Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

HIGHMARK MEDICARE SERVICES, INC., OVERSTATED ITS ALLOCABLE PENSION COSTS FOR CALENDAR YEARS 2008 THROUGH 2011

Inquiries about this report may be addressed to the Office of Public Affairs at Public.Affairs@oig.hhs.gov.

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Regional Inspector General

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Office of Inspector General

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EXECUTIVE SUMMARY

Highmark Medicare Services, Inc., overstated its allocable pension costs for the Medicare and Other segments by $383,000 and $5.4 million, respectively, for calendar years 2008 through 2011.

WHY WE DID THIS REVIEW

Medicare contractors are eligible to be reimbursed a portion of their pension costs, which are funded by the annual contributions that these contractors make to their pension plans. The amount of pension costs that the Centers for Medicare & Medicaid Services (CMS) reimburses to the contractors is determined by the cost reimbursement principles contained in the Federal Acquisition Regulation (FAR) and Cost Accounting Standards (CAS) as required by the Medicare contracts.

For this review, we focused on one Medicare contractor, Highmark Medicare Services, Inc. (Highmark). In particular, we examined the Medicare segment and Other segment allocable pension costs (which for this report we refer to as "pension costs") that Highmark used to calculate the indirect cost rates in its incurred cost proposals (ICPs).

The objective of this review was to determine whether the pension costs that Highmark used to calculate the indirect cost rates in its ICPs for calendar years (CYs) 2008 through 2011 complied with Federal requirements.

BACKGROUND

During our audit period, Highmark was a wholly owned subsidiary of Highmark, Inc., whose home office was in Camp Hill, Pennsylvania. Highmark administered Medicare Parts A and B operations under cost reimbursement contracts with CMS until the Medicare segment was sold to Diversified Services Options, Inc. (DSO), effective January 1, 2012.

With the implementation of Medicare contracting reform, Highmark continued to perform Medicare work after being awarded the Medicare administrative contractor (MAC) (Jurisdiction 12) contract on October 24, 2007. While performing its MAC work, Highmark also functioned as a Medicare Part A fiscal intermediary and Part B carrier, with those contracts terminating in July 2008 and December 2008, respectively. Highmark continued to work as the Jurisdiction 12 MAC until January 1, 2012, when Highmark, Inc., sold its wholly owned subsidiary, Highmark, to DSO.

Effective January 1, 1998, Highmark amended its disclosure statement to implement pooled costing. Medicare contractors use pooled costing to calculate the indirect cost rates that they submit on their ICPs. The pension costs are included in the computation of the indirect cost rates reported on the ICPs.

Under the provisions of Medicare contracting reform, CMS transitioned the functions of the fiscal intermediaries and carriers, which had executed the Title XVIII Medicare contracts, to

Medicare contractors. As part of this transition, the method by which Medicare reimbursed pension costs to the contactor changed from a cost reimbursement basis to an indirect cost basis. In accordance with the FAR and the Medicare contract, reimbursement of indirect costs was now based on indirect cost rates that met the negotiated indirect cost rates determined by the contract.

We reviewed $13,007,682 of Medicare segment pension costs used by Highmark in the calculation of its indirect cost rates for CYs 2008 through 2011. We also reviewed $215,594,095 of Other segment pension costs used by Highmark in the calculation of its indirect cost rates for this same time period.

WHAT WE FOUND

Neither the Medicare segment nor the Other segment allocable pension costs that Highmark used to calculate indirect cost rates complied with Federal requirements. Specifically, for CYs 2008 through 2011:

- Highmark used Medicare segment pension costs of $13,007,682 to calculate its indirect cost rates; however, we determined that the Medicare segment pension costs that Highmark should have used to calculate the indirect cost rates were $12,624,732. Thus, Highmark overstated the Medicare segment pension costs used to calculate its indirect cost rates by $382,950.

- Highmark used Other segment pension costs of $215,594,095 to calculate its indirect cost rates; however, we determined that the Other segment pension costs that Highmark should have used to calculate the indirect cost rates were $210,178,960. Thus, Highmark overstated the Other segment pension costs used to calculate its indirect cost rates by $5,415,135.

These overstatements occurred primarily because Highmark used incorrect CAS pension costs to calculate its indirect cost rates for CYs 2008 through 2011.

WHAT WE RECOMMEND

We recommend that Highmark:

- decrease the Medicare segment pension costs used to calculate the indirect cost rates by $382,950 for CYs 2008 through 2011 and

- decrease the Other segment pension costs used to calculate the indirect cost rates by $5,415,135 for CYs 2008 through 2011.

AUDITEE COMMENTS AND OUR RESPONSE

In written comments on our draft report, Highmark did not directly address our recommendations. However, it is clear from the comments that Highmark did not agree with our recommendations to reduce its Medicare segment and Other segment allocable pension costs by $382,950 and $5,415,135, respectively.

