculation overstates the costs of the Medicare product, thereby reducing any potential savings, reduction in premium amounts, or limiting the additional benefits the Plan can offer its Medicare beneficiaries.

We have summarized the Plan's comments and Office of Inspector General's response to those comments at the end of the FINDINGS AND CONCLUSION section of the report. We have modified the final report to take into consideration the Plan's comments as well as updating the Plan's actual 1997 Medicare administrative costs and these costs as a percentage of its total Medicare costs. The text of the Plan's comments can be found in the APPENDIX to this report.

INTRODUCTION

BACKGROUND

Medicare payments to risk-based MCOs are based on a prepaid capitation rate with no retroactive adjustments. This rate reflects 95 percent of the estimated costs that would have been incurred by Medicare on behalf of enrollees of the MCO if they received their covered services under Medicare's fee-for-service reimbursement method. Risk-based contractors

are required by section 1876 of the Social Security Act to prepare an ACR proposal and submit it to HCFA prior to the beginning of an MCO's contract period. The HCFA encourages MCOs to support their ACR proposals 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 a Medicare package of covered services to an enrolled Medicare beneficiary.

Prior to the 2000 Medicare contract year, MCOs calculated ACRs based on their commercial rates adjusted to account for differences in cost and use of services between Medicare and commercial enrollees. The development of a base rate was the first step of the process. The base rate was the amount that MCOs would charge their non-Medicare enrollees during the contract period. With regard to the inclusion of costs in the base rate, according to the HCFA HMO Manual, all assumptions, cost data, revenue requirements, and any 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.

After determining the base rate, the next step in the ACR process was to develop adjustments to arrive at the initial rate. The initial rate was the rate MCOs would have charged their commercial members if the commercial package was limited to Medicare coverage. The adjustments eliminated the value of those services not covered by Medicare that were included in the base rate or added the value of covered Medicare services not included in the base rate.

After the calculation of the initial rate, the rate was 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 resulted in the ACR. If the average Medicare payment amount was greater than the ACR, a savings was noted. The MCOs were required to use this savings to either improve their benefit packages to the Medicare enrollees, reduce each Medicare enrollee's premium, or contribute to a benefit stabilization fund.

To-date, risk-based MCOs are not prohibited from including costs for entertainment, charitable contributions, and gifts in their administrative rates due to a lack of 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.

The accumulation of costs, specifically those related to an MCO's Medicare package of services, will be a major factor in developing future ACR proposals beginning with the 2000 Medicare contract year. The Balanced Budget Act of 1997, which authorized the Medicare+Choice program, requires that the administrative cost component of the ACR be

determined using a relative cost ratio based on actual administrative costs incurred for Medicare beneficiaries in a base year to actual administrative costs incurred for non-Medicare enrollees in the same base year. The HCFA will use these cost ratios to determine the estimated funds needed to cover the cost of providing the package of covered services to an enrolled Medicare beneficiary.

SCOPE

Our review was performed in accordance with generally accepted government auditing standards. 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 when compared to the Medicare program's general principle of paying only reasonable costs. We reviewed only those internal controls considered necessary to achieve our objective.

To accomplish our objective, we:

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

Specifically, we reviewed administrative costs allocated to the Plan's commercial line of business for the FY ended September 30, 1996 because the Plan used these costs to support the 1997 ACR proposal. We reviewed the Medicare administrative costs because they will be the basis for future ACR proposals beginning with the 2000 contract year.

The Plan's administrative costs included the non-medical costs associated with: facilities, marketing, taxes, depreciation, reinsurance, interest, non-medical compensation, and profit. Most of the costs selected for review were from the following 10 accounts in the Plan's general ledger: meals, charitable contributions, meetings and conventions, presentations, sales/lead generation, marketing, building rent expense, promotional, image, and broker commissions.

The Plan's financial records for FY 1996 included administrative costs totaling \$70,396,170, which the Plan allocated \$45,485,210 to its commercial line of business and \$24,910,960 to its Medicare line of business. We judgmentally selected cost items from the general ledger totaling \$8,802,571. Of the total amount reviewed, the Plan allocated \$5,652,386 to its commercial line of business and \$3,150,185 to its Medicare line of business. Because of the limited scope of our review, our results cannot be considered representative of the universe and cannot be projected to the universe of administrative costs submitted by the Plan.

