The original documents are located in Box 22, folder "Medicare Administration Report (2)" of the James M. Cannon Files at the Gerald R. Ford Presidential Library.

It is very difficult to make management decisions without reliable cost data. This is true for HEW representatives but also for the carriers if they are to properly control costs.

It is recommended that HEW consider developing criteria and cost accounting standards as a guide to the industry. Consideration should be given to utilizing the Cost Accounting Standards (CAS) that are being developed for the defense industry by the Cost Accounting Standards Board, of which the Comptroller General is Chairman.1/

E. The Need for Incentives for Higher Carrier Performance

The present system of private carrier utilization for the administration of Medicare involves territorial monopoly. The exclusion of all potential competitors from a given geographical area runs directly counter to the philosophy underlying our "free enterprise" system, namely, that Government power should be brought to bear to create an environment within which the forces of free competition can properly operate. Here Government has done that which would be unlawful for private organizations to do, namely, to "divide up the market" on a geographical basis.

Ideally, the system of territorial monopoly would be eliminated, and we discuss below some proposals for impinging on the concept of

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1/ Needless to say, encouraging uniform cost accounting does not mean encouraging carriers toward developing uniform costs or cost estimates. Obviously, collaboration among carriers should not extend to pricing policies and practices.

territorial monopoly. Moreover, although (as stated at the outset) we have not studied issues involving the administration of a national health insurance program for the entire population, we are of the strong view that a system of territorial monopoly should be avoided.

Realistically speaking, in the time available and with the resources available we have not been able to identify and resolve the various obstacles to removing the territorial allocations. Some of the considerations which must be examined and dealt with are these:

(1) Is there any real obstacle to a complete sharing among carriers of data accumulated as to particular beneficiaries and providers of service?

(2) Is there any force to the argument that closer relationships with the medical profession are facilitated by a one-carrier system as distinct from a multi-carrier system?

(3) Would it be feasible for the Government to introduce a high element of "price" competition (viewing the Government as the consumer) by permitting only the carriers with the highest performance ratings to compete in other territories?

(4) If the providers of service are viewed as the "consumers", would their "consumer preference" work against public policy, i.e., in favor of the carriers which do the poorest job of utilization review?

We recommend that the Secretary (a) direct the Commissioner of Social Security to undertake, internally or with outside consultants,

a point-by-point analysis of the alleged obstacles to removal of territorial boundaries; and (b) develop a plan for opening up a single territory, on an experimental basis, for open competition among carriers--such as an area in which a contract termination is being considered because of poor performance. The lessons to be learned from an experiment in one territory would be well worth the risks of failure.

Since we are not recommending a removal of the system of territorial monopoly or "exclusive franchises" at this time, we shall now proceed to a consideration of ways of improving on the present system. We strongly believe that a system of exclusive franchising, with each franchise being protected from competition in the industry, requires building other incentives into the system. It would be against all experience and human nature to expect the most effective performance from persons or firms whose income or status will remain unchanged even if their performance is substandard.

A number of carriers have stated that the present incentives are adequate. While we recognize that some carriers are highly motivated by such factors as HEW's publication of cost and other data for all carriers, or by the desire to have a "good name" in the community as an aid to the sale of health insurance to non-Medicare groups and individuals, we have concluded that it is essential to the continued success of private carrier administration of Medicare that stronger incentives for effective performance be constructed.

F. Contract Termination as an Incentive to Performance

The present contracts between the Secretary and the carriers are for initial terms of one year and are automatically renewed for successive periods of one year "unless the Carrier or the Secretary gives written notice of intention not to renew the agreement at least 90 days before the end of the current period."

Accordingly, the carrier contracts are, to all intents and purposes, only one-year contracts.

In addition, the Secretary may terminate the agreement at any time (after reasonable notice and opportunity for hearing to the carrier) if the Secretary finds either that

> "(1) the Carrier has failed substantially to carry out this agreement, or
>
> (2) the Carrier is carrying out this agreement in a manner inconsistent with the efficient and effective administration of Part B of Title XVIII of the Act."

Our Committee has been advised that the carriers all wish to continue as participants in Part B. Accordingly, the threat of contract termination should be a meaningful incentive to performance.

We recommend that the Secretary's power to terminate carrier contracts be made into an effective incentive mechanism. The present roster of carriers and assigned territories cannot be viewed as immutable if the system of utilizing private carriers is to have validity from the viewpoint of public policy or viability from the viewpoint of efficient administration.

TERMINATION OF POOR CARRIERS

TERMINATION OF POOR CARRIERS POLICY

We recommend that HEW announce now a policy of non-renewal of contracts for those carriers consistently showing the poorest record of performance over the 3-year period commencing July 1, 1973--and then each year there might be additional carriers terminated on the basis of the performance of the prior 3 years.

Obviously this recommendation would not be meaningful unless progress is made rapidly on developing more refined performance criteria. Such an evaluation mechanism is an essential part of the Secretary's capacity to utilize the termination power.

We do not seek to specify how many of the lowest performers should be dropped--whether it might be as many as the lowest 10 percent as of July 1, 1976, and in each subsequent year, or a greater or lesser number, we cannot say. The ultimate decision may depend on where a significant dividing line appears in the array of carriers by an overall performance index.

Insofar as warning to carriers is concerned, we recommend that HEW announce a list of carriers in the "potential contract termination" category as early as July 1, 1975.

We fully recognize that the substitution of one carrier for another within a given geographical territory can be costly in terms of overall administrative costs and short-term inefficiencies resulting from the changeover. This consideration suggests that contracts would not be terminated for carriers where the cost or other performance criteria show insignificant deficiencies. On the

other hand, we are convinced that short-range disadvantages growing out of changeover problems are heavily outweighed by the long-range importance in not endowing any carrier with a permanent right to exercise a territorial monopoly. There have been several situations, in some cases initiated by the carriers themselves, in which one carrier has been replaced by another or where one carrier's geographical area has been reduced and the workload assimilated by another carrier with a contiguous geographical area.

G. Development of Other Incentives to Carrier Performance

BHI has attempted to develop various approaches to providing incentives to carriers, but none have been deemed sufficiently promising to put into effect. We consider now several possible approaches to encouraging more effective carrier performance.

(1) Reduced Governmental Controls

Running through the testimony of and correspondence from carrier representatives was a theme of dissatisfaction with the extent of Government controls over various aspects of carrier operations. As indicated below, we believe that some elements of Government control should be reduced on an "across-the-board" basis. The Committee believes that other elements of Government control might be removed on a selective basis for those carriers which have demonstrated a consistent record of superior performance.

REDUCTIONS OF GOVERNMENT ROLE AND CONTROLS

We recommend that a survey of all carriers be made to elicit proposals as to what regulatory or procedural requirements they would view as unnecessary to apply to carriers which consistently demonstrate their effectiveness and efficiency under such criteria of carrier performance as are developed. There may well be regulations which would be suitable for optional compliance, in the case of the best performing carriers.

Another suggestion as to a form of relief from close Government surveillance is that a carrier in the highest performance categories be exempt from the "continual presence" of the SSA's on-site representatives. 1/

1/ Staff paper, National Association of Blue Shield Plans.

In any event, we urge that a serious effort be made to exempt high performance carriers from the more extreme forms of Governmental surveillance and control.

(2) Financial Incentives and Rewards.

Until P.L. 92-603 of 1972 (H.R. 1) was enacted there was no opportunity for the Secretary to engage in incentive reimbursement types of arrangements with carriers. Section 222 of P.L. 92-603 now provides the Secretary with the authority to experiment with incentive reimbursement arrangements, including fixed price contracts, cost plus fixed fee or incentive fee, etc., to determine whether such arrangements would have the effect of inducing to the greatest degree effective, efficient and economical performance.

To date no incentive reimbursement arrangements have been entered into, although BHI is currently developing two demonstration projects. Each would involve an incentive performance fee. The first project would relate the performance fee to the three factors of cost, timeliness and quality of a carrier's claims workload related functions. The second project would provide performance incentives covering the carrier functions other than the first three, namely, professional relations, service departments, financeial, accounting, statistical, general and administrative operations. BHI hopes to have several incentive reimbursement contract demonstration projects in effect during the next fiscal year (commencing July 1974).

This progress is commendable, but we believe that still greater effort should be made to develop such plans.

It would seem, for example, that a flat fee per claim processed would have considerable appeal to those carriers which believed they could work further to reduce costs as they gain experience. Presumably, the flat fee would have to be renegotiated from time to time. It appears that BHI has not explored this possibly significant approach. Its significance is heightened by its possible use in soliciting bids by carriers which might wish to take on a territory with respect to which a carrier contract has been terminated. In other words, if carriers were asked to submit bids on the basis of a flat fee per claim processed, there would be the beginnings of one important area of competition among carriers.

We recommend that HEW give top priority to the formulation of further incentive reimbursement plans and that they be tested.

If financial incentives based on reimbursement to the carriers do not prove feasible, an alternative form of reward might be cash bonuses to executive and employees of the carrier who contribute significantly to the high performance of the carrier in Medicare. The designation of the particular recipients and the relative amounts to be awarded to particular individuals could be left to the carrier. A very small amount of Federal funds might go a long way in helping to assure top carrier performance.

(3) Reassignment of Segments of the Claims Workload

As indicated above, we have not made a recommendation for the removal of geographic monopolies for the assigned carriers. However, we do not believe a carrier should expect to continue to administer the entire assigned area if it cannot demonstrate the ability to perform satisfactorily.

We recommend, therefore, that BHI seriously consider the possibility of reassignment of portions of the claims processing workload of those carriers which are demonstrating poor performance--not so poor as to require total contract termination, but sufficiently poor as to call for some remedial action.

One possibility would be to reassign geographical segments, such as transferring the claims within a county which borders on another territory to the carrier which services that second territory. BHI has on several occasions realigned geographical areas of service to bring about greater balance of workloads and to provide improved services to beneficiaries, physicians, and other suppliers of services. In 1969, Occidental Life Insurance Company was assigned responsibility for 7 counties serviced by California Blue Shield, in addition to its original workload, lightening the workload of California Blue Shield by 20%. Similarly, 4 of 5 counties serviced by Illinois Medical Service were reassigned to Continental Casualty Company which had responsibility for the remainder of the State of Illinois. IMS retained 85% of their workload while Continental Casualty was able to absorb a 20% increase in workload.

Based on the experiences in these reassignments of geographical responsibilities, we believe BHI should make greater use of its authority to partially terminate or transfer workloads as a means of encouraging more effective carrier performance.

A second possibility, which might require a statutory change, would be to provide that all doctors commencing practice after a specified date within the assigned territory should process their claims with a second carrier rather than the poor-performance carrier.

We recommend that BHI be asked to report to the Secretary within one year as to the feasibility of using partial transfers of workload as means of spurring better carrier performance.

(4) Wider Dissemination of Results of Carrier Performance

At the present time the records of carrier performance are delivered essentially only to the carriers themselves, although BHI states that the reports are "disclosable to the public upon request." The Annual Contractor Evaluation Report with respect to a particular carrier is delivered only to that carrier.

We recommend that, at least annually, the results of carrier performance be published in the Federal Register with a customary release through the regular public information channels of HEW. This dissemination of vital public information would, we believe, go far toward compelling carriers to re-examine their Medicare performance if they are lagging.

Moreover, it would seem reasonable that each carrier should have available to it as a routine matter the Annual Contractor Evaluation Report with respect to every other carrier.

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FOR DISCUSSION ONLY

H. Carrier Role in Policy Making

While there is no question as to the Congressional intent that "overall responsibility for administration" of Medicare rests with the Secretary of HEW, Congress also intended that the private carriers, operating under contracts with the Secretary, "would have a major administrative role."[1/]

Clearly, this "major administrative role" of the carriers cannot be properly carried out unless the carriers actively participate in the formulation of general regulations for the operation of the program. The method chosen by Congress for carrying out a major national health program will not succeed if the private sector is not given an important role in the development of regulations relating to matters of administration

CARRIER ROLE IN POLICY MAKING - IMPLICATIONS TO NHI

While we are advised by the carriers that in recent years BHI concern and attention to obtaining information and advice from the carriers has shown marked improvement, we believe that much more can be done to improve communication between Government and the carriers.