Highmark referred to its agreement with our recommendations in related report A-07-13-00414 but did not agree with the methodology we used when applying prepayment credits. Specifically, Highmark did not concur with our interpretation of FAR 31.205-6(j)(2)(iii) as it relates to offsetting prepayment credits from the CAS funding target.

Nothing in Highmark's comments caused us to change our findings or recommendations. We disagree with Highmark's assertions about our methodology for the calculation of pension costs when prepayment credits exist.

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INTRODUCTION

WHY WE DID THIS REVIEW

Medicare contractors are eligible to be reimbursed a portion of their pension costs, which are funded by the annual contributions that these contractors make to their pension plans. The amount of pension costs that the Centers for Medicare & Medicaid Services (CMS) reimburses to the contractors is determined by the cost reimbursement principles contained in the Federal Acquisition Regulation (FAR) and Cost Accounting Standards (CAS) as required by the Medicare contracts.

For this review, we focused on one Medicare contractor, Highmark Medicare Services, Inc. (Highmark). In particular, we examined the Medicare segment and Other segment allocable pension costs (which for this report we refer to as "pension costs") that Highmark used to calculate the indirect cost rates in its incurred cost proposals (ICPs).

OBJECTIVE

Our objective was to determine whether the pension costs that Highmark used to calculate the indirect cost rates in its ICPs for calendar years (CYs) 2008 through 2011 complied with Federal requirements.

BACKGROUND

Highmark Medicare Services, Inc.

During our audit period, Highmark was a wholly owned subsidiary of Highmark, Inc., whose home office was in Camp Hill, Pennsylvania. Highmark administered Medicare Parts A and B operations under cost reimbursement contracts with CMS until the Medicare segment was sold to Diversified Services Options, Inc. (DSO), effective January 1, 2012.

With the implementation of Medicare contracting reform,[1] Highmark continued to perform Medicare work after being awarded the MAC (Jurisdiction 12) contract on October 24, 2007.[2] While performing its MAC work, Highmark also functioned as a Medicare Part A fiscal intermediary and Part B carrier, with those contracts terminating in July 2008 and December 2008, respectively. Highmark continued to work as the Jurisdiction 12 MAC until January 1, 2012, when Highmark, Inc., sold its wholly owned subsidiary, Highmark, to DSO.

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[1] Section 911 of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, P.L. No. 108-173 (MMA), required CMS to transfer the functions of fiscal intermediaries and carriers to Medicare administrative contractors (MACs) between October 2005 and October 2011. Most, but not all, of the MACs are fully operational; for jurisdictions where the MACs are not fully operational, the fiscal intermediaries and carriers continue to process claims. For purposes of this report, the terms "Medicare contractor" and "MAC" mean the fiscal intermediary, carrier, or MAC, whichever is applicable.

[2] Jurisdiction 12 consists of the States of Delaware, Maryland, New Jersey, and Pennsylvania, and the District of Columbia.

Effective January 1, 1998, Highmark amended its disclosure statement to implement pooled costing. Medicare contractors use pooled costing to calculate the indirect cost rates that they submit on their ICPs. The pension costs are included in the computation of the indirect cost rates reported on the ICPs. The FAR requires Medicare contractors to file final indirect cost rates on their ICPs 6 months after the year end. In turn, CMS uses the indirect cost rates in reimbursing costs under cost-reimbursement contracts.

Medicare Reimbursement of Pension Costs

CMS reimburses a portion of the Medicare contractors' annual pension costs, which are funded by the annual contributions that these contractors make to their pension plans. To be allowable for Medicare reimbursement, pension costs must be (1) measured, assigned, and allocated in accordance with CAS 412 and 413 and (2) funded as specified by part 31 of the FAR.

Under the provisions of the contracts that CMS developed with the Medicare contractors as part of the implementation of the MMA, the method by which Medicare reimbursed pension costs to the contractor changed from a cost reimbursement basis to an indirect cost basis. In accordance with the FAR and the MAC contract, reimbursement of indirect costs was now based on indirect cost rates that met the negotiated indirect cost rates determined by the contract.

HOW WE CONDUCTED THIS REVIEW

We reviewed $13,007,682 of Medicare segment pension costs used by Highmark in the calculation of its indirect cost rates for CYs 2008 through 2011. We also reviewed $215,594,095 of Other segment pension costs used by Highmark in the calculation of its indirect cost rates for this same time period.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our finding and conclusions based on our audit objectives.

Appendix A contains details of our audit scope and methodology.

FINDINGS

Neither the Medicare segment nor the Other segment allocable pension costs that Highmark used to calculate indirect cost rates complied with Federal requirements. Specifically, for CYs 2008 through 2011:

- Highmark used Medicare segment pension costs of $13,007,682 to calculate its indirect cost rates; however, we determined that the Medicare segment pension costs that Highmark should have used to calculate the indirect cost rates were $12,624,732. Thus, Highmark overstated the Medicare segment pension costs used to calculate its indirect cost rates by $382,950.

