

STATE OF NORTH CAROLINA

PERFORMANCE AUDIT

**DEPARTMENT OF HEALTH AND HUMAN SERVICES –
OFFICE OF MEDICAID MANAGEMENT
INFORMATION SYSTEM SERVICES**

REPLACEMENT MMIS IMPLEMENTATION

JANUARY 2012

OFFICE OF THE STATE AUDITOR

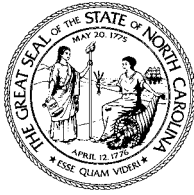
BETH A. WOOD, CPA

STATE AUDITOR

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INFORMATION SYSTEM SERVICES
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Beth A. Wood, CPA
State Auditor

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January 10, 2012

The Honorable Beverly Perdue, Governor
Members of the North Carolina General Assembly
Lanier M. Cansler, Secretary, Department of Health and Human Services
Angeline Sligh, Director, Office of Medicaid Management Information System Services

Ladies and Gentlemen:

We are pleased to submit this performance audit titled "*Department of Health and Human Services – Office of Medicaid Management Information System Services, Replacement MMIS Implementation.*" The audit objective was to determine if the Office of Medicaid Management Information System Services established controls to provide reasonable assurance that the replacement Medicaid Management Information System project would be fully implemented on time and on budget, after considering required federal and state mandated changes. Secretary Cansler reviewed a draft copy of this report. His written comments are included in the appendix.

The Office of the State Auditor initiated this audit to identify improvement opportunities for the procurement and oversight of the Medicaid Management Information System implementation project.

We wish to express our appreciation to the staff of the Office of Medicaid Management Information System Services 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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SUMMARY

PURPOSE

This audit report evaluates whether the Department of Health and Human Services (Department) - Office of Medicaid Management Information System Services' (Office) established controls to provide reasonable assurance that the replacement Medicaid Management Information System project would be fully implemented on time and on budget, after considering required federal and State mandated changes. The report makes recommendations so Department and Office management can take appropriate corrective action.

RESULTS

Management lacks documentation that clearly explains the evaluations and decisions that impact the implementation of the Medicaid Management Information System.

The Medicaid Management Information System is expected to be completed about 22 months late with total overall costs exceeding estimates by \$320.3 million. The reasons for the costs changes include schedule delays, federal and state mandates, and two additional years of operations that the Office contracted for with the Vendor.

The Office did not fully document its analysis of the impact that schedule delays had on the system implementation. The system has experienced delays for three reasons. First, the Vendors planned use 73% of the programming code from its New York system project to build North Carolina's system, and later found that it could only use about 32% of the code. Second, the Vendor experienced higher than expected staff turnover. And third, the length of time taken to review and approve project designs and deliverables exceeded budgeted amounts. Office management contends that only six months of delay in the replacement system go-live date is attributable to "schedule-slippage" or delays. However, the Office did not document its analysis or the reasoning used to determine the impact of the delays on the project.

Also, the Department and Office did not fully document how it determined the amount of damages for which the vendor was responsible. The contract did not define how responsibility for delays would be determined or how damages would be calculated. As a result, the Office found it necessary to negotiate the damage assessment with the Vendor. The Office required the Vendor to perform an analysis to determine how much of the 22-month implementation delay was due to "schedule slippage." Office management said it performed "deep analysis" of the Vendor prepared schedules. However, the Office did not fully document its reasoning and analysis for determining the damages. The Office then negotiated with the Vendor to determine how much of the slippage was caused by the Vendor. The Office agreed upon four months of damages. The Office assessed the Vendor \$10 million based on estimated damages. The Office also amended the contract so that neither party can obtain additional damages if those estimates later prove to be incorrect.

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Lastly, the Office did not timely identify about \$30.4 million of changes that the Vendor made to the design, development, and integration phase of the replacement Medicaid Management Information System project. Because the Office's monitoring procedures did not identify the unauthorized changes, the Office was not aware that the design of the system being built differed from the system that had been approved. In fact, the Department was not aware of some of the changes for more than a year after the changes were made. The Office refused to pay for some of the changes and accepted others. The Office negotiated a price of \$15 million for the changes it accepted.

RECOMMENDATIONS

The Department and Office should clearly document the reasoning and analysis used to determine and manage the effect of delays on the project.

The Department and Office should document its methodology and reasoning in determining how penalties were assessed on vendors. The Department and Office should also retain all documentation used to plan and conduct negotiations with vendors.

The Department and Office should ensure that monitoring procedures are effective for identifying deviations from the project plan. For efficiency, management could establish, document, and communicate to the vendor types of changes that the vendor can make without prior approval.

AGENCY'S RESPONSE

The Agency's response is included in the appendix.

INTRODUCTION

BACKGROUND

North Carolina currently contracts with Hewlett Packard Enterprise Services to operate the State's Medicaid Management Information System and process Medicaid claims payments. The computer system that the Department of Health and Human Services (Department) uses processes and pays over \$10 billion a year in health care claims for about 1.5 million Medicaid program participants. North Carolina purchased the current system from Electronic Data Systems in 1988.

In April 2004, the Department awarded a \$171 million contract to Affiliated Computer Services (ACS) to replace the existing system and serve as the new fiscal agent for the State's Medicaid Program. The Department also created the North Carolina Office of Medicaid Management Information System Services (Office) to provide oversight and manage activities for the procurement and implementation of support systems and services for the replacement System.

ACS did not perform in accordance with the contract. ACS was to complete the design, development, and installation phase of the contract by the summer of 2006. In March 2006, the Department granted a request to extend the completion date to August 2007. However, the Department denied a second ACS request to increase the contract cost and extend the design, development, and installation phase completion date to November 2007. After paying about \$5.6 million in project costs, the Department terminated the ACS contract in July 2006. In response, ACS filed a wrongful termination and breach of contract lawsuit against the State. The civil court case was settled in January 2007 at an additional cost of \$10.5 million to the State. In the settlement, ACS also agreed to install a suite of software to help the state's Medicaid program generate savings.

In 2009, the Department began its second attempt at replacing the system. The Department awarded a \$265 million contract to Computer Science Services, Inc (Vendor) in January 2009. The contract established a fully-implemented go-live date of August 2011 for the new system. However, in July 2010 the Vendor notified the Department that the Vendor would not be able to meet the established go-live date and requested an extension. After lengthy negotiations, the Department approved a contract amendment in July 2011 that granted an 18-22 month extension to build the system, increased contract price from \$265 million to \$494 million (86%), and extended the operational contract an additional two years.

The federal government is expected to fund up to 90% of the design, development, and installation cost for the new system.

OBJECTIVES, SCOPE, AND METHODOLOGY

The audit objective was to determine if the Office of Medicaid Management Information System Services (Office) has established controls that provide reasonable assurance that the replacement Medicaid Management Information System project would be fully implemented on time and on budget, after considering required federal and state mandated changes.

The Office of the State Auditor initiated this audit to identify improvement opportunities for the procurement and oversight of the system implementation project.

The audit scope included a review of project management practices and vendor contract information surrounding the current system replacement effort beginning January 1, 2009 through July 31, 2011. We conducted the fieldwork from February 2011 to December 2011.

To determine current management practices, we conducted interviews with Department of Health and Human Services (Department) and Office management, reviewed policies and procedures related to the replacement system project management, and reviewed Department and Office management meeting minutes.

To evaluate management controls, we compared Office project management practices to recommended best practices issued by the Project Management Institute and the IT Governance Institute.

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

1. IMPACT OF DELAYS NOT FULLY DOCUMENTED

The Office of Medicaid Management Information System Services (Office) at the North Carolina Department of Health and Human Services (Department) did not fully document its analysis of the impact that schedule delays had on the system implementation.

Schedule Delays

The Office and the Computer Sciences Corporation (Vendor) described three sources of schedule delays that impacted the system implementation.

One source of project delay was the Vendor's planned use 73% of the programming code from its New York system project to build North Carolina's system. In January 2009, the Vendor was awarded the contract and began work on North Carolina's system. In June 2010, the Vendor found that it could only use about 32% of the code from the New York project for North Carolina. Consequently, unplanned additional time and labor is necessary to complete North Carolina's system.

In a March 10, 2011, interview, the current State CIO said he would never have allowed the proposal to be accepted based on the estimated percentage of usable code. The State CIO said that he had experience with other information technology vendors making similar estimates and not being able to deliver.

The Office accepted the Vendor's proposed use of 73% of the New York project code without documenting any independent analysis that indicates the proposal was reasonable. Department management said it was not possible to determine whether the Vendor could use the New York project programming code until after the system was designed and programming was started. Furthermore, Department management said that the additional programming time and labor needed to complete the system does not cost the State anything because the State has a fixed cost contract.

A second source of project delay was higher than expected Vendor staff turnover. The risk of high staff turnover and planned mitigation actions were listed in the Vendor's proposal. The risk of high staff turnover was also documented in the project risk register¹ on May 2, 2009. The vendor reported high staff turnover to the project oversight committee beginning in April 2010. However, the staff turnover risk was not transferred to the issue register and actions taken to address the issue until October 6, 2010.

A third source of project delay was the length of time taken to review and approve project designs and deliverables. The Vendor and the Office stated that review and approval process sometimes exceeded the two cycles of review that were budgeted. Vendor personnel stated the review process resulted in numerous cycles of technical design and development being performed. Additionally, Office personnel stated that the Vendor

¹ Risks are listed in the projects risk register. When events occur and the risks are realized, the risks become issues and are documented in the issue register.

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wanted to meet its deliverable due date, so it would sometimes submit deliverables that were not complete. Office personnel said this added more review time and increased the number of cycles required to complete an acceptable deliverable.

Office documentation shows that on average, the deliverables required review and approval process took about 2.1 cycles. However, analysis of the documentation shows that 26% (59 of 226) deliverables required three or more review cycles.

The project delays not only extended the amount of time needed to complete the system, they resulted in additional costs to the State. Extending the project schedule requires the State to continue using the legacy system. As a result, the State incurs additional cost because the legacy system's operational costs are higher than the new system's operational costs are expected to be.

For example, the State will incur \$90.6 million in unplanned additional costs during a 22 month contract extension to modify the legacy system, operate the legacy system, and keep the Office operational. These costs would have been avoided if the new system had been operational by the original contract delivery date.

Impact Of Delays Not Fully Documented

Currently, the replacement system is expected to be completed about 22 months late and with total overall costs exceeding expectations by about \$320.3 million.

The new system's contract cost increased by \$229.7 million (86%) from \$265.2 million to \$494.9 million.

