California State Auditor

BUREAU OF STATE AUDITS

Department of Corporations:

To Optimize Health Plan Regulation, This Function Should Be Moved to the Health and Welfare Agency

CALIFORNIA STATE AUDITOR
BUREAU OF STATE AUDITS

May 1998
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CALIFORNIA STATE AUDITOR

KURT R. SJOBERG
STATE AUDITOR

MARIANNE P. EVASHENK
CHIEF DEPUTY STATE AUDITOR

May 5, 1998

97118.1

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the Bureau of State Audits presents its audit report concerning the regulation of health care service plans performed by the Department of Corporations' Health Plan Division (division). This report concludes that to meet future challenges in the health care industry, the division needs to be placed in an organizational structure that has health care as a primary mission. Therefore, we recommend that the Legislature move the division from the Department of Corporations and the Business, Transportation and Housing Agency.

Options for the organizational placement of the State's health plan regulatory program exist such as placing it within an existing department or creating a stand-alone entity. If the Legislature decides to place the regulatory program within an existing department, it should consider the Department of Health Services because it has regulatory functions that are most similar in skills and focus to those of the division. However, regardless of which choice is made, we believe the Health and Welfare Agency is the best location for this regulatory program.

Respectfully submitted,

KURT R. SJOBERG
State Auditor

BUREAU OF STATE AUDITS
660 J Street, Suite 300, Sacramento, California 95814 Telephone: (916) 445-0255 Fax: (916) 327-0019

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Summary

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After reviewing the organizational placement of health care service plan regulation, we recommend that this responsibility be moved from the Department of Corporations and placed within the State's Health and Welfare Agency. Specifically:

- ☑ ***Both the Business, Transportation and Housing Agency and the Department of Corporations lack the health care focus needed to meet future challenges in the industry.***
- ☑ ***The Health and Welfare Agency's primary mission and health care focus make it best suited to deal with these challenges.***

If the Legislature decides to place the regulation of health plans in an existing department, it should consider the Department of Health Services within the Health and Welfare Agency.

Results in Brief

Because both the health care industry and laws governing the industry are undergoing significant changes, the State should place regulatory responsibility for health care service plans (health plans) in a setting where health care is a primary focus. Although health plans have grown in number and complexity in the two decades since the State developed its regulatory structure for health plans, California continues to locate the responsibility for overseeing these plans in the Business, Transportation and Housing Agency (agency), which has business and transportation rather than health care as its primary focus. Currently, the Health Plan Division (division), which is part of the agency's Department of Corporations (Corporations), oversees more than 100 health plans. Further, since the 1970s, legislative changes have expanded Corporations' oversight of health plan operations by adding more stringent requirements to address the quality and delivery of care provided to health plan enrollees. Nonetheless, health care issues hold a minority interest for both the agency and Corporations, whose cardinal responsibilities include regulating certain investments and financial lenders.

During our review, we analyzed the skills, expertise, and focus of the Department of Consumer Affairs, the Department of Health Services, and the Department of Insurance; we did not attempt to ascertain the efficiency and effectiveness of operations at these departments nor at Corporations. All three departments perform, to varying degrees, the types of functions necessary to regulate health plans; however, of the three, the Department of Health Services, within the Health and Welfare Agency, offers the most suitable environment for the division. Additionally, we noted that the State also has the option of creating an entirely new entity that would perform the required regulatory functions.

Regardless of whether the State moves the division to an existing department or creates a new entity, our review concludes that the regulation of health plans belongs with the Health and Welfare Agency. In locating health plan oversight in this agency, the State can capitalize on the agency's expertise and its focus on health care matters.

Recommendations

To optimize the regulation of health plans, the Legislature should move the Health Plan Division, currently part of the Department of Corporations within the Business, Transportation and Housing Agency, to the Health and Welfare Agency. Further, if the Legislature decides to place the regulatory responsibility for health plans in an existing department, the Legislature should consider the Department of Health Services which has regulatory functions that are most similar in skills and focus to those of the Health Plan Division and has an overall health care related mission.

Agency Comments

The Business, Transportation and Housing Agency disagrees with our conclusions and recommendations except as they relate to the Department of Consumer Affairs and the Department of Insurance. Instead, it believes that the responsibility for regulating health plans should be assigned to a new department within the Business, Transportation and Housing Agency.

Similarly, the Health and Welfare Agency disagrees with our recommendation to place health plan regulation within that agency, citing a potential conflict of interest and concern that ensuring solvency of health plans is not directly related to its core objectives.

Finally, the Department of Health Services expresses concern that it may have a conflict of interest, and cites the governor's proposal that a new department be established to oversee managed care.

Introduction

Background

The Department of Corporations (Corporations) regulates three unique types of businesses in California: health care service plans (health plans), securities and franchise investments, and financial lenders in the State. Specifically, it licenses and conducts financial reviews and medical surveys of health plans, as required by the State's Knox-Keene Health Care Service Plan Act of 1975. In addition, Corporations regulates securities and franchise investments by registering the sale of franchises and licensing broker-dealers and investment advisors. Finally, Corporations licenses and examines mortgage bankers, finance lenders, and escrow companies.

