PERFORMANCE AUDIT

DEPARTMENT OF ECONOMIC SECURITY

CONTRACTING PRACTICES

Report to the Arizona Legislature
By the Auditor General
November 1995
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November 9, 1995

Members of the Arizona Legislature

The Honorable Fife Symington, Governor

Dr. Linda J. Blessing, Director
Department of Economic Security

Transmitted herewith is a report of the Auditor General, A Performance Audit of the Department of Economic Security's contracting practices. This report is in response to a May 5, 1993, resolution of the Joint Legislative Audit Committee. The performance audit was conducted as part of the sunset review set forth in A.R.S. §§41-2951 through 41-2957.

This is the final report in a series of six reports issued on the Department of Economic Security. Our report recommends that DES change the way it contracts with human service providers. The current approach, in which the Department negotiates individual rates with each provider, has resulted in wide differences in rates for similar services. Inequities can occur. For example, low-quality providers may receive higher rates than high-quality providers. To address this problem, DES should consider adopting standard, uniform rates for similar services. We also found that the Agency needs to limit use of consultants to appropriate purposes and manage consulting contracts more effectively.

My staff and I will be pleased to discuss or clarify items in the report.

This report will be released to the public on November 13, 1995.

Sincerely,

Douglas R. Norton

Douglas R. Norton
Auditor General

Enclosure

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SUMMARY

The Office of the Auditor General has conducted an audit of the Department of Economic Security (DES), pursuant to a May 5, 1993, resolution of the Joint Legislative Audit Committee. This performance audit, the final in a series of six audits of DES, was conducted as part of the sunset review set forth in Arizona Revised Statutes (A.R.S.) §§41-2951 through 41-2957. In accordance with the authorizing resolution, this audit examined an agencywide function within DES. In contrast, prior audits examined individual DES divisions or programs.

This audit examined DES contracting practices for two specific types of contracts: contracts with agencies providing human services, and contracts for consultant services. These two functions are a subset of DES' total contracting responsibilities, which also include day care services, contracts with foster care families, and DES contracts for supplies, equipment, and business services.

DES is a major contractor of services. In fact, it spends approximately $243 million annually on human service contracts alone — an amount greater than the budgets of 90 percent of all other state agencies. The effectiveness of DES contracting practices is important not only because of the significant dollars involved, but also because it impacts the care received by the many DES populations served. These populations include some of the most vulnerable groups served by state government; for example, children under state protective care, as well as persons with developmental disabilities. The DES processes for setting contractor rates are crucial in human service contracting because rates are established entirely by DES and the provider. In contrast, rates paid by DES for medical, dental, and day care services are influenced by ceilings or guidelines established by the Arizona Health Care Cost Containment System or the federal government.

Additionally, the audit examined DES' use of consultants and associated DES contracting practices. In the year ended June 30, 1994, DES spent over $4 million for consultant services.

DES Needs to Adopt a More Equitable Rate-Setting Methodology (See pages 7 through 15)

DES' current method of setting human services providers' rates is not working. To set rates, DES staff attempt to analyze an individual provider's costs for each different service and then negotiate rates for each service with the provider. Currently, there are over 10,000 rates in the State, and DES may have over 100 different rates for the same service. However, negotiating rates on a case-by-case basis produces gross differences

in rates among providers of the same service. For example, DES' Administration of Children, Youth, and Family has rate ranges from $41 per day to $118 per day for group homes supervised by house parents. The DES Division of Developmental Disabilities (DDD) also has extreme rate ranges for its most widely used service categories. Further, rate differences are not related to DES' evaluations and ratings of provider attributes. In some cases there appears to be an inverse relationship between rates and evaluation scores — providers with higher ratings are often paid less than providers with lower ratings.

DES should adopt a uniform rate-setting approach agencywide. In a uniform approach rates are standard and, in general, providers in the same geographic area receive the same rate for the defined client service and level of care. Other states found this approach eliminated inequity and thereby improved provider relations and enhanced competition for services. In fact, uniform rate setting is used or being implemented in 10 of 11 states surveyed and is the trend in human service contracting. DES' Rehabilitation Services Administration has successfully employed this approach for years.

DES Needs to Better Manage Its Use of Consultants (See pages 17 through 22)

Our review of 14 DES consulting contracts found that consultants were often used to perform routine tasks or to replace DES management. Consultants have been hired to write ad hoc reports and develop policy tasks that organizations typically accomplish internally. For example, one consultant was paid $150 an hour to write a procedures manual for case managers, a task that many DES staff are qualified to perform. DES also appears to hire consultants as replacements for management. While they perform essential work, they do so at considerable cost. One consultant, currently billing DES at $90 per hour, managed a unit in the Division of Developmental Disabilities for 6 years. Additionally, in some cases the consultant, rather than DES, controlled the project. In one contract, DES paid over $1 million but received few deliverables resulting in benefit to the State.

DES needs to ensure that it adequately assesses the need for a project or consultant resources. It also can better define projects and ensure that contracts sufficiently specify project tasks, deliverables, and due dates.

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INTRODUCTION AND BACKGROUND

The Office of the Auditor General has conducted a performance audit of the Arizona Department of Economic Security (DES) pursuant to a May 5, 1993, resolution of the Joint Legislative Audit Committee. This performance audit, the final in a series of six on the Department, was conducted as part of the sunset review set forth in Arizona Revised Statutes (A.R.S.) §§41-2951 through 41-2957. In accordance with the authorizing resolution, this audit examines an agencywide function within DES. In contrast, prior audits in the series were specific to single DES divisions or programs.

This audit examined DES contracting practices for two specific types of contracts: contracts with agencies providing human services, and contracts for consultant services. These two functions are a subset of DES' total contracting responsibilities, which also include day care services, contracts with foster care families, and DES contracts for supplies, equipment, and business services.