Office management contends that only \$67 million of the \$229.7 million in additional contract costs and only six months of the 22-month delay in the replacement system go-live date is attributable to "schedule-slippage" or delays. The conclusions are based on schedules and analysis that the Office asked the Vendor to prepare. Office management said that it performed "deep analysis" of the Vendor's schedules.

However, the Office did not document its independent analysis or document the reasoning used to determine the impact of the delays described above on the project.

The reasoning and analysis are needed to accurately separate the impact of the schedule delays from the impact of federal and state mandates and other changes to the system. For example, the Center for Medicare and Medicaid Services (CMS) published proposals for two new major Medicaid regulations (ICD-10 and 5010) in August 2008, just four months before the Department awarded the System contract to CMS. Other cost changes include two additional years of operations that the Office contracted for with the Vendor.

FINDINGS AND RECOMMENDATIONS

Change In Costs

A breakdown of the additional costs totaling \$320.3 million is listed in Table 1 below.

Table 1

Change in Project Costs (in millions)			
	Original Estimate	Additonal Costs	New Estimate
Legacy System:			
Cost Difference Between Current And New			
Vendor Operations Contracts	\$ -	\$ 37.2	\$ 37.2
Application for New Federal Mandates	-	2.3	2.3
Application for Mental Health Claims Payment	-	10.3	10.3
Application for NC Health Choice	-	7.0	7.0
Application for Nursing Homes	-	4.7	4.7
Other Legacy Component Costs	-	29.1	29.1
Total Additional Legacy Operational Costs	<u>\$ -</u>	<u>\$ 90.6</u>	<u>\$ 90.6</u>
New System:			
System Design and Build phase	\$ 68.8	\$ 77.8	\$ 146.6
New Federal Mandates	-	33.2	33.2
Operations Phase	180.5	71.3	251.8
Application for New Federal Health Reform	-	15.3	15.3
Application for Provider Enrollment	10.7	11.4	22.1
Application for Prescription Drug Use Review	4.7	2.9	7.6
Turnover Phase	0.5	-	0.5
Other System Enhancements and Changes	-	17.8	17.8
Total Additional Project Costs	<u>\$ 265.2</u>	<u>\$ 229.7</u>	<u>\$ 494.9</u>
Total Change in Costs	<u><u>\$ 265.2</u></u>	<u><u>\$ 320.3</u></u>	<u><u>\$ 585.5</u></u>

Source: Vendor original and amended contract pricing Table Z, change service requests, other system vendor contracts.

Recommendation: The Department and Office should clearly document the reasoning and analysis used to determine and manage the effect of delays on the project.

2. DAMAGES NEGOTIATIONS NOT FULLY DOCUMENTED

The North Carolina Department of Health and Human Services (Department) and its Office of Medicaid Management Information System Services (Office) did not fully document the damages negotiations with Computer Sciences Corporation (Vendor).

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Specifically, the Department did not document how responsibility for delays was determined or how damages were calculated.

The Department included penalties for nonperformance in its contract with the Vendor. The contract allowed the Department to charge the Vendor for the costs of operating the current system and for Office operations if the new system was not delivered on time. Section 30.44.2 of the original contract states:²

“If the State determines in its sole but reasonable discretion that the Replacement MMIS [Medicaid Management Information System] has not become operational substantially as a whole, or has not begun generating official data of record by the Targeted Operational Start Date [August 2011], **then the Vendor will be liable for all costs incurred by the State** to continue operation of those elements of the Legacy MMIS+ including the cost of continued operation of OMMISS [Office of Medicaid Management Information System Services] which must, in the State’s reasonable opinion, remain in operation (including possibly all elements of the Legacy MMIS+), operational, less the amount that the State would have paid the Vendor had the Replacement MMIS been timely made substantially operational as a whole.”

However, the contract was not clear about how the damages would be calculated. As a result, Office management found it necessary to negotiate the amount of damages for which the Vendor was liable. Office management stated, “It is important to note that these were negotiations, as both parties had differing interpretations on how the contract called for the damages to be calculated.”

First, the Office had to determine how much of a 22-month system implementation delay was due to “schedule slippage.” To determine the amount of slippage, the Office required the Vendor to prepare schedules and analysis. The Vendor’s analysis determined that only six months of the 22-month implementation delay was due to schedule slippage. Office management said that it performed “deep analysis” of the Vendor’s schedules and determined that this amount was reasonable. Although the auditors asked for documentation, the Office did not provide documentation of its independent analysis to show how the Office verified that six months was reasonable.

Next, the Office had to negotiate how much of the six-month slippage was the Vendor’s responsibility. Office management stated, “During negotiations, each side expectedly had their own version of what caused the six-month slippage. It was finally agreed upon that CSC [Vendor] bore 2/3 (four months) of the responsibility for the slippage.” Office management said, “For negotiating purposes, the State owned 2 months of the delay (to account for 200 legacy CSRs [change service requests] which were included in the technical design) and CSC [Vendor] owned 4 months.”

The Office assessed the Vendor for four months of damages in the amount of \$10 million received as monthly credits of \$166,666 to the operational phase of the project beginning in 2013.

² Section 30.44.2 of RFP 30-DHHS-1228-08-R.

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Office management said the \$10 million negotiated settlement covers the estimated damages. Office management stated, “Based on February 2011 estimates, the Department will, in fact, over-recover damages in the amount of approximately \$748,472.”

However, the Office does not have documentation that clearly explains its reasoning for including or excluding items from the damages calculation. For example, there is no documentation to explain why about \$12.7 million of additional legacy system costs were not included in the negotiations. These costs could meet the definition of “all costs incurred” by the State to continue operating the legacy system as stated in the original contract. Table 2 below lists items that the auditors identified as operational costs and other potential damages.

Table 2

	4 Months of Operations
Legacy System Contract - Medicaid claims processing	\$ 16,058,964
Mental Health Claims Payment Contract	1,878,996
NC Health Choice Processing (2 months)	700,000
Cost of Federally Required HIPPA 5010 Update	1,713,771
Cost of Federally Required ICD10 Update	623,960
IBM Fraud and Abuse	914,739
Purchase of Medical Care Services (DPH)	400,000
BlueCross BlueShield - NC Health Choice Medical Claims Proc	2,638,146
Medco - NC Health Choice Prescriptions (2 months)	2,659,062
ACS "Smart PA" Prior Authorization and Drug Utilization Cos	1,178,440
HP Preadmission Screening and Annual Assessment Review	853,044
Ingenix Fraud and Abuse	389,801
Ingenix DRIVE (Data Warehouse)	325,364
ACS State Healthcare Pharmacy PA Preauthorization	1,119,260
Total cost of Legacy System	31,453,547
Estimated continued Office operational cost	3,688,964
Total estimated operational costs of 4 month schedule slippage	\$ 35,142,511
 Cost for Operations of Replacement System per Table Z	 \$ (12,468,847)
 Total Amount of Auditor Identified Delay Costs	 \$ 22,673,664
Penalty Assessed On Vendor	(10,000,000)
Other Potential Penalty Amounts	\$ 12,673,664

Source: Vendor contracts and amendments, change service requests, OSBM budget documents

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Additionally, the damage estimate is just an estimate that could later prove to be inaccurate. The Office stated,

“First, to achieve an accurate cost of the damages related to the Targeted Operational Start Date, damages would have to be measured after-the-fact. The most accurate figure could only be calculated after all relevant costs are recorded for the ‘damage assessment period’. In the case of the \$10,000,000 damages being assessed to CSC [Vendor] in contract amendment #2, those damages were negotiated many months prior to the occurrence of the ‘damage assessment period’ and thus constitute projected damages.”

However, the terms of the contract amendment will prevent the State from obtaining additional amounts if the Office’s estimated damages prove to be incorrect or if the Office later identifies other damages that should have been included in the negotiations. Section 1.15 of contract amendment two states in part:

“Each Party shall have no liability to the other to the extent that such liability arises, or is asserted to arise, from a Party’s failure to timely act in accordance with any Integrated Master Schedule adopted by the Parties prior to the effective date of this Amendment.”

Consequently, it is important to have documentation that explains managements reasoning for the decisions made.

Recommendation: The Department and Office should document its methodology and reasoning in determining how penalties were assessed on vendors. The Department and Office should also retain all documentation used to plan and conduct negotiations with vendors.

3. MONITORING DID NOT IDENTIFY UNAUTHORIZED CHANGES

The Office of Medicaid Management Information System Services (Office) at the North Carolina Department of Health and Human Services (Department) did not timely identify about \$30.4 million of changes that the Computer Sciences Corporation (Vendor) made to the design, development, and integration phase of the replacement Medicaid Management Information System project.

The Vendor:

- Performed scope changes without direction from an Office contracting officer;
- Made changes to system requirements based on informal requests; and
- Accepted change requests from personnel who were not authorized to make system changes.

The National State Auditors Association’s “Best Practices in Contracting for Services” states:

FINDINGS AND RECOMMENDATIONS

“Contract monitoring is an essential part of the contracting process. Monitoring should ensure that contractors comply with the terms, performance expectations are achieved, and any problems are identified and resolved.”

Because the Office’s monitoring procedures did not identify the unauthorized changes, the Office was not aware that the design of the system being built differed from the system that had been approved. In fact, the Department was not aware of some of the changes for more than a year after the changes were made.

However, the contract terms protected the State from paying for unauthorized system changes. Sections 30.6.4 and 30.6.4k of the contract state:

“Vendor shall not be entitled to compensation for any services other than or in addition to the Services (as defined herein below) unless the change process is followed, which process the Vendor shall propose in its Change Management Plan.”

The Department rejected some of the unauthorized changes and accepted others. Because the changes were not pre-approved, the Department had to negotiate the price of the changes after they were made. The Department negotiated and agreed to the following prices:

- \$10.8 million for design “enhancements” that were not approved by the Department and were beyond the scope of the contract; and
- \$4.2 million for design changes that were not part of the baseline design.

Department management did not agree that the unauthorized changes were a problem. Department management stated that some of the changes were requirements that the Vendor would have made at a later date anyway, so the issue is really only one of timing. Other changes were system enhancements that it was more efficient for the vendor to make without seeking approval.

However, failure to identify unauthorized changes in a timely manner increases the risk that the State will not receive the system that it contracted for. Also, it increases the risk that the State could incur additional costs and need additional time to test unauthorized changes.

Recommendation: The Department and Office should ensure that monitoring procedures are effective for identifying deviations from the project plan. For efficiency, management could establish, document, and communicate to the vendor types of changes that the vendor can make without prior approval.

