



# STATE OF NORTH CAROLINA

**PERFORMANCE AUDIT**

**NORTH CAROLINA STATE HEALTH PLAN FOR  
TEACHERS AND STATE EMPLOYEES**

**BAPTIST HOSPITAL OVERPAYMENTS**

**SEPTEMBER 2011**

**OFFICE OF THE STATE AUDITOR**

**BETH A. WOOD, CPA**

**STATE AUDITOR**

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Beth A. Wood, CPA  
State Auditor

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**Office of the State Auditor**

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September 7, 2011

The Honorable Beverly Perdue, Governor  
Members of the North Carolina General Assembly  
Lacey Barnes, Interim Executive Administrator, State Health Plan for Teachers and  
State Employees

Ladies and Gentlemen:

We are pleased to submit this performance audit titled *State Health Plan for Teachers and State Employees - Baptist Hospital Overpayments Payments*. The audit objectives were to determine why the State Health Plan did not exercise its contractual right to adjust the outpatient discount rate, why the Plan was not successful in recovering the amount it determined was overpaid, and to determine the total amount overpaid. Ms. Barnes reviewed a draft copy of this report. Her written comments are included in the appendix.

The Office of the State Auditor initiated this audit to improve oversight of State Health Plan contracts and activities.

We wish to express our appreciation to the staff of the State Health Plan for Teachers and State Employees for the courtesy, cooperation, and assistance provided us during the audit.

Respectfully submitted,

A handwritten signature in cursive script that reads "Beth A. Wood".

Beth A. Wood, CPA  
State Auditor

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## **FINDINGS AND RECOMMENDATIONS**

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### **SUMMARY**

#### **PURPOSE**

This audit report evaluates the circumstances surrounding the overpayment<sup>1</sup> of outpatient medical claims provided by Wake Forest University Baptist Hospital (Baptist Hospital) and makes recommendations so the North Carolina State Health Plan for Teachers and State Employee (State Health Plan or Plan) management can take appropriate corrective action.

#### **RESULTS**

The State Health Plan did not increase the outpatient discount rate as allowed in the contract because it did not have a contract monitoring plan and did not seek or obtain annual outpatient fee increase information from Baptist Hospital. Because there was no contract monitoring, the Plan did not know outpatient fees increased, therefore it could not determine if an increase in the negotiated discount rate was allowed per the contract's inflation adjustment provision.

The State Health Plan was unsuccessful in recovering the approximately \$638,600 it later estimated was overpaid after March 1, 2006, because Baptist Hospital denied its attempts to recover the overpayment. Baptist Hospital claimed it complied with the terms of the contract and further stated that only in circumstances of noncompliance on its part can the Plan seek an adjustment to the rate after expiration of the contract. The Plan did not attempt to increase the outpatient discount rate until after the contract concluded. The contract did not specifically require Baptist Hospital to notify the Plan of outpatient fee increases, a deviation from the terms the Plan commonly used to contract with other North Carolina hospitals.

Many of the contract terms were not clearly defined, resulting in at least 96 possible combinations for calculating the over paid amount. Using the same method the Plan used for calculating the overpayment, the Plan paid approximately \$770,000 more to Baptist Hospital for outpatient services during the contract (July 1, 2003 to June 30, 2008) than it would have if the discount rate was adjusted for inflation. Using the combination of variables most closely aligned with the cost containment intent of the contract's inflation adjustment provision, the estimated overpayment to Baptist Hospital for outpatient services is approximately \$1.34 million, or 75% higher than the Plan's calculation method.

#### **RECOMMENDATIONS**

The State Health Plan should develop contract monitoring plans for all its service contracts. Contract monitoring plans should be based on a contract risk assessment and risk mitigation and contingency plans. Monitoring plans should include a listing of key contract provisions and any associated dates so that managers can quickly assess and verify whether vendors complied with contract terms.

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<sup>1</sup> "Overpayment" is the term used to describe the amount paid in excess of what would have been paid if the Plan had exercised its right to receive additional discounts from Baptist Hospital.

## **PERFORMANCE AUDIT**

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The State Health Plan should only enter into contracts that clearly define the scope of work, contract terms, allowable renewals, and procedures for changes. Contracts that allow for procedure or rate changes should always include terms that require the vendor to provide appropriate notice to the Plan. Additionally, Plan contracts should allow for recovery of overpayments for a reasonable period after the term of the contract.

