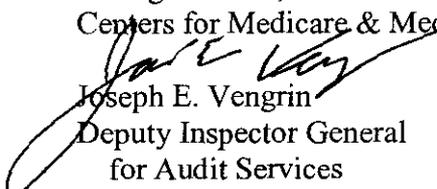




MAY 28 2004

**TO:** Wynethea Walker  
Acting Director, Audit Liaison Staff  
Centers for Medicare & Medicaid Services

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

**SUBJECT:** Audit of Blue Cross and Blue Shield of North Carolina's Claim for Post Retirement Benefit Costs to be Incurred After Termination of its Medicare Contract and Closing of its Medicare Segment (A-07-04-00162)

Attached is an advance copy of our final report on Blue Cross and Blue Shield of North Carolina's (North Carolina) claim for post retirement benefit (PRB) costs. We will issue this report to North Carolina within 5 business days.

We suggest that you share this report with the Centers for Medicare & Medicaid Services's components involved with monitoring the Medicare contractors' financial operations, particularly the Office of Financial Management, the Center for Medicare Management, and the Office of the Actuary.

North Carolina was a Medicare contractor until its contract was terminated in 2001 and, as such, was allowed to claim reimbursement for its Medicare employees' pension costs. Federal regulations set forth the allowability requirements, applicable methods of accounting, and the funding requirements for PRB costs under Government contracts. We determined that North Carolina's claim for PRB costs represented a retroactive change in accounting basis and a request for reimbursement of unfunded costs. Both are unallowable according to Federal regulations. Therefore, we recommend that North Carolina withdraw its claim for \$2,074,473 of unallowable PRB costs.

North Carolina disagreed with our interpretation of the Federal regulations and stated that our interpretation conflicts with sound business judgment applicable to contract terminations. Additionally, North Carolina stated that it would fund the PRB obligations as required.

We disagree with North Carolina's assertions. Federal regulations do not allow a retroactive change in accounting basis. Additionally, costs must be funded by the time set for filing the Federal tax return to be allowable according to Federal regulations. Therefore, we found nothing in North Carolina's response to cause us to change our opinion.

Please send us your final management decision, including any action plan, as appropriate, within 60 days. If you have any questions or comments about this report, please do not hesitate to call

Page 2 – Wynethea Walker

me or your staff may contact George M. Reeb, Assistant Inspector General for the Centers for Medicare & Medicaid Audits, at (410) 786-7104 or James P. Aasmundstad, Regional Inspector General for Audit Services, Region VII, at (816) 426-3591, ext. 225. Please refer to report number A-07-04-00162 in all correspondence.

Attachment



DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General  
Offices of Audit Services

JUN - 2 2004

Region VII  
601 East 12th Street  
Room 284A  
Kansas City, Missouri 64106

Report Number A-07-04-00162

Mr. Christopher Woodfin  
Vice President of Finance  
Blue Cross and Blue Shield of North Carolina  
P.O. Box 2291  
Durham, North Carolina 27702-2291

Dear Mr. Woodfin:

Enclosed are two copies of the Department of Health and Human Services (HHS), Office of Inspector General (OIG) final report entitled "Audit of Blue Cross and Blue Shield of North Carolina's Claim for Post Retirement Benefit Costs to be Incurred After Termination of its Medicare Contract and Closing of its Medicare Segment." A copy of this report will be forwarded to the action official noted below for review and any action deemed necessary.

Final determination as to actions taken on all matters reported will be made by the HHS action official. 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 members of the press and general public to the extent information contained therein 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 do not hesitate to call me at (816)426-3591, ext. 225, or Jenenne Tambke, Audit Manager, at (573)893-8338, ext. 21, or through e-mail at [Jenenne.Tambke@oig.hhs.gov](mailto:Jenenne.Tambke@oig.hhs.gov). Please refer to report number A-07-04-00162 in all correspondence.

