AHCCCS ADMINISTRATION

PERFORMANCE AUDIT

* * * * *

FINAL REPORT

FEBRUARY 6, 1985

Price Waterhouse

Price Waterhouse

OFFICE OF GOVERNMENT SERVICES

1801 K STREET, N.W.
WASHINGTON, DC 20006
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February 6, 1985

Mr. Douglas R. Norton
Auditor General
111 West Monroe
Phoenix, Arizona

Dear Mr. Norton:

We are very pleased to present the final report concerning our performance audit of the Arizona Health Care Cost Containment System's (AHCCCS) administration.

The AHCCCS program represents one of the most significant activities in which the State is engaged. We hope that our findings will serve to inform the Legislature and aid it in future deliberations it will make on AHCCCS and other programs.

We appreciate the considerable time you and your staff have devoted to guiding and assisting us in our efforts. Should you wish to discuss any aspect of our report further, please feel free to contact us.

Yours very truly,

Price Waterhouse

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DOUGLAS R. NORTON, CPA
AUDITOR GENERAL

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

February 6, 1985

Members of the Arizona Legislature
The Honorable Bruce Babbitt, Governor
Donald Schaller, M.D., Director
Arizona Health Care Cost Containment System

Transmitted herewith is the Price Waterhouse performance audit report on the AHCCCS administration. This report is in response to House Bill 2331 enacted by the Thirty-sixth Legislature in 1984.

Section I of the report is an executive summary. A response from McAuto Systems Group, Inc. is contained in Appendix F. A response from the Attorney General on behalf of the State is found in Appendix G. In addition, McAuto Systems Group, Inc. has filed with our office additional detailed comments which are available for review by interested parties.

If you have any questions about the report, please forward them to me.

Respectfully submitted,

Douglas R. Norton

Douglas R. Norton
Auditor General

Enclosure

cc: The Honorable Robert K. Corbin, Attorney General
Michael J. Malley, Esq.

Billings by MSGI, Compliance $4x10^6$? Contract limitations not clear
DHS monitoring
Performance by MSGI

I. EXECUTIVE SUMMARY

A. Purpose and Scope of the Audit

McAuto Systems Group, Inc. (MSGI) began work as Administrator of the new Arizona Health Care Cost Containment System (AHCCCS) program in June 1982. MSGI served in this capacity until March 15, 1984. During this time AHCCCS experienced a number of operating problems and the State and MSGI became embroiled in a contract dispute over the amounts due and the responsibilities of MSGI under the terms of the contract.

The State Legislature directed the Arizona Auditor General to conduct a performance audit of administrative and financial issues related to MSGI's tenure as AHCCCS Administrator. The performance audit was not intended to render judgments about the overall success of the AHCCCS program, which is the subject of a separate evaluation. Price Waterhouse was retained to address three areas identified by the Auditor General as being the focus of the performance audit:

1) Were the billings submitted by MSGI appropriate in terms of the contract and were the costs actually incurred?

2) Did the State Department of Health Services (DHS) effectively perform its monitoring and contract management functions?

3) How well did MSGI perform its duties as Administrator? What factors and organizations were responsible for the various operational problems experienced by AHCCCS?

The performance audit was conducted in two phases: 1) a pre-audit survey in which a number of major issues were identified, and 2) a detailed audit phase which pursued these

issues. This two phased approach enabled the work to focus on the areas of highest priority to the State. Accordingly, the report presents our findings and conclusions regarding these key areas, but does not necessarily represent an exhaustive discussion of the three groups of questions cited above.

Some of the issues addressed by this report are also the subject of pending litigation between the State and MSGI. It was not possible to conduct this performance audit without making certain legal assumptions and expressing certain factual opinions with which one party or the other will vigorously disagree. We must, however, emphasize that this report was not intended to, and does not purport to, render definitive conclusions of law about matters that are now in litigation, for that is the exclusive responsibility of the courts. In addition, it should also be noted that our work was necessarily confined to a set timeframe and level of resources. Because this issue is still in litigation, new facts may emerge which were not available to our project team during its factfinding work.

B. Summary of Major Findings

1. Financial Audit of MSGI's Billings

MSGI submitted bills totaling $17.1 million. We have tested $13.4 million of the costs and fees in those billings. This testing has resulted in our identifying billings of $2.2 million which are questioned and $1.8 million which are unresolved. These amounts do not include possible reductions of overhead billings and nonreimbursement of operating costs exceeding maximum annual baseline levels. These amounts can only be calculated after resolution of contract modification authority and other issues now in litigation.

Award fees and incentive fees comprise $1.9 million of the $2.2 million of costs and fees questioned. The remainder consists primarily of direct corporate charges.

- The contract between DHS and MSGI provided for award fees and incentive fees to be paid based on attainment of "superior performance." Among other things, criteria defining this were never agreed upon or negotiated and accordingly there is no basis for judging that they have been earned.

- The direct corporate charges questioned result from MSGI billing general administrative rates between 3.35% to 6.0% and in one case as high as 12.5% whereas it proposed 3.35%. The charges in excess of 3.35% are questioned on the grounds that the rate proposed was a negotiated and agreed rate applicable to the contract and any resultant modifications.

Purchased services and computer timesharing charges comprise, respectively, $1.2 million and approximately $400,000 of the costs and fees classified as unresolved.

- The unresolved purchased services relate to costs for MSGI subcontractors. $800,000 of this amount involves situations where a formal subcontract exists between MSGI and the subcontractor but the subcontractor was not officially approved by DHS as required.

- The remaining $400,000 of the $1.2 million relates to subcontractor arrangements which were not documented in formal agreements and, accordingly, we cannot determine the terms of these arrangements or evaluate them for conformance.

- In both of the above situations, it appears that, generally, services were rendered to support the subcontractor billings.

- The $400,000 of unresolved computer timesharing costs are primarily usage charges that are estimates not based on reports from MSGI's system accounting package. However, these charges are reasonably consistent with those charges which <u>are</u> supported by the system accounting package.

2. Performance Audit of the State's Monitoring Activities

We analyzed three areas with respect to the State's monitoring and contract management functions. Our findings with respect to these were as follows:

a. Overall Factors Affecting the Conduct of the Program's Administration

- The time allowed for program startup was too brief to enable required systems and procedures to be developed. This had an important, negative impact on operations after startup.
- The size of the program put the State at considerable financial risk when certain initial assumptions were proven wrong (e.g., number of fee for service claims and competitiveness of initial provider bids). Yet the health care nature and the complexity of the program made significant changes difficult to implement.

b. Adequacy of Contract Provisions and Contract Execution

- The State was remiss in taking a cost reimbursement approach for all work done. Several aspects of the AHCCCS Administrator's duties were susceptible to estimating fixed levels of effort or ranges for the purposes of setting contractor fees.
- The absence of any fixed price elements coupled with the subsequent failure to agree to specific deliverables, levels of effort and tasks in workplans (as envisioned in the contract) made definition of what was in or outside of MSGI's scope of work very difficult. The State also gave MSGI numerous directives altering MSGI's procedures or changing activities without relating these to the original budget or providing guidance as to what should be de-emphasized or not done.

c. Monitoring and Control of the Administrator

- State AHCCCS did not establish consistent, effective financial and management controls to oversee MSGI's expenditures and actions. For example, after the initial start-up period no master list of required deliverables was maintained and no monthly spending plan was required of MSGI.

- The absence of effective controls prevented the State from taking timely action to address the growing cost overruns and inefficiencies experienced in the administration of the program.

- The State lacked experienced personnel in several important areas, such as EDP systems. It also lacked understanding of significant contractual issues and responsibilities.

3. Performance Audit of MSGI's Actions as Administrator

We examined five aspects of MSGI's performance as AHCCCS Administrator. Our major findings with respect to these are as follows:

a. Compliance with the Administrator Contract

MSGI appears to have completed many of the responsibilities required under the Administrator's contract, but some key tasks were not performed well. In all areas the timeliness and degree of completion of certain tasks was less than that proposed. The tasks that were not performed had a significant impact on MSGI's ability to manage and operate the AHCCCS program. For example, the failure to develop the EDP reporting subsystems on a timely basis meant that monitoring and evaluation of the participating plans and fee for service payment trends could not be effectively performed. As a result, the detection of the unexpectedly high

level of fee for service claims, which caused a budget crisis for AHCCCS, was hindered.

b. Adequacy and Efficiency of MSGI's Major Activities

MSGI adequately performed the majority of activities associated with provider development and provider and member relations. Their performance in the areas of eligibility and enrollment was less effective because of problems arising in the eligibility determination process.

The timely and accurate processing of eligibility determinations was critical to the successful operation of the AHCCCS program. County eligibility offices, the Department of Economic Security (DES) and the U.S. Social Security Administration were responsible for processing eligibility determinations and submitting the data to MSGI. Due to several problems experienced at the county level and unexpected difficulties with transferring DES data, as well as some deficiencies in MSGI's operation, MSGI was not able to efficiently process these determinations. This in turn led to substantial enrollment problems, as the enrollment procedures were dependent on accurate and timely eligibility determinations.

c. EDP Systems Development and Operations

In this area we examined the efficiency of EDP systems development and the progress made in attaining Federal certification of the Medicaid Management Information Systems (MMIS). We found that:

- Significantly more systems personnel were used than proposed due to both new work and also very optimistically low proposal staffing levels.

- Total computer costs billed to the State were double the approved budget level. It appears that MSGI's cost proposal did not allow for the system modifications and corresponding increase in computer hardware usage normally expected to result from a demonstration project.

- The MMIS had not been certified as of March 15, 1984. Key required elements were not operational at that time. As a result, the State is likely to lose between $500,000 and $2 million in federal financial participation.

d. Contract Modifications

During the time that MSGI was the Administrator, they claim to have been directed to perform numerous tasks and functions that were not originally contemplated but that were within the scope of their responsibilities as Administrator. New work and related cost estimates were twice formally reduced to written and approved documents, commonly referred to as Modifications #1 and #2. In addition, a third modification was under discussion when the contract was terminated. This was to cover further work claimed by MSGI to be "new" and undertaken in Operational Year One. This modification was not formally approved. Some of this new work appears to have become integral parts of the AHCCCS program that the Administrator was to develop, install and operate.

There is considerable contention about whether AHCCCS management had the authority to increase the contract scope and cost significantly without benefit of further bidding, whether the work actually was "new" work and whether the cost estimates

proposed accurately reflect incremental costs to perform new work.

The answers to these issues require extensive discovery, legal analysis and, possibly, adjudication to finally resolve.

e. Use of Subcontractors

MSGI used subcontractors to a much greater extent than proposed for both new work and in place of MSGI personnel. The proposal stated that subcontracting would represent only 3% of the hours and 5.5% of the cost, or less than $500,000 over the life of the contract. Instead subcontractors were actually retained at a cost over $2 million. Substantial portions of this appears to be within the work MSGI was originally contracted to do. Several of those subcontracts were neither competitively procured nor approved by the State as required.

II. PURPOSE AND SCOPE OF THE AUDIT

A. Background and Purpose of the Performance Audit

On August 4, 1982 the Department of Health Services (DHS) entered into a contract with McAuto Systems Group, Inc. (MSGI) to administer the Arizona Health Care Cost Containment System (AHCCCS). AHCCCS is an experimental program formed by the State to respond to the health care needs of various disadvantaged populations eligible for Federal Medicaid benefits.

By fall, 1983 the AHCCCS program had experienced several operational problems. Further, by that time the State (defined as several parties in addition to the DHS) became embroiled in a protracted contractual dispute with MSGI. This dispute was to result with the State assuming full control for the administration of AHCCCS in March, 1984. During the dispute the State Legislature decided that a performance audit of AHCCCS administrative activities was needed to help resolve the conflicting claims and positions of the participants. Responsibility for conducting this performance audit was given to the Arizona Auditor General. In May the Auditor General retained Price Waterhouse to perform the work.

The Price Waterhouse staff assigned to this project were assembled from several disciplines within the firm, including the health care and government contracting, electronic data processing systems design and implementation, government operations management consultants and financial auditing. This report represents the combined efforts of this team.

B. Scope of the Work

The general guidelines for conducting performance audits of government units have been identified by the U.S. General Accounting Office's (GAO) "Standards for Audit of Government Organization, Programs, Activities and Functions." Part of this process involves review and comment by the organizations being audited. Our work was conducted under these guidelines.

It is important to note that the performance audit focused on the administration of the program by DHS and MSGI, and not upon the success of the program as it relates to the quality or cost of the health care provided. The U.S. Department of Health and Human Services' Health Care Financing Administration (HCFA), separately contracted for such an evaluation as part of the Arizona demonstration project.

To judiciously use the funds appropriated for the conduct of the performance audit and to conform to the GAO guidelines, a pre-audit survey was conducted. This early work served to identify and sharpen the focus of the issues which our review would examine in detail. As directed by the Auditor General and his staff, the second phase of the work concentrated on the major problems and questions surrounding the administration of AHCCCS under MSGI as identified in the pre-audit work. A listing of these issues is provided in Exhibit II-1.

The GAO guidelines also say that the auditor should afford the agency being reviewed the opportunity to discuss the findings before they are finalized. This was done with both MSGI and AHCCCS as well as their respective legal counsels. The Auditor General also extended to MSGI and AHCCCS the opportunity to include up to twenty pages of written reactions in this report.

MSGI's and the Attorney General's written reactions are at the end of this volume, marked as Appendix F and G, respectively. The Auditor General will make available at his offices any additional or longer responses.

The remainder of this report presents our findings and conclusions regarding these key areas. Appendix A presents our responses to questions raised in the RFP for the conduct of this performance audit.

Some of the issues addressed by this report are also the subjects of pending litigation between the State and MSGI. It was not possible to conduct this performance audit without making certain legal assumptions and expressing certain factual opinions with which one party or the other will vigorously disagree. We must, however, emphasize that this report was not intended to, and does not purport to, render definitive conclusions of law about matters that are now in litigation, for that is the exclusive responsibility of the courts.

In addition, it should also be noted that our work was necessarily confined to a set timeframe and level of resources. Because this issue is still in litigation, new facts may emerge which were not available to our project team when their factfinding was being conducted.

Finally, this report does not and was not intended to identify, explore, or discuss all issues which MSGI and AHCCCS have or might bring forth in their respective legal actions.

SUMMARY OF PRE-AUDIT SURVEY ISSUES PURSUED IN PHASE II

1. Financial Examination of the Propriety of Contract Costs

This issue involved a review of the billings submitted by MSGI to assess if they were appropriate in terms of the contract and if the costs were actually incurred. Specifically, this entailed examination of these categories of costs:

- Personnel and related costs
- Computer costs
- Facility costs
- Forms and supplies
- Purchased services
- Travel and other expenses
- General and administrative and direct corporate charges
- Award fees
- Incentive payments
- MSGI overhead
- Excess contractor costs

2. Performance Audit of MSGI's Activities

The series of issues developed for detailed investigation in this area included:

- MSGI's overall compliance with its contractual responsibilities.
- The efficiency of a series of functions: eligibility, enrollment, claims processing operations, and provider management and quality assurance.
- The efficiency of MSGI's EDP system development and operation.

- MSGI's progress in obtaining a certified Medicaid Management Information System.

- The use of subcontractors in relation to proposed costs and roles.

3. The Role of the DHS and AHCCCS Division in Contract Monitoring

The third area of investigation focused on the role of the State in monitoring, controlling and overseeing the State's contract with MSGI. This included:

- Reviewing the contract documents for the adequacy of their preparation and provision with respect to goals, deliverables and other measures.

- Review of applicable statutes, rules and other legal requirements that DHS/AHCCCS were to meet.

- Comparing the MSGI contract with Arizona to other states.

- Assessment of the contract modification process in light of the contractual requirements.

- Evaluating the adequacy of the financial and management controls utilized by the State to monitor MSGI.

- Reviewing the role of non-DHS units involved in the administration of the program.

III. FINANCIAL EXAMINATION OF THE PROPRIETY OF MSGI COSTS AND FEES BILLED

This section of our report consists of three parts which discuss: a) our approach to the financial/compliance audit, b) the results of our detail testing of the MSGI billings, and c) cost reimbursement limitation aspects of this contract.

A. Approach

From the onset of this audit, including the RFP, the proposal, the pre-audit survey, and progress reports, it has been understood that this portion would consist of an examination of and report on costs billed to the Department of Health Services by MSGI in relation to a) the AHCCCS contract and contract modifications and b) applicable cost principles and regulations. We found that the Arizona cost accounting principle and procedure statutes were limited at the time the Administrator contract was signed. We supplemented the contract, where we believed it to be unclear or non-specific, with the Federal cost accounting principles embodied in Chapters 30 and 31 of FAR. FAR is frequently used as guidance in evaluating the allowability of costs because it is the most developed articulation of government contract cost accounting principles and practices. In fact, FAR is the basis for the Federal Financial Participation in the administrator cost reimbursement aspects of the AHCCCS program.

The examination was to cover billings for the period from June 7, 1982 through March 15, 1984. The review, in short, was to ascertain by major expenditure category whether:

- Costs billed reflected actual expenditures made for the benefit of the AHCCCS program, as indicated and supported by documentation.
- Costs billed were in compliance with the contract and contract modifications.
- Costs billed were in accordance with applicable cost principles.

In keeping with this approach, we identified in the pre-audit survey report:

- A risk classification of higher, medium, or lower for each of the cost categories.
- A workplan for each cost category, identifying the nature of the audit procedures and amount of testing to be used, depending to a considerable extent on the risk assigned. This workplan also considered the relative significance of the total billing for each category and, where applicable, sub-category.

The results of our examination of costs and fees billed are discussed in Section B below. Exhibit III-4 at the end of this section provides some key terms and definitions related to government cost accounting and auditing.

B. Results of Testing of Costs and Fees Billed

Exhibit III-1 presents a summary view of costs and fees billed the State by MSGI for each major category and sub-category and the questioned and unresolved costs noted in our testing.

Following Exhibit III-1, by major category as presented in the exhibit are a) our major findings from our cost and fee audit work and b) brief descriptions of the nature of the costs and fees and our testing approach.

1. Personnel and Related Costs

(1) Findings

The most significant findings resulting from the audit work in this category are as follows:

- Several time sheets and salary authorizations were unapproved. We confirmed with co-workers that the tested employees were bona fide and did in fact commit the level of effort to the AHCCCS project for which they were paid.
- While there were numerous variances between the actual salary rates billed and the averages proposed, the variations tended to be both above and below the proposed rates in roughly equal proportion. MSGI had proposed billing actual labor rates.
- For fringe benefits, charges were adequately supported and consistently calculated. The charges were 11.6% of total salary costs as contrasted with the 15% estimated in the cost proposal.
- For the recruitment, relocation and travel costs tested ($124,670), $5,086 are questioned and $15,097 are unresolved.

EXHIBIT III-1

AHCCCS
SUMMARY OF BILLED, QUESTIONED AND UNRESOLVED COSTS

	Billed	Questioned	Unresolved
PERSONNEL AND RELATED COSTS			
Salaries	$ 5,732,036	$ --	$ 75,533
Benefits	664,614	--	--
Recruitment, relocation and travel	491,638	5,086	15,097
	6,888,288	5,086	90,630
COMPUTER COSTS			
Computer terminal and other computer time	2,031,381	9,722	366,018
Data communications	2,764	--	--
Maintenance	45,793	--	--
EDP supplies and back-up	127,280	--	--
	2,207,218	9,722	366,018
FACILITY COSTS			
Rent and security	251,721	--	--
Telephone	329,869	--	4,253
Office equipment and furniture	223,927	(1,147)	--
Amortization, depreciation and insurance	35,847	--	--
	841,364	(1,147)	4,253
FORMS AND SUPPLIES			
Postage, delivery, mailing	372,715	--	1,197
Forms, supplies and duplicating service	671,822	--	194
	1,044,537	--	1,391
PURCHASED SERVICES	2,699,846	79,460	1,163,396
TRAVEL AND OTHER EXPENSES	381,844	--	31,422
Subtotal	14,063,097	93,121	1,657,110
GENERAL AND ADMINISTRATIVE	49,579	36,292	--
DIRECT CORPORATE CHARGE	581,439	123,819	--
	631,018	160,111	1,657,110
Subtotal	14,694,115	253,232	1,657,110
AWARD FEES	270,702	208,105	--
INCENTIVE FEES	2,121,759	1,735,153	127,052
TOTAL	$17,086,576	$2,196,490	$1,784,162

- For the period June 1982 - November 1982, personnel and related costs include the salaries and overhead charges for certain MSGI Custom Systems Group personnel in New York. These overhead charges, in certain circumstances, may not be reimbursable (see item 10. on III-17 for further discussion).

- Salary charges of $75,533 are classified as unresolved because the timesheets do not indicate the level of effort dedicated to AHCCCS.

(2) Discussion

Personnel and related costs billed by MSGI total $6,888,288, or slightly over 40.3% of billed costs. Most of this amount is for salaries (83.2%), with benefits, recruitment, relocation, and travel comprising the balance.

We developed a statistical sampling plan for the automated payroll processed in New York and a nonstatistical plan for the manual payroll processed in Phoenix. 180 employees were selected from the automated system and 20 from the manual system. For these 200 employees, a comparison was also made between the actual pay rates and the average rates specified in the cost proposal for the applicable positions. Fringe benefit charges were tested to bank advices for employment tax payments and to payroll summaries. Finally, recruitment, relocation and travel were tested using a judgmental sample of thirty large payments in the following three months: August 1982, October 1982 and August 1983.

The recruitment and relocation expenses consist primarily of travel, meals and lodging for MSGI New York personnel temporarily working in Phoenix to support systems modification efforts and in some cases for their permanent transfer to Phoenix. Documentation was generally available for these costs, but in several

instances it was not sufficiently complete to allow us to reach a final decision as to the appropriateness of the charges. $5,086 in charges are questioned, with most of this relating to double-billings of airfares. In addition, $15,097 in charges are deemed unresolved. This amount is due to a variety of items, with inadequate documentation as to business purpose, such as $172 in meals expenses for a Phoenix employee, $2,385 in excess costs due to unexplained needs for first class airfares and $3,662 for apartment rentals in Phoenix not approved by the State.

Salary charges of $75,533 were incurred through intercompany invoices for the period January 1984 through July 1984 relating to the MSGI Vice President. MSGI representatives have indicated that a verbal agreement with DHS existed allowing direct allocation of the Vice President's salary to the AHCCCS project for this period as it was assumed that he would be fully devoted to the Arizona project. These costs were not to be covered by the direct corporate charge permitted by the contract. No written evidence was available to support this arrangement or that the individual devoted his full time and effort to the AHCCCS project during this time period. The related salary charges are classified as unresolved because the employee did not indicate on his time sheets at the time of preparation that his total efforts were devoted to AHCCCS. MSGI employees are required to indicate on their time sheets which projects they worked on.

2. Computer Costs

(1) Findings

The results of our testing in this category disclosed that:

- $9,722 are questioned, largely due to an accounting error resulting in an overcharge to the State for intercompany charges.

- $326,091 of intercompany computer charges are unsupported and therefore unresolved--$150,424 are estimated computer usage charges prior to a system accounting package being installed in New York and $175,667 are for charges such as tapes, disks, and ports that are not identifiable through the installed system accounting packages.

- MSGI New York data center computer costs for November 1982 through April 1983 ($229,886) include overhead. In certain situations this overhead is not reimbursable. The amount that may not be reimbursable cannot be determined at this time (See Item 10 on page III-17 for further discussion).

- The Defense Contract Audit Agency (DCAA) has not finalized its audits of the McDonnell Douglas Automation Company (McAUTO) costs for 1983 or 1984. The State should verify the final billings for computer services to the DCAA rates once the audit reports are issued.

- $39,927 of outside vendor charges are unsupported due to lack of documentation, a signed agreement or a bid stating prices. These charges are classified as unresolved.

- No exceptions were noted for EDP supplies, maintenance and data communications.

MSGI did not bill AHCCCS for computer expenses during the Implementation Period. November 1982 costs were based on a percentage of actual costs without support. New York data center catalog prices were used for December 1982 through April 1983. The St. Louis data center supported AHCCCS from April 1983 to March 1984, however, New York catalog prices were applied to 1983 St. Louis computer usage. In mid 1984 a credit was processed which reduced these costs.

(2) Discussion

Total costs billed by MSGI in this cost category are $2,207,218, or 12.9% of the total billed by MSGI. Of this, most

of the billed costs were for computer time and equipment charges (92.2%). EDP supplies and maintenance comprise most of the remainder.

We tested all invoices in this category in excess of $10,000. Of the charges selected, $1.7 million, or 90%, represented intercompany charges, and $201,000, or 10%, represented charges by other vendors.

3. Facility Costs

(1) Findings

In general, the results of the testing of this category can be summarized as follows:

- No significant billing exceptions were found in the transactions tested for this cost category.
- Depreciation and amortization charges generally were calculated based upon the remaining term of the contract at the date of purchase, i.e., depreciable lives did not exceed 40 months. This methodology typically resulted in a shorter depreciation life and therefore a larger depreciation charge when compared to the depreciation rates established for MSGI Corporate. All cost effects of this policy were negated, however, as a majority of the assets devoted to the AHCCCS project were subsequently purchased by the State at net book value.

(2) Discussion

Facility costs--including rent and security, telephone, office equipment rental and repair, and amortizations, depreciation, and insurance--amount to $841,364, or 4.9% of the total charges billed.

We tested charges in this category totaling $372,365, or 44.3% of total charges billed, and distributed among various sub-categories. Accounting policies and practices were also tested regarding asset amortization and depreciation.

4. Forms and Supplies

(1) Findings

The findings for this category are:

- There were a few exceptions due to lack of adequate documentation. These total less than one percent of total billings and of the billings tested.

(2) Discussion

Forms and supplies, including forms, general office supplies, postage and delivery charges, total $1,044,537, or 6.1% of billed charges.

Invoices tested in this category amounted to $60,566, or 9.0% of the total for mailing and delivery, and $109,776 for forms and supplies, or 29.5% of the total for this category.

5. Purchased Services

(1) Findings

The following findings resulted from our tests in this category:

- For nearly every subcontractor arrangement, MSGI did not comply with Contract General Provision 4 which required MSGI to obtain the advance written approval of the

Department for all subcontracts and modifications. Exhibit III-2 identifies the costs deemed unresolved because of failure to comply with this contract provision (they are listed as unapproved unresolved costs). Those subcontractors with written agreements are identified by asterisks.

- There also were several instances where no written contract could be found. These charges have also been included in other unresolved costs. There is insufficient criteria to determine if requested services were delivered and that the rates charged were as agreed.

- Three major subcontractors billed an aggregate of $38,750 in excess of the amounts authorized in their contracts with MSGI. These subcontractor billings are questioned because of the absence of authorization for them.

- One of the major subcontractors included annually increasing rates in its subcontract that were in excess of those in its commitment letter included in MSGI's proposal. These excess amounts, which total $30,700, are included in questioned costs as the commitment letter MSGI included in its cost proposal did not propose adjustable hourly rates. The subcontract agreement that AHCCCS and HCFA approved, however, did provide for periodic adjustment of the contractor's labor hour rates.

- There were legal expenses of $4,962 for corporate services that were inappropriately billed. These charges are questioned because the invoice states they relate to the AHCCCS--MSGI litigation.

- The Custom Systems Group charges included $5,048 in questioned costs due to first class airfares and expenses for Arizona employees and $3,958 in unresolved costs due to lack of documentation.

- MSGI's unaudited actual overhead rates were higher than its estimated rates used for billings. These actual rates may be adjusted upward or downward upon audit by the Defense Contract Audit Agency. The $14,703 net undercharge associated with the unaudited rates is classified as unresolved.

- MSGI Custom Systems Group billings from 12/82 through 1/84 include overhead. These overhead charges, in certain circumstances, may not be reimbursable (see item 10. on III-17 for further discussion).

- As directed by the Auditor General, our testing of external subcontract charges did not include detail testing of their respective billing records or accounting systems.

(2) Discussion

This cost category, totaling $2,699,846 of charges, is for subcontractual services rendered either by firms or individuals outside MSGI, or by a division of MSGI. These costs comprise nearly 15.8% of total MSGI charges.

Custom Systems Services Group, which is a separate operating division of MSGI, performed computer systems design and implementation work. An analysis of purchased services from this MSGI division, as well as external consultants, is shown on Exhibit III-2.

We tested costs totaling $2,398,775, or 88.8% of total costs billed to the State in this category. For intercompany charges of MSGI Custom Systems, four significant invoices were tested, totaling over $104,000, or 48% of the intercompany billings. We also selected charges from MSGI subcontractors that billed the larger amounts or were paid over two or more phases of the AHCCCS project. This test work totaled $2,294,372, or 85% of billings by subcontractors.

The subcontracts with several of MSGI's major subcontractors did not specify specific tasks or deliverables and the services expected were generally described as technical services or professional services. Their services to MSGI included correspondence assistance, document writing assistance, county and provider technical assistance and training, provider oversight assistance, systems development assistance, and AHCCCS policy liaison assistance.