The State Health Plan should ensure that its contracts are drafted and reviewed by individuals that know the subject matter and concerns of the parties thoroughly enough to anticipate potential areas of disagreement and specifically address them in the contract. The Plan should obtain independent industry experts to assist them with request for proposals, contract development, and related risk assessments to ensure that the Plan's interests and risk tolerance are appropriately addressed in the contract and contract monitoring plans.

### **AGENCY'S RESPONSE**

The Agency's response is included in the appendix.

## **INTRODUCTION**

### **BACKGROUND**

*North Carolina General Statute Chapter 135, Article 3*, authorized the creation of the North Carolina State Health Plan for Teachers and State Employees (State Health Plan or Plan). The State Health Plan became self-funded in October 1982. The Plan provides health care coverage to more than 667,000 teachers, state employees, retirees, current and former lawmakers, university and community college personnel, and hospital staff. The Plan also provides dependent coverage. The State Health Plan contracts with Blue Cross and Blue Shield of North Carolina to process all member claims.

The State Health Plan offered an indemnity plan as a health insurance option until July 1, 2008. An indemnity plan is a health benefit system in which the insurance company pays a percentage of each covered healthcare service. Prior to July 1, 2003, the indemnity plan paid participating hospitals one hundred percent (100%) of their usual and customary charges for outpatient services.

In 2003, the State Health Plan sought to reduce the amount paid for health care services and negotiated contractual discounts on medical services with most hospitals in North Carolina. The contract with Wake Forest University Baptist Medical Center (Baptist Hospital) was effective from July 1, 2003, until June 30, 2008, when the indemnity plan was terminated. In the contract, Baptist Hospital agreed to accept a percentage discount off allowed outpatient charges. The contract contained an inflation adjustment provision that allowed the State Health Plan to increase the discount rate if outpatient fees charged by Baptist Hospital increased more than the rate of inflation.

In 2009, the State Health Plan realized that it had not exercised its right to increase the outpatient discounts for several contracted hospitals, including Baptist Hospital. The Plan performed analyses to determine the amounts it overpaid and attempted to recover those amounts. While the State Health Plan recovered overpayments from some hospitals, the Plan did not recover any money from Baptist Hospital.

The State Health Plan paid Baptist Hospital \$24,638,900 for outpatient medical services provided to Plan members between July 1, 2004,<sup>2</sup> and June 30, 2008.

### **OBJECTIVES, SCOPE, AND METHODOLOGY**

The audit objectives were to determine why the State Health Plan did not exercise its contractual right to adjust the outpatient discount rate, why the Plan was not successful in recovering the amount it determined was overpaid, and to determine the total amount overpaid.

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<sup>2</sup> The contract began on July 1, 2003. The first outpatient fee increase was effective July 1, 2004.

## PERFORMANCE AUDIT

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The Office of the State Auditor initiated this audit to improve oversight of State Health Plan contracts and activities.

The audit scope included claims filed by Baptist Hospital for outpatient services provided to State Health Plan members between July 1, 2003 and June 30, 2008. We conducted the fieldwork from September 2010 to June 2011.

To achieve our audit objectives, we reviewed the contract between the State Health Plan and Baptist Hospital, interviewed Plan staff, reviewed Plan documentation and compared paid claims to the amount that would have been paid if the contract was fully enforced.

Specifically, we obtained and verified claims data from the Plan's claim processor regarding outpatient medical services provided by Baptist Hospital. We obtained fee schedules and fee increase information from Baptist Hospital and gained an understanding of how fee increases are determined. We obtained Consumer Price Index for all Urban Consumers (CPI-U) indexes from the U.S. Department of Labor. We then compared the amount paid to the amount that would have been paid if the contract was fully enforced.

Because of the test nature and other inherent limitations of an audit, together with limitations of any system of internal and management controls, this audit would not necessarily disclose all performance weaknesses or lack of compliance.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

We conducted this audit under the authority vested in the State Auditor of North Carolina by *North Carolina General Statute 147.64*.



## FINDINGS AND RECOMMENDATIONS

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### 1. FEE INCREASE INFORMATION NOT OBTAINED

The North Carolina State Health Plan for Teachers and State Employees (State Health Plan or Plan) did not increase the outpatient discount rate as allowed for in the contract because it did not receive, seek, or obtain annual outpatient fee increase information from Wake Forest University Baptist Hospital (Baptist Hospital). Because the State Health Plan did not know outpatient fees had increased, it did not determine if an increase in the negotiated discount rate was allowed.