Sincerely yours,

James P. Aasmundstad  
Regional Inspector General for  
Audit Services, Region VII

Enclosure - as stated

Page 2 – Mr. Christopher Woodfin

**Directly Reply to HHS Action Official:**

Ms. Rose Crum-Johnson  
Regional Administrator, Region IV  
Centers for Medicare & Medicaid Services  
Sam Nunn Atlanta Federal Center  
4<sup>th</sup> Floor 61 Forsythe Street, SW Suite 4T20  
Atlanta, Georgia 30303

**Department of Health and Human Services**

**OFFICE OF  
INSPECTOR GENERAL**

**AUDIT OF BLUE CROSS AND BLUE  
SHIELD OF NORTH CAROLINA'S  
CLAIM FOR POST RETIREMENT  
BENEFIT COSTS TO BE INCURRED  
AFTER TERMINATION OF ITS  
MEDICARE CONTRACT AND CLOSING  
OF ITS MEDICARE SEGMENT**



**JUNE 2004  
A-07-04-00162**

## **EXECUTIVE SUMMARY**

### **BACKGROUND**

Blue Cross and Blue Shield of North Carolina (North Carolina) administered Medicare Part A under cost reimbursement contracts until the contractual relationship terminated on October 31, 2001. In claiming costs, contractors were to follow cost reimbursement principles contained in Federal Acquisition Regulations (FAR), Cost Accounting Standards (CAS), and the Medicare contracts.

FAR sets forth the allowability requirements and applicable methods of accounting for post retirement benefits (PRB) costs under a Government contract. PRB costs can include, but are not limited to post retirement health care, life insurance provided outside a pension plan, and other welfare benefits, such as tuition assistance, day care, legal services, and housing subsidies provided after retirement.

Part 31 of FAR allows contractors to choose one of three accounting methods for measuring and assigning PRB costs to accounting periods. FAR further states that to be allowable, costs must be funded by the time set for filing the Federal income tax return or any extension thereof.

### **OBJECTIVE**

The purpose of our review was to determine the allowability of \$2,074,473 in PRB costs claimed for Medicare reimbursement by North Carolina. The \$2,074,473 represents PRB costs that will be incurred subsequent to the termination of North Carolina's Medicare contract.

### **SUMMARY OF FINDING**

The review showed North Carolina's claim for \$2,074,473 of PRB costs is unallowable for Medicare reimbursement because the claim represented a retroactive change in accounting basis and a request for reimbursement of unfunded costs.

### **RECOMMENDATION**

North Carolina should withdraw its claim for \$2,074,473 of unallowable PRB costs.

### **AUDITEE'S COMMENTS**

North Carolina disagreed with our report and submitted that it is fully entitled to the PRB costs at issue. In its response to our draft report, North Carolina stated that our interpretation of FAR conflicts with sound business judgment applicable to contract terminations and is so rigid that it conflicts with basic principles of cost reimbursement contracting. North Carolina also stated that our suggestion that the Centers for Medicare & Medicaid Services (CMS) would have agreed to terminal funding is unrealistic due to

historic difficulties that CMS encounters obtaining appropriations for the administration of the Medicare program. And, lastly, North Carolina stated that it would fund the PRB obligations as required.

### **OFFICE OF INSPECTOR GENERAL'S RESPONSE**

We do not agree with North Carolina's statements pertaining to our interpretation of FAR 31.205-6(o)(2), the inappropriateness of the terminal funding issue due to historical difficulties, and future funding of the PRB obligations. North Carolina's claim was calculated with immediate recognition of the full unfunded liability for current retirees, which is a change in accounting basis for both FAR and Statement of Financial Accounting Standards (SFAS) 106. FAR allows contractors the option of electing SFAS 106 accrual and terminal funding, but it requires the amortization of the transition obligation amount. Additionally, FAR states that to be allowable, costs must be funded by the time set for filing the Federal tax return.

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### **Appendix**

A - North Carolina’s Written Response

# **INTRODUCTION**

## **BACKGROUND**

North Carolina administered Medicare Part A under cost reimbursement contracts until the contractual relationship terminated on October 31, 2001. In claiming costs, contractors were to follow cost reimbursement principles contained in FAR, CAS, and the Medicare contracts.

FAR sets forth the allowability requirements and applicable methods of accounting for PRB costs under a Government contract. PRB costs can include, but are not limited to post retirement health care, life insurance provided outside a pension plan, and other welfare benefits, such as tuition assistance, day care, legal services, and housing subsidies provided after retirement. PRBs do not cover cash benefits and life insurance benefits paid by pension plans during the period following the employees' retirement. FAR further states that to be allowable, costs must be funded by the time set for filing the Federal income tax return or any extension thereof.