In this respect we wish to call attention to the Final Report of the Medicare Project of the National Academy of Public Administration, which was submitted to SSA under date of June 30, 1973. This Report concluded that a basic choice should be made for

> "SSA and its contractors to develop a relationship which will enable the private sector to add its full capability to the administration of the Medicare program."

1/ Report of House Ways and Means Committee on H.R. 6675, p.43.

to implement an increased role of the private sector, the Report stated that "Several basic decisions would have to be made by SSA."[1/] One of these is highly pertinent here, namely:

> "SSA would have to reorganize its Medicare administration policy processes, giving the contractors an earlier and more significant role in establishing policy and in formulating administrative procedures "

1/ The Report expressed these as follows:

> "(1) SSA would have to rely on established standards with an emphasis on results rather than detailed regulations, with recognition of the possible consequences of such action.
>
> "(2) SSA would have to reorganize its Medicare administration policy processes, giving the contractors an earlier and more significant role in establishing policy and in formulating administrative procedures.
>
> "(3) Top management of the agency would have to make strong efforts to change their own and their agency staff attitudes toward the contractors.
>
> "(4) To accomplish points (1), (2), and (3), top management must take a much more active role in negotiations and decision-making with the contractors.
>
> "(5) SSA would have to coordinate closely its activities with other units of the executive branch, recognizing that it is impossible to separate policy and administration and that it may be necessary to change attitudes in other parts of the government towards the administration of the Medicare program."

Various suggestions have been made in the course of our study to help achieve the objective of a more significant carrier role in formulating policy and procedures, and the following appear to us to be useful steps:

(1) At least annually there should be a conference held at HEW at which a representative of the Secretary and the Commissioner of Social Security meet with the chief executive officers and the top Medicare officers of the respective carriers. It would greatly aid the process of consultation if higher levels of management on both the side of Government and the private sector were more aware of the current problems. The administration of Medicare by private carriers is the performance on behalf of the citizens of the country of a highly important governmental function, and the officials of HEW and the carriers must allocate the time necessary to expose and deal with current issues.

It might be particularly useful if this conference could be scheduled to follow immediately the annual announcement of the results of applying the criteria of carrier performance. The chief executives should be personally involved in the discussion of the relative performance of the carriers.

(2) The Carrier Representative Group should be made a more effective body by

(a) developing a charter of its high-level advisory responsibilities and accountabilities; current advisory activities on the more technical issues should be eliminated;

(b) eliminating the process of rotation where all carriers agree that certain carrier representatives are providing effective leadership and consultation;

(c) developing a procedure whereby major policy differences between the Carrier Representative Group and BHI can be brought before the Commissioner of Social Security, with members of the Carrier Representative Group in attendance.

(3) BHI should solicit contractor views on preliminary position papers with the understanding that the positions so presented are not official views of the Department but rather "discussion" or "think" papers.

(4) The Technical Advisory Groups should be reduced in size, and restructured to advise SSA on technical instructions and issues. It should have a continuing responsibility.

(5) BHI should issue a Management Newsletter to provide a broader and more effective approach to the dissemination of management ideas and techniques among contractors. The Newsletter would encourage carriers to share their experiences with respect to various operational problems and would pass on to all contractors those techniques which have proved successful. Problems of mutual concern to BHI and the carriers could be openly discussed.

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VI. ROLE OF GOVERNMENT IN CARRIER DECISION-MAKING

ROLE OF GOVERNMENT IN CARRIER DECISION MAKING

The history of Medicare has been one of increasing Government involvement, as we have indicated, largely motivated by the objective of maintaining the fiscal integrity of the system.

As we have also indicated, the carriers testified before our Committee as to their objections to the extent of Government controls. We believe there is merit to their complaints, provided that they are prepared to accept the consequences of poor performance in the form of termination of contracts and transfers of workload.

The feasibility of reducing the minutiae of Government controls depends almost entirely on the reliability of criteria of carrier performance. Those criteria, if adequately developed, will enable SSA to test carrier performance by results. This is clearly the way in which "contracting out" by the Federal Government should work.

GOVERNMENT INVOLVEMENT IN DP — CONTINUING FRICTION

The most important area of decision-making by carriers which came under the examination of the Committee is the decision as to how data processing would be performed for the carrier. The carriers have found the involvement of BHI in the decision-making process to be a source of continuing friction.

So far as the legal framework is concerned, Section 1842(a) of the Social Security Act provides that the carriers contracting with HEW "will perform some or all of the following functions (or, to the extent provided in such contracts, will secure

performance thereof by other organizations) . . .)". (Emphasis added.) Article XVII, paragraph A, of the form of contract between the carriers and the Secretary requires the prior written approval of the Secretary before the carrier may "enter into any subcontract with a third party to perform any of the functions and duties including automated activities utilized in carrying out the responsibilities set forth in this agreement . . . ."

Below we make certain recommendations for improving the process of soliciting subcontract bids in connections with data processing. Assuming clear and precise standards for bidding, and assuming adequate competition at the subcontractor level, we believe the functions of BHI should be essentially those of reviewing the bidding process to assure that all requirements were met. Certainly BHI should not be in the position of favoring one type of subcontractor over another, or one data processing system over another.

PROPER PROCEDURES WOULD ELIMINATE BHI BIAS.

The difficulty arises over the fact that, as we conclude below, there is presently an inadequate degree of competition among data processing subcontractors. Paragraph C of Article XVII of the form of carrier contract provides:

"C. It is the policy of the Government to [illegible] procure property and services from responsible sources at fair and reasonable prices calculated to result in the lowest ultimate cost to the Government. In order to achieve this objective, competitive proposals shall be utilized to the maximum practical extent. If competition is not available or does not yield reasonable subcontract prices, the Carrier shall also be required to undertake appropriate price analysis in accordance with Part 1-3.807-2(b) of the Federal Procurement Regulations and to undertake cost-analysis in accordance with Part 1-3.807-2(c) of the Federal Procurement Regulations in all subcontracts subject to approval of the Secretary under paragraph B of this Article."

This contract provision is reasonable. As a general administrative rule, it is BHI's position that a carrier has complied with the competition requirements of the contract if three or more responsive proposals are secured. In any case where adequate competition is not available or reasonable subcontract prices are not obtained, the carrier will be asked to undertake cost analysis in an effort to achieve the desired results of competition. The cost analysis procedure would also be invoked when only a single responsive proposal is received by the carrier. This would be recognized as a sole source procurement situation. When necessary, the carrier would be required to document to the satisfaction of the Secretary its efforts to secure competition and the reasons for its failure. If the Secretary is satisfied with this documentation, then consideration of the proposal would proceed under the

"sole source" provisions prescribed in Article XVII-C of the carrier contract.[1/]

Because the contract imposes an obligation on the contractor to secure cost analysis or price analysis if competition is not available, the contractor's analysis is reviewed by BHI for reasonableness. BHI takes the position that the contractor's analysis should include the various elements of cost which make-up the proposal such as direct labor, machine costs, materials and supplies, purchased services, overhead, general and administrative etc. The contractor should also include detailed descriptions of the cost elements shown in the analysis, as well as comparisons to alternative methods.

1/ The Secretary issued specific general instructions in August 1972 requiring, for EDP subcontracted services, that the carrier must make a conscious effort to secure real competition and this solicitation must be sufficiently extensive to produce at least three acceptable competitive proposals and document its efforts if it fails to secure three. These general instructions are being revised to accommodate the new provisions in the 1973 carrier contracts, and they will cover the basic requirement that the carrier must issue a Request for Proposal (RFP) that is not biased or structured to a particular vendor or vendors but which permits and promotes the maximum competition. The revised instructions will also cover the need for the standards of comparison and the criteria for evaluation to be established in advance in writing and be issued simultaneously with the RFP. The instructions will contain a sample RFP and will include basic requirements for RFP's and the comparison standards and review criteria. The carriers will be required to submit in advance of issuance the RFP and comparison standards and evaluation criteria to BHI for review in every instance where the prior approval of the Secretary of the subcontract or purchase at issue is required under the carrier contract.

If BHI finds the analysis inadequate, necessary additional data are developed before the proposal is approved by BHI. Upon approval, the contractor is required to certify as to the currency, completeness, and accuracy of the data, in accordance with parts 1-3.807-3, and 1-3.807-4 of the Federal Procurement Regulations.

The Government involvement has been extensive in a number of recent situations in which BHI has been called upon to approve a data processing subcontract. While there may have been strong reasons for the BHI involvement in these situations, our Committee is being asked to chart a course for the future. In that context, we urge that BHI adopt the philosophy that unwise carrier decisions as to data processing subcontracts will show up in the results of carrier performance, and that BHI will put its faith in the capacity to measure results rather than in attempting to guide carrier decisions.

JUDGE CARRIERS ON RESULTS RATHER THAN INFLUENCE DP SUBCONTRACTORS

This philosophy and approach, if adopted, should resolve one issue which has recently been a topic of debate. It has been contended that, if the decision by a carrier to award a data processing subcontract is subject to BHI review and the approval of the Secretary, so also should the decision by a carrier to go "in house" for its data processing operations. We can understand the instinct to urge parallel treatment of the two situations, but we regard them as different legally and organizationally. The need for the approval of substantial

subcontract awards is a simple case of protecting the Federal Government, once it has entrusted the performance of a function to a particular contractor. The argument that a decision to go "in-house" requires the approval of the Secretary seems to us to involve a false premise, namely, that the original contract carried an implicit understanding that there would be subcontracting for data processing.

In any event, we believe it would be moving in the wrong direction to require price analysis, other than through application of the performance criteria, of carrier decisions to go "in house". Again, these decisions should be tested in the context of the overall results produced by a carrier.

A variation of the above-mentioned issue has also arisen, namely, as to the freedom of several carriers to join together in the performance of data processing functions through a joint venture or subsidiary. The contention of the carriers in this respect is that they would still be operating the data processing system themselves, albeit in combination with one or more other carriers. They contend that any requirement of competitive bidding imposed upon such a joint effort would frustrate their objectives.

Although we have not been confronted with specific proposals or examined a particular set of facts, we believe it would be useful to express an attitude concerning these joint proposals. Our Committee is of the view that, while it is difficult to

draw a line at any particular point, the line is best drawn at the point where a carrier relinquishes any material portion of its responsibility and functioning with respect to data processing. A delegation to a joint venture or a subsidiary clearly removes the carrier from total control over the delegated function. We think it is more in keeping with the spirit of the carrier contracts to treat a joint venture or a joint subsidiary as a subcontract for purposes of bringing to bear the requirements of bid solicitation.

* * *

This completes the portion of our Report which gives principal attention to the carriers themselves. The balance of the Report will focus primarily on the subcontractors in the data processing field, since many of the issues of public policy relate to, and much of the discussion concerning Medicare administration has revolved around, these subcontracts.

to three of the smaller carriers. Of the current five EDP subcontractors, the largest, EDSF, serves 11 carriers and, in the calendar year 1973, accounted for 87.7% of the claims processed by all EDP subcontractors. This represents a modest decline from 1971 and 1972 for which the comparable percentages were 90.9% and 91.7%, respectively. As a proportion of all Medicare Part B carriers' claims, EDSF's share was roughly 37% in 1971 and 1972, and 42.8% during the calendar year 1973. Three of the remaining four subcontractors have but one contract each, while one of the four serves two carriers. A summary of the current status of EDP subcontractors is as set forth in the following table 3:

TABLE 3
CLAIMS PROCESSED BY EDP SUBCONTRACTORS

CALENDAR YEAR 1973

EDP Claims Processing Subcontractors	Part B Carriers	Percent of National Workload Processed CY 1973	Percent of Subcontracted Workload Processed CY 1973
EDSF	Topeka, Kansas	1.2	2.5
EDSF	Pennsylvania BS	5.2	10.6
EDSF	California BS	9.0	18.5
EDSF	Texas BS	5.9	12.0
EDSF	Iowa BS	1.2	2.5
EDSF	Indiana BS	1.7	3.5
EDSF	Massachusetts BS	3.9	7.9
EDSF	New York BS (UMS)	8.3	17.1
EDSF	Minnesota BS	.6	1.3
EDSF	Arkansas BS	1.0	2.1
EDSF	Nationwide	4.3	8.7
EDSF	Puerto Rico SSS	.5	1.0
Subtotals		42.8	87.7
McDonnell-Douglas	Colorado BS	1.4	2.8
Data Inc.	South Dakota BS	.2	.5
Systems Resources, Inc.	Kansas City BS	.8	1.6
University Computing Co. 1/	Illinois BS	1.0	2.0
McDonnell-Douglas 2/	Connecticut General	.6	1.2
McDonnell-Douglas 3/	General American	1.1	2.3
Computer Services, Inc. 4/	Washington Physician Service	1.0	2.0
Subtotal		6.1	12.4
Total		48.9	100.1

1/ Operated by Univeristy Computing Company through 5/31/73. Since then, carrier has operated Model B in-house.
2/ Operated own system until 7/73 when McDonnell-Douglas installed its on-line system operated by McDonnell personnel
3/ Operated own system until 4/73 when McDonnell-Douglas installed its on-line system operated by McDonnell personnel
4/ CSI operates its own system for 18 of the 20 Washington Bureaus i.e., all except Spokane and King County.

