



DEC -7 2005

TO: Mark B. McClellan, M.D., Ph.D.
Administrator
Centers for Medicare & Medicaid Services

FROM: Daniel R. Levinson *Daniel R. Levinson*
Inspector General

SUBJECT: Review of Alabama's Medicaid Upper-Payment-Limit Calculations for Hospitals and Nursing Facilities (A-04-03-02027)

Attached is an advance copy of our final report on Alabama's Medicaid upper-payment-limit (UPL) calculations for hospitals and nursing facilities. We will issue this report to Alabama within 5 business days.

The UPL is an estimate of the amount that would be paid for Medicaid services under Medicare payment principles. In 2001, the Centers for Medicare & Medicaid Services (CMS) revised Medicaid's UPL regulations (42 CFR §§ 447.272 and 447.321) to require that States calculate a separate UPL for each of the following categories of providers: private facilities, State facilities, and non-State government facilities. Federal funds are not available for State expenditures that exceed these limits. Further, pursuant to section 1923 of the Social Security Act, States must consider UPL payments and other payments received on behalf of Medicaid and uninsured patients when calculating hospital-specific disproportionate share hospital (DSH) payment limits. Medicaid makes DSH payments to hospitals that serve disproportionate numbers of low-income patients with special needs.

Our objectives were to determine whether Alabama:

- calculated the UPL for State and non-State government hospitals and for non-State government nursing facilities in accordance with Federal regulations and the approved State plan amendments and
- properly included UPL payments in the calculation of hospital-specific DSH limits.

For State fiscal year (FY) 2003, Alabama generally calculated the State and non-State government hospital outpatient UPLs in compliance with the revised Federal regulations and its State plan amendment. However, Alabama did not comply with its State plan amendment when calculating the State and non-State government hospital inpatient UPLs, nor did it comply with the revised Federal regulations when calculating the non-State government nursing facility UPL. As a result, Alabama made UPL overpayments of \$35,688,049 (\$25,746,634 Federal share) in State FY 2003.

The hospital inpatient overpayments resulted from basing the inpatient UPLs on the Medicare prospective payment methodology. That methodology was contrary to Alabama's approved State plan amendment, which specifies that the State must use Medicare cost principles to calculate the inpatient UPLs. The nursing facility overpayments occurred because Alabama improperly included a State facility in the non-State government nursing facility UPL calculation.

Contrary to section 1923 of the Act, Alabama did not include all hospital UPL payments in its calculation of hospital-specific DSH limits. As a result, the State made potential DSH overpayments of \$67,543,551 (\$47,685,747 Federal share) in State FY 2003. We computed the \$67,543,551 overpayment on the basis of the UPL payments made and claimed for reimbursement by the State, i.e., we did not adjust the State's data by our UPL findings. The actual DSH limits and associated overpayments cannot be computed until the UPL findings in this report are resolved because the State must consider all UPL payments when calculating the DSH limits. Thus, we are leaving this matter to the State and CMS for resolution.

We recommend that Alabama:

- refund to the Federal Government \$25,746,634 in UPL overpayments to State and non-State government facilities,
- comply with the approved State plan when calculating hospital inpatient UPLs for State and non-State government facilities for periods subsequent to our audit period,
- remove the State facility from the non-State government nursing facility UPL calculation for periods subsequent to our audit period,
- work with CMS to resolve potential DSH overpayments currently valued at \$47,685,747, and
- include all UPL payments when calculating hospital-specific DSH limits for periods subsequent to our audit period.

The State did not specifically address our first and last recommendations but agreed with our third recommendation. With respect to our second recommendation, Alabama said that it did comply with its State plan amendment in the UPL calculations for inpatient hospital services and that CMS had determined that Alabama's UPL calculations were in compliance with the State plan. With respect to our fourth recommendation on resolving potential DSH overpayments, the State replied that it had properly calculated the cost of uncompensated care and was working with CMS on this issue.

The State's response did not warrant any revisions to the results of our review or to our recommendations.

Page 3 – Mark B. McClellan, M.D., Ph.D.

If you have any questions or comments about this report, please do not hesitate to call me, or your staff may contact George M. Reeb, Assistant Inspector General for the Centers for Medicare & Medicaid Audits, at (410) 786-7104 or Lori S. Pilcher, Regional Inspector General for Audit Services, Region IV, at (404) 562-7750.

