

**Memorandum**

Date SEP 18 1998
From *for* Michael Mangano
June Gibbs Brown
Inspector General

Subject Review of the 1997 Adjusted Community Rate Proposal For a Texas Risk-Based Managed Care Organization (A-06-98-00046)

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 (MCO) 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.

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 MCO's administrative costs. The attached report on selected administrative costs of a Medicare managed care risk contractor located in Texas 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, 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 the Texas 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 projected to the universe of administrative costs submitted by the MCO.

Medicare administration income included on the 1997 ACR proposal was approximately 300 percent of the Texas MCO's actual Medicare administrative expenses. The plan's Medicare income for administration based on the ACR proposal exceeded the plan's 1997 Medicare administrative costs by \$19,237,909. Income from HCFA to cover the plan's administrative costs for its Medicare contract totaled \$29,485,849; however, the plan's accounting records showed that these costs totaled \$10,247,940.

The administrative cost component on the 1997 ACR proposal included (1) a Medicare administrative rate that we believe to be inappropriate in light of the plan's actual Medicare administrative expenses, (2) estimated revenue requirement for Medicare reinsurance, (3) unsupported related party costs, (4) costs that would not be allowable if existing Medicare regulations were applied to risk-based MCOs, and (5) prohibited lobbying expenses. Specifically, the ACR submission included:

- A proposed Medicare administrative rate that exceeded the plan's actual administrative rate. The HCFA applied the percentage methodology that was used on the plan's commercial side (20 percent of medical premiums) to the Medicare administrative component on the 1997 ACR proposal even though the plan submitted a lower rate based on its actual plan experience. Actual Medicare administrative costs were about 9 percent of the medical premium for the 12-month period ending December 31, 1997;
- \$565,472 for Medicare reinsurance under an agreement with a related organization which had been eliminated for Medicare members in January 1996;
- \$10,909,164 in related party transactions for management fees and reinsurance expenses that were not supported by costs. While these types of expenses are allowable under Medicare fee-for-service, Medicare limits the provider's reimbursement to the related party's costs. The management fees and reinsurance expenses were based on negotiated agreements between related parties, and the plan was unable to identify the related parties' costs;
- \$141,166 relating to such items as entertainment, charitable donations, and gifts that would not have been allowed if Medicare cost reimbursement principles were in effect; and

- \$11,653 in lobbying costs which are prohibited under the plan's Medicare risk contract.

These costs would not be allowable 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 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 Texas plan. However, in response to our draft report, the Texas MCO officials did not take any exceptions to the facts presented 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-06-98-00046 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
TEXAS RISK-BASED
MANAGED CARE ORGANIZATION**



**JUNE GIBBS BROWN
Inspector General**

**SEPTEMBER 1998
A-06-98-00046**



SEP 18 1998

Memorandum

Date *for* *Michael Mangano*
June Gibbs Brown
Inspector General
From

Subject Review of the 1997 Adjusted Community Rate Proposal For a Texas Risk-Based Managed Care Organization (A-06-98-00046)

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 Medicare managed care risk contractor located in Texas for the 1997 contract year. 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.

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 of the plan for the upcoming year and must be supported by the individual MCO's operating experiences related to utilization and expenses.

Medicare administration income included on the 1997 ACR proposal was approximately 300 percent of the Texas MCO's actual Medicare administrative expenses. The MCO's Medicare income for administration based on the ACR proposal exceeded the MCO's 1997 Medicare administrative costs by \$19,237,909. Income from HCFA to cover the MCO's administrative costs for its Medicare contract totaled \$29,485,849; however, the MCO's accounting records showed that these costs totaled \$10,247,940.

The administrative cost component on the 1997 ACR proposal included (1) a Medicare administrative rate that we believe to be inappropriate in light of the plan's actual Medicare administrative expenses, (2) an inaccurate estimated revenue requirement for Medicare reinsurance, (3) unsupported related party costs, (4) costs that would not be allowable if existing Medicare regulations were applied to risk-based MCOs, and (5) prohibited lobbying expenses. Specifically, the ACR submission included:

- A proposed Medicare administrative rate that exceeded the plan's actual administrative rate. The HCFA applied the percentage methodology that was used on the MCO's commercial side (20 percent of medical premiums) to the Medicare administrative component on the 1997 ACR proposal even though the MCO

submitted a lower rate based on its actual plan experience. Actual Medicare administrative costs were about 9 percent of the medical premium for the 12-month period ending December 31, 1997;

- \$565,472 for Medicare reinsurance under an agreement with a related organization which had been eliminated for Medicare members in January 1996;
- \$10,909,164 in related party transactions for management fees and reinsurance expenses that were not supported by costs. While these types of expenses are allowable under Medicare fee-for-service, Medicare limits the provider's reimbursement to the related party's costs. The management fees and reinsurance expenses were based on negotiated agreements between related parties, and the MCO was unable to identify the related parties' costs;
- \$141,166 relating to such items as entertainment, charitable donations, and gifts that would not have been allowed if Medicare cost reimbursement principles were in effect; and
- \$11,653 in lobbying costs which are prohibited under the plan's Medicare risk contract.

