

GAO

Report to the Chairman and Ranking
Minority Member, Subcommittee on
Military Personnel, Committee on
National Security, House of
Representatives

July 1997

DEFENSE HEALTH CARE

Actions Under Way to Address Many TRICARE Contract Change Order Problems



**Health, Education, and
Human Services Division**

B-276226

July 14, 1997

The Honorable Steve Buyer
Chairman
The Honorable Gene Taylor
Ranking Minority Member
Subcommittee on Military Personnel
Committee on National Security
House of Representatives

To help contain health care costs, in late 1993 the Department of Defense (DOD) initiated TRICARE, its nationwide managed health care program for military beneficiaries. Under TRICARE, health care for about 8 million eligible beneficiaries is coordinated and managed on a regional basis using all available military hospitals and clinics, supplemented by contracted civilian services. By mid-1998, DOD expects to have implemented seven TRICARE managed care support contracts at an estimated total cost of \$17 billion. The dynamic nature of health care, the fact that contracts are awarded for 5-year periods, the uniqueness of the contracts, and other factors have resulted in the contracts' being continually modified. Change orders are a mechanism used by DOD to require its contractors to accept a DOD modification of the original contract.

Because of the large volume of change orders and their potential costs, you requested that we review DOD's process for managing change orders to determine (1) the number of, nature of, and reasons for the orders; (2) whether DOD is adequately managing the change order process; and (3) if appropriate, how DOD can improve the process.

To do this work, we interviewed DOD Health Affairs and TRICARE Support Office (TSO) officials as well as TRICARE contractors. We reviewed individual change orders and related DOD policies and regulations that apply to the orders and examined pertinent contract files for the five DOD TRICARE contracts that have been awarded. We also obtained and analyzed statistical data from DOD monthly change order status reports and discussed with officials the number of change orders, how long DOD has taken to settle—or complete negotiations with the contractors on—the orders, and reasons for the changes.

During our review, DOD instituted many actions to address problems we identified with the change order process. We discussed these efforts with DOD officials. Accordingly, to prepare a more timely report on the issues

being addressed, we reduced the scope of our work, including our review of the appropriateness of individual orders. Also, as agreed with your office, we did not attempt to independently estimate the orders' costs or their possible effects on TRICARE's need to be budget neutral.¹ We conducted our review between October 1996 and May 1997 in accordance with generally accepted government auditing standards.

Results in Brief

Since the 1994 award of the first TRICARE contract, 357 change orders, which cumulatively have increased tasks and overall costs, have been made to the five TRICARE contracts now in place.² DOD has settled 134 of the orders at a cost of about \$336,000. DOD estimated costs for the 223 orders that are yet to be settled at \$38 million. But DOD's initial cost estimates differ markedly from contractors' estimates. For example, contractor-submitted cost proposals for 85 of the 223 orders amounted to \$423 million.

The change orders, which averaged 43 per contract in 1996, have entailed policy, automated data processing (ADP), and operational changes to the contracts. About one-third have resulted from legislative or regulatory requirements; for example, legislation establishing a hospice benefit.³ The remainder were DOD-initiated changes, such as changing contractor reporting requirements.

Although there have been numerous change orders, DOD has not adequately managed the process. For example, rather than separately budgeting for the costs of individual change orders, DOD has used funds budgeted for other Defense Health Program (DHP) activities to pay for them—an approach that could potentially create a need for supplemental funding. In addition, DOD's initial cost estimates for new orders, the basis for obligating funds for the orders, have not been sound. As a result, DOD has not developed a reliable estimate of the total federal liability for the contract changes.

¹In referring to the TRICARE program and its health maintenance organization (HMO) type option, sec. 731 of the National Defense Authorization Act for FY 1994 (as amended) states that the HMO option must be administered so that the costs incurred under TRICARE are no greater than the costs that would otherwise have been incurred to provide health care to covered beneficiaries.

²In addition to the 357 change orders that require cost estimates and negotiated prices, DOD has issued over 70 change orders that typically involve minor changes related to administrative information contained in the contractual documents and that do not materially affect the requirements of the contracts or contract prices.

³The National Defense Authorization Act for fiscal years 1992 and 1993, P.L. 102-190, authorized a hospice benefit for beneficiaries.

Also, DOD has neither systematically reviewed the need for each order nor considered its likely costs and other effects. Moreover, DOD has not evaluated alternatives to amending the contracts that could achieve the same end. Thus, DOD has no assurance that only needed orders are issued and that their costs are minimized.

Finally, although DOD's goal is to settle orders within 180 days of issuance,⁴ the average TRICARE order settlement time has been 340 days. As of May 1, 1997, the average age of the 223 orders yet to be settled was 273 days. Failure to settle orders on time can reduce the contractors' cost control incentives and limit DOD's ability to negotiate prices after the contractor has incurred actual costs.

