DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

Washington, D.C. 20201

MAY 19 2005

TO: Herb Kuhn
Director, Center for Medicare Management
Centers for Medicare & Medicaid Services

FROM: Joseph E. Vengrin
Deputy Inspector General for Audit Services

SUBJECT: Review of Revenue From Vendors at Three Additional Group Purchasing Organizations and Their Members (A-05-04-00073)

The attached final report provides the results of our audit of revenue at three group purchasing organizations (GPOs) and their members. We previously issued a report in January 2005 on three GPOs entitled "Review of Revenue From Vendors at Three Group Purchasing Organizations and Their Members (A-05-03-00074)." This report contains the results of a second audit focusing on how much revenue three additional GPOs received from vendors and the disposition of that revenue.

GPOs are buying consortiums designed to leverage the purchasing power of members, primarily hospitals and other health care providers, and to allow them to obtain discounts on medical supplies. In exchange for administrative services and the ability to sell through a GPO to its members, vendors pay administrative fees to GPOs.

Our objectives were to determine (1) how much revenue three large GPOs received from vendors and what the disposition of that revenue was, (2) how members treated distributions of net administrative fee revenue received from GPOs on their Medicare cost reports, and (3) whether members properly recorded rebates received from vendors on their Medicare cost reports.

The three GPOs that we reviewed—which were among the largest in the United States—collected administrative fee revenue of $513 million during our audit period.[1] Of this amount, $275 million represented net revenue in excess of operating costs. The GPOs retained $58 million of the $275 million in net revenue to provide reserves and venture capital for new business lines. They distributed the remaining $217 million to members.

Based primarily on the significance of the dollars received, we reviewed how seven healthcare systems, representing several hundred GPO members, accounted for the net revenue distributed by the three GPOs. We reviewed Medicare cost reports for 38 hospitals under the 7 healthcare systems that received a total of $123 million, or 57 percent, of the $217 million distributed.

We found that one of the healthcare systems did not fully account for net revenue distributions on their Medicare cost reports. This healthcare system did not distribute all of its administrative

[1]We reviewed a 3-year period covering fiscal years 2001 through 2003.

fees to its member hospitals for inclusion, and subsequent offset, in the respective hospitals' cost reports. As a result, administrative fees of about $5 million related to 6 of the 38 hospitals reviewed were not offset on Medicare cost reports.

The same seven healthcare systems received rebates totaling $115 million directly from vendors or passed from vendors through the GPOs. A review of Medicare cost reports for the same 38 hospitals revealed that all GPO members offset rebates on their Medicare cost reports as required. We noted, however, that one GPO did not distribute all rebates received to its members. That GPO withheld $1.6 million of the total rebates.

Although the $5 million of net revenue distributions and $1.6 million of rebates not credited on Medicare cost reports was less than the amounts detailed in our prior report, we continue to believe that clarification of instructions from the Centers for Medicare & Medicaid Services to hospitals is needed and that recommendations in our prior report (A-05-03-00074) are timely and valid.

Should you have any comments on this report, please send them to us within 60 days. If you have any questions about this report, please do not hesitate to call me, or your staff may contact George M. Reeb, Assistant Inspector General for the Centers for Medicare & Medicaid Audits, at (410) 786-7104 or through e-mail at george.reeb@oig.hhs.gov. Please refer to report number A-05-04-00073 in all correspondence.

Attachment

Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

REVIEW OF REVENUE FROM VENDORS AT THREE ADDITIONAL GROUP PURCHASING ORGANIZATIONS AND THEIR MEMBERS

MAY 2005
A-05-04-00073

Office of Inspector General

http://oig.hhs.gov

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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 HHS divisions will make final determination on these matters.

EXECUTIVE SUMMARY

BACKGROUND

Group purchasing organizations (GPOs) are buying consortiums designed to leverage the purchasing power of members, primarily hospitals and other health care providers, and to allow them to obtain discounts on medical supplies. In exchange for administrative services and the ability to sell through a GPO to its members, vendors pay administrative fees to GPOs.

