DEPARTMENTAL GRANT APPEALS BOARD

Department of Health and Human Services

SUBJECT: California Department of Health Services
Docket Nos. 79-20-CA-HC
79-210-CA-HC
80-123-CA-HC
Decision No. 170

DATE: April 30, 1981

The State of California appealed three determinations by the Health Care Financing Administration (HCFA), disallowing a total of $7,613,820 in Federal financial participation (FFP) claimed under Title XIX (Medicaid) of the Social Security Act (Act) during the period January 1, 1971 - July 31, 1977. The appeals have been considered jointly without objection by the parties.

Introductory Summary

The amounts disallowed represent the Federal share of "duplicate" payments to fee-for-service providers for services rendered to Medicaid patients for whom the State had also made premium payments to prepaid health plans (PHPs). The State admits that these payments were in error and violated applicable regulations and that HCFA has, with a minor exception discussed below, correctly determined the amount of FFP claimed for these payments. The State argues, however, that the Board can, through adjudication, establish that these errors were within a reasonable tolerance level and, thus, allow FFP in these payments.

The Department of Health and Human Services (HHS, formerly HEW) has adopted, by regulation, a policy that fiscal disallowances based on error rates determined through quality control samples will be imposed only for eligibility errors in excess of specified tolerance levels. These regulations were not in effect for the Medicaid program during the relevant time period. Moreover, the State concedes that these "duplicate" payments can best be classified as "claims processing" errors. The quality control disallowance provisions have never applied to this type of error. The State contends, nonetheless, that since the Department and the courts have recognized the impossibility of running an error-free public assistance program, the Board should read the Act as permitting a reasonable tolerance for errors and, based on the evidence submitted by the State, determine that the errors here were reasonable, unavoidable, and de minimis, considering the circumstances at the time they were made.

The State has submitted evidence of good faith efforts to reduce errors, and we recognize that it may be impossible to eliminate errors completely, particularly in an experimental program such as the State's PHP program here. Moreover, the position which HCFA has taken in disallowing these

payments is not entirely consistent with the Department's current position in recognizing the need for tolerance levels, at least in some circumstances. On the other hand, to find for the State here we would have to adopt a a tenuous and convoluted reasoning process, substituting our own judgment for that of the Agency in an area of complicated programmatic concerns. Under the applicable regulations these were erroneous payments. While the statute may permit FFP in erroneous payments where the Secretary has exercised rulemaking authority to establish a reasonable tolerance level, Maryland v. Mathews, 415 F. Supp. 1206 (D.D.C. 1976), a standard of reasonableness for errors should be based on empirical studies and a consideration of all relevant factors. Even if we were to hold that in some circumstances the Board could, by adjudication, formulate a rule consistent with Departmental policy as expressed in a later regulation, it would be inappropriate for the Board to exercise such authority here. There are too few guides as to what the standard should be. Moreover, to adjudicate the issue we would have to intrude into an area of program operations more wisely left to the administering agency. There is no way of establishing reasonableness with mathematical precision and the determination of where, within a range of reasonableness, a tolerance level will be set necessarily involves a policy judgment. Accordingly, for reasons stated more fully below, we conclude that the disallowance should be upheld, except with respect to $52,000 for which adjustment has already been made.

This decision is based on the parties' submissions and on oral statements made by the parties at an informal conference held with the Panel Chair on January 29, 1981.

Case Background

Generally, Medicaid services under Title XIX (called Medi-Cal in California) are provided to eligible recipients through a fee-for-service system, the medical providers being paid directly by the State for the specific services provided. Title XIX also authorizes states to provide medical care through contracts with health insurance organizations, which provide health care to the recipient in return for a prepaid monthly premium. In California, these health insurance organizations are called prepaid health plans (PHPs). With the encouragement of the Federal Government, California began funding experimental PHP projects in 1968 and began contracting with PHPs on a regular basis in May 1972.