During our review, DOD attempted to address the problems we were identifying. For example, regarding budgeting for the orders, DOD is now developing a method to estimate anticipated change order costs for inclusion in future DOD budgets. To prepare new order cost estimates, DOD has engaged a consultant to independently estimate the cost of implementing each order before its issuance. Also, DOD now requires that, once a potential order's cost has been estimated, the Deputy Assistant Secretary of Defense for Health Services Financing review its appropriateness before approval. Finally, DOD has formed a task force and engaged an outside contractor to settle the orders in a more timely way and suggest ways to streamline the overall process.

We believe that DOD is taking needed steps to improve the change order process, and we urge DOD's continued efforts to bring the process under control. But the longer term efficacy of these efforts remains to be seen. In view of the leadership changes under way in DOD offices that manage the change order process, DOD's continued high-level management attention to implementing needed process improvements is essential.

Background

TRICARE is DOD's managed health care program operated in partnership with civilian contractors. The goals of TRICARE are to ensure high-quality, consistent health care benefits; preserve beneficiaries' choice of health care providers; improve access to care; and contain health care costs. Under TRICARE, seven managed care support contracts covering DOD's 12 health care regions will have been awarded to civilian contractors by mid-1998. Contracts are awarded for 5 years (1 year plus 4 option years),

⁴Sec. 43.204(b)(1) of the Federal Acquisition Regulation states that "contracting officers shall negotiate equitable adjustments resulting from change orders in the shortest practicable time."

and DOD estimates that these contracts together will cost about \$17 billion. TSO, within DOD's Office of the Assistant Secretary of Defense (Health Affairs), has the responsibility for administering the TRICARE contracts. Each contract is administered by a contracting officer. An administrative organization, called a lead agent, is designated for each of the 12 regions to coordinate the health care provided by all military treatment facilities in the region.

Since September 1994, DOD has awarded five TRICARE contracts totaling over \$11 billion: three contracts were awarded to Foundation Health Federal Services, one contract was awarded to Humana Military Healthcare Services, and one contract was awarded to TriWest Healthcare Alliance (see table 1).

Table 1: TRICARE Contracts, 1997

Dollars in Billions			
Region/area of coverage	Date of contract award	Contractor	Amount of award
11/Northwest	September 1994	Foundation Health Federal Services	\$0.66
6/Southwest	April 1995	Foundation Health Federal Services	1.81
9, 10, and 12/ California and Hawaii	August 1995	Foundation Health Federal Services	2.59
3 and 4/Southeast and Gulf South	November 1995	Humana Military Healthcare Services	3.65
7 and 8/Desert States and North Central	June 1996	TriWest Healthcare Alliance	2.32
Total			\$11.03

Two additional TRICARE contracts are scheduled for implementation by mid-1998.

Because the nature of health care is dynamic, the contracts are awarded for 5-year periods, and the contracts are unique, contracts are continually being modified. Change orders, which are issued by contracting officers at TSO,⁵ are a mechanism DOD uses to require its contractors to accept a DOD modification of the original contract. Typically, change orders are the result of policy, ADP, operations, and other changes to the TRICARE program. Some orders occur because of new laws or regulations. Most change orders affect all of the TRICARE contracts.

⁵Lead agents can issue change orders that are small in scope and pertain to lead agent requirements in the contracts. However, we included in our review only those change orders issued by TSO.

The Federal Acquisition Regulation (FAR), the Defense Federal Acquisition Regulation Supplement (DFAR), and other internal DOD guidance set forth the requirements governing the administration of change orders. The requirements include time frames within which government cost estimates must be obtained, orders must be settled, and interim payments to contractors must be made.

The change order process involves many steps. First, DOD Health Affairs directs TSO to initiate an order, which involves drafting language; obtaining comments from contractors; and, when costs are involved, developing the government cost estimate. On the basis of this estimate, funds are obligated. At this point, the TSO contracting officers provide the change order to their contractors. The contractors must respond with a cost proposal within 60 days. After receiving the contractors' cost proposal, DOD conducts a technical review and cost analysis and then negotiates with the contractors to determine the final price of the order.

In many cases, Health Affairs directs TSO to implement a single change to the TRICARE program but that change necessitates a separate change order for each contract. When this occurs, each of the orders has to be negotiated separately because the change's costs can vary by contract.

In October 1996, at the start of our review, TSO had 722 change orders that needed to be negotiated with contractors. Of these, 226 were for TRICARE contracts, and 496 were for other contracts that TSO administers, such as fiscal intermediary and dental contracts.

Changes in the leadership of DHP are now under way. The Assistant Secretary of Defense (Health Affairs) retired in March 1997, and, as of June 1, 1997, a permanent replacement had not been nominated. In January 1997, a new director reported to TSO and was charged with, among other matters, streamlining the change order process.