- Highmark used Other segment pension costs of $215,594,095 to calculate its indirect cost rates; however, we determined that the Other segment pension costs that Highmark should have used to calculate the indirect cost rates were $210,178,960. Thus, Highmark overstated the Other segment pension costs used to calculate its indirect cost rates by $5,415,135.

These overstatements occurred primarily because Highmark used incorrect CAS pension costs to calculate its indirect cost rates for CYs 2008 through 2011.

OVERSTATEMENT OF PENSION COSTS

Medicare Segment Pension Costs

Highmark used pension costs of $13,007,682 to calculate its indirect cost rates for the Medicare segment. We calculated CAS-based pension costs for CYs 2008 through 2011 for the Medicare segment in accordance with CAS 412 and 413. For details on the Federal requirements, see Appendix B.

We determined that the CAS-based pension costs for the Medicare segment were $12,624,732 for CYs 2008 through 2011. Thus, Highmark overstated the Medicare segment pension costs used to calculate its indirect cost rates for CYs 2008 through 2011 by $382,950. This overstatement occurred because Highmark used incorrect CAS pension costs when calculating its indirect cost rates for this time period.

Table 1 below shows the differences between the Medicare segment CAS-based pension costs that we calculated and the pension costs that Highmark used to calculate its indirect cost rates for CYs 2008 through 2011. Appendix C contains additional details on pension costs.

Table 1: Comparison of Pension Costs for the Medicare Segment

	Medicare Segment Pension Costs		
Calendar Year	**Per Audit**	**Per Highmark**	**Difference**
2008	$1,700,340	$1,695,676	$4,664
2009	4,215,170	4,391,760	(176,590)
2010	3,376,929	3,433,410	(56,481)
2011	3,332,293	3,486,836	(154,543)
Total	**$12,624,732**	**$13,007,682**	**($382,950)**

Other Segment Pension Costs

Highmark used pension costs of $215,594,095 to calculate its indirect cost rates for the Other segment. We calculated CAS-based pension costs for CYs 2008 through 2011 for the Other segment in accordance with CAS 412 and 413. For details on the Federal requirements, see Appendix B.

We determined that the CAS-based pension costs for the Other segment were $210,178,960 for CYs 2008 through 2011. Thus, Highmark overstated the Other segment pension costs used to calculate its indirect cost rates for CYs 2008 through 2011 by $5,415,135. This overstatement occurred because Highmark used incorrect CAS pension costs when calculating its indirect cost rates for this time period.

Table 2 below shows the differences between the Other segment CAS-based pension costs that we calculated and the pension costs that Highmark used to calculate its indirect cost rates for CYs 2008 through 2011. Appendix C contains additional details on pension costs.

Table 2: Comparison of Pension Costs for the Other Segment

	Other Segment Pension Costs		
Calendar Year	**Per Audit**	**Per Highmark**	**Difference**
2008	$39,478,592	$38,286,324	$1,192,268
2009	67,120,585	70,189,272	(3,068,687)
2010	51,291,441	52,347,671	(1,056,230)
2011	52,288,342	54,770,828	(2,482,486)
Total	**$210,178,960**	**$215,594,095**	**($5,415,135)**

RECOMMENDATIONS

We recommend that Highmark:

- decrease the Medicare segment pension costs used to calculate the indirect cost rates by $382,950 for CYs 2008 through 2011 and

- decrease the Other segment pension costs used to calculate the indirect cost rates by $5,415,135 for CYs 2008 through 2011.

AUDITEE COMMENTS

In written comments on our draft report, Highmark did not directly address our recommendations. However, it is clear from the comments that Highmark did not agree with our recommendations to reduce its Medicare segment and Other segment allocable pension costs by $382,950 and $5,415,135, respectively.

Highmark referred to its agreement with our recommendations in related report A-07-13-00414 (Appendix A) but did not agree with the methodology we used when applying prepayment credits. Specifically, Highmark did not concur with our interpretation of FAR 31.205-6(j)(2)(iii) as it relates to offsetting prepayment credits from the CAS funding target.

Below is a summary of Highmark's comments. Highmark's comments appear in their entirety as Appendix D.

- Highmark agreed that it should have adjusted its Final Administrative Cost Proposals for FYs 2003 through 2006 on the basis of the revised CAS pension cost calculations resulting from our prior audit (A-07-04-03163, issued January 21, 2005).