Another significant point in the distribution of market shares among subcontractors is the division of the market according to EDP system. At present, 16 of the 31 carriers operating systems inhouse employ the Model B system developed by SSA. This represents a rapid rise from four in 1970 and only nine as recently as 1972. In addition, three of the five subcontractors employ the Model B system with the result that some time in 1974, 20 of the 48 carriers will be using the SSA developed Model B system. The leading EDP subcontractor (EDSF) employs its own system as does one other subcontractor. In 1974, it is expected that more than two-thirds of the carriers will be using either Model B or the system developed by EDSF, and more than two-thirds of all claims will be processed in these two ways.

System	Number of Carriers Using Systems
SSA Model B System (Operational)	16
SSA Model B System (Scheduled)	1
SSA Model B - McAuto Version (Operational)	3
SSA Model B - McAuto Version (Scheduled)	0
EDSF System (Operational)	11
ASDC System (Operational)	3
Independently Developed Systems (Operational)	15
	49 1/

1/ Includes Travelers RRB inhouse system and Prudential with SSA Model B System in North Carolina and an inhouse system in Georgia and New Jersey.

What conclusions can one draw about the effectiveness of competition from these facts, and from the emerging trends in the industry? A carrier which does not wish to operate an inhouse EDP system has few alternatives (McAuto's new Medicare Part B system is now an alternative) to using EDSF. It should be noted that the GAO found only one qualified bidder (EDSF) for the specifications in the Nationwide Insurance Company competition. The competing subcontractors are few in number. Moreover, the development costs for most of the competing subcontractors have been financed through SSA's expenditures on the Model B system. However, as an alternative to EDSF, each carrier's option is to adopt an in-house EDP system. This option is facilitated by the fact that BHI is prepared to assist a carrier in implementing the Model B system, with the result that even carriers with very limited resources in computer "software" can have a fairly sophisticated in-house system. Also, in 1973, one of the five carriers with lowest unit costs was a relatively small carrier using the ASDC system for in-house EDP processing of claims. Thus, small carriers, at least for the time being, have additional viable alternatives to EDSF.

The problem as we see it, therefore, is not so much a question of monopoly power being currently wielded by the leading subcontractor, but, rather, the precarious position of the remaining subcontractors. This weakens the bargaining position of carriers who do not wish to operate inhouse systems. This has, limited and continues to limit the range of alternatives open to carriers.

Several of the EDP subcontractors, excluding McDonnell Douglas Automation Co., were very outspoken at our June 13, 1973 meeting to the effect that EDSF had already achieved a degree of dominance which makes new entry difficult. Moreover, some of them indicated they were withdrawing from the competition. The Committee also received letters from other EDP subcontractors indicating that they, too, were withdrawing from the competition. A quote from one of the letters is as follows:

> "Our history suggests that we have spent many thousands of dollars trying to compete in the Medicare data processing market through competitive bidding. Our success in achieving any significant awards has been minimal. Analysis of this 'competitive bidding' suggests that cost could not win an award, good service could not win an award, quality proposals could not win an award, and knowledge of Medicare processing could not win. Investigations by the General Accounting Office and the Legislative branch of the government did not reverse this trend." 1/

In summary, there are two types of inadequacy in competition insofar as data processing for Part B Medicare is concerned. The first type arises from the present trend for two EDP systems, that of EDSF and Model B, to assume an increasingly dominant role. This seriously limits the range of alternatives open to all carriers. The second concerns the options of carriers who do not wish, or are unable, to employ an in-house EDP system. For these carriers, the number of subcontractors is less than optimal for effective competition and the precarious position of some of the subcontractors threatens to make the situation worse in the future.

1/ UCC's letter of 6 5 73

B. Deterrents to EDP Competition

Although there are some individual EDP systems in use at this time by the private insurance companies, the present situation in the Medicare (Part B) program is that the carriers have basically two choices with respect to EDP--they can operate the Model B system (with government assistance from BHI), or they can subcontract. If the decision is to subcontract, then the choices for the large carriers are basically limited to EDSF or McAuto (McDonnell Douglas). It also appears that some personnel in BHI have strongly encouraged the carriers to convert to the Model B system, although this is not the official position of the BHI management.

BHI BIAS FOR MODEL SYSTEM

The problem with the overall trend is that many of the normal competitive factors are missing which normally could be relied upon to achieve good EDP services at lowest cost and to assure that claims are processed in the most efficient way. There are simply not enough competitors for those who wish to subcontract. If reliance is placed on the Model B system, or for that matter a single proprietary system, there is no assurance that the system will be efficiently designed--and not overdesigned with features that make it a very costly system to operate. In addition, a Government staff of about 75 will be hired to maintain and enhance the Model B system. In both situations, the costs will be borne by the taxpayer through the medium of the cost reimbursement contracts that BHI has with the carriers or as a direct cost of BHI.

As a result of presentations made at the public meetings and letters received from EDP subcontractors and carriers, there appear to be many obstacles to the entry of additional data processing firms to the Medicare (Part B) program. A listing and explanation of the major obstacles are as follows:

1. Domination by one subcontractor. One of the main problems cited by some other EDP subcontractors is the dominant position of EDSF. Whether or not these beliefs are justified, other EDP subcontractors feel it is very difficult to compete against EDSF with: (i) its reputation for doing a good job, (ii) its facilities management approach to handling all or most of the carriers' other data processing needs, (iii) its present dominance of the market with 87.7% of the subcontracted claims processing business (in calendar 1973), and (iv) its publicized active posture in presenting its views to Congress and the Executive Branch.

EDS REPUTATION

2. The initial development costs. A new entrant in the market for EDP services to carriers must incur development costs which an established firm no longer faces (unless it wishes to use the Model B system as its basic system). Consequently, a new entrant may find it difficult to meet the price of an established firm, since this price must cover the necessary development expenses. Moreover, the leading subcontractor, EDSF, is able to spread future development costs over a large volume of claims thus rendering it difficult for

new entrants to develop their own systems and still compete with the former for contracts that include development costs. Equally serious, a new system must compete with the large and continuing outlays of the Government for the enhancement of the Model B system. For example, through fiscal 1973, SSA will have spent over $6 million on maintenance and development of the Model B system. To the extent that private funds must be used for the development of a new system, the large expenditures of the Government constitute a severe competitive barrier to new entry.

MODEL SYSTEM IS DETERENT TO COMPETITION

3. Model B system is oriented toward IBM equipment. This means that other equipment manufacturers cannot readily adopt the Model B system. This is one explanation for the fact that some of the large equipment manufacturers have stayed away from the program.

4. Low confidence in procurement practices. The history of procurements for EDP subcontracts, which are primarily the responsibility of the carriers (prime contractor) with BHI review and approval, has not developed a high confidence factor in the fairness of the procurement procedures. The Comptroller General's report to the Subcommittee on Intergovernmental Relations Committee on Government Operations regarding the Award of Subcontract for Processing Medicare Claims for Physicians Services in Ohio and West Virginia,[1] details the problems in

1 Report B-164031(4), dated August 2, 1973

one of the more recent procurement awards. As one potential entrant to the field stated, 'you do not know if price, firm qualifications, approach to the work, etc. are going to prevail or not. The procurement procedures are too uncertain to justify the investment of proposing."

5. Delay in government review and approval. There are considerable delays (a mixture of Government and carrier responsibility) in the approval of contracts after the submission of bids. Since preparing bids is costly, long delays tend to discourage new entrants. The small size of many potential subcontractors, and their limited resources, aggravates the consequences of long delays.

6. Lack of carrier incentive to minimize EDP costs. Administrative failures in processing claims lead to adverse public criticism and serious embarrassment to the carriers. In contrast, higher than necessary costs do not attract much public attention and the carriers' contracts require full reimbursement for all costs incurred. Consequently, it is reasonable to expect that the pressure on carrier executives is to choose subcontractors who have already proven themselves, and to downgrade the importance of cost considerations as compared to demonstrated performance. Under these circumstances, new entrants face serious obstacles.

7. BHI is thought to favor the adoption of the Model B system. There is a widespread belief that BHI, perhaps inadvertently, and certainly without any official approval,

BHI MODEL SYSTEM BIAS

favors the adoption of the Model B system. Since all EDP subcontracts must be approved by SSA, a competing system is believed to face severe obstacles. Whether the belief is true or not, the expectation of an obstacle is in itself sufficient to discourage entry.

8. EDSF subcontract terms. The six-year contract term that EDSF has insisted on with carriers discourages entrants from entering the competition. As one competitor[1/] pointed out at the June 1973 meeting of the Committee, "Once you get ready to compete, you realize that most of the contracts will not be open for bid for several more years." As was noted above under Part V, the Government contracts with the carriers are on an annual renewal basis.

9. Possible Trend to In-House Operation. There are some indications that several of the carriers, who are now utilizing EDP subcontractors, are planning to bring the operations in-house. If this happens, it might also discourage additional firms from entering the competition because of the market diminution.

In summary, our Committee believes that there are some serious impediments to additional competitive entries into the data processing field of the Medicare (Part B) program. To the extent possible, these impediments must be removed--or at least

1/ McDonnell Douglas

reduced to a level which will permit a reasonable degree of competition. The Government was, in our view, right in developing a Model B system, because a viable alternative to EDSF was badly needed. We now believe the Government must modify existing policies and procedures and take some additional steps to insure more competition in data processing for Part B of the Medicare program.

C. Recommendations for Promoting Competition Among Subcontractors and EDP Systems

It is the Committee's view that an appropriate goal is an increase both in (1) the number of subcontractors, and (2) the number of competing EDP systems.

RECOMMENDATIONS FOR PROMOTING COMPETITION

While there is general agreement on the desirability of the first objective, some have argued that an increase in the number of EDP systems may entail duplication of effort and consequent waste. To be sure, there is always some waste in competing research and developments efforts and to diversity in production methods and design of products and services. But uniformity and integration of effort often yields only short-run savings. Particularly in an industry in which technology is changing rapidly, and in which the critical function of review of medical necessity is still in the rudimentary stages and heavily dependent on EDP systems, the primary emphasis should be on innovation and progress. The savings of uniformity are likely to be purchased at the price of sterility in technical developments and, ultimately, a much higher cost to the taxpayer. The appropriate cost objective is not that of

minimizing EDP costs but rather that of minimizing the total administrative cost of carriers and of reducing the waste associated with unnecessary medical services. Consequently, we recommend action in the areas discussed below.

1. Improvement of Procurement Procedures

Although we have stated earlier in this report that BHI should play a reduced role in the decision-making as to EDP subcontract awards, we believe it would be of great benefit if BHI could develop a procurement process and format which would assist the carrier to conduct a fair and equitable competition for subcontracts. This would build confidence within the data processing community in the overall procurement process. Some areas in which we believe there should be improvement are:

(a) Improved specifications in the requests for proposals (RFP).1/

(b) Possible financial awards to responsible bidders in order to defray the cost of developing proposals. This would particularly help the smaller subcontractors and should improve the quality and number of proposals.

(c) Explicit factors and weights for evaluating the proposals (price, approach, firm qualifications, etc.).