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Table 1 (see page 2) estimates the DES human service contract expenditures by division for state fiscal year 1993-94. Examples of contracted services include residential services for children in state care; residential, habilitation, and vocational services for persons with disabilities; and day programs for the aged. The table does not include medical, dental, day care, or foster care family services.

Table 1

Summary of DES Human Service Contracts by Division for the Year Ended June 30, 1994 (Unaudited)

Division	Number of Providers	Expenditures	Percent of Total
Developmental Disabilities	2,496	$128,595,681	52.99
Aging and Community Services	213	42,780,311	17.63
Children and Family Services	1,839	36,535,480	15.05
Employment and Rehabilitation Services	322[a]	33,192,155	13.68
Administrative Support[b]	23	1,306,843	0.54
Benefits & Medical Eligibility	7	254,140	0.10
Child Support Enforcement	1	36,676	0.02
DES Total	4,901	$242,701,286	100.00

(a) The number of providers for the Rehabilitation Service Administration within the Division of Employment and Rehabilitation Services was obtained from the Division's Integrated Rehabilitation Information System, rather than the Financial and Management Control System.

(b) Administrative Support includes multiple administrative divisions as well as DES advisory councils and the Director's Office.

Source: DES' Financial and Management Control System.

Organization of DES' Contracting Function

In general, DES contracting responsibilities are decentralized to the divisions for both human service and consulting service contracts. However, there are several centralized contracting functions, presented below.

- The Purchasing Section under the Division of Business and Finance has agencywide responsibility for the purchase of equipment and supplies.

- The Contracts Management Section (CMS) under the Division of Business and Finance has agencywide responsibility for assuring procurement code compliance and for training contract personnel.

- The Office of Policy, Planning, and Project Control (OPPPC) under the Director is responsible for centralized management of consulting projects designated by the Director as having critical agencywide importance.

Likewise, the divisions retain some contracting functions within division administration and decentralize other responsibilities to the district organizations across the State. For example, contracts between the Division of Developmental Disabilities (DDD) and their largest human service providers are developed and negotiated centrally, while contracts with smaller providers are managed by the districts. Similarly, the Administration of Children, Youth, and Families (ACYF) centralized the 1994-95 negotiation of contracts for residential living and development services that had previously been the responsibility of the districts. Other ACYF provider contracts are the responsibility of the district administrations.

Consulting contracts, other than those managed centrally by OPPPC, are initiated and managed by the divisions. Most division consulting contracts are administered centrally by division administration rather than by district administration.

As a result of having centralized, division, and district contracting functions, DES employs contract personnel in all these organizational units.

Audit Scope and Methodology

Our review of DES human service contracting focused on three areas within DES: the DDD, the ACYF, and the Rehabilitation Services Administration (RSA). These three DES organizations together account for almost 80 percent of the total estimated DES expenditures to agencies providing human services. (The total excludes medical, dental, day care, and foster care family services).

To evaluate human service contracting, we employed the following audit methodologies:

- Analysis of rates and expenditures for DDD, ACYF, and RSA using data from three different DES computer systems
- Contract file reviews in ACYF and DDD
- Review and analysis of data generated in ACYF's contract negotiation for the most recent two-year contract term beginning July 1, 1994
- Extensive surveys of multiple agencies in 11 states
- Review of internal DES contracting studies
- Interviews with DES management, contracting staff, and providers

In our second audit area, which examined DES' use of consultants, the audit scope was agencywide. However, we excluded automation contracts. To evaluate the use of consultants, we conducted an in-depth evaluation of 14 consulting contracts active in fiscal year 1993-94.

Audit limitations — We confronted several limitations due to the fact that DES' central financial information system does not directly link payments to individual contracts. Additionally, we found certain data essential for comprehensive rate analysis was inaccurate.

First, DES automated systems do not directly link payments to contracts. We attempted to obtain contract expenditure data from DES' central financial system and subsystems for three divisions. With the exception of the information system used by RSA, none of these systems directly link payments to the associated contracts. Thus, while information could be obtained on contracted rates and total payments to providers, without manually matching each payment voucher to the information system, we could not determine the total dollars paid for a given service or whether the rates paid corresponded to the contracted rate. Payments can be made from seven different DES systems and agencywide payment detail is not housed in a single system. The agencywide financial system (FMCS) was designed to link payments to contracts, collecting service type, units, and contract number for each payment; but DES does not use this application and therefore lacks critical information on individual contracts.

Second, DES cannot produce comprehensive data on how many units it purchases of each type of service. DES has no central tracking of such data and has not ensured that the division data is collected or accurate. Of the three divisions we examined, DDD and RSA have automated data on the rate paid and number of units purchased for each service category. ACYF, however, has not enforced accurate collection of service codes and units for its expenditures. While such data is entered into the ACYF data system, both DES staff and our review of the data raised serious questions regarding data integrity. The combination of data inaccuracy and data system deficiencies prevented important audit analyses; for example, we were unable to project the financial impact of implementing a uniform rate structure as recommended in Finding I.

The audit was conducted in accordance with government auditing standards.

The Auditor General and staff express appreciation to the Director and staff of the Arizona Department of Economic Security for their cooperation and assistance during the audit.

FINDING I

DES NEEDS TO ADOPT A MORE EQUITABLE RATE-SETTING METHODOLOGY

The rates DES pays its human service providers are often inequitable. Rates vary widely for similar services and are not tied to quality. DES should abandon its negotiated rate approach and adopt a uniform rate structure. States using uniform rate setting have found it easier to administer and more equitable.

DES' Current Rate-Setting Method Leads to Inequities

Despite both legislative and provider concern, DES pays providers very different rates for similar services. Because the current rate-setting method generates many unique rates for the same service, inequities result. Additionally, the rate-setting method can have negative impacts on the quality and cost of services, and DES' relations with its providers.

Rate inequities exist — DES has wide rate ranges for similar services within both DDD and ACYF. Our analysis found rates are not tied to service quality and DES often pays higher quality providers less than lower quality providers.