- Highmark did not concur with our "interpretation" of FAR 31.205-6(j)(2)(iii) as it relates to offsetting prepayment credits from the CAS funding target. In this context, Highmark referred to the methodology described in Appendix C, endnote 9, according to which we, as Highmark stated, "… generally disallowed quarterly interest because of the existence of Highmark's prepayment credits." Highmark disagreed with this methodology because, it said, "FAR 31.205-6(j)(2)(iii) does not even reference prepayment credits." Highmark added that under its interpretation of the FAR, "… interest is only unallowable if payment is made 30 days after the end of each quarter." Highmark stated that because it submitted its quarterly cash contributions within 30 days after the end of each quarter, its accrued interest is allowable based on FAR 31.205-6(j)(2)(iii).[3]

- Highmark also stated that while it understood our position of applying prepayment credits as of the first day of the year, that position is not supported by FAR 31.205-6(j)(2)(iii). Highmark added that our method for applying the prepayment credits is inconsistent with FAR 31.205-6(j)(2)(iii) because it limits a contractor's ability to decide the timing of its pension contributions beyond the limitations imposed by that regulation.

- Further, Highmark said that our methodology of applying prepayment credits as of the first day of the year contravenes CAS Board policy that prepayment credits should have a neutral impact from a cost accounting perspective. According to Highmark, our position would "… unfairly penalize contractors who have prepayment credits by reducing their allowable pension expense."

- On these bases, Highmark recalculated its total Medicare segment pension costs for FYs 2008 through 2011 as $13,005,736. Accordingly, Highmark identified a $381,004 difference (that is, an interest adjustment) between its recalculated amount of $13,005,736 and the $12,624,732 amount that we identified in our finding for the Medicare segment pension costs.

- Regarding the Other segment pension costs, of which only a portion is allocable to the Medicare business, Highmark recalculated its Other segment pension costs for FYs 2008 through 2011 as $215,862,694. Accordingly, Highmark identified a $5,683,734

[3] Highmark's comments included a table (shown on the second page of Appendix D) depicting the deposit dates of Highmark's quarterly contributions.

difference between its recalculated amount of $215,862,694 and the $210,178,960 amount that we identified in our finding for the Other segment pension costs.

- As part of its comments, Highmark provided a spreadsheet, prepared by its actuary, that demonstrated the impact of the interest adjustment on Highmark's pension plan in FY 2011.

OFFICE OF INSPECTOR GENERAL RESPONSE

Nothing in Highmark's comments caused us to change our findings or recommendations.

We disagree with Highmark's assertions about our methodology for the calculation of pension costs when prepayment credits exist. Although Highmark stated that our interpretation and application of prepayment credits is not supported by FAR 31.205-6(j)(2)(iii), that regulation states that "[i]ncreased pension costs are unallowable if the increase is caused by a delay in funding beyond 30 days after each quarter of the year to which they are assignable." This provision applies to all cash contributions made to the pension trust. Because Highmark had made contributions in excess of the CAS funding target in previous years, the resulting prepayment credits were available on the first day of the year to cover the assignable pension costs.

Highmark had already decided to fund these costs with contributions it made into the pension trust fund, and for that reason, these funds were unavailable to the contractor for any other purpose but to fund pension costs. Pursuant to FAR 31.201-2 and 31.201-3, it would not be reasonable for a prudent person in the conduct of competitive business to ignore the existence of available funds, earmarked for this purpose only, and thereby incur additional interest costs. By using current-period cash contributions in lieu of the available prepayment credits to liquidate its pension costs, Highmark would effectively be incurring additional costs by delaying the funding of the assignable pension costs. Highmark's approach of applying cash contributions instead of prepayment credits would identify additional interest costs of $381,004 and $5,683,734 for the Medicare segment and Other segment, respectively, that would be allocable under that methodology.

Highmark's reference to a discussion in the preamble to the publication of the final CAS Pension Harmonization Rule (CAS 412.50(b)(7))[4] is not relevant to the application of prepayment credits in the manner discussed in this report. Rather, the CAS Board discusses how prepayment credits will be allocated an equal share of investment earnings and administrative expenses based on the fund's performance. Although Highmark did not receive interest for quarterly contributions, it received interest on its prepayment credits (those contributions that exceeded the CAS funding target) at the valuation rate of interest, as described in Appendix C, endnote 4. CAS 412.50(a)(4) states: "The accumulated value of such prepayment credits shall be adjusted for interest at the valuation rate of interest until applied towards pension cost in a future accounting period." In the context of our finding that Highmark incorrectly calculated CAS pension costs, and with respect to our methodology as described in Appendix C, endnote 9, this provision of the CAS, rather

[4] 76 Fed. Reg. 81296, 81299 (Dec. 27, 2011).

than the discussion cited by Highmark, constitutes the relevant criteria to determine allocable pension costs.

APPENDIX A: AUDIT SCOPE AND METHODOLOGY

SCOPE

We reviewed $13,007,682 of Medicare segment pension costs used by Highmark in the calculation of its indirect cost rates for CYs 2008 through 2011. We also reviewed $215,594,095 of Other segment pension costs used by Highmark in the calculation of its indirect cost rates for this same time period.