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APPENDIX

Auditor's Response

We are required to provide additional explanation when an agency's response could potentially cloud an issue, mislead the reader, or inappropriately minimize the importance of our findings.

Generally Accepted Government Auditing Standards state,

When the audited entity's comments are inconsistent or in conflict with the findings, conclusions, or recommendations in the draft report, or when planned corrective actions do not adequately address the auditor's recommendations, the auditors should evaluate the validity of the audited entity's comments. If the auditors disagree with the comments, they should explain in the report their reasons for disagreement.

While we recognize that an audit report can result in a lot of defensiveness and emotion, we want to make sure the reader stays focused on the issues. Therefore, to ensure the availability of complete and accurate information and in accordance with Generally Accepted Government Auditing Standards, we offer the following clarifications.

The Department's response indicates that it would have preferred our audit to focus on potential future Medicaid Management Information System (MMIS) operational savings, the effect of additional federal funds on the state's economy, and the Department's reported savings from software acquired during the previous MMIS implementation attempt.

However, that was not the purpose of our audit.

Our audit simply asked (1) what caused the delay in implementing the new MMIS, (2) were the causes reasonably foreseeable by Department management as risks to the project, and (3) if the risks were reasonably foreseeable, did Department management have controls in place to address those risks.

We found that the MMIS implementation was delayed for reasons that were reasonably foreseeable by Department management. However, Department management did not clearly document its analysis or the reasoning used to decide on its response to those risks. Consequently, we recommended that the Department should clearly document its analysis and reasoning for management decisions in the future.

Why clear documentation? Because clear documentation and disclosure of government manager's reasoning, analysis, and decisions help make state government operations transparent to North Carolina's citizens and provide a mechanism to hold government managers accountable. As stated in the Government Auditing Standards, "The principles of transparency and accountability for the use of public resources are key to our nation's governing processes."

Apparently, the Department disagrees.

APPENDIX

The Department's response also claims that the Office of the State Auditor (OSA) disregarded state law by providing a draft audit report that did not include the Department's response to the General Assembly.

The Department is incorrect.

North Carolina General Statute 147-64.6 says, "the auditee's written response shall be included in the final report if received within 30 days from receipt of the draft report." [emphasis added] What was shared with the Legislature on December 13, 2011, was not a final report. Therefore, OSA was not required to include the auditee's response. However, OSA was required by N.C.G.S. § 147-64.5 and N.C.G.S. § 120-19 to cooperate with the General Assembly by providing upon their request the information OSA obtained in this audit as well as the Auditor's recommendations based on this information.

The Department's response also claims that the audit team did not have "sufficient information technology and project management experience and knowledge" to conduct the audit in accordance with Government Auditing Standards.

The Department is incorrect.

The audit team consisted of an external specialist and OSA staff that had the technical knowledge, skills, and experience necessary to conduct the audit. The audit team's certifications, education, and experience, included but were not limited to: Certified Information Systems Auditor (CISA), Project Management Professional (PMP), Certified Public Accountant (CPA), Master of Science (Computer Information Systems), Master of Business Administration (MBA), Bachelor of Engineering, 32 years of government auditing experience, and 12 years of experience in information technology governance, risk, and compliance.

The Department's response also claims that the audit team was not independent as required by the Government Auditing Standards because a member of the audit team was formerly employed by the Department as a contract manager.

The Department is incorrect.

The overarching principles of the Government Auditing Standards' independence standards are that an auditor should not (1) have a financial interest in the audit subject matter, or (2) audit their own work.

All audit team members were independent. None of the audit team members had any financial interest in the MMIS project. Furthermore, none of the audit team members had any involvement in contracting for or managing the current MMIS implementation project.

The Governor, Legislators, and the citizens of North Carolina should consider the clarification provided above when evaluating the Department's response to the audit findings.

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Beverly Eaves Perdue, Governor

Lanier M. Cansler, Secretary

December 20, 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 have reviewed your report on the findings and recommendations that resulted from fieldwork on the performance audit titled "*Department of Health and Human Services – Office of Medicaid Management Information System Services Replacement MMIS Implementation*". The following represents our response to the Audit Findings and Recommendations in this third draft report attempt, this one dated December 13, 2011.

Before providing the substantive response to the report, several matters need to be addressed.

The North Carolina General Statutes grants an auditee some basic due process rights in the audit process, and specifically requires the State Auditor to provide those rights.

§ 147-64.6. Duties and responsibilities.

*(13) At the conclusion of an audit, the Auditor or his designated representative shall discuss the audit with the official whose office is subject to audit and submit necessary underlying facts developed for all findings and recommendations which may be included in the audit report. On audits of economy and efficiency and program results, **the auditee's written response shall be included in the final report if received within 30 days from receipt of the draft report.** [emphasis added]*

However, the State Auditor has disregarded this law in several instances.

OMMIS Performance Audit Response

The Honorable Beth Wood
December 20, 2011
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First, the Auditor withheld the Department's December 9th response from the "draft report" released for public consumption on December 13. That is, the report presented to the public and the legislature a one-sided story instead of a balanced report containing the Department's comments that the auditors had received four days earlier on Friday, December 9. Thus, the Department was denied due process afforded by the General Statutes.

Second, the December 14, 2011 News and Observer story covering the legislature's discussion of a draft audit, quotes Auditor Wood as saying, "*Feet were dragged,*" in regards to the absence of the Department's response. This is certainly not a true statement. The Department timely emailed and hand-delivered its response to the Auditor's second draft report on December 9, 2011.

The "*feet dragging*" comment is even more puzzling since the Department did not even receive this third draft report until 2:45 pm on December 13, - eight hours after the Auditor had released a draft to others. Furthermore, we have no way of knowing whether the draft we received is the same as what was distributed to others earlier that day or was modified during the Auditor's December 13 delivery delay. Obviously, it is impossible to respond to a revised report that the Department had not even received.

Third, the statement following the above quote in the News and Observer article further reports that "*DHHS has up to 30 days to send its official response.*" It is indeed puzzling again that your office stated the same day, in the transmittal dated December 13 of the revised draft report,

"As indicated in the transmittal letter, please have your Agency Response returned to us in both electronic and hard copy by 3:00pm on Tuesday, December 20, 2011."

Clearly, the transmittal instructions to the Department allows only seven days for our response—not 30 days, as reported and required by General Statute. Additionally, the December 13 cover letter to the Department in the revised audit draft further specifically requests:

"Since this report is in confidential draft form, we ask that you help prevent premature release by sharing it only with those staff members whose input is necessary for your reply."

This request is disingenuous in view of your own premature release of a "*draft report*" eight hours earlier to Fiscal Research, the legislators and the media—all occurring before the Department even received the third draft report at 2:43 pm on December 13, 2011. This action falls far short of professionalism and disregards any claim that the audit was conducted in compliance with GAO government auditing standards 3.02, 3.03, 3.04.

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Indeed, the Auditor's pattern of abbreviated due dates for responding to the moving target of "findings" presented in each draft report has placed an undue burden on project staff, who simultaneously carry a heavy project workload. The pattern is illustrated by the following table.

Report Draft	Date Report Received	Response Time Allowed per Transmittal	General Statute Allowance
1	Nov. 7	14	30
2	Nov. 10	19*	30
3	Dec. 13	7	30
* 10 days additional time requested and granted			

We are also deeply concerned regarding external impairments non-compliance with the GAGAS requirement at section 3.10, External Impairments. This section states *"Audit organizations must be free from external impairments to independence"*. Example indicators of possible impairments include *"c. unreasonable restrictions on the time allowed to complete an audit or issue the report;"*

Specifically, the response deadline imposed by the auditors for the second draft report was apparently urgent, since a request for even a one week extension due to multiple deaths and medical emergencies affecting the OMMISS management staff responsible for responding was denied by the auditors. Four days after the auditor received our written response from the Department, a draft report was released to the Associated Press without including the Department's response. The report release was made on the same date as hearings by the Legislative Oversight Committee. According to the Associated Press, the hearing included the following legislator comments:

- *"We have had this same issue for eight years and we never get it done. If we can't do better than that, then we should get out of this project."*
- *The project "seems to be turning into a money pit," If this was in the private sector, then somebody would have been let go a long time ago."*

After the hearings were held, the auditor allotted the Department seven days to respond to the third revision of the report draft. It is unclear why the extension request which was made before the Legislative hearings was denied. However, the day after the legislative hearing, an additional seven days was granted for a response to third version of the draft report. We can only conclude that it was important not to share the Department's response which disagreed with most of the report.

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General Response

The Department is generally very supportive of audits since they can bring value to management. However, we cannot state that this audit has been of any value to the State due to fundamental flaws in the audit process.

In brief,

- OSA failed to adhere to generally accepted government auditing standards ("GAGAS") as published in the Government Auditing Standards, July 2007 Revision (GAO-07-731G), the standards in effect for this audit.
- The audit team attempted to audit what is arguably the largest and most complex IT project in State government without sufficient information technology and project management experience and knowledge as required by GAGAS 3.43(d)(2). Thus, findings and recommendations were flawed from a lack of understanding and knowledge of IT projects.
- The audit team had minimal, if any, legal expertise but was critical of contract language drafted by highly qualified IT attorneys from the Office of the Attorney General, ITS legal staff, and respected legislatively-mandated private legal counsel. The contract was also reviewed and approved by Center for Medicare and Medicaid Services (CMS) Federal contract oversight staff. The audit team's recommendation conflicted with legal advice from our Attorney General's Office and external legal counsel regarding the original contract, the damages settlement and contract amendment. GAGAS 3.43(d)(5)
- The audit team had an unresolved conflict of interest since one of the auditors was a member of DHHS-DMA contract management during the period covered by the audit, which conflicts with GAGAS 3.02, 3.03 and 3.04.
- In addition, the findings in the report have continued to change significantly in each report version since the findings were first proposed four months ago, on August 17. A number of findings have been properly removed, yet the remaining findings still contain inaccuracies and/or fail to reflect a balanced perspective.

The unique nature and cost associated with this 8,000 page contract is often misunderstood. Simply put, the replacement contract has two main components:

- | | |
|--------------------------------------|------------------|
| (1) to develop the MMIS system and | \$ 186.7 million |
| (2) operate the MMIS for seven years | \$ 282.5 million |

➤ **Operations Cost.** When the auditors speak of "*overall costs exceeding estimates by \$320.3 million,*" they are mixing and confusing apples and oranges. Practically all

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of the operations costs are future and none of it is exceeding estimates. Quite to the contrary, the operational prices are \$116 million less than what we are and would be paying HP-EDS to operate the current legacy system for the same period of time. So there is certainly no "cost overrun" of any future CSC operations costs which, in fact, are only huge savings.