A more equitable basis for funding services is needed. In DDD, for example, for group homes serving persons with developmental disabilities, rates range from $56.70 per day to $123.95 per day even when the highest and lowest rates are excluded.[1] There are a total of 109 rates for this service. Wide rate ranges exist for other DDD services as well. For example, there are 107 different rates for adult day treatment and training services ranging from $1.96 to $16.03 per hour. While client differences account for a portion of the rate variation, our review suggests many differences among rates may be unjustified.

In 1994, concern over rate differences led the Legislature to mandate that DES establish a fair rate structure for DDD services. A.R.S. §36-557.K directs DDD to:

> *"establish a rate structure that ensures an equitable funding basis for private non-profit and for profit agencies. In fiscal year 1995-1996 and each fiscal year thereafter, the division shall review and may adjust the rate structure."*

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(1) In order to exclude rates for exceptional cases, we eliminated the highest and lowest 6 percent of the rates based on the actual units of service purchased by DES.

However, wide rate ranges also exist within ACYF. In fact, for residential services presented in Table 2, one provider has rates twice the amount of another provider. Table 2 illustrates some of the ACYF services where rates vary widely. For example, rates range from $76 to $179 per day for therapeutic group home service.

Table 2

DES Administration for Children, Youth, and Families Rate Ranges for Residential Services

Service Description	Number of Unique Rates	Lowest Rate	Highest Rate
Therapeutic Group Home	26	$76.00/Day	$179.00/Day
Group Home House Parent Model	8	$41.00/Day	$118.41/Day
Group Home Staff Model	37	$60.00/Day	$149.82/Day

Source: Auditor General analysis of DES rates for the 22-month contract term ending June 30, 1996.

The wide rate differences cannot be explained by DES' evaluations and ratings of provider attributes.[1] Surprisingly, we found ***higher rated providers are actually paid less*** than lower rated providers.[2] We analyzed the rates of 40 providers of ACYF group home staff model services. Of the 40, 8 of the 10 with the *highest* evaluation scores had below average rates. At the same time, 6 providers from among the 10 rated *lowest* of the 40 had above average rates.

(1) To evaluate provider quality, we reviewed DES' evaluations of the providers' contract proposals. We combined the points assigned for methodology and experience on 1994-95 proposal evaluations scored by DES staff. The points assigned for experience and methodology include factors such as expertise of staff, appropriateness of treatment methods, and client outcomes.

(2) We computed correlation coefficients relating the provider's evaluation points to the contracted rate for the service for five residential service categories. We found a statistically significant **inverse** relationship between evaluation scores and rates for the combined total population of residential services. In specific service categories, we also found a statistically significant **inverse** relationship between evaluation scores and rates for the staff model and parent model group homes. For residential treatment centers, therapeutic group homes, and the independent living model homes, we found no statistically significant relationship between rate and high evaluation scores.

Similarly, an analysis of ACYF therapeutic group homes also shows higher rated providers may receive lower rates than lower rated providers, as illustrated in the following examples from our analysis.

- Seven of ten providers with the *highest* evaluation scores had below average rates.
- The therapeutic group home provider with the *highest* evaluation score had below average rates.
- Another highly rated home received no rate increase during state fiscal year 1995 despite having rates 20 percent below the average for residential treatment services (the majority of providers received rate increases averaging 18 percent for residential treatment services).

Meanwhile, other providers with lower evaluation scores received rate increases. The following case example clearly illustrates that rates are not related to DES' evaluations of provider attributes.

- During the State's last contracting cycle, data indicated that one ACYF group home had the fifth lowest rating out of 40 providers. Further, it appears the provider submitted incorrect information regarding its proposed rates — the costs submitted by the provider were inflated 82 percent above the costs found in its year-end financial statements. However, the provider received an increase of nearly 12 percent, raising its rates 26 percent above the average rate paid to other providers for the same service.

DES staff and providers alike claim that rate inequities exist. High-level DES administrators, program managers, and contracting staff expressed the opinion that DES' current rate-setting methodology generates rate inequities. Additionally, providers we interviewed claimed that the DES contracting system is inequitable. The following is an example of the type of inequitable rate decisions that frustrate providers.

- In 1994, the Legislature appropriated $453,000 for fiscal year 1995 to DDD to increase the rates of its providers. According to a DES schedule dated June 4, 1995, $240,574 was paid to two large Maricopa County providers. The remaining $222,514 was divided among 22 other providers. In a letter to the Legislature explaining its rate increase decisions, DES reported it used the money to raise rates that were below the mean. However, the rate of one of the two providers receiving large increases was already above the mean. Other DDD providers, who had gone years without rate increases and had rates below the mean, received no monies from the appropriation.

Why current methodology does not work — The current rate-setting method is a fundamental contributor to rate inequity. The basic assumptions underlying the rate-setting method are not accurate and, as a result, the process does not work well.

In general, DES sets provider rates after analyzing the provider's proposed cost for each individual service. These proposed costs and the provider's historical rates serve as the basis for rate negotiations. DES' current rate-setting method can be best described as a form of "cost-based, negotiated rate setting." However, the assumptions underlying this method are:

- DES has complete specifications for each desired service,
- DES has the time and expertise to analyze and identify the true costs of each provider's services,
- There is adequate competition among providers to: 1) create an incentive to operate efficiently and at the lowest costs, and 2) allow DES not to contract with a provider whose costs may be too high.

In reality, these assumptions are invalid for the following reasons.