After the California Auditor General reported that payments were being made to fee-for-service providers for services which should have been covered by premium payments to PHPs, the HEW (now HHS) Audit Agency performed a series of audits to identify the amount of such "duplicate" payments. The following disallowances resulted:

Board Docket No.	Audit Control No.	Period	Amount of Disallowance
80-123-CA-HC	00210-09	June 1972-June 1973 and August 1973 - December 1973	$1,109,006

		month of July 1973 and periods prior to June 1972	371,047 (estimate
79-20-CA-HC	80215-09	September 1 - December 31, 1975	429,973
79-210-CA-HC	90203-09	January 1, 1974 - August 31, 1975 and January 1, 1976 - July 31, 1977	5,703,794

The State does not dispute the amount of duplicate payments with one exception. Included in the disallowance in Docket No. 79-20-CA-HC is $52,000 which the State originally claimed for the Federal share of payments to Los Angeles County but later repaid after recouping the amounts from the County. HCFA at first took the position before this Board that the fact that the State had made adjustments for these payments would not be a basis for reversal of the disallowance. The State persuasively argued, however, that by recouping the money from the County it had avoided duplicate payments, and HCFA now concedes that the disallowance should be withdrawn with respect to this $52,000. See Memorandum to file dated February 5, 1981; Transcript, pp. 78-80. Thus, the amount remaining in dispute is $7,561,820.

As the State points out, "The payments are not truly duplicated, as no other provider has been paid for the specific service. However, they do pay for services which should have been provided by the PHP which received the capitation payment for the specific recipient." Application for Review, Docket No. 79-20-CA-HC, p. 2. Causes of this duplication, identified in Audit Report ACN 80215-09, included inadequate controls over the issuance of temporary Medi-Cal cards by county welfare departments; errors made by fiscal intermediaries in screening claims for proper Medi-Cal labels; and errors made by the State's computer system in issuing permanent Medi-Cal cards. During the period audited, the State took steps to correct for these errors and reduced the rate of errors significantly. See State's submission of December 23, 1980.

The State does not deny that these duplicate payments were contrary to the requirements of applicable regulations. 1/ While some of the causes

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1/ HCFA relied in Docket Nos. 79-20-CA-HC and 79-210-CA-HC on the provisions of 45 CFR 249.82(c)(6)(vii), but based the disallowance in Docket No. 80-123-CA-HC on Section 249.82(b)(1). While it appears that the first cited section provides a stronger basis for a determination that FFP is not available in the payments, we do not need to reach the issue here since the State concedes that FFP is not available in payments to fee-for-service providers for recipients enrolled in PHPs. Application for Review, Docket No. 79-20-CA-HC, p. 1; State's Brief dated May 22, 1979, p. 7; Transcript, p. 15.

of duplicate payment errors are related to the eligibility determination process, the State admits that the errors are not eligibility errors or errors in the rate of payment, so that the category into which the errors best fit is that of claims processing errors. Transcript, p. 42; see, also, 42 CFR §431.800(b).

History of Tolerance Level Provisions

The issue here is best understood if viewed in the historical context of the Department's efforts to deal with erroneous payments in the Aid to Families with Dependent Children (AFDC) Program and in the Medicaid Program involved here.

Efforts to reduce error in AFDC resulted in the evolution of "quality control," a system of sampling assistance cases to assess the accuracy of eligibility determinations and calculation of payment amounts. The system is "designed to measure error rate levels and to provide information on the nature and causes of errors so that corrective actions and other administrative improvements may be undertaken." 43 FR 29311, July 7, 1978. Beginning in the early 1970's the Department proposed a series of rules to use extrapolation from quality control samples as a means of determining the amount of erroneous payments made by a state for its entire AFDC caseload during the sampling period, and to base disallowances on that extrapolation. These rules were highly controversial and no disallowances were taken pursuant to the early versions. In a revised notice of proposed rulemaking published on May 19, 1975, the Department asserted that it was required by the Social Security Act to exclude from FFP "States' erroneous payments to ineligible recipients and overpayments to eligible recipients above reasonable limits established by the Secretary." 40 FR 21737. The proposal was said to reflect "the Secretary's awareness that under the administrative structures presently existing in most States, a requirement at this time that States eliminate all erroneous payments, with a resultant disallowance of Federal financial participation in any erroneous payments is unrealistic." 40 FR 21737.

