



DEPARTMENT OF HEALTH AND HUMAN SERVICES
OFFICE OF AUDIT SERVICES
233 NORTH MICHIGAN AVENUE
CHICAGO, ILLINOIS 60601

REGION V
OFFICE OF
INSPECTOR GENERAL

November 10, 2003

CIN: A-05-02-00056

Mr. Kevin Goodno
Commissioner
Minnesota Department of Human Services
444 Lafayette Road
St. Paul, MN 55155-3815

Dear Mr. Goodno,

The attached final report provides the results of our self-initiated "Review of Capitated Payments in Minnesota's Medicaid Managed Care Program." A copy of this report will be forwarded to the action official noted below for his review and any action deemed necessary.

Our objectives were to determine: (i) if payments made for enrollees in the Prepaid Medical Assistance Program (Program) exceeded expenses and, if so, (ii) to determine if the excess amounts (retained earnings) were reasonable.

Although payments made for enrollees in the Program exceeded plan expenditures in each of the years reviewed, the Minnesota Department of Human Services (State agency) generally reacted to excessive retained earnings by adjusting the capitated payment rates in the following year. The overall average retained earnings rate for the nine Program managed care health plans for calendar years 1997 through 2001 was 6 percent, which we consider reasonable. We noted that the State agency included administrative costs and a profit factor for its State-funded Prepaid General Assistance Medical Care (General Assistance) program in the actuarial rate calculations for the Program in 2001 and 2002. This was contrary to Federal cost principles and misstated the actuarial calculations available for future rate setting. Since the State agency used its discretion and chose not to follow the actuary's recommended rate increase, there was no effect during 2001 and 2002. The State agency, instead, negotiated a contract with the plans with an overall increase of 4.85 percent over the 2000 rates. The 2000 rates did not include any costs shifted from the General Assistance program, and the rate increase is considered reasonable.

To comply with new rules that must be implemented by June 16, 2003, the State agency needs to change its rate setting process by excluding costs from other programs and establishing Program rates that are actuarially sound. The State agency must ensure that it complies with this requirement in the development of the rates effective January 1, 2004. By changing its procedures, the State agency will eliminate a possible overstatement of Program costs calculated under the current method. By not acting, the State agency's current calculation methods would inappropriately increase the Program's actuarially estimated expenses and reasonable profit by about \$6.2 million.

Final determination as to actions taken on all matters reported will be made by the HHS action official named below. We would appreciate your views and the status of any further action taken or contemplated on our recommendations within 30 days. Your response should present any

comments or additional information that you believe may have a bearing on the final determination.

In accordance with the principles of the Freedom of Information Act, (5 U.S.C. 552, as amended by Public Law 104-231), Office of Inspector General reports are made available to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act which the Department chooses to exercise. (See 45 CFR Part 5.)

If you have any questions or comments about this report, please contact Leon Siverhus, Audit Manager, at 651-290-3762.

To facilitate identification, please refer to Report Number A-05-02-00056 in all correspondence relating to this report.

Sincerely,



Paul Swanson
Regional Inspector General
for Audit Services

Enclosures – as stated

Direct Reply to HHS Action Official:

Jacqueline Garner – CMS Regional Administrator
Centers for Medicare & Medicaid Services – Region V
233 North Michigan Avenue, Suite 600
Chicago, Illinois 60601

Department of Health and Human Services

**OFFICE OF
INSPECTOR GENERAL**

**REVIEW OF CAPITATED PAYMENTS
IN MINNESOTA'S MEDICAID
MANAGED CARE PROGRAM**

**MINNESOTA DEPARTMENT OF
HUMAN SERVICES**



**NOVEMBER 2003
A-05-02-00056**

Office of Inspector General

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OAS FINDINGS AND OPINIONS

The designation of financial or management practices as questionable or a recommendation for the disallowance of costs incurred or claimed as well as other conclusions and recommendations in this report represent the findings and opinions of the HHS/OIG/OAS. Authorized officials of the awarding agency will make final determination on these matters.



EXECUTIVE SUMMARY

OBJECTIVE

The audit objectives were to determine: (i) if payments made for enrollees in the Prepaid Medical Assistance Program (Program) exceeded expenses and, if so, (ii) to determine if the excess amounts (retained earnings) were reasonable.