Attachment



DEPARTMENT OF HEALTH AND HUMAN SERVICES

Office of Inspector General
Office of Audit Services

REGION IV
61 Forsyth Street, S.W., Suite 3T41
Atlanta, Georgia 30303

DEC - 8 2005

Report Number: A-04-03-02027

Ms. Carol Herrmann
Medicaid Director
Alabama Medicaid Agency
501 Dexter Avenue
Montgomery, Alabama 36103-5624

Dear Ms. Herrmann:

Enclosed are two copies of the Department of Health and Human Services (HHS), Office of Inspector General (OIG) final report titled "Review of Alabama's Medicaid Upper-Payment-Limit Calculations for Hospitals and Nursing Facilities." A copy of this report will be forwarded to the action official noted on the next page for review and any action deemed necessary.

The HHS action official will make final determination as to actions taken on all matters reported. We request that you respond to the HHS action official within 30 days from the date of this letter. Your response should present any comments or additional information that you believe may have a bearing on the final determination.

In accordance with the principles of the Freedom of Information Act, 5 U.S.C. § 552, as amended by Public Law 104-231, OIG reports issued to the Department's grantees and contractors are made available to the public to the extent the information is not subject to exemptions in the Act that the Department chooses to exercise (see 45 CFR part 5).

If you have any questions or comments about this report, please contact me at (404) 562-7750, or have your staff contact Peter Barbera, Audit Manager, at (404) 562-7758. Please refer to report number A-04-03-02027 in all correspondence.

Sincerely,

Lori S. Pilcher
Regional Inspector General
for Audit Services, Region IV

Enclosures

Direct Reply to HHS Action Official:

Mr. Renard L. Murray
Associate Regional Administrator
Division of Medicaid & Children's Health
Centers for Medicare & Medicaid Services
U.S. Department of Health and Human Services
61 Forsyth Street, SW, Suite 4T20
Atlanta, Georgia 30303-8909

Department of Health and Human Services

**OFFICE OF
INSPECTOR GENERAL**

**REVIEW OF ALABAMA'S MEDICAID
UPPER-PAYMENT-LIMIT
CALCULATIONS FOR HOSPITALS
AND NURSING FACILITIES**



**Daniel R. Levinson
Inspector General**

**DECEMBER 2005
A-04-03-02027**

Office of Inspector General

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In accordance with the principles of the Freedom of Information Act (5 U.S.C. 552, as amended by Public Law 104-231), Office of Inspector General, Office of Audit Services reports are made available to members of the public to the extent the information is not subject to exemptions in the act. (See 45 CFR Part 5.)

OAS FINDINGS AND OPINIONS

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



EXECUTIVE SUMMARY

BACKGROUND

Upper Payment Limits

The upper payment limit (UPL) is an estimate of the amount that would be paid for Medicaid services under Medicare payment principles. In 2001, the Centers for Medicare & Medicaid Services (CMS) revised Medicaid's UPL regulations for hospitals and nursing facilities.

The revised regulations changed the manner in which States calculate the UPL for various categories of providers. Pursuant to the former rule, States were required to calculate a UPL for all facilities and another UPL for State-owned facilities. The revised regulations instead require States to calculate a separate UPL for each of the following categories of providers: private facilities, State facilities, and non-State government facilities. The regulations also created transition periods in which eligible States were allowed to make payments up to the category-specific UPL plus an excess amount (calculated based on the portion of Medicaid payments that exceeded the UPL in the applicable base year). Federal matching funds are not available for State expenditures that exceed these limits.

Medicare Payment Methodologies

In the past, Medicare paid hospitals and skilled nursing facilities based on cost principles, i.e., based on actual, reasonable costs incurred. In 1983, CMS implemented a new payment methodology based on prospective payments. Under the inpatient prospective payment system, Medicare pays acute care hospitals a predetermined, per discharge rate for inpatient services. Similarly, since 1998, Medicare has paid skilled nursing facilities a predetermined rate for each day of care based on service needs. Neither payment rate is related to the actual costs incurred in treating an individual beneficiary.

Disproportionate Share Hospital Payments

Section 1923 of the Social Security Act (the Act) requires States to make disproportionate share hospital (DSH) payments to hospitals that serve disproportionate numbers of low-income patients with special needs. Section 1923 prohibits these payments from exceeding the hospital-specific DSH limit, which is generally defined as the cost of uncompensated care. States must consider UPL payments and other payments received on behalf of Medicaid and uninsured patients when calculating hospital-specific DSH payment limits.