Achieving our objective did not require that we review Highmark's overall internal control structure. We reviewed the internal controls related to the pension costs claimed for Medicare reimbursement to ensure that the pension costs were allocable in accordance with the CAS and allowable in accordance with the FAR.

We performed our fieldwork at Highmark in Camp Hill, Pennsylvania, in September 2012.

METHODOLOGY

To accomplish our objective, we:

- reviewed the portions of the FAR, CAS, and Medicare contracts applicable to this audit;

- reviewed information provided by Highmark to identify the amount of pension costs used in Highmark's calculation of its indirect cost rates for CYs 2008 through 2011;

- used information that Highmark's actuarial consulting firms provided, including information on assets, liabilities, normal costs, contributions, benefit payments, investment earnings, and administrative expenses;

- examined Highmark's accounting records, pension plan documents, annual actuarial valuation reports, and Department of Labor/Internal Revenue Service Forms 5500;

- determined the extent to which Highmark funded CAS-based pension costs with contributions to the pension trust fund and accumulated prepayment credits;

- engaged the CMS Office of the Actuary to calculate the pension costs based on the CAS (the calculations were based on separately computed CAS-based pension costs for the Medicare segment and the Other segment);

- reviewed the CMS actuaries' methodology and calculations; and

- provided the results of our review to Highmark officials on July 12, 2013.

We performed this review in conjunction with the following audits and used the information obtained during this review:

- *Highmark Medicare Services, Inc., Understated Its Medicare Segment Pension Assets and Understated the Medicare Segment Excess Pension Liabilities as of January 1, 2012* (A-07-13-00414) and

- *Highmark Medicare Services, Inc., Claimed Some Unallowable Medicare Pension Costs for Fiscal Years 2003 Through 2009* (A-07-13-00415).

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our finding and conclusions based on our audit objectives.

APPENDIX B: FEDERAL REQUIREMENTS RELATED TO REIMBURSEMENT OF PENSION COSTS

FEDERAL REGULATIONS

Federal regulations (FAR 52.216-7(a)(1)) address the invoicing requirements and the allowability of payments as determined by the Contracting Officer in accordance with FAR subpart 31.2.

Federal regulations (FAR 31.205-6(j)) require Medicare contractors to measure, assign, and allocate the costs of all defined benefit pension plans in accordance with CAS 412 and 413. Federal regulations (FAR 31.205-6(j)) also address allowability of pension costs and require that Medicare contractors fund the pension costs assigned to contract periods by making contributions to the pension plan.

Federal regulations (CAS 412) (as amended) address the determination and measurement of pension cost components. This regulation also addresses the assignment of pension costs to appropriate accounting periods.

Federal regulations (CAS 413) (as amended) address the valuation of pension assets, allocation of pension costs to segments of an organization, adjustment of pension costs for actuarial gains and losses, and assignment of gains and losses to cost accounting periods.

MEDICARE CONTRACTS

The contracts state: "Once each month following the effective date of this contract, the Contractor may submit to the Government an invoice for payment, in accordance with FAR clause 52.216-7, 'Allowable Cost & Payment.'"

APPENDIX C: ALLOCABLE PENSION COSTS FOR HIGHMARK MEDICARE SERVICES, INC., FOR CALENDAR YEARS 2008 THROUGH 2011

Date	Description		Total Company	Other Segment	Medicare Segment	Gateway Segment
2008	Contributions	1/	$251,581,464	$251,581,464	$0	$0
	Discount for interest	2/	($16,621,149)	($16,621,149)	$0	$0
January 1, 2008	Present value contributions	3/	$234,960,315	$234,960,315	$0	$0
	Prepayment credit applied	4/	$42,561,656	$39,478,592	$1,700,340	$1,382,724
	Present value of funding	5/	$277,521,971	$274,438,907	$1,700,340	$1,382,724
January 1, 2008	CAS funding target	6/	$42,561,656	$39,478,592	$1,700,340	$1,382,724
	Percentage funded	7/		100.00%	100.00%	100.00%
	Funded pension cost	8/		$39,478,592	$1,700,340	$1,382,724
	Allowable interest	9/		$0	$0	$0
2008	CY allocable pension cost	10/		$39,478,592	$1,700,340	$1,382,724

Date	Description	Total Company	Other Segment	Medicare Segment	Gateway Segment
2009	Contributions	$38,399,318	$38,399,318	$0	$0
	Discount for interest	($1,071,269)	($1,071,269)	$0	$0
January 1, 2009	Present value contributions	$37,328,049	$37,328,049	$0	$0
	Prepayment credit applied	$73,504,245	$67,120,585	$4,215,170	$2,168,490
	Present value of funding	$110,832,294	$104,448,634	$4,215,170	$2,168,490
January 1, 2009	CAS funding target	$73,504,245	$67,120,585	$4,215,170	$2,168,490
	Percentage funded		100.00%	100.00%	100.00%
	Funded pension cost		$67,120,585	$4,215,170	$2,168,490
	Allowable interest		$0	$0	$0
2009	CY allocable pension cost		$67,120,585	$4,215,170	$2,168,490