The final rule, which appeared in the Federal Register on August 5, 1975, provided for disallowance of FFP for that portion of a state's expenditures for ineligibles represented by a case error rate in excess of 3% and for overpayments represented by a case error rate in excess of 5%, commencing with the July-December 1975 quality control sampling period. In the case of Maryland v. Mathews, 415 F. Supp. 1206 (D.D.C. 1976), the District Court for the District of Columbia found that these "tolerance levels were arbitrarily established at 3% and 5% without the benefit of an empirical study" and, therefore, the regulation was framed in an arbitrary and capricious manner and was an abuse of discretion. The Court held that the regulation was inconsistent with the Social Security Act "by preventing the states from furnishing assistance as far as practical given the conditions of the state, and is therefore invalid." 415 F. Supp. at 1212.

The Court in Maryland also concluded from its interpretation of Title IV-A of the Act (AFDC) that "payments which are not made properly, pursuant to the approved plan, are not to be matched by federal funds," but upheld the Secretary's authority, under Section 1102 of the Act, to promulgate a regulation providing for disallowances of FFP only for erroneous payments in excess of a reasonable established tolerance level. 415 F. Supp. at 1212. The Court's decision was based, in part, on a recognition of the complexity of the eligibility determination process and the impossibility of totally eliminating errors.

No regulation setting tolerance levels had been promulgated for the Medicaid Program up to that point. A system of quality control for Medicaid eligibility determinations was used in the early 1970's, discontinued in 1973, and then reinstituted effective July 1, 1975. 40 FR 27222. The Medicaid quality control system was revised on April 1, 1978, to include measurement of payment errors due to uncollected third party insurance and claims processing errors.

After the decision in Maryland, the Department made empirical studies and proposed new regulations applicable to both the AFDC and Medicaid programs. 43 FR 29311, July 7, 1978. The new regulations, as proposed, would have set as an ultimate goal an error rate of 4% for both payments to ineligibles and overpayments to eligibles. The Department received and considered over a long period of time comments on these proposed regulations. Final regulations adopted on March 7, 1979, provided that, to avoid a disallowance, a state must either not exceed the national weighted mean payment error rate calculated for a specified base sampling period or must meet a prescribed rate of reduction in the percent of payments in error. 45 CFR 205.41 (AFDC) and 42 CFR 431.801 (Medicaid); 44 FR 12578.

The March 7 final rule did not adopt the 4% ultimate goal which had been proposed. The preamble explained that the Department was instead undertaking an 18-month study to determine a reasonable ultimate goal for eligibility error rates in each program. Setting of this ultimate goal was related to a recognition that at some point further error reduction is not cost-effective. 44 FR 12578. These rules also provide for waiver of disallowances based on quality control error rates where a state demonstrates that its failure to meet the standard is due to factors beyond its control, including "sudden and unanticipated workload changes which result from changes in Federal law and regulation." 42 CFR 431.801(f), 44 FR 12591.

The preamble to the July 7, 1978 proposed regulations had requested suggestions regarding a proposal to apply quality control fiscal reductions to Medicaid claims processing errors, the kind in issue here. The discussion of this proposal explained that a lower error tolerance level was being considered for claims processing than for eligibility errors because "claims processing errors are more easily

controlled with appropriate management and computer system techniques." 43 FR 29314. Commenting on this proposal, a number of states suggested that no tolerance level should be set for claims processing errors at that time because of the lack of empirical data and that separate tolerance levels should be set for different types of errors. In response to these comments, the Department determined, "For the time being, we will not set a tolerance level for these types of errors." 44 FR 12590.

Amendments to the March 7, 1979 rules were necessitated by Congressional action. 44 FR 55314, September 25, 1979 (proposed rule); 45 FR 6326, January 25, 1980 (final rule). Based on a directive in Section 201 of the Labor-HEW Appropriation Bill for Fiscal Year 1980 (H.R. 4389), as referenced in the Continuing Resolution for Fiscal Year 1980 (P.L. 96-123), the amended rules require states to reduce their eligibility payment error rates in AFDC and Medicaid to 4% by September 30, 1982. The amended rules also provide for the possibility of waiver of a disallowance where a state has made a good faith effort to meet its target error rate by timely implementing a corrective action plan reasonably designed to meet the target error rate. 42 CFR 431.802(f)(2)(v), 45 FR 6333.