Hundreds of Change Orders Issued to Modify TRICARE Contracts

As of October 1996, a total of 248 change orders that could affect the cost of the TRICARE contracts had been issued. By May 1997, this number had increased to 357. Table 2 shows the number of orders issued for each TRICARE contract and region.

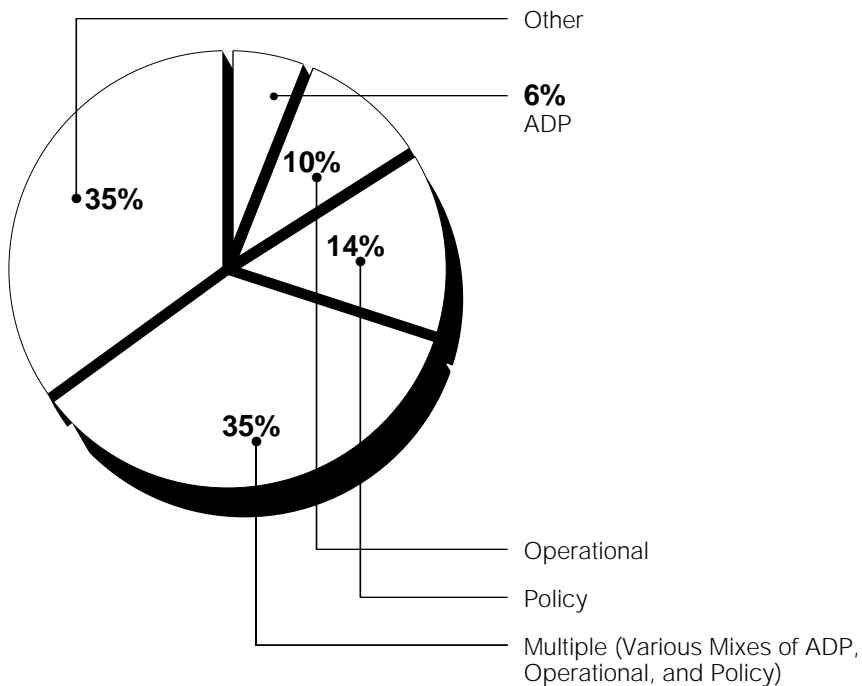
Table 2: TRICARE Change Orders by Contractor, Region, and Status, May 1, 1997

Contractor/region	To be settled	Settled	Total
Foundation/11	56	56	112
Foundation/6	46	30	76
Foundation/9, 10, and 12	47	29	76
Humana/3 and 4	52	19	71
TriWest/7 and 8	22	0	22
Total	223	134	357

For the 134 settled orders, most of which cost DOD little or nothing, the total negotiated price was about \$336,000. DOD's estimated costs for the 223 to-be-settled orders is \$38 million. But this estimate differs markedly from the contractors' estimates. At the time of our review, contractors had submitted cost proposals for only 85 of the 223 open orders, and their estimates amounted to \$423 million.

TRICARE contract change orders averaged 43 per contract in 1996. Figure 1 shows the variety of kinds of change orders for TRICARE contracts.

Figure 1: Types of TRICARE Change Orders, May 1997



Source: GAO analysis of data provided by TSO.

Policy changes include the authorization of new benefits or changes in the administration or payment of current benefits. Examples of such orders include revising the definition of medically necessary ambulance services and issuing new guidance on heart and lung transplants.

ADP orders involve creating, maintaining, or reporting data and changes to systems requirements. Such orders have included changes to the Defense Enrollment Eligibility Reporting System and changes to implement the Health Care Service Records.

Change orders classified by TSO as operational in nature include changes to the administration of the TRICARE program. Such orders have included changes to regional participation in clinical trials for a cancer demonstration project and revisions to home health care billing procedures.

Some orders incorporate policy and ADP changes, for example, or ADP and operational changes. An example is an order expanding the definition of foreign medical claims to include claims for services provided on a ship outside U.S. territorial waters.

In addition to these types of orders, DOD has issued others applicable to one or more contracts. Examples include authorizing travel costs incurred by contractors for government training and orders directing contractors to report information about ongoing provider fraud investigations. Table 3 shows the number of each type of change order that has not yet been settled.

Table 3: Types of Change Orders Not Yet Settled, May 1, 1997

Type	Number
Policy	31
ADP	14
Operations	22
Multiple	77
Other	79
Total	223

TSO data indicate that about one-third of all TRICARE change orders were required by law or regulation. Examples are implementation of a hospice benefit and revision of the active duty dependent inpatient cost-sharing provisions for mental health services. Two-thirds were DOD-initiated change orders, such as changing contractor reporting requirements, establishing a new TRICARE logo, and requiring contractors to distribute dental program brochures.