- DES does not have detailed specifications for each service it purchases.
- DES staff cannot adequately identify provider costs. Many of the 172 DES staff involved in the process across the State have limited financial backgrounds and are not trained in analyzing costs nor provided with guidelines for what constitute acceptable costs. These staff are involved in negotiating over 10,000 separate rates, and may have to negotiate with the providers' accountants.
- Adequate competition does not exist. The demand for many services often meets or exceeds the supply and DES sometimes has to contract with undesirable providers regardless of whether their rates are too high. In addition, under the current method certain established providers have an advantage over others because of their financial expertise, control of the market (especially in rural areas and for highly specialized services), and long-standing relationships with DES staff. This makes market entry extremely difficult and further limits competition.
- Without adequate competition, providers lack an incentive to decrease costs. In fact, the incentive for providers involved in the current process is to increase rather than decrease costs. If providers can prove increased costs they can receive higher rates. Those providers managing their programs more efficiently cannot justify rates as high as those of other providers.

Because of these conditions, rates are often set subjectively, on a case-by-case basis, and inequities occur. While some of these problems could be addressed by better training and the development of cost guidelines, our research suggests the best way to address them is to adopt a new rate-setting method.

DES Will Benefit from Uniform Rate Setting

Many of the problems with the current rate-setting method could be solved by using uniform rates. Uniform rate setting is the current national trend for human service contracting. States implementing uniform rate setting have eliminated inequity, improved relations with providers, and are better able to focus on quality. However, it will take time to implement and should be done in a manner that avoids significant cost to the State. It must also be done in a manner that reduces, rather than increases, differences in rates paid to the same providers by DES and other state agencies.

Under uniform rate setting, programs define client-based levels of care and delineate the specific services required for each level.(1) Programs then determine which costs are acceptable for each type of service based on cost data from all the providers. Uniform rates are set at or near the median of the costs for each service.

Uniform rate setting in other states – We surveyed 11 states(2) and found that 10 had either implemented or are in the process of implementing uniform rate setting in ACYF, DDD, or RSA comparable programs. Uniform rates are used for DDD services in 7 of the 11 states surveyed. Likewise, 7 of the 11 states use uniform rates for ACYF services.

States use the inherent flexibility of uniform rate setting to design structures specifically tailored to their needs. For example, states define levels of care and set rates differently. Some states accounted for geographical differences between their urban and rural areas. The following case examples display the flexibility of uniform rate setting.

- **Levels of care** – States define levels of care differently. For example, California developed four levels of care for community care facilities providing DDD services, while Utah has five tiers of care for most DDD services. Michigan and Missouri created four and three levels of care, respectively. States have also defined different

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(1) For example, if DDD established five different levels of care for its clients, the first level would apply to DDD's most functional clients, and level five would apply to the most severely disabled clients.

(2) We selected six states because of their proximity and similar demographics to Arizona (Colorado, Idaho, Nevada, New Mexico, Texas, and Utah). Five additional states were identified by national experts, such as the U.S. General Accounting Office, the U.S. Department of Health and Human Services, and the Child Welfare League of America, as having the best human service contracting practices (California, Illinois, Michigan, Minnesota, and Missouri).

levels of care for ACYF services. Currently, DES has hundreds of rates for these same services.

- **Maximum rates** — States set rates differently. For example, California set rates for DDD services at the 65th percentile of aggregate costs for services. Most other states, including Utah, Missouri, and Michigan, set rates at or near the median (50th percentile) for ACYF and/or DDD services.

- **Regional differences** — States established rates for their various geographical locations. For example, California pays different set rates to Los Angeles County and San Francisco County. Services cost more in San Francisco County. Utah has a set rate schedule by county as well. As a result, Utah and California account for the economic differences between their urban and rural areas. In the DES rate analysis we found that current rate differences in ACYF are not related to the provider's geographic location.

Benefits of uniform rates — States using uniform rate setting derived many benefits, including improved relations with providers, enhanced competition, and a better focus on quality.

- **Improved relations with provider community** — Prior to uniform rate setting, providers in other states were upset and, in some cases, undertook legal actions against the state. In most instances, their legislative bodies mandated that their human service agencies address rate inequities. Uniform rate setting eliminated many perennial problems between the provider communities and social service agencies in other states because the inequities and unfairness associated with their systems disappeared.

- **Improved competition** — States also reported enhanced competition because providers understand that "an even playing field" exists for everyone. Providers can decide whether to go into business based on a known rate. Utah indicated that competition has increased as a result of uniform rate setting because the approach diminished control over the market held by larger and well-established providers.

  Additionally, in contrast to DES' current rate-setting methodology, uniform rate setting provides incentives for providers to control their costs and implement innovative practices. Other states with uniform rates, such as California and Utah, found that providers manage their programs more efficiently in order to remain competitive. A director within Utah's Department of Human Services noted that providers must now concentrate on controlling costs and improving quality rather than on cultivating political connections.

- **Promotes focus on quality rather than costs** — Uniform rate setting permits other states to concentrate on provider performance and client outcomes rather than on provider financial data. For example, California, New Mexico, and Utah all noted that uniform rate setting allows their staff to spend more time on quality concerns and less time on paperwork. Likewise, DES could redirect some of the significant resources it now dedicates to provider rate analysis and negotiation. Some of these staff could be used to develop systems to measure and reward provider quality.

- **Provides groundwork for the eventual use of performance-based contracting —** Once DES establishes fair and equitable rates for services and ensures that all providers are on an even "playing field," the Agency can move toward performance-based contracting. Performance or incentive-based contracting ties a provider's compensation to client outcomes rather than solely on the provision of services. Under performance contracting, DES can define desired client outcomes and design methods to measure provider achievement of the outcomes. Those providers who reach or exceed benchmarks can be rewarded with higher rates and more client referrals. According to the State Procurement Office, performance-based contracting is already allowed under state law. However, DES would have to work with State Procurement in developing specific contract provisions.

***Implementing uniform rate setting at DES* —** Although significant challenges exist, DES can successfully implement uniform rate setting agencywide. Implementation will take time, require moderate expenditures, and must be designed to fit Arizona's specific needs. However, by investing in uniform rate setting, DES will realize long-term benefits.

