DEPARTMENT OF HEALTH & HUMAN SERVICES
Centers for Medicare & Medicaid Services
7500 Security Boulevard, Mail Stop S2-14-26
Baltimore, Maryland 21244-1850

CMS
CENTERS FOR MEDICARE & MEDICAID SERVICES
CENTER FOR MEDICAID & CHIP SERVICES

Disabled and Elderly Health Programs Group

OCT 2 4 2013

Ms. Sandy Terrell, Acting Medicaid Director
Division of Medical Assistance
North Carolina Department of Health & Human Services
1985 Umstead Drive
Raleigh, NC 276003

Dear Ms. Terrell:

During the Centers for Medicare & Medicaid Services' (CMS) review of the contracts for North Carolina's Mental Health, Developmental Disabilities & Substance Abuse Services program, we identified that the arrangement between the Division of Medical Assistance (DMA) and the local management entities (LMEs) to provide Medicaid services may be classified as subgrants or intergovernmental agreements that are subject to the cost principles set forth in the Office of Management and Budget (OMB) Circular A-87 (A-87).[1] In such circumstances, Department of Health and Human Services (HHS) regulations at 45 C.F.R. § 92.22[2] limit the use of Medicaid grant funds to "allowable costs," which are determined in accordance with A-87. For grants and subgrants with state and local governments, allowable costs under A-87 do not include profit or other increments above cost. This includes the amounts by which capitation payments paid to a governmental entity under an intergovernmental agreement or subgrant exceed the costs incurred under that agreement or subgrant.

For purposes of analyzing the behavioral health contracts between North Carolina and the LMEs, there are two critical issues:

1. Whether the entities which have capitated payment arrangements with the DMA are considered local governments; and
2. Whether the arrangements with these local governments are in the nature of intergovernmental agreements or subgrants to which A-87 cost principles apply.

State or Local Government Status

For purposes of A-87, local government is defined in Attachment A, paragraph B.16 as "a county, municipality, city, town, township, local public authority, school district, special district, intrastate district, council of governments (whether or not incorporated as a non-profit

[1] OMB Circular A-87, http://www.whitehouse.gov/omb/circulars_a087_2004
[2] http://www.gpo.gov/fdsys/pkg/CFR-2011-title45-vol1/pdf/CFR-2011-title45-vol1-sec92-23.pdf

corporation under state law), any other regional or interstate government entity, or any agency or instrumentality of a local government." The entities with which DMA has arrangements appear to be the county government itself, a community mental health agency, or a mental health authority – all of which fall under the definition of local government as either a county, a local public authority, or an instrumentality of a local government.

Application of A-87 Principles

The second point of analysis – whether A-87 cost principles apply to these arrangements – turns on the definition of the arrangement. If the arrangements have the characteristics of a subgrant or an intergovernmental agreement, then A-87 cost principles apply. If the arrangements have the characteristics of validly procured contracts for this purpose, then they do not. In order for an arrangement between the state and a public entity to be considered a validly procured contract, the following elements must be in place:

- The services must be openly procured
- All bidders must be provided the same terms for performance
- Rates must be set through an arms-length negotiation without any conflict of interest among the negotiators

If these elements of a contract are not met, then the arrangement cannot be considered a validly procured contract for the purposes of determining allowable costs and would be subject to the cost principles of A-87 for that purpose.

The CMS has reason to believe, based on the information currently available, that the LMEs are subject to sole source procurement and receive reimbursement on a risk basis. The absence of a competitive process when public entities are involved categorizes the arrangement as a subgrant or intergovernmental transfer subject to A-87 principles. If you have information or any documentation that may support a different interpretation of the nature of the arrangement, please share it with us.

If the arrangements are subgrants or intergovernmental agreements, CMS has identified two potential options for the state to consider:

1. Make these arrangements into valid contracts by openly procuring behavioral health services and making the counties compete on the same basis as with any other commercial entity (including using the same basis for determining the capitation payment whether the winning bidder is the county or a commercial entity); or
2. Comply with A-87 principles by changing the payment methodology for these arrangements and reimburse the counties only for the costs of services actually rendered (plus administrative costs consistent with an approved cost-allocation plan) under a non-risk contract.

We recognize that changing a long-standing delivery system will take time and potentially state legislation. We know the process begins with a frank discussion of these issues, which we would like to schedule in the near future.

We would like to reach a mutually agreeable resolution of this issue, and look forward to working with you to that end. Jackie Glaze, Associate Regional Administrator for Medicaid and Children's Health in our Atlanta Regional Office, will contact your office to arrange an opportunity for us to discuss appropriate next steps.

Sincerely,

Nancy Z. Klimon

Nancy Klimon, DrPH
Director, Division of Integrated Health Systems

cc: Jackie Glaze, ARA, CMS Atlanta Regional Office
Cheryl Brimage, CMS Atlanta Regional Office
Kia Carter-Anderson, CMS Atlanta Regional Office
Barbara Coulter Edwards, Director, Disabled & Elderly Health Programs Group, CMS
Camille Dobson, Senior Policy Advisory for Managed Care, CMS Central Office
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Division of Medical Assistance

Pat McCrory
Governor

Aldona Z. Wos, M.D.
Ambassador (Ret.)
Secretary DHHS

Sandra Terrell, MS, RN
Acting Director

November 27, 2013

Via electronic delivery and U.S. Mail

Nancy Klimon, DrPH
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Dear Dr. Klimon:

I am writing to acknowledge receipt of your correspondence dated October 24, 2013. I understand from that letter that Jackie Glaze, Associate Regional Administrator for Medicaid and Children's Health in the Atlanta Regional Office, will be contacting North Carolina to arrange an opportunity for us to discuss the issues addressed in your correspondence.

As you might expect, North Carolina was surprised to receive the letter outlining the Centers for Medicare & Medicaid Services' concerns regarding the cost principles set forth in the Office of Management and Budget (OMB) Circular A-87 and the arrangement between the Division of Medical Assistance and the local management entities (LMEs) to provide Medicaid services. We believe we have information to share with CMS that should alleviate those concerns and we look forward to working together to reach a mutually satisfactory resolution of this issue.

Very truly yours,

Sandra Terrell, MS, RN

cc: Richard Brennan, DMA Chief Financial Officer
Rod Davis, DHHS Chief Financial Officer
Emery Milliken, DHHS General Counsel
Dave Richard, Director, DMH/DD/SAS