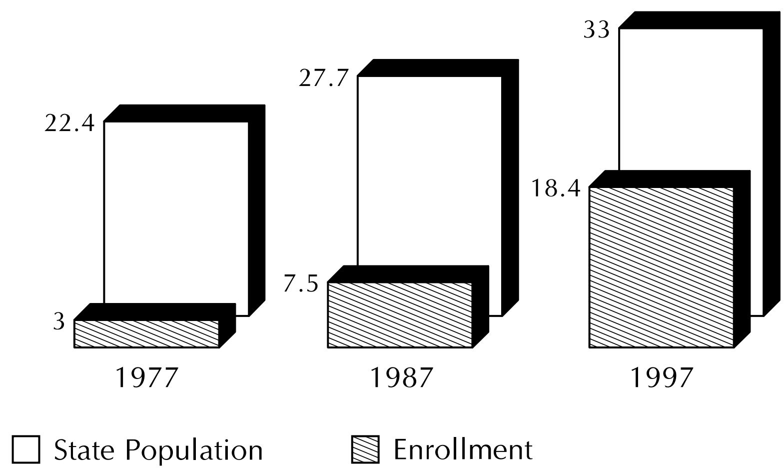
The mission of Corporations' Health Plan Division (division) is to "assure the accessibility and availability of medically necessary health care, delivered with appropriate quality-of-care oversight, to Californians through financially sound managed care systems." The division regulates more than 100 health plans throughout the State, including "full-service plans" such as health maintenance organizations (HMOs) and specialized plans that deliver dental, vision, mental health, chiropractic, or pharmacy services.

Health Plan Enrollment Has Increased Dramatically in California

Health plan enrollment in California has increased significantly in the past 20 years. Rising costs and competition have led to a shift away from traditional fee-for-service insurance plans toward more cost-conscious, prepaid managed care, including full-service health plans. As illustrated in Figure 1, the number of Californians enrolled in full-service health plans regulated by Corporations grew from 3 million in 1977 to 18.4 million by 1997.

Figure 1

Over the Last 20 Years, Enrollment in Full-Service Health Plans Has Risen Significantly



(Amounts in millions)

Not only has enrollment increased over the past 20 years, but enrollment as a percentage of the total state population has also increased. In 1977, about 13 percent of the total state population was enrolled in full-service health plans, whereas in 1997 about 56 percent was enrolled.

Managed Care Has Evolved Over the Last 20 Years

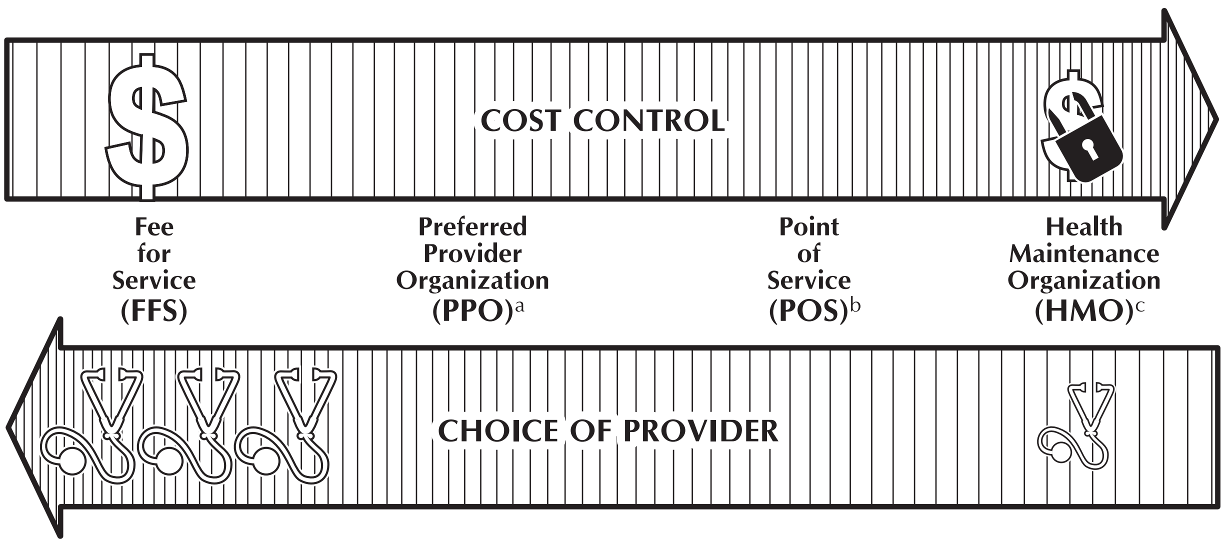
Since the 1970s, managed care has evolved to include a variety of health plans. Unlike traditional fee-for-service plans, which reimburse doctors and hospitals (providers) for each individual service they provide, managed care reimburses providers with periodic fixed (capitated) payments. While fee-for-service plans give the consumer the choice of which provider to use, managed care plans generally limit enrollees' choice of providers.