Date	Description	Total Company	Other Segment	Medicare Segment	Gateway Segment
2010	Contributions	$51,000,000	$51,000,000	$0	$0
	Discount for interest	($851,890)	($851,890)	$0	$0
January 1, 2010	Present value contributions	$50,148,110	$50,148,110	$0	$0
	Prepayment credit applied	$55,210,941	$51,291,441	$3,376,929	$542,571
	Present value of funding	$105,359,051	$101,439,551	$3,376,929	$542,571
January 1, 2010	CAS funding target	$55,210,941	$51,291,441	$3,376,929	$542,571
	Percentage funded		100.00%	100.00%	100.00%
	Funded pension cost		$51,291,441	$3,376,929	$542,571
	Allowable interest		$0	$0	$0
2010	CY allocable pension cost		$51,291,441	$3,376,929	$542,571

Date	Description	Total Company	Other Segment	Medicare Segment	Gateway Segment
2011	Contributions	$60,880,000	$60,880,000	$0	$0
	Discount for interest	($1,016,512)	($1,016,512)	$0	$0
January 1, 2011	Present value contributions	$59,863,488	$59,863,488	$0	$0
	Prepayment credit applied	$56,977,758	$52,288,342	$3,332,293	$1,357,123
	Present value of funding	$116,841,246	$112,151,830	$3,332,293	$1,357,123
January 1, 2011	CAS funding target	$56,977,758	$52,288,342	$3,332,293	$1,357,123
	Percentage funded		100.00%	100.00%	100.00%
	Funded pension cost		$52,288,342	$3,332,293	$1,357,123
	Allowable interest		$0	$0	$0
2011	CY allocable pension cost		$52,288,342	$3,332,293	$1,357,123

ENDNOTES

1/ We obtained Total Company contribution amounts and dates of deposit from Internal Revenue Service Form 5500 reports. The contributions included deposits made during the CY and accrued contributions deposited after the end of the CY but within the time allowed for filing tax returns. We determined the contributions allocated to the Medicare segment during the pension segmentation review (A-07-13-00414) and pension costs claimed for Medicare reimbursement review (A-07-13-00415). Therefore, the amounts shown for the Other segment represent the difference between the Total Company, the Medicare segments, and the Gateway segment.

2/ We subtracted the interest that was included in the contributions deposited after the beginning of the valuation year to discount the contributions back to their beginning-of-the-year value. For purposes of this Appendix, we computed the interest as the difference between the present value of contributions (at the CAS valuation interest rate) and actual contribution amounts.

3/ The present value of contributions is the value of the contributions discounted from the date of deposit back to the first day of the CY. For purposes of this Appendix, we deemed deposits made after the end of the CY to have been made on the final day of the CY, consistent with the method established by the Employee Retirement Income Security Act prior to the implementation of the Pension Protection Act.

4/ A prepayment credit represents the accumulated value of premature funding from the previous year(s). A prepayment credit is created when contributions, plus interest, exceed the end-of-year CAS funding target. A prepayment credit is carried forward, with interest, to fund future CAS pension costs.

5/ The present value of funding represents the present value of contributions plus prepayment credits. This is the amount of funding that is available to cover the CAS funding target measured at the first day of the CY.

6/ The CAS funding target must be funded by current or prepaid contributions to satisfy the funding requirement of the FAR 31.205-6(j)(2)(i).

7/ The percentage of costs funded is a measure of the portion of the CAS funding target that was funded during the CY. Because any funding in excess of the CAS funding target is accounted for as a prepayment in accordance with CAS 412.50(c)(1), the funded ratio may not exceed 100 percent. We computed the percentage funded as the present value of funding divided by the CAS funding target. For purposes of illustration, the percentage of funding has been rounded to four decimal places.

8/ We computed the funded CAS-based pension cost as the CAS funding target multiplied by the percent funded.

9/ We assumed that interest on the funded CAS-based pension cost, less the prepayment credit, accrues in the same proportion as the interest on contributions bears to the present value of contributions. However, we limited the interest in accordance with FAR 31.205-6(j)(2)(iii), which does not permit the allowable interest to exceed the interest that would accrue if the CAS funding target, less the prepayment credit, were funded in four equal installments deposited within 30 days after the end of the quarter.

10/ The CY allocable CAS pension cost is the amount of pension cost that may be allocated for contract cost purposes.