FINDINGS

Although payments made for enrollees in the Program exceeded plan expenditures in each of the years reviewed, the Minnesota Department of Human Services (State agency) generally reacted to excessive retained earnings by adjusting the capitated payment rates in the following year. The overall average retained earnings rate for the nine Program managed care health plans for calendar years 1997 through 2001 was 6 percent, which we consider reasonable. We noted that the State agency included administrative costs and a profit factor for its State-funded Prepaid General Assistance Medical Care (General Assistance) program in the actuarial rate calculations for the Program in 2001 and 2002. This was contrary to Federal cost principles and misstated the actuarial calculations available for future rate setting. Since the State agency used its discretion and chose not to follow the actuary's recommended rate increase, there was no effect during 2001 and 2002. The State agency, instead, negotiated a contract with the plans with an overall increase of 4.85 percent over the 2000 rates. The 2000 rates did not include any costs shifted from the General Assistance program, and the rate increase is considered reasonable.

To comply with new rules that must be implemented by June 16, 2003, the State agency needs to change its rate setting process by excluding costs from other programs and establishing Program rates that are actuarially sound. The State agency must ensure that it complies with this requirement in the development of the rates effective January 1, 2004. By changing its procedures, the State agency will eliminate a possible overstatement of Program costs calculated under the current method. By not acting, the State agency's current calculation methods would inappropriately increase the Program's actuarially estimated expenses and reasonable profit by about \$6.2 million.

RECOMMENDATION

We recommend that the State agency exclude General Assistance related administrative costs and profit factors from the Program in future rate calculations.

STATE AGENCY'S RESPONSE

In a letter dated October 24, 2003, State agency officials concurred with the findings and recommendation presented in the report. They stated the rate setting process has been changed for 2003 and 2004 to comply with the new Federal regulations concerning actuarial sound rates for Medicaid managed care plans. The State agency's response is included in its entirety as an appendix to this report.

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INTRODUCTION

BACKGROUND

Title XIX of the Social Security Act (Act) authorizes Federal grants to States for Medicaid programs that provide medical assistance to needy people. Each State administers its Medicaid program in accordance with an approved State plan, which meets certain requirements for setting payment amounts. In general terms, this provision requires that payment for care and services be consistent with efficiency, economy, and quality of care. The Medicaid program is jointly funded by State and Federal appropriations, with applicable shares varying by State and by year. For Minnesota, the Federal share for the Medicaid managed care and the Medicaid fee-for-service program is about 50 percent.

In recent years there has been significant growth in Medicaid managed care, as an alternative to the traditional fee-for-service system. Under the managed care concept, the State agency negotiated contracts with entities, such as health maintenance organizations and prepaid health plans, to provide health care services to recipients. These entities agree to provide a specific set of services to Medicaid enrollees in return for a predetermined periodic payment per enrollee. The goal of managed care programs is to enhance access to quality care in a cost effective manner. Regulatory waivers authorize the states to implement managed care programs and allow flexibility in the design and implementation of these programs.

Minnesota first implemented managed care for Medicaid recipients in three counties in 1985. The Program was expanded throughout the State to include 69 of the State's 87 counties by 2001. In December 2001, more than 208,000 of Minnesota's approximately 396,000 Medicaid recipients were enrolled in the Program. Under this prepayment concept, the State agency established prepayment rates and generally reacted to any resulting excess retained earnings by adjusting its capitated payment rates in the following year. For calendar years 1997 through 2001, the overall average retained earnings rate for the nine managed care health plans was 6 percent.

Minnesota also provided managed care services under its own General Assistance program. This program is entirely State-funded and provided services to individuals not eligible for Medicaid. Under the General Assistance program, the State agency controls the design of the program, range of services to be provided, and eligibility for enrollment. In December 2001, enrollment in the General Assistance program totaled more than 16,000 recipients.

OBJECTIVE, SCOPE AND METHODOLOGY

Objective. The audit objectives were to determine: (i) whether payments made for enrollees in the Program exceeded expenses and, if so, (ii) whether the excess amounts (rate of return) were reasonable.

Scope. Our audit was performed in accordance with generally accepted government auditing standards. The review was limited to examining the financial statements of the nine managed care health plans participating in the Program during 1997 through 2001. We analyzed the statements in order to determine the reasonableness of the capitated payments made to the plans.

Because of the limited scope of our review, we did not review the overall internal control structure of the State agency. Our internal control testing was limited to those procedures related to the rate-setting process. Our fieldwork was performed at the State agency during the period May through November 2002.

Methodology. We reviewed the financial statements to determine whether revenues exceeded expenses and rates of return (retained earnings) were reasonable. We also determined whether retained earnings were retained, invested, or returned to the State agency.