Beginning in 1993, SFAS 106 required contractors to report the accrued liability for PRBs for current and retired employees in their financial statements. FAR allows contractors the option of electing SFAS 106 accrual accounting for funded PRBs, or recognizing PRB costs on the cash or terminal funding basis for Government contract purposes, if that had been their practice.

## **OBJECTIVE, SCOPE, AND METHODOLOGY**

### **Objective**

The objective of our audit was to determine whether PRB costs claimed for the period subsequent to North Carolina's termination were allowable for Medicare reimbursement.

### **Scope**

We reviewed documentation in support of North Carolina's August 11, 2003 claim of \$2,074,473 for present value of PRB costs to be incurred subsequent to the termination of the Medicare contract. We did not review North Carolina's internal control structure.

### **Methodology**

In performing our review, we used information as presented in North Carolina's Termination Claim for Post Retiree Welfare Benefits Liabilities, which included support provided by North Carolina's consulting actuaries. We examined North Carolina's PRB claim in relation to applicable laws and regulations to determine whether North Carolina complied with regulatory requirements.

We performed this review in conjunction with our audits of pension segmentation<sup>1</sup> and pension costs<sup>2</sup> for a terminated contractor. We used the information obtained from these pension audits in performing this review.

Our audit was performed in accordance with generally accepted government auditing standards.

## **FINDING AND RECOMMENDATION**

North Carolina claimed \$2,074,473 in PRB costs representing the estimated present value of PRB costs that will be incurred by North Carolina after the termination of its Medicare contracts. The claim represented (1) a retroactive change in accounting basis with immediate recognition of the transition obligation and (2) a request for reimbursement of unfunded costs. None of these costs are allowable in accordance with FAR, SFAS 106, and the Medicare contract, therefore, the costs are unallowable for Medicare reimbursement.

### **FAR, SFAS 106, AND MEDICARE CONTRACT**

#### **FAR**

According to FAR 31.205-6(o)(2) PRB costs can be calculated using one of the following:

**Cash Basis** (or pay-as-you-go) - recognizes PRB costs when they are paid.

**Terminal Funding** - recognizes the entire PRB liability as a lump-sum payment upon termination of employees. The lump-sum payment must be remitted to an insurer or trustee for the purpose of providing PRBs to retirees. The lump-sum payment is allowable if amortized over a period of 15 years.

**Accrual Basis** - measures and assigns costs according to generally accepted accounting principles and pays costs to an insurer or trustee to establish and maintain a fund or reserve for the sole purpose of providing PRBs to retirees. The accrual must be calculated in accordance with generally accepted actuarial principles and practices as promulgated by the Actuarial Standards Board.

FAR further states that to be allowable, costs must be funded by the time set for filing the Federal income tax return or any extension thereof. PRB costs assigned to the current year, but not funded by the tax return time, are not allowable in any subsequent year.

---

<sup>1</sup> Report Number A-07-02-03017, Blue Cross Blue Shield of North Carolina Pension Segment Closing Audit, issued in final on February 6, 2003.

<sup>2</sup> Report Number A-07-02-03030, Blue Cross Blue Shield of North Carolina Pension Costs Claimed for Medicare Reimbursement, issued in final on April 29, 2003.

## **SFAS 106**

In 1990, the Financial Accounting Standards Board issued SFAS 106 which established accounting standards for PRBs. SFAS 106 significantly changed the practice of accounting for PRBs from the cash basis to the accrual basis for financial statement purposes.

With the implementation of SFAS 106, companies are required to report in their financial statements the accrued liability for PRBs for current and retired employees. SFAS 106 requires the annual reporting of net periodic service costs, as well as a transition obligation (i.e., the initial unfunded liability when accrual accounting is first adopted) which may be recognized either immediately or amortized over the average remaining service of active plan participants. FAR allows contractors the option of electing SFAS 106 accrual accounting, but it requires the amortization of the transition obligation.

## **Medicare Contract**

Paragraph A of Item II of Appendix B to the Medicare contract requires that the contractor use the same accounting practice to estimate, accumulate, and report costs. Additionally, changes in accounting practice are only permitted on a prospective basis.