Our field work was performed from September 1998 through December 1998 and included several site visits to the Plan's offices.

FINDINGS AND CONCLUSION

FINDINGS

We found that the administrative cost component on the 1997 ACR proposal included costs that: (1) exceeded actual Medicare administrative expenses; (2) would not be allowable if existing Medicare regulations were applied to risk-based MCOs; (3) related to prohibited lobbying activities; and (4) pertained to unsupported related-party transactions, reinsurance, and other costs. We also found some similar costs charged to the Plan's Medicare line of business, which will become a factor in ACRs for Medicare contract years beginning in 2000.

Costs That Exceeded Actual Medicare Expenses

The 1997 ACR proposal included administrative costs that exceeded the Plan's actual 1997 Medicare administrative costs by \$20,127,515. The ACR proposal contained an estimate of the funds needed to cover administrative costs of the Medicare package of services totaling \$49,165,176; however, the Plan's accounting records showed that actual Medicare administrative costs totaled \$29,037,661.

The administrative costs included in the ACR resulted from the Plan using its commercial administrative rate of 19 percent of medical premiums to represent the administrative costs necessary to provide the Medicare package of covered services to enrolled beneficiaries. However, the actual administrative rate was determined to be 10.5 percent based on Medicare administrative costs recorded in the Plan's FY 1997 general ledger.

The Plan's use of the commercial administrative rate is in accordance with HCFA requirements. The only requirement that HCFA has regarding the inclusion of costs on the ACR proposal is that 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.

Costs Not Traditionally Allowed by Medicare

Administrative costs charged as commercial expenses, such as alcoholic beverages, tickets for sporting events, social club dues, charitable contributions, travel, and fines and penalties, that did not appear proper and necessary were included in the FY 1996 financial records supporting the 1997 ACR. These administrative costs, totaling \$389,506, were questionable when compared to Medicare's principle of paying only reasonable costs.

We found an additional \$425,335 in similar administrative expenses that were allocated to the Plan's Medicare line of business that appeared questionable. Although the Medicare administrative costs are not a factor in the 1997 ACR proposal, costs allocated to the Medicare line of business will be considered in the development of the ACR for contract years beginning in 2000.

The following table illustrates, in detail, the costs allocated to the commercial and Medicare lines of business that appeared questionable.

| DESCRIPTION | COMMERCIAL | MEDICARE | TOTAL |
|--|-------------------|-------------------|-------------------|
| ENTERTAINMENT: | | | |
| Alcoholic Beverages | \$ 17,010 | \$ 8,829 | \$ 25,839 |
| Sporting Events | 56,695 | 3,627 | 60,322 |
| Other (e.g., meals, gifts, social club dues) | 94,393 | 129,051 | 223,444 |
| SUBTOTAL | \$ 168,098 | \$ 141,507 | \$ 309,605 |
| AUTO ALLOWANCE IN EXCESS OF IRS MAXIMUM MILEAGE RATE: | \$ 129,533 | \$ 179,744 | \$ 309,277 |
| CHARITABLE CONTRIBUTIONS: | \$ 70,989 | \$ 87,865 | \$ 158,854 |
| OTHER: | | | |
| Artwork and Landscaping | \$ 6,566 | \$ 7,716 | \$ 14,282 |
| Excess Parking Rental Costs | 7,088 | 5,799 | 12,887 |
| Image (e.g., towing, donations) | 5,099 | 81 | 5,180 |
| Dues to Civic Organizations | 0 | 1,905 | 1,905 |
| Photography | 1,287 | 317 | 1,604 |
| Fines and Penalties | 322 | 156 | 478 |
| Duplicate Voucher | 248 | 202 | 450 |
| License Fees Unrelated to Medicare Product | 224 | 0 | 224 |
| Membership Dues for Independent Consultant | 52 | 43 | 95 |
| SUBTOTAL | \$ 20,886 | \$ 16,219 | \$ 37,105 |
| TOTAL QUESTIONABLE COSTS | \$ 389,506 | \$ 425,335 | \$ 814,841 |