Implementing uniform rate setting is a step-by-step process requiring time and effort. Initially, each DES program will need to define levels of care for their clients and then establish fair rates for each level. These rates may then need to be adjusted for regional differences in costs. DES states it may also need to adjust the rates to compensate new vendors for start-up costs which may exceed the uniform rate. However, not all states make this adjustment.

This whole process of implementing uniform rates will take longer for DDD than other DES programs because of the diverse nature of its client population. Programs in other states took from three to five years to completely implement uniform rate structures. DES would, however, have some internal guidance available in implementing this system. DES' Rehabilitation Services Administration has successfully used this method of rate setting for years.

Costs to establish a uniform rate structure were generally moderate for other states. For example, Utah and Michigan experienced minimal implementation costs because they used existing staff resources to define service levels and rates. Utah used four FTEs for four years. California's costs were more substantial since the State used consultants to help set rates and hired permanent rate-setting staff. These states noted that costs were compensated for by long-term reductions in staff hours needed for reviewing providers' budgets under their old systems. For example, Utah now needs only one FTE to maintain its set rate structure for human services.

Costs to the State — Uniform rate setting will impact the rates of most providers. The rates of providers below a set rate will be raised while the rates of providers above a set rate will be reduced. DES and the Legislature will need to determine whether providers with rates above the set rate will be reduced to the set rate immediately or will be given time to prepare for rate decreases.

Other states allowed providers varying lengths of time to prepare for rate cuts. For example, New Mexico immediately reduced rates while Utah continued to pay the higher rates to some providers for a year.

Finally, while this system could be implemented so as to be cost neutral to the State, uniform rate setting is not guaranteed to relieve rate pressures in Arizona. We were unable to determine whether DES currently has funding to adequately compensate providers. If DES' budget cannot support adequate rates under the current system, moving to a uniform rate system will not relieve pressures from existing providers, and new providers will be unlikely to enter the market.

Impacts on other agencies' rates — Uniform rate setting in DES will impact Arizona's Single Purchase of Care (SPOC) effort. Currently, DES, the Department of Health Services, the Arizona Health Care Cost Containment System, the Department of Education, and the Department of Youth Treatment and Rehabilitation are working together to jointly purchase licensed behavioral health services. In 1993, the Governor's Action Council for Behavioral Health recommended that these agencies develop interagency agreements in order to avoid duplicating contracting functions for children's behavioral health services. The first jointly issued request for proposal is expected to be published in January of 1996 for contracts taking effect in July 1996.

Under SPOC, all five state agencies will generally pay the same rate to a provider. Thus, any uniform rates adopted by DES for behavioral health services need to be adopted by the other SPOC agencies. SPOC representatives we spoke with support a more comparable rate for similar services.

Additionally, there are some residential and other services used by multiple state agencies that are not currently guided by the SPOC effort. Thus, as DES establishes uniform rates, continuing multi-agency efforts are needed to ensure that other agencies do not undermine DES' efforts by offering significantly higher rates to the same providers for similar services.

RECOMMENDATIONS

1. Although it may take several years to implement, DES should begin now to develop uniform rate setting for human service contracting. ACYF could be expected to implement the uniform approach sooner than DDD.

2. After implementing uniform rates, DES should next consider moving to performance-based contracting.

3. While the new rate structure is being designed, DES should allocate any new appropriations for provider increases in a more objective, justifiable manner. If possible, DES should take into account provider quality, the provider's rate in relation to the average rate for the service, and the provider's length of time without an increase in comparison to other providers.

FINDING II

DES NEEDS TO BETTER MANAGE ITS USE OF CONSULTANTS

Because DES frequently uses consultants, it must ensure consulting contracts are well-managed. We found DES can better manage consultant projects to ensure consultant expenditures result in benefit to the State.

DES' Use of Consultants

DES contracted over $4 million to more than 110 consultants in fiscal year 1993-94. However, since many of these contracts span multiple-year terms, the costs are actually far higher. In fact, DES committed over $17 million to these same contracts over multiple years through June 30, 1994. Table 3 (see page 18) summarizes DES' financial commitment to consulting contracts in fiscal year 1993-94.

Consultants perform a wide variety of tasks throughout DES, ranging from automation system design to policy manual development and contract negotiation. In fiscal year 1993-94, the Division of Children and Family Services (DCFS) and the Division of Developmental Disabilities (DDD) used consultant services most extensively. In DDD, consultants were used to develop new licensing standards, conduct training, and negotiate provider contracts. ACYF also was engaged in a variety of consulting projects, one of which is intended to achieve complete redesign of the child welfare system. Large, multi-year projects include the Federal Revenue Maximization contract, the Early Prevention, Diagnosis, and Treatment (EPSDT) program design contract, and the Total Quality Management contract; all managed by the Division of Administrative Services with approximately $1.5, $1.3, and $.8 million, respectively, committed over multiple years through June 30, 1994.

Table 3

Cost of DES Consulting Contracts for the Year Ended June 30, 1994 (Unaudited)

Division	Number of Active Consulting Contracts	Amount Encumbered in 1993-1994
Children and Family Services	30	$1,316,761
Developmental Disabilities	8	952,233
Administrative Services	12	834,089
Business and Finance[a] Data Administration	2	637,900
Aging and Community Services	6	176,033
Child Support Enforcement	8	87,028
Benefits and Medical Eligibility	9	82,815
Employment and Rehabilitation Services	38	62,663
DES Totals	113	$4,149,522

[a] The Business and Finance Division administers two automation contracts also utilized by the Division of Data Administration.

Source: Contract listings from the Contract Management Section's database and the Purchasing Section.

DES Needs to Better Manage Its Consulting Contracts

While there are many appropriate uses of consultants in DES, state dollars are wasted when costly consultants perform routine tasks and when expensive projects do not yield results. Therefore, DES should develop mechanisms to ensure consultants are necessary and that consultant projects are successful.