OBJECTIVES

Our objectives were to determine whether Alabama:

- calculated the UPLs for State and non-State government hospitals and for non-State government nursing facilities in accordance with Federal regulations and the approved State plan amendments and

- properly included UPL payments in the calculation of hospital-specific DSH limits.

SUMMARY OF FINDINGS

Upper-Payment-Limit Calculations

For State fiscal year (FY) 2003, Alabama generally calculated the State and non-State government hospital outpatient UPLs in compliance with Federal regulations and its State plan amendment. However, Alabama did not comply with its State plan amendment when calculating the State and non-State government hospital inpatient UPLs, nor did it comply with Federal regulations when calculating the non-State government nursing facility UPL. As a result, Alabama made UPL overpayments of \$35,688,049 (\$25,746,634 Federal share) in State FY 2003.

The hospital inpatient overpayments resulted from basing the inpatient UPLs on the Medicare prospective payment methodology. That methodology was contrary to Alabama's approved State plan amendment, which specifies that the State must use Medicare cost principles to calculate the inpatient UPLs. In computing the UPLs, the State multiplied each hospital's Medicaid bed days by the "Medicare payment per diem rate" for the hospital. The State developed this per diem rate by dividing historical base-period Medicare inpatient prospective payments to the hospital by the number of days Medicare beneficiaries spent in the hospital.¹

The nursing facility overpayments occurred because Alabama improperly included a State facility in the non-State government nursing facility UPL calculation. The revised Medicaid regulations require a separate UPL calculation for each category of provider.

Calculation of Disproportionate Share Hospital Limits

Contrary to section 1923 of the Act, Alabama did not include all hospital UPL payments in its calculation of hospital-specific DSH limits. As a result, the State made potential DSH overpayments of \$67,543,551 (\$47,685,747 Federal share) in State FY 2003. We computed the \$67,543,551 overpayment on the basis of the UPL payments made and claimed for reimbursement by the State, i.e., we did not adjust the State's data by our UPL findings. The actual DSH limits and associated overpayments cannot be computed until the UPL findings in this report are resolved because the State must consider all UPL payments when calculating the DSH limits. Thus, we are leaving this matter to the State and CMS for resolution.

RECOMMENDATIONS

We recommend that Alabama:

- refund to the Federal Government \$25,746,634 in UPL overpayments to State and non-State government facilities,

¹Medicare inpatient prospective payments included diagnosis-related group payments, direct and indirect medical education payments, DSH payments, outlier payments, and capital costs.

- comply with the approved State plan when calculating hospital inpatient UPLs for State and non-State government facilities for periods subsequent to our audit period,
- remove the State facility from the non-State government nursing facility UPL calculation for periods subsequent to our audit period,
- work with CMS to resolve potential DSH overpayments currently valued at \$47,685,747, and
- include all UPL payments when calculating hospital-specific DSH limits for periods subsequent to our audit period.

STATE'S COMMENTS

The State did not specifically address our first and last recommendations but agreed with our third recommendation. With respect to our second recommendation, Alabama said that it did comply with its State plan amendment in the UPL calculations for inpatient hospital services and that CMS had determined that Alabama's UPL calculations were in compliance with the State plan. With respect to our fourth recommendation on resolving potential DSH overpayments, the State replied that it had properly calculated the cost of uncompensated care and was working with CMS on this issue.

The full text of Alabama's comments is provided in the appendix.

OFFICE OF INSPECTOR GENERAL'S RESPONSE

The State's comments did not warrant any revisions to the results of our review or to our recommendations.

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STATE’S COMMENTS

INTRODUCTION

BACKGROUND

Our audit was part of a multistate review of upper-payment-limit (UPL) calculations conducted at the request of the Centers for Medicare & Medicaid Services (CMS).

Medicaid Program

Title XIX of the Social Security Act (the Act) authorizes Federal grants to States for Medicaid programs that provide medical assistance to needy persons. Each State Medicaid program is jointly financed by the Federal and State Governments and administered by the State in accordance with a State plan approved by CMS. The Federal Government pays its share of Medicaid expenditures to a State according to a formula contained in section 1905(b) of the Act.

At the State level, the Alabama Medicaid Agency is responsible for administering the Medicaid program. CMS administers the program at the Federal level.