The State Health Plan and Baptist Hospital entered into a contract effective July 1, 2003, to June 30, 2008, where the parties agreed to percentage discount on outpatient medical services provided to Plan members. The contract contained an inflation adjustment provision that allowed for an increase in the discount rate if the outpatient fee increased more than the “Medical Cost Component” of the U.S. Department of Labor’s Consumer Price Index (M-CPI). If outpatient fees increased more than the M-CPI inflation rate, the State Health Plan had the right to increase the outpatient discount rate by the amount that the fee increase exceeded the rate of inflation.

However, the State Health Plan did not have a plan for monitoring Baptist Hospital outpatient fee increases and determining if an inflation adjustment discount was allowed, and no one was assigned this responsibility. As a result, inflation adjustment analyses were not performed, and the discount rate was not increased during the entire contract period.

The State Health Plan should have sought fee increase information directly from Baptist Hospital as part of its contract monitoring plan. The National State Auditors Association “Best Practices in Contracting for Services” states, “Contract Monitoring is an essential part of the contracting process. Monitoring should ensure that contractors comply with contract terms, performance expectations are achieved, and any problems are identified and resolved. Without a sound monitoring process, the contracting agency does not have adequate assurance it receives what it contracts for.”

Because the State Health Plan did not monitor Baptist Hospital outpatient fee increases and did not increase the discount rate as allowed in the contract, the State Health Plan paid more to Baptist Hospital for outpatient services than it had to per the contract.

**Recommendation:** The State Health Plan should develop contract monitoring plans for all its service contracts. Contract monitoring plans should be based on a contract risk assessment and risk mitigation and contingency plans. Monitoring plans should include a listing of key contract provisions and any associated dates so that managers can quickly assess and verify whether vendors complied with contract terms.

## FINDINGS AND RECOMMENDATIONS

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### 2. CONTRACT DID NOT REQUIRE NOTICE OF FEE INCREASES

In early 2009, the North Carolina State Health Plan for Teachers and State Employees (State Health Plan or Plan) became aware that the discount rate never increased for many of the contracting hospitals, including Wake Forest University Baptist Hospital (Baptist Hospital). The Plan devised a plan to notify Baptist Hospital of the omission, obtain outpatient fee increase information from the Baptist Hospital, compute the discount rates and overpaid amount, and recover the overpaid amount. However, the State Health Plan was unsuccessful in recovering the approximately \$638,600 it estimated was overpaid since March 1, 2006, because the Plan did not attempt to increase the outpatient discount rate “during the term of the agreement.”<sup>3</sup>

Because of the three-year statute of limitations, the Plan and its counsel, the North Carolina Office of the Attorney General (Attorney General), limited their recovery attempt to March 1, 2006: a look-back period of three years once the Plan notified Baptist Hospital of the omission. Based on that date, the State Health Plan calculated that approximately \$638,600 was overpaid and sought reimbursement from Baptist Hospital through the Attorney General in November 2009.

In February 2010, counsel for Baptist Hospital wrote that they believed that the State Health Plan’s claim for reimbursement of overpaid amounts lacked merit because the contract did not require Baptist Hospital to notify the Plan of outpatient fee increases and that Baptist Hospital fully complied with the terms of the contract<sup>4</sup>. Counsel pointed out that since there was no breach of the contract, the Plan could not increase the discount rate after the contract period. Baptist Hospital offered to settle the dispute for \$20,000. The State Health Plan did not officially accept the offer due to the on-going audit. Baptist Hospital later withdrew the offer.

The State Health Plan should not have agreed to a contract that did not require notification of outpatient fee increases, especially in light of the fact that the contract allowed for increases in the discount rate if fees went up faster than inflation. By agreeing to the contract, the Plan accepted the responsibility for identifying outpatient fee increases.

A well-constructed contract should (1) protect the interest of the State, (2) identify key responsibilities of the parties, including notice obligations, and (3) document the mutual agreement, the substance, and parameters of what was agreed upon. The National State Auditor Association’s “Best Practices in Contracting for Services” states, “The contract should clearly state and define the scope of work, contract terms, allowable renewals, and procedures for any changes.” Without a notice obligation, specifics of important contract items may change without both parties knowing that a change occurred.