We previously issued a report in January 2005 on three GPOs entitled "Review of Revenue From Vendors at Three Group Purchasing Organizations and Their Members (A-05-03-00074)." This report contains the results of a second audit focusing on how much revenue three additional GPOs received from vendors and the disposition of that revenue.

There has been considerable public interest in recent years regarding the operations of GPOs and their receipt of vendor fees. The Senate Judiciary Committee, Subcommittee on Antitrust, Competition Policy and Consumer Rights, has investigated the GPO industry and conducted hearings. The longstanding congressional concern about vendor fees appeared in a 1986 House conference report, expressing concern about the level of vendor fees and directing the Secretary of Health and Human Services to monitor vendor payment arrangements for possible abuses (House Conference Report 99-1012 (1986)). The U.S. Federal Trade Commission recently conducted hearings about the business practices of GPOs and issued a report describing such practices. The press has also shown considerable interest in the GPO industry. For example, the New York Times published a series of investigative reports in 2002.

Although the Department of Health and Human Services does not directly "regulate" GPOs, Medicare regulations provide guidance on the reporting of rebates that hospitals receive from vendors. Specifically, 42 CFR § 413.98 and chapter 8 of the Provider Reimbursement Manual generally require health care providers to offset purchase discounts, allowances, and refunds of expenses against expenses on their Medicare cost reports.

Medicare-certified institutional providers, such as hospitals, are required to submit an annual cost report to a fiscal intermediary. The information in cost reports is one of the primary sources that the Medicare Payment Advisory Commission (MedPAC) uses in reviewing the reasonableness of Medicare payment levels. MedPAC provides advice to the Congress on payment levels and other issues affecting Medicare.

OBJECTIVES

Our objectives were to determine (1) how much revenue the three additional GPOs received from vendors and what the disposition of that revenue was, (2) how members treated distributions of net administrative fee revenue received from GPOs on their

Medicare cost reports, and (3) whether members properly recorded rebates received from vendors on their Medicare cost reports.

SUMMARY OF FINDINGS

Group Purchasing Organization Fee Revenue

The three additional GPOs reviewed—which were among the largest in the United States—collected administrative fee revenue of $513 million during our audit period.[1] Of this amount, $275 million represented net revenue in excess of operating costs. The GPOs retained $58 million of the $275 million in net revenue to provide reserves and venture capital for new business lines. They distributed the remaining $217 million to members.

Treatment of Distributed Net Revenue

Based primarily on the significance of the dollars received, we reviewed how seven healthcare systems, representing several hundred GPO members, accounted for the net revenue distributed by the three GPOs. We reviewed Medicare cost reports for 38 hospitals under the 7 healthcare systems that received a total of $123 million, or 57 percent, of the $217 million distributed.

We found that one of the healthcare systems did not fully account for net revenue distributions on their Medicare cost reports. This healthcare system did not distribute all of its administrative fees to its member hospitals for inclusion, and subsequent offset, in the respective hospitals' cost reports. As a result, administrative fees of about $5 million related to 6 of the 38 hospitals reviewed were not offset on Medicare cost reports.

Treatment of Rebates From Vendors

The same seven healthcare systems received rebates totaling $115 million directly from vendors or passed from vendors through the GPOs. A review of Medicare cost reports for the same 38 hospitals revealed that all GPO members offset rebates on their Medicare cost reports as required. We noted, however, that one GPO did not distribute all rebates received to its members. That GPO withheld $1.6 million of the total rebates.

Although the $5 million of net revenue distributions (page 4) and $1.6 million of rebates (page 5) not credited on Medicare cost reports was less than the amounts detailed in our prior report, we continue to believe that clarification of instructions from the Centers for Medicare & Medicaid Services to hospitals is needed and that recommendations in our prior report (A-05-03-00074) are timely and valid.

[1]We reviewed a 3-year period covering fiscal years 2001 through 2003.