We conducted an in-depth evaluation of 14 DES consulting contracts active in fiscal year 1993-94 that encompassed 5 program areas and an agencywide project. Due to the complexity of evaluating automation system design, automation contracts were excluded from our sample. Ten of the 14 were selected because they were costly nonautomation contracts managed by different DES divisions. The remaining four were selected because our initial review raised questions regarding the contract's appropriateness. For example, one of the four appeared to duplicate the work of another consultant.

Poor use of consultants is costly to the State — DES retains high-priced consultants to perform routine tasks better suited to internal staff. In 5 of the 14 contracts consultants performed tasks requiring no specialized expertise — tasks that many categories of DES staff are qualified to perform. In fact, we found consultants writing ad hoc reports and developing policy, tasks that organizations typically can accomplish internally. For example, in DDD an actuarial firm (first hired to perform actuarial work) wrote policy manuals and procedures for case managers. DES paid the consultant $150 an hour to perform those tasks.

DES also appears to use consultants as replacements for management. While these persons often perform crucial functions for the Department, they do so at costs that may far exceed the cost of work performed by DES staff. In 5 of the 14 contracts examined there was a long-term reliance on consultants who made managerial decisions. Examples of consultants in managerial roles are presented below.

- One consultant managed a DES unit for six years. The consultant was hired by DDD in 1989 to run the Managed Care Unit and was still managing the unit as of June 1995. The consultant outlasted five different unit directors and appears to be indispensable for her knowledge of the provider community and her historical perspective. Currently, the consultant writes policy and procedures, creates and analyzes statistical reports, advises the managed care director, and develops the provider network. The services are currently billed at $90 per hour. In contrast, the hourly wage of a comparable DES manager is approximately $27. (DDD use of the consultant varies from year to year. For example, in fiscal year 1993-94, DDD paid the consultant over $80,000; while for the first 9 months of fiscal year 1994-95 DDD has paid the consultant approximately $25,000.)

- Another consultant managed DES staff in redesigning licensing rules for providers serving persons with developmental disabilities. DES hired the consultant because all other project managers were busy with other assignments. In this case, the consultant services cost over $136,000 — three times the cost of a DES project manager.

DES managers told us that consultants are used either because staff does not have the necessary expertise to perform a function, or because there is simply no one in DES who has the time available to perform the function. Since the scope of our audit was limited to contracting, we were unable to evaluate whether DES has the managerial capacity to effectively perform the breadth of functions for which it is responsible. However, using consultants is a costly alternative to using internal resources.

It is also costly when DES fails to manage projects and implement results. In one contract we evaluated, no one in DES managed the project or was accountable for its success or failure. DES spent $1.07 million with little apparent result as is detailed below.

- **ACYF's contract with a "big six accounting firm" —** For much of the term of this $1.1 million contract, there was no DES project manager, nor any individual in management designated with this responsibility. The contract had three primary projects. Two of the three projects yielded limited benefits to the State.

  In one project begun in November 1993, the consultant was assigned to complete a management control review. However, no significant changes have occurred in ACYF operations due to the contract. Interviews with DES staff and a memo to DES from the consultant revealed there was little oversight of the project by DES and DES did not fulfill its commitment to provide staff for the project. ACYF management changed three times and division management two times during the course of the project, contributing to the lack of attention paid to it.

  In February 1994, DES engaged the consultant under the same contract to provide assistance to ACYF in negotiating provider rates for a 22-month contract period ending June 30, 1996. However, the purpose of this $225,000 project was not clearly specified in the contract file. According to DES management the project was initiated to centralize negotiations and to train DES employees in negotiating methods. While the project did centralize negotiations under the direction of the consultants, the consultants excluded DES staff from some of the critical points of the negotiations, reducing the training of DES employees that took place. DES executive management said that when it became aware that DES employees had been excluded from the negotiations, it intervened to correct the problem. However, much of the opportunity to train DES employees was lost.

***Multiple weaknesses in consultant management* —** Our review revealed significant weaknesses in DES processes to manage consultants. First, DES has no mechanism to assess whether a consultant is necessary. Second, contract language is often vague, with inadequate description of project objectives and deliverables. And third, in some cases, no one is held accountable for project outcome. While DES has a substantial number of contract management personnel, they are not utilized fully to develop effective consultant contracts.

DES does not have policies governing the use of consultants nor formal guidelines to evaluate project necessity. The absence of such policies and guidelines can lead to high consultant costs for performance of tasks that DES staff can perform, or the initiation of projects with marginal value and few benefits. We interviewed management and contract personnel in 4 DES divisions regarding 14 consultant contracts. In only one case did the division evaluate DES internal resources prior to hiring a consultant. However, in 5 of the 14 projects, we were told that a consultant was used because DES did not have sufficient internal resources.

DES contract language needs to clearly describe project tasks and due dates. In 7 of 14 contracts evaluated we found vague language. Vague language allows projects to drift, enabling DES to use consultants for routine tasks; and also contributes to DES projects that do not yield desired results. The Administrator of the State Procurement Office noted that vague contract language leaves the State indefensible in the event of a breach of contract. For example, in one DES contract, the consultant was directed to provide technical assistance "in certain perplexing situations." However, DES failed to define "perplexing situations." In another contract, the consultant was directed to "upon request from the division provide any other actuarial or consulting services." Finally, in the ACYF contract cited earlier, the contract did not clearly specify the purpose of the project.

DES can better use existing contract staff to strengthen management of consultant contracts. DES employs 68 contract management personnel who each earn an average of over $29,800 per year. While many of these resources are dedicated to provider contracts (discussed in Finding I), most divisions have contract personnel in their central administrations. Yet the contract specialists responsible for division consulting contracts are not fully utilized to develop effective contract language. They have no authority to ensure substantive contract quality. We found contract specialists simply assembling contracts from boilerplate forms, the requests for proposals, and the accepted proposals. Strengthening the role of contract management personnel would help establish more accountability for project management, results, and implementation.