DOD Not Managing Process Effectively

DOD has not managed change orders in an effective manner. Among the problems are, first, that DOD has not separately budgeted for the estimated costs of orders, so its budget does not reflect TRICARE's total cost. Second, DOD has not methodically estimated costs of new orders; therefore, its estimates have not reliably reflected the actual federal liability for the orders. Also, DOD has issued orders without a formal review

of their impact on TRICARE, their costs, and the availability of funds. Consequently, DOD cannot be assured that each change order is necessary, is issued at the most reasonable cost, and can be funded. Finally, DOD has not settled orders within its own time frame of 180 days. Of the 134 orders settled as of May 1, 1997, the average finalization time was 340 days. Such delays in settling costs may reduce the contractor's incentive to control costs and place DOD at a disadvantage when negotiating change orders because contractors have already incurred actual costs.

DOD Not Budgeting for Orders

DOD does not include in its budget the estimated costs for new change orders or the out-year costs of settled orders. Only the award price of TRICARE contracts is reflected in DOD's budget justification documents. Thus, DHP's budget does not reflect the TRICARE program's total cost. Although the 134 change orders settled so far have increased TRICARE's price by about \$336,000, the change orders still outstanding are potentially far more costly: Contractors' estimates for about 38 percent of the open orders amount to \$423 million.

Since orders are not separately budgeted for, when new orders have been obligated or settled, they have been funded from monies budgeted for other DHP programs.⁶ While significant funding problems have not yet surfaced, the potential for them has increased considerably now that DOD is actively seeking to reduce its order backlog and is settling many more orders far sooner than it had been. And, a number of costly orders simultaneously going to settlement could potentially create the need for supplemental funding. Similarly, the failure to reliably estimate the costs of new orders and adequately fund them can delay their implementation and protract their settlement times.

According to a DOD official, change orders have not been budgeted for because DOD has lacked a reliable basis for projecting the cost of change orders. DOD has also lacked experience predicting the volume, frequency, and types of changes that would be made to the TRICARE contracts once under way.

New Order Cost Estimates Have Been Unreliable

DOD has not had a reliable approach for estimating the costs of new orders because, according to DOD officials, it has lacked the in-house expertise. TSO personnel, who initiate the change order paperwork and make the

⁶Ninety-seven percent of the FY 1997 DHP appropriation of \$10.2 billion is operations and maintenance funds. The TRICARE program, including TRICARE contract change orders, is funded with operations and maintenance monies.

initial estimates, told us they were unschooled in estimating such costs. They told us they often guessed at what the government's costs might be or requested an informal estimate from the contractor and used a variation of that figure for their estimate. As a result, DOD has had little confidence in the reliability of individual order estimates and less in the potential aggregate government costs of unsettled orders. Thus, DOD has lacked a sound estimate of the actual federal liability for the contract changes it has made.

DOD requirements state that when each change order is initiated, a government cost estimate should be prepared. This estimate becomes the basis for obligating funds for the order. A poor estimate can result in either underobligating funds for the order, resulting in the need for more funds upon the order's settlement, or overobligating funds, resulting in unnecessarily tying up funds needed for another DHP program activity. These cost estimates also provide the basis for contractors to receive provisional payments for work completed before the order has been settled. Contractors may receive from 50 to 75 percent of the government cost estimate upon submission of valid invoices. Poor cost estimates result in overpaying or underpaying contractors for work completed on the order before it is settled, at which time an adjustment is made on the basis of the final negotiated amount.

Cost/Benefit Analyses Not Performed

DOD has modified TRICARE contracts without first reviewing the potential effects on the program of each order, its cost, whether less costly alternatives were available, or the availability of funds. Thus, DOD has had no assurance that each change order is needed, its costs have been minimized, potentially more cost-effective alternatives to the order have been considered, or funds are available. Under these conditions, Health Affairs has initiated about two-thirds of the contract change orders. And, once directed to go ahead with the order, TSO has then attempted to estimate the order's costs, obligate funds, and instruct the contractor to submit a cost proposal and proceed with the new work tasks.

Knowing the likely costs and other information about the orders would position Health Affairs to consider changing an order in some way to lessen its prospective expense. In some cases, it would also allow Health Affairs to wait until the region's contract was re-bid and build the change into the new request for proposal, thus subjecting the order to the competitive bid process. In other cases, Health Affairs could simply not proceed with the order. Moreover, knowing the funding availability for

each new order would enable Health Affairs to consider delaying, expediting, or otherwise timing change order issuance to correspond with availability of funds. Finally, more complete information would position DOD officials to weigh an order's effects on the entire program.

Orders Not Settled in a Timely Way

DOD's goal is to settle orders within 180 days after issuance. But only 23 of the 134 orders settled as of May 1, 1997, have met this timeframe. As a result, at our review's outset, DOD had a backlog of over 226 TRICARE contract orders and 496 outstanding orders from other contracts. Delaying the settlement of orders can reduce the contractor's incentive to control costs and places the government at a disadvantage when negotiating orders because the contractor has performed the work at no risk and is paid for actual costs incurred.