➤ **Development Cost.** The balance is development costs, which were estimated at \$90.8 million four and a half years ago. However, CMS and State policy changes, major State and Federal legislative changes have roughly doubled the development cost estimation. These are required changes that MMIS program management staff have absolutely no control over, yet in dealing with these mandatory changes, management is accused of being unable to properly manage. These are baseless accusations.

We expected that the project management of NC MMIS Replacement Project would receive careful, considered, and fair analysis, and some helpful recommendations. Unfortunately, this performance audit offers none of that. In retrospect, far from providing the objective and impartial analysis that the public expects from audit professionals, it appears that the auditors' efforts have centered around supporting a predetermined and incorrect conclusion that the project was not properly managed. This performance audit process has actually detracted from DHHS management's time managing a very complex IT project over the last eleven months and produced no recommendations of value.

As stated earlier, the Department is very supportive of audits that bring value and are balanced in their presentation of the facts. We certainly wish that had been the case in this report, but for the reasons indicated, we disagree with much of the report. One of the auditors actually said at the conference in a joking manner, "*You know auditors have to find something.*" This is not a joking matter. This audit has been an unproductive eleven month exercise. We would certainly prefer not to have to spend additional time and money to address what is a valueless report, but the Department was given no other option.

The late Watts Humphrey of the *Software Engineering Institute*¹ and recipient of the President of the United States National Medal of Technology and Innovation award, is often called the "Father of Software Quality". Watts Humphrey wisely observed and succinctly

¹ The SEI serves the nation as a federally funded research and development center based at Carnegie Mellon University, an organization that is well known for its highly rated programs in computer science and engineering. As part of Carnegie Mellon, the SEI operates at the leading edge of technical innovation. The SEI staff has advanced software engineering principles and practices and has served as a national resource in software engineering, computer security, and process improvement. Mr. Humphrey was awarded the prestigious President's Medal of Technology and Innovation in 2003.

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stated:

"We have been changing managers for years, but it should now be obvious that the problem isn't bad managers: They are good people put in untenable positions."²

When State and Federal legislation either adds to or modifies the amount of work that has to be completed to have an up-to-date system, our project managers are indeed put in an untenable position when expectations are to perform what is sometimes double the original work (scope) within the original cost and schedule--truly an untenable position that should never have the catchy but inaccurate phrase "*cost exceeding expectations by about \$320.3 million.*"

It is regrettable that such a beneficial IT project for the state has been subject to such ill-informed, negative, and unfounded criticism. Some very **significant positive project aspects were ignored in the report**. For example,

1. Upon implementation, the MMIS project will save approximately \$2.5 million per month. The State will recover its investment in the project in approximately 22 months and generate \$82 million in additional savings over the life of the contract--\$ 116 million that would otherwise be paid to HP-EDS to operate the legacy MMIS system.
2. According to the well-known NCSU economist, Dr. Michael Walden, federal funds that come into the State produce approximately a 10% benefit to the State's economy through various income, sales taxes and turnover factor in the local economy. Thus, most of the 10% State match for the project is recovered the same year through increased State tax revenues.
3. One small part of the program already implemented, Supplemental Drug Rebate/PDL, has already recovered \$54.6 million for the State since becoming operational in May 2010. This part of the MMIS program cost \$1.1 million to develop, thereby generating a \$53.5 million saving for the State in less than two years.
4. Even on the terminated ACS contract, the Department negotiated and received additional software as part of the settlement. However, more importantly than the \$10.5 million settlement cost is that the State secured additional vendor-owned software as part of the settlement negotiations agreement. One of these software packages, Smart PA, has saved the Medicaid program \$191 million to-date, easily surpassing the settlement cost multiple times, actually making a significant "profit"

²Humphrey, W. (July/August 2010). Why do large projects fail?, *Crosstalk*, Vol. 23 (No. 4). Retrieved from <http://www.crosstalkonline.org/storage/issue-archives/2010/201007/201007-Humphrey-2.pdf>

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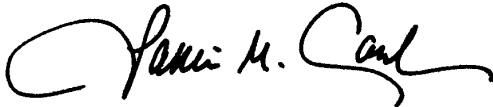
for the State. This failure to report an important positive fact is an example of unbalanced reporting.

Further, one of the auditors was actually the DHHS Medicaid contract administrator for the Smart PA software contract when it was being implemented following the ACS settlement. Thus, the nondisclosure of the huge savings is perplexing.

It is the Department's hope that this response will be read and that the facts presented in this response will negate the inaccurate information that has been bantered around since the improper release of this third version of the audit report.

If you need any additional information, please contact Monica Hughes at (919) 855-3720.

Sincerely,

A handwritten signature in black ink, appearing to read "Lanier M. Cansler". The signature is fluid and cursive, with a large initial "L" and a long, sweeping underline.

Lanier M. Cansler

Cc: Dan Stewart, CPA
Mike Watson
Maria Spaulding
Eddie Berryman, CPA
Laketha M. Miller, CPA

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Audit Report - Purpose

Audit Report Excerpt

This audit report evaluates whether the Department of Health and Human Services (Department) - Office of Medicaid Management Information System Services' (Office) established controls to provide reasonable assurance that the replacement Medicaid Management Information System project would be fully implemented on time and on budget, after considering required federal and State mandated changes. The report makes recommendations so Department and Office management can take appropriate corrective action.

DHHS Comment: We disagree that the auditors considered the "required federal and State mandated changes" as part of their audit. In fact, this phraseology was not added until version 3 of the audit report-- after countless attempts by the Department in previous draft responses to make the auditors aware of the schedule-based budgetary impacts that these mandated changes have had on the project. At this point, the auditors' incorporation of federal and state mandated changes into their evaluative criteria transcends disingenuousness, particularly given their persistent reluctance to embrace this rationale as previously expressed by the Department. The auditors imply that MMIS replacement cost and time can be achieved on original budgets and schedules. Basically, all large MMIS replacement projects do exceed the original budget and schedule -- just as is the case in North Carolina since they are in essence a "moving target" since they constantly change. However, to label all contract changes "budget overruns" is a misnomer.

There can be a variety of reasons for changes, but the common thread is that these are dynamic IT systems—meaning that there are many scope changes due to policy, as well as Federal and State legislative actions that occur after the RFP date. The scope must be changed (i.e. contract amended) to incorporate these changes so that the old legacy system process can be transferred to the new system without any transition issues. That does not translate into mismanagement; quite the contrary, it indicates that the original contract scope is being brought up-to-date for the changes that have taken place since the original RFP which in North Carolina was over four and a half years ago (RFP date July 2007).

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Audit Report - Results

Audit Report Excerpt

Management lacks documentation that clearly explains the evaluations and decisions that impact the implementation of the Medicaid Management Information System.

DHHS Comment: It is overly simplistic for the auditors to make a broad generalization regarding management's purported lack of documentation, especially considering the auditors' lack of experience and knowledge of IT projects. The activities of the MMIS Program Office are well managed and appropriately documented. The auditors express concern specifically about documentation it believes should be in place regarding the recent negotiation to extend the contract; however, the Department believes that the appropriate due diligence occurred during the negotiations in concert with legal representation from the NC Attorney General's Office and external legal counsel.

The Office maintains over 250,000 pages of electronic documentation and in excess of 1.5 million files. All of these records are maintained in accordance with federal, state and departmental records retention statutes, rules, policies and guidelines.

Audit Report Summary Recommendation

Audit Report Excerpt

The Department and Office should clearly document the reasoning and analysis used to determine and manage the effect of delays on the project.

The Department and Office should document its methodology and reasoning in determining how penalties were assessed on vendors. The Department and Office should also retain all documentation used to plan and conduct negotiations with vendors.

The Department and Office should ensure that monitoring procedures are effective for identifying deviations from the project plan. For efficiency, management could establish, document, and communicate to the vendor types of changes that the vendor can make without prior approval.

DHHS Comment: The new Recommendations 1 and 2 – like the revised Findings 1 and 2 – are virtually the same topic, and thus redundant. Also, there's no evidence to support a recommendation to "retain" documentation – that is, there's no basis that the Department and/or Office discarded any documentation—quite the contrary.

The recommendation provides no value to management since the Department has a

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comprehensive monitoring plan in place. In addition, the Program has an outside Independent Verification and Validation (IV&V) which reports independently to management internally and externally to ITS, CMS and the Program Sponsor.

Program management's time could have been better spent working on the project rather than attempting to educate the auditors for eleven months and providing voluminous documentation for them which was apparently not understood or did not support the negative bias of the audit report.

Audit Report Introduction

BACKGROUND

Audit Report Excerpt

North Carolina currently contracts with Hewlett Packard Enterprise Services to operate the State's Medicaid Management Information System and process Medicaid claims payments. The computer system that the Department of Health and Human Services (Department) uses processes and pays over \$10 billion a year in health care claims for about 1.5 million Medicaid program participants. North Carolina purchased the current system from Electronic Data Systems in 1988.

DHHS Comment: This is not completely correct. North Carolina originally purchased the system from Electronic Data Systems in 1977. EDS was awarded the contract to continue operations and enhance the solution in 1988.

Audit Report Excerpt

In March 2006, the Department granted a request to extend the completion date to August 2007. However, the Department denied a second ACS request to increase the contract cost and extend the design, development, and installation phase completion date to November 2007. After paying about \$5.6 million in project costs, the Department terminated the ACS contract in July 2006. In response, ACS filed a wrongful termination and breach of contract lawsuit against the State. The civil court case was settled in January 2007 at an additional cost of \$10.5 million to the State. In the settlement, ACS also agreed to install a suite of software to help the state's Medicaid program generate savings.

DHHS Comment: This audit narrative has errors.

The statement that "ACS did not perform in accordance with the contract" is inappropriate due to the terms of the settlement agreement.

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The Department did not extend the completion date for the ACS solution to August 2007.

The “After paying about \$5.6 million in project costs,” and “In response, ...” clauses detract from an objective statement of facts – they inject the auditors’ own judgmental and erroneous inferences.

The ACS settlement was not based upon the lawsuit, but rather upon the terms and conditions of the contract. ACS did not cure its contract breach within the time frame specified; therefore the Department terminated the contract and in accordance with the contract’s terms and conditions, the Department reimbursed the vendor for work in progress.