(d) Insistence that all prospective subcontractors respond to the written specifications in the RFP but allow the subcontractors to propose other approaches if they wish.

1/ Chapter 3, Comptroller General's report (B-164031(4) to the Sub-Committee on Intergovernmental Relations Committee on Government Operations regarding the Award of Subcontract for Processing Medicare Claims for Physicians Services in Ohio and West Virginia.

(e) Improved requirements as to how the subcontractor should quote prices so as to facilitate comparisons among proposals.

2. Evaluation of Bids and the Decision-Making Process

Unreasonable delay is one of the worst features of government procurement, and it has obviously crept into the Medicare (Part B) procurement process along with carrier initiated delays. We recommend that a reasonable time schedule be established (90 days should be ample), announced, and adhered to, with respect to award of EDP subcontracts.

SSA APPROVAL DELAYS

In addition, the written and announced factors and weights for evaluating the proposals should be strictly adhered to by the carriers. BHI should review the process followed to assess its fairness, which would include review of the RFP before it is issued. Also, BHI should insist that all subcontractors be treated equally and fairly if negotiations take place after the proposals have been submitted.

3. Separation of Government Decision-Making Process from the Model B Data Processing Group in BHI

The industry (carriers and EDP subcontractors) believes that there is undue influence on the selection of EDP subcontractors by the Model B data processing group. Actually there are two EDP groups within BHI, one for the development of the Model B system and one for monitoring the data processing area for the Medicare (Part B) program. It is the latter group that reviews the subcontract awards,

SEPARATE GOVERNMENT DECISION MAKING FROM BHI

and BHI personnel do not believe there is a conflict of interest situation. However, the two groups rely on each other for technical advice and have the same individual supervising them; therefore, they are too close to avoid the appearance of possible bias.

We recommend that as long as BHI maintains and enhances the Model B system another group should review the EDP subcontract awards. This could be done by SSA, HEW, GSA, or some source selection committee or peer review group. This problem will be solved if our recommendation as to contracting out of responsibility for maintenance of the Model B system is adopted.

4. Term of Subcontracts

As previously noted in the report, the six-year term of the EDSF contracts is too long and tends to restrict competition. A one-year contract is generally unfair in the field of data processing because of the large start-up investment. The committee believes BHI should consider a three-year term for new EDP subcontract awards, and annual renewals of each subcontract thereafter.

3 YEAR CONTRACT WITH ONE YEAR RENEWAL

5. Redoubling of Efforts to Get EDP Manufacturers and/or Computer Software Houses to Enter the Medicare (Part B) Data Processing Competition

As we have discussed earlier, if primary reliance for EDP data processing is to be on the private sector, and if carriers desire to use subcontractors as distinct from operating inhouse systems, then more EDP subcontractors are needed. It is the Committee's judgment that other companies would enter the competition for

subcontracts if some of the impediments (as outlined in the previous section of the report) were removed. In fact, some companies have indicated to the Committee, on an informal basis, that they are very interested in the Medicare (Part B) program.

(6) Development of New and Improved EDP Systems

The Committee believes that HEW should consider the development of at least one new alternative EDP system and the financing of its development by Government funds on a competitive basis. The procurement request should require that the winning contractor offer both a systems assistance option and a facilities management option. The new system would be owned by the Government, therefore, the carriers would have the option of (i) using the system with their own in-house staff, (ii) using the system with contractor systems assistance, and (iii) using a facilities management subcontractor to operate the system. This new system would go a long way toward insuring that there would be at least three qualified competitors in every subcontract procurement. It would also give the carriers some additional options for their in-house systems. This approach of developing a new system would also be a good method for assessing the strengths and weaknesses of the Model B System and other existing systems. It is generally agreed by industry and Government personnel that the Model B system was developed under less than optimum conditions.

We recognize that this proposal might be subject to critisism because of the additional cost involved to the Government. However, such costs would be small as compared to the possible benefits given the anticipated scale of Medicare and other public health insurance programs. The Committee also believes that there is merit in funding carrier improvements of in-house systems. At the Committee's public hearing in May 1973, several carriers voiced their strong desire to have federal funds to enhance their own data processing systems. We believe there should be an annual competition for Government funding of promising in-house improvements, and that BHI should have a follow-up review process to evaluate the system improvements. Of course, all successful improvements would be available to other carriers.

(7) Research and Development Program for Medicare EDP Systems

The Committee believes that there should be a continuous research and development program for Medicare EDP systems. This would assist in keeping current or even pushing the state of the art in EDP technology and/or Medicare program developments. These research efforts would be pursued outside of existing systems, and would probably be concentrated in such areas as medical necessity, utilization, etc., screening procedures. Awards to finance such research should be made on a competitive basis possibly utilizing procedures currently used for research grants by the National Science Foundation.

(8) BHI's Model B System

SSA's involvement as the developer and maintainer of the Model B system and the de facto system consultant for carriers utilizing the Model B system has steadily increased. The current budget planning calls for the Model B section of BHI to be staffed with about 75 employees. While we commend BHI for its action in developing the Model B system in order that the carriers have the option of at least one good in-house system, we are convinced that the objective now should be that of withdrawal of BHI from operational responsibility. An interim arrangement could be entered into with an independent contractor for maintainance of the Model B system. Such contractual arrangement could be terminated at the earliest date consistent with assurance of adequate competition. We would define adequate competition as three to five private firms capable of bidding and being judged as responsive to a predetermined set of specifications (RFP), and/or carriers having enough options to assist with the maintenance of their in-house systems.

MODEL SYSTEM BUDGET INCREASE

RECOMMEND FARMING-OUT MODEL SYSTEM

An orderly approach to Government withdrawal from the continuing maintenance of the Model B system might be (i) an early announcement of such intent, (ii) a competitive procurement to obtain the services of an outside contractor to maintain the Model B system at least three years (this step could be taken in the near future because it would not change the degree of competition), (iii) an annual assessment thereafter by BHI to determine if the

continued maintenance of the Model B System by an independent contractor is necessary rather than relying upon each carrier to maintain its own system (either directly or through a data processing subcontractor), and (iv) an orderly reassignment of BHI's Model B staff to other Government positions.

Our Committee considered and rejected the idea that the Government should first drop its maintenance of the Model B system without providing an alternative means of maintaining the system. The primary reason for this conclusion is that, without Model B, adequate competition is not available at this time. The Government should not be in the position of creating a private monoploy with taxpayer funds through action or inaction on its part. An orderly withdrawal is absolutely necessary.

At the same time, the Government should not compete with the private sector, as clearly stated in Bureau of the Budget Circular A-76. A pertinent quote from the latest revision (dated March 3, 1966) of the circular is as follows:

GOVERNMENT COMPETITION WITH PRIVATE SECTOR

BOB A-76

> "There is no change in the Government's general policy of relying upon the private enterprise system to supply its needs, except where it is in the national interest for the government to provide directly the products and services it uses."

D. Access to Records of Subcontractors and Affiliates

The costs incurred by Medicare carriers for data processing services obtained by contract are significant and are borne by the Government through cost reimbursement to the carriers. HEW should establish procedures that will assure fair and effective competition and, as a consequence, reasonable prices.

Under date of January 8, 1974, the Comptroller General wrote a letter to Congressman Fountain[1/] in response to certain questions posed by Congressman Fountain. Some of these questions are ones that our committee was asked to consider (see Appendix D). The Comptroller General concluded that the Federal Property and Administrative Services Act and the Federal Procurement Regulations do apply to agreements between the Social Security Administration and Medicare carriers.

The Comptroller General also stated that (assuming there is an absence of adequate competition) the contracting officers should insure, before approving proposed subcontracts, that carriers have undertaken price or cost analyses and have required submission and certification of cost or pricing data by the subcontractor. This will have the effect of requiring certified cost and pricing data, subject to audit and appropriate contract remedies, whenever the price is not based upon adequate price competition or catalog or market prices of commercial items sold to the general public in substantial quantities.

1/ Chairman, Subcommittee on Intergovernmental Relations, House Committee on Government Operations, House of Representatives.

The Comptroller General's letter also appears to support the recent move by BHI to include an examination of records clause in the recent revision of the subcontractor contract and clearly states that, with this clause, the Government has the right to review the records of any parent corporation or a subsidiary at any tier or a division of a subcontractor.

The Committee concurs in these positions. Clearly, the citizens of the country are entitled to know the facts on costs and profits of subcontractors who are ultimately paid by the taxpayers. When such facts are not forthcoming, suspicions, rumors, and exaggerations develop and much time and energy is expended by both Government and private industry people in debating issues without the necessary financial facts.

DRAFT

For Discussion Only

E. Possible Additional Conflict-of-Interest Regulation of Carriers vis-a-vis Relationships with Subcontractors

Early in the deliberations of the Committee, in addition to the suggestions of bias on the part of Government in relation to the Model B System and in addition to suggestions of political activity, there were some suggestions of possible conflicts of interest on the part of officers and directors of carriers in relation to the selection of subcontractors. Instances were alluded to officers or directors of certain carriers also having an interest in the business welfare of certain subcontractors.

CONFLICT OF INTEREST

Our Committee did not seek to investigate these alleged relationships, largely for reasons of time. However, we do recognize that one of the deterrents to free and open competition can be belief , whether real or imagined, that decisions as to contract or subcontract awards are not being made on a completely unbiased basis.

Because of the recognized talent of many of the officers and directors connected with the Part B carriers, their services are often sought by other corporations and they frequently serve as directors or advisory board members of other organizations or have financial interests in other organizations. We have examined the forms of the carrier contracts, and the following two provisions of Article IX provide an adequate contractual basis for dealing with the problem of potential conflicts of interest:

> "H. The Carrier shall establish and maintain procedures and controls for the purpose of preventing any of its

directors, trustees, officers or responsible employees from using their positions with the Carrier for purposes of furthering their private business interests, to the detriment of the Medicare program, and from using any material or information, not otherwise in the public domain, obtained by the Carrier from the Secretary or developed by the Carrier in performing its functions under this agreement to promote their private business interests."

"I. The Carrier shall establish and maintain procedures and controls for the purpose of preventing any if its directors, trustees, officers or responsible employees, directly or indirectly, from accepting payment from any person of any fee, commission, compensation, gift or gratuity as an inducement or acknowledgment for the award of a subcontract."

In order that the intent of these provisions can be fully carried out, we recommend that HEW request the carriers which use or plan to use a subcontractor to have a simple form of conflict-of-interest questionnaire signed by its officers and directors annually and also at the time bids are received for a major subcontract. Such a questionnaire could simply ask whether the recipient has any financial interest as an officer, director, employee, stockholder or otherwise, in named subcontractors. The questions should be framed to reach out at indirect interests, such as where a director of a carrier is a bank officer and his bank does business with a subcontractor. These named subcontractors would consist of the carrier's existing subcontractor insofar as the annual questionnaire is concerned and would consist of all potential subcontractors which have submitted bids if a procurement is under way.

Questionnaires of this type are a useful preventive measure and are utilized by many corporations. We think they would serve to strengthen subcontractor confidence that the carrier decisions are not tainted by conflicts of interest.

F. Possible Regional or National Data Processing Centers

The previous recommendations on the EDP subcontract part of the Medicare (Part B) program were primarily based upon the existing pattern of operation; namely, each carrier doing its own processing or utilizing a subcontractor. Another possibility, which both Government and industry have discussed with the Committee, is the utilization of regional or national data processing centers. The Committee believes that this possible future course of action should be fully investigated

In the last few years, several large corporations and other large organizations have performed feasibility studies in connection with their own data processing needs and they concluded that significant savings could be achieved by establishing regional or national data centers. These savings, it was asserted, have resulted from reduced EDP equipment requirements, reduced personnel levels and elimination of duplication of effort. It would appear that the Medicare (Part B) program could possibly obtain similar savings. At the same time, there are those who dispute the potential savings of consolidated EDP centers. The Committee did not receive evidence that would substantiate either side of the issue. However, it should be noted that the EDSF approach is basically a regional system now, as are,

to a lesser degree, the McDonnell, Aetna, Travelers and Prudential data processing operations. Also, there is the new regional center at Illinois Blue Shield.