EXHIBIT III-2

ANALYSIS OF PURCHASED SERVICES

Organization	Billed Costs	Questioned Costs	Unresolved Costs	
			Unapproved	Other
Custom Systems Group	$ 217,554	$ 5,048	$	$ 3,958
(MSGI)				$(14,703)
Milliman and Robertson	251,342	1,285	95,057	
Mountain States Comp.	7,777		7,777	
SBC Systems	12,783		12,783	
Dr. Donald F. Schaller	9,483		9,483*	
Datatronics	10,471		10,471	
Ernst & Whinney	888,950	54,115	326,485*	
Dr. George Rowland	26,158		26,158*	
Presidio Group	17,733		17,733*	68
NAMES	12,506		5,587	382
			6,537*	
Starlex	110,258		110,258	
Shirley Kera	14,322		12,484*	1,838
Melody Chasen & Associates	454,066		247,357*	426
AAAHC	113,596	14,050		
Ladendorf & Ridge;	365,983	4,962	142,890	
Ridge & Isaacson			140,367*	
Other--not tested	186,864			
	$2,699,846	$79,460	$1,171,427	$ (8,031)

*Indicates a written contract did exist.

These subcontractor billings are supported by time, rate and expense summaries which in some cases are not tied to specific projects or tasks performed. The subcontractor billings were reviewed and approved by appropriate MSGI personnel. As previously discussed, subcontractor records supporting the billings were not tested.

6. Travel and Other Expenses

(1) Findings

Following are our findings for this category:

- Unresolved costs totaled $31,422 or approximately 32% of the costs tested, a significant exception rate.

  A substantial portion of the unresolved costs are due to procedural and documentation exceptions. For example, expense reports which did not explain the business purpose of the reimbursement or travel expense.

(2) Discussion

The total expenses in this cost category represent $381,844, or 2.2% of the total charges billed by MSGI. About 84% of the category is for travel.

We selected 22 of the largest reimbursements for travel and expense reports--they totaled $24,226, or 7.6% of all travel costs billed by MSGI. We reviewed $15,113 for travel and $8,900 for other expenses related to the MSGI Vice President. We also reviewed $51,387 or 82.9% of the other expenses billed to the State.

7. General and Administrative and Direct Corporate Charges

(1) Findings

Following are the findings for these cost charge categories:

- The Direct Corporate charges should be based on the proposal rate and not on actuals since the MSGI cost proposal specifically describes the methodology for calculating the amount. Using this approach, $123,819 in Direct Corporate charges are questioned.
- Additional amounts of Direct Corporate charges might be questioned upon disposition of other costs questioned and unresolved. No amount has been calculated for these potential reimbursement decreases because the ultimate dispositions are not known.
- The General and Administrative rate for open enrollment is reduced to 3.35% in keeping with the fixed rate in the original proposal.

(2) Discussion

This category totals $631,018 in charges, or 3.7% of total costs.

The MSGI proposal indicated that a Direct Corporate charge of approximately 3% related to McDonnell Douglas Corporation would be charged on all costs of the AHCCCS project cost center.

Over the period under audit, the rate charged increased from 3.35% to 6.00%. We believe the precise formula in the proposal (costs divided by .9676) should be followed throughout the term of the contract.

8. Award Fees

(1) Finding

Following are our findings for this category:

- Total award fees billed to DHS by MSGI for Implementation, Operational Years One and Two and Termination are $270,702. Award fees of $62,597 are billable to DHS, based upon the contract provisions.
- The remaining award fees ($208,105) are classified as questioned because the parties did not agree to criteria under which they were to be earned and because they are subject to possible reduction by costs in excess of baseline.

(2) Discussion

The contract between State AHCCCS and MSGI provides for $270,702 of award fees. Thirty percent (30%) of the award fee, or $81,211, was fixed and payable ratably over the term of the contract. The remaining seventy percent (70%), or $189,491, of the award fee was to be payable upon satisfactory performance in accordance with procedures to be negotiated by the parties to the contract. Furthermore, the 70% portion of the award fee was subject to reduction by costs in excess of 110% of the prorata baseline costs for any operational year that were not already absorbed through reduction of the incentive fees provided by the contract.

Review of the contract, interviews with representatives of DHS and MSGI, and review of the various transmittals between DHS and MSGI indicated that no specified criteria were ever agreed upon for the 70% portion of the award fee.

The following summary presents a comparison of total award fees billed by MSGI to total award fees calculated based upon the parameters established in the contract as described above:

Contract Phase	Award Fees Billed	Calculated Award Fees	Unresolved Award Fees Billed
Implementation	$27,068	$27,068	-
Operational Year One	81,204	24,363[a]	$56,841
Operational Year Two	33,835	11,166[a]	22,669
Termination	128,595	-	128,595
	$270,702	$62,597	$208,105

9. Incentive Fees

(1) Findings

Based on the contractual provisions and data and information collected in various phases of the performance audit, the following findings resulted:

- Of the $2,121,759 billed the State for incentive fees, $1,862,205, or 87.8%, are deemed questioned or unresolved.
- An amount of incentive fees of $52,052 claimed by MSGI in the Implementation Period and not paid by the State relates to an objective for which the documentation was inconclusive as to whether it was properly earned. We have categorized this amount as unresolved.

a. Comprised solely of the monthly amount for the fixed award fee not subject to reduction by costs in excess of baseline.

- An amount of $65,904 of incentive fees for the Implementation Period represents a double billing of the amount disallowed by the State, plus an adjustment of the incentive fee billing to an amount equal to 14% of total direct costs for the Implementation Period. This amount is classified as questioned costs.

- Insufficient documentation exists to determine whether the $75,000 open enrollment incentives were earned. These charges have been classified as unresolved.

- The remainder of the incentive fees ($1,669,249) claimed were considered as questioned because: 1) no criteria were negotiated and agreed to for evaluation of performance, 2) MSGI has billed incentive fee amounts in excess of the amounts provided by the contract and modifications, 3) MSGI has billed incentive fees on termination costs which are not subject to incentive fees, and 4) the amount of incentive fees to be reduced by costs in excess of baseline limitations cannot be determined until other issues are finalized.

(2) Discussion

The contract between MSGI and the State provided for $1,299,536 of incentive payments to be made to MSGI for achieving "superior performance" objectives. These objectives were to be negotiated by September 15th for each ensuing Operational Year. The objectives for the Implementation Period were agreed upon at the time of the contract signing.

Forty percent of the incentive amount was allocated to the Implementation Period and the remaining sixty percent was to be ratably split between the three operational years. The annual incentive fee was subject to dollar for dollar offset by costs incurred in that year in excess of 110% of the year's baseline.

In addition to the above incentive pool, Modification #2 added $75,000 to the incentive fee pool for open enrollment and stated that these fees were not subject to the offset provisions.

These incentives related to six specified milestones at $12,500 for each milestone achieved. Documentation for determining earning of these incentives was not available.

Modification #1 did not increase the incentive fee pool and none of the documentation on proposed Modification #3 included discussion of an increase in the incentive fee pool.

Special Provision 15 of the contract provides that the contractor will be reimbursed its reasonable actual costs in termination of the contract by the Department. The contractor has billed incentive fees on these termination costs. The contract is silent as to the applicability of fees on termination costs as well as reimbursement of costs incurred in the event of contractor termination of the contract.

10. MSGI Overhead

(1) Finding

Following is our finding in this category of costs:

- The amount of potentially non-reimbursable MSGI overheads cannot be determined at this time because the calculations are dependent upon resolution of such issues as questioned and unresolved costs, contract modification authority and other contract interpretation matters.

(2) Discussion

MSGI proposed that the AHCCCS project would be established as a separate cost center. Consequently all costs charged to that cost center would be direct costs to the contract. The contract appears to restrict the reimbursement of other MSGI unit overhead when annual operational year costs exceed 100% of baseline.

Approximately $300,000 of MSGI overhead is included in MSGI's Operational Year One and Two Purchased Service and Computer Charges billings. This overhead is for MSGI Custom Systems Group billings from 12/82 through 1/84 and MSGI New York data center charges from 11/82 through 4/83.

Additionally, the MSGI Custom Systems Group personnel were billed as Personnel and Related Costs during 6/82 through 11/82, which includes both the Implementation Period and Operational Year One. Approximately $150,000 of such MSGI overhead included in the Operational Year One billings may be non-reimbursable.

11. Excess Contractor Costs

(1) Finding

Following is our finding in this category of costs:

- The amount of potentially non-reimbursable costs resulting from exceeding the contractual baseline cost cannot be determined at this time.

(2) Discussion

Special Provision 3.4(a) of the contract provides that: "The contractor shall be reimbursed its additional costs up to a total contract cost equal to one hundred twenty five percent (125%) of the yearly baseline costs; provided, however, that the only costs reimbursed in excess of the baseline costs shall be Contractor's direct costs, without addition of overhead, profit or margin of any kind."

As more fully described in Section C following, this issue is strongly contested between the parties in litigation. We have

made no estimate of the effect, if any, of this contract clause because the calculation is dependent on resolution of the questioned and unresolved costs, contract modification authority and other statutory and contract language issues.

C. Cost Reimbursement Limitations

Based upon our review the contract in question is considered to be a cost reimbursement rather than fixed price contract. Cost reimbursement type contracts are used when the materials or services required are unique or include sufficient uncertainties; that it is unlikely that an adequate number of qualified bids will be received; or the prices proposed will be substantially higher to cover the risks associated with contractor performance.

The support for this contract being cost reimbursement is embodied in the contract and the RFP. Special Provision 5 of the contract states, "The parties recognize that the agreement embodied in the Request for Proposals and the Contractors Cost and Technical Proposals is necessarily vague as to specific tasks to be undertaken during each phase of the project." The RFP states:

- "The Administrator will have responsibility under the supervision of the Director of Health Services for the application and administration of the rules and regulations in implementing the AHCCCS. The Administrator will be responsible for a wide variety of duties, including but not necessarily limited to . . ."
- "The specific scope of activities under these categories of performance is and will continue to be subject to development and/or change during the period of performance under this contract."
- "The State, in selecting the Administrator, will assess the proposer's understanding and willingness to modify or develop alternatives, as well as his capability to respond to new conceptual demands."

- "The Administrator will be the architect of many portions of the program . . ."
- "A cost reimbursement type contract . . . with negotiated incentive payments is anticipated due to the
  - uncertainty of scope of work
  - flexibility required to alter work direction
  - responsiveness required to meet changing needs"

The RFP Introduction also provides an indication of the possible scope, authority and flexibility expected which states:

- "The purpose of this procurement action is to select an Administrator who will have responsibilities for assisting the Arizona Department of Health Services in the design, and implementation of this project and who will then have full operational responsiblity for AHCCCS, subject to supervision by the Director of the Arizona Department of Health Services."
- "The Arizona Health Care Cost Containment System was established by the Thirty-Fifth Arizona Legislature to provide an innovative health delivery system."

Under the terms and conditions of this contract, "The Contractor shall be paid its cost for work performed, on the basis presented in its Cost Proposal, subject to adjustment . . ." These adjustments are penalty features involving reductions of incentive and award fees and restrictions on contractor overhead. These features were intended as a contractor incentive toward cost containment.

While reimbursement is limited by these penalties and ultimately by the total contract value, unlike a fixed price arrangement, under a cost reimbursement contract a contractor is entitled to its allowable incurred costs even though all of the specified tasks may not be achieved.

Although the authorized expenditure limit or cost limitation is usually the stated amount of the contract, this amount may be increased by certain actions of the contracting parties. One such action may occur when an authorized representative of the contracting party requests new work beyond that envisioned in the original contract. Usually the contractor is entitled to reimbursement for costs incurred in the pursuit of new work if the work has been authorized by a responsible official of the contracting agency. Conversely, the authorized expenditure limit could be reduced for the cost of work the contractor is relieved of performing. Such additions or reductions are usually formalized in written modifications to the contract.

Without consideration of the special conditions we have described, by which authorized expenditures or cost limitations may be increased or decreased, this contract provided that the contractor could be reimbursed for up to 125% of what was referred to as baseline costs. However, the application of the term baseline costs and many other aspects of the cost limitation provision are subject to many interpretations.

Our examination of the cost limitation provisions of the contract identified, through our analysis, discussions with representatives of the Attorney General's Office and MSGI representatives, the following major contentious and as yet unresolved issues regarding the interpretation of the cost limitation provision.

1) A question exists as to whether the contract value is limited based on aggregate contract value, annual baselines or some other variation thereof.

2) The authority of State officials to obligate the State for work performed which was not contemplated by the initial contract.

3) The contract is silent on the issue of baseline calculation in the event of contract termination, such as has occurred.

These very significant issues are all "key" factors relative to determining cost limitations under the contract and thus must be definitively resolved to arrive at a final determination of allowable contract costs. The scope of our examination did not contemplate our pursuit of these issues beyond their identification. Additionally it was recognized that final resolution of these issues was beyond the scope of a financial audit.

The significance of the cost limitation issues and the magnitude of the issues and amounts involved in the resolution of determination of cost limitations warranted further exploration and discussion. We determined that presentation of an example of the type of computation which would be required to be made would provide an appropriate vehicle for such discussion. For purposes of the example we applied to the resolution of outstanding issues, where practicable, our judgment as to how such areas would be treated under Federal contracting practices. Estimates of the amounts involved were based upon documentation which has been made available to our staff which in some respects is not adequate for definitive computation. While we recognize that Federal procurement practices may not directly apply to these circumstances they nevertheless are expected to provide a source of guidance which may assist in the final resolution of the issues.

Based upon our reading of the contract there are five major components which enter into a determination of baseline costs and the contract's cost limitations. The following discussion describes each of the components and the approach we have taken to their recognition in the example. The discussion is followed by

an example (Exhibit III-3) of the computation which would be made at such time as all currently unresolved issues are concluded.

1. Original Contract

The amount of the original contract is the first component of contract value and baseline cost determination. The amount included in the example computation for the original contract is that which appears in the signed contract. However, the total contract value of $11,404,638 is not in agreement with the sum of baseline cost plus incentive and award fee as shown in the text of the contract, by $552,000.

2. Modifications #1 and #2

Whether the amount of these signed modifications should be included in the determination of contract value and baseline costs is in dispute. While it has been contended that they may not be recognizable, we have assumed for purposes of the example that they are includable on the basis that they are represented by fully executed agreements.

3. Extension of Modification #1

Consideration of including in the computation an amount representative of Modification #1 work performed in Year Two involves two considerations. First the work was not covered by an executed agreement. Secondly, the contractor did not maintain cost records sufficient to identify costs related to this work.

While there is opposition to allowing consideration of these costs, under Federal procurement practices such costs may be includable to the extent they represent efforts that were

explicitly or constructively authorized by a responsible official of the contracting agency and are on-going requirements of the system the contractor was to operate. Accordingly, for purposes of this example we have estimated the amounts involved and included them in the computation. This estimate could not be subjected to audit verification and is based on an analysis of the amounts agreed upon in the executed agreement for Operational Year One.

4. Proposed Modification #3

The issues involved in the inclusion of amounts related to work performed in connection with proposed Modification #3 are similar to those involved in the extension of Modification #1 to Year Two. Accordingly, for the same reasons cited in the case of the extension of Modification #1 we have assumed that such costs are includable in the contract value and baseline costs. The estimates were based upon a review of available documents which were not sufficiently supported to permit audit verification.

Neither costs related to Year One or Two were covered by a signed modification agreement, although negotiations for Year One were being conducted at the time of termination.

5. Contract Cost Limitation Factors

Special Provision 3.4 of the contract provides the technique for determining total contract value and baseline costs as well as for allocation of fee and overhead reduction to costs. A detailed calculation is only possible after determination of the unresolved issues discussed in items 2-4 above.

The contract provides for the increasing of the baseline costs by 25% to arrive at the cost reimbursement limitations. This 25% increase, however, virtually eliminates the incentive and award fees provided in the contract.

Exhibit III-3 only demonstrates the potential impact on contract monies to pay contractor costs. It does not address the annual cost containment features of the contract--annual operational year baseline calculations for reducing incentive and award fees and MSGI overhead. These reduction calculations also cannot be made until the amounts for items 2-4 above, if any, are established.

The presentation in Exhibit III-3 is provided for example and demonstration purposes only and is not intended to represent our expectations of the final outcome of the pending unresolved issues, since the scope of our work did not:

- Permit a definitive determination or audit of amounts incurred by MSGI and estimated herein, related to Modification #1 costs incurred in Year Two and the proposed Modification #3 costs.
- Include determination of amounts by which cost reimbursements could be reduced for work the contractor may have been relieved of performing.
- Include a comprehensive investigation of the records and actions of the parties for purposes of determining whether or not new work was properly authorized.

Resolution of Outstanding Issues

In addition to the uncertainties surrounding the previously discussed factors, resolution of the following additional factors may result in further adjustment of the cost reimbursement. The

EXHIBIT III-3

AHCCCS

EXAMPLE COMPUTATION COST REIMBURSEMENT LIMITATION

(in thousands)

	Baseline Costs	Award Fee	Incentive Fee	Unassigned Contract Value	Total Contract Value
1. Original Contract	$ 9,282	$1,300	$271	$552	$11,405
2. Modifications #1 and #2					
Modification #1	2,049				2,049
Modification #2	628		75		703
Totals	11,959	1,300	346	552	14,157
3. Extension of Modification #1 in Year Two	1,100[a]				1,100
4. Proposed Modification #3, including $300,000 extension in Year Two	1,800[a]				1,800
	$14,859[b]	$1,300	$346	$552	$17,057[b]

(a) Would be limited to amounts incurred.

(b) Not increased for inflation adjustment provision of the contract.

following steps should be addressed to resolve the issues discussed above:

1) Pursue the final resolution of questioned and unresolved costs as identified in Exhibit III-1 and discussed throughout Section III.

2) Assess the acceptability of the extent and scope of testing performed herein and elsewhere by State representatives and where deemed necessary extend testing.

3) Seek a resolution of those cost limitation issues related to (i) annual vs. aggregate baseline cost limitations; (ii) allocation of cost limitations to mid-year terminations; and, (iii) the ability of State representatives to orally obligate the State for costs not contemplated in contracts.

4) Following the resolution of issues in (1) and (3) above, consider the necessity to perform additional audit tests relative to (i) allocation of annual costs; (ii) determination of actual second year costs on Modification #1 and costs of Modification #3; and, (iii) costs associated with tasks the contractor was relieved of performing, if any.

5) Calculate cost limitations and compare to accepted costs to identify any need for further cost reimbursement adjustments.

KEY TERMS AND CONCEPTUAL DEFINITIONS RELATING TO GOVERNMENTAL CONTRACT COST ACCOUNTING

The conduct of the audit of the costs billed requires a thorough understanding of cost principles, or customary conventions for classifying, recording, allocating and reporting costs of individual cost objectives and contracts by Federal government contractors.

Following are a few key terms and definitions important to understanding the context in which contract cost auditing is performed.

Direct and Indirect Costs

Direct costs are costs identifiable with a specific final cost objective, e.g., a contract, whereas indirect costs are incurred for more than one cost objective. Direct costs of insignificant amounts may be treated as indirect costs for administrative convenience. Consistent application of criteria for identifying costs as either direct or indirect is essential. Once a cost is identified as a direct cost to a particular contract, the same type of cost, incurred in similar circumstances, may not be included in any indirect expense pool allocated to that contract or any other contract.

There is no prescribed manner in which costs should be accounted for as direct costs and which as indirect costs. The criteria for charging costs as direct or indirect are based on an analysis of a contractor's organization, businesses and contracts. Indirect costs should be accumulated into logical cost

groupings to permit distribution of expenses in relation to benefits received by cost objectives (departments, contracts, etc.).

Questioned Costs

Questioned costs are costs which are identified by the auditor as not allowable because a) they are not in conformance with specific sections or limitations of applicable procurement statutes and regulations or the provisions of the contracts between the parties, b) they are unreasonable in that a prudent businessman would not incur such costs to achieve the requirements or objectives of the contract between the parties, and c) the costs are not allocable to the contract, i.e., they are not related, directly or indirectly, to the accomplishment of the requirements or objectives of the contract.

Unresolved Costs

Unresolved costs are a) costs for which sufficient information and documentation is not available to make a determination as to whether the cost is acceptable or questionable and b) costs which are generally acceptable except for technical or procedural errors.

These costs usually have many characteristics of acceptability but, they are not sufficiently documented that they are clearly acceptable. Frequently the contractual parties with authority to make, accept contract payments and settlements negotiate these costs.

IV. PERFORMANCE FINDINGS

Our performance findings are presented in the form of our Pre-Audit Survey issues. They are divided between: Section A, which focuses on the actions of State AHCCCS and Section B, which primarily focuses on MSGI. Comments regarding both are made at times when a subject involved both parties extensively. Section III provides summary comments regarding the contractual basis of the agreement with MSGI and the implications for the amounts claimed by MSGI for its Administrator services.

A. Performance of DHS and State AHCCCS Division in Contract Monitoring

1. Overall Factors Affecting the Conduct of the Program's Administration

While not an explicit issue investigated in our work, we identified three overall factors which significantly influenced the administration of the AHCCCS program. These are discussed below.

(1) Findings

Two aspects of the enabling legislation resulted in difficulties in program implementation: 1) the size of the program in light of its numerous untested features, and 2) the short timeframe between passage of the law and program startup. Further, the AHCCCS program was initiated in an environment which did not have institutions or personnel familiar with pre-paid health plans or Medicaid.

(2) Discussion

Our audit work did not include extensive research into the origin and development of the AHCCCS statutes. However we did identify areas where the enabling legislation resulted in significant operational problems. In presenting this information we do not purport to render judgments about the overall value of the AHCCCS program, but rather to provide insights into the factors which significantly influenced the program's administration during the period June 1982 through March 1984.

With respect to the size and timing of the AHCCCS program, our discussions with HCFA, MSGI and State AHCCCS officials all indicate that the magnitude of the AHCCCS experiment, especially when combined with the short timeframe allowed for program startup, virtually assured that significant operational problems would be experienced. Some of the considerations which lead to this conclusion are:

- Most of the provider plans did not exist at the time the legislation passed, and the plans themselves were quite diverse, e.g., county-based, for profit, etc.

- Unlike many other demonstration projects (even other HMO-based experiments elsewhere in the country), AHCCCS was instituted on a very large scale. The subject of the experiment--health care--made it extremely sensitive since it dealt with people's fundamental well being. Under these conditions the program could not be stopped to correct operational problems, nor significantly changed without risking disruption to the complex chain of participants, providers and governmental units involved in the program.

- In the same vein, the AHCCCS program was intentionally designed to test new approaches to Medicaid. It was therefore necessary to make a number of assumptions about how the program would work, not all of which obviously could be accurate. When certain assumptions were proven wrong (e.g., workability of co-payment

premiums, number of fee-for-service claims, and competitiveness of initial provider bids) the large scale of the program put the State at considerable financial risk. This forced the need to hurriedly change the policies and procedures of the program, with obvious consequences for the smoothness of implementation and ongoing operations.

- The AHCCCS legislation allowed only 10.5 months between enactment and program startup. As a point of comparison, in 1984 HCFA developed a recommended timetable for fiscal intermediary/MMIS procurements for ongoing Medicaid programs. As can be seen in Exhibit IV-1, this timetable has substantially longer periods of time for the Administrator procurement process and for EDP system development than was available for AHCCCS.

2. Adequacy of Contract Provisions and Contract Execution

This area of our performance audit centered on these issues: a) reviewing the contract documents for adequacy of preparation (especially with respect to goals, deliverables and other measures) and comparing the AHCCCS contract documents to other states, and b) assessing the subsequent contract modification efforts which were made.

a. Review of Contract Documents and Comparison to Other States

The AHCCCS contract with MSGI included the Request for Proposals (RFP) for an Administrator, the Cost and Technical Proposals of MSGI, the contract, and certain correspondence exchanged during contract negotiations. We also reviewed tape recordings and transcripts of the negotiation sessions.

EXHIBIT IV-1

COMPARISON OF 1984 HCFA GUIDELINES TO AHCCCS TIMETABLE

Event	HCFA Recommendation	Actual AHCCCS Timing
RFP Preparation	2 to 3 months	2 months
Proposal Submission Date	Up to 90 days, but no less than 60 days after RFP release date	32 days
Evaluation of Proposals	60 days	48 days
Contract Award Date (Signing)	6 months after RFP release date	5 months after release date
Installation Period	180 days after contract award. More time if major system changes are being implemented.	57 days, despite major new systems design requirements
Operational Date	1 year after RFP release date	7 months after RFP release date

(1) Findings

The RFP was deficient by taking a cost reimbursement approach for all work to be performed, and it failed to provide or require identification of assumptions with respect to anticipated workload and associated levels of effort.

MSGI's proposal was vague in many respects and assumed a minimal number of staff required to perform as the Administrator.

The proposal evaluators of the State did not consider the cost per labor unit provided when considering the costs proposed by MSGI and the other firms bidding.

The contract documents consistently failed to define and specify the contractual requirements of the Administrator. The incentive payment device was overburdened by trying to serve too many objectives, such as cost containment and reward for superior performance. The State fell into the posture of saying it needed substantial flexibility for change while never having firmly established a base set of tasks and associated resource levels from which shifts could be measured. A trend was established of rolling forward the time at which agreements would be made on the complex issues of definitive tasks, deliverables, deadlines and resources, and performance measures/incentives. This trend would continue during the operational phase of the program.

The failure to define specific tasks with associated levels of effort left the State without adequate benchmarks against which to measure contractor cost performance. Use of a solely cost reimbursement approach exposed the State to significant cost increases as specific tasks and program requirements were gradually formed.

(2) Discussion

RFP

The RFP was developed in large part over a three week period in mid-January 1982. Because of the lengthy time requirements for each of the steps in procuring an Administrator (i.e., RFP issuance, question and answer sessions, preparation of proposals, evaluation and selection, contract negotiation, Arizona Attorney General and HCFA review and finally award), there was a pressing need to initiate the process quickly. The firm of Compass Consulting Group was given a small contract to assist the State staff to draft an RFP.

During this time there was a general agreement that the AHCCCS program was charting a new course for which there were few precedents. AHCCCS was established as an experiment. Further, legislation adding the important enrollment function to the Administrator's duties was passed after the bidders had responded to the RFP. In addition, the rules and regulations of the program had significant implications for program execution. They were quite voluminous and subject to an extensive public hearings process. They would not be initially issued until after the Administrator's contract had been signed.

In light of the above, after broadly discussing the Administrator's duties, the RFP stated this guidance:

- "The specific scope of activities under these categories of performance is and will continue to be subject to development and/or change during the period of performance under this contract."
- "The State, in selecting the Administrator, will assess the proposer's understanding and willingness to modify

or develop alternatives, as well as his capability to respond to new contractual demands."

With respect to the basis for payments to the Administrator, the RFP said: "A cost reimbursement type contract with negotiated incentive payments is anticipated."

The RFP also stated that bidders should present their proposed costs by cost account and major function, to include broad activities such as quality assurance, claims processing, and provider solicitation and management. This information did not easily lend itself to a task or unit of output type of costing or control. This factor became a major source of difficulty in subsequent contract modification efforts.

While it is clear that many important elements of the AHCCCS program were still taking shape when the RFP was drafted, much more could have been done in the RFP to establish parameters for the program:

- In the May, 1980 Report on Medicare Contracting by the President's Management Improvement Council it was recommended that fiscal intermediary contracts be a mixture of fixed price and cost reimbursement. The Council said that in some areas of uncertainty fixed prices for different ranges of estimated workload could be utilized.

- Certain tasks were susceptible to estimating, for example: the number of medical quality assurance reviews and financial audits to be conducted per year, the effort required to design and implement the claims processing system elements, the number of staff expected to be used for public relations and to maintain the MMIS after installation, and the level of technical assistance to be afforded to providers.

- If the State was uncertain with respect to the levels of effort needed, it could have required bidders to specifically state the assumptions they used to develop their

cost proposals. Without stated assumptions by either side, comparative evaluation of cost estimates became extremely difficult.

MSGI Proposals

MSGI's proposals appear to have consistently estimated the minimal staff levels needed to fulfill the functions defined in the RFP, based on both the assumption of near optimal conditions and only reflecting the resources needed for the limited specific requirements defined in the RFP. This conclusion is based on our professional judgment and comparison to the other bids received. No record remains of the basis for MSGI's actual assumptions.

The MSGI proposal clearly assumes that the contract will be run on a task basis as evidenced by the specifics in the Management Section of the proposal. As proposed, new tasks would be estimated before work began and actual task expenditures would be prepared on a monthly basis. However, there was a general vagueness in MSGI's proposal with respect to the quantification of numbers of staff to be devoted to specific tasks, dates for delivery of work products (beyond the Implementation Period), and units of output or workload expected. The proposal frequently included sweeping generalities in its commitments, such as "Systems will provide full capability for enrolling members, collecting premiums, enrolling and paying capitated providers, and providing the information reporting requirements of AHCCCS" and also stating the "AHCCCS requirements can be met with minimum development effort." The staffing levels presented in the cost proposal combined numerous capabilities within any given functional area. This made it impossible to determine the actual staffing levels proposed on a given task.

MSGI consciously accepted a substantial element of risk in its pursuit of the optional part of the RFP which called for offerors to propose incentive payment arrangements. In its proposal, MSGI said "MSGI proposes a costing arrangement which is designed to put MSGI at risk for failing to achieve the program objectives and will concurrently reward it if AHCCCS achieves the results sought by the State of Arizona." MSGI's proposal presented some suggested incentives, but recognized that further discussion would likely be needed before agreement could be reached with the State. The incentives represent another important element, along with deliverable schedules, levels of effort and other components which would have to be settled at the time of the contract signing or even later.