Arguments

The position which HCFA has taken in this appeal is that the absence of any formally promulgated regulation establishing a specific tolerance level for the types of errors in question here is determinative of the issue. HCFA argues that "until such time as applicable regulations are enacted, the agency is required to enforce existing regulations...," including regulations denying FFP in these erroneous payments. Memorandum in Support of Respondent's Motion for Summary Judgment, Docket No. 79-20-CA-HC, p. 3. According to HCFA, the rule that the Board is "bound by applicable laws and regulations," at 45 CFR 16.8(a), precludes the Board from finding that the duplicate payment errors here were within a reasonable tolerance level and that, therefore, FFP is available.

The State admits that no tolerance regulation applies to the payments in question but argues that the absence of such levels "indicates not that no tolerance level should exist but only that there is not at the moment a recognized fixed level at which a tolerance is pegged," and that the regulations may serve as a guide to what is reasonable. Application for Review, Docket No. 79-20-CA-HC, p. 3.

The State points out that the Act provides for Federal participation in a percentage "of the total amount expended during such quarter as medical assistance under the State plan...." Section 1903(a)(1) of the Act. The State takes the position that "improper or erroneous expenditures, which are of a rate sufficiently low that it cannot

within the realm of practicality be reduced, are so necessarily a part of the proper expenditure of funds for medical assistance that they must be considered eligible for FFP under the quoted language." State's Brief, p. 7. According to the State, "if HEW had the power to promulgate a regulation providing for tolerance levels, then the statute upon which the regulation is based must allow tolerance" and the statute may be directly interpreted to determine the scope of those tolerances. State's Brief, p. 4.

In support of its argument, the State cites the recognition, in Department regulations and the Maryland case, that programs such as Medicaid cannot conceivably be run error-free. Thus, the State argues, a reasonable error rate is a necessary cost of doing business, a cost which should not be borne solely by the states. Transcript, p. 8; Application for Review, Docket No. 79-20-CA-HC, p. 1.

Because the State views the matter, in part, as a question of interpretation of the concept of "cost" in the Medicaid statute, the State takes the position that "this Board may find in the adjudicatory context that as to this particular narrow program [PHPs] a particular rate of error is within the normal cost of the program and is within the tolerance which the Federal government has allowed." Transcript, p. 8.

Part of the State's argument is the proposition that the PHP program cannot be lumped together with the general Medicaid Program for the purpose of determining what a reasonable overall error rate would be since the duplicate payment problem is unique and since most of the errors occurred while the PHP program was in its experimental stages. State's Brief, p. 13; Application for Review, Docket No. 79-20-CA-HC, p. 2. Thus, the figures which the State presents as its error rates for the periods in question are duplicate payment amounts as a percentage of total PHP capitation payments.

The State characterizes the showing which a state should be permitted to make to avoid disallowance of erroneous payments as a showing "that the amount of the misexpenditure either is impossible to avoid altogether, given the nature of the program, or is of so small a scope that the cost of attempting to avoid that error rate would be greater, or arguably greater, at least, than the error rate itself." Transcript, pp. 6-7. Presumably, the State would apply the "unavoidability" standard to the initial stages of the PHP program and the "cost-effective" standard to later stages, after the State had taken corrective action to reduce duplicate payment errors, but failed to eliminate them completely.

The State also argues in the alternative that FFP is available in de minimis errors under Section 1903(a)(7) of the Act. This section provides for FFP at a 50% rate in amounts "found necessary by the Secretary for the proper and efficient administration of the State plan."

HCFA acknowledges that, although it has never been considered as a policy matter whether Section 1903(a)(7) could be used to pay for some errors, arguably the Secretary could treat some errors as an administrative cost under that section. Transcript, p. 69. However, the State claimed FFP in the "duplicate" payments here as medical assistance costs rather than as administrative costs. In any event, we do not reach the issue of whether FFP might be allowable in some erroneous payments as an administrative cost under Section 1903(a)(7), since our ultimate decision concerning the appropriateness of the Board establishing the reasonableness of errors through adjudication would be the same.