We analyzed data for the nine managed care health plans participating in the Program during 1997 through 2001. To a limited extent, we assessed the reasonableness of the rate setting methodology for this period through 2002.

FINDINGS AND RECOMMENDATION

Although payments made for enrollees in the Program exceeded plan expenditures in each of the years reviewed, the State agency generally reacted to excessive retained earnings by adjusting the capitated payment rates in the following year. The overall average retained earnings rate for the nine Program managed care health plans for 1997 through 2001 was 6 percent, which we consider reasonable. We noted that the State agency included administrative costs and a profit factor for its State-funded General Assistance program in the actuarial rate calculations for the Program in 2001 and 2002. This was contrary to Federal cost principles and misstated the actuarial calculations available for future rate setting. Since the State agency used its discretion and chose not to follow the actuary's recommended rate increase, there was no effect during 2001 and 2002. The State agency, instead, negotiated a contract with the plans with an overall increase of 4.85 percent over the 2000 rates. The 2000 rates did not include any costs shifted from the General Assistance program, and the rate increase is considered reasonable.

To comply with new rules that must be implemented by June 16, 2003, the State agency needs to change its actuarial process by excluding costs from other programs and establishing Program rates that are actuarially sound. The State agency must ensure that it complies with this requirement in the development of the rates effective January 1, 2004. By changing its procedures, the State agency will eliminate a possible overstatement of Program costs calculated under the current method. By not acting, the State agency's current calculation methods would inappropriately increase the Program actuarially estimated expenses and reasonable profit by about \$6.2 million.

CHANGING THE ACTUARIAL PROCESS

Even though Program rates calculated for 2001 and 2002 were not effected by the Program actuarial estimation methods, rates set in future years may be overstated, if actuarial procedures are not changed. The State agency disregarded the actuarial estimate and negotiated lower rates for 2001 and 2002. However, the use of the current methodology, which included other program costs in the Program actuarial rate development process, would inflate the actuarial estimate that may be considered during future rate setting. Other program costs are unallowable and unallocable to the Program and should not be included in the development of an actuarially sound rate, as required by new guidelines effective June 16, 2003. As a result, the State agency needs to change its process for actuarially estimating Program expenses and profit target, in order to have a reasonable profit by the plans and an actuarially sound basis for rate setting in the future. The State agency must ensure that it complies with this requirement in the development of the rates effective January 1, 2004.

In establishing the Program's actuarial rate recommendation for 2001 and 2002, we noted that the State agency included administrative costs and a targeted profit level for its General Assistance program. In an actuary's letter, the rate-setting logic for the increase to the Program rates was described, as follows:

...The State agency set the overall profit target equal to 1% of revenue, excluding investment income. This profit target varies by population. For various reasons, the State agency has chosen to set the profit target for the General Assistance program equal to breakeven, or 0%, and reallocate all administrative expenses from General Assistance to the Program. The profit target for the Program was increased to 1.1% in order to balance to an overall target of 1%....

By setting its profit margin for the State-funded General Assistance program at zero, increasing expected profit margins for the Program by 10 percent (1% increased to 1.1%) and by reallocating all administrative expenses from General Assistance to the Program, the State agency could inappropriately increase the disbursements by the Program. This is contrary to Federal cost principles and misstates the actuarial calculations available for future rate setting.

The OMB Circular No. A-87, Cost Principles for State, Local, and Indian Tribal Governments, Attachment A, General Principles for Determining Allowable Costs, provides basic guidelines for establishing the allowability and the allocability of costs. To be allowable in accordance with section C. 1., costs must:

...Be necessary and reasonable for proper and efficient performance and administration of federal awards....

...Be allocable to federal awards....

Regarding allocability, section C. 3. states:

...A cost is allocable to a particular cost objective if the goods or services involved are chargeable or assignable to such cost objective in accordance with relative benefits received....

Since the State agency used its discretion and chose not to follow the actuary's recommended rate increase, there was no effect during 2001 and 2002. The State agency, instead, negotiated a contract with the plans with an overall increase of 4.85 percent over the 2000 rates. The 2000 rates did not include any costs shifted from the General Assistance program, and the rate increase is considered reasonable.