Proposal Evaluation

The RFP stated that 25% of the total points assigned by the State's proposal evaluators were to be awarded on the cost bids. The original cost proposals received ranged between $7.5 million and $21.55 million for the three years plus start-up period, as follows:

Jurgovan and Blair	$21,556,400	
Hancock - Dikewood	$18,872,000	
EDS	$15,726,330	
CSC	$13,558,300	
MSGI	$ 9,386,000	*
Blue Cross/Blue Shield	$ 7,524,718	

* Including $1,123,000 in incentives

The State's proposal review committee awarded MSGI points in line with its proposed cost, which was the second lowest of the

six responsive bids received. In making this decision the committee did not consider the cost per labor unit proposed (i.e., MSGI proposed an operational staff of 47, whereas the other bids ranged from 63 to 116).

Between the time the RFP was prepared and when it was issued an official AHCCCS director was named, Henry Foley. He has said that his previous involvement was one of providing comments over the phone, and that he had indicated he felt the RFP lacked specificity. However, on his first day in office he approved public release of the RFP. He later became chairman of a group of three which rendered final judgment on the selection of MSGI.

Contract

The AHCCCS Administrator's contract was a cost reimbursable type, with additional award and incentive fee features. It too did not clarify the specific tasks to be accomplished and associated levels of resources or the performance measures/incentives to be used beyond the first few months. These critical items were supposed to be identified later in detailed workplans developed and negotiated annually.

The incentive fee device appears to have been overburdened by the terms of the final contract. The incentives were originally conceived in the RFP as being a means of encouraging attainment of important objectives. MSGI embraced this concept in its proposal and made it the major opportunity for profit. The contract, however, added the concept of incentives serving as an overall contractor cost containment tool. Further, the contract referred to the incentive payments as being "based upon superior performance." This last reference was to cause confusion among

State AHCCCS staff later, when some felt that incentive payments should not be made when operational problems were being experienced. Our review of other state Medicaid contracts indicates incentives are usually not used, and especially not given such an important role.

During the taped contract negotiations there was much concern evidenced by State representatives about the ability of MSGI to perform its duties within the proposed cost. MSGI repeatedly stated their figure was realistic. To address this concern, a capping mechanism was introduced, with offsetting reductions of the incentives and award fees if the cost exceeded that proposed. However, the contractual basis for setting this cap was the overall bid price as it relates to the tasks and deliverables within either: 1) any of the contract documents or 2) the to-be-agreed-upon workplans. The vagueness of the contract documents, the failure to agree to workplans and subsequent directives from the State expanding MSGI's scope of work made the 125% capping device ineffective. It is also clear from listening to the tapes of the contract negotiations that the two parties never really came to a joint understanding of what the contractual basis actually was. The State saw fixed price elements in its 125% capping mechanism and incentive/award fee offsets. MSGI viewed it much more as a simple cost reimbursement contract.

The six other state RFPs and contracts which we surveyed and HCFA model RFP recommendations (issued in 1984) contain a consistently higher degree of specificity and contractor requirements than do the AHCCCS contract documents. Appendix B provides a detailed description of the results of our comparisons. Again, it was the state's perception that little could be defined concerning the details of the AHCCCS program that resulted in few

specifics and requirements being included in the AHCCCS contract documents.

In addition, our review of other state contracts noted that the New York contract with MSGI contains another particular item which the Arizona contract does not have--it clearly states that McDonnell Douglas Corporation is the ultimate contracting party, not just the small subsidiary--with correspondingly small assets --which MSGI is. This point has been a subject of litigation in Arizona.

b. Development of Workplans and Contract Modifications

There were two important elements of the contract which we identified for detailed review for State AHCCCS adherence to contractual requirements: annual workplan approval and modification of the contracts. Associated with the workplan development were the respective roles identified for the State AHCCCS and MSGI groups.

(1) Findings

Although the contract negotiations and the contract itself placed great significance on the need to develop and agree upon detailed workplans, this was not accomplished beyond the initial Implementation Period. Incentive criteria were also never finalized for Operational Years One and Two, thus failing to supply the important motivating force envisioned in the contract documents. An associated problem was the failure thoughout the contract period to adequately define the respective roles of MSGI and the State AHCCCS Division.

In the absence of definitive contract documents and approved workplans, determination of what was within or outside of the contractor's scope of work and decisions about contract modifications became extremely difficult. The newness of the program, the crisis atmosphere which often prevailed and the high degree of change of top officials from both MSGI and the State units also contributed to this problem, and to a lack of timeliness in seeking formal contract amendments as required in the contract and by HCFA.

(2) Discussion

Workplans

The contract called for workplans to be developed and agreed upon two weeks before the start of each operational year. A plan for the Implementation Period was to be finalized shortly after the contract was signed, which did occur. The Implementation Period consisted of start-up tasks which were covered in considerable detail in MSGI's proposal. This detail served as the basis for the workplan.

MSGI did not provide a Year One workplan to State AHCCCS until October 18, 1982--five weeks after agreement was to have been reached. The following events took place subsequently:

- Henry Foley distributed the plan to his staff for comment.
- Foley's initial reaction to the plan was negative because MSGI was behind schedule on the Implementation Period tasks. He felt it was somewhat pointless to establish a Year One workplan while startup tasks were still underway (this work was completed in December).
- The State staff responded to Foley by noting that a number of areas in the proposed plan were already, or

would soon be, behind schedule. They felt other areas lacked detail, and some required change due to the many programmatic decisions being made.

- A series of meetings were scheduled to discuss the plan but not held due to various timing conflicts. (Foley wanted MSGI's Executive Vice-President, Howard Waltman, to attend as well as MSGI's on-site project director, Richard Kline.)

- MSGI, meanwhile, continued to perform duties along these lines: 1) conducting regularly scheduled activities which were known (e.g., claims processing), 2) responding to various short term crises and problems which were steadily arising as the program developed, 3) reacting to decisions made at meetings between Foley and Kline, and 4) pursuing some of the work items identified in the contract documents, e.g., design of the MMIS.

- Foley then decided to develop a joint State/MSGI plan. This was done, but not shared with MSGI for several weeks. It was prepared without MSGI input, was not detailed and did not cover all the activities underway.

- By mid-February 1983 the leadership of State AHCCCS began to be shared by Foley, Sam Thurmond (Governor Babbitt's special representative for AHCCCS), a Governor's Working Group consisting of executive and legislative branch representatives, and Don Mathis (later named to head the DHS). The focus was on several pressing policy issues which required prompt resolution, not on development of a longer term workplan.

- Upon taking over as head of DHS in April 1983 Don Mathis felt there were major problems confronting the program involving open enrollment and rebidding of provider contracts for the coming fall. Further, Operational Year One was more than half over. In May, MSGI's Kline left, further disrupting program continuity. Mathis became convinced that the existing contract was both complex and unspecific, and that a new one should be negotiated. Top priority was therefore not given to development of a plan for the remainder of Year One.

The Year Two plan was not submitted by MSGI until October 21, 1983. Extensive amounts of both MSGI and State AHCCCS staff time were devoted to this plan, the preparation of the proposed

Modification #3, and Year Two incentives. State AHCCCS staff raised a number of issues regarding the Year Two plan as well as Modification #3, which dealt with MSGI's perceptions about the verbal and written directives it had received during Year One.

The Year Two plan represented a mix of functional activity costing, as was presented in MSGI's proposal, and task based costing. In late 1983 the Attorney General's office became involved in the Modification #3 issue and took the position that all costs had to be traced back to the original contract documents. The Year Two plan, the incentives for Year Two and Modification #3 all became viewed as interdependent, and the negotiations now involved three parties, with involvement from the Legislature as well.

Roles of MSGI and State AHCCCS

The AHCCCS legislation said: "The Administrator will have full operations responsibilities, subject to the Director's supervision." Nevertheless a broad range of activities needed to be accomplished to get AHCCCS underway in a short time, so in December 1981 DHS established a team of 12 temporarily assigned staff. This group was later enlarged to about 25 and was responsible for many operational tasks that required intensive effort since an Administrator did not start work until June 1982. However as of that October the State's role in these activities was to theoretically stop, and an overall monitoring posture was to be adopted. In practice this became quite difficult to do:

- Several of the State's start-up activities, such as the preparation of rules and regulations, were still under development.
- There were inquiries from many quarters about the program, ranging from policy and operating questions

from the Legislature and HCFA to detailed individual member problems. It was impossible to merely refer all these to MSGI.

- DHS/AHCCCS clearly had to officially approve many activities, such as the RFPs and contracts with providers and policy statements.

- Critical interagency problems and coordination needs arose, such as the transfer of eligibility information from the Department of Economic Security's data files. These required representation by State AHCCCS officials as well as MSGI.

- Input was necessary on technical as well as policy issues raised by MSGI. New ground was frequently being broken here. (In fact the State's delay in making policy decisions at times significantly hindered MSGI's activities.)

As these items pressed for attention and, as operational problems were experienced by MSGI, the State AHCCCS staff vacillated between an oversight and operational role. An example of duplication of duties is in DHS's second annual report on AHCCCS: "Although the Administrator maintains a 24 hour telephone line to answer recipient questions about the program, the AHCCCS Division also performs this role. Division staff act as intermediaries between recipients and the Administrator, health plans and government agencies to resolve the inevitable problems which result from a complicated new program."

The blurring of roles led to significant problems in policy analysis and decisionmaking. State AHCCCS staff looked to MSGI to fully analyze issues and problems and develop alternatives, while MSGI felt the AHCCCS Division, as the State's representative, was responsible for determining policy and decisionmaking. Because they were not directly involved in operational problems (in a program that was new and rapidly evolving), DHS staff sometimes lacked the knowledge to respond on a timely basis to

queries for direction. Instead their reaction was frequently to request further information. This led to frustration and delays on all sides.

Contract Modifications

The contract documents envisioned that significant, ongoing changes would be needed to the AHCCCS program and its administration. They stated that all modifications would have to be approved in writing by the State. The State AHCCCS project director was given the authority to modify the scope of work and associated costs.

During the first several months of the project MSGI and the State utilized a Transmittal Memorandum procedure for policy communication. As time passed this procedure became overused, with subjects of varying importance raised by both sides. Many of the transmittals from the State give guidance to MSGI on policy decision, comment on a deliverable, call attention to problems, raise an issue for urgent attention, etc. It becomes difficult to sort out among these memoranda what is in or outside of original work scope, and most do not provide guidance on what should be of lower priority or not done if the task being discussed is pursued immediately. However several of these transmittals do specifically discuss Year One budget levels, while Henry Foley directed AHCCCS. In two of these, MSGI's project director stated:

- "MSGI intends to stay within the total operational budget as defined by you." (This was $4.023 million, in January 1983.)
- In a later MSGI memo to Don Mathis the same approved budget allocation is specified.

Subsequent interviews have indicated that both Foley and Kline felt that the transmittal-approved levels as of February 1983 would be adhered to by MSGI for Year One. However, several factors intervened to cloud this apparently clear budget limitation:

- Many people from both MSGI and DHS/AHCCCS agree that verbal directives were frequently given to MSGI without regard to the "new work" issue.
- Direction of MSGI came partly under Sam Thurmond for a time, then Don Mathis and later Greg Fahey. Thurmond wrote some directives to MSGI independent of Mathis. Both Fahey and Mathis agree that MSGI did considerable new work during 1983.
- Several of the transmittals appear to contain new directives. Examples are listed in Exhibit IV-2.

Contract amendments were not made and formal modifications were not submitted to HCFA until many months had passed, even when transmittals could have been used as a basis for doing so. The reason for this appears partly to be that the State AHCCCS leadership expected to change the nature of the contract during the summer of 1983, but later learned that HCFA would not approve a radical revision or restructuring without a full recompetition.

The State was remiss in executing the contract provisions calling for formal contract amendments to be made for new work. Contract changes were informally made and not through the amendment process required in the contract. This contributed to allowing the size of MSGI's monthly expenditures (and bills paid) to grow far beyond that officially budgeted. Other states with fiscal intermediaries follow a practice of concurrently reviewing a proposed modification internally and submitting a draft request to HCFA. Another device, used to avoid the need for frequent modifications, is to maintain a certain number of data processing

EXHIBIT IV-2

EXAMPLES OF TRANSMITTAL MEMORANDA

- A June 19, 1983 transmittal from Mathis to Skelton authorizes MSGI to add up to $25,000 to the work of Milliman and Robertson.
- A November 23, 1982 transmittal, Foley to Kline, deals with 24 hour emergency coverage.
- A December 2, 1982 transmittal, Foley to Kline, tracks several transmittals, including two dealing with Native Americans and Long-Term Care.
- A December 3, 1982 transmittal advises MSGI on the need to devote more staff attention to case management.
- A November 30, 1982 transmittal, Foley to Kline, requests MSGI to initiate new procedures in the quality assurance area.
- A December 8, 1982 transmittal Foley to Kline, requests more MSGI staff resources be devoted to county-by-county implementation and operations plans.
- A December 20, 1982 tranmittal, Foley to Kline, stated that as a result of discussions on Native Americans with the State Legislature and the Governor's Office, a new policy was being implemented by AHCCCS which would alter MSGI's procedures.
- A March 23, 1983 transmittal, Foley to Kline, stated that "the AHCCCS Division has decided to include the provision of dentures as a covered benefit..." Again, MSGI procedures were to be changed.
- Transmittals on March 15, 18 and 29, 1983, between Foley and Kline, brought MSGI into a more active role in Newborn Care.
- On April 1, 1983, Foley to Kline, a transmittal stated that as a result of negotiations with HCFA, the AHCCCS Division agreed to expand coverage of medically necessary transportation. Once again MSGI was given additional duties.

personnel in a separate task group which is to be used only for short-term and/or high priority projects. California has used this method and has reduced tremendously the number of contract amendments needed.

3. Monitoring and Control of the Administrator

In this part of our review we examined the adequacy of the financial and management controls utilized by the State to monitor MSGI.

(1) Findings

State AHCCCS did not establish consistent, effective financial and management controls so as to enable it to effectively oversee MSGI's operations and expenditures. It did not have an adequate grasp of some important contractual issues and as a result let critical contract related problems and adverse trends continue even after they were identified. It lacked experienced personnel in several areas.

(2) Discussion

Financial and Management Controls

In terms of financial and management controls, we noted the following:

- The State did not require MSGI to submit a monthly spending plan for Year One. Neither did it require monthly reports on MSGI staff levels. Had it done so, the "cost overrun" and "verbal modification" issues would have been identified much earlier in 1983 than they were. Earlier identification might have permitted the contractual issues to be raised, addressed and

resolved before they became multi-million dollar disputes.

- An audit of MSGI's first quarter billings for Year One was conducted and identified some significant concerns, e.g., MSGI use of non-Phoenix staff who were billed at much higher overhead rates. However this effort was hurried, was not completed and was not repeated for subsequent periods. The issue identified was not resolved.

- State AHCCCS did not insist that those reports promised in MSGI's proposal be delivered, thus missing important information on program and administrative costs.

- No master list of deliverables was prepared based upon the contract documents. We have only found one partial attempt to identify such items. Consequently, consistent monitoring of MSGI's requirements under the contract was not performed. The Implementation Period was closely monitored by the State, but significantly this is the only period for which a work plan had been agreed upon.

The reasons for these deficiencies cover a gamut of items: insufficient experience, frequently changing leadership, pressure of a continuing crisis atmosphere, frequent statutory and policy changes, an expectation that a new contract would redefine the details of the MSGI relationship, and a lack of definition of duties within AHCCCS staff with respect to monitoring MSGI.

Contractual Issues

State AHCCCS demonstrated a lack of understanding in terms of the contractual rights and workings of the contract. Examples include:

- The concept of "direct costs" was misunderstood. The State felt that any costs incurred would be charged only the 3% general and administrative rate bid by MSGI. However, overhead costs incurred by other MSGI divisions, other McDonnell Douglas Corporation units, and subcontractors are not subject to this limitation.

- All the State Directors paid MSGI on the basis of the payments being "subject to audit." This term was used to mean that some future audit would recover any costs not allowable under the contract. However this overlooked: 1) the possibility that the State simply misunderstood provisions such as "direct costs" and the susceptibility of the contract to modification from transmittals and verbal directives, and 2) the difficulty of conducting such an audit in a dynamic environment with no workplans and specific, task driven budgets.

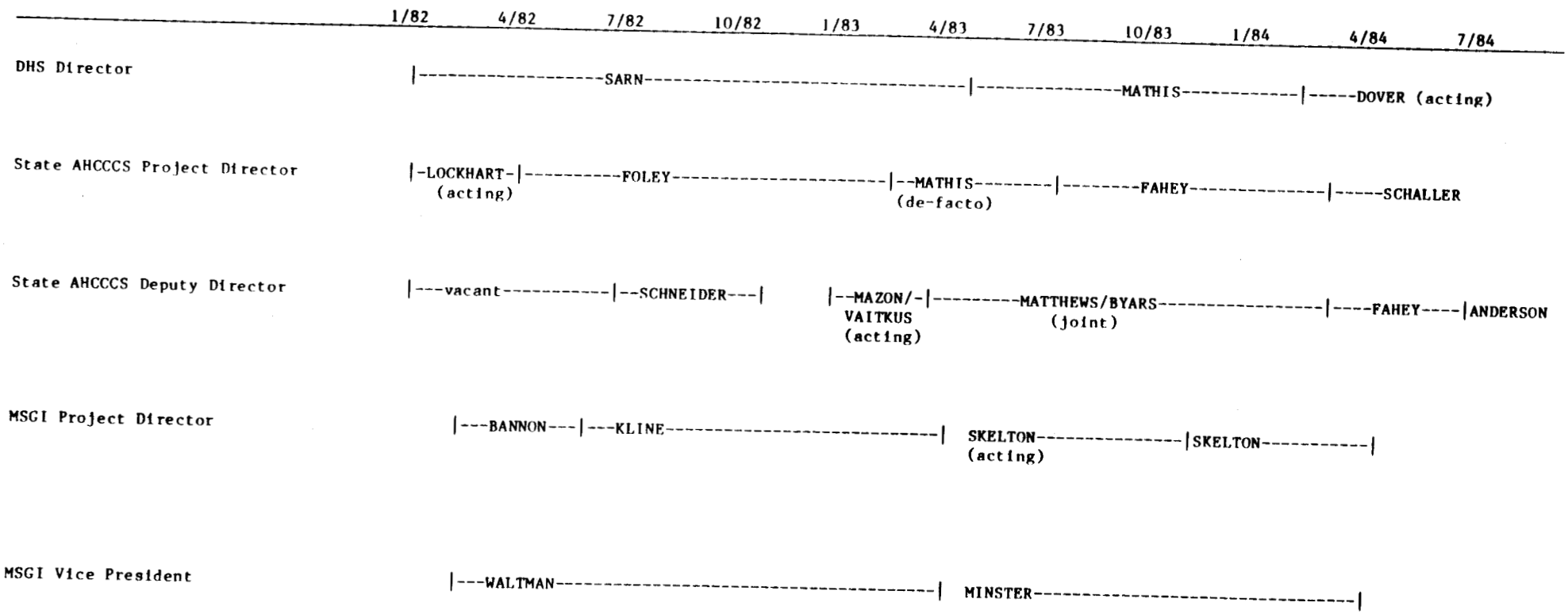
- State AHCCCS staff raised questions about their ability to direct MSGI to undertake organizational changes, influence the location of MSGI's computer processing activities and other issues. These questions were usually not resolved.

Personnel Experience

State AHCCCS staff lacked sufficient expertise in several vital areas including: data processing (EDP) systems design, fiscal intermediary oversight and to some degree in the Medicaid program itself. EDP systems expertise was a particularly soft spot within DHS/AHCCCS. Mike Savino was hired in December 1982 to become the systems monitor, however he actually was an auditor with only a little systems experience and in addition was also given multiple assignments. Aldona Vaitkus was then assigned this responsibility but she similarly did not have a technical EDP background and also was involved in many other projects. In the period February through August 1983 Sam Thurmond had intermittent involvement with AHCCCS--first concentrating on the systems design work but later becoming involved in numerous other issues. He did have a systems background, but was not permanently assigned to AHCCCS. By the end of 1983 DHS/AHCCCS still had no permanent systems monitoring expertise.

A major cause, as well as a symptom of AHCCCS's problems, is the heavy turnover of top State and MSGI management. Exhibit IV-3 provides a summary of this situation.

MSGI AND STATE AHCCCS LEADERSHIP TURNOVER



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B. Performance Audit of MSGI's Activities

This part of our report covers five areas related to MSGI's performance as AHCCCS Administrator:

1) Compliance with the Administrator Contract
2) Efficiency of MSGI's Major Activities
3) EDP Systems Development and Operations
4) Assessment of the Amount of New Work Performed
5) Use of Subcontractors

1. Compliance with the Administrator Contract

This discussion responds to the question of how well MSGI fulfilled its contractual responsibilities with respect to major tasks and deliverables. The MSGI work on EDP systems development is discussed separately.

(1) Findings

MSGI appears to have substantially completed many of the responsibilities required under the Administrator's contract, though several key tasks were not performed. The key tasks that were not performed, however, had a significant impact on MSGI's and State AHCCCS' ability to manage and operate the AHCCCS program. In all areas the timeliness and degree of completion of certain tasks were not performed as proposed.

(2) Discussion

As noted earlier, the contract documents were generally vague with respect to specific deliverables, levels of effort and deadlines. However, we conducted a detailed review of these documents to assess MSGI's compliance with those areas which were specified. This review relied necessarily on the technical proposal, RFP and implementation workplan. Workplans for Operational Years One and Two were submitted though never approved. The discussion of new work performed is presented in section 4 (below). Furthermore, none of the submitted workplans contained performance standards, as proposed.

Presented below is a summary discussion of the major tasks and deliverables proposed that were completed or not completed by MSGI. Appendix C presents a detailed summary of their contract deliverable compliance.

Management and Control

MSGI proposed very detailed and very well defined steps that would be followed to ensure proper management and control of the AHCCCS project. Some of these steps (such as the use of transmittals) were taken but most were not resulting in an overall lack of control.

Formal written progress reporting from MSGI to State AHCCCS was not implemented on an ongoing basis. MSGI's technical proposal stated that weekly, monthly and quarterly progress and status reports would be provided to State AHCCCS. However, no monthly or quarterly status reports were prepared and only six biweekly status reports (November 1982 through February 1983) have been identified. Discussions with MSGI project directors

have indicated that this was not considered a high priority by either State AHCCCS or MSGI.

Project reporting even within MSGI was very intermittent. Some managers required weekly status reports from their staff and followed up on their contents, while others sometimes required them and then would stop. The use of project reporting appears to have depended on the individual manager, rather than being a project-wide policy.

Provider Development

During the Implementation Period, MSGI was responsible for developing the AHCCCS provider structure. This included pre-bid solicitation, preparation of Requests for Proposals (RFPs), evaluating provider proposals, and drafting contract documents. MSGI completed all of the provider development activities and in fact performed additional tasks as required by State AHCCCS.

Under the MSGI technical proposal it was envisioned that only one RFP would be developed and released for provider solicitation. However, during summer 1982 it was determined that additional RFPs would be required for special populations, such as the public/private group, long-term care, and Native Americans.

These additional RFPs and the associated effort involved in their development, evaluation and contract award were not anticipated in the MSGI proposal or contract. It is doubtful whether any party could have anticipated the need for additional RFPs due to the demonstration nature of this project. No other state has attempted to devise and implement a state-wide competitive bidding process of this nature.

Program Relations (Public, Provider, and Member)

MSGI was responsible for developing public relations materials, and provider and member materials, procedures and training during the Implementation Period. It appears that the majority of public relations was performed by State AHCCCS personnel, including media campaigns, news releases, interviews, etc. Public relations activities performed by MSGI included such items as development of member posters, member information kits and letters sent to AFDC/SSI recipients. The public relation roles for State AHCCCS and MSGI were not adequately defined during the Implementation Period. Subsequent to implementation, State AHCCCS assumed responsibility for public relations and MSGI assumed responsibility for provider and member relations.

Provider Management

MSGI was responsible for the procurement and evaluation of contracts for existing and new plans, plan financial and liability management, contract compliance monitoring and review, and plan audits.

The AHCCCS legislation permitted a two year initial contract with providers. However, State AHCCCS determined during the Implementation Period that the contract period would be limited to one year. This decision necessitated rebidding in summer 1983. This was a major new work item not anticipated for Operational Year One under the original contract.

MSGI was required to conduct financial audits of the Prepaid Health Plans (PHPs). This task was not completed in the first year. MSGI stated that the reason was the plans would not have financial statements until after one year of operations. Audit

procedures were not finalized until November 1983. There is indication that visits were made to the plans in Spring 1983 to obtain an overview of their financial systems and to determine the timeliness of their payments to subcontractors. Also, letters of compliance were sent to the plans. However, we were unable to determine the scope of these reviews or to verify that all plans had been visited. As a result of concerns regarding one plan, a financial review of it was conducted and a draft report submitted. Related functions such as monthly review of provider financial activity (claims paid), payment backlogs, financial ability and evaluation of provider performance were not performed by MSGI. Only two claims aging reports (March and April 1983) were identified which summarized the aging of claims for the plans. Plans were required to submit quarterly and monthly financial data to MSGI. The plans did not submit the data to MSGI. Some efforts were made to enforce this requirement. The State did apply sanctions to two plans in the second year of the program. Since contract compliance and financial audit activities were not performed by MSGI, the State could not be assured of the plans' financial solvency. Therefore an important feature of the demonstration nature of the AHCCCS project--to evaluate the development, financial status and operations of the plans-- was hampered.

Significant problems relating to fee-for-service claims were experienced by providers early in the program. Some of these problems stemmed from decisions made by the State at the inception of the program. Initially the counties were to collect, review and approve fee-for-service claims and then send a bill to MSGI on a summary basis. However, a last minute decision was made by State AHCCCS to have the fee-for-service providers submit claims directly to MSGI which increased their workload. The providers were not familiar with the claim forms

and MSGI did not have the opportunity to provide training at that time. As a result, there were numerous claims submitted containing errors. Provider correspondence indicates that claims were being rejected with no indication to the provider as to what the problem was and how to resolve it.

Quality Assurance

MSGI was required to develop a Quality Assurance (QA) Plan, to conduct medical and administrative audits of each plan and to provide consulting assistance to individual provider plans in the development of their internal quality assurance/utilization review plans. The medical quality assurance reviews which were performed were done by a subcontractor not included in MSGI's proposal. Delay in MSGI's implementation of automated reporting systems resulted in the inability of MSGI to perform many quality assurance activities as envisioned in their technical proposal. Although complete and accurate encounter data were not received until well into the program, the fee for service component should have been operational. Most significantly, the absence of the automated reporting systems contributed to an inability to identify the presence and/or magnitude of fraud and abuse within the program and the quality of care being received by members.

Assistance and Planning

MSGI's proposal provided for assistance and planning activities. These activities included providing technical assistance to PHPs in utilization review techniques, developing comparisons of plans to be supplied to potential enrollees, and developing annual AHCCCS program evaluation reports. None of these activi-

ties were performed. These activities were given low priority by MSGI and there is no indication that this work was ever discussed or scheduled.

2. Effectiveness of MSGI's Major Activities

This part of the report provides our assessment of the effectiveness of MSGI's performance in several key functional areas: a) eligibility, b) enrollment and c) provider management.

(1) Findings

MSGI adequately performed the majority of activities associated with provider development and provider and member relations. Their performance in the areas of eligibility and enrollment was less effective because of problems arising in the eligibility determination process.

The timely and accurate processing of eligibility determinations was critical to the successful operation of the AHCCCS program. County eligibility offices, DES and SSA were responsible for processing eligibility determinations and submitting the data to MSGI. Due to problems experienced by these agencies as well as some deficiencies in MSGI's operation, MSGI was not able to efficiently process them. This in turn led to substantial enrollment problems as the enrollment procedures were dependent on accurate and timely eligibility data.

(2) Discussion

Eligibility

MSGI was not responsible for the eligibility determination function. The Department of Economic Security (DES) determined eligibility for recipients who received Aid for Families with Dependent Children (AFDC). The Social Security Administration (SSA) made determinations for those aged, blind, or disabled persons receiving Supplemental Security Income (SSI). County eligibility offices determined eligibility for medically needy or medically indigent (MN/MI) persons.

Under the Administrator Contract, MSGI was responsible for designing and implementing an eligibility tracking system which would interface with the eligibility systems of DES and SSA. DES and SSA were responsible for submitting accurate data on a timely basis. MSGI was to provide training for eligibility workers, conduct quality control reviews of county eligibility processes, and pre-screen hard copy eligibility forms prior to data entry.

The primary eligibility problems identified were: insufficient county staffing, limited initial training by MSGI of these staff, and DES EDP system incompatibility with MSGI's eligibility tracking system. These problems, stemming from the inception of the program, caused incomplete, inaccurate and delayed eligibility determinations to be submitted to MSGI. As a result of these problems, the ability of MSGI to enroll an AHCCCS eligible member into a PHP was significantly diminished.