APPENDIX D: AUDITEE COMMENTS

HIGHMARK

December 9, 2013

Mr. Patrick Cogley
Regional Inspector General for Audit Services
Office of Audit Services, Region VII
Department of Health and Human Services
601 East 12th Street, Room 0429
Kansas City, MO 64106

Subject: <u>OIG Report Number A-07-13-00416</u>

Dear Mr. Cogley:

Thank you for affording Highmark Inc. ("Highmark") this opportunity to comment on the U.S. Department of Health and Human Services, Office of Inspector General ("OIG"), draft audit report entitled *Highmark Medicare Services, Inc., Overstated Its Allocable Pension Costs for Calendar Years 2008 Through 2011.*

We have carefully reviewed both the draft audit report and the additional detailed supplemental information received from the audit team. Our comments on the findings specific to this report are provided below:

1. Highmark agrees that the demographic recommendations in OIG Report No. A-07-13-00414 impact the Medicare segment pension costs.

2. Highmark does not concur with OIG's interpretation of FAR 31.205-6(j)(2)(iii) as it relates to offsetting the prepayment credits from the CAS funding target. Our rationale for this disagreement is outlined below.

The OIG audit report generally disallowed quarterly interest because of the existence of Highmark's prepayment credits. The OIG explained its rationale for disallowing quarterly interest in a footnote to the report:

> We assumed that interest on the funded CAS-based pension cost, less the prepayment credit, accrues in the same proportion as the interest on contributions bears to the present value of contributions. However, we limited the interest in accordance with FAR 31.205-6(j)(2)(iii), which does not permit the allowable interest to exceed the interest that would accrue if

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the CAS funding target, less the prepayment credit, were funded in four equal installments deposited within 30 days after the end of the quarter.

OIG Report No. A-07-13-00416 at 14, n.9.

Highmark disagrees with the rationale offered by OIG because FAR 31.205-6(j)(2)(iii) provides no support for OIG's position that quarterly interest cannot accrue if the contractor has prepayment credits. FAR 31.205-6(j)(2)(iii) does not even reference prepayment credits. Instead, FAR 31.205-6(j)(2)(iii) simply provides that "[i]ncreased pension costs are unallowable if the increase is caused by a delay in funding beyond 30 days after each quarter of the year to which they are assignable." Accordingly, interest is only unallowable if payment is made 30 days after the end of each quarter. As shown below, Highmark submitted quarterly cash contributions within 30 days after the end of each quarter. The accrued interest on Highmark's quarterly pension payments is therefore allowable in accordance with the plain language of FAR 31.205-6(j)(2)(iii).

Highmark Qualified Pension Plan Contributions

April 15, 2008 - January 1, 2012

Contribution Date		Amount
3/31/2011	$	60,800,000
3/31/2010	$	51,000,000
7/15/2009	$	19,199,659
4/15/2009	$	19,199,659
12/15/2008	$	12,895,366
12/15/2008	$	200,000,000
10/15/2008	$	12,895,366
4/15/2008	$	12,895,366
4/15/2008	$	12,895,366

We understand that OIG takes the position that contractors are required to apply prepayment credits as of the first day of the fiscal year. As discussed above, that position is not supported by FAR 31.205-6(j)(2)(iii), which does not reference prepayment credits. To the contrary, Highmark submits that OIG's position is inconsistent with FAR 31.205-6(j)(2)(iii), because it would limit a contractor's ability to decide the timing of its pension contributions beyond the limitations imposed by that regulation. OIG's position requires every contractor with prepayment credits to make 100% of its annual pension contribution (up to the amount of the prepayment credit) on the first day of the fiscal year. Such a position is contrary to the plain language of FAR 31.205-6(j)(2)(iii), which expressly allows contractors to make quarterly payments, and which expressly provides that interest on such payments is allowable so long as the payment is made within 30 days after the end of each quarter.

OIG has cited to no other authority that would require contractors to apply prepayment credits at the start of the fiscal year or risk having their accrued quarterly interest disallowed. Highmark respectfully submits that the OIG's position contravenes stated CAS Board policy that prepayment credits should be neutral from a cost accounting perspective. *See* 76 Fed. Reg. 81296, 81299 (Dec. 27, 2011) ("A decision to fund in excess of the CAS assigned cost should have a neutral impact on Government contract costing, although it might have a transitory negative impact on the contractor's cash flow."). OIG's position would unfairly penalize contractors who have prepayment credits by reducing their allowable pension expense. In particular, contractors without prepayment credits could recover interest on their quarterly pension contributions, while contractors with prepayment credits would not be entitled to such interest. This would be true even where the contractor, like Highmark, actually submitted cash contributions throughout the year, and thus actually accrued interest on its pension obligations. Where the CAS Board previously recognized that the use of prepayment credits should have a neutral impact on government contract cost accounting, OIG's position is unsupportable not simply as a matter of law, but also as a matter of policy.

Highmark recalculated its total Medicare segment pension costs for FYs 2008 through 2011 as $13,005,736. This amount includes the impact of Item No. 1 (*i.e.,* the recommendation of OIG Report No. A-07-13-00414), but does not reflect acceptance of Item No. 2 (*i.e.,* the interest adjustment). The difference between the recalculated amount of $13,005,736 and the OIG Report amount of $12,624,732 of $381,004 represents the interest adjustments discussed above. Our actuary has developed these revised figures based on the information contained in OIG Report Nos. A-07-13-00414 and A-07-13-00415, and the additional detailed supplemental information received from the audit team.