DOD's average settlement time for the 134 settled orders was 340 days. Change orders were settled in as few as 17 or as many as 1,055 days. As of May 1, 1997, the average age of the 223 orders to be settled was 273 days. Historically, TSO has not achieved its settlement time goal either. We analyzed change orders to a Civilian Health and Medical Program of the Uniformed Services (CHAMPUS) Reform Initiative contract under which health care services were delivered between August 1988 and January 1994.⁷ We found that DOD's average settlement time for 41 change orders was 1,504 days—over 4 years.

Failure to promptly settle orders is problematic for both DOD and the contractors. First, DOD funds are tied up for long periods, since final prices remain unknown until orders are settled. In addition, contractors who submit initial cost proposals later have to update their estimates to reflect actual costs incurred. This takes contractor time and resources and can potentially increase DOD costs because the contractors' cost control incentive has been reduced.

DOD officials told us that the order backlog was caused by staff shortages and the generally ambitious schedule to award all the TRICARE contracts before the end of fiscal year 1997. They said that TSO staff, normally assigned to contract administration functions, including change order management, were diverted by tasks associated with awarding the new TRICARE contracts.

⁷The CHAMPUS Reform Initiative contract was a forerunner of the TRICARE contracts.

Other Related Problems

Since many of the change orders must be implemented upon issuance, contractors essentially have been funding the contract changes with little or no DOD reimbursement until the orders are settled. Contractors are entitled to receive provisional payments for actual work completed before orders are settled. So far, only one contractor has done so. However, it took DOD 8 months to pay four of the invoices submitted by this contractor because the invoices were not properly tracked by TSO. Finally, by delaying order settlement, some smaller health care companies lacking the capital to fund orders for such protracted periods may be discouraged from bidding on TRICARE contracts.

Relatedly, DOD requires contractors to submit cost proposals within 60 days of an order's issuance, but DOD has not enforced this requirement. Currently, contractor cost proposals have yet to be submitted on 186 orders that are older than 60 days. Without such proposals, settlement negotiations cannot begin. A representative of one contractor told us it has not submitted cost proposals in a timely way because (1) it has not received needed clarification from DOD on the orders' specifics and (2) it did not anticipate the volume of DOD orders and lacked the staff to cost out new contract changes.

DOD Is Acting to Correct Identified Problems

During our review, DOD initiated a host of actions to address the problems we identified in the change order process. Specifically, Health Affairs is developing a methodology to estimate and budget for the cost of new orders; has engaged a consulting firm to prepare independent government cost estimates for new change orders; and has implemented procedures to review and evaluate proposed orders before going ahead with them. Also, a team of contract specialists was formed at TSO to focus on and expedite the settlement of open orders, and other efforts are under way to streamline the process.

Fiscal Year 1999 Budget to Include Cost Estimate for Anticipated Orders

Health Affairs is now attempting to develop a methodology that will enable it to budget for orders expected to be issued in future years. DOD officials told us that its implementation goal is fall 1997. Thus, DOD plans to include such order cost estimates in its fiscal year 1999 budget. Also, DOD will include out-year costs for settled orders beginning with its fiscal year 1999 budget.

DOD officials told us that budgeting for the change orders will provide a more structured funding process. It will also facilitate order issuance

decisions with improved information on whether funds are available to support the TRICARE contracts.

New Order Cost Estimates to Be Improved

Instead of continuing to make “guesstimates” or basing its cost estimates for new orders on contractors’ informal cost estimates, DOD has acted to obtain independent government cost estimates for TRICARE change orders. In November 1996, DOD engaged a consulting firm to prepare cost impact statements for each order and to analyze contract cost effects for use in developing independent government cost estimates. This information should enable DOD to assess the costs and technical effects of new changes, and it should be especially useful in negotiating orders with the contractors. As of April 1997, the consultant had been assigned to prepare 22 cost estimates on proposed change orders.

Health Affairs to Review and Approve Orders Before Issuance

In March 1997, DOD established a new requirement that all proposed orders be reviewed and approved by Health Affairs before issuance. The review will evaluate each order’s effects on the health care system, its costs, and the availability of funds. In short, the Deputy Assistant Secretary, Health Services Financing, will evaluate the need for the order and decide whether to implement it.

Thus, program managers initiating orders are now required to provide documentation (1) describing the proposed change in detail and including draft contract modification language, (2) ensuring that an independent government cost estimate has been performed, and (3) earmarking funding sources to defray the order’s estimated cost. According to DOD, the new procedures are aimed at bringing discipline to the process and ensuring that appropriate funding is available for each TRICARE contract change.