## **CLAIM FOR \$2,074,473 OF PRB COSTS**

On August 11, 2003, North Carolina claimed \$2,074,473 in PRB costs representing the estimated present value of PRB costs that will be incurred by North Carolina after the termination of its Medicare contracts. None of these costs are allowable in accordance with FAR and therefore the costs are unallowable for Medicare reimbursement.

## **RETROACTIVE CHANGE IN ACCOUNTING BASIS AND REIMBURSEMENT OF UNFUNDED COSTS**

### **Retroactive Change in Accounting Basis**

Prior to terminating its Medicare contract, North Carolina's normal practice for Government contracting purposes was to claim PRB costs using accrual accounting with recognition of the transition obligation on an amortized basis. Using this methodology, North Carolina was reimbursed for funded accrued PRB costs totaling \$454,138 incurred through the contract termination date. However, North Carolina claimed \$2,074,473 to cover the unfunded present value of PRB costs to be paid subsequent to the contract termination date.

North Carolina's claim was calculated as of January 1, 2003 with immediate recognition of the full unfunded liability for current retirees. Therefore, this claim represents a retroactive change in accounting practice that is unallowable per FAR and North Carolina's Medicare contract.

## **Reimbursement of Unfunded Costs**

Although North Carolina has established a reserve to provide PRBs to retirees, it has not funded the \$2,074,473 claim. In accordance with FAR, to be allowable, costs must be funded by the time set for filing the Federal income tax return.

## **UNALLOWABLE CLAIM FOR PRB COSTS**

North Carolina's claim for \$2,074,473 of PRB costs represents (1) a retroactive change in accounting basis with immediate recognition of the transition obligation (lump-sum payment) and (2) a request for reimbursement of costs that have not yet been funded. None of these costs are allowable in accordance with FAR and the Medicare contract, therefore, the costs are unallowable for Medicare reimbursement.

## **RECOMMENDATION**

North Carolina should withdraw the August 11, 2003 claim of \$2,074,473 for PRB costs.

## **AUDITEE'S COMMENTS**

North Carolina's comments are summarized in the following paragraphs and presented in their entirety at Appendix A.

North Carolina disagreed with our interpretation of FAR 31.205-6(o)(2) stating that it conflicts with sound business judgment applicable to contract terminations and is therefore erroneous. North Carolina states that our erroneous interpretation enables us to state that North Carolina's claim represents an immediate recognition of the transition obligation which constitutes a retroactive change in accounting basis. Due to the termination of the Medicare contract there is no continuing contract vehicle under which North Carolina can be reimbursed for costs incurred whether on an amortized basis or otherwise. These PRB costs are directly related to the performance of the Medicare contract work and the Office of Inspector General's (OIG) interpretation of FAR 31.205-6(o)(2) is erroneous as a matter of law and cannot bar North Carolina's recovery of these costs.

North Carolina also stated that our suggestion that CMS would have agreed to terminal funding is unrealistic due to historic difficulties that CMS encounters obtaining appropriations for the administration of the Medicare program. These difficulties arise during the negotiations with contracting preceding issuance of the Notice of Budget Authorization. Over the years, these negotiations result in authorization of administrative costs in amounts less than the contractor believed necessary. Therefore, North Carolina stated that contractors would have been ill-advised to pursue terminal funding of its PRBs and would consider it a waste of time and energy.

And, lastly, North Carolina stated that OIG's criticism of PRB liabilities on the basis that they are unfunded is also misplaced. North Carolina will fund the projected costs of providing PRBs by depositing in an irrevocable grantor trust an amount equal to the actuarially determined present value of the future cost of providing the benefits.

## **OIG'S RESPONSE**

We do not agree with North Carolina's statements pertaining to our interpretation of FAR 31.205-6(o)(2), the inappropriateness of the terminal funding issue due to historical difficulties, and future funding of PRB obligations.

As stated in our report, North Carolina's claim was calculated with immediate recognition of the full unfunded liability for current retirees, which is a change in accounting basis for both FAR and SFAS 106. This immediate recognition can be viewed as using the terminal funding method for basis for the claim. Once more, FAR allows contractors the option of electing SFAS 106 accrual and terminal funding, but it requires the amortization of the transition obligation amount.