Specifically, the major problem areas in eligibility were:

- County eligibility determinations were required to be completed within 30 days of receipt of application. In

April 1983 it was estimated that some counties were taking two to four months to determine eligibility. The reasons for this are insufficient personnel at the county level and a larger number of individuals seeking AHCCCS eligibility than was anticipated.

- County eligibility workers made numerous errors in completing the required forms because of insufficient training. The short startup timeframe precluded MSGI from adequately training these personnel. Errors included duplicate numbering, mismarking due to failure to understand definitions, and failure to submit forms to MSGI.

- MSGI failed to provide timely and accurate reports to the counties which could have allowed them to identify and correct errors made.

- MSGI failed to notify AHCCCS MN/MI members 60 days prior to their eligibility expiration dates as stated in the Eligibility Manual. This resulted in lapses in enrollment for some members, confusion among the plans as to why enrollments were dropping and an additional burden on certain counties which, in the absence of timely MSGI action, assumed this notification responsibility themselves.

- As many as 6,000 members were affected by inconsistencies in DES and AHCCCS data file contents and formats. This "APIS mismatch" problem stemmed from the DES eligibility for AFDC assistance being based on household units versus the AHCCCS person-by-person approach. The mismatches in eligibility counts which frequently resulted had to be resolved through special EDP analysis efforts and manual reconciliations by MSGI. AHCCCS and MSGI originally assumed that DES would provide one set of compatible data.

Enrollment

The procedures for enrollment into a PHP were dependent on MSGI receiving the necessary documentation identifying an individual as eligible for AHCCCS benefits. As this documentation was not timely or accurate, there were delays in enrollments and enrollments into the wrong plan. The ability of MSGI to complete

enrollments was further hindered in the second year with the decision by the State to allow an open enrollment period while eligibility problems identified in the first year had not yet been resolved.

Errors were made by MSGI enrollment clerks in completing enrollment forms, but these errors impacted the enrollment process to a much lesser degree than did the eligibility problems.

Due to the short time-frame involved in the implementation of the AHCCCS program, it is doubtful whether most of the eligibility problems and their subsequent impact on the enrollment process could have been avoided.

Other factors related to the enrollment function include:

- The decision to establish a "pre-enrollment" process prior to AHCCCS program start-up caused substantial errors and confusion among members and plans. It was intended to identify and enroll people eligible for AHCCCS rather than wait until they were in need of medical services. However the process was out of sequence since contracts had not yet been signed with pre-paid plans and eligibility determinations had not been made.

- Several policy changes which took effect in October 1983 substantially increased the number of eligible but not enrolled people. This surge is depicted in Exhibit IV-4. Created by the State's decision to rebid PHP contracts for Year Two and permit members to select another plan if they wished, it also caused at least 2,000 members to be enrolled in the wrong plan (due to a multiple choice option that was offered). These errors, plus a shift in enrollment processing policy which allowed enrollment only on the first and fifteenth of each month, led to a large increase in fee-for-service payments made by the State. This contributed to the AHCCCS budget crisis in early 1984.

- Several other operational problems were experienced, including inadequate response by MSGI to telephone

AHCCCS ELIGIBLE POPULATION

AS OF	SSI	AFDC	MN/MI	TOTAL	NOT ENROLLED
03/07/83	30,509	74,322	35,246	140,077	7,425
04/04/83	30,367	76,162	43,022	149,551	6,148
04/30/83	30,191	74,943	52,165	157,299	7,908
06/01/83	29,363	67,045	58,980	155,388	7,292
07/01/83	29,706	69,191	61,430	160,327	6,686
08/02/83	29,557	66,886	57,612	154,055	6,523
09/02/83	29,483	66,840	52,987	149,310	6,183
09/24/83	29,475	66,210	53,509	149,194	5,363
10/28/83	29,639	72,822	52,211	154,672	15,246
12/30/83	30,164	72,661	57,462	160,287	14,232
01/26/84	30,803	73,687	65,967	170,457	15,394
02/23/84	31,181	74,933	67,625	173,739	10,587

Taken from the Summary Recapitulation Reports.

inquiries by plans concerning member eligibility questions.

Provider Management

While MSGI adequately performed PHP procurement activities relating to the provider development function, their performance was not adequate in provider management. MSGI was not effective in providing overall monitoring and technical assistance to the plans. MSGI did not ensure compliance by the plans with financial reporting requirements. Adequate technical assistance was not provided by MSGI to the PHPs either through outside technical expertise or in-house staff. In Operational Year One there was inadequate MSGI staff assigned to provider management. Rather than monitoring the plans, MSGI efforts were focused on resolving individual plan inquiries dealing with plan enrollments and payments. As a result, the plans did not receive assistance in developing internal management systems as originally envisioned under MSGI's proposal.

MSGI was not and could not be effective in enforcing the reporting of encounter data by PHPs. The effectiveness of MSGI in collecting encounter data was hindered by the failure of State AHCCCS to sanction plans for poor or non-compliance.

Delay in the implementation of the S/URS reporting subsystem resulted in the inability of MSGI to perform many quality assurance activities as envisioned in their technical proposal. This lack of performance resulted in the inability to identify the presence and/or magnitude of fraud and abuse within the program and the quality of care being received by members. The medical audit conducted by AAAHC found that the quality of medical care provided to AHCCCS patients appeared to be at least equivalent to

the care rendered by AHCCCS providers to their private non-AHCCCS patients in the various communities throughout the state. However, AAAHC also identified a few isolated instances of very poor medical care as well as one instance that suggested fraud and abuse of the system. Use of the S/URS reporting system would have helped MSGI to identify these situations on an ongoing basis.

3. EDP Systems Development and Operations

This part of the performance audit examined: a) the efficiency of MSGI's EDP systems development and operations and b) the progress made in obtaining a certified Medicaid Management Information System (MMIS).

a) Efficiency of EDP Systems Development

(1) Findings

Significantly more systems personnel were used than proposed due to both additional new work and to very optimistically low proposal staffing estimates that could not be attained by MSGI. The use of New York Custom Systems personnel (a cost center separate from the Phoenix based staff) and subcontractors contributed to the increased cost of the systems work. The dispersion of systems staff (i.e., New York, Phoenix and subcontractors), lack of clear lines of responsibility, misconceptions MSGI had about the operating environment in Arizona, high turnover of systems staff, and lack of consolidated staffing reports all resulted in inefficiencies in the use of these staff.

Significantly more computer costs and computer related purchased services were incurred than were proposed, but given

the lack of definition in MSGI's proposal, it is difficult to assess the precise cost impact. It does appear that the cost proposal did not allow for the system modifications and corresponding increased computer hardware usage that would normally be expected to result from a demonstration project. The total computer costs billed to the State were double the approved budget level.

(2) Discussion

A key factor in the performance of the AHCCCS program is the EDP systems development. The RFP stipulated that bidders must propose a certified MMIS that would be modified to encompass AHCCCS unique requirements, and that this implemented system must itself be certifiable. Appendix D provides a description of each of the six subsystems in an MMIS. Areas that were reviewed are staff cost control, staff experience, level of effort, management controls, computer costs, and computer related purchased services.

Staff Cost Control

Due to the formats used in the MSGI proposal it is difficult to determine exactly how many EDP personnel were proposed. However the following appears most likely based on the functions defined within the claims processing area:

LEVEL/CATEGORY	5/82	6/82	7/82	8/82	9/82	10/82	11/82	12/82
02-Senior Analyst	1	1	1	1	1	-	-	-
03-Senior P/Analyst	3	3	3	3	3	2	1	-
04-Mgt. Analyst	2	4	4	4	4	2	1	-
05-Programmer	-	4	4	5	5	5	5	3
	6	12	12	13	13	9	7	3

The time period from June through November as proposed encompassed all implementation efforts. The staffing required for ongoing maintenance and modification of the systems from December 1982 through the end of the contract (September 1985) was proposed at three personnel.

Some categories such as computer operations personnel were not included in the cost proposal though they were required for program operations and were mentioned in the technical proposal. The technical proposal did mention the possibility of Long Beach or New York staff assisting those fully dedicated to the AHCCCS project though no corresponding costs were included in the cost proposal. But in fact MSGI New York Custom Systems personnel provided significant levels of support in both Arizona and New York. These personnel, as part of MSGI's Custom Systems Group, provided support to AHCCCS as well as other MSGI projects. These personnel were billed to the AHCCCS project in one of three ways: 1) directly through the AHCCCS payroll register, 2) through monthly intercompany invoices, and 3) individually, as separate, independent subcontractors.

Generally New York personnel were moved from the intercompany invoice to the AHCCCS payroll register once it was determined that they would be assigned to AHCCCS on a full-time basis. The intercompany invoicing of the Custom Systems personnel resulted in higher costs to AHCCCS since the Custom Systems Group used 155% overhead and 28% G&A rates whereas the costs from the AHCCCS payroll register used actual fringe benefit costs (approximately 12%) and the proposed 3% G&A.

There was no consolidated report that combined the hours from the above three sources to allow MSGI systems management (or State AHCCCS) to know exactly how many hours were being spent by

systems personnel on AHCCCS. It was not until August 1983 that the Arizona staff began to provide the majority of the systems support; New York staff continued to support AHCCCS through the end of 1983. Exhibit IV-5 shows the breakdown of number of systems staff on a monthly basis. As can be seen the actual systems staffing levels significantly exceeded the proposed systems staffing levels.

Experience

Design efforts, as compared to the later programming and testing phases of systems development, are better accomplished when staffed with more senior personnel who have sufficient experience to design a system well. In contrast, two-thirds of the Arizona staff had less than five years of experience. Also of importance was the lack of Medicaid experience on the Arizona staff. This was somewhat balanced by the experience of the New York staff. The result of insufficiently experienced personnel is an implementation effort that takes longer and which is not as efficiently achieved.

Level of Effort

The amount of work required to implement MSGI's New York MMIS system in Arizona was far more than MSGI had proposed. Of the six subsystems, two were totally new, one had few changes, and three had significant changes. There is however no documentation to support how extensive these changes were (even though MSGI proposed to deliver documentation identifying the changes to the New York MMIS).

The work was significantly more than proposed for several reasons. The State did not have as much in place when MSGI

EXHIBIT IV-5

ANALYSIS OF SYSTEMS PERSONNEL

(Number of Staff)

	Arizona Staff	N.Y. Staff on AZ Payroll	Custom Systems	Purchased Services*	Total	Proposed
7/82	6	2	5	-	13	6
8/82	7	3	11	4	25	12
9/82	8	6	6	11	31	12
10/82	6	6	2	7	21	13
11/82	5	11	3	4	23	13
12/82	5	26	1	4	36	9
1/83	6	27	3	4	40	7
2/83	7	29	-	3	39	3
3/83	6	26	1	2	35	3
4/83	7	22	-	2	31	3
5/83	8	16	1	2	27	3
6/83	9	14	1	1	25	3
7/83	11	13	2	1	27	3
8/83	12	9	2	1	24	3
9/83	12	8	-	-	20	3
10/83	14	5	2	-	21	3
11/83	12	-	1	1	14	3
12/83	13	-	1	1	15	3
1/84	15	-	-	-	15	3
2/84	14	-	-	-	14	3
3/84	13	-	-	-	13	3

*Includes MSGI personnel engaged as independent contractors.

started work as MSGI had assumed. Rules and regulations were not finalized, an agreement with DES regarding eligibility files was not finalized until mid-1983 and work on county eligibility forms (used for data input) had not been finished. Processing DES eligibility information required significantly more work than anticipated since the eligibility file passed to MSGI included a number of different DES program eligibles, not just AHCCCS (DES apparently did not have the budget to produce an AHCCCS-dedicated tape; the DES AHCCCS-dedicated tape is still in testing).

It also appears, however, that MSGI assumed the optimal situation when developing its proposal estimates. For example, to assume that three programmers could maintain and modify the MMIS for a demonstration Medicaid project was very unrealistic. Three programmers would be realistic only if the narrowest definition of maintenance were assumed and the AHCCCS program were stabilized. No other bidder proposed this low a staff figure (the next lowest estimate was eight). In contrast to its proposal, MSGI's Year Two workplan had provision for 12 programmers to maintain and modify the AHCCCS system.

Management Controls

Procedures to control changes to be moved into production appear to have been very informal. No documented integrated or independent testing appears to have been performed as part of this process. We have found no evidence that the system change control technique proposed by MSGI was ever used, though some controls were instituted several months after implementation.

No cost to complete assessments for system changes were performed (in fact even the project directories of system changes did not include scheduled completion dates). No monthly labor

hour and cost reports were prepared or used. The result was a general lack of control of the systems effort. The reason most frequently given is that so many crises were occurring that there was no time for project control techniques and that no matter what was planned, it was going to change anyway.

Computer Costs

MSGI did not bill AHCCCS for any computer expenses during the Implementation Period as a result of an agreement between the New York State Medicaid Project Director and the State AHCCCS Project Director. November 1982 costs are based on a percentage of actual costs with no detailed support. For the months of December 1982 through April 1983 catalog prices developed for the New York data center were used by MSGI. In general it is difficult to assess the reasonableness of catalog prices given that costs depend on how a data center is configured, on what resources a job uses, on what units of measure are used and on the overall volume of the data center. However we found the government rates of another vendor to be comparable to the catalog rates charged by MSGI. The volumes for December and January are not substantiated and the volumes for February and April appear to be low.

As of mid-April 1983, the St. Louis data center supported AHCCCS. The St. Louis data center had a well tested methodology to bill computer usage; however, for 1983 costs, New York recast the cost figures using the New York catalog prices. There is no clear explanation nor any justification for such action. The result was a significantly increased cost for 1983--a credit was later applied in mid-1984 to reduce these costs.

Exhibit IV-6 presents cost and usage data on a monthly basis for the period November 1982 through March 1984. The usage data is presented in terms of the number of computer jobs run. In reviewing this usage data, several trends become apparent:

- Usage increased after the transfer from the New York data center to the St. Louis data center. This is most probably due to New York not capturing all relevant information.
- The number of long production jobs increased over time and became more expensive as the size of the files grew (e.g., the member cross-reference listing).
- S/URS and MARS testing in January and February 1984 had a significant impact on costs ($60,650 in January and $76,491 in February). This probably occurred in December of 1983 as well, though reports were not broken down in such a way that this could be determined.

Purchased Services

Computer related purchased services totaled over $625,000 for the Implementation Period and Operational Years One and Two. The majority of this (at least $590,000) was spent on programming services to supplement the New York and Arizona systems staff. In general the rates charged were equivalent to the costs for New York intercompany charges though higher than costs for systems staff on the Arizona payroll.

b. MMIS Certification

(1) Findings

As of March 15, 1984 the MSGI MMIS had not been certified. An Advanced Planning Document (APD) had not been approved. Furthermore, the Management and Administrative Reporting (MARS)

EXHIBIT IV-6

DATA CENTER COSTS

	USAGE COSTS		ESTIMATED NUMBER OF JOBS
	ACTUAL	STANDARD	
New York Data Center			
11/82	$ 44,229	$ -	N/A
12/82	36,629	-	N/A
1/83	49,861	-	N/A
2/83	9,883	-	5,000
3/83	40,726	-	5,000
4/83	14,082	-	5,000
St. Louis Data Center			
4/83	12,466	14,207	2,000
5/83	58,026	68,700	9,700
6/83	71,872	82,347	12,000
7/83	70,048	70,086	9,500
8/83	79,423	83,966	10,000
9/83	95,415	135,280	15,000
10/83	89,916	139,244	9,500
11/83	81,169	108,967	7,700
12/83	151,554	175,865	11,000
1/84	179,410	182,413	N/A
2/84	188,073	190,341	8,000
3/84	94,864	117,075	4,200

Dedicated equipment, disk pack and on-line (ROSCOE) charges have not been included.

and the Surveillance/Utilization Review (S/URS) subsystems were not producing data and Explanations of Benefits (EOBs) had not been produced and mailed to recipients. The AHCCCS system was therefore not certifiable as of March 15, 1984. The result is a loss of federal financial participation (FFP) at the higher rates for operating a certified MMIS. The estimated FFP loss to the State is between $500,000 and $2 million--there is insufficient data to determine the exact loss at this time.

(2) Discussion

Our focus was to determine: 1) whether or not MSGI performed in a manner which supported MMIS certification and 2) as of what date or dates the MMIS could be judged as certifiable. It is necessary to state that only HCFA can perform an official certification review in a particular Medicaid jurisdiction.

The issue regarding certification of the AHCCCS MMIS is important because of the level of FFP available to the State for MMIS design, development, installation and operation. FFP is available at 90 percent for design, development, installation or improvement of a mechanized claims processing and information retrieval system, if the system is approved by HCFA. FFP is available at 75 percent of expenditures for operation of an approved system. FFP for other approved administration is only at 50 percent with certain other incentive and penalty provisions.

The normal process of MMIS certification approval is for the State agency to interface with HCFA. As such the State agency prepares and forwards the following two documents to the HCFA Regional Office for prior approval:

a. Advanced Planning Document (APD)

b. Detailed Implementation Plan (DIP)

The normal process continues with the State (through its contractor) submitting documentation that substantiates the MMIS system and requesting a formal Certification Review. Each step is projected and spelled out by the APD.

Based on our review, we found that:

1. The technical proposal defined an operational date for the entire MMIS of October 1, 1982. The implementation workplan deferred the operational date for MARS and S/URS to December 31, 1982.

2. The State submitted an APD in December 1982 for HCFA review. This APD covered the period from the RFP for the AHCCCS Administrator through the expected normal completion of the MSGI contract (September 1985). There was a distinct and different process requested in this APD; this different process was for a two phase certification. Specifically, Phase I was that the Recipient, Provider, Reference and Claims processing subsystems would be operational (and could be certified) as of October 1, 1982; Phase II was for certain modifications to the baseline MMIS system and for completion of the MARS and S/URS subsystems by March 31, 1983.

3. Much of the MMIS system, excluding MARS and S/URS, was operational by October 1, 1982 and most was operational by December 31, 1982. MARS and S/URS were not operational until 1984. S/URS development was delayed at the State's request during February - April 1983. The decision to subcontract with Chasen further delayed implementation. The APD dated February 29, 1984 and submitted to HCFA on April 2, 1984 requested Phase I certification as of December 31, 1982 and Phase II certification as of June 30, 1984.

4. At the time of our review an approved APD was not in effect. Conversations with HCFA have indicated that the February 1984 APD was revised to request certification for the entire system as of June 30, 1984 and approved as such by HCFA in October 1984.

October 1, 1982 was the date under federal regulation by which each qualified State was to have a certified MMIS or face penalties. There is no documentation to confirm HCFA's approval of a two phase process, and the December 1982 APD was never acted upon by HCFA (it was not formally approved, returned or rejected).

The MARS and S/URS subsystems were not capable of being certified while MSGI was the contractor. Output reports from these subsystems did not include all necessary data until June 1984. The availability of encounter data continued to be a major topic of correspondence between HCFA and the State, particularly after the sampling approach proposed by State AHCCCS had been rejected by HCFA.

Retroactive certification of an MMIS for 75 percent FFP may occur for an approved system under the following conditions:

a. All of the required data and report items are present for the complete period for which 75 percent FFP is being claimed, and

b. The Explanations of Benefits (EOBs) have been issued to a sample of individuals who have received services on a regular basis (within 45 days of payment) during the complete period being claimed.

At no time did MSGI issue an EOB. EOBs are used in detecting fraud and abuse by being sent to a sample of members to match claimed service to the service actually provided. MSGI's original design included EOBs as part of the S/URS subsystem. When efforts to implement the MSGI proposed S/URS were abandoned and a subcontract was begun to install S/URS II, efforts com-

menced to develop a separate EOB process. The programs to produce EOBs were completed in January 1984 by the same subcontractor that implemented S/URS II.

Although a phased certification was again proposed in the revised APD dated February 29, 1984, it appears that the State's opportunity to take advantage of a phased certification process no longer existed after December 1983. However, it does not appear that HCFA ever communicated this fact to the State or MSGI or even notified them of this possibility.

4. Assessment of the Amount of New Work Performed

This area of our work attempted to quantify the amount of new work performed by MSGI over and above the work which was originally proposed and covered by the original baseline amounts in the contract. In doing this we utilized the set of documents referred to as proposed Modification #3. This package was an attempt by both MSGI and State AHCCCS to define and quantify the work being performed by MSGI above the contractually approved levels. This modification was never finalized.

Because MSGI did not keep time and expense records on a task basis, it was not possible for us to reconstruct or verify the costs incurred on the Modification #3 tasks. Instead, we used the following approach:

- We started with the document MSGI prepared to justify and quantify its costs for the 26 activities in Modification #3.
- We reviewed internal memoranda prepared by State AHCCCS personnel regarding various elements of this proposed modification.

- We considered the fact that the State AHCCCS Project Director has said he was willing to accept approximately $2 million of the tasks as being "new work." We also noted that in the spring of 1983 the acting head of the DHS had orally approved continuation of many of the tasks listed, which were described then as "new work."

- We reviewed the tasks claimed to be "new work" and compared it to the list of tasks we compiled from the original proposal. When sufficient information was available we made judgments, based upon our fact-finding in the performance audit, regarding what tasks and parts of tasks appeared to reasonably be "new work."

(1) Findings

Our analysis of the contract documents in comparison to the amounts proposed in Modification #3 indicate the following:

- Approximately $1.5 million of new work was performed during Operational Year One which was not officially authorized but which MSGI was either directed to do or initiated action itself in the responsible performance of its duties as AHCCCS Administrator.

- We were unable to resolve whether approximately $1.1 million of work was or was not new due to the vagueness of the original contract documents, insufficient justifications available and the difficulty in knowing the extent that certain staff actually worked on new versus old work. It would appear reasonable that this is a mixture of new and originally proposed work.

- We believe that approximately $600,000 of the Modification #3 work was completely within the scope of work originally proposed by MSGI.

(2) Discussion

For five months in mid-1983 MSGI worked on the proposed Modification #3. On October 21, 1983 MSGI delivered it to State AHCCCS for review. Internal State AHCCCS memoranda indicate that

extensive review of the package took place over the next three months. By February 1984 the State AHCCCS project director forwarded to the DHS Director a contract modification that DHS was willing to sign, which amounted to over $2.4 million.

Exhibit IV-7 summarizes the provisions contained in both the October 1983 and February 1984 versions of Modification #3 as well as noting internal State AHCCCS staff comments. Because MSGI did not keep time records by task, MSGI made estimates by asking people to recall how they spent their time. Some of these estimates appear to be unreasonable. For example they define additional work of .62 man years for the project director at a cost of $45,980, even though one was already in the contract on a full-time basis. As another example, the modification also attempts to justify the addition of five directors at an hourly cost of $32.00 when the proposal had assumed supervisors at an hourly cost of $20.50 would be sufficient. Further, the October 1983 version of Modification #3 includes costs for computer time for Operational Year One of $808,200 (2,694 hours at $300) whereas the <u>total</u> actual cost for <u>all</u> computer time for that period was $884,293. MSGI was in effect saying that new work accounted for 91% of all the computer costs incurred. As a further comparison, the original cost proposal had Year One computer time costs of $327,000 (or $344,000 including terminals), and contract Modifications #1 and #2 had increased this amount to $504,000.

Our analysis of each of the provisions of Modification #3 is discussed separately in Appendix E. Exhibit IV-8 summarizes that discussion.

EXHIBIT IV-7

CONTRACT MODIFICATION 3

	10/21/83 VERSION	AHCCCS COMMENT	2/10/84 VERSION
OPERATIONS			
A. Split capitation rosters	$ 62,164	Deny	$ 0
B. CCS	33,208	Approve	33,208
C. Foster children	29,360	Partial	29,360
D. Long-term care	109,045	Approve	109,045
E. Special procedure codes	69,000	Partial	0
F. Reinsurance	25,529	Approve	25,529
G. Newborn	90,674	Approve	90,674
H. Sam Thurmond reports	148,758	Partial	0
I. Retro-emergency	129,347	Approve	129,347
J. SSI	70,808	Deny	0
K. Rollovers	105,257	Approve	105,257
L. Assignments	141,075	Deny	0
M. Member fixes	95,310	Deny	0
N. Duplicate members	72,246	Partial	72,246
O. Payment rules	114,476	Deny	0
P. APIS	464,072	Deny	464,072
Q. Pricing schedule	102,823	Deny	102,823
R. IHS	147,366	Approve	147,366
ADDITIONAL PROCUREMENTS	331,281	No Comment	331,281
LEGAL SUPPORT	162,493	No Comment	59,010
CLAIMS SCHEDULE	345,719	No Comment	345,719
PHASE-IN OF COUNTIES	238,071	No Comment	238,071
SECURITY SYSTEMS	17,408	No Comment	0
SYSTEMS IMPLEMENTATION TRAVEL	25,373	No Comment	25,373
ANNUAL MEDICAL AUDIT	110,468	No Comment	110,468
ACTUARIAL SERVICES	35,062	No Comment	26,749
	$3,276,393		$2,445,598

EXHIBIT IV-8

ANALYSIS OF CONTRACT MODIFICATION 3

	NEW WORK	UNRESOLVED	ORIGINAL WORK
OPERATIONS			
A. Split capitation rosters	$ 0	$ 0	$ 62,164
B. CCS	24,342	5,158	3,708
C. Foster children	15,720	13,640	0
D. Long term care	105,337	0	3,708
E. Special procedure codes	32,312	36,688	0
F. Reinsurance	8,091	13,730	3,708
G. Newborn	67,950	19,016	3,708
H. Sam Thurmond	17,956	0	130,802
I. Retro-emergency	107,365	19,016	2,966
J. SSI	0	0	70,808
K. Rollovers	103,774	0	1,483
L. Assignments	34,602	106,473	0
M. Member fixes	0	0	95,310
N. Duplicate members	69,280	0	2,966
O. Payment rules	0	0	114,476
P. APIS	272,982	191,090	0
Q. Pricing schedule	0	0	102,823
R. IHS	139,950	0	7,416
ADDITIONAL PROCUREMENTS	309,032	0	22,249
LEGAL SUPPORT	61,358	101,135	0
CLAIMS SCHEDULE	0	345,719	0
PHASE-IN OF COUNTIES	0	234,363	3,708
SECURITY SYSTEMS	17,408	0	0
SYSTEM IMPLEMENTATION TRAVEL	0	25,373	0
ANNUAL MEDICAL AUDIT	110,468	0	0
ACTUARIAL SERVICES	26,749	0	0
	$1,524,676	$1,111,401	$632,003

5. Use of Subcontractors

This issue investigated the use of the five largest subcontractors employed by MSGI for AHCCCS responsibilities.

(1) Findings

MSGI used subcontractors to a much greater extent than proposed for both new work and in place of MSGI personnel. The proposal stated that subcontracting would represent only 3% of the hours and 5.5% of the cost, or less than $500,000 over the life of the contract. Instead subcontractors were actually retained at a cost of over $2 million. Substantial portions of the subcontractor work appear to be within the work MSGI was originally contracted to do.

(2) Discussion

The five major subcontractors and their billings to MSGI were:

Ernst & Whinney	$888,950
Milliman & Robertson	251,342
AAAHC	113,596
Melody Chasen & Associates	454,066
Ladendorff & Ridge and Ridge & Isaacson	397,371

Only the first two subcontractors were included in MSGI's proposal. Furthermore beyond the original proposal, all services were acquired on a non-competitive basis. Although MSGI was exempt from State competitive procurement regulations, its proposal had promised to seek competitive bids for subcontracts.

Exhibit IV-9 summarizes key points for the five major subcontractors: whether specific work was included in the proposal and who was proposed to perform the work, whether subcontracts were approved by State AHCCCS as required by the contract and at what level, and what actual costs were. Generally when subcontracts were well-defined with contract ceilings specified, the costs were contained. When broad scopes of work were used with no subcontract ceiling, costs grew significantly. Subcontractor expenses were not well managed by MSGI or properly monitored by DHS.

Highlights of our findings are:

- Ernst & Whinney's proposed role was in the provider contract management area. In addition however, they performed a number of functions which MSGI had proposed that it would do. No effort appears to have been made to determine whether alternative subcontractors could have performed the considerable additional work Ernst & Whinney was given beyond their originally proposed role. The rates they charged also appear to be higher than normally obtained through competitive bidding on government contracts and higher than MSGI rates for the same work.

- Milliman & Robertson's proposed role was to provide actuarial and statistical services during Implementation. Milliman & Robertson often performed additional actuarial work in response to direct requests from the State AHCCCS staff.

- The Accreditation Association for Ambulatory Health Care, Inc. (AAAHC) signed a contract with MSGI in 1983 to provide annual medical audits of the plans. Ernst & Whinney recommended engaging AAAHC, rather than hiring and training MSGI staff, as proposed. State AHCCCS approved this even though it was recognized that the cost would be higher.