Therefore, the \$10.5 million was not “an additional cost” in settlement; the State owed that amount to the vendor for work performed up to the contract cancellation date. Furthermore the “cost to the State” was \$ 1.05 million—10% of the \$ 10.5 million. CMS paid the remaining 90%.

However, more importantly than the termination cost is that the State secured additional vendor-owned software as part of the settlement negotiations agreement. One of these software packages, Smart PA, has saved the Medicaid program \$191 million to-date, easily surpassing the termination cost multiple times, actually making a significant profit for the State. These huge savings were provided to the auditors who chose not to present them in their report. If \$10 million is worthy of mention, why not note something good--\$191 million in associated savings?

Note: One of the auditors was actually the State Medicaid contract administrator for the Smart PA software contract when it was being implemented following the ACS settlement. Thus, the nondisclosure of the savings is perplexing. It is inexplicable how an auditor with such intimate knowledge of the contract could not only miscalculate the State’s cost responsibility, but also fail to disclose \$190+ million in savings, despite having both figures readily available.

Audit Report Excerpt

After lengthy negotiations, the Department approved a contract amendment in July 2011 that granted an 18-22 month extension to build the system, increased contract price from \$265 million to \$494 million (86%), and extended the operational contract an additional two years.

DHHS Comment: What the report does not state is that in addition to the two additional years of operations, the contract amendment provides significant contract scope increases

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to comply with major Federal and State legislative changes that have occurred in the four plus years since the RFP was issued. The operational cost is still future and is \$116 million less than the State is currently paying the legacy vendor. Of the \$494 million, \$282.5 million is for future operational cost over the next seven years. The balance is for development cost plus added program areas such as Health Information Technology Medicaid Incentive Payments Solution (HIT/MIPS).

Further, the contract amendment cost includes a pool of 205,000 hours for legislative and policy changes (past and future) that will undoubtedly continue to occur up to the implementation date of July 2013.

Also, the report fails to mention that only a portion (four months) of the schedule extension is related to the original contract and the balance is related to legacy changes, as well as State/Federal legislative and policy changes over which OMMISS management has no control.

OBJECTIVES, SCOPE, AND METHODOLOGY

Audit Report Excerpt

The audit scope included a review of project management practices and vendor contract information surrounding the current system replacement effort beginning January 1, 2009 through July 31, 2011. We conducted the fieldwork from February 2011 to December 2011.

DHHS Response: What we find strange is that the fieldwork should have been complete when the seven Audit Issue Sheets were distributed to the Department on August 17, 2011. Those findings were largely without merit and were reduced to three Issue Sheets ten weeks later on October 26, 2011. The auditors should have been close to drafting a final report in August. However, almost three months later, the Department finally received two draft reports on November 7 and 10, 2011 stating, “We conducted the fieldwork from February 2011 to September 2011”. This third draft report, received by the Department on December 13 – after the draft was released to the public – now states that fieldwork was “to December 2011.” How could the auditor’s office draft two audit reports without having complete fieldwork? We believe that this is a prime example of the auditors continuing to try and find something when earlier audit findings and conclusions failed.

Audit Report Excerpt

To determine current management practices, we conducted interviews with Department of Health and Human Services (Department) and Office management, reviewed policies and

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procedures related to the replacement system project management, and reviewed Department and Office management meeting minutes.

To evaluate management controls, we compared Office project management practices to recommended best practices issued by the Project Management Institute and the IT Governance Institute.

DHHS Comment: While the auditors conducted many interviews, in our opinion they lacked the necessary IT experience and qualifications to audit a highly complex IT program and form legitimate conclusions and recommendations. Although the auditors recognized their limited IT knowledge and experience and looked up IT standards, no one can become an overnight expert in the IT world. In contrast, the OMMISS office has highly competent IT managers with over 192 years of collective IT experience among just seven of the top managers. In addition, the project is staffed with a diverse cross-section of other IT and business professionals among which include CPAs, engineers, lawyers, nurses, pharmacists, and project management specialist with numerous certifications (PMP, OPM3-CC, OPM3-CA, PE, ITIL, CTFL, and Six Sigma).

In this, the auditors' third draft report, the auditors do not document a comparison to any Project Management Institute standards. So, based on their "evaluation" methodology and criteria, they came up with little in the way of substantive findings/recommendations; and the result is flawed auditors' opinions.

Audit Report Excerpt

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.

DHHS Comment: The Department does not believe this to be correct. Generally Accepted Government Auditing Standards require, among other things, independence, specialty competence, and freedom from external impairment, as noted in various sections of the report response.

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FINDINGS AND RECOMMENDATIONS

1. IMPACT OF DELAYS NOT FULLY DOCUMENTED

Audit Report Excerpt

The Office of Medicaid Management Information System Services (Office) at the North Carolina Department of Health and Human Services (Department) did not fully document its analysis of the impact that schedule delays had on the system implementation.

DHHS Comment: Apparently the auditors do not understand a fixed fee contract for an agreed upon scope contract. The contract provides for damages for Vendor delays, which in this instance amounted to \$10 million associated with a four-month schedule slippage acknowledged by the Vendor.

The report fails to mention that part of the additional cost and time is a pool of 205,000 hours that includes past and even future changes that will be used to accommodate mandated policy and legislative changes up to the estimated go-live date of July 2013.

Schedule Delays

Audit Report Excerpt

One source of project delay was the Vendor's planned use 73% of the programming code from its New York system project to build North Carolina's system. In January 2009, the Vendor was awarded the contract and began work on North Carolina's system. In June 2010, the Vendor found that it could only use about 32% of the code from the New York project for North Carolina. Consequently, unplanned additional time and labor is necessary to complete North Carolina's system.

In a March 10, 2011, interview, the current State CIO said he would never have allowed the proposal to be accepted based on the estimated percentage of usable code. The State CIO said that he had experience with other information technology vendors making similar estimates and not being able to deliver.

The Office accepted the Vendor's proposed use of 73% of the New York project code without documenting any independent analysis that indicates the proposal was reasonable. Department management said it was not possible to determine whether the Vendor could use the New York project programming code until after the system was designed and programming was started. Furthermore, Department management said that the additional programming time and labor needed to complete the system does not cost the State anything because the State has a fixed cost contract.

DHHS Comment: Under CMS' guidance, the Department followed a Statement of Objectives (SOO) solicitation for bids. A SOO approach is a solicitation document in which the government

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department describes the key objectives that vendors must meet in their proposals and is different than a SOW or Statement of Work which is much more prescriptive. This allows vendors to maximize their resources and flexibility using the most innovative and cost-effective approaches to supplying a solution to the RFP. Thus, the emphasis in this IT approach is results or product-oriented rather than attempting to dictate every step of the process. It represents a streamlined approach in which the vendor is given significant latitude on how they build the solution. In other words, the State's interest is in the product/solution. This approach leverages the vendor's knowledge and experience. With a SOO backdrop, systematic software reuse is still the most promising strategy for increasing productivity and improving quality in the software industry. Success in code reuse relies heavily on the context in which it is implemented and the vendor's ability to clearly articulate the baseline solution in a manner that engenders the end users' confidence in the products "as is" and its ability to satisfy its business need.

The auditor's statement that *"the Office accepted the Vendor's proposed use of 73% of the New York code without documenting any independent analysis that indicates the proposal was reasonable"* is asinine and shows a lack of understanding of the work involved in making such an analysis – one which could be conducted only after tens of thousands of man-hours. Such an analysis could be performed only after design documents were prepared which involved the generation of over 100,000 pages of documentation for the North Carolina solution. Only after that process occurred could an analysis be conducted which is exactly what happened, and took additional months of analysis to complete. It was at that time that the Vendor notified the State that the usage/reuse was not as great as anticipated and there would be a delay despite the Vendor's remediation efforts of bringing on an additional 100 staff to compensate for the lower usage rate. Perhaps the auditors have a greater insight into the process than the vendor who has operated the New York system since 1986. This writeup is indicative of a lack of IT competence to audit a highly complex IT program.

GAO Auditing Standard 3.43(d)(2) states that *"staff assigned to a GAGAS audit should collectively possess:...skills appropriate for the work being performed; for example, skills in (2) information technology if the work involves review of information systems."*

The North Carolina system had over four million lines of code at the end of September 2011 and is still growing every day. The New York system has sixteen million lines of code. The auditors' assumption that this is a simple task shows their lack of IT expertise and understanding. IT professionals would have to perform a detailed comparison of the two systems to form an accurate conclusion as to the estimated usage.

There are currently over 17,000 function points in the NC solution which represent a measure of system complexity.

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A second source of project delay was higher than expected Vendor staff turnover. The risk of high staff turnover and planned mitigation actions were listed in the Vendor's proposal. The risk of high staff turnover was also documented in the project risk register³ on May 2, 2009. The vendor reported high staff turnover to the project oversight committee beginning in April 2010. However, the staff turnover risk was not transferred to the issue register and actions taken to address the issue until October 6, 2010.

DHHS Comment: There is absolutely no recognition on the auditors' behalf that CSC added over 100 additional staff to compensate for the turnover and the lower-than-expected usage of the base New York system. Again, the Vendor took steps of adding staff, providing bonuses for staff that stay until the project is complete and matching competing employment offers.

The auditors also chose not to mention another important fact that was shared with them regarding the demand for health IT professionals is at an all-time high due to healthcare reform, proliferation of electronic health records, and major Federal and state changes to the Medicaid programs across the country. The Vendor has done a very good job remediating the turnover issue and has kept the Department informed of its actions. It is part of each monthly briefing to the MMIS Project Steering Committee. One of the auditors actually attended the last Project Steering Committee and the turnover report has been 1.67% average per month for 2011, which is better than our contract requirements.

The statement that *"the staff turnover risk was not transferred to the issue register and actions taken to address the issue until October 6, 2010"* is an inaccurate representation of the facts. Numerous steps were taken before October 2010. Project documentation verifies various risk mitigations:

- 1) Follow SEI CMMI Level 3 compliant Engineering Development Process which captures and retains technical information, such as meeting minutes, business process diagrams, and data models - August 02, 2010;
- 2) Develop and institute a staff retention plan for critical technical employees - August 23, 2010;
- 3) Review and capture the business knowledge reflected in the legacy system – December 18, 2009;
- 4) Leverage the collaborative workspace to capture system knowledge and ensure no single point of failure - January 4, 2010; 5) Conduct team building exercises during the initial DDI phase - February 2, 2009.

³ Risks are listed in the projects risk register. When events occur and the risks are realized, the risks become issues and are documented in the issue register.