Upper Payment Limits

While States have flexibility in determining payment rates for Medicaid providers, they must follow Federal requirements and their approved State plans. Any revisions to a State plan must be approved by CMS (42 CFR §§ 430.10 and 430.12). CMS has allowed States to use different rates to pay hospitals and nursing facilities as long as the payments, in total, do not exceed the UPL.¹ The UPL is an estimate of the amount that would be paid for Medicaid services under Medicare payment principles.

To limit abuses in the application of UPL requirements, in 2001 CMS revised its regulations (42 CFR §§ 447.272 and 447.321). The revised regulations required States to calculate a separate UPL for each category of provider.² The regulations also created transition periods in which eligible States were allowed to make payments up to the category-specific UPL plus an excess amount (calculated based on the portion of Medicaid payments that exceeded the UPL in the applicable base year). Federal matching funds are not available for State expenditures that exceed these limits.

Disproportionate Share Hospital Payments

Section 1923 of the Act requires States to make disproportionate share hospital (DSH) payments to hospitals that serve disproportionate numbers of low-income patients with special

¹For non-State government hospitals, Federal regulations allowed Medicaid payments up to 150 percent of the UPL from March 13, 2001, to May 14, 2002.

²The three categories are privately owned and operated, State government owned or operated, and non-State government owned or operated facilities.

needs. Section 1923 prohibits these payments from exceeding the hospital-specific DSH limit, generally considered the amount of incurred uncompensated care costs.

Uncompensated care costs are the costs of medical services provided to Medicaid and uninsured patients, less payments received for those patients. States must consider UPL payments and other payments received on behalf of Medicaid and uninsured patients when calculating the hospital-specific DSH payment limits.

Medicare Payment Methodologies

Until 1983, Medicare paid hospitals based on cost principles, i.e., based on actual, reasonable costs incurred. Hospitals submitted claims for individual stays and submitted cost reports showing actual costs incurred for each fiscal year. In 1983, CMS implemented a new Medicare payment methodology based on prospective payments. Under the inpatient prospective payment system (PPS), Medicare pays acute care hospitals a predetermined, per discharge rate for inpatient services based on diagnosis-related groups. Each diagnosis-related group has a nationally derived relative weight that reflects the expected average cost of care for Medicare beneficiaries in the group. The payment to an individual hospital is not related to the actual costs incurred by the hospital in providing care to a Medicare beneficiary.

Until 1998, Medicare paid skilled nursing facilities based on actual, reasonable costs incurred, with limits on some routine costs (e.g., room and board). Under the skilled nursing facility PPS, Medicare now pays the facilities a predetermined rate for each day of care. Beneficiaries are assigned to resource utilization groups based on service needs. The group assignment and the facility's location, among other factors, determine the per diem payment for the beneficiary's stay. The payment is not related to the actual costs incurred by the skilled nursing facility in treating a beneficiary.

OBJECTIVES, SCOPE, AND METHODOLOGY

Objectives

Our objectives were to determine whether Alabama:

- calculated the UPLs for State and non-State government hospitals and for non-State government nursing facilities in accordance with Federal regulations and the approved State plan amendments and
- properly included UPL payments in the calculation of hospital-specific DSH limits.

Scope

Our audit covered State fiscal year (FY) 2003 UPL calculations under the following State plan amendments:³

³The State FY begins October 1 and ends September 30.

- 94-17 for State and non-State government hospital inpatient services,
- 95-03 for State and non-State government hospital outpatient services, and
- 99-02 for non-State government nursing facility services.

We also reviewed UPL and DSH payments from October 1, 2002, through September 30, 2003. During this period, the State made hospital inpatient UPL payments of about \$222.5 million, hospital outpatient UPL payments of about \$54 million, nursing facility UPL payments of about \$58.8 million, and DSH payments of about \$354 million.

The hospital inpatient UPL payments of \$222.5 million included \$153.7 million of category-specific payments and \$68.8 million of excess amount payments (calculated based on the portion of Medicaid payments that exceeded the UPL in State FY 2000, the applicable base year). The nursing facility UPL payments of \$58.8 million included \$7.5 million of category-specific payments and \$51.3 million of excess amount payments.

We did not review the overall internal control structure of the Alabama Medicaid Agency or the providers because we accomplished the audit objectives through substantive testing.

We performed fieldwork at the Alabama Medicaid Agency in Montgomery, AL.