- MSGI did not have sufficient staff to complete the MARS and S/URS reporting subsystems as proposed. Melody Chasen & Associates performed this work. All individuals familiar with the Chasen subcontract have spoken

EXHIBIT IV-9

SUMMARY OF MAJOR SUBCONTRACTORS

SUBCONTRACTOR	IN PROPOSAL*	CONTRACT APPROVAL	CONTRACT VALUE	ACTUAL COST
ERNST & WHINNEY				
Original Contract	Yes	Yes	$435,000	$435,000
Amendments	No	Yes	75,000	98,415
Second Contract	No/ MSGI	No	--	355,535
MILLIMAN & ROBERTSON				
Original Contract	Yes	Yes	155,000	156,285
Follow-on Work	No	Part	26,000	95,057
AAAHC				
Original Contract	MSGI	Yes	99,000	113,596
MELODY J. CHASEN & ASSOCIATES				
Original Contract	MSGI	Yes	180,400**	184,709
EOB Amendment	MSGI	Yes	22,000**	22,000
MARS Amendment	MSGI	No	--	247,357
LADENDORFF & RIDGE and RIDGE & ISAACSON				
Implementation Work	MSGI	Yes	--	39,462
Year-One Non-Litigation	No	Yes	82,560**	149,755
Year-One Litigation	No	No	--	59,369
Year Two Non-Litigation	No	No	--	87,533
Year Two Litigation	No	No	--	29,698
Corporate Work	No	No	--	31,554***

*MSGI indicates work was proposed to be done by MSGI personnel.
**Plus Expenses
***$26,592 of this was later reversed.

very highly of their work. The rates charged ($65 per hour for system analysis and $55 per hour for programming versus corresponding MSGI charges of $25 and $15 per hour) were substantially higher than those proposed by MSGI. The assertion that using Chasen & Associates was as cost effective as what was proposed is difficult to assess since MSGI's proposal did not break down costs in such a manner as to allow comparison.

- Some of the subcontracted legal work involved areas such as policy issues, grievance procedures, EEOC, legislation issues, provider subcontracts, lobbying and responding to legislators, much of which was originally proposed to be done by MSGI, as well as litigation services originally proposed to be done by the State. The amount billed in Year One significantly exceeded that approved by State AHCCCS.

RESPONSES TO QUESTIONS RAISED BY THE AUDITOR GENERAL

Question 1: Were the billings submitted by MSGI appropriate in terms of the contract and were the costs actually incurred?

Section III of our report provides the results of the audit testing we conducted of the billings submitted by MSGI to the State. Eleven categories of costs were examined:

- Personnel and related costs
- Computer costs
- Facility costs
- Forms and supplies
- Purchased services
- Travel and other expenses
- General and administrative and direct corporate charges
- Award fees
- Incentive fees
- MSGI overhead
- Excess contractor costs

We have identified questioned and unresolved costs for each of these categories. Of the $17.1 million billed by MSGI, we determined the followed:

- $2.2 million were questioned. Of this, $1.9 million relate to incentive and award fees for performance according to criteria which were never agreed upon and therefore not earned in our judgment.

- The majority of the remainder of the questioned costs relate to general and administrative charges in excess of the agreed upon 3.35% rate.

- $1.8 million were unresolved. Purchased services account for $1.2 million in unresolved costs. These are associated with either subcontractor agreements with MSGI which were not approved by DHS or where no formal subcontract was developed.

- $400,000 in computer timesharing costs are unresolved due to their not being supported by MSGI's system accounting package.

Question 2: Is MSGI in compliance with the contract, applicable statutes, and rules and regulations with regard to all functions and responsibilities?

In Appendix C we present a detailed categorization of MSGI's achievement of its contractual commitments. Section IV.B of this report describes highlights of this information.

In general MSGI completed most of its major responsibilities required under the Administrator's contract, although some important responsibilities were not performed. In many areas the degree and timeliness of completion of certain tasks was not in line with the performance proposed by MSGI. In several instances these shortcomings had a significant negative impact on the proper administration of the program and caused difficulties to be experienced by AHCCCS members, pre-paid plans and providers.

Question 3: Was the systems development effort efficient and effective and were systems developed in a timely manner?

We reviewed MSGI's systems development work in Section IV.B of this report. We found that significantly more systems personnel were used than proposed due to both new work requirements and very optimistically low proposal staffing estimates. Further, MSGI did not have effective management, planning or control systems in place, resulting in inefficiencies in the systems development effort.

The failure by MSGI to achieve a HCFA-certified Medicaid Management Information System during its tenure as Administrator may cause the State to lose between $500,000 and $2 million in Federal grant support. This would be caused by the failure to have several required subsystems operational.

Question 4: Were computer expenses and costs charged for equipment and services reasonable and appropriate?

We found the charges made by MSGI for use of computer equipment to be reasonable, although the usage and therefore the resulting amounts billed were much higher than was proposed by MSGI. The cost of computer services used by MSGI were reasonable and appropriate. Section IV.B presents our findings with respect to this area.

Question 5: Were incentive payments properly earned and received in compliance with contract provisions?

Our findings with respect to incentive payments are detailed in Section III. There were $260,000 in payments actually made, and we agree that these were properly earned. An additional $75,000 in incentives for the open enrollment work may have been earned, but we could not find sufficient documentation on achievement of the targets to support this and the State never paid MSGI for them. Since no agreements were ever made with respect to other incentives, they could not be considered earned in our judgment.

Question 6: Was staffing reasonable and appropriate in number and qualifications, for purposes of efficiently and effectively administering the AHCCCS program?

As noted in Question 3 above, the systems development staff levels proposed were too low to adequately achieve the work required. Staffing proposed in other areas was usually at the minimum needed to achieve those tasks specifically stated in the contract documents. It did not allow for further definition of the work to be performed or for contingencies to develop which were anticipated by all parties. As a result, MSGI's staff levels rose considerably over the level proposed.

Generally the Arizona-based systems development staff was less experienced than that proposed. This had a negative impact on systems design effort during the Implementation Period and early in the program's operational phase, where experienced personnel are required for efficient effort. More experienced staff in MSGI's New York offices were added in 1983.

Question 7: Were payments to consultants and other subcontractors reasonable and appropriate? Were consultants and subcontractors qualified?

The payments to subcontractors are analyzed in Sections III and IV. We found that:

- MSGI did not obtain State approval for nearly every subcontract; in some cases no written contract document could be found. These unresolved costs total $1,163,396.
- Questioned costs of $79,460 result from items such as: charges in excess of contract ceilings, charges in excess of committed rates and unallowable legal expenses.

We examined the five largest subcontractors and found their qualifications to be appropriate. MSGI was remiss in not competitively bidding these as they had proposed, however. Also, MSGI frequently failed to obtain the State's approval of the use of these subcontractors, and several were used to perform functions which MSGI had proposed to do.

Question 8: Has MSGI efficiently and effectively performed the eligibility systems, enrollment, claims processing, member relations, provider management and quality assurance functions? Were costs of providing these services reasonable?

Section IV.B of our report describes our review of MSGI's work in these areas. MSGI was not responsible for determining member eligibility. This function was performed by a combination of the counties, DES and SSA. Numerous problems arose at the county level, many of which were related to the newness of the AHCCCS program and the very short time available before program startup. Also, DES computer files were not compatible with MSGI's and with what MSGI and State AHCCCS had expected.

As a result of these and other problems the eligibility determination process was seriously hindered. This in turn undermined MSGI's ability to properly enroll members and assign them to plans. These problems were fundamental to the difficulties AHCCCS experienced.

In several of the other functions for which MSGI was responsible duties were only partly performed and sometimes subcontractors were used to do work MSGI had originally proposed to do. No performance indicators were ever developed which could be used to evaluate MSGI's efficiency. We were unable to determine the reasonableness of costs associated with these functions as MSGI did not capture costs on that basis.

Question 9: Has MSGI established systems and procedures necessary for adequate program evaluation?

MSGI accomplished very little in regard to program evaluation. MSGI was still completing work on program reporting subsystems when its role as Administrator ended. Other tasks, such as evaluation and financial audits of plans, were given low priority by MSGI and not performed.

Question 10: Were provisions of the contract adequate for effective management and control of the Administrator?

Section IV.A of the report describes key elements of the contract documents and assesses their adequacy. The contract with MSGI was seriously deficient in several respects:

- It utilized a cost reimbursement approach for all work performed instead of a mixture of fixed price or level of effort ranges for certain tasks.
- It failed to define many deliverables, tasks, deadlines, performance goals and associated levels of effort. This made monitoring and control activities very difficult.
- It placed great importance on workplans and incentive criteria but deferred development of these. No agreements were ever reached.

Question 11: Were contract modifications properly documented, evaluated and approved?

Contract modifications are described in Section IV.A. The State AHCCCS leadership changed several times while MSGI was Administrator. Each project director had his own approach to handling modifications. In no case were they handled in a timely fashion, and there were several instances of written directives given to MSGI which significantly changed their work or added new tasks. Several months passed before these changes were attempted to be defined as official modifications.

Question 12: Were DHS internal administrative and accounting controls adequate to ensure the propriety of payment to MSGI, and were payments, including incentive payments, proper?

Section IV.A of our report discusses the administrative controls utilized by DHS. In general they were not sufficient to identify unfavorable trends and take corrective action. For example monthly spending plans were not prepared by DHS or required of MSGI, and DHS placed too much reliance on MSGI's overall contract spending limitation without considering the unspecific nature of the contract documents.

The incentive payments have been discussed under Question 5.

Question 13: Was DHS in compliance with all applicable statutes and rules regarding its contract oversight responsibilities?

Our investigation of this question revealed few clear instances of specific statutory or regulatory requirements made of DHS regarding AHCCCS contract oversight. Our work did not pursue this issue in detail.

Question 14: Has DHS effectively monitored and controlled the Administrator contract?

As can be seen in the responses to Questions 11 and 12, DHS did not effectively monitor and control the Administrator's contract. In addition to the problems mentioned earlier, DHS staff were not experienced in certain critical areas such as EDP systems development. Also, the differentiation between the MSGI and DHS roles with respect to areas such as dealing with the public and preparing AHCCCS rules was never well defined, thus hindering the ability to monitor activity against predetermined expectations.

Question 15: Has DHS effectively fulfilled its overall program management, policy setting and federal reporting role as it impacts the administration of the program?

There were significant delays in determining AHCCCS policy in several important areas that affected the administration of the program, e.g. determining the status of newborns of AHCCCS eligible women. Our interviews with HCFA personnel indicated that there were numerous reporting requirements which were not fulfilled. Some of this was caused by the failure of MSGI to develop required program reporting subsystems and some because DHS did not take action to fulfill its reporting responsibilities.

The draft Advanced Planning Document submitted to HCFA listed several DHS oversight responsibilities. Few of these were fulfilled, especially those related to system development.

Question 16: Has DHS established systems and procedures necessary for adequate program evaluation?

The answer to this Question is similar to that for Question 9. Several aspects of program evaluation were either not initiated or given low priority by MSGI, and DHS did not take significant action independent of this. However HCFA is conducting a separate evaluation of AHCCS.

SUMMARY OF SELECTED RFP AND CONTRACT PROVISIONS--ARIZONA VS. OTHER STATES

Provision	State	Description
1. Performance bonds	Kansas	$1 M bond vs. loss of FFP and non-performance.
	Texas	$5 M bond Loss of FFP guaranteed by contractor.
	North Carolina	$5 M bond for material breaches left uncured. Contractor liable for loss of FFP.
	New York	$5 M bond.
	California	Contractor liable for lost FFP.
	Massachusetts	$3 M for development stage, $8 M for operations. Contractor liable for loss of FFP.
	Arizona	$1 M to secure performance of the contractor.
2. Liquidated damages	Kansas	Contractor pays for lost staff time of State personnel. Contractor liable for payment errors.
	Texas	Several formulae developed, e.g., provider payment delays, accuracy of payments.
	North Carolina	$100/day for delinquent reports, several other items subject to liquidated damages.
	New York	10 percent reduction on a given invoice for more than 30 days tardiness on a given deliverable.
	California	Numerous types of liquidated damages, up to $10 K/day, depending on element involved.
	Massachusetts	25 percent of each invoice reserved until Federal certification of MMIS.
	Arizona	None stated.
3. Key personnel clauses	Kansas	2 week notice required before change made. No state approval required.
	Texas	15 day notice required. No written approval required.
	N. Carolina	Unfilled key personnel subject to $100/day in liq. damages. 15 day notice required and written approval.
	New York	Written state approval required. State has right to request removal of contractor personnel.
	California	State reserves right to approve all key personnel.
	Massachusetts	State has right to interview and reject any substitute named to those proposed. Nine key personnel specified.
	Arizona	Prior written notice required if any of six specified personnel are changed.
4. Role of Fiscal Intermediary and State	Kansas	State agency described, responsibilities of each unit described. State duties include issuing all policy determinations, establishing eligibility, issuing ID cards.
	Texas	Six page description of respective duties of State and contractor.
	North Carolina	Detailed listing of State and contractor responsibilities included. MMIS liaison position established, project officer is State agency Deputy Director.
	New York	Extensive list of contractor duties listed.
	California	A contracting officer is designated to be the main contractor interface point.
	Massachusetts	A contract officer and four support staff are to handle all contractor directives. State makes all policy determinations. State must respond in 10 days to policy requests, acceptance of deliverables. Rejection of deliverables must be explained in writing.
	Arizona	Contractor's role is covered in several pages. Almost no discussion of State role.

SUMMARY OF SELECTED RFP AND CONTRACT PROVISIONS--ARIZONA VS. OTHER STATES

Provision	State	Description
5. Level of effort definition	Kansas	Full-time professional relations staff. Number of training sessions specified.
	Texas	Telephone operator and provider relations staff levels established.
	North Carolina	One full-time systems person required by contractor for special requests.
	New York	Systems development staff level of effort stated. Number of training sessions, full-time regional office staff, percent of telephone inquiries, etc. also stated.
	California	Special Projects Systems development staff level assumed at 30, with specific skill/pay levels. Can be lowered by State with 30 day notice.
	Massachusetts	Project plan for each task required, including number of hours by skill level and task. Assumed volume of claims made for first year.
	Arizona	No assumed levels of effort for any elements. Contractor required to state percent of key personnel involvement.
6. Performed measures defined	Kansas	Based on prior contractor's experience in processing claims.
	Texas	MMIS terminal response time, special reports response, other measures set.
	North Carolina	Turn-around time for claims processing and maximum response time for written inquiries stated.
	New York	Extensive list of performance standards included (13 pgs.).
	California	Expressed in terms of elaborate liquidated damages provisions.
	Massachusetts	Excessively slow payment of claims results in five percent reduction in payments.
	Arizona	None stated. To be negotiated prior to start of each year of the contractor part of incentive fees and award fee payment
7. MMIS components defined	Kansas	Detailed description of each subsystem's operational features is provided.
	Texas	Contract has a 48 page description of MMIS capabilities required.
	North Carolina	Several pages of system and software documentation requirements are included in contract.
	New York	Embodied in performance standards.
	California	Extensive description of each subsystem component required.
	Massachusetts	Very detailed description of each aspect included (input forms, lists of edits, etc.)
	Arizona	RFP has five pages of general MMIS capabilities. Contractors invited to submit recommended encounter data elements and system output reports, and intended use of such data.
8. Deliverables, deadlines, milestones	Kansas	System enhancements each have a specific time deadline (13 listed).
	Texas	All payments withheld in a month where a milestone is not met.
	North Carolina	Deadline established for completion of each subsystem.
	New York	Ten percent deducted from an invoice payment if a milestone is more than 30 days overdue. Formal list of meetings and content is specified.
	California	Provides for monthly and quarterly deliverables, specification of deliverable content.
	Massachusetts	Scheduled start and completion date for each task is required. General criteria for acceptance of deliverables is defined.
	Arizona	No deadlines or milestones for program in RFP or Contract. Proposal milestones incorporated into contract, but they assumed a June start date for project. Work plans were to be approved which contained these.

SUMMARY OF SELECTED RFP AND CONTRACT PROVISIONS--ARIZONA VS. OTHER STATES

Provision	State	Description
9. Amendments to Contract	Kansas	Six made in three years.
	Texas	Five amendments within one and one half years.
	North Carolina	Several executed through HCFA. Also, small changes done via "administrative change order" without HCFA
	New York	N/A
	California	Fifty-four made over 5 years. Special projects group existence now avoids these.
	Massachusetts	N/A
	Arizona	Two made in one and one half years, third attempted.
10. Incentives	Kansas	None.
	Texas	None.
	North Carolina	None.
	New York	None.
	California	75 percent Contractor-25 percent State sharing of any cost reductions other than on cost reimbursement items.
	Massachusetts	3 percent incentive of total contract price paid for making the first deadline in the operational phase.
	Arizona	Incentives could be paid for up to 14 percent of the total contract amount.

AHCCCS

CONTRACT COMPLIANCE MATRIX

Contract Requirement	Source: RFP	Source: Technical Proposal	Source: Cost Proposal	Source: Contract	Contract Compliance: Performed	Contract Compliance: Not Performed	Comments
GENERAL PROVISIONS							
1. Scope of work as defined by contract may be amended by AHCCCS Project Director and adjustment to baseline costs may be mutually agreed. No change in services shall be made without prior written approval.	p. 57 p. 68			Sec.4(h) Gen. Prov. 15	X	 X	Mods 1 and 2 attest to this. Some approval was verbal; the increased scope was seldom identified as such by MSGI in advance.
2. Detailed workplans for each phase shall define tasks and performance standards and shall be negotiated and agreed upon with budgets by the following dates: Implementation 7/28/82 Year 1 9/15/82 Year 2 9/15/83 Year 3 9/15/84				Sec. 5	Partial		Implementation workplan on time. Operational workplans were submitted late with no performance standards and were not agreed upon.
Completion of tasks and achievement of incentives shall be documented by MSGI.					Partial		Incentive achievement was documented. The lack of workplans prevented formal documentation of task completion.
3. Subcontracting:							
- Requires advance written approval	p. 63			Gen. Prov. 4	X		Was obtained for AAAHC, Chasen and Isaacson. Was obtained for original E&W and M&R contracts.
- Copy of subcontract shall be submitted within 30 days	p. 63					X	Subcontracts forwarded to the State were done so only intermittently.
- Will be on a competitive basis			p.I.H-2		Partial		Large ones were not; multiple quotes were obtained for the smaller ones.
All purchases will be initiated via approved purchase requisition			p.I.H-2		X		
4. Key personnel require advance notice of diversion and DHS approval.	p. 55					X	
5. Bonds required:							
- $1,000,000 performance bond within 30 days of award, renewable annually	p. 55	Cover letter			X		
- fidelity bond covering employees and officers		Cover letter			X		
- $50,000 proposal bond		p. II-1			X		

AHCCCS

CONTRACT COMPLIANCE MATRIX

Contract Requirement	Source: RFP	Source: Technical Proposal	Source: Cost Proposal	Source: Contract	Contract Compliance: Performed	Contract Compliance: Not Performed	Comments
GENERAL PROVISIONS (Continued)							
6. Facilities in Phoenix with	p. 56				X		
- On site visits by DHS and HCFA	p. 57				X		
- Audits by DHS	p. 58				X		
7. Reporting shall be at regular intervals specified by AHCCCS Project Director				Sec. 6			
- Monthly progress reports		p. VII.B.1-5				X	Occasional reports only.
- Weekly progress meeting minutes		p. VII.C-2, VIII.A-2				X	Occasional biweekly meeting minutes. Meetings not held continuously.
- Monthly status meeting minutes		p. VII.C-2, VIII.A-3				X	No scheduled meetings held continuously.
- Quarterly executive meeting reports		p. VII.C-2, VIII.A-3				X	No evidence has been found.
8. Management and Control							
- Implementation of MSCS		p. VII.B.1-3, VIII.A-3				X	Implementation workplan deleted this requirement.
- Use manual project control reports for short-term		p. VIII.A-2				X	At best these were done on an informal verbal basis.
- Produce a memorandum of understanding after contract signing		p. VII.B.1-2				X	No evidence has been found.
- Review/revise organization as required		p. VII.B.1-2			X		
- Review/update staffing plans		p. VII.V.1-7				X	No written staffing plans found.
- Establish formal communication procedures and guidelines for documentation, signoffs and change requests		p. VII.B.4-2			Partial		Transmittal process established. No evidence of remainder.
- Deliver an operational procedures memorandum		p. VII.B.4-2				X	No evidence has been found.
- Establish/coordinate advisory group and deliver charter to DHS		p. VII.C-2, VII.B.1-8				X	
- Implement formal transmittal process		p. VIII.A-2			X		
- Update project schedule monthly		p. VII.A-3				X	No formal project schedule agreed to or maintained.
- Weekly staff report by each person		p. VIII.B.1-1			X		Occasionally done in some areas.
- Regularly reconcile transmittal logs		p. VIII.B.1-1			X		Done occasionally.
- On a monthly basis task leaders will indicate actual hours/task		p. VIII.B.3-1				X	Have found no evidence to support any records maintained on a task basis.
- Continual monitoring of operational and developmental milestones		p. VIII.B.1-16				X	Not in any formal way.
9. Deliver document showing resolution and definition of contractual areas not addressed in RFP.		p. VII.B.1-4				X	

AHCCCS

CONTRACT COMPLIANCE MATRIX

Contract Requirement	Source: RFP	Source: Technical Proposal	Source: Cost Proposal	Source: Contract	Contract Compliance: Performed	Contract Compliance: Not Performed	Comments
CLAIMS/SYSTEMS							
1. MMIS Certification							
o Customize base MMIS for AHCCCS		p. III-6			X		Some areas were not implemented as proposed (e.g., S/URS).
o Satisfy HCFA as to conceptual equivalency		p. III-6			X		APD addresses this.
o Deliver systems qualifiable for federal reimbursement	p. 13	p. III-7				X	Not done by 3/15/84.
o Assist DHS in developing APD and in defining certification review and conceptual equivalency		p. VII.B.1-2			X		
2. System Implementation							
o Participate in definition of AHCCCS program		p. V.B.2-9			X		
o Install base system in Long Beach	p. 10	p. VII.B.4-2				X	Base system installed in N.Y.
o Develop functional requirements/ functional flows		p. VII.B.4-3, V.B.2-9			X		Not formally documented however.
o Finalize forms design		p. VII.B.4-3			X		
o Obtain appropriate sign-offs		p. VII.B.4-3			Partial		System designs were not signed off. Provider RFPs and contracts were.
o Deliver general design document that		p. VII.B4-4			X		GSD delivered 8/82 however did not
- identifies base system programs						X	identify base programs or changes to base
- identifies modifications by subsystem and program						X	programs.
o Develop detail design document		p. VII.B.4-5			X		DSD delivered 3/83.
o Code and test system		p. VII.B.4-6			X		
- modify N.Y. system		p. V.B.2-9					
- develop new software as required		p. V.B.2-9					
o Organize test team		p. VII.B.4-6				X	
o Prepare test plan						X	Should have been part of APD.
o Perform and document integrated testing		p. VII.B.4-29				X	No documentation found.
o Consult with DHS re: new data elements and the elimination of unused data elements		p. VII.D.2-7			?		
o Establish and initiate procedures to operate software		p. V.B.2-9			X		Done 2 months after implementation.
o Define procedures to receive accurate eligibility data	p. 18				X		

CONTRACT COMPLIANCE MATRIX

Contract Requirement	Source: RFP	Source: Technical Proposal	Source: Cost Proposal	Source: Contract	Contract Compliance: Performed	Contract Compliance: Not Performed	Comments
CLAIMS/SYSTEMS (Continued)							
3. System Capabilities							
o On-line access to all major files		p. VI.A.1-4			X		Inquiry only to some files.
o Accept both FFS and encounter data on paper and on tape/diskette	p. 16	p. VI.A.1-3 p. VI.A.4-2, VI.A.5-24			X		No requirement for diskette.
o Produce encounter data status report		p. VI.A.1-3, VI.A.4-2			X		
o Accept Arizona FFS claim formats		p. VI.A.4-2				X	MSGI dictated format.
o Produce federal, county and state expenditure reports		p. VI.A.4-2				X	Programs ready but need budget data from State.
o Member enrollment by family		p. VI.A.4-3			X		Case number identifies family.
o Identify primary care physicians		p. VI.A.4-3			X		
o Monthly capitation payments and roster on remittance statement	p. 16	p. VI.A.4-3			X		Produced as of 10/82.
o Produce demographic reports	p. 9	p. VI.A.4-3			X		Part of eligibility tracking system.
o Receive member updates from various sources		p. VI.A.4-3			X		
o MARS and S/URS reports to aid start-up of new providers		p. VI.A.1-3				X	Not done by 3/15/84.
o Produce ID cards	p. 23	p. VI.A.1-4			X		
o MARS and S/URS will meet federally mandated requirements	p. 11	p. VI.A.1-4				X	Not done by 3/15/84.
o Premium billing and collection		p. VI.A.4-4				X	Work was initiated but requirement was later dropped.
o Produce checks, remittance statements, check registers, IRS 1099 data and reports		p. VI.A.5-4			X		
o Claims in suspense and adjudicated within last 4 months are on-line		p. VI.A.5-5			X		
o 12 date segments allowed for prices		p. VI.A.5-11			X		
o Medicare cross-over claims	p. 11	p. VI.A.5-13			X		
o Allow multiple certification periods/categories of service for providers		p. VI.A.6-2			X		
o Allow different rates for different member categories		p. VI.A.6-2			X		
o Maintain yearly/cumulative payment data		p. VI.A.6-3			?		
o Bendix/buy-in tape matches		p. VI.A.7-3			X		
o On-line member file		p. VI.A.7-3			X		MSGI staff had on-line inquiry access.
- To be reevaluated during year 1		p. VI.A.7-3				X	No reevaluation done.
o Periodic complete edits of reference files		p. VI.A.8-5				X	Weekly updates include edits. No complete file edit capability provided.
o Manual/automated member transaction input		p. VI.A.7-3			X		

AHCCCS

CONTRACT COMPLIANCE MATRIX

Contract Requirement	Source: RFP	Source: Technical Proposal	Source: Cost Proposal	Source: Contract	Contract Compliance: Performed	Contract Compliance: Not Performed	Comments
CLAIMS/SYSTEMS (Continued)							
o TPL edits on members		p. VI.A.10-1			X		
o Produce composite EOBs through S/URS		p. VI.A.12-3				X	Not done by 3/15/84.
o 9 proposed MARS encounter data reports		p. VI.A.13-4			Partial		Some done as of 4/83. Not used however.
o System to confirm eligibility and enroll members at point of service if necessary		p. VI.D.3-2				X	The new auto-assign (implemented after 3/15/84) does this.
o Receive complete and accurate county eligibility data		p. VII.A-5			X		Data was received, even though not not complete and not accurate.
o Tracking system to trace eligibility status of each client				Mod. 1	X		
o Support open enrollment				Mod. 2	X		
o Interface with various eligibility sources	p. 18	p. VIII-4			X		
o MARS will generate management information reports required by DHS		p. VI.A.13-1				X	Not done by 3/15/84.
o Collect data and produce reports required by federal government	p. 18					X	Encounter data not complete and no sanctions applied by State. HCFA reports not produced.
o System driven utilization review	p. 18					X	Implemented after 3/15/84.
o Sufficient audit trails	p. 58				X		
4. Claims/systems operations							
o Maintain on-site systems staff		p. III-6			X		Supported by NY staff through 10/83.
o Maintain tape/diskette provider log		p. VI.A.5-24			X		Only receive tapes.
o Compile daily claims receipt statistics		p. VI.A.5-24			X		Done manually.
o Use automated document counting equipment		p. VI.A.5-25			X		
o Maintain daily reject statistics by providers		p. VI.A.5-26			X		
o Compile summary weekly/monthly claim reports		p. VI.A.5-26			X		
o Prepare daily preprocessing report by 11:00 a.m.		p. VI.A.5-26				X	
o Make 2 original microfilm rolls/ 2 duplicates		p. VI.A.5-27			?		
o Compile data entry productivity statistics		p. VI.A.5-28			X		Done manually.
o Review/decide prior authorization requests		p. VI.A.5-33			X		
o TPL for FFS claims	p. 11	p. VI.A.10-1			X		
o Certain S/URS reports will be made available to capitated providers		p. VI-A-12-1				X	Not done by 3/15/84.

AHCCCS

CONTRACT COMPLIANCE MATRIX

Contract Requirement	Source: RFP	Source: Technical Proposal	Source: Cost Proposal	Source: Contract	Contract Compliance: Performed	Contract Compliance: Not Performed	Comments
CLAIMS/SYSTEMS (Continued)							
o S/URS can be used to estimate cost of encounter services had they been FFS		p. VI.A.12-2				X	Not done by 3/15/84.
o Some MARS reports will be given to capitated providers to support management		p. VI.A.13-1				X	Not done by 3/15/84.
o Reports will be supplemented by on-site visits to analyze reports and establish procedures and controls		p. VI.A.14-1				X	This contributed to lack of use.
o Develop data base to establish and evaluate rates	p. 19	Cover letter p. V.A-1			X		Performed by M&R.
o Perform on-going evaluation of AHCCCS	p. 19	Cover letter				X	Crisis management did not allow for this.
o Provide technical advice to system users and state/county interfaces		p. V.B.3-7			X		
o Prepare special reports as requested		p. V.B.3-7			X		For example Sam Thurmond reports.
o Operate RJE/communications facilities		p. V.B.3-7			X		
o Control production system updates		p. V.B.3-7			X		After some time had passed.
o Balance jobs in each processing cycle		p. V.B.3-7			X		Done manually by operations.
o Microfilm equipment available to trace claims processing		p. V.B.4-4			X		
o Monitor fee-for-service utilization		p. VI.A.1-3				X	Lack of MARS and S/URS reports did not allow for this.
o Monitor HMOs for utilization and profit		p. VI.A.1-3				X	
o Monitor demographic and utilization patterns		p. VI.A.1-3				X	
o Manage financial aspects of program		p. VI.A.1-3				X	Lack of reporting capability.
o Process accurately completed enrollment forms from state agencies		p. VI.A.7-1			X		Enrollment became MSGI's responsibility.
o Deliver		p. VII.C-3					
- Weekly reports/balance sheets					?		
- Biweekly reports/financial documents					?		
- MARS and S/URS reports						X	Not done by 3/15/84.
o Review emergency claims for medical necessity	p. 17				X		
o Medical professionals perform medical and utilization reviews	p. 17				Partial		Some were done by Medical Director.
o Verify primary care authorization	p. 17				X		
o Distribute claim forms for FFS and encounter data	p. 17				X		
o Maintain up-to-date system documentation	p. 25					X	Not maintained and only after 3/15/84 was consolidated set put together.