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<sup>3</sup> Section III.2.B of the contract between the Plan and Baptist Hospital.

<sup>4</sup> The lack of a contract clause requiring Baptist Hospital to notify the Plan of fee increases is a deviation from the terms and conditions the Plan used to contract with most other North Carolina hospitals.

## FINDINGS AND RECOMMENDATIONS

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Because the State Health Plan did not increase the outpatient discount rate during the contract period and agreed to a contract that did not require Baptist Hospital to notify the Plan of outpatient fee increases, the Plan was unable to hold the vendor legally accountable for returning amounts paid in excess of the cost containment intent of the contract. By its own calculation, the lack of notice obligation and failure to increase the outpatient discount rate cost the State Health Plan at least \$638,600 and possibly as much as \$1.34 million (see finding 3).

**Recommendation:** The State Health Plan should only enter into contracts that clearly define the scope of work, contract terms, allowable renewals, and procedures for changes. Contracts that allow for procedure or rate changes should always include terms that require the vendor to provide appropriate notice to the Plan. Additionally, Plan contracts should allow for recovery of overpayments for a reasonable period after the term of the contract.

### 3. OVERPAYMENT IS HIGHER THAN CALCULATED BY THE PLAN

Using the North Carolina State Health Plan for Teachers and State Employees' (State Health Plan or Plan) method for calculating the overpayment, the Plan paid approximately \$770,000 more to Wake Forest University Baptist Hospital (Baptist Hospital) for outpatient services between July 2004 and June 2008 than it would have if the contract was fully enforced during that same time period.<sup>5</sup> However, considering the cost containment intent of the contract's inflation adjustment provision,<sup>6</sup> the estimated overpayment to Baptist Hospital for outpatient services is approximately \$1.34 million, or 75% higher than the Plan's calculation method.

The reason for the difference is that the contract between the State Health Plan and Baptist Hospital did not adequately specify key contract terms necessary to calculate a definitive rate discount adjustment. Furthermore, the method used by the Plan to calculate the overpayment did not strictly follow the cost containment intent of the contract's inflation adjustment provision.

Complete and clear contract terms are critical to a well drafted contract to capture the mutual intent of both parties. The "Texas Guide to Contract Management" states that "The person who drafts the contract must know the subject matter and concerns of the parties thoroughly enough to anticipate potential areas of disagreement and specifically address them in the contract."

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<sup>5</sup> Because of the three-year statute of limitations, the Plan and its counsel, the North Carolina Office of the Attorney General, limited the recovery period to March 1, 2006 (a look-back period of three years once the Plan notified Baptist Hospital of the omission). Based on that date, the State Health Plan calculated that approximately \$638,600 was overpaid and sought recovery of that amount.

<sup>6</sup> The contract's inflation adjustment provision allowed the Plan to increase the outpatient discount rate in order to off-set the portion of any fee increase that exceed the rate of inflation.

## FINDINGS AND RECOMMENDATIONS

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In this instance, the lack of contract clarity resulted in at least 96 possible combinations for calculating the overpayment amount. Because there are multiple ways of calculating the overpayment, it could range from range from around \$163,000 to \$1.94 million.

There are four key variables that most affect the calculation of the discount rate and subsequently the amount overpaid by the Plan. In the following bullet points, these variables are discussed and the range of the overpayment is narrowed.

- The contract did not specify if the comparison between the outpatient fee increase and increase in inflation should be made on a year-to-year basis or compared back to the first (“base”) year. However, it appears that the intent of the contract was for each year to stand on its own. By eliminating the base-year method, the re-calculated overpayment range is between \$263,000 and \$1.94 million.
- The contract states clearly that the discount amount is applied to Baptist Hospital’s outpatient charges. However the State Health Plan used the overall fee increase, which includes both inpatient and outpatient increase.<sup>7</sup> Using any fee increase information other than the outpatient fee increase would be varying from the one point on which the contract is clear. Using the outpatient fee increase makes the overpayment range from \$1.1 million to \$1.94 million.
- The contract specified that the rate of inflation is the “Medical Cost Component” of the Consumer Price Index (CPI-U). However, there is no category or sub category of the U.S. Department of Labor’s CPI-U entitled “Medical Cost Component.” The State Health Plan used the Medical Care Services category in its calculation at the suggestion of the U.S. Bureau of Labor Statistics. However, since the inflation adjustment provision was specific to outpatient services, the logical inflation category to use is the Outpatient Hospital Services CPI-U. Using that inflation category makes the overpayment range from \$1.25 million to \$1.35 million.
- The last key variable not clearly defined in the contract is the specific 12-month period used to measure inflation. The contract states that “any consecutive twelve month period” can be used to compare outpatient fee increases to inflation. In its calculation, the State Health Plan used the 12-month periods ending December 31, six months after the July 1 fee increase. Using the 12-month period ending June 30, would be the most reflective of the change in CPI-U that Baptist Hospital was trying to offset with their price increase. Using those 12-month periods results in an overpayment amount of approximately \$1.34 million.