EDP costs and processing techniques must be considered only part of the overall administration of the Medicare (Part B) program. Nonetheless, we regard the question of regional centers as potentially important and therefore recommend that BHI contract for an independent feasibility study to determine the benefits and costs of this approach to processing claims.

(See conclusions at outset.)

Charles A. Bowsher
Michael Gort
Roswell B. Perkins,
Chairman

Department of Health, Education, and Welfare
Charter
Advisory Committee on Medicare Administration, Contracting, and Subcontracting

Purpose

The Secretary is granted authority to enter contracts and subcontracts in his administration of the health insurance for the aged program (Medicare) established by P.L. 89-97 (July 30, 1965), as amended, including P.L. 92-603 (October 30, 1972), the implementation of which requires the advice of the Advisory Committee on Medicare Administration, Contracting, and Subcontracting.

Authority

42 U.S. Code 1314 and 42 U.S. Code 1395b-1

This Committee is governed by the provisions of P.L. 92-463 which sets forth standards for the formation and use of advisory committees.

Function

The Advisory Committee on Medicare Administration, Contracting, and Subcontracting advises the Secretary and the Commissioner, Social Security Administration, concerning broad organizational and operational matters, contract formulation, and reimbursement principles applicable to Medicare contracts and subcontracts.

Structure

The Committee consists of four members, not otherwise in the employ of the United States who are selected by the Secretary from among persons outstanding in fields related to law, contracts, public administration, and economics. The Secretary shall appoint one of the members to serve as chairman.

Each member shall hold office for a term of one (1) year, except that any member appointed to fill a vacancy occurring prior to the expiration of the term for which his predecessor was appointed shall be appointed for the remainder of such term.

Management and staff services are provided by the Social Security Administration and the Director, Advisory Group Staff, Program Review, Bureau of Health Insurance, who serves as Executive Secretary.

Meetings

Meetings will be held at the call of the chairman with the advance approval of a Government official who also approves the agenda. It is anticipated meetings will be called monthly. A Government official will be present at all meetings.

Meetings are open to the public except as determined otherwise by the Secretary; notice of all meetings is given to the public.

Meetings are conducted and records of the proceedings kept, as required by applicable laws and departmental regulations.

Compensation

Members are paid at the rate of $75 a day, including travel time, and receive per diem and travel expenses in accordance with Standard Government Travel Regulations.

Annual Cost Estimate

Estimated annual cost for operating the Committee, including compensation and travel expenses for members, but excluding staff support is $14,400. Estimated annual man-years of staff support requirement is 3.0 man-years, at an estimated cost of $65,000.

Reports

An annual report will be submitted to the Secretary through the Commissioner, Social Security Administration, upon termination of the Committee. The report will contain as a minimum a list of members and their business addresses, the dates and places of meetings, and a summary of the Committee's activities and recommendations made during the year. A copy of the report will be provided to the Department Committee Management Officer.

Termination Date

Unless renewed by appropriate action prior to its expiration, the Advisory Committee on Medicare Administration, Contracting, and Subcontracting will terminate one year from the date this Charter is approved by the Secretary.

Approved:

26 FEB 1973
Date

Secretary

THE SECRETARY OF HEALTH, EDUCATION, AND WELFARE
WASHINGTON, D. C. 20201

C H A R T E R

Advisory Committee on Medicare Administration, Contracting, and Subcontracting

Purpose

The Secretary is granted authority to enter into contracts and subcontracts in his administration of the health insurance for the aged program (Medicare) established by P.L. 89-97 (July 30, 1965), as amended, including P.L. 92-603 (October 30, 1972), the implementation of which requires the advice of the Advisory Committee on Medicare Administration, Contracting, and Subcontracting.

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The Advisory Committee on Medicare Administration, Contracting, and Subcontracting shall consist of four members, including the Chairman. Members shall be selected by the Secretary from authorities knowledgeable in the fields of law, contracts, public administration, and economics. Members shall be invited to serve for overlapping terms. Management and staff services shall be provided by the Social Security Administration and the Director, Advisory Groups Staff, Program Review, Bureau of Health Insurance, who shall serve as Executive Secretary.

Meetings

Meetings shall be held monthly at the call of the Chairman, with the advance approval of a Government official who shall also

approve the agenda. A Government official shall be present at all meetings.

Meetings shall be open to the public except as determined otherwise by the Secretary; notice of all meetings shall be given to the public.

Meetings shall be conducted, and records of the proceedings kept, as required by applicable laws and Departmental regulations.

Compensation

Members who are not full-time Federal employees shall be paid at the rate of $75 a day, including travel time, plus per diem and travel expenses in accordance with Standard Government Travel Regulations.

Annual Cost Estimate

Estimated additional committee operating cost for period February 26, 1974, to June 30, 1974, is $4,800. Estimated additional requirement for staff support is 1.0 man-year, at an additional cost of $22,000.

Reports

An annual report shall be submitted to the Secretary through the Commissioner, Social Security Administration, not later than June 30, 1974, which shall contain as a minimum a list of members and their business addresses, the Committee's functions, dates and places of meetings, and a summary of the Committee's activities and recommendations made during the year. A copy of the report shall be provided to the Department Committee Management Officer.

Termination Date

Unless renewed by appropriate action prior to its expiration, the Advisory Committee on Medicare Administration, Contracting, and Subcontracting will terminate June 30, 1974.

APPROVED:

February 15, 1974
Date

/s/ Caspar W. Weinberger
Secretary

THE SECRETARY OF HEALTH, EDUCATION, AND WELFARE
WASHINGTON, D. C. 20201

NOTICE OF RENEWAL OF THE ADVISORY COMMITTEE ON MEDICARE ADMINISTRATION, CONTRACTING, AND SUBCONTRACTING

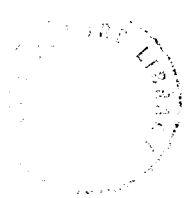
I hereby determine that renewal of the Advisory Committee on Medicare Administration, Contracting, and Subcontracting beyond February 25, 1974, is in the public interest in connection with the performance of duties imposed on the Department by law, that such duties can best be performed through the advice and counsel of such a group and, therefore, the Committee is continued until June 30, 1974.

February 15, 1974
Date

/s/ Caspar W. Weinberger
Secretary

COMMITTEE MEMBERS

Name:	Perkins, Roswell Burchard
Address:	Office: Debevoise, Plimpton, Lyons and Gates 299 Park Avenue, 31st Floor New York, New York, 10017 Tel. No. PL 2-6400
	Home: 1158 Fifth Avenue New York, New York 10029
Date and Place of Birth:	May 21, 1926 Boston Massachusetts
Present Position:	Partner, Debevoise, Plimpton, Lyons and Gates (Law Firm), New York City (since 1956)
Education:	Pomfret (Connecticut) School (1940-43) A.B. (cum laude), Harvard (1945) LL.B. (cum laude), Harvard Law 1949)
Past Experience:	Law Associate, Debevoise, Plimpton, Lyons and Gates, New York City (1949-53) Assistant Counsel to Special Subcommittee to Investigate Organized Crime in Interstate Commerce, Senate (U.S.) Interstate and Foreign Commerce Committee (1950) Assistant Secretary, DHEW (1954-56) Counsel to Governor Nelson A. Rockefeller (1959)
Special Activities:	Director, Fiduciary Trust Company, New York City Director, The Commonwealth Fund, New York City Director, Salzburg Seminar in American Studies Member, Overseers Committee to Visit Harvard College Member, Overseers Committee to Visit Kennedy School of Government, Harvard University Trustee, Pomfret School Former member, Advisory Council, Woodrow Wilson School of Public and International Affairs, Princeton University (1966-69) Member, Advisory Board, Fordham University School of Social Service Co-Chairman, Lawyers' Committee for Civil Rights Under Law Former Director and Secretary, New York Urban Coalition Former Director and Secretary, Greater New York Fund



Affiliations:

American Law Institute (Member of Council)
American Arbitration Association (Former Director and member of Executive Committee)
Council on Foreign Relations

American Bar Association
New York State Bar Association
Association of the Bar of the City of New York (Former member of Executive Committee)
Associated Harvard Alumni (Vice President, 1969-70; President, 1970-71)
Harvard Law School Association (Former member, National Council)

Name:	Bowsher, Charles Arthur
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Date and Place of Birth:	May 30, 1931 Elkhart, Indiana
Present Position:	Partner, Arthur Andersen & Co., C.P.A.'s Washington, D.C. office (1971-)
Education:	B.S., University of Illinois (1953) N.B.A., University of Chicago (1956)
Past Experience:	Partner, Arthur Andersen & Co., C.P.A 's Chicago office (1956-67) Assistant Secretary of the Navy (1967-71)
Awards:	Distinguished Public Service Award, U.S. Navy (1969, 71) Distinquished Public Service Award, Department of Defense (1971)
Special Activities:	Chairman, Board of Visitors, Defense Systems Management School Member, Board of Trustees and Executive Committee, National Security Industrial Assn. Member, Federal Government Executive Committee and Management Advisory Services Division Task Force, American Institute of Certified Public Accountants. Member, Public Sector Advisory Committee, Metropolitan Washington Board of Trade Alumni Association, Pi Kappa Alpha, University of Illinois (President, 1958-65) Member, Alumni Council, University of Chicago Graduate School of Business
Affiliations:	American Institute of Certified Public Accountants District of Columbia Institute of Certified Public Accountants Alumni Association, Graduate School of Business, University of Chicago (Vice President, 1965-67) University of Illinois Alumni Association Metropolitan Washington Board of Trade

University Club
United States Naval Institute
Navy League of the U.S., D.C. Council
University of Illinois Alumni Association

Name:	Gort, Michael
Address:	Office: Economics Department State University of New York John Lord O'Brian Hall, North Campus Buffalo, New York 14260
	Home: 425 Woodbridge Avenue Buffalo, New York 14214
Date and Place of Birth:	1923 Russia
Present Position:	Professor of Economics, State University of New York, Buffalo, New York (1963-) and Senior Research Staff, National Bureau of Economic Research (1972-)
Education:	A.B. Brooklyn College (1943) M.A., Columbia (1951) Ph.D., Columbia (1954)
Past Experience:	Visiting Professor of Economics, Northwestern University (1967-68) Economist, U.S. Department of Commerce (1962-63) Associate Professor of Finance, University of Chicago (1957-62) Research Associate, National Bureau of Economic Research (1954-57) Lecturer in Economics, University of California, Berkeley (1951-54) Research Fellow, Social Science Research Council (1949-51) Economic Analyst, U.S. Treasury Department, (1945-47)
Special Activities:	Consultant to U.S. Federal Trade Commission, (1966-68) U.S. Department of Commerce, (1963-65) U.S. Bureau of the Census (1955)

DATES AND LOCATIONS OF MEETINGS

Dates	Locations
March 9, 1973	Washington, D.C.
April 9, 1973	Washington, D.C.
May 4, 1973	New York, New York
May 31, 1973 1/	Washington, D.C.
June 13, 1973 2/	New York, New York
July 26, 1973	New York, New York
September 28, 1973	New York, New York
November 5, 1973	Baltimore, Maryland
November 30, 1973 3/	Washington, D.C.
February 8, 1974	New York, New York
March 1, 1974	New York, New York
March 18, 1974	New York, New York
March 29, 1974	New York, New York
April 5, 1974	New York, New York
April 15, 1974	New York, New York

1/ Meeting with carriers-representatives were as follows:
John McCabe, President, Michigan Medical Service Inc.
Richard Erickson, Executive Director, South Dakota Medical Service, Inc.
Morris Fitzmorris, Vice President, Pan American Life Insurance Co.
John L. Thompson, President, Massachusetts Blue Shield, Inc.
Dale Skelton, Second Vice President, Admin., General American Life Insurance Co.
Charles Stewart, Executive Vice President (Gov't Programs) California Physicians Service
Robert Stewart, Director, Medicare Administration, Aetna Life and Casualty
Victor Brian, President, Medical Service of D.C.
George Melcher, M.D., President, Group Health, Inc.