Regarding the Other segment pension costs, of which only a portion is allocable to the Medicare business, Highmark recalculated its total Medicare segment pension costs for FYs 2008 through 2011 as $215,862,694. Again, this amount includes the impact of Item No. 1, but does not reflect acceptance of Item No. 2. The difference between the recalculated amount of $215,862,694 and the OIG Report amount of $210,178,960 of $5,683,734 represents the interest adjustments discussed above. Our actuary has developed these revised figures based on the information contained in draft reports A-07-13-00414 and A-07-13-00415, and the additional detailed supplemental information received from the audit team.

Finally, enclosed with this submission is a spreadsheet prepared by our actuary that demonstrates the impact of the interest adjustment on Highmark's pension plan in FY 2011.

Thank you again for affording Highmark the opportunity to comment on this report. We believe that resolution of the issues raised can best be achieved through an open dialogue between the government and Highmark. In that regard, please do not hesitate to contact me at (412) 544-6902 or through email at Janine.Colinear@Highmark.com if you have any questions regarding this response.

Sincerely,

Janine K. Colinear
Chief Accounting Officer
Highmark Inc.

Enclosure

Highmark Retirement Plan. Quantification of Interest Disallowance and Reconciliation of Original Results to Recent Audit (Calendar Year Results)

	Col (1)	Col (2)	Col (3)	Col (4)	Col (5)	Col (6)	RECONCILIATION TO AMOUNTS SHOWN IN DRAFT OIG AUDIT LETTERS Col (7)	Col (8)	Col (9)
	Highmark Original (pre audit) - Assuming Payment as of Beginning of Calendar Year	Highmark Updated (post audit) - Assuming Payment as of Beginning of Calendar Year	CMS (per audit) - Assuming Payment as of Beginning of Calendar Year	Highmark Original (pre audit) submitted for reimbursement - Time Weighted - Calendar Year	Highmark Updated (post audit) which should have been submitted for reimbursement - Time Weighted - Calendar Year	CMS (per audit) - Time Weighted - Beginning of Calendar Year due to Prepayment Credit	Impact of audit findings (other than disallowance of interest on contributions): Col (5) - Col (4)	Impact of disallowing interest on contributions: Col (6) - Col (5)	Net impact as shown in Table 2, page 4 of Report 416: Col (7) + Col (8)
i. Annual Costs for 2011									
Indirect	52,237,434	52,288,342	52,288,342	54,770,828	54,824,204	52,288,342	53,376	-2,535,862	-2,482,486 *
Medicare	3,325,554	3,332,293	3,332,293	3,486,836	3,493,900	3,332,293	7,064	-161,607	-154,543
Gateway	1,360,991	1,357,123	1,357,123	1,426,996	1,422,940	1,357,123	-4,056	-65,817	-69,873
Total	56,923,979	56,977,758	56,977,758	59,684,660	59,741,044	56,977,758	56,384	-2,763,286	-2,706,902
ii. Assumed Contribution Dates									
a. Payment date #1		01/01/2011	01/01/2011	N/A	N/A	01/01/2011			
b. Payment date #2		N/A	N/A	04/30/2011	04/30/2011	N/A			
c. Payment date #3		N/A	N/A	07/30/2011	07/30/2011	N/A			
d. Payment date #4		N/A	N/A	10/30/2011	10/30/2011	N/A			
e. Payment date #5		N/A	N/A	12/31/2011	12/31/2011	N/A			
iii. Contributions actually paid									
a. Payment date #1			56,977,758	N/A					
b. Payment date #2			N/A	14,921,165	14,921,165				
c. Payment date #3			N/A	14,921,165	14,921,165				
d. Payment date #4			N/A	14,921,165	14,921,165				
e. Payment date #5			N/A	14,921,165	14,921,165				
f. Total			56,977,758	59,684,660	59,684,660				
iv. Prepayment Credits Applied									
a. Payment date #1					14,096	56,977,758			
b. Payment date #2					14,096				
c. Payment date #3					14,096				
d. Payment date #4					14,096				
e. Payment date #5					56,384				
f. Total									

* Amount flagged with asterisk matches the 2011 value shown in Table 2 (page 4) of Report A-07-13-00416. Table 2 (page 4) of report 416 also contains results for 2008 - 2010. Reconciliation of 2008 - 2010 not provided herein since the theory applicable to 2008 - 2010 of Table 2 (page 4) of report 416 is identical to what is shown above.

The disallowance of the interest due to the timing of contributions also applies to Table 1 (page 3) of Report 416 and Table 1 (page 3) of Report A-07-13-00415. However, those results are not developed here because they are on a fiscal, rather than calendar year basis.