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All of these items were deemed successful and the risk was closed in September 2009. The risk was later reopened with information updates in 11/09, 12/09, 1/10, 3/10, 6/10, and 8/10 before it was converted to an issue in 11/10.

Project management identified turnover as a risk, and when it became an issue, it was properly and efficiently handled by the vendor and the State. This is a prime example of the system working right. The auditors are late in identifying the issue or the solution. This is a “Johnny-come-lately” finding and recommendation.

Audit Report Excerpt

A third source of project delay was the length of time taken to review and approve project designs and deliverables. The Vendor and the Office stated that review and approval process sometimes exceeded the two cycles of review that were budgeted. Vendor personnel stated the review process resulted in numerous cycles of technical design and development being performed. Additionally, Office personnel stated that the Vendor wanted to meet its deliverable due date, so it would sometimes submit deliverables that were not complete. Office personnel said this added more review time and increased the number of cycles required to complete an acceptable deliverable.

Office documentation shows that on average, the deliverables required review and approval process took about 2.1 cycles. However, analysis of the documentation shows that 26% (59 of 226) deliverables required three or more review cycles.

DHHS Comment: This is another example where the auditors attempt to influence the reader and are willing to quote the percentage that took three or more cycles without indicating that **an even larger percent (30%) required only one cycle for review**. Neither is there any mention of the fact that there were 226 deliverables involved. Neither do their findings note that only 4 of these timely deliverables were on the critical path. (The critical path is simply all the tasks that determine the end date in a project schedule.) If the auditors wanted to present a balanced narrative, why not reflect all of the deliverable cycles which is much more objective than cherry-picking negative interview comments to create a finding. A cycle review of 2.1 against a 2.0 plan is a good rate. It is not only indicative of the Office’s attention to details of importance, but it also demonstrates the vendor’s willingness to promptly address and resolve any relevant concerns pertaining to deliverables.

Impact of Delays Not Fully Documented

Audit Report Excerpt

Currently, the replacement system is expected to be completed about 22 months late and with total overall costs exceeding expectations by about \$320.3 million.

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The new system's contract cost increased by \$229.7 million (86%) from \$265.2 million to \$494.9 million.

Comments by the NC Attorney General's Office:

The Audit Report overstates the increase in cost resulting from Amendment #2's extension of the development schedule. The Audit Report concludes the overall cost of the Replacement MMIS Project will exceed original projections by \$320.3 million. For readers who wish to know the details, this figure appears at the bottom of the center column of Table 1 on the Audit Report, and is obtained by adding the \$90.6 million "Total Additional Legacy Operational Costs" from the top half of that column to the \$229.7 million "Total Additional Project Costs" from the bottom half of the column. Adding these two forms of "additional" cost is misleading because the Legacy MMIS contract will be terminated in accordance with its terms once the Replacement MMIS is operational. As a result, the Department will never pay for operation of both systems at the same time. The Audit Report double-counts operational costs because it fails to factor in this handoff of operations between systems.

There is another flaw in the Audit Report's assessment of operational costs beyond the double-counting explained above. None of the post-development operational cost of the Replacement MMIS system should be counted as a "project" cost because the Replacement MMIS Project lasts only as long as it takes to design, develop and implement the Replacement MMIS. The "project" ceases once operation of the Replacement MMIS system begins and the substitution of Fiscal Agents is complete. The Audit Report's \$494.9 million figure in Table 1 should be labeled as the State Auditor's determination of the total additional *contract* cost, not the total additional *project* cost. (The Department believes that \$494.9 million is an excessive figure in either context.) This also does not deduct the \$10 million in damages from the vendor.

There is another misleading aspect of the Audit Report's treatment of operational cost beyond the improper addition and double-counting of post-development cost described in the two preceding paragraphs. The Audit Report briefly acknowledges that Amendment #2 adds two more years of Replacement MMIS operations. The report then embeds the cost of those two years into the overall "additional cost" that is said to result from delays in system development. This is misleading because even if there had been no delay in development whatsoever, the State would ultimately purchase additional years of operational services. The Department merely seized upon the negotiations for Amendment #2 as an opportunity to secure an earlier contractual commitment for additional, post-development services from the vendor. The vendor kept all their rates constant with no inflationary increases which will save the State additional monies during these two additional years of operations. (The State pays the legacy vendor approximately \$50 million a year for operating the legacy system.)

The Audit Report's \$320.3 million projection of increased cost is inflated in other respects. The

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Department's original Replacement MMIS budget included \$22 million for certain change requests that were approved by CMS from the very beginning of the project, but which were to be approved by Statewide IT Procurement later, as each change request was individually presented to Statewide IT Procurement during the course of the project. Although this \$22 million in increased funding was anticipated from the beginning of the project and approved by CMS, the Audit Report adds this amount to its projection of additional costs as if the \$22 million were a cost overrun due to mismanagement. (This differing treatment of the \$22 million in change requests is reflected in the Department's assertion that the value of the base contract is \$287 million rather than \$265 million. See the differing base contract values in the Audit Report's Table 1 and the Department's table below.)

The table below better documents the financial impact of Amendment #2. Dollars are reported in millions.

Amended Contract		\$ 485	
Two Additional Years of Operations		\$ (76)	
HIT/MIPS		\$ (15)	
Approved by Statewide IT Procurement		\$ 394	
New Concepts in the Amendment			
POP		\$ (6)	
5010/ICD-10		\$ (34)	
Basis for Comparing to Original Contract	\$ 287	\$ 354	\$ 67
Changes /CSRs	\$ 22	\$ 27	\$ 5
Legacy CSRs Included in the Design		\$ 4	\$ 4
Enhancements beyond the Contract		\$ 11	\$ 11
Schedule and Scope Impact (^ months)		\$ 15	\$ 15
Infrastructure to Extend the Schedule		\$ 31	\$ 31
Final Integration Testing		\$ 3	\$ 3
22 additional months of EVC and Retro DUR		\$ 8	\$ 8
Operational Credit (Damages)		\$ (10)	\$ (10)
Total			\$ 67

When the factors discussed above are taken into account, the overall cost of the Replacement MMIS Project is more likely to exceed original projections by \$67 million rather than \$320.3 million.

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Audit Report Excerpt

Office management contends that only \$67 million of the \$229.7 million in additional contract costs and only six months of the 22-month delay in the replacement system go-live date is attributable to "schedule-slippage" or delays. The conclusions are based on schedules and analysis that the Office asked the Vendor to prepare. Office management said that it performed "deep analysis" of the Vendor's schedules.

DHHS Comment: The "schedule" or Integrated Master Schedule (IMS) is a contractually required time-based schedule containing the networked, detailed tasks necessary to ensure successful program/contract execution. The IMS is traceable to the integrated master plan, the contract work breakdown structure, and the statement of work. The IMS is used to verify attainability of contract objectives, to evaluate progress toward meeting program objectives, and to integrate the program schedule activities with all related components.

The auditors display their lack of knowledge of the contract and IT project management by inferring that there is something inappropriate about asking the Vendor to prepare the "schedule"; however, in accordance with the contract, it is the Vendor's responsibility to create this schedule as a deliverable for State review. Likewise, all the contract deliverables are produced by the vendor and reviewed by the State Project Office. It is rather presumptuous to question the appropriateness of a negotiation without having fully reviewed the contract details beforehand.

Auditor Report Excerpt

For example, the Center for Medicare and Medicaid Services (CMS) published proposals for two new major Medicaid regulations (ICD-10 and 5010) in August 2008, just four months before the Department awarded the System contract to CMS in December 2008.

DHHS Comment: Why do the auditors not use the RFP date, July 2007, which was the important date and the date that established the scope of the original contract upon—the basis for all vendor bids. Instead of four months, there is a difference of 18 months between ICD-10,5010 regulations and the the RFP release. Apparently, the auditors are suggesting that the State should have known 18 months in advance of a Federally-published proposed rule. Neither we nor the auditors know what is going to happen in terms of Federal and State legislation in one month—much less 18 months in advance.

Audit Report Excerpt

Change In Costs

A breakdown of the additional costs totaling \$320.3 million is listed in Table 1 below.

DHHS Comment: The Department refutes the auditors' findings and annotates Table 1 as presented in the "Explanation" column below with the associated explanation appended to the table. The auditors apparently still do not understand the contract, cost and changes after

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eleven months of work. We believe that one reason is the lack of IT expertise and experience on the audit team.

The top portion of the Table 1 depicts Legacy System costs due to the delay in the go-live date, and the bottom half of the table depicts New System costs. The auditor's comment that overall costs increased over \$300 million is misleading in that at no time will DHHS be paying for operations for both the Legacy and Replacement systems; at best, only the differential in the cost of operating the Legacy system over the Replacement system should be included in the auditor's calculations.

Additionally, the auditor's \$300+ million calculation is disingenuous since it does not point out that two additional years of operations (at no price increase over the final year of the base contract) are included in the amended contract price. The base contract included 7.4 years of Provider Enrollment and Retro DUR activity and 5 years of core operations; the amended contract includes 9.4 years of Provider Enrollment and Retro DUR activity and 7 years of core operations. The HIT/HIE laws did not even exist at the time the base contract was executed. DHHS decided to leverage the provider database created by the early Provider Enrollment activity to satisfy the HIT/HIE requirements, which are not requirements for the Replacement MMIS.

The so-called increase of over \$300 million documented in this section is supposedly the "Effect" of the 22-month delay in the go-live date of the Replacement MMIS. The auditors failed to mention that a schedule slippage not associated with change would address only 6 months of the 22-month delay—two months of which dealt with legacy system changes. Included in the 22-month delay are: a DHHS requested four-month Provider Operations Preparedness phase for 70,000 providers, a DHHS-approved two-month Final Integration Testing phase, federally mandated HIPAA 5010 and ICD-10 compliance, and numerous state legislatively mandated changes directed to reduce Medicaid costs.

The maximum effect of the Conditions listed in the finding is best documented in DHHS' response to the finding Full Amount of Damages not Charged; which DHHS calculated to be \$10 million (recoverable from CSC) and only 3% of the amount listed in this finding.