RECOMMENDATIONS

1. DES should develop guidelines governing the use of consultants to help ensure project necessity, and help determine when to use consultants over existing staff resources.

2. DES should give contract management specialists responsibility and authority to ensure well-written contracts that include:

   - Clearly defined scope of work
   - Well-defined consultant and DES tasks
   - Clearly defined deliverables
   - Time schedules
   - Implementation strategy

3. The Department should ensure that project documentation clearly specifies the DES staff positions that are responsible for project management, results, and implementation.

Agency Response

ARIZONA DEPARTMENT OF ECONOMIC SECURITY
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Linda J. Blessing, DPA
Director

November 3, 1995

Mr. Douglas R. Norton, CPA
Auditor General
Office of the Auditor General
2910 North 44th Street, Suite 410
Phoenix, Arizona 85004

Dear Mr. Norton:

Thank you for the opportunity to respond to the Contracting Practices performance audit. Enclosed is the department's detailed response.

The department concurs, in concept, with the recommendations related to establishing a uniform rate-setting methodology and performance-based contracting approach. However, our research indicates that uniform rate-setting may not remedy the issues associated with the current negotiated rate methodology. Moreover, uniform rate-setting may not necessarily improve provider relations, enhance competition, or relieve rate pressures in Arizona.

The department embraces the point made in the report that provider increases should be equitably allocated. The department disagrees, however, with the report's conclusion that the fiscal year 1995 provider increase was inequitably allocated. The fiscal year 1995 provider increase was administered in a fashion that ensured continuity of services to clients. In the future, the department will maintain better documentation of how provider increases are allocated.

The department disagrees with the report's recommendation that calls for the establishment of additional guidelines and processing steps to govern the use of consultants. Currently, Assistant Directors have the authority, responsibility and accountability for determining the need for consultant services. The establishment of additional guidelines is unnecessarily burdensome and bureaucratic.

The department is in accord with the recommendation that the contract management specialist positions should be reviewed to determine their ideal scope of authority and responsibility. Additionally, the department agrees with the recommendation that project documentation should routinely specify those positions responsible for project management.

Finally, the department wishes to express its appreciation to you and your staff for the time and effort invested in this critically important audit.

Sincerely,

Linda J. Blessing

Linda J. Blessing

DEPARTMENT OF ECONOMIC SECURITY
RESPONSE
TO THE CONTRACTING PRACTICES PERFORMANCE AUDIT

Finding I: DES Needs to Adopt a More Equitable Rate-Setting Methodology

The Department supports, in concept, recommendations 1 and 2 of the report. These recommendations state that the Department should implement a uniform rate-setting approach for human services and after implementation, the Department should consider moving to performance-based contracting. Uniform rate setting would stabilize provider rates for a given service, and in the long run, the benefits listed in the report could be achieved. In fact, the Division of Developmental Disabilities is currently working on a uniform rate proposal.

However, the Department has several concerns with uniform rate setting that it would like to bring to the attention of the Legislature. The Department surveyed a number of other states including: Colorado, Idaho, Nevada, New Mexico, Utah, Illinois and Michigan. The results of the survey indicated that the audit report over-simplified the standard rate-setting process as follows:

- The report states that DES currently may have hundreds of rates for a given service. Uniform rate setting as proposed in the audit report may not remedy that situation.

  For example, one service could have one rate for each of the five levels of service in each of the State's six districts. Therefore, the service could have up to thirty different uniform rates. Since the rate is actually a not-to-exceed cap, providers would still be required to submit proposals. Each proposal could offer the Department a different rate; and consequently, the Department could still have over one hundred rates for a given service.

  This situation is similar to that experienced by the Utah Department of Human Services and the Michigan Office of Foster Care Management. Both of these entities have established standard rates and can have over one hundred rates for services.

- The audit report indicates that DES could expect improved relations with the provider community as a result of implementing uniform rates.

  The Department believes that relationships with the providers would improve for one segment of the provider community - those providers whose rates are below what will be the uniform rate. Uniform rate setting will divide providers into two groups: those whose rates are currently below the uniform rate and those providers whose rates are currently above the uniform rate.

- The audit report indicates that DES could expect improved competition because providers would understand that an "even playing field" exists for everyone.

  A uniform rate could force a number of providers out of the market. The full cost of doing business may not be reimbursed by the uniform rate and, therefore, it might not be economically viable to continue to do business with DES. Also, the uniform rate may not be sufficient to attract new providers. Since demand already exceeds supply, further reductions in supply would negatively impact the Department. The audit report could be substantially improved if the report's recommendations included a provision for providing a stipend, or some other mechanism to finance provider start-up costs. Without a mechanism to finance provider start-up costs the market could soon be dominated by those entities who could secure sufficient capital to acquire office and direct service space and equipment.

In fact, stipends are used to finance start-up costs for new service delivery facilities at the Illinois Department of Mental Health and Developmental Disabilities. Illinois is one of the states the audit report identifies as having the best human service contracting practices.

- The report states that implementation of uniform rates could be accomplished with a "moderate" level of expenditures with virtually no maintenance costs.

  The Department discussed implementation and maintenance costs with a number of other states. Five states could not even provide the Department with a cost estimate for the original design and implementation phases of uniform rate setting. Michigan, California and New Mexico used consultants to establish uniform rates. New Mexico had the most detailed cost information. For ten treatment/service components in it's Community Based Services programs with a total budget of $10 million, New Mexico spent $125,000 developing uniform rates. Since DES provides approximately 140 human services with a budget in excess of $300 million, it is reasonable to expect a substantially larger investment will be required by DES.

  Michigan and New Mexico estimate their annual expenditures at $100,000 and $344,000 respectively for maintenance of the uniform rate system.