The HCFA requires 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. The Texas MCO used its actual Medicare administrative expense rate in its initial ACR proposal. However, HCFA required the MCO to increase its administrative percent rate to correlate with its commercial rate even though the MCO had historical data that demonstrated its Medicare administrative rate would be significantly lower.

The MCO is not prohibited from including items such as entertainment, charitable donations, and gifts in its administrative rate 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 effect of including costs in the ACR proposal that exceed actual cost or would be unallowable under Medicare principles, resulted in reimbursement that was three times the MCO's best estimate of its actual costs. This reduced any potential savings from the Medicare payments. In addition, this methodology impacts the amount available to Medicare beneficiaries for additional benefits or reduced premium amounts.

Because of the lack of criteria for inclusion of costs on the ACR proposal, there are no recommendations addressed to the Texas MCO. 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.

In responding to our draft report, the Texas MCO took no exceptions to the facts presented in the report.

INTRODUCTION

Background

Medicare payments to risk-based MCOs are based on a prepaid capitation rate with no retroactive adjustments. 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. The MCO is required to use this savings to either improve its 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 1997 ACR proposal submitted by the Texas plan, and assess whether the costs were appropriate under Medicare's principle of reasonableness. To accomplish our objective, we:

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

We reviewed commercial administrative costs because they support the commercial base rate in the ACR proposal, and this rate is used to derive the Medicare ACR. We reviewed Medicare administrative costs because (1) the MCO submitted to HCFA the Medicare administrative rate based on actual cost experience, and (2) plans will be required as of the 1999 Medicare contract year to record both commercial and Medicare costs actually incurred during Calendar Year 1997 to establish relative cost ratios which will be used to derive the Medicare ACR. Therefore, it is important for the plans to screen both commercial and Medicare costs which impact the ACR calculations.

We reviewed the MCO's 1996 financial records for the 9-month period ending September 30, 1996 which were used as support for the 1997 ACR proposal. The administrative costs included the non-medical costs associated with: facilities, taxes, legal fees, non-medical compensation and accounting. However, most of the administrative costs we selected for review were from eight categories on the MCO's general ledger: travel and entertainment, seminars, public relations, advertising, consulting, repairs and maintenance, association dues, and miscellaneous. From these accounts, we generally selected all non-recurring cost items over \$1,500. We reviewed 33 Medicare items totaling \$154,881 and 197 commercial items totaling \$775,095.

We reviewed reinsurance costs totaling \$58,443 for Medicare and \$3,859,159 for commercial. The commercial amount includes costs of a related organization. We also reviewed administration management contract costs incurred by the plan under an agreement

with a related organization totaling \$612,312 for Medicare and \$7,116,980 for commercial. We requested documentation to support the cost to the related organization.

In total, we reviewed Medicare costs totaling \$825,636 and commercial costs totaling \$11,751,234.

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 MCO. Because we reviewed a judgmental sample, our findings cannot be projected to the universe of administrative costs submitted by the MCO.

Our work was performed at the plan offices in Texas and in our offices in Dallas and Austin, Texas. Field work was conducted from April 1998 to July 1998.

FINDINGS AND RECOMMENDATIONS

Medicare administrative income which is based on the 1997 ACR proposal exceeded actual expenses by about 300 percent. The administrative cost component on the ACR proposal included: (1) an inappropriate Medicare administrative rate, (2) an inaccurate estimated revenue requirement for Medicare reinsurance, (3) unsupported related party costs, (4) costs that would not be allowable if existing Medicare regulations were applied to risk-based MCOs, and (5) prohibited lobbying expenses.

Income for Medicare Administrative Costs Exceeded Actual Expenses

The MCO's income from Medicare for administration based on the ACR proposal exceeded the plan's 1997 Medicare administrative costs by \$19,237,909. Income from HCFA to cover the plan's administrative costs for its Medicare contract totaled \$29,485,849; however, the plan's accounting records showed that the actual costs only totaled \$10,247,940.

Administrative Rate

The HCFA applied the percentage methodology that was used on the MCO's commercial side (20 percent of medical premiums) to the Medicare administrative component even though the submitted ACR proposal was based on the plan's past Medicare cost experience. The 20 percent includes administrative costs, premium taxes, and a profit margin. Actual Medicare administrative costs were about 9 percent of the Medicare medical premium based on administrative costs incurred by the plan for the 12-month period ending December 31, 1997. Regarding premium taxes, the MCO did not assess a premium tax on its Medicare premiums. The remaining profit margin should be limited to its normal profit on its non-Medicare enrollees.