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INTRODUCTION

BACKGROUND

Group Purchasing Organizations

Group purchasing organizations (GPOs) are buying consortiums designed to leverage the purchasing power of members, primarily hospitals and other health care providers, and to allow them to obtain discounts on medical supplies. In 2002, the Government Accountability Office (GAO) reported that "Hospitals buy everything from sophisticated medical devices—for example, cardiac defibrillators—to commodities such as saline solution through GPO-negotiated contracts. By pooling the purchases of their member hospitals, . . . [GPOs] are intended to negotiate lower prices from vendors (manufacturers and distributors) . . . ."[1] GAO also reported that " . . . hundreds of GPOs operate today, but only about 30 negotiate sizeable contracts on behalf of their members."

In exchange for administrative services and the ability to sell through a GPO to its members, vendors pay administrative fees to GPOs. While conducting prior work at GPOs and their members, we noted that GPOs' revenues from vendor fees substantially exceeded operating costs.

Recent Scrutiny of Vendor Payments

There has been considerable public interest in recent years regarding the operations of GPOs and their receipt of vendor fees. The Senate Judiciary Committee, Subcommittee on Antitrust, Competition Policy and Consumer Rights, has investigated the GPO industry and conducted hearings. The longstanding congressional concern about vendor fees appeared in a 1986 House conference report, expressing concern about the level of vendor fees and directing the Secretary of Health and Human Services to monitor vendor payment arrangements for possible abuses (House Conference Report 99-1012 (1986)). The U.S. Federal Trade Commission recently conducted hearings about the business practices of GPOs and issued a report describing such practices. The press has also shown considerable interest in the GPO industry. For example, the New York Times published a series of investigative reports in 2002.

Although the Department of Health and Human Services does not directly "regulate" GPOs, Medicare regulations provide guidance on the reporting of rebates that hospitals receive from vendors. Specifically, 42 CFR § 413.98 and chapter 8 of the Provider Reimbursement Manual generally require providers to offset purchase discounts, allowances, and refunds of expenses against expenses on their Medicare cost reports.

[1] "Group Purchasing Organizations: Pilot Study Suggests Large Buying Groups Do Not Always Offer Hospitals Lower Prices," GAO-02-690T, April 30, 2002.

Medicare Cost Reports

Medicare-certified institutional providers, such as hospitals, are required to submit an annual cost report to a fiscal intermediary. The cost report contains provider information such as facility characteristics, utilization data, costs and charges by cost center (in total and for Medicare),[2] Medicare settlement data, and financial statement data. Medicare contractors use these data to compute some elements of Medicare reimbursement, such as inpatient outlier payments.

The Medicare Payment Advisory Commission (MedPAC), an independent Federal body established by the Balanced Budget Act of 1997, provides advice to Congress on payment levels for Medicare providers and other issues affecting Medicare. The information in Medicare cost reports is one of the primary sources that MedPAC uses in reviewing the reasonableness of Medicare payment levels.

Prior Audit

In January 2005, our office issued a report addressing the amount of revenue GPOs receive from vendors and the disposition of that revenue. The report, entitled "Review of Revenue From Vendors at Three Group Purchasing Organizations and Their Members (A-05-03-00074)", found that all three GPOs reviewed generated revenue from vendors' administrative fees in excess of related operating costs. The report noted that GPOs collected administrative fee revenue of $1.8 billion for the period reviewed. Of that amount, $1.3 billion represented net revenue in excess of operating costs. The GPOs retained $415 million of the $1.3 billion in net revenue to provide reserves and venture capital for new business lines. They distributed the remaining $898 million to members.

OBJECTIVES, SCOPE, AND METHODOLOGY

Objectives

Our objectives were to determine (1) how much revenue three additional GPOs received from vendors and what the disposition of that revenue was, (2) how members treated distributions of net administrative fee revenue received from GPOs on their Medicare cost reports, and (3) whether members properly recorded rebates received from vendors on their Medicare cost reports.

Scope

We selected three of the largest GPOs in the United States for our review. We reviewed a 3-year period covering fiscal years 2001 through 2003. Based on our review of financial information, we selected several members of each GPO for site reviews. The seven healthcare systems selected received a total of $123 million, or 57 percent, of the total net administrative fee distributions from the GPOs of $217 million.