AHCCCS

CONTRACT COMPLIANCE MATRIX

Contract Requirement	Source: RFP	Source: Technical Proposal	Source: Cost Proposal	Source: Contract	Contract Compliance: Performed	Contract Compliance: Not Performed	Comments
IMPLEMENTATION: PROVIDER DEVELOPMENT							
1. Pre-Bid Provider Soliciation and Support	p. 18	III-3					
o Meet with providers and prepare memo summarizing results of meeting		V.B.2-8 VI.B.2-6 VII.B.3-4			X		No indication of memo - E&W task.
2. Obtain and Evaluate Provider Suggestions	p. 3						
o Written response to all written suggestions		VII.B.3-5 V.B.2-8				X	No indication - E&W task.
o Forward suggestions to DHS when modification to regulations indicated						X	No indication - E&W task.
3. Detail AHCCCS Structure to Providers		III-3					
o Report detailing specifics of each delivery option for providers		V.B.2-8 VI.B.3-1 VII.B.3-6				X	Appendix F of the second year RFP.
4. Finalize AHCCCS Structure Definition		V.B.2-8					
o Memo identifying areas of policy uncertainty and proposed resolution		VII.B.3-7				X	No indication - E&W task.
5. Assist Providers in Proposals	p. 7	III-3					
o Reports to providers as necessary	p. 19	VI.B-3 VII.B.3-8				X	Group meeting held; indication that individual providers contacted State as they could not reach MSGI during first year. Technical assistance log sheets prepared by E&W during second year.
6. Define Provider's Internal Requirement Structure	p. 19	V.B.2-8 VI.B.3-1					
o Program guidelines in each of six areas		VII.B.3-9			X		
7. Prepare RFP Materials and Performance Criteria	p. 7 p. 19	III-5 V.B.2-7, 8					
o Draft procurement procedures and performance criteria		VI.B.4-1 VII.B.3-10			X		
8. Review Legislative Intent and Policy		VI.B.4-1					
o Memorandum identifying issues in need of clarification		VII.B.3-11			X		No indication of memo.

AHCCCS

CONTRACT COMPLIANCE MATRIX

Contract Requirement	Source: RFP	Source: Technical Proposal	Source: Cost Proposal	Source: Contract	Contract Compliance: Performed	Contract Compliance: Not Performed	Comments
IMPLEMENTATION: PROVIDER DEVELOPMENT (Continued)							
9. Establish Providers Procurement Procedures o Draft procedures for bidding/ evaluating and selecting bids	p. 7 p. 18	III-5 V.B.2-7 VI.B.4-2 VIII.B.3-12			X		
10. Draft County Specific RFPs	p. 18	III-5 V.B.2-7 VI.B.4-1 VII.B.3-13			X		Not county - specfic as decision made to award more than one contract if bidders were qualified.
Finalize and Issue RFPs		V.B.2-7 VII.B.3-14			X		Issued 7/2/82; approximately 8 other RFPs issued for special populations.
Hold Briefings and Bidders' Conference		V.B.2-7 VII.B.3-15			X		4 workshops held 7/12 - 7/15/82. Bidders' Conference 7/16/82.
Evaluate Proposals from Bidders o Evaluate bids o Submit report to the State		V.B.2-7 VII.B.3-16			X		Report not formalized during first year. County specific bid evaluation reports prepared during second year.
Establish Market Prices o Report defining an acceptable range of possible market prices		V.B.2-7 VI.B.3-2 VII.B.3-17			X		
Negotiate with Provider Groups o Prepare materials to guide State in negotiations o Assist State in negotiations	p. 7 p. 19	V.B.2-7 VII.B.3-18			X		State procurement regulations did not allow State to negotiate; voluntary price reductions (VPR) accepted on 9/19/82. Analysis necessary to determine awards based on VPR performed.
Prepare Contract Documents and Contract Monitoring Procedures	p. 19	V.B.2-8 VI.B.5-1 VII.B.3-19			X		Site visits on 9/7, 9/8, 9/14 and 9/15 to validate bids.
Pre-Operational Technical Assistance o Reports and analysis to specific providers as required	p. 7	III-3 V.B.2-8 VII.B.3-20				X	No indication.

AHCCCS

CONTRACT COMPLIANCE MATRIX

Contract Requirement	Source: RFP	Source: Technical Proposal	Source: Cost Proposal	Source: Contract	Contract Compliance: Performed	Contract Compliance: Not Performed	Comments
IMPLEMENTATION: RESEARCH AND DATA ANALYSIS							
1. Develop AHCCCS Actuarial Data Base	p. 44	VII.B.5-3			X		M&R report.
2. Review Actuarial Data Base With Bidders		VII.B.5-6			X		Workshops on 7/21 and 7/22.
3. Design Reference Point Data Base		VI.B.3-2 VII.B.5-7			X		M&R report.
4. Establish Rate Setting Methodology		VI.B.3-2 VII.B.5-8			X		M&R report.
5. Recruit Financial Analysis and Risk Management Staff		VII.B.5-9				X	Decision made to continue with M&R.

AHCCCS

CONTRACT COMPLIANCE MATRIX

Contract Requirement	Source: RFP	Source: Technical Proposal	Source: Cost Proposal	Source: Contract	Contract Compliance: Performed	Contract Compliance: Not Performed	Comments
IMPLEMENTATION: PROGRAM RELATIONS (PROVIDER, MEMBER AND PUBLIC)							
1. Consult with Community Groups	p. 6						
o Schedule meetings, summary reports		VII.B.6-3			X		
2. Development of Public Relations Materials	p. 21	V.B.2-11					
o Public relations materials as required		VI.D.1-1,2 VII.B.6-4				X	Majority prepared by State as State assumed responsibility.
o Orientation packages		VII.B.6-4			X		
o Seminar plans					X		
3. Publicize/Distribute AHCCCS Material	p. 6	V.B.2-11					
o Memorandum detailing target groups		VI.D.1-1				X	No indication.
o Memorandum outlining media campaign		VII.B.6-5				X	Draft report submitted 11/82. No indication it was finalized; State assumed responsibility
4. Develop/Distribute AHCCCS Provider Information	p. 21	V.B.2-11					
o Instructions for enrolling		VI.D.2-1,4, 9			X		
o Enrollment application		VII.B.6-6			X		
o Manuals for completing encounter forms					X		
o Training seminars						X	No training provided for FFS providers during implementation.
o Provider manual and grievance procedures					X		Grievance procedures not completed on timely basis.
5. Develop/Distribute AHCCCS Member Information	p. 21	VI.D.1-2 VII.B.6-7			X		
6. Develop Methodology/Provider Training Materials		VI.D.2-4 VII.B.6-8			X		
7. Conduct Provider Training	p. 21	V.B.2-11 VI.D.2-5 VII.B.6-9			X		
8. Identify Fee for Service (FFS) Areas Requirements		V.B.2-11 VII.B.6-10			X		
9. Prepare and Distribute FFS Enrollment Packages	p. 21	VI.D.2-1 VII.B.6-11			X		

AHCCCS

CONTRACT COMPLIANCE MATRIX

Contract Requirement	Source: RFP	Source: Technical Proposal	Source: Cost Proposal	Source: Contract	Contract Compliance: Performed	Contract Compliance: Not Performed	Comments
IMPLEMENTATION: PROGRAM RELATIONS (Continued)							
10. Create FFS Provider File		VI.D.2-2 VII.B.6-12			X		
11. Develop Member Enrollment Interfaces		VII.B.6-13			X		
12. Define Member Enrollment Process o Procedure manual and grievance procedures		V.B.2-12 VI.D.3-2, 6, 7 VII.B.6-14			X		
13. Prepare Inquiry Procedures o Procedures manual for operations	p. 24	V.B.2-12 VII.B.6-16			X		
14. Hire and Train Inquiry Staff o Training plan		V.B.2-12 VII.B.6-17			X		No training plan identified.

AHCCCS

CONTRACT COMPLIANCE MATRIX

Contract Requirement	Source: RFP	Source: Technical Proposal	Source: Cost Proposal	Source: Contract	Contract Compliance: Performed	Contract Compliance: Not Performed	Comments
OPERATIONS: PROVIDER MANAGEMENT							
1. Procurement and Evaluation		V.B.3-14					
o Analyze prevailing utilization patterns		VII.C-7				X	No indication.
o Formulate specific market approach						X	No indication.
o Conduct presentations to provider groups					X		
o Evaluate responses and draft contracts					X		
2. Financial Analysis and Risk Management	p. 9	VI.B.5-2					
o Monitoring expenses and payments under each contract, control over emergency/out of plan expenditures and actuarial analysis of risk pool liabilities		VII.C-7			X		
o Monthly risk management status reports						X	No indication.
3. Contract Compliance, Monitoring and Review	p. 8	VI.B.5-2	V.B.3-15				
o Periodic and regular review of major contract terms		VII.C.-8				X	State staff reviewed contract contingencies.
o Comparison of relative contractor performance						X	No indication.
o Renegotiation of contracts						X	Open bidding for second year.
o Quarterly contract compliance reports						X	No indication.
o Monthly review of provider financial activity (claims paid)						X	No indication.
4. Audit	p. 9	V.B.3-15					
o Develop procedures for conducting audits		VII.C.-8 V.B.3-15			X		Not finalized until 11/23/83.
o Formulate schedules and sampling techniques		VII.C-8			X		Not finalized until 11/23/83.
o Conduct audits and analyze results						X	Not performed for first year due to unavailability of plan financial data.
o Audit reports as prepared						X	Draft HCPA report - 3/19/84.
5. Ongoing AHCCCS Provider Information	p. 22	VII.B.6-22					
o Status reports		VII.B.6-22				X	Limited status reports.
o Updated materials					X		

AHCCCS

CONTRACT COMPLIANCE MATRIX

Contract Requirement	Source: RFP	Source: Technical Proposal	Source: Cost Proposal	Source: Contract	Contract Compliance: Performed	Contract Compliance: Not Performed	Comments
OPERATIONS: PROVIDER MANAGEMENT (Continued)							
6. Provider Grievances o Review and resolve provider grievances	p. 9	VI.D.2-9			X		
7. Ongoing AHCCCS Provider Training o Status reports	p. 21	VII.B.6-24			X		

AHCCCS

CONTRACT COMPLIANCE MATRIX

Contract Requirement	Source: RFP	Source: Technical Proposal	Source: Cost Proposal	Source: Contract	Contract Compliance: Performed	Contract Compliance: Not Performed	Comments
OPERATIONS: MEMBER RELATIONS							
1. Ongoing AHCCCS Member Information	p. 22	VII.B.6-23					
o Status reports						X	Limited status reports.
o Updated materials					X		
2. Member Grievances	p. 10	VI.D.3-8, 9					
o Establish Joint Committee for Improved Member Relations (JCIMR) to review referred grievances	p. 22 p. 24				X		JCIMR not established; formed joint committee of State and MSGI.
o Collect, classify and record all grievances						X	Provider responsibility; MSGI surveillance unknown.
o Written summary of grievance procedures in poster format/displayed at each medical facility						X	No indication. MSGI developed member grievance procedures which were sent to each plan.
3. Respond to inquiries	p. 9 p. 22	VI.D.3-7			X		

AHCCCS

CONTRACT COMPLIANCE MATRIX

Contract Requirement	Source: RFP	Source: Technical Proposal	Source: Cost Proposal	Source: Contract	Contract Compliance: Performed	Contract Compliance: Not Performed	Comments
OPERATIONS: QUALITY ASSURANCE							
1. Case Management Review	p. 23	V.B.3-12					
o Publish guidelines and criteria, monitor procedures of providers		VI.C.4-4 VII.C-5			X		
o Field visits to providers					X		
o Mail periodic questionnaires to sample members/use of EOBs						X	EOBs not used.
o Select random sample of members to study over time						X	No indication.
o Review contracts of participating physicians						X	
o Review of solicitation materials and provider information program					X		
2. Enrollment Monitoring	p. 23						
o Review enrollment procedures		V.B.3-12			X		
o Audit selected enrollee		VII.C-5				X	No indication.
o Review member grievance procedures					X		
o Review specific grievances					X		
o Review member correspondence					X		
o Distribute questionnaires to sample members						X	No indication.
o Quarterly enrollment monitoring reports						X	No indication.
3. Utilization Review	p. 19						
o Monitor U/R activities of existing HMOs	p. 20	V.B.3-13				X	No indication.
o Provide utilization data to new providers and monitor data		VI.C.2-2 VI.C.3-2, 3				X	No indication.
o Audit FFS providers through S/URS		VII.C-5				X	S/URS not operational.
o Audit prior authorizations					X		
o Quarterly comparative utilization reports						X	No indication.
o Monthly utilization reports for new capitated providers						X	No indication.
4. Fraud and Abuse Control (Provider and Member)	p. 11	V.B.3-13					
o Design and define exceptions reports	p. 20	VII.C.-5				X	No indication.
o Evaluate exception reports	p. 23					X	No indication.
o Prepare documentation package					X		When identified by outside agency.
o Perform EOB confirmations and field audits						X	No indication.

AHCCCS

CONTRACT COMPLIANCE MATRIX

Contract Requirement	Source: RFP	Source: Technical Proposal	Source: Cost Proposal	Source: Contract	Contract Compliance: Performed	Contract Compliance: Not Performed	Comments
OPERATIONS: QUALITY ASSURANCE (Continued)							
o Conduct first level review of potential cases					X		
o Refer potential cases to state agency					X		
o Reports of potential fraud and abuse, as necessary						X	No indication.

AHCCCS

CONTRACT COMPLIANCE MATRIX

Contract Requirement	Source: RFP	Source: Technical Proposal	Source: Cost Proposal	Source: Contract	Contract Compliance: Performed	Contract Compliance: Not Performed	Comments
OPERATIONS: MISCELLANEOUS							
1. Establish Problem Research and Resolution Unit	p. 22	V.B.3-9					
o Routine pend correction and coding					X		
o Medical review of selected FFS claims					X		
o Research and resolution of aged pends					X		
o Research and response to provider inquiries					X		
o Evaluation of pend statistics					X		
2. Establish Third Party Recovery and CoPremium Unit	p. 11	V.B.3-9					
o Notify capitated providers of potential third party involvement	p. 25				X		Unit established in 3/83. Medicare edit may not have been operational until July 1983.
o Pursue retroactive third party recovery for member					X		
o Tracking/follow up of TPR claims status					X		
3. Establish Program Relations Control System		VI.D.2-7					
o Maintain complete records of all telephone and written inquiries (by type and nature)					X		
o Daily analysis of logs for patterns						X	
o Weekly Reports to include number of inquiries (by type) received, resolved, pending resolution, and forwarded to DHS for resolution					X		Indication some reports were prepared.

AHCCCS

CONTRACT COMPLIANCE MATRIX

Contract Requirement	Source: RFP	Source: Technical Proposal	Source: Cost Proposal	Source: Contract	Contract Compliance: Performed	Contract Compliance: Not Performed	Comments
ENROLLMENT							
1. Implementation							
o Identification of potential enrollees, preparation and mailing of materials	5/19/82 letter from MSGI to AHCCCS Director				X		
o Group meetings at eligibility offices/ other sites for training					X		
o Face to face enrollment process					X		
o Assignment of eligibles not participating in enrollment process					X		
2. Operations							
o Enrollment workers present at sites					X		

AHCCCS

CONTRACT COMPLIANCE MATRIX

Contract Requirement	Source: RFP	Source: Technical Proposal	Source: Cost Proposal	Source: Contract	Contract Compliance: Performed	Contract Compliance: Not Performed	Comments
ASSISTANCE AND PLANNING							
1. Utilization Review Techniques	p. 46	VI.E.3					
o Provide assistance to providers in setting up U/R program						X	No indication.
o Develop summary and detailed U/R reports						X	No indication.
o Provide U/R training						X	No indication.
2. Comparison of Programs	p. 46	VI.E.4-1				X	No indication.
o Provide comparisons of various competitive delivery systems contracting with AHCCCS available to members for enrollment decisions							
3. AHCCCS Program Evaluation		VI.E.5-1				X	No indication.
o Prepare annual report evaluating AHCCCS program							

AHCCCS

CONTRACT COMPLIANCE MATRIX

Contract Requirement	Source: RFP	Source: Technical Proposal	Source: Cost Proposal	Source: Contract	Contract Compliance: Performed	Contract Compliance: Not Performed	Comments
FINANCIAL MANAGEMENT							
1. Monthly invoices							
- Costs by cost account	p. 49			Sec. 8	X		
- Costs by functional area	p. 49		p. I.B-1		X		
Maintain/make available all evidence pertaining to costs/expenses for at least three years after contract termination.	p. 17			Gen. Prov. 8	X		
2. Incentive invoices shall be submitted for approval upon completion				Sec. 8	X		
3. Separate cost center for AHCCCS			p. I.A-1		X		
4. Weekly timesheets will							
- Accumulate separate charges by major function			p. I.B-1		X		Personnel assigned to functional departments.
- Contain project codes			p. I.H-3			X	
Monthly computerized analysis will show hours/dollars by department/task			p. I.H-4			X	
5. Audits							
o On-site internal audit staff			p. I.H-10		X		
o MDC's public accountants will perform operational audits periodically during the year			p. I.H-10			X	
o MSGI corporate auditor will perform surprise audits as needed			p. I.H-10		Partial		One performed in 6/83.
o Accounting system will be audited			p. I.H-11			X	
6. Financial manager will							
o Develop internal control procedures			p. I.H-1		X		
o Issue monthly and year-to-date financial reports			p. I.H-1			X	
o Maintain computerized G/L system			p. I.H-1		X		Implemented in October 1983.
o Maintain computerized A/P system			p. I.H-1		X		Implemented in October 1983.
7. Reconciliation of all payments to providers	p. 9				X		

MMIS Subsystem Description

An MMIS as defined by HCFA (Health Care Financing Administration) has six subsystems:

- Member (or Recipient)
- Provider
- Reference (procedure, diagnosis, formulary)
- Claims
- MARS (Management and Administrative Reporting System)
- S/URS (Surveillance/Utilization Review System)

MSGI proposed its certified New York MMIS as the base system and that New York staff familiar with the New York MMIS develop the AHCCCS system.

The HCFA State Medicaid Operations Report describes the six subsystems within the AHCCCS environment as follows:

- The Member Subsystem's primary functions are to maintain current and historical membership eligibility and enrollment records, and to support the activities of capitation payments, claims payments, contracted provider enrollments and membership reporting. The Member (recipient) master files are updated by the State Department of Economic Security (DES) Assistance Payment Information System (APIS), which contains records of categorically eligible AFDC recipients. In addition, AHCCCS receives information on Supplemental Security Income recipients and county eligibility information which are also used to update the Member Subsystem files.

- The Provider Subsystem maintains current and historical information on contracted AHCCCS providers and is used in support of enrollment of qualified providers,

maintenance of provider enrollment records, and provide reimbursement. This Subsystem interfaces with the Member Subsystem, the Claims Subsystem, and the Financial Subsystem to ensure an accurate relationship between a provider and its members, consistency between a member and a provider submitting claims on behalf of the member, and the distribution of proper payment to a provider. The Provider Subsystem is also used in management and utilization reporting.

- The Reference Subsystem contains three functional files used to provide reference data and edit criteria to support claims and encounter data processing. These are the Procedure, Diagnosis, and Formulary files. The Reference Subsystem also contains limits and other data on fee-for-service providers such as the providers who may bill for these services, age and sex of recipients for whom these services were billed, locations of where services were rendered, permissable frequency of a service to one recipient, maximum number of units of services per claim and special program codes which flag procedures such as family planning, abortion, etc.

- The primary function of the Claims and Encounter Data Processing Subsystem is to ensure timely, accurate, and cost effective collection of encounter data, and payment of fee-for-service claims while observing all federal and State regulations. In addition, the Claims Subsystem is to provide all information necessary for management and utilization reporting functions which monitor and control the AHCCCS Program. It edits and prices claims and encounter data for member and provider eligibles, checks for appropriateness of services claimed, assures that required prior approval services are properly identified, and determines correct payment for these services. Claims and encounters are suspended when there are discrepancies. The Claims Subsystem checks for duplicate claims and encounters submitted by providers, excessive frequencies of the same services, or other inconsistencies on the current or previous claim or encounter. The financial system produces capitation payments for prepaid health plans and paid claims checks for fee-for-service providers, rosters of Prepaid Health Plan (PHP) members enrolled within each month, remittance advices for fee-for-service providers indicating the basis for the check calculation, and encounter data status reports for all PHPs indicating errors detected on their encounter claims.

- The MARS Subsystem is designed to produce a variety of summary and detail reports that assist management at three functional levels--administration, operations, and provider relations. Administrative reports include overall management controls, policy and fiscal planning, and local and federal reporting. Operational reports concentrate on claims receipts, review and adjudications, and payments with particular reference to sources of delays and errors. Provider relations reports include all activity associated with enrollment and certification, audits, evaluations, and education. Unlike typical MARS reporting systems in a standard MMIS, the AHCCCS MARS must include all capitation and encounter statistics in addition to the usual fee-for-service data.

- The S/URS Subsystem is designed to provide comprehensive profiles of health care delivery and utilization patterns in various categories authorized under AHCCCS. Its objective is to reveal potential misutilization and promote corrections of actual misutilization of services in the AHCCCS system. The S/URS subsystem also facilitates the investigation of inadequacies in the levels of care and employs the basic approach of using exception reporting to reach these objectives. Again, like MARS, the AHCCCS S/URS would incorporate all capitation and encounter statistics in addition to the usual fee-for-service data. S/URS also produces Explanations of Benefits (EOBs) which are summaries for each claim finalized of the procedures performed, charges submitted and charges paid. They are sent to both the provider and the recipient.

Detailed Analysis of Proposed Modification 3

Each of the detailed costs below do not include the corporate allocation of 3.35% or fringe benefits costs of 15%. Exhibits IV-7 and IV-8 include the allocation.

Split capitation rosters requests .97 full-time equivalent (FTEs) at a cost of $26,478 plus $29,700 for computer costs. To split capitation rosters from one list into two (for prospective and retrospective) should reasonably be included under system maintenance and modification for which the contract provides. It would certainly not require the costs defined to add the needed code.

CCS (Crippled Children Service) special processing requests .40 FTEs at a cost of $16,580, $7,700 for computer costs, $3,200 for Ernst & Whinney, and $2,100 for other costs. CCS clearly required additional work as a special population that was not envisioned in the RFP or proposal. The computer costs and EDP systems FTEs appear reasonable. What is questionable is the need for .15 FTEs for finance personnel at a cost of $4,340.

Foster Children Coverage requests .46 FTEs at a cost of $13,225 and $13,200 for computer costs. Again special populations were not envisioned in the RFP or proposal and would be considered new work, though the computer costs appear excessive for only adding one paragraph of code.

Long-term care requests 3.3 FTEs at a cost of $52,967, $15,800 in computer costs, and $28,800 in other costs. The requirement to distinguish long-term care recipients from other AHCCCS recipients was not envisioned, nor the additional work

resulting from the counties not identifying them as such. The costs would therefore be new work and do appear reasonable.

Special procedure codes requests .98 FTEs at a cost of $27,187 and $35,500 for computer costs. Modifying the procedure and formulary files to the extent required for Maricopa would not reasonably be included under the normal contract system maintenance. However, the computer costs appear to be excessive in comparison to the other tasks presented.

Reinsurance requests .40 FTEs at a cost of $12,190, $4,500 for computer costs and $6,183 for Ernst & Whinney. The involvement of MSGI in reinsurance policy and claims processing is clearly new work. However since the claims were processed manually, the need for computer costs of $4,500 and for systems time at a cost of $2,604 is questionable. The level of Ernst & Whinney involvement is also questionable.

Newborn coverage requests 2.34 FTEs at a cost of $50,554, $16,800 in computer costs and $12,800 in other costs. Newborn coverage policy did change several times over this period causing multiple meetings/discussions over what the policy should be and subsequent redirection. The only questionable portion of the costs is the need for one full-time Data Specialist in the program support area for all of Operational Year One at a cost of $16,000.

Special Sam Thurmond reports requests 1.58 FTEs at a cost of $56,150, $66,600 in computer costs, $7,366 for Ernst & Whinney and $5,400 in telephone costs. Most of the reports were requested because MARS was not functioning nor were any other reports developed in its place. Only two reports appear to be unique requirements for Thurmond that MSGI would not have needed

to properly manage. Furthermore, even these two reports would not be classified as new work since the proposal stipulates that if any special report requests cannot be done within the existing resources, then the requester will be so notified. Thurmond did however get assistance on the preparation of the White Paper and this would seem to be new work.

Retro-emergency coverage requests 2.49 FTEs at a cost of $57,876, computer costs of $36,800, and other costs of $21,800. Retro-emergency coverage is a peculiarity of Arizona that could not have been envisioned by MSGI and would therefore be considered new work. The costs appear reasonable with the exception of the need for a full-time quality control analyst for all of Operational Year One at a cost of $16,000.

SSI processing requests 1.25 FTEs at a cost of $36,273 and computer costs of $26,800. Since MSGI was aware that SSI would be supplying eligibility information, the problems defined do not appear to go beyond normal operations and would therefore be considered within the originally defined work.

Rollovers-county determination requests 1.55 FTEs at a cost of $43,780, computer costs of $38,100 and other costs of $13,400. "Grandfathered" and "oathed" determinations of eligibility represent operational complexities that would not have been envisioned. New data elements and new reports were required as a result of these eligibility forms. The costs appear reasonable for this new work.

Assignments and related issues requests 2.72 FTEs at a cost of $60,352, computer costs of $28,400 and other costs of $38,700. The timing of the original eligibility determinations, enrollments and the provider contract awards clearly presented opera-

tional difficulties that could not have been envisioned. The special projects 1.65 FTEs should therefore be allowable. However the need for the systems, provider and computer costs is questionable.

Member fixes requests 2.07 FTEs at a cost of $50,280, computer costs of $27,400 and other costs of $7,000. Clearly eligibility determination problems created more difficulties than envisioned by either MSGI or State AHCCCS. However member fixes were a function anticipated by MSGI and can therefore not be classified as new work.

Duplicate members requests 1.19 FTEs at a cost of $35,831, computer costs of $24,900 and other costs of $3,800. Pseudo SSNs created enormous difficulties which were not discovered until early 1983. The work is clearly new work and the costs appear reasonable.

Payment rules requests 1.54 FTEs at a cost of $49,971 and computer costs of $53,300. Changing payment rules would seem to be part of normal system maintenance and thus not new work. Furthermore the computer costs appear very excessive.

Assistance Program Identification System (APIS) requests 9.47 FTEs at a cost of $197,771, computer costs of $184,900 and other costs of $36,700. Without question this area was the most complex one faced by MSGI for which it was not prepared. The RFP specified that the Administrator would receive 14 county files, 1 SSI file and 1 DES file of clean AHCCCS eligibility data. Instead DES' APIS could only provide all its eligibles (some of whom were AHCCCS eligible and some who were not) on a case basis (not on a member basis as required by AHCCCS). The only cost that appears unreasonable is the computer cost.

Pricing schedule requests 1.10 FTEs at a cost of $37,645 and computer costs of $56,200. This should have been included in MSGI's proposal as part of its responsibility for paying claims and in fact was in the implementation work plan as MSGI's responsibility. The cost then would not be classified as new work.

Indian Health Services (IHS) policy changes requests 2.29 FTEs at a cost of $70,153, computer costs of $49,400 and other costs of $12,500. The numerous memos on what the IHS policy should be are clear evidence of new work. The costs appear reasonable.

Additional procurements requests 1.43 FTEs at a cost of $46,258, Ernst & Whinney costs of $201,752, Milliman and Robertson costs of $53,910 and other costs of $12,400. The follow-on RFPs in 1982 for Native Americans and long-term care and the second year RFPs in 1983 were not envisioned in the RFP or proposal. The preparation of provider contracts also went beyond what was envisioned. Given the rate structures of the subcontractors, the costs appear reasonable. Our point is that E&W was more costly than if MSGI had hired staff.