Methodology

To accomplish our objectives, we:

- reviewed Federal laws and regulations pertaining to UPLs and DSH payments,
- compared Federal regulatory requirements with the methodology for calculating UPLs established in the various State plan amendments,
- reviewed the classification of facilities included in each UPL category,
- tested the accuracy of underlying Medicaid and Medicare data that Alabama used to calculate UPLs,
- traced the UPL and DSH payments to the CMS-64 quarterly expenditure reports to determine whether the State claimed the payments for Federal reimbursement,
- reviewed prior Office of Inspector General audit documentation from the base year (State FY 2000) because the State claimed excess amount payments during our audit period based on State FY 2000 data, and
- reviewed the State's supporting records to determine whether the State included UPL payments in the calculation of hospital-specific DSH limits.

In determining the potential DSH overpayment, we:

- calculated the Medicaid DSH limit on a hospital-specific basis using the State's most recent uncompensated care survey,
- included 100 percent of the UPL payments,
- compared our calculated Medicaid DSH limits with DSH payments made by the State, and
- relied on information provided by CMS for the DSH payments made by the State.

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

FINDINGS AND RECOMMENDATIONS

For State FY 2003, Alabama generally calculated the State and non-State government hospital outpatient UPLs in compliance with Federal regulations and its State plan amendment. However, Alabama did not comply with its State plan amendment when calculating the State and non-State government hospital inpatient UPLs, nor did it comply with Federal regulations when calculating the non-State government nursing facility UPL. As a result, Alabama made UPL overpayments of \$35,688,049 in State FY 2003.

Furthermore, Alabama did not include all hospital UPL payments in its calculation of hospital-specific DSH limits, which is contrary to section 1923 of the Act. As a result, the State made potential DSH overpayments of \$67,543,551 in State FY 2003. We computed the \$67,543,551 overpayment on the basis of the UPL payments made and claimed for reimbursement by the State, i.e., we did not adjust the State's data by our UPL findings. The actual DSH limits and associated overpayments cannot be computed until the UPL findings in this report are resolved because the State must consider all UPL payments when calculating the DSH limits. Thus, we are leaving this matter to the State and CMS for resolution.

UPPER-PAYMENT-LIMIT CALCULATIONS

Alabama's noncompliance with Federal regulations and with the State plan amendment resulted in category-specific UPL overpayments of \$35,688,049 (\$25,746,634 Federal share) in State FY 2003, as detailed in Table 1 on the next page.

Table 1: UPL Overpayments in State FY 2003

UPL Payment Type	Total Overpayment	Federal Share
State hospital inpatient	\$15,044,212	\$10,832,888
Non-State government hospital inpatient	19,122,300	13,817,098
Total hospital inpatient	\$34,166,512	\$24,649,986
Non-State government nursing facility	1,521,537	1,096,648
Total	\$35,688,049	\$25,746,634

State and Non-State Government Hospital Inpatient Upper-Payment-Limit Funding

Of the category-specific hospital inpatient UPL payments totaling \$153.7 million in State FY 2003, \$34,166,512 did not meet the requirements of State plan amendment 94-17. The amendment specifies that Alabama must use Medicare cost principles in calculating the hospital inpatient UPLs. However, Alabama used the Medicare PPS methodology (converted to a per diem basis) to calculate UPLs totaling \$106,605,310.

In computing the UPLs, the State multiplied each hospital's Medicaid bed days by the "Medicare payment per diem rate" for the hospital. The State developed this per diem rate by dividing historical base-period Medicare inpatient PPS payments to the hospital by the number of days Medicare beneficiaries spent in the hospital.⁴

To determine whether a UPL overpayment occurred, we compared the State's 2003 UPL calculations based on the Medicare PPS methodology with our UPL calculations based on Medicare cost principles.

Although the State did not have cost information available for State FY 2003, it did have hospital cost data available for State FY 2000, as well as trend factors for inflation. Therefore, we used the State's 2000 cost data and applicable inflation factors to determine what the 2003 UPLs would have been based on the State's methodology and Medicare cost principles as required by the State plan. Our calculation of the UPLs totaled \$72,438,798. We compared our calculation with the State's UPLs totaling \$106,605,310 and determined that the State had overstated the UPLs, as well as the actual Medicaid payments, by \$34,166,512 (\$24,649,986 Federal share). The \$34,166,512 is ineligible for Federal reimbursement.