Discussion

1. Board Authority

In analyzing the State's argument, we begin with the proposition that the payments in question were unallowable under applicable regulations. Under other circumstances, this might be dispositive of the case. HCFA is correct that, under 45 CFR 16.8, the Board is bound by applicable laws and regulations. Here, however, the State argues that Section 1903(a)(1) of the Act must be read to subsume into the concept of "medical assistance" costs certain costs which might, if one examined them separately, be unallowable, but which are associated with errors within a reasonable tolerance and are therefore allowable. In this context, §16.8 does not preclude our review, since one may view the regulations as either silent on costs within a tolerance level (if one applies) or as in conflict with the statute. That is to say, it is too facile an answer to respond that it is determinative of the issue that the payments in question here were erroneous under applicable regulations; we have an obligation to go further to determine whether the regulations may be incomplete, and therefore inapplicable, or even at odds with the statute, if one agrees with the State. Although we ultimately conclude that, even if the Board could establish a tolerance level through adjudication, to do so would be inappropriate, nothing precludes our review in the first instance.

2. Possibility of Proceeding by Adjudication

The State cites SEC v. Chenery, 332 U.S. 194 (1947) (Chenery II), for the proposition that in certain situations an administrative agency must retain the power to deal with problems on a case-by-case basis if the administrative process is to be effective. Chenery II does indicate that an agency may sometimes proceed by adjudication in appropriate circumstances, such as where an agency may not have had sufficient

experience with a particular problem to establish a hard and fast rule. 332 U.S. at 202-203. The State argues that here, where California was experimenting with a new medical delivery system, "this is precisely the situation which could not be handled through prospective rulemaking ... ." State's Brief, p. 6.

While Chenery II, and other cases cited by the State (State's Brief, p. 10), support the notion that an agency may proceed by adjudication in certain circumstances, they also, however, stand for the proposition that "the choice made between proceeding by general rule or by individual, ad hoc litigation is one that lies primarily in the informed discretion of the administrative agency." 332 U.S. at 203. As discussed below, there are a number of factors here which weigh against a choice of proceeding to establish a reasonable tolerance for errors by adjudication.

Moreover, as the cases indicate, the position that an agency may proceed by adjudication is premised on the view that the matter involved is one of statutory interpretation. The Court in Chenery II spoke of "filling in the interstices" of the statute involved there, and of "case-by-case evolution of statutory standards." 332 U.S. at 203. While we do not find it necessary to reach the issue here in view of our conclusion that it would be inappropriate for us to proceed by adjudication, we note that this may not be a matter of statutory interpretation. The State's argument that the concept of "cost" in the Act necessarily includes reasonable errors is not supported by any legislative history nor does it necessarily follow from the fact that the Department has promulgated regulations allowing a reasonable tolerance for errors identified through quality control samples. The State's reliance on the Maryland v. Mathews case, cited above, is misplaced in this regard. While the Court in Maryland did recognize the practical impossibility of running an error-free program, the case does not support the position that reasonable errors should be considered a necessary cost of the program in which the Federal Government is required to participate. The Court in Maryland rejected the states' argument there that erroneous payments could be considered payments made as "aid or assistance" under Title IV-A. 415 F. Supp. at 1211-1212. Moreover, the Court discussed the Secretary's authority to promulgate a regulation allowing FFP in erroneous payments up to a reasonable established tolerance level as deriving from the Secretary's authority under Section 1102 of the Act. That section provides that the Secretary "shall make and publish such rules and regulations, not inconsistent with [the Act], as may be necessary to the efficient administration of the functions with which [he] is charged" under the Act. The Court's holding that the Secretary could exercise this authority to promulgate a regulation permitting a reasonable tolerance for errors determined pursuant to quality control does not necessarily mean that the statute may be directly interpreted to provide for tolerances and to determine what their scope should be.