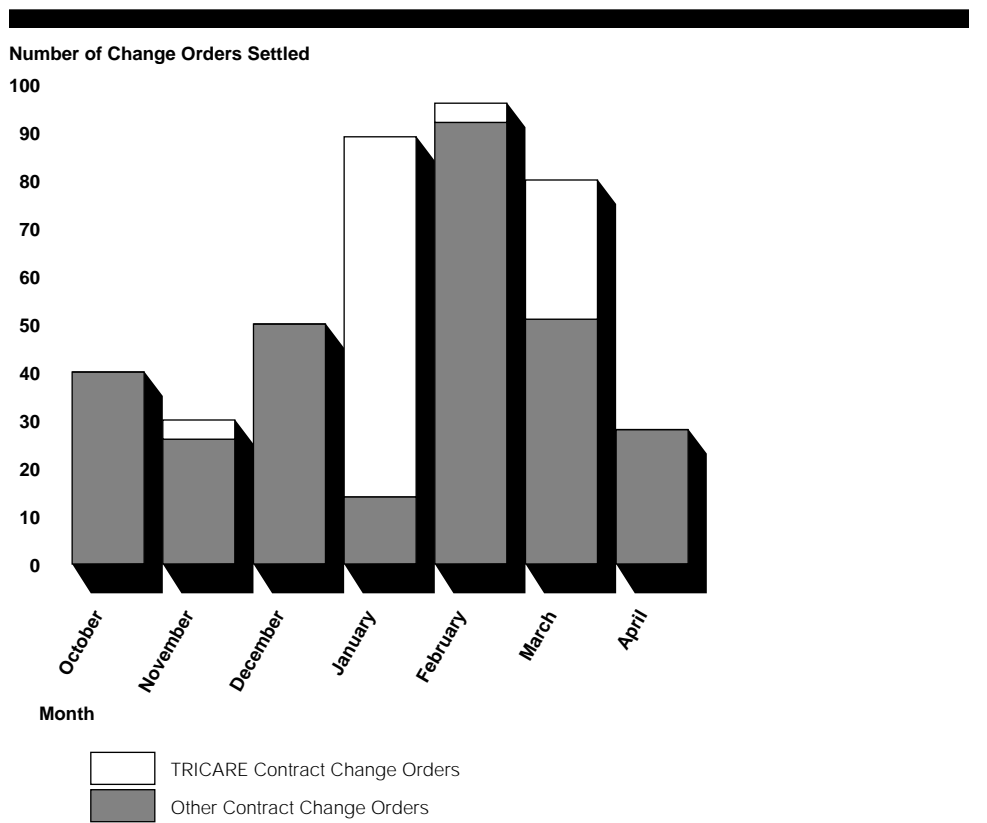
Team Formed to Expedite Order Settlement

A team of contract specialists has been assembled at TSO to expedite the settlement of all open change orders. TSO officials told us that the team is focused on reducing the order backlog to a manageable and consistent level—the goal is 100 to 150 open orders—by 1999.

In August 1996, TSO formed a team to settle the mounting change order backlog. In October 1996, the team had 7 members; by May 1997, it had 10 members. The team consists of five specialists hired under contract with TSO, three TSO employees, and two specialists temporarily assigned from

the Defense Contract Management Command.⁸ A TSO official told us it plans to hire two additional team members to help reduce the change order backlog. Before October 1996, only 22 TRICARE orders had been settled. As figure 2 shows, the team has increased the number of TRICARE orders settled since that time and has settled orders for other contracts administered by TSO as well.