	In Millions			Note
		DHHS Estimates Due to Slippage	DHHS Estimates Due to Change	
	OSA Estimates			
Legacy System				
Cost Difference Between Legacy and Replacement MMIS Operations Costs	\$ 37.2	\$ 8.3	\$ 22.4	A

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Application for New Federal Mandates	\$ 2.3	\$ -	\$ 1.7	B
Cost Difference Between Legacy Mental Health and Replacement Mental Health Operations Costs	\$ 10.3	\$ -	\$ -	C
Application for NC Health Choice	\$ 7.0	\$ -	\$ 0.6	D
Application for Nursing Homes	\$ 4.7			E
Other Legacy Operations Costs	\$ 29.1	\$ 7.9	\$ 21.2	F
Total Additional Legacy Operations Costs	\$ 90.6	\$ 16.2	\$ 45.9	
Replacement System:				
System Design and Build phase	\$ 77.8	\$ 15.0	\$ 40.8	G
New Federal Mandates	\$ 33.2		\$ 33.2	H
Operations Phase	\$ 71.3	\$ -	\$ -	I
Application for New Federal Mandates	\$ 15.3		\$ -	J
Application for Provider Enrollment	\$ 1.4	\$ -	\$ -	I
Application for Prescription Drug Use Review	\$ 2.9	\$ -	\$ -	I
Other System Enhancements and Changes	\$ 17.8	\$ -	\$ 17.8	
Damages Assessed	\$ -	\$ (10.0)	\$ -	K
Total Additional Replacement Costs	\$ 229.7	\$ 15.0	\$ 91.8	
Total Change In Costs	\$ 20.3	\$ 31.2	\$ 137.7	L
HIT/MIPS	\$ -	\$ -	\$ 15.3	J
Total Change (MMIS and HIT)	\$ 320.3	\$ 31.2	\$ 153.0	

Source: Vendor original and amended contract pricing Table Z, change service requests, other system vendor contracts.

Note A: See Note A of response to table 2. \$1,390,642 per month.

Note B: Only 5010 work is applicable, OSA also included ICD-10 business training.

Note C: Included in first line (difference in Replacement and Legacy MMIS+)

Note D: Only the Legacy DDI portion of NCHC is applicable. Not the operation costs, as ops cost would have been charged by CSC.

Note E: The Project Office has no reference for this charge with respect to the Replacement Solution

Note F: The Project Office has no reference for this charge with respect to the Replacement Solution.

Note G: OSA overstated by \$22,000,000 because, although not include in initial contract not to exceed price, \$22 M in changes was expected and included in budgets and approved by CMS.

Note H: (HIPAA 5010 and ICD-10)

Note I: The addition of two more operational years to the contract, has no impact on "project costs". By including in this table, OSA is either ignorant of the facts or is purposely trying to inflate the cost of the

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slippage to startle the reader. These are costs that the State would have always needed to pay for; the State will always pay for MMIS operations.

Note J: HIT, although part of the amendment, has nothing to MMIS or schedule slippage. These are new non-MMIS costs imposed by federal regulations, regardless to schedule.

Note K: Although OSA was aware of the damages assessed, chose not to include in this table.

Note L: This line should be labeled Total Change in MMIS.

Audit Report Excerpt

Recommendation: The Department and Office should clearly document the reasoning and analysis used to determine and manage the effect of delays on the project.

DHHS Comment: It is the Department's opinion that the auditors did not clearly nor fully document the reasoning and analysis presented in this finding, as indicated by the annotations in Table 2.

2. DAMAGES NEGOTIATIONS NOT FULLY DOCUMENTED

Audit Report Excerpt

The North Carolina Department of Health and Human Services (Department) and its Office of Medicaid Management Information System Services (Office) did not fully document the damages negotiations with Computer Sciences Corporation (Vendor). Specifically, the Department did not document how responsibility for delays was determined or how damages were calculated.

The Department included penalties for nonperformance in its contract with the Vendor. The contract allowed the Department to charge the Vendor for the costs of operating the current system and for Office operations if the new system was not delivered on time. Section 30.44.2 of the original contract states:⁴

"If the State determines in its sole but reasonable discretion that the Replacement MMIS [Medicaid Management Information System] has not become operational substantially as a whole, or has not begun generating official data of record by the Targeted Operational Start Date [August 2011], then the Vendor will be liable for all costs incurred by the State to continue operation of those elements of the Legacy MMIS+ including the cost of continued operation of OMMISS [Office of Medicaid Management Information System Services] which must, in the State's reasonable opinion, remain in operation (including possibly all elements of the Legacy MMIS+), operational, less the amount that the State would have paid the Vendor had the Replacement MMIS been timely made substantially operational as a whole."

⁴ Section 30.44.2 of RFP 30-DHHS-1228-08-R.

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However, the contract was not clear about how the damages would be calculated. As a result, Office management found it necessary to negotiate the amount of damages for which the Vendor was liable. Office management stated, "It is important to note that these were negotiations, as both parties had differing interpretations on how the contract called for the damages to be calculated."

Comments by the NC Attorney General's Office:

The Audit Report criticizes the Replacement MMIS Contract for not being clear about how damages for vendor delay would be calculated under RFP Section 30.44.2.

The damages in the Replacement MMIS RFP were drafted by the State with the assistance of the North Carolina Department of Justice and the law firm of Hunton & Williams LLP. NC DHHS' selection of Hunton & Williams LLP was in keeping with the NC legislature's mandate in Session Law 2007-323 to "engage the services of private counsel with the pertinent information technology and computer law expertise to review requests for proposals and to negotiate and review contracts associated with MMIS+." The RFP was also reviewed as a whole by Statewide IT Procurement and ITS legal staff.

A deliberate choice was made to refrain from precisely defining a method for calculating damages arising in relation to RFP Section 30.44.2. First, those who drafted the RFP for the State sought to avoid the significant risk that a highly precise RFP Section 30.44.2 could be construed as a liquidated damages provision. Second, the drafters recognized that the section would first appear in an RFP, not in a one-to-one contract. The section could not be so elaborate or controversial as to delay the bidding process or deter desirable bidders.

RFP Section 30.44.2 is essentially a restatement of the common law concept of damages based on the "cost of cover." The true cost of cover is never known until after the party that did not receive performance has incurred the cost of obtaining substitute performance (or has incurred the cost of continuing its own performance after the time at which it had planned to cease its performance). It is relatively easy to specify in advance a method for calculating the cost of cover in a failed contract for the purchase of goods. In a complex service contract, however, any advance formula is inherently speculative.

Courts disfavor and generally will not award speculative damages. Courts will award "actual" or "liquidated" damages. "Actual" damages are just what one would expect: the damages actually incurred rather than the amount calculated by a preconceived methodology (unless through luck or simplicity of circumstances the two happen to be the same). "Liquidated damages" are damages agreed to in advance as to amount or methodology of determination. Liquidated damages are only enforceable after non-performance if the parties reasonably agreed in advance that actual damages would be too uncertain and difficult to calculate once things have actually gone wrong.

Unfortunately, the more precise detail the parties bring to their advance agreement about the

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computation of damages, the more they risk that the law will find an implied liquidation of damages. From the State's perspective, the problem with liquidated damages is that these predetermined damages (whether predetermined by amount or methodology) are by law the *only* damages the aggrieved party may receive, *even if the actual damages prove to be dramatically greater.*

With the foregoing concerns in mind, the RFP drafters chose to preserve a right to actual damages by describing the "cost of cover" in RFP Section 30.44.2 with the same generality that the common law of contracts describes that concept. In a courtroom, a judge would award actual "cost of cover" damages for a complex services contract after hearing the parties make arguments and presentations of their appraisals of the damages. Those arguments and appraisals would not be much different in form and content from those criticized in Section 2 of the Audit Report. A similar dialogue is to be expected when the parties decide to avoid litigation and determine prospective damages on their own.

The Audit Report notes that the damages finally agreed upon are necessarily a forward-looking "estimate that could later prove to be inaccurate." The same must be said of any other methodology that might have been applied to determine damages before August 2011. The true amount of damage could not be known with accuracy until after the then-yet-to-arrive Targeted Operational Start Date.

The Audit Report criticizes Section 1.15 of Amendment #2 for providing that "Each Party shall have no liability to the other to the extent that such liability arises, or is asserted to arise, from a Party's failure to timely act in accordance with any Integrated Master Schedule adopted by the Parties prior to the effective date of this Amendment."

The Audit Report appears to miss a major goal of Amendment #2. The Amendment was always intended to serve, in part, as a settlement of damages. The criticized language is standard, legal settlement language.

From a realistic legal perspective, the only way in which the State might have received the full amount of damages that could be obtained under RFP Section 30.44.2 would have been by terminating the Contract and suing for breach. However, NC DHHS did not consider termination to be a wise course of action. The Replacement MMIS Project is too vital to the State. The alternative was to enter into an Amendment to adjust the Project's development schedule.

Amendments require negotiation. In a comprehensive renegotiation of the timetable for a major project, it is not unusual for the parties to settle the amount of actual or prospective damages that have arisen through the date of amendment. Each side always compromises to some extent in a settlement agreement. OMMISS recognized that it might later identify other damages that could have been included in the negotiations, but OMMISS also knew that accepting this uncertainty is an unavoidable part of reaching a final settlement of prospective, future damages.

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The Audit Report appear to take the position that NC DHHS had no responsible alternative other than to demand and obtain the full amount of damages that could conceivably be obtained under RFP Section 30.44.2. Another alternative, however, was to view RFP Section 30.44.2 as a powerful negotiation tool, a tool which set the uppermost boundary of the damages that NC DHHS could threaten to extract from the vendor unless the vendor agreed to an amendment with terms satisfactory to the State.

To reach a workable compromise that kept the Replacement MMIS Project underway, it is to be expected that NC DHHS would obtain something less than the maximum damages that could conceivably be assessed under RFP Section 30.44.2. That section operated as the RFP drafters hoped and expected it would in the event of an interim, negotiated settlement of damages. If the Replacement MMIS agreement had been terminated rather than amended, NC DHHS would have sought every dollar that RFP Section 30.44.2 could provide.

For the reasons set forth above, RFP Section 30.44.2 was drafted with the generality of the common law concept of "cost of cover" damages. Damages were negotiated through an exchange of information similar to that which would have taken place in a court of law. The damage provisions of RFP Section 30.44.2 were applied effectively and in keeping with their design.

These negotiation principles are analogous to statistical sampling work performed by the auditors, including the Federal HHS Office of Inspector General. Amounts are statistically estimated at both high and low values (confidence intervals); however, paybacks are based on a midpoint or point estimate which is considered fair to both parties.

Audit Report Excerpt

However, the Office does not have documentation that clearly explains its reasoning for including or excluding items from the damages calculation. For example, there is no documentation to explain why about \$12.7 million of additional legacy system costs were not included in the negotiations. These costs could meet the definition of "all costs incurred" by the State to continue operating the legacy system as stated in the original contract. Table 2 below lists items that the auditors identified as operational costs and other potential damages.