The lack of clear and complete contract terms made it difficult, if not impossible, for the State Health Plan or anyone else to accurately calculate the amount it overpaid Baptist Hospital for outpatient services. In this case, the range between the lowest and highest

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<sup>7</sup> For the year ending June 30, 2005, Baptist Hospital did not report separate inpatient and outpatient fee increases. The Plan and auditors used the overall fee increase in their calculation for that year.

## FINDINGS AND RECOMMENDATIONS

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overpayment calculations is almost \$1.8 million. Even if the contract allowed an adjustment to the discount rate after the term of the contract, it is unlikely that the Plan and Baptist Hospital would quickly agree to the overpayment amount given the contract's lack of clarity on critical contract terms.

***Recommendation:*** The State Health Plan should ensure that its contracts are drafted and reviewed by individuals that know the subject matter and concerns of the parties thoroughly enough to anticipate potential areas of disagreement and specifically address them in the contract. The Plan should obtain independent industry experts to assist them with request for proposals, contract development, and related risk assessments to ensure that the Plans interests and risk tolerance are appropriately addressed in the contract and contract monitoring plans.

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August 26, 2011

The Honorable Beth A. Wood, State Auditor  
Office of the State Auditor  
2 South Salisbury Street  
20601 Mail Service Center  
Raleigh, North Carolina 27699-0601

Dear Ms. Wood:

We are in receipt of the draft performance audit report titled "State Health Plan – Baptist Hospital Overpayments" submitted to the Plan on August 5, 2011. As requested, the Plan's response to the audit report is attached for your review and inclusion in the final report.

Please contact me if you have any questions or require additional information.

Sincerely,

A handwritten signature in blue ink that reads "Lacey P. Barnes". The signature is written in a cursive style.

Lacey P. Barnes  
Interim Executive Administrator



**State Health Plan for Teachers and State Employees  
Response to Office of State Auditor Performance Audit, “State Health Plan –  
Baptist Hospital Overpayments” Dated August 5, 2011**

**Plan Response:** The Plan agrees with the Auditor’s findings and recommendations and had initiated improvements in contract management prior to the commencement of this audit.

Contract Management Information Technology: In 2009 the Plan purchased an electronic contract management system to assist in monitoring all Plan contracts. Contract documents and deliverables are set up in the system when the contract is executed. The system then provides email alerts to the contract business owner and contracting department when each deliverable is due. The implementation of a contract management system allows the Plan to take action on its contracts when needed to ensure compliance and protect the interests of the Plan.

Organizational Realignment: In 2010 the Plan created a new position, Director of Contracting and Legal Compliance, to oversee its contracting staff and to develop and implement high quality policies and procedures to guide the Plan’s contracting practices from procurement through contract close out.

Improvements: The Plan is aggressively developing enhanced monitoring capabilities by focusing more resources in terms of staffing, enhancing our existing contractual agreements to create more transparency and accountability as well as tracking deliverables and trending performance over time. As new contracts are developed, the Plan is focused on transparency and accountability through the use of performance based contracting methods. As a result, we are developing contracts that are comprehensive and clearly stated, with specific deliverables and performance guaranties designed to address and mitigate identified risks associated with the agreement. The Plan routinely works with content experts and consultants to ensure that it has access to appropriate advice in developing complex contracts. The Plan has made improvements in all of the areas included in this contract audit; however, those changes were not in place during the audit period. We view contract management as a core capability and will continue to employ continuous quality improvement practices to ensure that the Plan receives the highest value for our members and the taxpayers of our state.



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