Figure 2: Number of Change Orders Settled, October 1996-April 1997

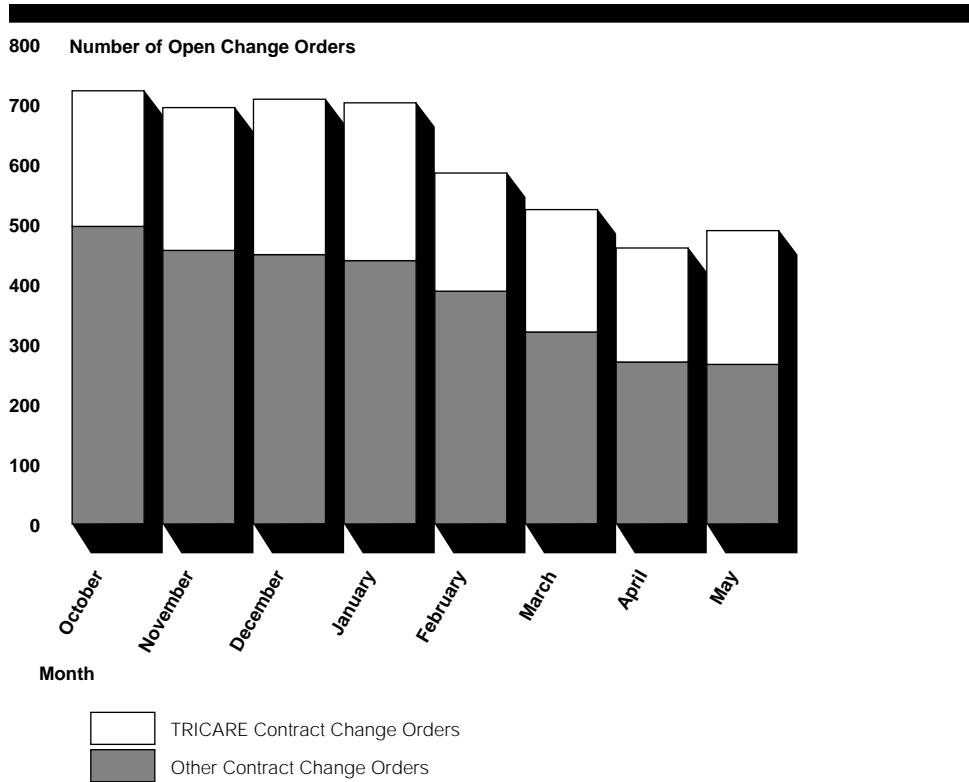


Source: GAO Analysis of data provided by TSO.

Figure 3 shows the number of change orders that remained to be settled, by month.

⁸Defense Contract Management Command is located within the Defense Logistics Agency. Its mission is to provide contract administration services in support of DOD and other designated federal organizations. The Denver Defense Contract Management Command office does price and cost analysis work for TSO.

Figure 3: Number of Change Orders That Remained to Be Settled, October 1, 1996-May 1, 1997



Source: GAO analysis of data provided by TSO.

Other Corrective Actions Taken

In March 1997, DOD hired a management consulting firm to review and recommend improvements to TSO’s change order process. The firm’s study is to develop ways to help further reduce the current backlog and prevent future backlogs.

TSO also notified contractors to begin submitting overdue (beyond the 60 day post-issuance requirement) cost proposals for low-cost or no-cost change orders. Contractors were told that proposals not received within 30 days could be unilaterally settled by DOD. A TSO official told us most contractors have attempted to respond to this effort to reduce the backlog.

Additionally, TSO is revising its provisional payment procedures so that contractors can be paid more quickly for actual costs incurred. Further, TSO is attempting to develop a standard format for contractors’ use when

submitting cost proposals in order to expedite TSO's evaluation of proposals and shorten order settlement times.

Conclusions

The hundreds of change orders that have been made to the TRICARE contracts are likely to have a significant effect on program costs and operations. Yet DOD has not reliably estimated the costs of the orders, separately budgeted for such costs, or systematically reviewed the need for each order and whether more cost-effective alternatives existed. Moreover, new TRICARE change orders and previously existing orders have backlogged, and change order settlement times have greatly exceeded requirements. The process, in short, has been managed ineffectively.

DOD has now initiated actions to reduce the number of orders that have not been settled and address the other problems we identified with the change order process. When fully implemented, these actions should bring needed discipline to the system: They should position DOD to better ensure the need for, cost-effectiveness of, and timely settlement of contract change orders. But the long-term efficacy of these efforts remains to be seen.

Recommendation

We recommend that the Secretary of Defense direct the Assistant Secretary of Defense (Health Affairs) to continue providing the high-level management attention that DOD has begun to focus on implementing the needed change order process improvements.

Agency Comments

In commenting on a draft of this report, DOD officials concurred with our recommendation that both the Acting and incoming Assistant Secretary of Defense (Health Affairs) continue providing high-level management attention to needed change order process improvements. DOD officials also raised four points related to technical accuracy.

First, DOD officials took exception to our assertion that DOD's corrective actions were initiated during our review, pointing out that DOD acted to improve the change order process well before our review began. While it is true that in 1995 DOD assigned one TSO individual to negotiate all change orders, as the report indicates, the change order settlement team was not formed until August of 1996 or expanded to its needed strength until October 1996. DOD's other actions, such as its attempt to develop budgeting methodologies for orders slated for issuance in future years and for settled

orders' out-year costs in future years' budgets; its new requirement that Health Affairs review and approve all proposed orders before issuance; its revision of provisional payment procedures; and its hiring of a consulting firm to recommend improvements to the entire process each occurred during our review. Rather than disputing when DOD took these actions, our more important concerns—and we believe DOD's, as well—are such issues as the yet-unknown extent of federal liability for TRICARE contract change orders and whether DOD's actions to fix the broken process will succeed.

DOD officials also believed our report did not adequately convey that DOD now has an approach for reliably estimating new order costs. We disagree. As we reported, not until November 1996, when DOD's hired consultant started preparing Independent Government Cost Estimates for new orders, did DOD have a reliable approach for estimating new order costs because it lacked the needed in-house expertise. We believe that this effort appears to be working reasonably well and should help DOD make sound cost estimates for each new order and, in time, for the total federal liability for the numerous contract changes DOD has made.