2/ Meeting with data processing subcontractors-representatives were as follows:
Richard A. Laudati, President, Applied Systems Development Corporation
W.R. Vickroy, Vice President for Marketing, McDonnell Douglas Automation Company
J.R. VonGillern, President, Systems Resources Inc.
Milledge A. Hart, III, President, E.D.S. Federal Corp.
Norman Kelly, President, National Time Sharing & Data Service
John L. Krakauer, Director, Health Care Corp., Optimum Systems Inc.

3/ Meeting with Secretary of Health, Education, and Welfare

SEAL

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-164031(4) January 8, 1974

The Honorable L. H. Fountain, Chairman
Subcommittee on Intergovernmental Relations
House Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

Further reference is made to your letter of April 30, 1973, which requested our views on several questions concerning contracts with carriers under part "B" of the Medicare program. By letter of July 17, 1973, copy enclosed, the Acting General Counsel, Department of Health, Education and Welfare (HEW), provided us with a statement of that agency's views on the questions presented.

Your questions, with a discussion of HEW's position and a statement of our views, follow:

> "1. Do the Federal Property and Administrative Services Act and the Federal Procurement Regulations apply to agreements between the Social Security Administration and Medicare carriers?"

We understand that the agreements to which your question refers are those entered into between the Secretary of HEW and carriers pursuant to section 1842 of the Social Security Amendments of 1965, Public Law 89-97, July 30, 1965, 79 Stat. 286. Section 1842 is codified at 42 U.S.C. 1395u and provides, inter alia, that the Secretary is authorized to enter into contracts with carriers which will perform, or secure the performance of, various administrative functions in connection with the voluntary supplementary medical insurance program established by Public Law 89-97.

The HEW Acting General Counsel in his letter of July 17, 1973, answers this question in the affirmative:

> "In my opinion, the contracts between the Secretary and carriers under Part B of the Medicare program authorized by §1842 of the Social Security Act, 42 U.S.C. §1395u, are contracts within the meaning of §302(a) of the Federal Property and Administrative Services Act of 1949, 41 U.S.C. §252(a). That Act and the Federal Procurement Regulations therefore apply to these contracts to the extent consistent with the Social

> "Security Act, which authorizes these contracts and prescribes certain of their terms and conditions. For example: The contracts may be entered into without formal advertising; the Secretary is given broad discretion in determining contractor responsibility; the contracts may provide for automatic renewal; and advance payments are permitted. Social Security Act, §1842, 42 U.S.C. §1395u."

We agree with the Department's conclusion. As the Acting General Counsel points out, the applicability of the Federal Property and Administrative Services Act of 1949 (hereinafter the Property Act) and the Federal Procurement Regulations (FPR) issued pursuant to title III thereof to the procurement of supplies and services is as provided in 41 U.S.C. 252(a):

> "(a) Executive agencies shall make purchases and contracts for property and services in accordance with the provisions of this chapter and implementing regulations of the Administrator; but this chapter does not apply--
>
> (1) * * * * *
>
> (2) when this chapter is made inapplicable pursuant to section 474 of Title 40 or any other law, but when this chapter is made inapplicable by any such provision of law sections 5 and 8 of this title shall be applicable in the absence of authority conferred by statute to procure without advertising or without regard to said section 5."

40 U.S.C. 474 does not contain an exemption for any purchases and contracts made by HEW. Further, review of Public Law 89-97 as a whole and its legislative history does not indicate that Congress intended that the contracting authority in Public Law 89-97 or in section 1842 thereof constitute "other law" within the meaning of 41 U.S.C. 252(a)(2), and thus be exempt from the Property Act. It is noted that section 1842(b)(1) provides that the Secretary may enter into contracts without regard to any requirement for competitive bidding pursuant to 41 U.S.C. 252(c)(15), i.e., as "otherwise authorized by law," and thus subject to the FPR. See 41 U.S.C. 260. Moreover, this limited, explicit exemption from the provisions of the Property Act and R.S. 3709 (41 U.S.C. 5) tends to negate any contention that Congress intended to create a broader, implied exemption from Title III of the Property Act. Further, we note that while the Secretary is granted limited discretion as to the terms of the contracts, there is no provision in section 1842 to the effect that the contracting authority may be exercised without regard to

any other provision of law; that is to say, section 1842 lacks the relatively standardized language which has been used to exempt certain procurements from the statutes which generally govern purchases and contracts by the Government. See 46 Comp. Gen. 183, 185-186 (1966). Accordingly, we concur in the Department's affirmative answer to your first question.

> "2. In the absence of a specific waiver or circumstances giving rise to a specific exemption, do the 'Truth in Negotiation' provisions of the Federal Procurement Regulations require contracting officers to insure, before approving proposed subcontracts, that carriers have undertaken price or cost analysis and have required submission and certification of cost or pricing data by the subcontractor?
>
> "If so, in the absence of compliance with such requirement or requirements, does the contracting officer have authority to approve subcontracts and would purported approval without authority obligate the government?

FPR 1-3.807-3 directs the contracting officer to require a prospective contractor to submit and certify written cost or pricing data prior to the award of any negotiated contract expected to exceed $100,000 in amount or the pricing of any contract modification expected to exceed $100,000 in amount, subject to certain exceptions. With regard to subcontracts, subsection (d) provides:

> "Any contractor who has been required to submit and certify cost or pricing data in accordance with this § 1-3.307-3 shall also be required to obtain cost or pricing data from his subcontractors under the circumstances set forth in the appropriate clause in § 1-3.814-3."

FPR 1-3.814-3 provides for the inclusion of clauses in the prime contract which specify that the contractor shall require subcontractors to submit and certify cost or pricing data prior to the award of certain subcontracts. Where, as here, firm fixed price subcontracts are involved, the clause included in the prime contract would require the Medicare carrier to obtain cost or pricing data from a subcontractor in the following circumstances:

> "Prior to the award of any other subcontract, the price of which is expected to exceed $100,000 or to the pricing of any subcontract change or other modification for which the price adjustment is expected to exceed $100,000, where the price or price adjustment is not based on adequate price competition, established catalog or market prices of commercial items sold in

"substantial quantities to the general public, or prices set by law or regulation."

Also, FPR 1-3.807-10(b) provides that where the contracting officer's consent to a proposed subcontract is required, as is the case with the Medicare contracts, consent is conditioned upon the carrier conducting either price analysis or cost analysis, depending on the circumstances:

> "In the review of subcontracting there should be assurance that the contractors obtain competition, if available, from qualified sources in their award of subcontracts to the extent consistent with the procurement of the required services or supplies. Contractors shall be required to undertake appropriate price analysis (see § 1-3.807-2(b)) in all significant subcontract transactions, and to undertake cost analysis (see § 1-3.807-2(c)) if competition is not available or does not yield reasonable subcontract prices. Where the contracting officer's consent to subcontract is required (see § 1-3.903), price or cost analysis shall be required as a condition to such consent."

The submission of cost or pricing data precedes cost analysis, which, by definition, involves the evaluation of such data. FPR 1-3.807-2(c). Price analysis, on the other hand, does not involve evaluation of cost or pricing data. FPR 1-3.807-2(b).

In view of the foregoing, a general statement of the circumstances where a contracting officer should insure, before approving a proposed subcontract, that the Medicare carrier has secured the submission and certification of cost or pricing data and has conducted cost analysis of such data would be as follows. By virtue of the contract clauses set forth in FPR 1-3.814-3, supra, a Medicare carrier would be obligated by the terms of its contract with the Government to obtain the submission and certification of cost or pricing data prior to award where the subcontract price is expected to exceed $100,000 and "is not based on adequate price competition, established catalog or market prices of commercial items sold in substantial quantities to the general public, or prices set by law or regulation." Cost analysis of such data is required by regulation (FPR1-3.807-10(b)) where it appears that "competition is not available or does not yield reasonable subcontract prices." By virtue of the same regulatory provision, the contracting officer is directed to condition his consent upon the conduct of cost analysis in such situations.

The HEW Acting General Counsel takes the view that the requirement for price or cost analysis as a condition to the contracting officer's consent to the subcontract may be regarded as a condition subsequent. In other words, the contracting officer may give approval prior to a subcontract award on condition that the carrier perform price or cost analysis at a later time. We do not believe this interpretation is correct. The pricing techniques set forth in FPR 1-3.807-1, et seq., are clearly directed at determining whether a proposed price or the contractor's estimated costs indicate that the resulting contract price will be fair and reasonable. To interpret the regulations as permitting required price or cost analysis to be conducted after contract award renders them virtually meaningless.

As for your question of the contracting officer's authority to approve a subcontract where there is a departure from some of the above requirements, we believe that the legal effect of such action would depend on the time such issue was raised and, most importantly, the particular facts and circumstances involved.

As for the factual background of Medicare Part B contracts and subcontracts, we understand that until recently, HEW had in effect taken the position that FPR was not generally applicable to such contracts; specifically, HEW did not regard the FPR provisions relating to cost or pricing data, supra, as having applicability. Further, only a small number of firms apparently possessed the expertise necessary to perform the data processing work involved in Medicare Part B claims. As a result, since the inception of the Part B insurance program a large percentage of the carriers' subcontracts for data processing work have been awarded to one particular company or to one of this company's subsidiaries. We understand that in past years, there was sometimes no competitive bidding for the subcontracts; that cost or pricing data were not obtained from prospective subcontractors; and that approval of subcontracts was sometimes not given until after they were awarded and performance had begun.

In regard to these past contracts, the issue of whether the contracting officer had authority to approve a subcontract where cost or pricing data had not been obtained, and whether such approval would obligate the Government, could arise in the context of a dispute between the Government and a carrier over reimbursement of the carrier's costs related to its data processing subcontract. The Government could raise the contention that, where cost or pricing data were not obtained, approval of a particular subcontract was without legal effect, or that there was no timely approval, and therefore that the carrier's costs in connection with the subcontract are not reimbursable.

In response to these contentions, a carrier could argue that improper approval by the contracting officer estops the Government from later refusing to reimburse subcontract costs. This was essentially the result in the case cited by the Acting General Counsel of HEW, Branch Banking and Trust Company v. United States, 120 Ct. Cl. 72, cert. denied, 342 U.S. 893 (1951). See also Penn-Ohio Steel Corporation v. United States, 354 F. 2d. 254 (Ct. Cl. 1965); Power Service Corporation v. Joslin, 175 F. 2d. 698 (9th Cir., 1949). While a definitive answer is not possible, it appears doubtful that improper subcontract approval could serve as a tenable basis for refusing to reimburse subcontract costs.

Given the factual background of the Medicare Part B contracts and subcontracts, we have little doubt that as a matter of policy it is highly desirable for the contracting officer to condition his approval of data processing subcontracts on the carriers' obtaining cost or pricing data and conducting cost analysis.

Recent changes which have been made in the terms of the prime contracts indicate that HEW has recognized both the importance of obtaining subcontractor cost or pricing data and the requirements imposed by the FPRs. The terms of the prime contracts in effect during fiscal year 1974 provide generally for prior written approval of both first tier and lower tier subcontracts. The contracts also provide as follows:

> "It is the policy of the Government to procure property and services from responsible sources at fair and reasonable prices calculated to result in the lowest ultimate cost to the Government. In order to achieve this objective, competitive proposals shall be utilized to the maximum practical extent. If competition is not available or does not yield reasonable subcontract prices, the Carrier shall also be required to undertake appropriate price analysis in accordance with Part 1-3.807-2(b) of the Federal Procurement Regulations and to undertake cost-analysis in accordance with Part 1-3.807-2(c) of the Federal Procurement Regulations in all subcontracts subject to approval of the Secretary under paragraph B of this Article."
>
> "For any subcontract or modification of a subcontract entered into or renewed under this agreement where the estimated cost to Medicare under the subcontract exceeds $100,000 and is not based on adequate price competition, established catalog or market prices of commercial items sold in substantial quantities to

> "the general public, or prices set by law or regulation, the Carrier shall, in accordance with Parts 1-3.807-3, and 1-3.807-4 of the Federal Procurement Regulations, require the subcontractor to submit written cost or pricing data and certify that the cost or pricing submitted was accurate, complete, and current prior to the entry into the subcontract or modification of a subcontract. The Carrier further agrees, through inclusion in all such subcontracts, to require subcontractors to maintain full and complete accounting records to support cost or pricing data submitted aforesaid, to require subcontractors to provide for full access by the Carrier, the Secretary, and the Comptroller General of the United States for the purpose of of examining the accuracy of cost or pricing data submitted as aforesaid, and in accordance with Parts 1-3.807-5 and 1-3.814-3 of the Federal Procurement Regulations to agree to a reduction in price if the cost or pricing data submitted is found to be defective."