North Carolina erroneously concluded that we suggested CMS would have approved a change to the terminal funding methodology. Our draft report did not make this suggestion. We merely reviewed North Carolina's claim for unfunded PRB costs at the request of CMS.

With respect to the future funding of PRB obligations, FAR states that to be allowable, costs must be funded by the time set for filing the Federal tax return. In its response North Carolina clearly stated that it will fund the projected costs not that it has in fact, funded the projected costs.

Therefore, North Carolina should withdraw its claim of \$2,074,473 for PRB costs because the claim represents a retroactive change in accounting basis and a request for reimbursement of unfunded costs, which are unallowable in accordance with FAR.

# **APPENDIX**

**POWELL  
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FRAZER &  
MURPHY LLP**  
ATTORNEYS AT LAW

ATLANTA ■ WASHINGTON

direct dial 202-624-7227  
bshirk@pgfm.com

April 23, 2004

**Via Facsimile and Federal Express**  
**(816) 426-3655**

Mr. James P. Aasmundstad  
Regional Inspector General for Audit Services  
Office of Inspector General  
Office of Audit Services  
Region VII  
U.S. Department of Health and Human Services  
601 East 12<sup>th</sup> Street  
Room 284A  
Kansas City, MO 64106

Re: Audit of Blue Cross and Blue Shield of North Carolina's Claim for Post Retirement Benefit Costs to be Incurred After Termination of its Medicare Contract and Closing of its Medicare Segment;  
Draft Report No. A-07-04-00162

Dear Mr. Aasmundstad:

This letter responds to the HHS Office of Inspector General's ("OIG") draft report entitled "Audit of Blue Cross and Blue Shield of North Carolina's Claim for Post-Retirement Benefit Costs to be Incurred After Termination of its Medicare Contract and Closing of its Medicare Segment," No. A-07-04-00162, (hereinafter "Draft Report" or "Report"). The Draft Report recommends that Blue Cross and Blue Shield of North Carolina ("BCBSNC") withdraw its claim for \$2,074,473 in post-retirement benefit ("PRB") costs. Specifically, the OIG reasons that BCBSNC's PRB costs are unallowable because the costs represent: (1) a retroactive change in accounting basis with immediate recognition of the transition obligation and (2) a request for reimbursement of unfunded costs.

BCBSNC disagrees with the OIG's conclusions in this regard and respectfully submits that the company is fully entitled to the PRB costs at issue in the context of the October 31, 2001 termination of its Medicare contract. Specific responses to the OIG's positions are set out in more detail below.

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FRAZER &  
MURPHY LLP  
ATTORNEYS AT LAW

Mr. James P. Aasmundstad  
Regional Inspector General for Audit Services  
Office of Inspector General  
Office of Audit Services  
U.S. Department of Health and Human Services  
April 23, 2004  
Page 2

**I. The OIG Interpretation of FAR 31.205-6(o)(2) Conflicts With Business Judgment Standard Applicable To Contract Terminations and Is Therefore Erroneous**

The OIG's recommendation that BCBSNC is not entitled to an adjustment for its PRB costs incurred pursuant to Financial Accounting Standard (FAS) 106 is based on an erroneous interpretation of FAR 31.205-6(o)(2). This erroneous interpretation enables the OIG to characterize such an adjustment as an unapproved accounting change that constitutes immediate recognition of a "transition obligation." The OIG's approach to the question of reimbursement of these costs is clever and in fact sophistic because it shifts the discussion from mutual consideration of issues of equity and fairness appropriate to a termination proceeding to a one-sided and inappropriate insistence on the strict application of technical accounting concepts. The OIG's insistence on the technical and mechanistic application of accounting concepts rather than the use of sound business judgment to assure fair compensation to the contractor is in direct conflict with the FAR provisions governing termination proceedings, which state in relevant part:

(a) A settlement should compensate the contractor fairly for the work done and the preparations made for the terminated portions of the contract, including a reasonable allowance for profit. Fair compensation is a matter of judgment and cannot be measured exactly. In a given case, various methods may be equally appropriate for arriving at fair compensation. *The use of business judgment, as distinguished from strict accounting principles, is the heart of a settlement.*

(b) The primary objective is to negotiate a settlement by agreement. The parties may agree upon a total *amount* to be paid the contractor without agreeing on or segregating the particular elements of costs or profit comprising this amount.