[2]A cost center is generally an organizational unit having a common functional purpose for which direct and indirect costs are accumulated, allocated, and apportioned.

Our review was limited to the extraction of financial data from books and records, much of it verifiable to audited financial statements, and to interviews with officials and staff from each GPO and GPO member. A detailed review of internal controls was not necessary to meet our audit objectives.

Methodology

To accomplish our objectives, we:

- reviewed relevant laws, regulations, legislative history, and CMS guidance;
- examined organization and financial information related to the three GPOs and the seven healthcare systems;
- determined the types of fees collected by GPOs and their members;
- identified the agreements between GPOs and their members and vendors;
- quantified revenue distributed by GPOs to their owners and members; and
- determined whether the 38 hospitals reported net administrative fee revenue distributions and rebates on their Medicare cost reports.

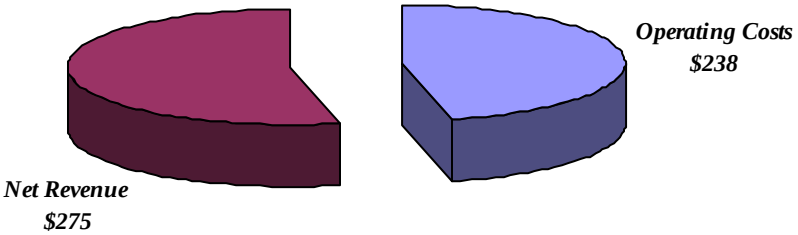
We conducted our audit in accordance with generally accepted government auditing standards.

RESULTS OF REVIEW

GROUP PURCHASING ORGANIZATION FEE REVENUE

Administrative fees paid by vendors to GPOs comprised the vast majority of revenue received by the three GPOs we reviewed. All three GPOs generated revenue from vendors' administrative fees in excess of related operating costs. The GPOs collected administrative fee revenue of $513 million for the period reviewed. Of this amount, $275 million, or 54 cents of every dollar collected, represented net revenue in excess of operating costs. The remaining $238 million, or 46 cents of every dollar collected, was used to cover the GPOs' operating costs . (See Figure 1.)

Figure 1: Total GPO Revenue of $513 Million
(in Millions)

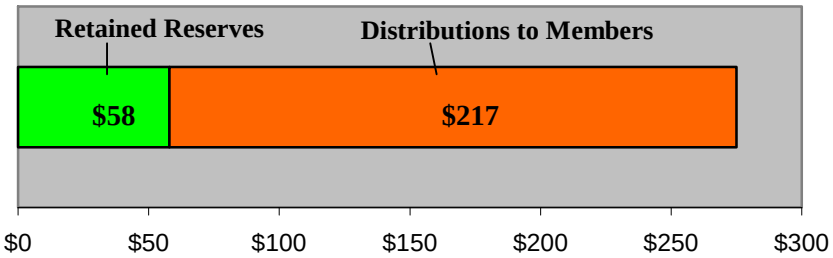


Generally, the administrative fees collected were 3 percent or less of the cost of the goods or services. However, we noted that one GPO had several contracts that paid fees in excess of 3 percent.

TREATMENT OF DISTRIBUTED NET REVENUE

Of the $275 million in net revenue in excess of operating costs, $217 million was distributed to members. The GPOs retained the remaining $58 million to provide reserves and venture capital for new business lines. (See Figure 2.)

Figure 2: Disposition of $275 Million in Net Revenue
(in Millions)



Based primarily on the significance of the dollars received, we reviewed how seven healthcare systems, representing several hundred GPO members, accounted for the net revenue distributed by the three GPOs. We reviewed Medicare cost reports for 38 hospitals under the 7 healthcare systems that received a total of $123 million, or 57 percent, of the $217 million distributed. The results of our review are summarized in the following table.