Further, regarding our references to contractors' estimated costs of \$423 million for only a fraction of the open orders, DOD officials said we should have pointed out that contractors have an incentive to submit high estimates to build a bargaining position for negotiating with the government. We agree that contractors may behave this way in some cases, but certainly not in all. We found, moreover, that for about 91 percent of the settled TRICARE orders, contractors' initial cost estimates were the same as or lower than DOD's estimates. Also, for the 32 percent of settled orders for which contractors' estimates were lower than DOD's estimates, all were settled at or below the contractors' estimates. For example, for Foundation Health Federal Services' region 11 contract, the contractor's initial estimate for an order requiring shockwave lithotripsy reimbursement was \$9,067, while DOD's cost proposal was \$125,000, yet the final settled price was \$9,067. Similarly, the contractor's initial estimate for a change order implementing hospice benefits was \$30,971, while DOD's estimate was \$265,563, yet the final settled price was \$28,758. Thus, we did not make the change to our report that DOD suggested.

Finally, DOD pointed out that the report's reference to DFAR change order settlement times was incorrect, and we corrected the citation.

DOD's comments appear in the appendix in their entirety.

We are sending copies of this report to the Secretary of Defense and will make copies available to others upon request. Please contact me on (202) 512-7101 if you or your staff have any questions concerning this report. Other major contributors to this report include Daniel M. Brier, Assistant Director; Cheryl A. Brand, Evaluator-in-Charge; William Temmler; Arthur Trapp; and Alan Wernz.

A handwritten signature in black ink that reads "Stephen P. Backhus". The signature is written in a cursive style with a large, prominent 'S' and 'B'.

Stephen P. Backhus
Director, Veterans' Affairs and
Military Health Care Issues

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Abbreviations

ADP	automated data processing
CHAMPUS	Civilian Health and Medical Program of the Uniformed Services
	Services
DFAR	Defense Federal Acquisition Regulation Supplement
DHP	Defense Health Program
DOD	Department of Defense
FAR	Federal Acquisition Regulation
HMO	health maintenance organization
TSO	TRICARE Support Office

Comments From the Department of Defense



HEALTH AFFAIRS

THE ASSISTANT SECRETARY OF DEFENSE

WASHINGTON, D. C. 20301-1200

JUN 7 8 1997

Mr. Stephen P. Backhus
Veterans' Affairs and Military Health Care Issues
Health, Education, and Human Services Division
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. Backhus:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report "DEFENSE HEALTH CARE: Actions Taken to Address Numerous TRICARE Contract Change Order Problems," dated June 4, 1997 (GAO Code 101498/OSD Case 1377).

In general, we concur with the GAO draft report and have already initiated the necessary corrective action. However, we did identify four issues related to technical accuracy:

1. The report implies in several places that DoD initiated corrective action at the time of GAO's review via the phrase, "during our review ..." In fact, DoD initiated actions to improve the change order process well before the GAO review began. The "Change Order (CO) team" was initiated in 1995 and the "streamlining process" began in the spring of 1996.
2. We do not agree with the GAO's conclusion that "DoD has not reliably estimated the costs of the orders ..." In August 1996, we submitted a Task Order to an independent contractor intimately familiar with the Managed Care Support contracts to explore the feasibility of providing DoD with Independent Government Cost Estimates (IGCEs) for change orders. This task order resulted in a contract modification which took effect in November 1996. The process initiated via this effort has been working extremely well.
3. The references to the \$423 million of contractor estimated change orders on pages 3 and 10, should indicate for the reader that contractors have a natural incentive to submit high estimates to establish their initial position for entering negotiations with the government. The financial records reflect the government's initial estimate of change order liability which is subsequently adjusted when the negotiations are finalized between the government and the contractor.

Now on pp. 2 and 6.

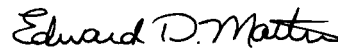
Appendix I
Comments From the Department of Defense

4. Lastly, the report states that "... the DFAR allows 180 days to settle orders, which DoD has adopted as its goal even though this regulation allows more time if needed." The references cited do not allow for 180 days to settle orders. FAR 43.204(b)(1) states "Contracting officers shall negotiate equitable adjustments resulting from change orders in the shortest practicable time." The TRICARE Service Office (TSO) has adopted 180 days as the goal for settlement completion time.

Other concerns relating to technical accuracy are being provided under separate cover directly to GAO for their consideration.

We concur with the GAO recommendation that both the Acting and incoming Assistant Secretary of Defense (Health Affairs) continue providing high-level management attention to the needed change order process improvements. We are confident that the changes we have initiated, which began before the GAO review, will enable DoD to correct all perceived shortcomings of the change order process.

Should you have any questions concerning this response please contact LTC Douglas Dudevoir at (703) 695-3331.



Edward D. Martin, M.D.
Acting Assistant Secretary of Defense

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