The determination of whether one of the "based on" exemptions cited above is applicable requires the exercise of sound judgment by procurement officials. Where a decision that the "based on" concept should not apply has been reached after an extensive and careful review of the factual matters involved, there has been a proper exercise of judgment and the certified cost or pricing data must be furnished. See 49 Comp. Gen. 216 (1969).

The question of the extent of the Government's obligation under approved subcontracts is further discussed in questions 3 and 4, infra.

> "3. In the absence of specific statutory authority, can a contracting officer through approval of a subcontract validly impose either a conditional or unconditional obligation on the government for a period in excess of the period for which funds have been appropriated to carry out the agreement with the carrier?"

As the Acting General Counsel's letter points out, funds are obligated at the time a binding agreement in writing is entered into by the Secretary and a carrier. 31 U.S.C. 200(a)(1); 38 Comp. Gen. 190 (1958). Since these are cost contracts, the exact amount of the Government's obligation remains to be determined in accordance with FPR Subpart 1-15.2. Costs which are reasonable, allowable, and allocable will be reimbursed to the carriers. However, we do

not believe that the approval of a subcontract per se creates any obligation of appropriated funds for any period of time. See the discussion of your question 4, infra. Further, from the terms of the prime contracts, it does not appear that there is any direct contractual relationship (privity of contract) between the Government and the subcontractors. The Government's approval of a subcontract is insufficient to create privity. It has been held that even where a prime contract provides for Government approval of the subcontractor and of all the terms of the subcontract, and that the subcontractor will be subject to all the terms of the prime contract, no privity of contract exists between the Government and the subcontractor. Continental Illinois National Bank et al. v. United States, 112 Ct. Cl. 563 (1949).

> "4. Where valid, does approval of a subcontract by the Social Security Administration constitute a determination that the contract price is 'reasonable' and that the amount paid to the subcontractor is fully reimbursable to the carrier?"

In this regard, the terms of the agreement currently in effect between the Secretary and the carriers provide as follows:

> "Prior written approval given by the Secretary under any of the provisions of this Article shall not be construed to constitute a determination of the allowability or unallowability of any costs under this agreement unless so stipulated."

In view of this provision, we conclude that approval of a subcontract per se would not validly determine that the resulting costs incurred by the prime contractor are fully reimbursable; the determination of reimbursable costs would still have to be made in accordance with FPR Subpart 1-15.2.

> "5. Under an agreement providing for reimbursement of 'reasonable costs,' can the Department of Health, Education, and Welfare properly reimburse claimed expenses where, because access to records is refused, HEW cannot verify that all services and supplies involved were actually provided and that the costs were 'reasonable'?"

The Acting General Counsel of HEW has answered this question in the negative as follows, and we concur in his views:

> "It would be improper to reimburse costs under a contract unless they were determined to be reasonable. Application of this principle has given rise to the

> "appeal of Kansas Blue Cross and Blue Shield, ASBCA No. 17772, which is presently pending before the Armed Services Board of Contract Appeals (designated as the representative of the Secretary to hear and decide appeals under contracts of this Department). There the Social Security Administration, being unable to audit the records of a supplier of data processing services to a Medicare Part B carrier, made its own determination of what a reasonable cost for the services should be. The contractor has appealed that decision. If the Administration can obtain sufficient information apart from the contractor's records, it can, of course, make its determination either that the claimed costs are reasonable or that they are unreasonable, as the case may be."

"6. Is the intent of statutory requirements concerning contractual provisions for examination of records accomplished by provisions requiring access to records of a subcontractor but not permitting access to the records of affiliated firms providing a major portion of the supplies and services furnished under the subcontract?"

Both the Federal Property and Administrative Services Act of 1949 and the Armed Services Procurement Act direct that a clause shall be included in negotiated contracts providing in substance that the Comptroller General and his representatives are entitled, until the expiration of three years after final payment, to examine any books, documents, papers, or records of the contractor, or any of his subcontractors, that directly pertain to, and involve transactions relating to, the contract or subcontract. See 41 U.S.C. 254(c) and 10 U.S.C. 2313(b), respectively. These provisions were added to the procurement statutes by Public Law 82-245, October 31, 1951, 65 Stat. 700.

Senate Report No. 603 on S. 921, the bill enacted as P.L. 82-245, August 1, 1951, stated at page 2 that the purpose of the act was as follows:

> "The Federal Property and Administrative Services Act of 1959 and the Armed Services Procurement Act of 1947 are general legislation of permanent application to a very large percentage of Government procurement. They authorize negotiation of contracts without advertising under certain specified circumstances in the discretion of the agency head. Since it is well recognized that negotiated contracts are at the

> "same time effective procurement instrumentalities under special circumstances, and require close supervision and control, this legislation would make examination by the Comptroller General a permanent part of procurement procedure on a basis of broad application. This bill would have the effect of extending the examination provisions added to the First War Powers Act by Public Law 921 of the Eighty-first Congress."

The intent behind a similar provision added to the First War Powers Act, 1941, by Public Law 81-921, January 12, 1951, 64 Stat. 1257, was described by Congressman Celler at page 17305 of the Congressional Record, House, January 2, 1951:

> "As I understand the Hardy amendment, the powers given are like a Damoclean sword that will hang over the heads of the contractors whose contracts are changed. The amendment will give power to the General Accounting Office to go into the books and delve into the records of these contractors who have been relieved to determine whether or not there is fraud or over-reaching or whether they have done anything untoward, in which event reports will be made and suitable action may be taken. The power of investigation and inquiry of the General Accounting Office should be an excellent deterrent. Those reports also would be of great help subsequently on the question of renegotiation."

The sponsor of the amendment to the First War Powers Act, Congressman Hardy, also sponsored H.R. 2574, 82d Congress. S. 921 was passed in lieu of H.R. 2574 after being amended to contain provisions of the House bill, as passed. A statement of Congressman Hardy as to H.R. 2574's purposes is contained at page 13499 of the Congressional Record, House, October 15, 1951:

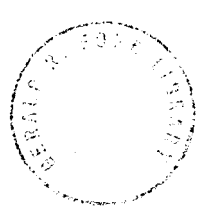
> "The major purposes of this bill are twofold: One, to give the Comptroller General the proper tools to do the job the Congress has instructed him to do; and, two, to provide a deterrent to improprieties and wastefulness in the negotiation of contracts."

The foregoing statements of purpose are indicative of a strong Congressional concern over possible excessive costs in negotiated contracts and of the need to establish an investigatory procedure adequate to enable this Office to carry out its auditing

responsibilities. It should be noted that the statutes themselves do not authorize this Office to examine contractors' records; rather, they provide for the inclusion in negotiated contracts of a clause giving such rights. The specific meaning of the clause and the extent of this Office's powers thereunder are matters necessarily determined on a case-by-case basis. The legislative history and the Congressional intent expressed therein are, of course, for consideration in determining the meaning of the clause as applied to a particular situation. Cf. Hewlett-Packard Company v. United States, 385 F. 2d. 1013 (9th Cir., 1967).

Initially, the language of the clause on its face indicates that the scope of access is limited to first-tier subcontractors, since it refers to the records of "his"--that is, the prime contractor's--subcontractors. See, in this regard, 32 Comp. Gen. 277 (1952). We do not believe this limitation completely excludes the possibility that the contractual rights conferred by the access clause would enable this Office to obtain access to records of what might be termed an affiliated lower-tier subcontractor, since, in view of the Congressional purposes discussed above, in appropriate circumstances it is conceivable that the records of the lower-tier subcontractor could directly pertain to, and involve transactions relating to, the (first-tier) subcontract.

This theory as applied to the facts of the Medicare subcontracts as we understand them would require looking behind the corporate organization of the first-tier subcontractor to determine if its corporate form is merely a device to circumvent the Government's right of access to records of the lower-tier subcontractor which is actually performing the work. We note that the courts have sometimes considered whether the corporate form is being used to circumvent a statute. However, limited instances where exception has been taken to the general rule that the reasons for incorporation will not be questioned have usually involved situations where an affiliated corporation was being used to evade a clear statutory prohibition. See, for example, Northern Securities Co. v. United States, 193 U.S. 197 (1904) and Anderson v. Abbott, 321 U.S. 349, rehearing denied 321 U.S. 804 (1944). In the event of an attempt to pierce the corporate veil of a Medicare subcontractor, the contention could be made that, since the statutory access to records provisions do not impose any clear prohibition or liabilities upon forms of corporate organization, the interests of the Government are not sufficiently compelling to justify looking behind the particular corporate form of organization involved. While the matter is not free from doubt, after careful review of the facts and circumstances of the Medicare carrier contracts and subcontracts, we are of the view that the theory of access to affiliated lower-tier subcontractors under the contract access clause is not legally viable.



In any event, we note that the provisions of the currently effective carrier contracts provide for access to records of affiliated lower-tier subcontractors.

"Article XX
EXAMINATION OF RECORDS

"A. The Carrier shall maintain adequate accounting records covering the use of funds under this agreement. The carrier agrees that the Secretary and the Comptroller General of the United States (including their duly authorized representatives) until the expiration of three years after final payment for the term of this agreement or of the time periods for particular records specified in Part 1-20 of the Federal Procurement Regulations (41-CFR Part 1-20), whichever expires earlier, shall have access to and the right to examine any directly pertinent books, documents, papers, and records of the Carrier involving transactions related to this agreement.

"B. The Carrier further agrees to include in all subcontracts under this agreement, a provision to the effect that the subcontractor agrees that the Secretary and the Comptroller General of the United States (including their duly authorized representatives) until the expiration of three years after final payment for the term of the subcontract or of the time periods for particular records specified in Part 1-20 of the Federal Procurement Regulations (41-CFR Part 1-20), whichever expires earlier, shall have access to and the right to examine any directly pertinent books documents, papers, and records of subcontractors, and those of any parent, affiliated or subsidiary organization performing under formal or informal arrangement any service or furnishing any supplies or equipment to the subcontractor, involving transactions related to the subcontract. The term 'subcontract' as used herein excludes (1) purchase orders not exceeding $2,500 and (2) subcontracts or purchase orders for public utility services at published rates established for uniform application to consumers."

"7. Do the Federal Procurement Regulations require reservation of a government right to inspect and audit records of lower tier subcontractors where the prime contract provides for approval of subcontracts and all or part of the first tier subcontract is of a 'time and material' type?"

We agree with the HEW Acting General Counsel's view that the reservation of the Government's right for access to records of lower-tier contractors applies where the contract is wholly of the time and materials type, or where the other circumstances of FPR 1-3.903-2(c) are applicable. The Medicare carrier subcontracts do not appear to fit the description of time and materials type contracts, which are contracts which provide for the procurement of property or services on the basis of (1) direct labor hours at specified fixed hourly rates and (2) material at cost. FPR 1-3.406-1(a). In any event, as indicated previously, the terms of the current agreement between the Secretary and the Medicare carriers provide for the access to and the right to examine any directly pertinent books, documents, papers, and records of subcontractors, and those of any parent, affiliated or subsidiary organization.

Sincerely yours,

Robert F. Keller

/s/

Deputy Comptroller General
of the United States

Enclosure

SEAL

DEPARTMENT OF HEALTH, EDUCATION, AND WELFARE
OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20201

OFFICE OF THE
GENERAL COUNSEL

Honorable Elmer B. Staats
Comptroller General
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

July 17, 1973

Dear Mr. Staats:

In reply to your letter of May 16, 1973 to the Secretary, we have the following responses to the questions posed by Congressman Fountain:

1. In my opinion, the contracts between the Secretary and carriers under Part B of the Medicare program authorized by §1842 of the Social Security Act, 42 U.S.C. §1395u, are "contracts" within the meaning of §302(a) of the Federal Property and Administrative Services Act of 1949, 41 U.S.C. §252(a). That Act and the Federal Procurement Regulations therefore apply to these contracts to the extent consistent with the Social Security Act, which authorizes these contracts and prescribes certain of their terms and conditions. For example: the contracts may be entered into without formal advertising; the Secretary is given broad discretion in determining contractor responsibility; the contracts may provide for automatic renewal; and advance payments are permitted. Social Security Act, §1842, 42 U.S.C. §1395u.