Legal support requests $157,228 for additional outside legal services. MSGI's proposal assumed legal support would be required during implementation. The litigation work at a cost of $59,369 is however clearly outside what was envisioned. The amount above $80,000 for non-litigation work conflicts with the specific budget limit set by the AHCCCS Project Director in February 1983. This work addressed areas such as provider subcontracts, special groups, grievance procedures, EEOC, policy issues and legislation issues.

Claims schedule requests 6.11 FTEs at a cost of $131,060, computer costs of $153,800 and other costs of $30,000. Increasing the frequency of claim cycles to weekly and biweekly clearly was done at the direction of the State. However, MSGI's proposal does indicate claim payment cycles will occur at weekly and biweekly intervals. Furthermore, claims cycles did not begin in October 1982. As described in the 1984 Waiver Request the very structure of the AHCCCS Program required daily member updates, though in fact MSGI's proposal only stated weekly updates. The personnel and computer costs both appear excessive.

Phase-in of counties requests 7.85 FTEs at a cost of $140,746 and other costs of $68,500. Phase-in was a mechanism to ease in the submission of claims by the counties to MSGI until all the fee-for-service providers could be enrolled and trained. This task was within the scope of MSGI's proposal but would have required additional personnel to accomplish before October 1, 1982 (and may not have been physically possible anyway). The resulting confusion did generate new work though the costs appear unreasonable given that the claims volume was within MSGI's stated proposal assumption.

Security systems requests $16,844 for off-hour guard service. Given that 24-hour operation was not envisioned in the proposal, the cost seems reasonable.

Systems implementation travel requests $24,551 for travel expenses due to computer hardware not being in place in Arizona in sufficient time as a result of the late contract signing. The cost at first appears reasonable; however, the MSGI Project Director at the time stated that he could absorb the cost in his budget and the cost is more than offset by the lack of computer

costs during Implementation, even though MSGI's cost proposal and thus the baseline contract value allowed for such.

Annual medical audits requests $99,000 for AAAHC and $8,250 for Ernst & Whinney. Though the RFP required medical audits, no frequency was specified. Furthermore having AAAHC perform the audits rather than MSGI gave the results more credibility. The costs would be considered new work and, given the rate structures, do appear reasonable.

Actuarial services requests $25,882 for Milliman and Robertson for services not envisioned by the State or MSGI and directed to be done by the State AHCCCS Acting Director. The work would be new work and the costs appear reasonable.

APPENDIX F

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MCAUTO Systems Group, Inc.'s Comments

To

Price Waterhouse's

AHCCCS Administration Performance Audit

Final Report Draft

February 4, 1985

MCDONNELL DOUGLAS CORPORATION

MCAUTO SYSTEMS GROUP, INC.
100 West Clarendon, Suite 1700, Phoenix, Arizona 85013
(602) 248-8012

MCAUTO Systems Group, Inc. ("MSGI") agreed with the Legislature that the Auditor General should conduct an independent audit of the role of MSGI and the State in implementing and administering the AHCCCS program. Price Waterhouse, as the Auditor General's contractor, has now performed that audit, with which MSGI cooperated fully. MSGI is heartened by the overall finding set forth in the Price Waterhouse Final Report (the "PW Report") that "in general, MSGI completed most of its major responsibilities required under the Administrator contract." When all is said and done, a fair reading of the PW Report leads to the conclusion that, without further discussion, the State owes MSGI at least $1.8 million, and, more realistically, $3,579,764, as the following table shows (see PW Report, Exhibit III-1):

Total costs billed to State by MSGI	$17,086,576
Less: Total costs questioned by PW	2,196,490
	$14,890,086
Less: Total "unresolved costs"	1,784,162
	$13,105,924
Less: Amount paid to MSGI by State	11,310,322
Amount unquestioned now owed to MSGI	$ 1,795,602
Add: Amount listed as "unresolved"*	$ 1,784,162
MSGI Costs** Now Due:	$ 3,579,674

While MSGI agrees with Price Waterhouse's basic conclusion that the Administrator contract is a cost reimbursement contract (see PW Report at IV-9)

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* We believe all the "unresolved" costs are clearly documented, attributable to MSGI's contract performance, benefited the State, and so are reimbursable under this cost reimbursement contract. The PW Report notes that "[unresolved costs] usually have many characteristics of acceptability but, they are not sufficiently documented that they are clearly acceptable. Frequently the contractual parties . . . negotiate these costs." (PW Report, Exhibit III-4, page 2 of 2).

** Not addressed here are MSGI's claims for termination, loss of business, incentives, and other issues which are the subject of litigation.

entitling MSGI to payment for all costs incurred, it is disappointed that Price Waterhouse did not adequately follow through on that conclusion. Thus, Price Waterhouse failed squarely and adequately to address the overriding issue: given the chaotic and continually changing nature of the AHCCCS program, did MSGI basically do what the State asked it to do and therefore is MSGI entitled under the contract to payment for all the costs it incurred for the services it performed? Rather than addressing this issue head-on, the PW Report often equivocates. We believe the following salient points are not adequately addressed and resolved by the PW Report.*

1. The PW Report does not address the fact that MSGI has not been paid its cost of performance.

The PW Report accurately describes the Administrator contract as a cost reimbursement contract, rather than a fixed price contract (PW Report, III-18 through III-20), and notes that "under a cost reimbursement contract a contractor is entitled to its allowable incurred costs even though all the specified tasks may not be achieved." (PW Report, III-19) Nevertheless, the PW Report disregards the cost reimbursement nature of the contract by characterizing some of MSGI's costs as "questioned" or "unresolved," due apparently to the purported difficulty of determining "allowable" incurred costs.

MSGI performed its contractual responsibilities with the cost reimbursable nature of the contract in mind. Both the State and MSGI recognized that, when the contract was signed, MSGI's duties were "necessarily vague as to specific tasks" which MSGI would undertake, because of the experimental and unknown nature of AHCCCS itself: the first statewide prepaid indigent health care system

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* MSGI has filed more detailed and extensive responses to the PW Report with the Auditor General as part of its public comments on the PW Report.

in the country. MSGI's Technical Proposal to the State, which the State agreed to, specifically contemplated that after the contract was signed, there would be detailed workplans and detailed budgets prepared, which would tie MSGI's duties down to measurable tasks. Once those workplans and budgets were adopted, MSGI and the State would then have a clear set of benchmarks to use in evaluating how the program was running. But the State never adopted workplans, though MSGI repeatedly asked it to do so. (See PW Report at IV-4, IV-11)

Without detailed workplans, MSGI was contractually obligated to perform according to "the directions of the Project Director"* (i.e., the State AHCCCS Director). Throughout its tenure as AHCCCS Administrator, MSGI was not given specific, measurable tasks to accomplish because the State failed to adopt any workplans. (See PW Report at IV-9) Thus, MSGI's sole task was to do whatever the AHCCCS Director said to do in performing AHCCCS-related activities. MSGI responded fully to each and every directive it received from the State Directors. In short, MSGI performed its contract duties. It is that simple.

The underlying fallacy of the PW Report is that it attempts to define a "baseline" set of tasks against which to measure MSGI's performance, although such a "baseline" set of tasks never existed in reality because there never were any workplans which were, contractually, the only way to define MSGI's specific duties. In actuality, the "workplan" was always: do what the State tells you, and the State will reduce it to writing later (a fact the PW Report does recognize, see PW Report at IV-4, IV-11 through IV-17). Had there been workplan-defined tasks, the PW exercise in trying to "measure" MSGI's performance would be valid. But, unfortunately, the PW Report speculates about what should have

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* Administrator Contract, Special Provision 5.

occurred had there been defined workplans, rather than looks at what actually did occur.

In short, MSGI was required to implement a totally new Medicaid alternative program in a hostile and changing environment, with little, and often conflicting, guidance from the State. Under its cost reimbursement contract, which contained no set limit on how much money was available for any particular activity since no definite workplan existed which "budgeted" specific dollars for specific tasks, MSGI was entitled to recover all costs incurred in performing that difficult function. MSGI did what it was told to do, and often was urged to "do more," as State AHCCCS Directors Don Mathis and Greg Fahey have testified. Thus, MSGI justifiably expected that all its costs would be fully paid by the State, and they were not.

2. The PW Report never deals with the State's refusal to allow MSGI the right to earn a profit.

MSGI was the only bidder on the AHCCCS contract to propose that its profit would depend on incentives which were to be adopted by the State after the contract was signed. It was this incentive feature of MSGI's bid which helped it win the contract award, because it demonstrated MSGI's willingness to tie its profit to overall contract performance. The State never adopted incentives for the operational years MSGI was Administrator; it refused to do so despite MSGI's repeated requests. The State Directors continually told MSGI that the incentive pool would be available at some vague future time for MSGI to earn, once workplans, budgets, contract amendments, all the "details" of contract administration, had been worked out by the State.

Instead of complying with its contractual obligations, the State took over the AHCCCS Administrator function and subsequently attempted to deny MSGI its rightfully earned profits under the theory that no formal incentive criteria

had been adopted. That was fundamentally a bad faith breach of contract by the State. MSGI has been placed in the unjust position of being at the whim of State administrators who refused to negotiate the incentives to which MSGI was entitled under the contract, yet the State now seeks to punish MSGI for claiming profits which the State unilaterally and wrongfully refused even to discuss. Because the State wrongfully refused to implement the profit mechanism contemplated by the contract, it hardly follows that MSGI was not entitled to earn profit. Of the approximately $2.2 million questioned by the PW Report, $1.7 million represents operational incentive fees which MSGI rightfully earned in performing its contract exactly as it was instructed by the State.

Another equally erroneous finding of the PW Report is that $208,105 in award fees is "questioned." This amount is a flat award fee that MSGI was promised when it signed the contract, which MSGI was told by all State AHCCCS Directors to pro rate and bill over the 40 months of the contract, which MSGI billed on a monthly basis, and which MSGI was paid without complaint by the State, with the State's full knowledge of what this fee was and why it was being paid. Price Waterhouse, in this instance, is making an erroneous legal judgment, directly contrary to the position taken by every cognizant State official.

3. The PW Report's treatment of State AHCCCS Division's deficiencies is incomplete.

The PW Report acknowledges several serious failings on the part of the State in carrying out its contractual and statutory obligations. Among these, PW correctly notes that:

> "[A] broad range of activities needed to be accomplished to get AHCCCS underway in a short time . . . . [Nevertheless] several of the State's start-up activities, such as the preparation of rules and regulations, were still under development [as of AHCCCS start-up on October 1, 1982]." PW Report at IV-14.

"[T]he State AHCCCS staff vacillated between an oversight and operational role. . . . The bluring of roles led to significant problems in policy analysis and decision-making." PW Report at IV-15.

"Many of the transmittals from the State [to MSGI] give guidance to MSGI on policy decision, comment on a deliverable, call attention to problems, raise an issue for urgent attention, etc. It becomes difficult to sort out among these memoranda what is in or outside of original work scope, and most do not provide guidance on what should be of lower priority or not done if the task being discussed is pursued immediately." PW Report at IV-16

"Contract amendments were not made and formal modifications were not submitted to HCFA until many months had passed, even when transmittals could have been used as a basis for doing so. The reason for this appears partly to be that the State AHCCCS leadership expected to change the nature of the contract during the summer of 1983, but later learned that HCFA would not approve a radical revision or restructuring without a full recompetition." PW Draft at IV-17

"The State was remiss in executing the contract provisions calling for formal contract amendments to be made for new work. Contract changes were informally made and not through the amendment process required in the contract. This contributed to allowing the size of MSGI's monthly expenditures (and bills paid) to grow far beyond that officially budgeted." PW Draft at IV-17

"State AHCCCS did not establish consistent, effective financial and management controls so as to enable it to effectively oversee MSGI's operations and expenditures. It did not have an adequate grasp of some important contractual issues and as a result let critical contract related problems and adverse trends continue even after they were identified. It lacked experienced personnel in several areas." PW Report at IV-18.

But, the PW Report does not adequately elaborate on these problems, or put in context the incredible shifting, chaotic, often directionless, State executive "leadership" from the Governor on down which characterized the first two years of AHCCCS. Thus, the Report understates the need MSGI faced on a daily basis to put out fires, pay the bills, and "fix" daily problems. MSGI bid this

cost reimbursement Administrator contract knowing that AHCCCS was experimental, and knowing that there would be unforeseen problems that would have to be resolved. However, MSGI did not, and could not, expect that its costs would burgeon daily, as the vicissitudes of Arizona county politics, State administrative ineptness, inaccurate reporting in the press, incomplete and inaccurate eligibility data, and the all-important demands of bringing into existence quality health care for a statewide population came swirling over it.

In its Technical Proposal, MSGI proposed an orderly management system of detailed workplans and budgets to be worked out with the State after the contract was signed. MSGI assumed that it would begin work in an orderly State environment where those workplans and budgets would be negotiated and taken seriously by State officials. Instead, MSGI faced chaos, reacted as best it could, and now finds itself questioned for incurring costs for services that every AHCCCS Director requested it perform. The PW Report nowhere fairly deals with this conundrum. To be sure, the PW Report accurately discusses many of the numerous problems of too short a start-up time for AHCCCS, vascillating State leadership, poor eligibility data, etc., but it simply does not tie all these problems together to portray an accurate and comprehensive picture of the State-created mess in which MSGI found itself. Nor does the PW Report describe how the pervasive failure of the State adequately to perform its own duties, constantly hindered MSGI in its performance, and drove up MSGI's costs.

When MSGI agreed to cooperate with an independent audit by Price Waterhouse, we understood that Price Waterhouse would fully and fairly explore the State's performance and how that impacted on MSGI. While Price Waterhouse examined every aspect of MSGI's performance, it artificially limited its investigation of the State to how the State performed its role of monitoring MSGI. Price Waterhouse's incomplete look at the State's overall AHCCCS

performance constitutes a serious shortcoming in the audit, and a serious disservice to the Legislature.

We believe it was fundamentally unfair and misleading for the PW Report to include a "compliance matrix" (with which we vehemently take issue) for MSGI's performance, without including a similar matrix showing what duties the State failed to perform.*

At a minimum, the following glaring deficiencies on the part of the State and the consequences that inevitably flowed therefrom should have been fully examined and explained:

1. The State's failure to approve workplans and budgets for Operational Years One and Two (Paragraph 5 of the Special Provisions).

2. The State's failure to approve incentive payment schedules for Operational Years One and Two (Paragraph 3 of the Special Provisions).

3. The State's failure to document contract modifications (Paragraph 4(h) of the Special Provisions).

4. The State's failure to pay MSGI money owed to it for costs incurred by MSGI in December, 1983, and January-March, 1984, or give adequate assurances that amounts owed would be paid (general contract law and Paragraph 9 of the Special Provisions).

5. The State's repeated delay or failure to make policy decisions such as:

   (a) Coverage of Native Americans
   (b) Reinsurance
   (c) Services for newborns
   (d) Long-term care
   (e) Matters dealing with difficult patients

6. The State's failure to consult MSGI before making policy decisions (e.g., the State's eleventh hour decision to invoke the "phase-in" provision of the AHCCCS legislation).

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* We have included such a matrix in our detailed comments to the PW Draft filed with the Auditor General.

7. The State's delay in promulgating rules and regulations that were necessary to operate the Program.

8. The State's failure to provide eligibility data of sufficient quality to enable MSGI to do its job.

9. The State's failure to advise MSGI of major problems with the eligibility data bases, including APIS and the county eligibility systems.

10. The State's failure to impose sanctions against providers for their failure to provide encounter data and financial data.

Finally, the PW Report does not focus on the loss of Federal Funding Participation ("FFP") program dollars caused by the State's own conduct. While Price Waterhouse may not have considered it a part of its audit, this is critical because the magnitude of lost dollars to the State of Arizona dwarfs the dollars which were the primary focus of this audit. A large amount of potential federal matching funds were apparently given up by the State when Dr. Foley:

A. Arbitrarily declared the "developmental phase" terminated at a fixed dollar amount, thereby causing the State to lose 90 percent FFP for work customarily viewed as developmental--and reimbursable--in other Medicaid programs; and

B. Negotiated an agreement under which the State was either not reimbursed or reimbursed at a nominal rate for categoricals who were eligible but not enrolled in a plan, thereby causing the State to forfeit a substantial part of the total fee-for-service expenditures for the program.

At present, the full extent of the loss is unknown, but through its actions and inactions, the State of Arizona may have unnecessarily lost millions of federal dollars, as Mr. Mathis testified recently under oath.

4. MSGI's contract performance.

Because of space limitations, our comments here are limited to major issues raised by the PW Report.

A. Audit Findings

(1) Subcontractor Services

The PW Report equivocates when it lists as "unresolved" $1,163,396 in costs which MSGI incurred in subcontracting portions of the work it was required to do under its contract to support AHCCCS (See Exhibit III-1, Exhibit III-2, and Section IV.5) The PW analysis misinterprets the facts in its discussion of those costs.

First, the PW Report proceeds from the mistaken assumption that "substantial portions of the subcontractor work appear to be within the work MSGI was originally contracted to do." This assumption ignores the fact that the "work MSGI was originally contracted to do" was never really defined because there were never detailed workplans to define it. The work done by each of the subcontractors listed was necessary and for the benefit of AHCCCS, was utilized by AHCCCS, was accepted by the State, and was not within any defined duty to be undertaken by MSGI. All of the work was done because, in MSGI's opinion, it was cost-effective at the time for subcontractors to do the work given the increasing and shifting demands of AHCCCS and the severe time constraints under which MSGI was forced to work.

It is only with the benefit of hindsight that the PW staff which conducted this study can now second-guess MSGI's decision to utilize subcontractors. In any event, PW does not question that the State received the services of the subcontractors and that the services were of substantial value to AHCCCS. Under cost reimbursement principles (recognized in the PW Report), MSGI's costs for its subcontractor services, which the State always

knew about and which services it always accepted, must be borne by the State. It is simply inappropriate to classify these costs as "unresolved" when there is no dispute that the State always accepted the benefits of these costs, and in most instances, directly ordered MSGI to incur these costs. They are costs clearly proper under MSGI's cost reimbursement contract.

(2) Computer Charges

MSGI agrees with the PW Report that MSGI's computer charges were reasonable (see PW Report, Appendix A, p. 3 of 8) and clearly supportable. However, the PW Report classifies as "unresolved" $366,018 in computer charges (see Exhibit III-1 and p. III-6). MSGI agrees that a portion of this amount is not fully supported with a "paper trail," but instead was based on reasonable estimates of computer usage by MSGI management familiar with data processing operations. PW itself has found that these charges "are reasonably consistent with those charges which are supported by the system accounting package" (p. I-3). We believe that this amount of "unresolved" computer charges should be recognized as reasonable--PW itself does so--and reimbursable costs of MSGI's contract performance.

MSGI agrees that when DCAA completes its audit of MSGI's and MCAUTO's computer charges, should there be any question of adjusting provisional rates to final, audited rates, both the State and MSGI should again review the issue of computer charges. Until the need for such adjustments is established, however, all computer charges, including the $366,018 listed as "unresolved," should be clearly reimbursed to MSGI as part of its cost of performing its contract.

(3) General and Administrative and Direct Corporate Charges

In its Technical Proposal, MSGI informed the State that all its operations included an allocation of a McDonnell Douglas Corporation ("MDC")

corporate charge which was, at the time the Technical Proposal was submitted, approximately 3.35 percent. MSGI's Technical Proposal nowhere guaranteed that this would be a fixed G&A rate over the life of the contract. Indeed, it is common for a G&A rate to fluctuate over time, and it is customary for this cost to be passed through by the contractor to the customer under a cost reimbursement contract. That is precisely what MSGI did under the current contract: it charged a "provisional" MDC G&A rate based on estimates of current G&A costs, and then later adjusted this "provisional" rate to reflect actual historical costs as those costs became known. In fact, the provisional rate for MDC G&A and direct corporate charges was adjusted down to an actual rate of 2.45 percent for 1982, and up to an actual rate of 4.8 percent for 1983 (including open enrollment, which was a separate contract modification which included a separately negotiated G&A rate).*

The PW Report erroneously concludes that a MDC G&A rate of 3.35 percent was guaranteed and fixed for the life of the contract, and therefore, questions $123,819 (see III-12). Again, the PW Report fails to follow through with its finding that this is a cost reimbursement contract, under which MSGI is entitled to its full historical costs, including the costs of MDC corporate G&A as those costs are calculated for all other MSGI contracts. It should be noted that Price Waterhouse nowhere questions the method of calculating MDC corporate G&A.

(4) The Issue of the "Baseline"

The PW Report raises the question (which it does not resolve) of whether MSGI ever in fact overran the contract baseline. (See PW Report,

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* The actual rate for 1984 is not yet determined; a provisional rate of 6 percent has been used until the actual rate is finally determined.

pp. III-18 through III-25) This is a hypothetical issue, but a serious one, and constitutes an example of the manner in which the PW Report sometimes clouds rather than clarifies matters.

The short answer to this question is this: because there were no workplans, and because MSGI was obligated to do whatever the AHCCCS Director told it, whatever costs it incurred would automatically become the "baseline" of the contract, and these costs should have been promptly reflected in the written documents as part of the contract amendment process (which State officials never satisfactorily understood, see PW Report at IV-11 and IV-12).* Thus, there can be no question whether MSGI's costs exceeded the baseline because all MSGI's costs were the baseline: MSGI's costs always exactly equaled 100 percent of the baseline.

Price Waterhouse recognizes that, without workplans, budgets, and definite contract amendments (all of which the State absolutely refused to either negotiate with MSGI or unilaterally impose), it is next to impossible to say what a "baseline" of duties or costs might be (see PW Report at IV-12). Undaunted by this observation, the PW Report speculates that such a "baseline" may exist (if only in the imagination of the PW review team), solely for purposes of conducting its audit. In reality, however, the contract "baseline" of duties and costs was (1) whatever the Director told MSGI to do and (2) whatever the cost MSGI incurred in doing it. Without detailed workplans and budgets that the State never implemented, MSGI's duties were to do everything the Director said, and the "budget," just like the "baseline" was, simply, whatever it cost to perform those duties. Because this

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* Thus, the costs of modifications 1, 2, and 3 should without question be included in the contract baseline figures, as Exhibit III-3 tentatively does.

"baseline" shifted from day to day as MSGI's duties shifted from day to day, MSGI was always working at 100 percent of its costs (including its G&A), and never exceeded this baseline. The whole of the PW Report discussion at pages III-17 through III-23 thus needlessly complicates rather simple facts: the State never really "defined" how much MSGI was supposed to spend in doing what it was being required to do; absent such a definition, MSGI was entitled at the very least to recover 100 percent of its costs, and have those costs recognized as the contract baseline.

B. MSGI Performance Findings

We must stress again that MSGI, from the day it signed the contract, was hindered in its performance by the crisis atmosphere that marked the State's administration of AHCCCS, and that kept the State from defining detailed tasks, budgets, workplans, contract modifications, and other tools of management MSGI expected, and had a right to expect, would mark its participation in AHCCCS.

We agree that "MSGI adequately performed the majority of activities associated with provider development and provider and member relations." (PW Report, IV-28). We also agree that "their performance in the areas of eligibility and enrollment was less effective because of problems arising in the eligibility determination process." (Id.) However, we think that the PW Report makes no effort to quantify what those eligibility problems were, and the impact those problems had on the whole of MSGI's efforts.*

Price Waterhouse appears to be laboring under a misperception of MSGI's Technical Proposal. That proposal did not, and was not intended to, spell out in detail what MSGI's duties would be. Rather, the proposal described general

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* See MSGI's detailed comments on file with the Auditor General for further discussion of this point. Similarly, see MSGI's discussion of its role in Provider Management.

areas in which MSGI would assume responsibility after detailed workplans were agreed to. Since this never happened, it is inappropriate for Price Waterhouse to criticize MSGI for failing to meet obligations that never were fully defined. In particular, we object to the following PW Report findings.

(1) Quality Assurance

MSGI strongly disagrees with the suggestion that MSGI did not adequately implement quality assurance measures. Quality assurance was a top priority of MSGI throughout the time it served as Administrator. MSGI conducted medical audits, case-by-case review of questioned problems, and a daily response to all questions about quality assurance.* In any event, the "bottom line," as is well known to the Legislature, is that several studies have concluded the quality of medical care in AHCCCS was as good as the care in the community at large. Governor Babbitt has on several occasions repeated this fact in his recent comments about AHCCCS (at least once to Congress). This accomplishment of high-quality health care did not come to pass magically on March 16, 1984, when the State took over the administrator function; it was well known while MSGI was AHCCCS Administrator.

(2) EDP Systems Development and Operation

The PW Report accurately notes that much of the so-called MMIS system was operational by October 1, 1982, and most was operational by December 31, 1982, excluding MARS and S/URS (IV-41)--we will return to these two components of the MMIS system later. But, the PW Report seriously mis-characterizes some of MSGI's efforts in developing and maintaining some parts of the computer systems.

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* See MSGI's detailed response filed with the Auditor General for further information about MSGI's quality assurance activities.

Contrary to the PW Report's discussion regarding staffing levels, MSGI always staffed its computer operations appropriately. The constantly changing demands and unforeseen data processing problems that arose because of AHCCCS's short start-up time and shifting definitions, and the inadequacy of data furnished to MSGI, required MSGI to increase substantially the number of people it used to develop computer systems. It must be emphasized that most of the work done by MSGI's computer designers and programmers was in the area of system design, not routine maintenance or routine processing of data.*

Finally, the PW Report erroneously suggests that MSGI did not fully perform its duties to deliver two subsystems of the MMIS system (see PW Report at IV-39, IV-43, Appendix A, p. 2 of 8). As the PW Report notes (but then ignores) as to one of those subsystems, S/URS "development was delayed at the State's request during February-April, 1983" (IV-41). MSGI diligently arranged for the development and implementation of S/URS as soon as the State resolved its differences with HCFA over what kind of encounter data would be utilized to "drive" S/URS. Timely implementation of S/URS is simply not a problem that can be attributed to MSGI, but instead was the responsibility of the State executive branch, particularly Henry Foley and Sam Thurmond, both of whom held up S/URS development to pursue with HCFA their own theories of data collection and processing.**

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* See MSGI's detailed comments on file with the Auditor General regarding this point.

** See MSGI's detailed comments on file with the Auditor General for a fuller discussion of Messrs. Foley and Thurmond's digressions from HCFA requirements.

The development of the other subsystem at issue, MARS, was always a "backburner" item, and known to be so by all AHCCCS Directors, who urged MSGI to devote its computer software design resources elsewhere in an attempt to "fix" the numerous kinds of problems, including, most importantly, eligibility data problems AHCCCS faced (see, e.g., the PW Report discussion at IV-29 through IV-33): eligibility data problems impaired how or if people would be treated and was therefore of critical importance to the AHCCCS patient, and not just to HCFA.

It is the State's responsibility, not MSGI's, to obtain federal certification for an MMIS system. MSGI is not aware of any facts that preclude the State of Arizona from obtaining HCFA consideration for some form of retroactive adjustment to Federal Financial Participation (FFP), once Arizona determines to seek federal certification of the MMIS system (which we believe Arizona has yet to do).

Finally, the PW Report conjectures without discussion (at I-6) that a functioning MARS could have somehow alerted State officials to the magnitude of the so-called "budget crisis" associated with overutilization of AHCCCS fee-for-service provisions. First, the fee-for-service problem arose out of legislative changes which occurred in the fall of 1983. Second, by December, 1983, both the State AHCCCS Division and the Governor <u>did</u> know that there were alarmingly high levels of fee-for-service usage (and payment), though neither Governor Babbitt nor Department of Health Services personnel knew the exact magnitude of the problem. Greg Fahey testified that he believed his staff at AHCCCS was remiss in not discovering the problem sooner and reporting it to him, since they <u>did</u> have data available to them pointing up dramatic increases in fee-for-service usage after October,

1983. Nevertheless, both Mr. Fahey and the Governor decided not to do anything about the problem once they discovered it in December, 1983, until they had quantified it, which occurred in February, 1984. It is difficult to speculate what, if anything, could have been done differently had MARS been operational, since the fee-for-service usage problem was inherent in the Legislatively-created statute, and the magnitude of the problem was, if not immediately quantifiable, at least known in gross terms by the Governor and DHS within two months after the new law went into effect.

The solution to the problem was to change the statute, and such a change was not made until several months after the Governor chose to inform the Legislature. Had he done that two months earlier, perhaps the magnitude of the problem would not have grown. In any event, it was not MARS (or lack of it) that caused or even aggravated the problem; rather the problem was created by the Legislature's decision to allow the sort of fee-for-service provision it did, and the decision of the Governor and the State AHCCCS Director not to inform the Legislature immediately just how serious a drain this was on AHCCCS funds.

(3) Proposed Contract Modification 3

For nine months MSGI attempted to get the State to modify the contract to reflect work that MSGI had performed, but which had not been "documented" in the formal contract documents. For nine months, the State procrastinated, throughout the summer, fall and winter of 1983-84, and failed to conduct meaningful negotiations. At one point, the State promised to resolve the issue by November, 1983, then failed to meet that commitment. The new work and associated costs covered by "Mod 3" are described fully in MSGI's detailed comments on file with the Auditor General. Here it is enough

to say that the PW Report's classification of $1.5 million as "new work," $1.1 million as "unresolved," and $600,000 as "original work" is sheer guesswork about what would have been new work under detailed workplans, had there been detailed workplans.