We attribute the improper allocation of General Assistance program costs to the Program rate setting process to the State agency's rate setting logic. The State agency treats its three health care programs (Program, General Assistance, Minnesota Care) as a single package. The State agency requires participating health plans to provide services to each of the three programs. Historically, the plans had profited under the Program and generally experienced losses in the General Assistance and Minnesota Care programs. During 1997 through 2001, the plans experienced losses in the General Assistance program every year, while the Minnesota Care program was profitable only in 2001. Although the plans complained about the losses, the State agency argued that the plans were still making an overall profit from Program reimbursements. In our opinion and based on the actuary quotation, the Program is, in effect, subsidizing the two State programs.

New regulations require that capitated rates be actuarially sound. By changing its procedures to comply with the new requirements, the State agency will eliminate a possible overstatement of Program costs calculated under the current method.

Medicaid Managed Care provisions, 42 CFR Part 438.6(c), requiring that capitated rates be "actuarially sound" must be implemented by State agencies by June 16, 2003:

...we have established a requirement that payment rates in risk contracts be actuarially sound, that is, that they have been developed in accordance with generally accepted actuarial principles and practices, are appropriate for the populations and services under the contract, and have been certified by an actuary as meeting the requirements in this rule

Based on 2001 costs, we estimate that payments could be inappropriately increased by \$6.2 million per year (\$3.2 FFP), if procedures are not changed.

To estimate inappropriate costs resulting from reliance on the current process, we subtracted the General Assistance program administrative expenses from Program disbursements, reflecting both cost and an increase for intended profit. The actuarial description presents an effective increase in the Program profit target of 10 percent (1%

increased to 1.1%). We estimated that the General Assistance program administrative costs and profit shifted to the Program would be approximately \$6.2 million.

Our calculations are presented in Appendix A.

RECOMMENDATION

We recommend that the State agency exclude General Assistance related administrative costs and profit factors from the Program actuarial rate calculations in the future.

STATE AGENCY'S RESPONSE

In a letter dated October 24, 2003, State agency officials concurred with the findings and recommendation presented in the report. They stated the rate setting process has been changed for 2003 and 2004 to comply with the new Federal regulations concerning actuarial sound rates for Medicaid managed care plans. The State agency's response is included in its entirety as an appendix to this report.

APPENDICES

APPENDIX A

**ESTIMATED COST OF GENERAL ASSISTANCE PROGRAM COSTS
SHIFTED TO THE PROGRAM**

2001 Estimate

Program Disbursements	\$611,360,000
Less: General Assistance Administrative Costs	<u>5,571,000</u> (a)
Program Disbursements with Combined Profit	\$605,789,000 (b)
Combined Target Profit Percentage	101.1% (c)
Estimated Program Disbursements (excluding profit (b) / (c))	\$599,197,824 (d)
Target Profit - Combined Program and General Assistance ((b) - (d))	\$6,591,176 (e)
Program Profit ((e) / 110%)	\$5,991,978 (f)
General Assistance Profit ((e) – (f))	\$599,198 (g)
General Assistance Costs Shifted to PMAP ((a) + (g))	\$6,170,198 (h)
FFP at 51.1%	\$3,153,487 (i)

This calculation shows the estimated amount of General Assistance administrative costs and profit target based on 2001 actuarial rate amounts.



Minnesota Department of **Human Services** _____

October 24, 2003

Paul Swanson
Regional Inspector General for Audit Services
Department of Health and Human Services
Office of Audit Services
233 North Michigan Avenue
Chicago, Illinois 60601

Re: Report Number A-05-02-00056

Dear Mr. Swanson:

Thank you for your request to review your draft report entitled, "Review of Capitated Payments in Minnesota's Medicaid Managed Care Program."

We agree with your finding that the 2000 rates paid to health plans were reasonable. The Minnesota Department of Human Services has also changed the rate setting process for 2003 and 2004 to comply with the new federal regulations concerning actuarially sound rates for Medicaid managed care plans.

We have enclosed some recommendations on changes to the report text.

Thank you for including us in this process. If you have further questions please contact Sandy Burge, of the Department staff, at (651) 296-7429.

Sincerely,

A handwritten signature in black ink, appearing to read "Brian J. Osberg".

Brian J. Osberg
Assistant Commissioner Health Care

Enclosure

ACKNOWLEDGEMENTS

This report was prepared under the direction of Paul Swanson, Regional Inspector General for Audit Services. Other principal Office of Audit Services staff who contributed include:

Leon Siverhus, *Audit Manager*

Brent Storhaug, *Senior Auditor*

Shirley Loos, *Auditor*

For information or copies of this report, please contact the Office of Inspector General's Public Affairs office at (202) 619-1343.