2. Federal Procurement Regulations, §1-3.807-10(b), provides that "where the contracting officer's consent to subcontract is required . . . price or cost analysis shall be required as a condition to such consent." The FPR does not, however, contain the analogous requirement that, when subcontractor cost and pricing data are required, 1/ and the prime contract requires contracting officer approval of subcontracts, a subcontract may not be approved until the required data are furnished.

1/ FPR §1-3.807-3 requires contractors under certain types of contracts to submit cost and pricing data and a certification that it is accurate, complete, and current. FPR §1-3.807-3(d) requires such contractors to obtain cost and pricing data and a similar certification from subcontractors under certain subcontracts. Contracts under which cost and pricing data are required are subject to price reduction if the data furnished by the prime contractor or any subcontractor are incomplete, inaccurate, or not current.

Since the requirement of subcontract approval is independent of the requirement that the subcontractor submit cost and pricing data it cannot be said that the contracting officer lacks authority to approve a subcontract until the cost and pricing data has been submitted. Nor do I feel that the contracting officer lacks authority to approve a subcontract when the subcontractor has failed to perform a cost and price analysis even though the FPR expressly conditions that approval on the conduct of a cost and price analysis. In Branch Banking and Trust Co. v. United States, 120 Ct. Cl. 72, cert. denied, 342 U.S. 893 (1951), a contracting officer approved a subcontract which called for compensation in excess of that permitted under the contract. The Government sought to withhold the amounts paid in excess of the contract limitation, but the Court of Claims held that the Government was estopped to deny the binding effect of the contracting officer's approval of the subcontracts and consequently could not recover. Your office, too, has refused to direct cancellation of a contract despite the fact that the agency failed either to require cost and pricing data or to waive the requirement in accordance with the Federal Procurement Regulations. 46 Comp. Gen. 631 (1967).

3. Funds are ordinarily obligated by execution of a contract which meets the requirements of 31 U.S.C. §§200 and 712a, as interpreted by your decisions. Approval of a subcontract does not constitute an obligation of funds and could therefore not be considered to obligate the Government beyond the term of the original contract. Approval of a long term subcontract may, however, restrict the Government's opportunity to challenge the allowability of costs incurred under that subcontract and charged to a prime contract subsequently executed. (See our answer to question 4, below.)

4. One of the principal purposes of requiring subcontract approval is to give the Government the opportunity to review the reasonableness of the proposed subcontract price. Opinions of your office strongly suggest that a contracting officer should not approve a subcontract which contains an unreasonably high price. 41 Comp. Gen. 424, 427 (1961). Accordingly, we feel that Government approval of a subcontract would be deemed, by a board of contract appeals or a court, to be a determination that the price was reasonable and the Government would be unable to challenge the reasonableness of the cost of an approved subcontract. 2/ This answer should not, however, be taken to suggest that we are not aware of decisions of your office to the effect that subcontracts should not be approved if the award would be prejudicial to the interests of the United States (such as 49 Comp. Gen. 668 [1970]) or that we intend to disregard these decisions.

2/ This result is suggested in McDonnell Douglas Corp., NASA BCA No. 467-13, 68-2 BCA Par. 7316 at p. 34,030.

5. It would be improper to reimburse costs under a contract unless they were determined to be reasonable. Application of this principle has given rise to the appeal of Kansas Blue Cross and Blue Shield, ASBCA No. 17772, which is presently pending before the Armed Services Board of Contract Appeals (designated as the representative of the Secretary to hear and decide appeals under contracts of this Department). There the Social Security Administration, being unable to audit the records of a supplier of data processing services to a Medicare Part B carrier, made its own determination of what a reasonable cost for the services should be. The contractor has appealed that decision. If the Administration can obtain sufficient information apart from the contractor's records, it can, of course, make its determination either that the claimed costs are reasonable or that they are unreasonable, as the case may be.

6. The only statutory requirement for examination of records applicable to contracts of this Department is §304(c), of the Federal Property and Administrative Services Act, 41 U.S.C. §254(c), which requires inclusion in negotiated contracts of a clause giving the Comptroller General access to records "of the contractor or any of his subcontractors". While we have no independent opinion as to the intent of that statute, we would assume that the requirements contained in the clauses prescribed by the FPR fully carry out its intent.

7. FPR §1-3.903-2(c) requires reservation of a Government right to inspect and audit the books and records of lower tier subcontractors where the prime contract provides for approval of subcontracts and the first tier subcontract is of a time and material type, with the proviso that such a right to inspect and audit shall not be reserved contractually at or below the point where a firm fixed-price subcontract intervenes. This requirement clearly applies where the first tier subcontract is wholly of the time and material type. All carrier subcontracts under Medicare Part B are on a fixed price per claim basis.

Sincerely yours,

/s/ mbh

St. John Barrett
Acting General Counsel

LISTING OF BACKGROUND MATERIAL

I. Background Paper for Perkins Committee

II. Analysis of Intermediaries' and Carriers' Administrative Costs July-June 1972

III. Title XVIII Health Insurance for the Aged (P.L. 89-97, July 30, 1965) of the Social Security Act, as amended

IV. Composite of the Social Security Act and H.R. 1 (P.L. 92-603, October 30, 1972) Volume II, Title XVIII

V. Summary of the Provisions of H.R. 1 (pp. 8-25 Medicare)

VI. New Legislative Proposals, FY 1974 Budget, Commissioner's Bulletin No. 129

VII. Part A - Agreement with Blue Cross Association as Intermediary

VIII. Part A - Agreement with Commercial Intermediaries

IX. Part B - Agreement with Carriers, Commercial and Blue Shield

X. Part B Intermediary Manual, Part 1 Administration

XI. Criteria for Determination of Reasonable Charges HIR-5

XII. Reasonable Charges (A Training Handbook) SS PUB 98-71

XIII. Medicare Part B Carriers - Geographical Map

XIV. Bureau of Health Insurance - Regional Boundaries

XV. Bureau of Health Insurance - Organizational Chart

XVI. Identical Memorandum No. 73-21, Part B Carrier Performance Indicators

XVII. December 1972 SMI Carrier Workload Report

XVIII. Professional Standards Review Organization Task Force Progress Report

XIX. Edits Used in the Part B Model System

XX. Bureau of the Budget--Circular No. A-76 revised Policies for Acquiring Commercial or Industrial Products and Services for Government Use

XXI. Bureau of Health Insurance Identical Memorandum No. 73-21 Part B Carrier Performance Indicators

XXII. Bureau of Health Insurance Memorandum of February 12, 1973- December 1972 SMI Carrier Workload Report

XXIII. SMI Benefits for the Aged (Agreement with Carrier Pursuant to Section 1842 of the Social Security Act as Amended).

XXIV. Summary of the Report of the Commission on Government Procurement

XXV. PSRO Implementation Plan (Preliminary-December 1, 1972)

XXVI. Minutes of Committee Meetings

A. March 9, 1973

B. April 9, 1973

C. May 4, 1973

D. May 31, 1973

E. June 13, 1973

F. July 26, 1973

G. September 28, 1973

H. November 5, 1973

I. November 30, 1973

J. February 8, 1974

K. March 1, 1974

L. March 18, 1974

M. March 29, 1974

N. April 5, 1974

O. April 15, 1974

XXVII. Summary of Recommendations by Contractors Who Appeared on May 31, 1973, before the Advisory Committee on Medicare Administration, Contracting, and Subcontracting

XXVIII. Summary of Recommendations by Subcontractors Who Appeared on June 13, 1973, before the Advisory Committee on Medicare Administration, Contracting, and Subcontracting, or submitted statements to the Committee.

XXIX. Testimony on the use of private carriers in the administration of Medicare

XXX. Report of the Conference on Medicare Administration

XXXI. Reports on contract performance and evaluation, and contractor workloads and costs

XXXII. GAO report on Nationwide Mutual Insurance Co.

XXXIII. Draft procedures for requesting approval of systems changes or subcontracting for EDP services - Part B

XXXIV. Staff Papers

1. Medicare Part B Claims Process

2. SSA Model B System Expanded Comments

3. Quantification of Administrative Costs for Part B Carriers Subcontract Costs, Claims Processed, etc.

4. Response to Dr. Michael Gort's letter of January 29, 1973

5. Congressional and Public Posture on the Data Processing Issue

6. Evaluation of the Proposal for "Opening the Books" of Second Tier Contractors

7. Analysis of PSRO Issue and Bearing on Committee Objectives

7A. Update on Current PSRO Activities

8. Broad Issues Confronting the Medicare Administration and their Relationships to the Issues Facing the Committee

8A. Current Status of Usage of Different EDP Systems

9. Efforts to Promote Competition in the Area of Data Processing Subcontracts

10. Digest of Terms of Data Processing Subcontracts Entered Into by the Medicare Administration Prime Contractors

11. Summary of Available Alternative Data Processing Systems, Regional Data Center Concepts, and Other Alternatives

12. Statement on Incentives and Alternatives in Terms of Current Prime Contracts (Clarify Intent of Section 222 of Public Law 92-603)

13. Legal Opinion as to the Scope of Section XIXB of the Prime Carrier Contract

15. History of Instructions Issued on Subcontracting Procedures

16. Current Delegations of Authority for Approval of Subcontracts

17. Comments: "Report of the Commission on Government Procurement"

17A. H.R. 9059, A Bill to Create an Office of Federal Procurement Within the Executive Office of the President

18. History and Development of Performance Measurements, Criteria, Reports, and Comparative Analyses Developed and their Usage by BHI in Managing the Program with Cross-References to Background Document No. 16

19. Quantification of Data for Part B Carriers by In-House or Subcontracted Data Processing Operations (Listed by Type of System, Subcontract, In-House Unit Cost, Data Processing, Total Costs, etc.)

20. Statement on Conflict on Interest and Related Clauses Contained in Current Medicare Contracts

21. BHI Clearing-House Role in Providing Assistance to Contractors

22. Summary of Revised System for Evaluation of Contractor Performance

23. Separation of the Functions of Maintenance of the Model B System and Evaluation of Carrier Recommendations Regarding Subcontractors for EDP Services

24. Probable Effects if Federal Government's Maintenance and Enhancement of the Part B Model System Were Terminated

25. Characteristics of the Data Centers Used in Medicare (SSA, Intermediary/Carrier, Regional), Advantages and Disadvantages

XXXV. Statements of Contractors

A. Aetna Life and Casualty (Robert E. Stewart)

B. California Physicians' Service (Charles W. Stewart)

C. General American Life Insurance Co. (Dale A. Skelton)

D. Massachusetts Blue Shield Inc. (John L. Thompson)

E. Medical Service of D.C. (Victor M. Brian)

F. Michigan Medical Service, Inc. (John C. McCabe)

G. Pan American Life Insurance Company (Norris V. Fitzmorris)

H. South Dakota Medical Service, Inc. (Richard C. Erickson)

I. Blue Shield of Western New York

J. National Association of Blue Shield Plans

XXXVI. Statements of Subcontractors

A. Applied Systems Development Corp. (Richard A. Laudati)

B. Computer Systems, Inc. (John Watford)

C. Computer Task Group Inc. (R. A. Marks)

D. Cybernetics and Systems Inc. (Kenneth E. Snyder)

E. Delphi Associates Inc. (Robert N. Trombly)

F. Electronic Data Systems Corp. (Milledge A. Hart III)

G. McDonnell Douglas Automation Company (W. R. Vickroy)

H. National Time Sharing and Data Services Inc. (Norman P. Kelly)

I. Optimum Systems Inc. (John L. Krakauer)

J. Systems Resources Inc. (J. R. Von Gillern)

K. University Computing Company (Douglass M. Parnell, Jr.)

L. Vantage Computer Systems, Inc. (Robert L. Smith)

M. Electronic Data Systems Corp. Additional Materials. (Milledge A. HartII