Treatment of Net Administrative Fee Revenue Distributions Received by 7 Healthcare Systems and Related 38 Hospitals ($ in Millions)

Number of Members Reviewed	Total GPO Revenue	Net Revenue Amount Distributed	Distributed Amount Reviewed	Amount Offset on Cost Reports	Amount Not Offset	Percent Offset
38	$513	$217	$123	$118	$5	96%

We found that one healthcare system did not fully account for net revenue distributions on their Medicare cost reports. This healthcare system did not distribute all of its administrative fees to its member hospitals for inclusion, and subsequent offset, in the respective hospitals' cost reports. As a result, administrative fees of about $5 million

related to 6 of the 38 hospitals reviewed were not offset on Medicare cost reports. Those revenue distributions did not exceed the costs of the related cost centers.

We could not find any guidance from the Center for Medicare & Medicaid Services (CMS) specifically addressing the reporting of net revenue distributions to GPO members from our review of the CMS Provider Reimbursement Manual or our contacts with various CMS and departmental staff. Given the increasing participation of GPOs in the health care marketplace, we believe that specific CMS guidance regarding the treatment of GPO net revenue distributions on Medicare cost reports would help promote full reporting in this area.

TREATMENT OF REBATES FROM VENDORS

GPO members consistently offset vendor rebates on their Medicare cost reports as required. However, we noted that one GPO did not distribute all rebates received to its members. That GPO withheld $1.6 million of the total rebates. Regulations (42 CFR § 413.98) and chapter 8 of the Provider Reimbursement Manual require GPO members to offset purchase discounts, allowances, and refunds of expenses against expenses on their Medicare cost reports.

A rebate is a form of a discount that is given not at the time of sale but at a later time, such as on a quarterly or yearly basis. Rebates are usually dependent on achieving a specified purchasing volume.

At the seven healthcare systems, we examined a total of $115 million in rebates to determine how the members treated rebates received directly from vendors or passed through their GPOs. GPO members consistently offset vendor rebates on their Medicare cost reports when received directly or passed through their GPO. However, one GPO did not distribute rebates to its members. A total of $1.6 million in rebates received from vendors were not offset against costs.

EFFECT OF INCONSISTENT OR INCORRECT REPORTING OF NET REVENUE DISTRIBUTIONS AND REBATES

Cost reports play an important role in determining Medicare payments to hospitals that do not participate in the prospective payment system (PPS), as well as those that do. The less than full reporting of net revenue distributions and rebates on Medicare cost reports has a very direct impact on non-PPS hospitals, such as critical access, psychiatric, and cancer hospitals. Medicare reimburses these hospitals based on their actual costs of providing services. Therefore, failure to reduce costs by GPO net revenue distributions or rebates will result in larger Medicare payments.

Although Medicare pays PPS hospitals at a fixed rate per patient for a particular service, the data in cost reports directly affect some payments to PPS hospitals. For example, the data in cost reports are used to calculate payments for “outlier” cases in which patients are unusually expensive to treat. The amount of an outlier payment is, in part, based on

the relationship between the "retail" amount that a hospital charges for a service and the cost of providing that service. Using data submitted by each hospital on its yearly cost report, CMS's contractors calculate a hospital-specific ratio of costs to charges and generally use that ratio to determine if the hospital is eligible for outlier payments. The ratio will be too high if costs shown on a hospital's cost report are overstated. Multiplying a ratio that is too high by an individual patient's charges can then result in erroneous Medicare outlier payments to the hospital.

Because the costs shown on cost reports affect reimbursement to non-PPS as well as PPS hospitals, we believe that full reporting of GPO net revenue distributions and rebates by members is necessary for equitable Medicare reimbursement.

In addition, MedPAC and CMS continually evaluate Medicare operations to determine what changes, if any, are needed in Medicare reimbursement policies. For hospital reimbursement, much of the information used in their evaluations centers on cost report data. CMS could use the information in this report and, where necessary, perform additional analysis to assess whether GPO revenue distribution patterns should be considered in evaluating Medicare reimbursement policies.

CONCLUSIONS

Although the $5 million of net revenue distributions (page 4) and $1.6 million of rebates (page 5) not credited on Medicare cost reports was less than the amounts detailed in our prior report, we continue to believe that clarification of CMS instructions to hospitals is needed and that recommendations in our prior report (A-05-03-00074) are timely and valid.