3. The Choice of Adjudication or Rulemaking

Even if the statute could be interpreted to permit a reasonable tolerance and a determination of reasonableness could be made on a case-by-case basis, the choice to proceed in that manner should be based on an informed judgment as to the appropriateness of adjudication rather than rulemaking. There are a number of factors which weigh against our deciding that adjudication would be appropriate here.

The disallowance determination which we are reviewing here is a determination that a tolerance level does not apply, not a determination that the errors disallowed were above a level which was reasonable. Thus, our analysis of the issues of reasonableness would involve, not an evaluation of whether the Agency properly considered all relevant factors, but an initial examination of how the question should be approached. First, we would have to determine whether the standards of "unavoidability" and "cost-effectiveness" proposed by the State are the correct measures of reasonableness. We would have to consider whether the PHP program may be examined separately or must be viewed in the context of the State's entire Medicaid Program, whether duplicate payment errors can be examined apart from other claims processing errors, and whether other states' experiences are relevant. The amount of factual data which would need to be accumulated is potentially staggering. The Department's setting of tolerance levels for eligibility errors took place in the context of the quality control system which provided the necessary data and experience. The quality control system did not apply to Medicaid claims processing errors until 1978, so that system would not provide information relating to this type of errors. Setting a tolerance level for these error would involve an after-the-fact construction of a data base.

As the Court indicated in Maryland, the determination of what is a reasonable tolerance for errors is one which should be based on empirical studies and consideration of all relevant factors. Where a determination of what is reasonable requires expertise and experience in program operations, a comparison of various states' performance, and an evaluation of the feasibility of reducing errors in a cost-effective manner, we think that the regulatory (or legislative) process is the most appropriate one for making such a determination.

Moreover, there is no way of determining with mathematical precision the exact point at which a tolerance level should be set. The concept of reasonableness may lead to identification of a range within which errors should be tolerated, but the choice of a specific figure within that range involves a policy judgment. Where a matter involves an exercise of programmatic judgment, the Board will not normally interfere.

The State argues that the regulations promulgated may serve as a guide to the Board as to where a tolerance level should be set. Those regulations do not, however, set a tolerance level for claims processing errors, the type of errors involved here. In part in response to states' comments, the Department determined in 1980 that there was insufficient empirical data available as a basis for setting such a tolerance. The discussion of this indicates also that there is reason not to adopt the same standard for claims processing errors as for eligibility errors. Thus, this is not a situation where we could analogize to a standard set through the regulatory process, merely applying it to an earlier period.

Given all these considerations, we have determined that, even if we could proceed by adjudication to set a tolerance level for the State's errors, we should not do so.

This conclusion does not, however, preclude the Agency from choosing to reevaluate its own power in this regard. Some of the barriers to the Board proceeding by ad hoc adjudication here do not apply to HCFA. As the State argues, to a certain extent it is the victim of the slowness of the regulatory process. If the quality control disallowance provisions had not been so controversial and a tolerance level had been set for this type of error, the State may have possibly met the standard or qualified for a waiver based on the experimental nature of the program or the State's prompt corrective action. The HCFA policy of disallowing for all individually identified erroneous payments does not afford the State this possibility.2/ While we agree with HCFA that it is difficult to consider $7 million as a de minimis amount of errors, HCFA arguably could allow FFP in some of the payments as an administrative cost, or interpret the statute to permit a tolerance, or exercise rulemaking authority to retroactively allow FFP in reasonable errors on a proper showing.

2/ HCFA admits that the states are not expected to run an error-free Medicaid Program. It nevertheless supports its position for disallowing for all individually identified erroneous payments, not only on the regulatory language, but on the basis of fairness. It claims that there is an informal or de facto tolerance built in by the "horse and buggy" audit system. Since the limited number of auditors permits examining only a small portion of a state's entire Medicaid Program, for every error discovered by the auditors for which repayment is required, there may be ten times as many in the unaudited parts of the program. This argument overlooks the fact that if there is an overall tolerance level, a state may, if it works hard enough, be able to avoid repayment for any errors.

Conclusion

For the reasons stated above, we conclude that the disallowance should be upheld, in the reduced amount of $7,561,820.

/s/ Cecilia Sparks Ford

/s/ Norval D. (John) Settle

/s/ Alexander G. Teitz, Panel Chair