(c) *Costs and accounting data may provide guides, but are not rigid measures, for ascertaining fair compensation. In appropriate cases, costs may be estimated, differences compromised, and doubtful questions settled by agreement. Other types of data, criteria, or standards may furnish equally reliable guides to fair compensation. The amount of recordkeeping, reporting, and accounting related to the settlement of terminated contracts should*

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April 23, 2004  
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*be kept to a minimum compatible with the reasonable protection of the public interests.*

(FAR 49.201 (emphasis added).)

The Courts and Boards of Contract Appeals have consistently held that business judgment is the appropriate standard to be applied in resolving cost issues in the context of termination settlements. "Federal regulations contemplate settlement of termination for convenience proposals by agreement, with business judgment, as distinguished from strict accounting principles, as the heart of the settlement." *Tagarelli Brothers Construction Co.*, ASBCA 34793, 88-1 BCA 20363 (1987) at 102,989, *aff'd on reconsideration*, 88-2 BCA 20546 (1988). Such costs when related to a termination are subject to a lesser, rather than a greater, level of scrutiny. *See e.g., Appeal of Freedom Elevator Corp.*, GSBICA 7259, 85-2 BCA 17964 (1985) (the purpose of a termination settlement is to fairly compensate the contractor and make it whole for the costs it incurred in performing the terminated work); FAR 31-205.42 Termination Costs ("terminations generally give rise to the incurrence of costs *or the need for special treatment of costs that would not have arisen had the contract not been terminated*") (emphasis added).

Here, because BCBSNC has terminated and ceased work under its Medicare contract there is no continuing contract vehicle under which the company can be reimbursed for costs incurred and monies paid to fund CMS's share of the future PRB liabilities, whether on an amortized basis or otherwise. The OIG interpretation of FAR 31.205-6(o)(2) requiring continued amortization of these PRB costs as a condition of their allowability in the context of a contract termination is in direct conflict with the provisions of the FAR governing termination of Medicare contracts and must give way to those provisions. *cf. Andy International Inc.*, ASBCA No. 20397, 76-2 BCA 20,397 ("where an apparently fair and reasonable clause because of circumstances fails in its purpose or operates to deprive either party of the substantial value of the bargain, it must give way to the general remedy provisions of this Article."), *citing Wilson Trading Corporation v. David Ferguson, Ltd.*, 244 N.E.2d 685 (N.Y. 1968), Uniform Commercial Code, § 2-719, official comment 1. BCBSNC remains obligated, pursuant to its established PRB policy, to continue to pay PRBs to its Medicare segment retirees, covered dependents and covered spouses in the future. These costs are directly related to the performance of the Medicare contract work and have been incurred for the benefit of the Medicare program. The OIG's interpretation of FAR 31.205-6(o)(2) so as to preclude reimbursement of BCBSNC's costs is erroneous as a matter of law and cannot bar BCBSNC's recovery of these costs.

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April 23, 2004  
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**II. The OIG's Rigid and Mechanistic Interpretation of FAR 31.205-6(o)(2) Is Erroneous Because It Conflicts With Basic Principles of Cost Reimbursement Contracting**

The OIG's interpretation is also at odds with the cost reimbursable nature of the BCBSNC's Medicare Contract. Specifically, BCBSNC's contract expressly provided that "the Intermediary, in performing its functions under this agreement, shall be paid its costs of administration under the principle of *neither profit nor loss* to the Intermediary." Intermediary Subcontract at Art. XIII, A. (emphasis added) The Armed Services Board of Contract Appeals has explained the purpose of and reasoning underlying the above provisions as follows:

At the heart of this type of contract is the implicit understanding that the Government, in consideration of the contractor's undertaking to perform without fee or profit, will assure the risk of losses not attributable to unreasonable conduct on the part of the contractor, an understanding in keeping with the basic principle that risk of loss should be commensurate with opportunity for profit. No other premise is consistent with the Government's oft-stated policy of treating its contractors fairly and justly, and with its policy of utilizing no-profit contracts. . . [no] contractor would enter into a nonprofit contract on any other basis.