The State AHCCCS Director, Greg Fahey, would have approved changes in the written contract baseline of approximately $2,445,588 as "new work," under Mod 3 had not the Attorney General intervened. Again, it is an unfortunate but inescapable fact that there was no adequate contract documentation precisely because the State never adopted detailed workplans, budgets, and contract modifications. As previously noted, for Price Waterhouse to hypothesize "baselines" as if such documents existed, and then try to work from these hypothetical baselines is unrealistic, albeit well intentioned. We believe that, at a minimum, $2.445 million, which the AHCCCS Director himself would have approved but for the Attorney General's interference, should be classified clearly as "new work," and the balance of MSGI's claim for $3.276 million under Mod 3 classified as "unresolved," even by the standards used by Price Waterhouse. Of course, we believe that the entire $3.276 million Mod 3 claim is supportable as new work, and as a cost incurred under the contract.

Conclusion

We do not doubt the competence, sincerity, or impartiality of Price Waterhouse in its conduct of this audit, and we agree with much of what is in the audit. We do, however, in large part doubt the realism of the audit's simply ignoring the messy reality of the contract under discussion:* a contract

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* See PW Report at IV-9: "The AHCCCS Administrator's contract was a cost reimbursable type . . . . [But] it . . . did not clarify the specific tasks to

never "definitized" by workplans, budgets, or contract amendments all due to the State's failure to perform its obligations. Absent such "definitization," it is only realistic to analyze this contract as it was: a cost reimbursement contract, with duties, costs, and baselines, all shifting from day to day at the discretion of the AHCCCS Director.

Despite all its problems, AHCCCS, which MSGI helped create, was on its way to becoming truly successful while MSGI was Administrator; AHCCCS was meeting the Legislature's goals of providing effective, high-quality, cost-effective medical care to a large number of Arizona citizens who could not afford such care on their own. Despite all the recognized difficulties, AHCCCS was implemented by MSGI quickly, with a minimum of trouble and a maximum of benefit to the patient (though not to the Administrator). We take some pride in this substantial accomplishment, which Governor Babbitt now claims for Arizona State government as he discusses AHCCCS outside this State. We regret that our relationship with that same Arizona State government has been so disappointing and unhappy.

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be accomplished and associated levels of resources or the performance measures/ incentives to be used beyond the first few months. These critical items were supposed to be identified later in detailed workplans developed and negotiated annually."

APPENDIX G

Attorney General
1275 WEST WASHINGTON
Phoenix, Arizona 85007
Robert K. Corbin

February 4, 1985

Mr. Douglas R. Norton
Auditor General, State of Arizona
111 West Monroe, Suite 600
Phoenix, Arizona 85003

Re: State of Arizona's Comments Regarding AHCCCS Administration Performance Audit Final Report Draft, January 25, 1985

Dear Mr. Norton:

Set forth below is a summary of the State's comments regarding the AHCCCS Administration Performance Audit Final Report Draft, dated January 25, 1985. Because of the page limitations that your office has imposed, it is not possible to articulate the shortcomings of the audit report in detail. The discussion below summarizes and reiterates many of the comments provided to you in advance of and at the audit exit conference on January 16, 1985. The State's comments with respect to the audit report fall into several general categories.

First, and of most consequence, the report is based upon unsubstantiated and erroneous legal assumptions and conclusions that are contrary to the contract between MSGI, as the former AHCCCS Administrator, and the State of Arizona. Although the report concedes that a key area it was retained to address was whether MSGI's billing to the State were "appropriate in terms of the contract", the approach taken in the report disregards express provisions of the contract as interpreted under controlling principles of Arizona law. Instead, the draft report improperly applies to the AHCCCS Administrator Contract those legal and cost principles pertinent to federal cost reimbursement contracts (for example, Department of Defense contracts for aircraft construction).

Second, with respect to much of the work that MSGI alleged to be "new work" for which it should be paid by the State, the report finds that MSGI's "guesstimates" of these amounts allegedly incurred either "could not be subjected to audit verification" or "were not sufficiently supported to permit audit verification" by Price Waterhouse. Nevertheless, the report includes these unverifiable amounts in its analysis and determination of baseline costs under the contract and the contract's cost limitations.

Third, in many instances the report appears to give undue emphasis and praise to MSGI for some areas of performance while under-emphasizing the many important areas where MSGI failed to perform. For example, the report finds that MSGI failed to perform some key tasks and that those tasks that were not performed had a significant impact on MSGI's ability to manage and operate the AHCCCS program. The report neglects to note, however, that the State is named as a defendant in a $25 millon lawsuit filed by hospitals throughout the State which claim, in part, that MSGI failed to audit and monitor the financial solvency of provider groups in the AHCCCS program. Moreover, the State may lose up to $2 million of federal financial participation funds as a result of MSGI's failure to deliver a federally certifiable MMIS for the AHCCCS program.

Fourth, although the draft report purports to analyze and value those tasks which MSGI alleges were "new work" for which it should be reimbursed, the report fails to analyze or in any way to evaluate those costs associated with tasks that MSGI was relieved of performing, as well as contract deliverables that MSGI utterly and simply failed to perform.

Finally, several of the key findings and conclusions in the report lack adequate factual support based on the record developing in the ongoing litigation between MSGI and the State. Indeed, several of the findings and conclusions in the report are squarely at odds with and expressly refuted by documentary evidence and testimony in connection with the litigation. The findings and conclusions set forth in the audit report are to be the result of Price Waterhouse's review of only a limited portion of the documentary evidence relevant to MSGI's tenure as AHCCCS Administrator. Several of the findings and conclusions are refuted by the sworn testimony of the persons directly involved in the matters described in the audit report. The State and its attorneys were available at all times during the audit to provide documentation or to discuss the issues involved. The auditors elected to meet with the State's attorneys on only one occasion, and even that meeting was very brief.

Each of these areas is discussed more fully below.

I. The Audit Report Makes Unwarranted and Unsubstantiated Legal Interpretations Regarding the Contract

The express purpose of the Price Waterhouse audit was "to conduct a performance audit of administrative and financial issues related to MSGI's tenure as AHCCCS Administrator".

Notwithstanding this limited scope, the audit report is premised on several unsupported and improper legal assumptions that are contrary to the governing provisions of the Contract as interpreted under controlling principles of Arizona law.

At the outset the audit report represents that the audit was conducted in accordance with the United State's General Accounting Offices ("GAO") Standards for Audit of Government Organizations Programs, Activities and Functions". Section C of the GAO standards requires that auditors conduct a careful review of applicable laws and regulations, and specifically recommends that the auditors "consult with legal counsel when questions arise concerning the interpretation of law and regulations". This guideline was not followed with respect to this critical aspect of the audit report,* even though many of the report's findings and conclusions are premised upon the auditors' assumptions and opinions regarding the nature and interpretation of the AHCCCS Administrator Contract.

The fundamental flaw in the report is that its findings and conclusions are not based on a reasonable legal interpretation of the four corners of the parties' contract in accorance with Arizona law. The report makes the unsupported legal assumption that federal law and custom applies to the State's "cost reimbursement type" contract and ignores the express provisions of the contract documents in making findings regarding the allowability of costs and MSGI's performance.

Underlying much of the audit report's findings and conclusions is the legal determination that the term "cost reimbursement type contract" as used in the State of Arizona's Request for Proposals for the AHCCCS Administrator Contract denoted a particular and special form of contract with all of the attendant provisions as defined and utilized by the federal government in its contracts. There is no legal or factual basis to support the auditors' application of law relevant to federal cost reimbursement contracts to the AHCCCS Administrator

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*/ It was not until the audit exit conference in mid-January 1985 that the auditors discussed the legal assumptions that permeate the audit report with counsel for the State. By this late date, of course, a draft report had been prepared, the field work had been completed, and funds allocated for the audit had been consumed. The auditors' post-audit discussion with counsel for MSGI and the State during the course of the audit conference is not sufficient to fulfill the GAO guidelines.

Contract. The State's Contract was procured pursuant to the competitive bidding statutes of the State of Arizona. Moreover, the Administrator Contract expressly states that it "shall be construed in accordance with Arizona law." General Provisions, Paragraph 2(b). General Provisions Paragraph 2(b) also states that "any action thereunder shall be brought in an appropriate Court of the State of Arizona . . . . " The lawsuit arising out of the contract was filed and is pending in the State of Arizona Superior Court precisely because the contract involves only questions of State law and not federal questions requiring resolution by a federal court.

The legal interpretation, meaning and resulting contract implications that the audit report assumes for the term "cost reimbursement" is contrary to the parties' agreement as expressed in the contract documents, and ignores controlling principles of Arizona law relating to competitively bid public contracts. The only possible basis for several of the report's approach, findings and conclusions (such as the failure to evaluate and offset the value of MSGI's failure to deliver certain contract deliverables, the acceptance of McDonnell Douglas Corporation's (MDC) commercial computer rates, or the acceptance of indirect costs from MDC's and MSGI's New York operations), is to assume that federal law (including federal statutes, rules and regulations) applies to the State's competitively bid contract. The legal and cost principles that apply to Federal government contracts do not supercede the controlling contract law of Arizona regarding the contract between MSGI and the State.

There is no question that the contract between MSGI and the State for AHCCCS Administrator services was authorized only by and subject to the competitive bidding process. See A.R.S. §§ 36-2903.C; 41-1051 et seq. The Administrator Contract and the validity of any post-award agreements, if any, between MSGI and the State must be construed in accordance with the Arizona caselaw limitations on public competitive bid contracts. Under Arizona caselaw, a significant limitation on public competitively-bid contracts is that material and substantial changes or modifications are prohibited.*

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*/ In 1923, the Arizona Supreme Court in Greenlee County v. Webster, 15 Ariz. 183, 215 P. 161 (1923), invalidated a number of significant post-award modifications by the county in a construction contract as violative of the public policy underlying the competitive bidding laws. In Greenlee County the (footnote continued on next page).)

The audit report also fails to consider Arizona law with regard to limitations on the authority and limits on the power of public officials. Although the audit report acknowledges that there are questions regarding the power of

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* (Continued)

contract expressly authorized contract modifications and cost increases for alterations in the location, quantity and extent of work to be performed. The contract also authorized modifications and increases to the bid amount for extra, new and unforseen work requested by the County and provided that the contract would not be invalidated by such changes. The contract provided that extra or new work would be compensated by cost plus 15%.

The Court initially recognized that contract provisions authorizing alterations to plans and specifications are common to provide flexibility to make necessary changes that cannot be anticipated in advance. The Court made it very clear, however, that these contract provisions could authorize only incidental changes and could not authorize material an substantial departures from the scope of work that was originally contemplated and proposed:

> Changes that radically extend the amount of work, or that eliminate large portions of the work, or that greatly increase the cost thereof, are usually not included within the provision allowing alterations or modifications of the plans or specifications.
>
> * * *
>
> It may be seriously doubted whether even the board of supervisors could order changes or alterations in the location of the roadbed as radical, thereby increasing the cost to the county in so great a sum, unless the price to be paid for such excess was fixed in competitive bids. 215 P.2d at 164 (emphasis added).

The public policy articulated by the Court in Greenlee County which prohibits substantial and material changes to public competitive bid contracts is still the law in Arizona. See Chicago Title Insurance Company v. Renaissance Homes Ltd., 139 Ariz. 494, 679 P.2d 517 (1983).

State officials to authorize additional work by MSGI, the report nevertheless evaluates MSGI's claimed "new work" and includes it in the report's analysis of overall contract value and baseline costs.*

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*/ The law of Arizona is clear that ". . . persons dealing with public officer's are bound, at their peril, to know the extent and limits of their power and that no right can be acquired except that predicated upon authorized acts of such officers." Pinal County v. K. Pomeroy, 60 Ariz. 448, 455, 139 P.2d 451, 454-55 (1943). The general law regarding limitations on the authority of public officials is clear that public officers have only such power and authority as are clearly conferred by law or necessarily implied. The rationale underlying this rule of law is as follows:

> Express statutory powers cannot be broadened by implication, and usage and custom will not serve to enlarge such power and authority.
>
> While acquiescence in an officer's acts may persuasively point in doubtful cases to the existence of a power, it does not confer power. An officer may not do everything not forbidden in advance by some legislative act.
>
> Where the law creates an office, one holding such office has no authority to perform any act not legitimately within the scope of such authority. The acts of public officers are binding only when they act within the scope of their authority, statutes delegating powers to public officers must be strictly construed. All persons dealing with public officers must inform themselves as to their authority and are bound at their peril, to ascertain and know the extent and limits of their authority. Acts which are within the apparent, but excess of the actual, authority of officers will not bind the government which they represent unless ratified by it. Public officers ordinarily may ratify such acts as they could have authorized, but the void acts of a public officer cannot be ratified. (emphasis added). 67 C.J.S. Officers § 190 at 633, 634.

The only authority that State officers had to pay and contract with MSGI as the administrator was pursuant to the terms of the competitively bid contract. By contracting with the State, MSGI was bound at its peril to know the extent and limitations of the law relating to competitive bid contracts in Arizona and the authority of public officers. In participating in the competitive bid process, MSGI was legally bound to perform the functions of the administrator pursuant to the terms and price set forth in its bid proposal and any subsequent modifications by the parties are subject to the limitations prescribed by Arizona law. Neither MSGI nor State officers ever had binding legal authority to contract in a manner not authorized by or inconsistent with the Contract as construed under Arizona law.

The audit report does not reflect a contract interpretation based upon and limited to the Administrator Contract provisions and controlling principles of Arizona law. The report makes no findings regarding the propriety of MSGI's costs in excess of 100% as required by the contract. Specifically, the parties agreed to reimbursement up to an additional 25% of the yearly authorized budget to allow flexibility for cost overruns. It was agreed, however, that all costs between 100% and the total of 125% in each year could reflect direct costs only. Par. 4(a) Special provisions. The report makes no findings with respect to whether the amounts in excess of 100% of the authorized yearly baseline are direct costs only, or whether they include indirect costs such as the 3% G & A expense to MDC and other indirect cost formulas.

There is no basis to justify the report's failure to value and offset MSGI's non-performance of functions as contemplated in MSGI's technical proposal and the amount of its public bid, <u>except</u> pursuant to federal law and all of its attendant provisions governing federal cost reimbursement contracts. In fact, the contract expressly contemplates that the State has the right to monetary damages for MSGI's non-performance of the proposed administrator services including, but not limited to, performance failures, costs of transition and administrative expenses in excess of MSGI's public bid. For example, Paragraph 12, Special Provisions, contemplates damages in excess of the performance bond for MSGI default of performance; Paragraph 12(d), General Provisions requires MSGI to pay administrator costs in excess of the public bid; Paragraph 12(g), General Provisions, authorizes the State all rights and remedies provided by law or under the contract. In addition, the Contract provides that the State will not be liable for administrator services that are not performed. <u>See</u>, Paragraph 4(h) which provides for the reduction in costs for tasks that are not performed.

Similarly, the report's conclusions regarding MSGI and MDC's commercial computer rates which reflect corporate algorithms and cost multipliers is clearly contrary to express provisions of the contract and can be justified only in certain limited instances in cost reimbursement contracting under federal law. The Contract, and specifically MSGI's Cost and Technical Proposals, are clear that MSGI could charge the State only for direct costs for work performed under the Contract regardless of location. There is no exception for computer costs. In fact, the Cost Proposal and State's RFP clearly contemplate that computer usage will be billed as direct charges only without the addition of corporate overhead and other indirect expenses. The report's conclusion allowing MSGI and MDC's commercial computer rates and formulas is contrary to the terms of MSGI's own bid proposal and controlling principles of Arizona law requiring all costs and cost methods to be identified in the competitive bid process.

The audit report gives effect to selected provisions of the contract while ignoring other related provisions. One example is the report's apparent determination that the contract authorizes the parties to modify the contract for "new" or extra work and to increase the baseline costs. The report makes no reference, however, to the same Contract provision that contemplates reductions in the baseline for tasks that are deleted and removed from the responsibility of the administrator, such as the collection of copremiums which was repealed by the State Legislature in the spring of 1983. Paragraph 4(h) of the Special Provisions. This provision of the contract clearly contemplates and requires the downward adjustments to the authorized contract value for administrator tasks that are not performed, regardless of the reason.

The audit report also ignores -- without explanation -- controlling provisions of the Contract in the report's analysis of MSGI's proposed Contract Modification #3. Notwithstanding the legal question as to the scope of Paragraph 4(h) of the Special Provisions, construed in light of the Arizona competitive bidding laws, and the validity of "new tasks" that were in fact agreed upon by the parties, there are serious questions as to the propriety of MSGI's proposed Modification #3 work as "new tasks" under the terms of the contract. The contract clearly authorizes the parties to modify the contract in writing for "new tasks" subject to the inherent limitations of a competitive bid contract. Paragraph 4(h), Special Provisions. Paragraph 15 of the General Provisions expressly prohibits the Contractor from undertaking "new tasks" in the absence of the written approval of the State. Moreover, MSGI's Technical Proposal refers to the use of a written transmittal

process to "serve as the only formal mechanism by which DHS and MSGI will agree to commit themselves". (MSGI Technical Proposal, at VIII-A-2.)

There is no evidence of written authorization or agreement by the State for MSGI to undertake the items in Modification #3 as new tasks. Nor is there any evidence that MSGI representatives ever mentioned, no less sought agreement, that such tasks would result in increased costs to the State. These tasks stand in direct contrast to the added functions described in Modifications #1 and #2 which involved detailed discussion and documentation reflecting the parties' agreement and the increased costs associated with each item as contemplated by the Contract. The significance of the documented agreements and transmittals for Modifications #1 and #2 is that most of the proposed Modification #3 items were undertaken by MSGI during the same time period as Modifications #1 and #2, yet were not proposed to the State as the subject of contract modification until late October, 1983 -- almost one year after they were undertaken and only after serious questions were raised as to the validity of MSGI's monthly billings to the State.*

The Contract requires the parties <u>to agree</u> upon the scope and costs of new tasks prior to any undertaking by MSGI. This did <u>not</u> occur for Modification #3 tasks. This prior agreement and approval requirement is necessary to serve as the mechanism to resolve ambiguities or differences between the parties as to the scope of work contemplated in the original bid proposal. The parties' compliance with the Contract provisions as to millions of dollars of new tasks in Modifications #1 and #2 but not Modification #3 raises serious doubt as to whether MSGI itself viewed these items as new tasks at the time they were undertaken. MSGI's own treatment of the Modification 3 items is most telling in determining whether these items should properly be construed as legitimate and authorized additions to the contract in contrast to original contract deliverables.

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*/ The record is clear that the State and MSGI were involved in several of the proposed Modification #3 tasks on a regular basis for months during the contract term and that MSGI never gave notice that it claimed these items were "new tasks" with increased costs under the contract. (See Deposition of Greg Fahey at 3894-3895, 3909-3910, 3912-14, 3922, 3996-3997, 4008, 4110-11).

If the State and MSGI were unable to agree upon particular itemms, the contract authorized preservation and resolution of the parties' differences and claims, pursuant to the Disputes Clause in Paragraph 5 of the General Provisions. In this case, MSGI failed to raise the Modification #3 items as "new tasks" with added costs until long after the tasks were undertaken, management personnel of both parties had changed and serious disputes existed as to the propriety of MSGI's billings. If MSGI did not perceive these tasks as "new tasks" with identifiable increased costs when they were undertaken, there is certainly no basis for the audit report's inclusion of such costs in the contract value and baseline costs.

The audit report's selective approach to contract analysis is further demonstrated by the report's finding that the parties' failure to agree upon tasks in workplans "made definition of what was in or outside of MSGI's scope of work very difficult." Audit Report at I-4. The report also states: "The State also gave MSGI numerous directives altering MSGI's procedures or changing activities without relating these to the original budget or providing guidance as to what should be de-emphasized or not done." This finding misconstrues and ignores the contemplation of the parties as set forth in the Contract. The State did not have the burden to delineate the meaning and deliverables set forth in MSGI's Technical Proposal, which constituted part of the Contract documents. The Contract clearly prohibits MSGI from undertaking new tasks without written State authorization. General Provisions, ¶ 15(b). Moreover, Paragraph 4(h) of the Special Provisions contemplate agreement of the parties as a condition of additions to the Contract. Similarly, Paragraph 5 of the Special Provisions expressly envisions the possibility of the parties lack of agreement to a workplan, in which case the contractor is required to continue performance in accordance with the contract documents and the direction of the Project Director. The workplan could not legally be used as a vehicle to materially change the terms of the competitive bid contract.

The audit report also improperly fails to value and offset the State's claims against MSGI for its performance failures throughout the contract term despite detailed findings of performance failures in the Contract Compliance Matrix appended to the report. As a result, the report's conclusions relating to the propriety of MSGI's billings are at best incomplete.

II. The Report's Treatment of Alleged "New Work" is superficial and Unsupported by the Factual Record.

The audit report includes the contract value and baseline costs those amounts that MSGI contends related to work performed in connection with proposed Modification #3. The inclusion of these amounts is particularly puzzling in light of the report's finding that these costs "were not sufficiently supported to permit audit verification." Audit Report at III-23. Notwithstanding the absence of adequate documentation to permit audit verification of the validity or reasonableness of these changes billed by MSGI to the State, the audit report adopts MSGI's position and includes the Modification #3 amounts in its analysis of the contract value and baseline costs.

The evidentiary record is clear that the State did not authorize these increased costs for Year 2 of the Contract. See Deposition of Greg Fahey, former State AHCCCS Project Director at pages 3908, 3910, and 3923. Moreover, the audit report fails to consider that many of these costs were one time costs or involved development costs that should have been reduced for the operational phases, even if they had been authorized.

The record is equally clear that MSGI unilaterally and voluntarily decided to undertake many tasks without State knowledge or approval. For example, former AHCCCS Project Director, Greg Fahey, testified that he was not aware that MSGI was operating a Tucson office until his receipt of MSGI's proposed workplan for Year 2 at the end of October, 1983. Similarly, Mr. Sam Thurmond, Governor Babbitt's appointee, testified that MSGI made the unilateral and voluntary decision to subcontract with Mr. Murray Goldman for the preparation of a "White Paper" on encounter data and that he was not involved in any way in that decision. In fact, the audit report allows approximately $1.5 million of "new work" in Operational Year One on the basis that the work was directed although not officially authorized by the State, or initiated by MSGI "in the responsible performance of its duties as AHCCCS administrator." Again, this is contrary to the Contract's provisions. There is no basis for the audit team to stand in the shoes of the parties and to retroactively authorize contract changes.

The audit report's analysis of Modification #3 ignores express provisions of the Contract. If, in fact, additional work was requested by the State, the Administrator had the responsibility as a prudent manager and in accordance with the Contract to submit to the State in writing a scope of work change that delineated what work was originally contemplated and what constituted "new" work, to assign value to this new work and to request an increase in the baseline for the new work. See General Provisions, Paragraph 15(b).

A substantial deficiency in the report is the superficial assessment of the amount of "new work" that MSGI contends it performed. Audit Report at IV-23. Although the report concedes that "it was not possible . . . to reconstruct or verify the costs incurred on the Modification #3 tasks," the report purports to assess the amount of "new work" based essentially the auditors' perceptions of internal memoranda that attempted to approximate the value of the Modification #3 tasks. Apart from obviously superficial methodology, the report's approach of "sitting as judge and jury" on this issue in the litigation is inappropriate and, again, inconsistent with the facts.

Contrary to the report's factual premise, the evidence is clear that State AHCCCS personnel became aware of MSGI's cost overrun and the "verbal modification" issues in the Spring of 1983, the earliest point in time that one reasonably could identify and detect the problem based on MSGI's billings to the State. In response to State inquiries regarding MSGI's billings in excess of the authorized contract budget, new management at MSGI assured the State's representatives that <u>former</u> State officials had, in fact, verbally modified the contract by authorizing "new tasks" as defined in the Contract. The State's new managment relied upon these representations and continued payment to MSGI, subject to audit, and in reasonable reliance upon MSGI to present cost documentation to substantiate those alleged verbal modifications so that formal contract amendments could be prepared. MSGI not only failed to provide any evidence of such agreements or authorization of such modifications (as required by Paragraph 15(b) of the General Provisions), but MSGI was plainly unable to provide State officials with reliable financial and accounting evidence to substantiate MSGI's alleged costs associated with these purported modifications. (<u>See</u> Greg Fahey Deposition at 3654-57; 3724-25; 3791; 4067-68). In light of these facts, there is no factual basis for the report's findings and conclusions.

III. The Report Underemphasizes MSGI's Serious Performance Failures and Fails to Value Costs Relating to Contract Deliverables that MSGI Failed to Perform

Throughout the report there is undue emphasis placed on those limited areas where MSGI performed and entirely insufficient emphasis on the many key tasks that MSGI failed to perform. For example, in the Executive Summary of the report at page I-5 it states that "MSGI appears to have completed many of the responsibilities required under the Administrator's contract, but some key tasks were not performed well." In fact, however, several key tasks were not performed at all, as the discussion in Section IV of the report points out. In like vein, although the report comments that the "tasks that were not performed had a significant impact on MSGI's ability to manage and operate the AHCCCS program," the report fails to observe that MSGI's performance failures also had a significant negative impact on the State's ability to administer the program and on the State's monitoring and contract management functions with regard to MSGI.

Throughout the report there are such comments that de-emphasize MSGI's shortcomings and purport to excuse MSGI's failure to deliver that which it had contracted to provide the State. Another apparent example is the report's observation that in preparing its bid proposals MSGI utilized "very optimistically low proposal staffing levels." Similarly, the report emphasizes the "experimental" nature of the program and the short time frame for start-up as additional circumstances that hampered MSGI's ability to perform.

Although the report notes these matters, it fails to observe that all companies -- including MSGI -- that submittted proposals in response to the State's RFP in the Spring of 1983 were fully aware of the October 1 date for start-up of the program. Indeed, MSGI's strongest selling point was that MSGI already had a federally certified MMIS that could be adapted to the AHCCCS program needs with only minimal modifications. That, of course, proved to be untrue. Moreover, MSGI represented in its Technical Proposal that it had substantial expertise in the area of health care delivery systems and expressly stated that MSGI "has carefully reviewed and analyzed the requirements of the Arizona Health Care Cost Containment System (AHCCCS)" and was familiar with the requirements of the program. MSGI's representations in its Technical and Cost Proposals (which form part of the contract between MSGI and the State of Arizona) were much more than simply "optimistically low." MSGI's proposals were nothing short of a "low ball" bid to obtain the contract; MSGI's proposals did not build in all costs that MSGI reasonably should have anticipated to incur in providing the deliverables set

forth in the Contract. Thus, the report's suggestion that MSGI's proposal assumed a minimal number of staff required to perform as Administrator is misleading.

Similarly, throughout the report it is stated that the contract documents failed to define and specify the contracted requirements and deliverables of the Administrator. This statement ignores that the MSGI Technical and Cost Proposals are part of the Contract. Moreover, the Contract documents were not so unreasonably vague as to preclude reasonable definition and specification of the Contract deliverables and requirements of MSGI. Indeed, from its examination of the Contract documents, the auditor's were able to prepare a twenty page, single-spaced list of Contract deliverables set forth in the RFP, Cost and Technical proposals and the Contract (General and Special Provisions). Viewed in this light, statements in the report such as the State never firmly established a base set of tasks simply are not accurate. Moreover, the audit report ignores MSGI's self-imposed commitment to perform certain tasks (as set forth at Section VII.B of the Technical Proposal) such as "Define the AHCCCS program" (VII.B.1-9); "obtain DHS AHCCCS program definition approval" (VII.B.1-11); "Detail design - CEDPS" (VII.B.4-5). All of these tasks relate to the formulation and definition by MSGI of contract deliverables.

IV. The Report is Based on Facts That Are Inconsistent with the Evidentiary Record

A problem that permeates the entire report is that many of the findings and conclusions lack adequate factual support and are inconsistent with the evidentiary record developing in the litigation between MSGI and the State of Arizona. The audit field work which forms the basis for the report consisted principally of a review of only a limited portion of the documents pertinent to MSGI's performance as AHCCCS Administrator and to the State's monitoring and contract management functions. The result is that the report's findings and conclusions reflect only piecemeal information regarding the issues.

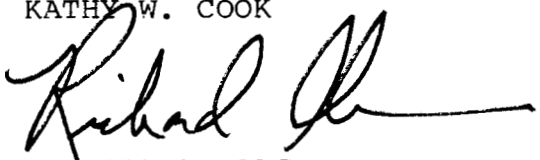
The report attempts to side-step this deficiency by suggesting that "new facts may emerge which were not available to [the] project team during its fact finding work." Audit Report at I-2. This comment ignores the fact that State representatives were available at all times during the audit filed work to provide documentation or generally to discuss any aspect of the audit. The audit team elected to meet briefly with the State's attorneys on only one occasion.

Conclusion

For the reasons set forth above, we believe there are serious problems, deficiencies and shortcomings in the AHCCCS Administration Performance Audit Final Report Draft. Several of the key findings and conclusions in the report lack adequate factual support. Moreover, the entire approach taken by the report hinges on unsubstantiated and erroneous legal assumptions and conclusions that are contrary to the terms of the AHCCCS Administrator Contract.

Very truly yours,

KATHY W. COOK



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