DHHS Comment: There is nothing illusory or complex about the damages calculation that would be represented in reams of analysis. With respect to Table 2, currently at issue is not the 6 month slippage and how it was determined, because it was not negotiated. Instead, it was obtained from the revised baseline IMS which was supplied by the Vendor in accordance with the contract and reviewed in detail by the State. Nor is the 4 month/2month split between CSC/State at issue, because that was negotiated and staff interview notes explain the rationale regarding the same. The dollars associated with the 4 month time frame were not "negotiated" but were "calculated" based on the difference between the current operations cost of the NC MMIS + and the cost proposed in the CSC bid for operating the Replacement solution. The NC MMIS+ as "defined" in the contract, includes the current legacy MMIS and the Integrated

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Payment and Reporting System (IPRS). All the other systems or solutions listed in Table 2, by definition are exempt from inclusion.

Table 2

	4 Months of Operations
Legacy System Contract - Medicaid claims processing	\$ 16,058,964
Mental Health Claims Payment Contract	1,878,996
NC Health Choice Processing (2 months)	700,000
Cost of Federally Required HIPPA 5010 Update	1,713,771
Cost of Federally Required ICD10 Update	623,960
IBM Fraud and Abuse	914,739
Purchase of Medical Care Services (DPH)	400,000
BlueCross BlueShield - NC Health Choice Medical Claims Proc	2,638,146
Medco - NC Health Choice Prescriptions (2 months)	2,659,062
ACS "Smart PA" Prior Authorization and Drug Utilization Cos	1,178,440
HP Preadmission Screening and Annual Assessment Review	853,044
Ingenix Fraud and Abuse	389,801
Ingenix DRIVE (Data Warehouse)	325,364
ACS State Healthcare Pharmacy PA Preauthorization	1,119,260
Total cost of Legacy System	<u>31,453,547</u>
Estimated continued Office operational cost	<u>3,688,964</u>
Total estimated operational costs of 4 month schedule slippage	\$ 35,142,511
 Cost for Operations of Replacement System per Table Z	 \$ (12,468,847)
 Total Amount of Auditor Identified Delay Costs	 \$ 22,673,664
Penalty Assessed On Vendor	<u>(10,000,000)</u>
Other Potential Penalty Amounts	\$ <u>12,673,664</u>

Source: Vendor contracts and amendments, change service requests, OSBM budget documents

Audit Report Excerpt

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Additionally, the damage estimate is just an estimate that could later prove to be inaccurate. The Office stated,

"First, to achieve an accurate cost of the damages related to the Targeted Operational Start Date, damages would have to be measured after-the-fact. The most accurate figure could only be calculated after all relevant costs are recorded for the 'damage assessment period'. In the case of the \$10,000,000 damages being assessed to CSC [Vendor] in contract amendment #2; those damages were negotiated many months prior to the occurrence of the 'damage assessment period' and thus constitute projected damages."

Recommendation: *The Department and Office should document its methodology and reasoning in determining how penalties were assessed on vendors. The Department and Office should also retain all documentation used to plan and conduct negotiations with vendors.*

DHHS Comment. As previously stated, there is nothing illusory or complex about the damages calculation that would be represented in reams of analysis. With respect to Table 2, currently at issue is not the 6 month slippage and how it was determined, because it was not negotiated. Instead, it was obtained from the revised baseline IMS which was supplied by the Vendor in accordance with the contract and reviewed in detail by the State. Nor is the 4 month/2month split between CSC/State at issue, because that was negotiated and staff interview notes explain the rationale regarding the same. The dollars associated with the 4 month time frame were not "negotiated" but were "calculated" based on the difference between the current operations cost of the NC MMIS + and the cost proposed in the CSC bid for operating the Replacement solution. The NC MMIS+ as "defined" in the contract, includes the current legacy MMIS and the Integrated Payment and Reporting System (IPRS). All the other systems or solutions listed in Table 2, by definition are exempt from inclusion.

Furthermore the recommendation to "retain" documentation is completely unfounded because the report contains no evidence that the Department and/or Office discarded or otherwise failed to retain any documentation.

3. MONITORING DID NOT IDENTIFY UNAUTHORIZED CHANGES

Audit Report Excerpt

The Office of Medicaid Management Information System Services (Office) at the North Carolina Department of Health and Human Services (Department) did not timely identify about \$30.4 million of changes that the Computer Sciences Corporation (Vendor) made to the design, development, and integration phase of the replacement Medicaid Management Information System project.

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The Vendor:

- *Performed scope changes without direction from an Office contracting officer;*
- *Made changes to system requirements based on informal requests; and*
- *Accepted change requests from personnel who were not authorized to make system changes.*

DHHS Comment: This is a negative comment and reflects either poor or non-existent understanding by the auditors. As previously commented, a SOO approach, allows vendors to maximize their resources and flexibility using the most innovative and cost-effective approaches to supplying a solution to the RFP. Thus, the emphasis in this SOO IT approach is results or product oriented rather than attempting to dictate every step of the process. It represents a streamlined approach where the vendor is given significant latitude on how they build the solution. In other words, the State's interest is in the product/solution. This approach leverages the vendor's knowledge and experience. The State did not pay for any changes unless the changes were mandated legacy system changes that had to be incorporated into the new replacement system to be in sync with the legacy system at time of system turnover. The Department has not paid for other changes but is appreciative to CSC, the vendor, for contributing improvements to the system at **no cost** to the State.

Audit Report Excerpt

Department management did not agree that the unauthorized changes were a problem. Department management stated that some of the changes were requirements that the Vendor would have made at a later date anyway, so the issue is really only one of timing. Other changes were system enhancements that it was more efficient for the vendor to make without seeking approval.

DHHS Comment: Deliverables reviewers are allowed to make recommendations to the vendor for inclusion in the solution. The Department management recognized these changes as positive risk or "opportunity risk." In these instances, the project manager or project team may allow the introduction of these types of risks to try to gain more value later. A key aspect of a positive risk is that you put yourself in a position to take on the risks. They are risks that a project team knowingly takes upon itself because it perceives there to be advantages in doing so. In accordance to PMBOK, "Accepting an opportunity is being willing to take advantage of it if it comes along, but not actively pursuing it."⁵

Audit Report Excerpt

⁵ Project Management Institute. A Guide to Project Management Body of Knowledge Fourth Edition (PMBOK Guide), 2008, pg. 305

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However, failure to identify unauthorized changes in a timely manner increases the risk that the State will not receive the system that it contracted for. Also, it increases the risk that the State could incur additional costs and need additional time to test unauthorized changes.

DHHS Comment. We have two basic issues with the auditor's statements. First, all changes, whether with HP and the legacy system or with CSC and the replacement system are negotiated prices. This is standard protocol for all systems unless it is a time and materials-based contract. However, the CSC replacement system contract and the HP legacy contracts are both fixed fee. Any changes are negotiated based on estimated time to complete the project which is reviewed by IT professionals. To protect the State, CSC and HP had to also bid hourly rates for all future work. Thus, negotiation is straightforward. The "unauthorized changes" were legacy system changes that had to be made and actually it was more beneficial for CSC to make these changes early although we agree that CSC was at risk since they did not have a signed CSR at the time the work was completed. Conversely, under the auditor's methodology, CSC would have built the system as outlined in the RFP and then had to come back and change what they had just designed and built. This actually builds additional risk into the program since the risk level increases at a rate commensurate with the amount of patches and changes to the system. We would agree with the auditors that it would be best to have the paperwork done in advance, even though there was no financial harm in the way it was handled.

Due to the auditors' limited knowledge of IT projects and solutions, they did not correctly understand the nature of the enhancements and their impact in properly aligning the replacement solution with advancements in Medicaid Information Technology Architecture (MITA). CMS requires that all enhancements bring the solution in greater alignment with MITA strategies. With that said, CMS authorized and supported their inclusion and approved the associated funding.

Audit Report Excerpt

Recommendation: The Department and Office should ensure that monitoring procedures are effective for identifying deviations from the project plan. For efficiency, management could establish, document, and communicate to the vendor types of changes that the vendor can make without prior approval.

DHHS Comment. The Department agrees with the auditor's report to the extent that enhancements to the design were not closely monitored, and for a good reason. All deliverables are very closely reviewed to ensure that all contractual requirements are met. There are legitimate reasons why enhancements would be added to the system. For one, the donor system (in this case NY Medicaid) may already have functionality included that is above and beyond the contractual requirements; the Office would not want to remove enhancements to North Carolina's system that came along with the donor system at no cost to North Carolina. Secondly, the vendor may add functionality to the system at no cost to North Carolina that will help enable them to sell the system to another state. In the deliverable review process, should the State recognize enhancements beyond the contractual requirements, the State is under no

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obligation to ask for the enhancements to be removed, nor is the State obligated to pay for any of the enhancements.

Of the \$30 million in enhancements noted in the auditor's report, the Office recognized that about half of them were legacy system changes and would be required in the Replacement MMIS; for those enhancements the Office negotiated a cost of \$15 million for the vendor to complete the design, construction, testing and implementation. The auditor's report stated that *"Because the changes were not pre-approved, the Department had to negotiate the price of changes that were made"*. The auditors failed to recognize that every change is negotiated, whether it is pre-approved or not and whether it is a single change or part of a bundle of changes. The Department does not have the right to unilaterally set the price of a change.

The enhancement costs listed in the auditor's report is the cost to have the enhancements designed, coded, tested and implemented. All of these enhancements were discussed with the vendor after the design phase and before the construction phase. The actual time and cost expended by the vendor at that point was less than 20% of the total effort to have the changes implemented.

Readers of this report should understand that reviewing large design documents to ensure all contractual requirements are addressed is a very difficult and time-consuming task. To review the same documents to identify free enhancements to the system further intensifies this task. In this particular case, identifying enhancements that are included in the donor system and distinguishing them from vendor-added enhancements to the system require the reviewers to be experts in the NY Medicaid system. To monitor and document enhancements that were given to the State free of charge would have exponentially increased cost and time to the project.

At face value, the Department agrees that identifying and documenting enhancements to the system would be a benefit – one that certainly would have been realized if fiscal and time-based constraints did not exist. Additional work should always be considered from a benefit/cost analysis. However, as a practical matter, the Department does not consider monitoring for free enhancements to be a financially or logistically prudent use of State resources, as the project's budget and schedule would be negatively impacted. Expending additional personnel and monetary resources for something that is "free" does not pass the benefit/cost prudence test.

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