Lobbying Costs

The Plan included \$51,568 for lobbying and political activity costs in the 1997 ACR proposal. Such costs should have been eliminated when computing the ACR. According to Article IX, section D of the MCO contract with the Plan, there is a prohibition against the use of Medicare funds to influence legislation or appropriations. This contract provision incorporates section 31.205-22 of the Federal Acquisition Regulation (FAR) which defines unallowable lobbying and political activity costs. The FAR states that costs incurred for contributing to a political party, campaign, or political action committee are unallowable.

The Plan incurred an additional \$41,288 in unallowable costs related to lobbying which were allocated to its Medicare line of business. Although the Medicare administrative costs are not a factor in the 1997 ACR proposal, costs allocated to the Medicare line of business will be considered in the development of the ACR for contract years beginning in 2000.

Unsupported Costs

The Plan was unable to provide support for \$4,265,312 in costs associated with related-party transactions, reinsurance, and 33 account payable vouchers. While these expenses may be allowable Medicare expenses, the Plan could not provide the supporting documentation that we deemed necessary to fully evaluate the costs. Accordingly, no determination could be made on the allowability of these amounts.

| DESCRIPTION | COMMERCIAL | MEDICARE | TOTAL |
|------------------------------------|---------------------|-------------------|---------------------------|
| RELATED-PARTY TRANSACTIONS: | \$ 3,301,726 | \$ 0 | \$ 3,301,726 ¹ |
| REINSURANCE: | 466,034 | 381,301 | 847,335 |
| OTHER SAMPLED TRANSACTIONS: | 58,388 | 57,863 | 116,251 |
| TOTAL UNSUPPORTED COSTS | \$ 3,826,148 | \$ 439,164 | \$ 4,265,312 |

CONCLUSION

We question whether many of the administrative costs allocated to the commercial line of business should have been included in the Plan's 1997 ACR proposal because the costs either exceeded actual Medicare costs or would be unallowable under Medicare cost principles. The inclusion of these questionable costs 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 reduction in premium amounts. We also question whether many of the types of administrative costs allocated to the Plan's Medicare line of business in FY 1996 should be included in future ACR proposals.

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. Thus, no recommendations were addressed to the Plan. Instead, we are sharing the results of this review with HCFA so that appropriate legislative changes can be considered.

¹An allocation between the Plan's commercial and Medicare lines of business could not be determined due to the absence of supporting documentation.

AUDITEE COMMENTS

In response to our draft report, the Plan agreed with our findings and conclusion with a few exceptions. The Plan disagreed with our conclusion that lobbying and political activity costs were inappropriately included in the 1997 ACR. Specifically, the Plan commented that there is no directive in the regulations or HCFA's ACR instructions to exclude these costs and, therefore, lobbying and political activities may be included in the calculation of the ACR. Further, the Plan indicated that the inclusion of such costs in the base rate of the ACR calculation would be irrelevant to the overall calculation based on the amount of the premium waived in the Plan's ACR proposal.

The Plan noted the reason for the inability to produce the supporting documentation for related-party transactions and reinsurance was that the former parent company did not furnish the documents for the audit. The Plan also commented on the recent and proposed revisions to the ACR methodology. The text of the Plan's comments can be found in the APPENDIX to this report.

OIG RESPONSE

We agree that the regulations applicable to risk-based MCOs and HCFA's ACR instructions do not prohibit lobbying and political activities and that corporate funds were used to pay for these activities. However, the managed care contract between the Plan and HHS provides that no part of any funds under the agreement are to be used for lobbying and political activities. We also disagree that the costs associated with these activities are irrelevant to the Medicare premium calculation when compared to the amount of the premium waived in the Plan's ACR proposal.