These types of overpayments will occur in the future if the State continues to violate the State plan by using the Medicare PPS methodology, rather than cost principles, to compute the UPLs.

⁴Medicare inpatient PPS payments included diagnosis-related group payments, direct and indirect medical education payments, DSH payments, outlier payments, and capital costs.

Nursing Facility Upper-Payment-Limit Funding

Of the \$7,477,614 in category-specific nursing facility UPL payments in State FY 2003, \$1,521,537 did not comply with Federal regulations.

Federal regulations (42 CFR § 447.272) provide for separate aggregate upper limits on payments to State, non-State, and private facilities. However, Alabama improperly included a State nursing facility in the UPL calculation for non-State government facilities. The State’s UPL calculation totaled \$7,477,614, including \$1,521,537 for the State facility. Therefore, Alabama made \$1,521,537 (\$1,096,648 Federal share) in Medicaid payments in excess of the properly calculated UPL. The \$1,521,537 is ineligible for Federal reimbursement.

These types of overpayments will occur in the future if the State continues to violate Federal regulations by including a State facility in the UPL calculation for non-State government facilities.

CALCULATION OF DISPROPORTIONATE SHARE HOSPITAL LIMITS

Contrary to section 1923 of the Act, Alabama did not include all hospital inpatient and outpatient UPL payments in its calculation of hospital-specific DSH limits.

Section 1923 of the Act prohibits DSH payments from exceeding the hospital-specific DSH limit, which represents the costs incurred during the year of furnishing hospital services to Medicaid and uninsured patients less payments received for those patients (i.e., the cost of uncompensated care). In August 2002, CMS issued a letter to State Medicaid directors clarifying the requirement that States must include Medicaid UPL payments as a reduction of Medicaid and uninsured costs when calculating hospital-specific DSH limits.

As shown in Table 2, Alabama’s calculation of the hospital-specific DSH limits for State FY 2003 included only \$144.1 million of the \$276.5 million in actual UPL payments to State and non-State government hospitals.

Table 2: UPL Payments Excluded From the DSH Calculation

Total UPL payments (inpatient and outpatient)	\$276.5 million
Less amount included in the DSH calculation	<u>144.1 million</u>
Amount excluded from the DSH calculation	<u><u>\$132.4 million</u></u>

The State’s calculation reduced the cost of uncompensated care only by the portion of the UPL payments that the hospitals retained. Upon receipt of the UPL payments, the hospitals returned a portion of the funds to the State through intergovernmental transfers (IGTs). The State’s hospital-specific DSH limit calculation did not include the \$132.4 million of UPL payments returned to the State.

As a result, Alabama overstated the State FY 2003 DSH limits and made DSH overpayments of \$67,543,551 (\$47,685,747 Federal share). We computed the \$67,543,551 overpayment on the basis of the UPL payments made and claimed for reimbursement by the State, i.e., we did not adjust the State's data by our UPL findings. The actual DSH limits and associated overpayments cannot be computed until the UPL findings in this report are resolved because the State must consider all UPL payments when calculating the DSH limits. Thus, we are leaving this matter to the State and CMS for resolution.

RECOMMENDATIONS

We recommend that Alabama:

- refund to the Federal Government \$25,746,634 in UPL overpayments to State and non-State government facilities,
- comply with the approved State plan when calculating hospital inpatient UPLs for State and non-State government facilities for periods subsequent to our audit period,
- remove the State facility from the non-State government nursing facility UPL calculation for periods subsequent to our audit period,
- work with CMS to resolve potential DSH overpayments currently valued at \$47,685,747, and
- include all UPL payments when calculating hospital-specific DSH limits for periods subsequent to our audit period.

STATE'S COMMENTS AND OFFICE OF INSPECTOR GENERAL'S RESPONSE

Alabama did not specifically address our first and last recommendations. Agreeing with our third recommendation, Alabama said that it had removed the State-owned facility from the non-State government nursing facility UPL calculation. A summary of the State's comments on our other recommendations, along with our response, follows. The full text of Alabama's comments is provided in the appendix.

Compliance With State Plan

State's Comments

With respect to our second recommendation, Alabama said that it did comply with its State plan amendment in the UPL calculations for inpatient hospital services and that the State plan provides that UPL payments will be based on "Medicare principles." The State added that CMS had determined that Alabama's UPL calculations were in compliance with the State plan.