The Medicare administrative component that was based on actual Medicare costs was overridden by HCFA because the only requirement 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. Allocating administration based on a percent computation grossly inflates the plan's administration needs for Medicare. The reason is that this methodology takes advantage of the effect of medical utilization factors on the administrative component. The result is that the amounts for administration tend to be a product of the medical premium rather than reflecting what is needed to cover administrative costs.

As a result of HCFA applying the 20 percent commercial rate to Medicare, the administrative rate increased \$70.66 per member per month (PMPM) causing an overall loss of \$27.96 PMPM on the ACR proposal. Consequently, it appeared to HCFA that the MCO would suffer significant losses. The MCO officials believed that this loss was essentially a "paper" loss which was created by using the 20 percent factor for administrative costs. The MCO was able to satisfy HCFA's insolvency concerns; however, HCFA did not adjust the ACR rate to more accurately reflect projected expenses. Accordingly, the inflated ACR adversely impacted the amount available to Medicare beneficiaries for additional benefits or reduced premium amounts.

Reinsurance

The administrative component on the ACR proposal includes reinsurance. The excess administration contains an inaccurate estimated revenue requirement for reinsurance. The proposal included \$565,472 for Medicare reinsurance with a related organization, however, this agreement was eliminated for Medicare members effective January 1, 1996.

Administrative Costs Not Typically Allowed by Medicare

Administrative costs were included in the ACR proposal that would not be allowable if existing Medicare regulations were applied to risk-based MCOs. The 1997 ACR proposal was based on actual administrative costs incurred by the plan during the 9-month period ending September 30, 1996. Administrative costs totaled \$42,508,165 for this period with \$30,788,607 charged as commercial, \$5,011,550 charged as Medicaid, and \$6,708,008 charged as Medicare.

A review of selected categories of the MCO's administrative costs totaling \$12,576,870 (\$11,751,234 for commercial and \$825,636 for Medicare) showed that the ACR proposal included:

- ▶ unsupported related party administrative costs totaling \$10,909,164 for management contract fees and reinsurance. The reasonableness of these costs could not be established.
- ▶ commercial costs totaling \$141,166 for entertainment, charitable donations, association dues, employee gifts, and physician appreciation luncheons that did not appear proper and necessary when compared to the Medicare reimbursement principle of reasonableness; and
- ▶ commercial costs totaling \$11,653 related to political contributions and lobbying which are prohibited in the plan's risk contract.

Of the total \$12,576,870 in costs tested, the remaining \$1,514,887 were found to be reasonable under Medicare principles.

Related Party Transactions

Unsupported related party administrative costs totaling \$10,909,164 were included in the ACR proposal for management fees and reinsurance expenses. Of this amount \$10,296,852 was allocated to commercial and \$612,312 to Medicare. While management fees and reinsurance expenses are allowable Medicare expenses, the expenses for related party transactions are limited to the related party's costs under Medicare fee-for-service regulations. The MCO could not provide the costs of the related organizations for management contract fees and reinsurance. Accordingly, no determination could be made on the allowability of these amounts.

Entertainment, Charitable Donations, Association Dues, Gifts, Physician Luncheons

Administrative costs charged as commercial expenses such as entertainment, charitable donations, association dues, employee gifts, and physician appreciation luncheons that did not appear proper and necessary were included in the ACR. These administrative costs totaling \$141,166 were questionable when compared to the Medicare reimbursement principle of reasonableness. Although these costs were recorded as commercial expenses, they impact the Medicare ACR calculation.

The following is a breakdown of the \$141,166 in costs that would be unallowable under both an MCO cost reimbursement contract and a Medicare fee-for-service reimbursement arrangement:

- \$79,500 for charitable donations and sponsorships,
- \$23,242 for sporting event tickets,
- \$14,573 for association dues which are related to lobbying, entertainment, and networking,

- \$12,362 for an annual golf tournament and membership,
- \$ 9,001 for physician and their staff appreciation luncheons,
- \$ 1,293 for alcohol purchases, and
- \$ 1,195 for employee flowers.

Political Contributions

The MCO included \$11,653 for lobbying entertainment and political contributions in the ACR proposal. Such costs should have been eliminated when computing the ACR. According to Article IX, Section D of the MCO contract, there is a prohibition against the use of HCFA 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.

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.

Inclusion of administrative costs in the MCO's ACR proposal that are not typically allowed by Medicare, result in an inflated 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.

Recommendations

Because of the lack of criteria for inclusion of costs on the ACR proposal, there are no recommendations addressed to the Texas MCO. 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 Texas MCO Comments

On August 21, 1998, the Texas MCO responded to a draft of this audit report. The MCO took no exceptions to the facts presented in the report.