The purpose of calculating the ACR is to estimate the Plan's cost of providing the Medicare package of covered services to an enrolled Medicare beneficiary. Although HCFA recommends that MCOs use commercial administrative expenses for the purpose of developing their ACRs, the intent is that those costs would reflect the costs necessary to deliver the Medicare product to its Medicare beneficiaries. Since the costs of lobbying and political activities were included in the Plan's estimate of necessary costs, the terms of the contract between the Plan and HHS would apply. Furthermore, the effect of including the costs deemed unallowable or unreasonable, regardless of their significance, in the ACR calculation overstates the costs of the Medicare product, thereby reducing any potential savings, reduction in premium amounts, or limiting the additional benefits the Plan can offer its Medicare beneficiaries.

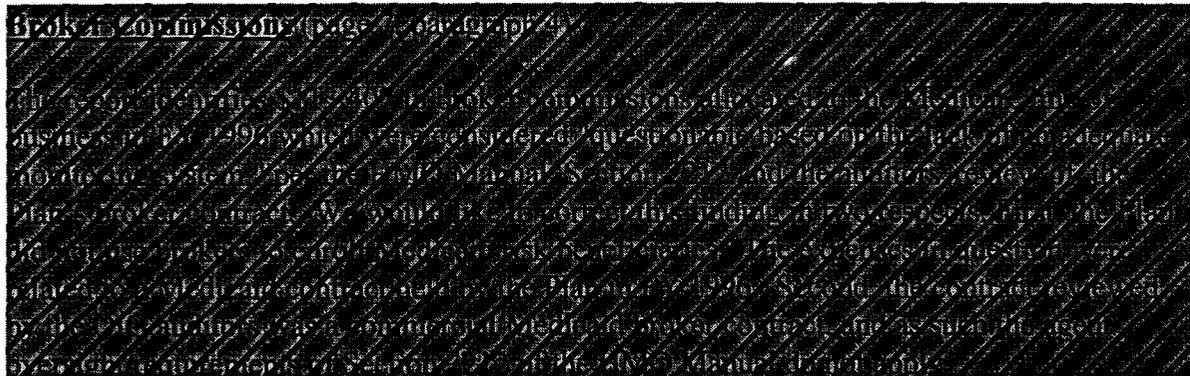
APPENDIX

**RESPONSE TO OFFICE OF INSPECTOR GENERAL AUDIT
OF A CALIFORNIA RISK-BASED MCO'S
1997 ADJUSTED COMMUNITY RATE PROPOSAL
(COMMON IDENTIFICATION NUMBER: A-09-98-00093)**

February 19, 1999

This letter constitutes the response of the California MCO (the Plan) to the January 22, 1999 draft report of the findings of OIG's review of the adjusted community rate (ACR) proposal submitted to the Health Care Financing Administration (HCFA) by the Plan for the Medicare contract year ending December 31, 1997. The Plan is pleased to have been useful in OIG's nationwide review of the ACR process, and welcomes this opportunity to comment on both the findings of this particular review and the ACR process as a whole.

In general, the Plan accepts the auditors' findings and conclusions as written, with the following corrections as submitted below.



Office of Audit Services Note - The above comments have been deleted because they pertain to material included in the draft report but not included in this final report.

Unsupported Costs (page 7, paragraph 3)

The report states that the Plan was unable to provide documentation to support approximately \$4.3M in related party transactions and reinsurance. Please note that the reason for our inability to produce the requested supporting documentation is that these documents are held by the former parent company of the Plan, which did not furnish us with copies for the audit.

***☞ Office of Audit Services Note - The response submitted by the California MCO, ☞
dated February 19, 1999, was modified to safeguard the Plan's identity.***

Lobbying Costs (page 2 and page 7, paragraphs 1-2)

The auditors identified \$51,568 in lobbying and political activity costs for FY 1996 which "are prohibited under the Plan's Medicare risk contract" and "should have been eliminated when computing the ACR." The OIG's rationale for this conclusion is that "[a]ccording to Article IX Section D of the HMO contract [between HCFA and] the Plan, there is a prohibition against the use of Medicare funds to influence legislation or appropriations.