  Additionally, the audit report states that a uniform rate-setting system "...could be implemented so as to be cost neutral for the State." This assertion contradicts a statement earlier in the report that says "...we were unable to project the financial impact of implementing a uniform rate structure..." Accordingly, the report should not lead readers to believe that standard rate setting is cost neutral when an analysis has not been performed.

Recommendation 3 of Finding I states that "...DES should allocate any new appropriations for provider increases in a more objective, justifiable manner." The Department concurs, in concept, with this recommendation and will continue to strive to allocate provider increases equitably. In the future, the Department will maintain better documentation of how provider increases are allocated.

However, allocating provider increases as a percentage change in the providers' rates is very difficult. It cannot be done unless all of the following things are static:

- the client caseload
- the units of service delivered by the provider
- the mix of services offered by a provider

Oftentimes a provider will contract to deliver a more specialized service that was not provided in the previous year. Additionally, the client caseload continually increases. Finally, the amount paid to a given provider is a function of both the provider's <u>rate</u> and the number of service <u>units</u> delivered to clients. Accordingly, while a provider's rate may have increased by one percent or more, expenditures to a given provider may have decreased since the number of service units provided may have decreased. Likewise, expenditures to a given provider may have increased due to a substantially larger number of service units being delivered. Therefore, it is virtually impossible to state that a given unit of service, resulting in a certain dollar expenditure was a part of the one percent provider increase, particularly in light of the increased demand for services as a result of caseload growth.

The two contractors who received the reported "large" increases also provide services to large numbers of clients. In fact, the providers serve well in excess of 500 clients. These providers also will generate annual total expenditures well in excess of $10 million. The $240,544 does not represent a windfall to these providers. The $240,574 represents less than 2.5% of these contractors' total expenditures. Additionally, the report's assertion that only $222,514 was available for the remaining providers is incorrect. The total available for the provider increase was $1,182,000, not $453,000 as listed in the report. This amount is easily derived from the fiscal year 1995 appropriations report.

In allocating funds to these two providers the Division had to, therefore, weigh the numbers of clients served as well as evidence presented by the providers that they could no longer sustain the losses being incurred. When combined, these two factors were more than adequate to justify the increase. Therefore, by relieving some of the financial pressure on these providers, the Division was able to ensure continuity of services to a large number of clients.

In summary, the Division's allocation of the one percent provider increase should not be characterized as "...an example of the type of inequitable rate decisions that frustrate providers."

Finding II: DES Needs to Better Manage It's Use of Consultants

The first recommendation for this finding states that "DES should develop guidelines governing the use of consultants to help ensure project necessity, and help determine when to use consultants over existing resources."

The Department does not concur with this recommendation. This recommendation will only serve to build another bureaucratic process within the Department.

It appears that the basis for this finding is that in 5 of 14 projects the auditors were told that a consultant was procured because DES did not have sufficient internal resources. It is the Department's position that no other justification is necessary. The allocation of internal resources is a management decision. Each Division's Assistant Director is responsible and held accountable for determining the need for consultants.

The audit report admits that the auditors did not evaluate the Department's managerial capacity to effectively perform its duties. Since the auditors did not evaluate managerial capacity, it is safe to assume that they did not evaluate work load, time pressures, or the strengths, weaknesses and expertise of staff; factors that the Department considers when making decisions to contract services.

Recommendations 2 and 3 state that the Department should give Contract Management Specialists responsibility and authority to ensure well written contracts and that the Department should ensure that project documentation clearly identifies the DES staff positions that are responsible for project management. The Department agrees that the role of the Contract Management Specialist could be examined to determine if the positions should be given additional responsibility and authority. The Department also agrees that those positions responsible for project management should be clearly defined.

DEPARTMENT OF ECONOMIC SECURITY
RESPONSE
TO THE CONTRACTING PRACTICES PERFORMANCE AUDIT

The Department has noted several weaknesses in Finding II:

- The report states that DES contracted for over $4 million with consultants in fiscal year 1994. While the amount of money spent on consultants is significant, the report should indicate that consultant activity is very small in relation to total DES activity. In fiscal year 1994, the $4 million contracted to consultants represents .2% of all DES activity totalling over $1.7 billion.

- The report states that one consultant managed a DES unit for six years. This assertion is simply not true. The Division of Developmental Disabilities has continually reduced the billable hours for the consultant in question. In fact, the billable hours for this consultant were reduced to about 890 hours in fiscal year 1994 and were further reduced to less than 400 hours for fiscal year 1995. These hours are not sufficient to manage a DES unit as the report states.

- The report states that a consultant was used to redesign licensing rules at a cost three times greater than that of a DES project manager. What the report fails to state is that this project was very difficult and very successful. The auditors underestimated the difficulty of achieving consensus among advocates, providers and families. The report also does not state that all deliverables were properly completed.

- The report states that consultants are costly alternatives to using internal resources. The audit report does not recognize several factors. First, the addition of permanent positions will be more costly in the long run. Also, the Department is appropriated, professional and outside services funding for various purposes. Finally, the Governor, the Department and the Legislature are all interested in privatization. This was evident in the fiscal year 1996 appropriation whereby the Department was appropriated funding to acquire a consultant for welfare reform evaluation. This appropriation is $50,000 and is substantially in excess of the cost for a permanent full-time position.

- The report indicates that the ACYF contract with a big six accounting firm yielded limited benefits, and that part of project required the consultant to train Department employees in negotiating methods. The report goes on to state that Department staff were excluded from some of the critical points of the negotiations and therefore much of the opportunity to train DES employees was lost.

  The Department disagrees with these assertions. First, the deliverables from the contract are included in the design of the Department's CHILDS project and the related processes. Second, the report should indicate that Department staff were only excluded from the initial provider negotiations. Department staff participated in all of the effort to prepare for negotiations and all subsequent negotiation sessions, after the initial sessions, with providers. Finally, the Department's staff utilized the negotiation training during fiscal year 1996 contract negotiations.