Office of Inspector General's Response

Alabama provided no evidence to support the statement that it had complied with its State plan. Although the State plan required using Medicare cost principles to calculate hospital inpatient UPLs, the State used Medicare PPS principles. Therefore, the State did not comply with its State plan.

Furthermore, the State provided no evidence that CMS had determined that Alabama's UPL calculations were in compliance with its State plan. On the contrary, CMS stated the following in a May 29, 2002, letter to Alabama:

The State contends that they could use private hospitals and Medicare PPS principles in the computation of their UPL under the approved State plan. We note that nowhere in the approved State plan are private providers or Medicare PPS mentioned The approved State plan clearly refers only to public providers and cost data and CMS is required to provide federal matching in that manner.

Disproportionate Share Hospital Calculation

State's Comments

With respect to our fourth recommendation on resolving potential DSH overpayments, Alabama replied that it had properly calculated the cost of uncompensated care. The State noted that hospitals included Medicaid revenue in that calculation and excluded payments that would be considered a "cost of doing business." According to the State, it has been and will continue working with CMS on this issue.

Office of Inspector General's Response

Alabama did not properly calculate the cost of uncompensated care because it did not include all UPL payments in the calculation. The "cost of doing business" payments that Alabama excluded from its uncompensated care calculation represented the portion of UPL payments that hospitals returned to the State via IGTs. We disagree that funds returned to the State through IGTs are a cost of doing business.

Federal criteria and prior CMS statements support our position. As defined by section 1923 of the Act, uncompensated care costs represent the costs incurred during the year of furnishing hospital services to Medicaid and uninsured patients less payments received for those patients. In an August 2002 letter, CMS clarified the requirement that States must include all Medicaid UPL payments as a reduction of Medicaid and uninsured costs when calculating hospital-specific DSH limits. Additionally, CMS specifically addressed Alabama's procedure for calculating uncompensated care in a letter dated May 16, 2002:

We do not believe that the IGT is a cost of hospital services Instead, we believe that the IGT is . . . not a cost of doing business that increases the total amount of uncompensated care. We do not believe that section 1903 (w) (6) of the Social

Security Act requires that we recognize IGTs as a cost of hospital services or patient care.

Because Alabama's procedure did not comply with Federal requirements, we continue to recommend that Alabama work with CMS to resolve \$47,685,747 in potential DSH overpayments and include all UPL payments when calculating future hospital-specific DSH limits.

APPENDIX



BOB RILEY
Governor

Alabama Medicaid Agency

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CAROLA HERRMANN, MPH
Commissioner

September 30, 2005

Ms. Lori S. Pilcher
Regional Inspector General for Audit Services,
Region IV
Room 3T41
61 Forsyth Street S.W.
Atlanta, Georgia 30303-8909

Re: OIG Report "Audit of Alabama's Medicaid Upper Payment Limits for Non-State Government Hospitals and Nursing Facilities." Report Number: A-04-03-02027.

Dear Ms. Pilcher:

I am writing to respond to the Health and Human Service's Office of Inspector General's ("OIG") draft report released on August 3, 2005, report number A-04-03-02027 (the "Report"). The Report alleges that Alabama Medicaid did not calculate enhanced payments to hospitals in accordance with its' approved State Plan, that Alabama did not include Upper Payment Limit (UPL) payments in its' Disproportionate Share Hospital (DSH) calculation and that Alabama included a State owned facility in the non-State government nursing facility UPL calculation.

Alabama did comply with our own State Plan in the UPL calculations for inpatient hospital services. The State Plan states the enhanced payments will be based on Medicare principles not to exceed Medicare upper limits in the aggregate. CMS has determined that Alabama is in compliance with our State Plan in the calculation of the enhanced payments.

Alabama did properly calculate the cost of uncompensated care. The hospitals included revenue from Medicaid in the calculation of the cost of uncompensated care. They excluded payments from the calculation which would be considered as a cost of doing business. We have been and will continue to work with CMS on this issue.

Alabama has removed the State owned facility from the non-State government nursing facility UPL calculation.

Alabama appreciates the opportunity to respond to this draft report. If you have any questions please do not hesitate to contact me at 334-242-5600.

Sincerely,

A handwritten signature in black ink, appearing to be 'C. Herrmann', with a long horizontal flourish extending to the right.

Carol Herrmann
Commissioner