We disagree with OIG's conclusions regarding the appropriateness of inclusion of these expenses in the 1997 ACR. Per HCFA requirements, Medicare risk contractors use the same administrative load as a percent of expenditures in the ACR calculation as is used in determining commercial rates for the contract period. Nowhere in our reading of the regulations or HCFA's ACR instructions is there a directive to exclude costs for lobbying and political activity. This was also the conclusion of external experts we consulted, who are collectively responsible for hundreds of ACR proposals and have never heard of such an adjustment being required.

Moreover, payments for these activities come out of corporate funds, rather than "Medicare funds." Even were one to accept the argument that including corporate lobbying expenses in the base rate administrative costs of the ACR calculation (and are therefore part of the justification for HCFA Medicare risk payments) somehow makes these "Medicare funds," the amount of premium waived in the proposal makes their contribution to the calculation irrelevant.

Unlike the report's other conclusions, which merely identify types of expenses which would not be allowable under Medicare's definition of reasonable costs, this conclusion clearly states that the plan has made an error under current rules. For the reasons outlined above, we ask OIG to seek confirmation that its position on the admissibility of lobbying expenses in the ACR is correct before submitting the final version of this report to HCFA.

Additional Comments

It has long been noted that the ACR methodology is in need of revision. HCFA has begun this effort with the year 2000 filing. However, the year 2000 changes have focused primarily on the cost of covered services, and we are pleased that OIG is in the process of reviewing the administrative portion of the process. As OIG develops its recommendation to HCFA, we would ask it to consider the following issues.

In recent years, there has been support for tying Medicare HMO compensation more closely to actual incurred costs, resulting in the payment changes mandated by the Balanced Budget Act of 1997. The plan does not object to risk adjustment for Medicare beneficiaries in

concept - indeed, a certain degree of experience rating is a standard practice for most health plans. However, we are concerned that HCFA and legislators, in an effort to reduce overall Medicare payments, appear to be moving in a direction which links compensation so closely to incurred costs that plan profitability is precluded.

For example, the risk adjustment methodology for M+C payments adjusts compensation for individual beneficiaries based on their historical utilization. The success of any health insurance plan is predicated on pooling risk for large numbers of individuals such that expenses in the aggregate are less than premium revenue. HCFA's methodology minimizes health plans' ability to manage risk effectively across pools of beneficiaries by tying reimbursement to the inpatient cost experience of individuals. Indeed, this approach gives perverse short-term incentives for poor utilization management and thus works against HCFA's long term goals for cost containment.

A similar trend has been evident in recent discussions of the administrative component of the ACR. The OIG report notes the ACR methodology allowed the Plan to include a 19% administrative load for the Medicare line of business in the 1997 ACR, while actual Medicare administrative costs for FY 1996 were 12%. This statement, while technically accurate, is presented in isolation and ignores two significant pieces of information. First, Medicare HMOs have historically returned "excess payments" to beneficiaries in the form of additional benefits and \$0 premium plans. This is true of the Plan, whose cost of providing services to Medicare beneficiaries in 1998 ran to 88.6% of HCFA payments. Second, the 19% commercial administrative load also includes a provision for plan profitability - a component that is not reflected in the 12% incurred administrative costs. Furthermore, in 1998, the Plan's Medicare business had a profit margin of only 2%, with the balance going to administration of the product and the cost of services to beneficiaries.

Office of Audit Services Note - The percentage of Medicare administrative costs (12 percent) has been updated to 10.5 percent in the final report to reflect the actual 1997 Medicare costs, rather than 1996 costs.

Previous reviews of the administrative component of the ACR have largely ignored these facts, and have been used by some legislators and the media as evidence of health plan overpayment. We would ask OIG and HCFA to consider that to the extent changes in the ACR methodology reduce compensation or increase costs to health plans, these changes are likely to result in reductions in benefits, increases in beneficiary premiums, or both. This is

Office of Audit Services Note - The response submitted by the California MCO, dated February 19, 1999, was modified to safeguard the Plan's identity.

an outcome that serves neither health plans nor beneficiaries, as the recent reductions in plan participation under the Medicare+Choice program have clearly demonstrated.

Again, we thank you for this opportunity to contribute to this study.