Wyman-Gordon Company, ASBCA 5100, 59-2 BCA ¶ 2344

**III. The OIG Suggestion That CMS or Its Predecessor Agency HCFA Would Have Agreed to Terminal Funding of BCBSNC's PRB Obligations During Contract Performance Is Unrealistic and Unfair In Light of, Among Other Things, the Historic Difficulties Faced By Those Agencies Obtaining Appropriations for Administration of the Medicare Program**

The OIG's suggestion that BCBSNC should have requested terminal funding during the course of performance of its Medicare contract and that its failure to do so caused it to assume the risk of nonreimbursement is based on (a) an unrealistic view of the amount of money Congress has been willing to appropriate annually for administration of the Medicare program and (b) an unfair assumption that the agency personnel who have managed the program over the years lacked the wherewithal to understand that approval of such a request would give rise to serious funding issues and potentially complicate administration of the program. Among other things, an agency decision to make a lump sum reimbursement to one contractor for terminal

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funding of its PRB obligations during contract performance could have resulted in other contractors requesting such reimbursement requiring, in turn, an agency explanation to Congress as to why the appropriation request appeared to have ballooned in certain years. Moreover, neither the agency nor any given contractor receiving such a lump sum reimbursement could be sure that the sum would remain appropriate over time because, for example, the number of contractor employees dedicated to Medicare with vested rights to PRBs could increase, causing a concomitant increase in the amount of the liability thereby and a contractor request for additional funds. Given these and other potential problems, discussion of which is beyond the scope of this response, the career government managers responsible for administration of the Medicare program would have had good and sufficient reason to deny such a request. And, as the contract allows the government to non-renew a Medicare contract simply by giving timely notice to the contractor, the contractors were necessarily aware that those same managers had the wherewithal to discipline any contractor who insisted on pressing such a request.

The difficulties faced by CMS in obtaining sufficient funding for administration of the Medicare program are reflected in the approach the agency has historically taken in its annual negotiations with contractors preceding issuance of the Notice of Budget Authorization. In brief, such negotiations have over the years often tended to result in authorization of administrative costs in amounts less than the contractor believed necessary for proper administration of the contract. In such circumstances contractors who wished to continue performing their contracts would have been ill-advised to pursue terminal funding of PRBs and would in any event view such a pursuit as a waste of time and energy.

In sum, the OIG's suggestion requires a "use it or lose it" interpretation of the terminal funding provision of FAR 31.205-6(o)(2)--an interpretation that is patently unfair when the "use" of that funding mechanism is precluded by the facts and circumstances surrounding contract performance.

#### **IV. BCBSNC Will Fund the PRB Obligations as Required by FAR 31.205-6(o)(2)**

The OIG's criticism of BCBSNC's PRB liabilities on the basis that they are unfunded is also misplaced. Concomitant with the CMS's commitment to fund this Medicare related liability, BCBSNC will fund the projected costs of providing the PRBs by depositing in an irrevocable grantor trust at BB&T, an independent bank, an amount equal to the actuarially determined present value of the future cost of providing the benefits. BCBSNC has committed, for itself and its successors, to continue to provide the post-retirement benefits to the covered individuals at the same level of premium cost sharing between BCBSNC and the Medicare segment retirees as they were being provided as of the date the trust was created. While the level

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of cost sharing will not change from year to year, BCBSNC may make changes to the plan features in order to control medical inflation.

In the event there are no longer any funds in the trust while any of the covered retirees, covered dependents, or covered spouses remain entitled to receive benefits, BCBSNC or its successor may thereafter modify the amount of retiree contribution required, or may modify or discontinue providing one or more of the benefits. In the event there are no longer any covered retirees, covered dependents, or covered spouses living, but there are funds remaining in the trust, those funds will revert to BCBSNC or its successor. As provided by 48 C.F.R. 31.205-6(o)(6), the government will "receive an equitable share of any amount of previously funded PRB costs which revert to or inure to" BCBSNC or its successor.

Sincerely,



W. Bruce Shirk

For POWELL, GOLDSTEIN, FRAZER & MURPHY LLP

WBS:bct

cc: Mr. Christopher C. Woodfin  
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