Because fee-for-service plans have had limited ability to oversee excessive treatment prescribed by providers, costs of these plans escalated, as did the costs borne by employers who are the main purchasers of health care. In response to increasing health care costs, HMO enrollment grew rapidly during the 1980s and new types of managed care plans came into existence such as preferred provider organizations, or PPOs, and point-of-service, or POS, plans. Each managed care plan uses a range of techniques to control costs, such as making a capitated payment for each enrollee regardless of the services provided, measuring the amount and appropriateness of individual service, and contracting selectively with providers.

Figure 2 illustrates the relationship between the level of costs and provider choices of the different types of health care plans.

Figure 2

Models of Health Care Plans



[a] A preferred provider organization, or PPO, offers financial incentives, such as low out-of-pocket costs, to enrollees who obtain medical care from a preset list of physicians and hospitals. A PPO covers services obtained from out-of-network providers, but the enrollee pays a higher portion of the cost.

[b] A point-of-service plan, or POS, is a product that combines both HMO features and out-of-pocket coverage with economic incentives for using network providers.

[c] A health maintenance organization, or HMO, offers a comprehensive set of health services for very little out-of-pocket cost to the enrollee but supplies almost no coverage for services not provided by the HMO.

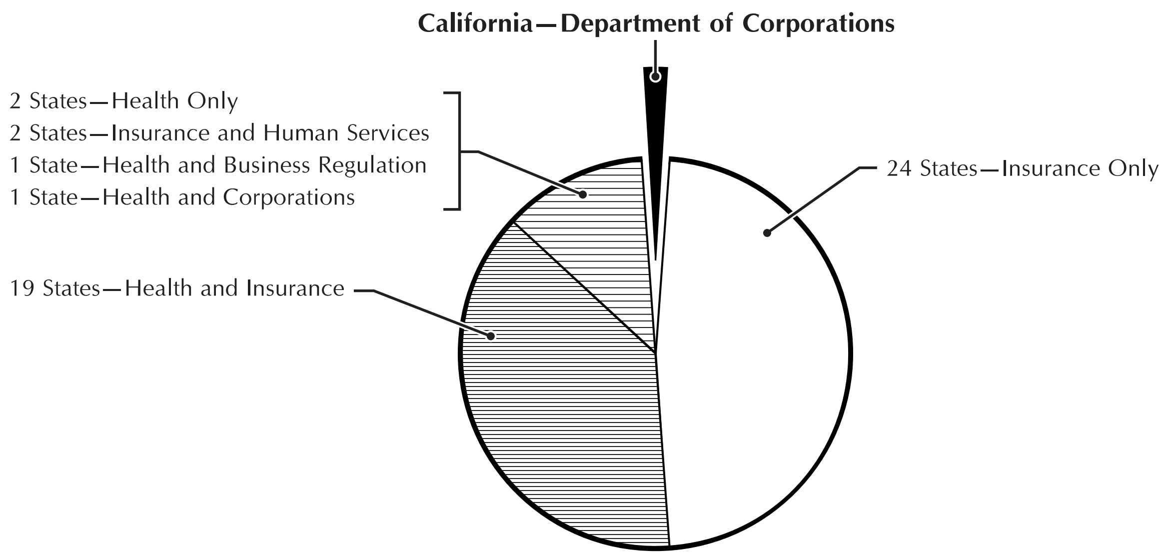
California's Regulation of Health Plans Is Unique

In comparison to the other 49 states, California is unique in that its licensing and primary oversight responsibilities for HMOs lies entirely within Corporations instead of within its insurance or health department. Although the Department of Health Services is responsible for ensuring that those health plans it contracts with to provide services to Medi-Cal recipients do so in accordance with their contracts, Corporations has sole licensing and primary oversight responsibility for these health plans.

A 1997 report titled *State Oversight of Integrated Health Systems* describes how government in each of the 50 states oversees managed care. This report was a self-study by officials in every state who provided information regarding their respective oversight responsibilities. As illustrated by Figure 3 below, states have primarily chosen their insurance or health departments, or a combination of both, to address their licensing responsibilities.

Figure 3

Most States' Insurance or Health Departments License HMOs



A Task Force Recently Studied Managed Care Regulation in California

In response to interest concerning consumer protection and the quality and cost of health plans, an amendment to the Knox-Keene Health Care Service Plan Act of 1975 created the Managed Health Care Improvement Task Force (task force) in 1996. The task force's January 1998 report discusses California's current health care environment, the trends and changes in health care delivery, and how these changes have affected the health care industry.

Because of the size and complexity of the health care industry and the degree of public interest, the task force recommended that health plans have their own regulatory entity that could meet the challenges of the constantly evolving and expanding industry. Further, the task force recommended that the new state entity be led by management with in-depth understanding of health care and with the ability to work in cooperation with the industry, employers, and consumer groups to define and address broad problems. The task force also concluded that apparent and actual inconsistencies exist in Corporations' regulation of health plans and noted instances in which Corporations' approval process delayed health plan modifications. Finally, according to the task force's report, Corporations has missed opportunities for streamlining its regulation.

Scope and Methodology

The Joint Legislative Audit Committee asked us to determine whether Corporations has the institutional capacity to regulate health plans as required by statute and in a manner that promotes consumer protection as a top priority. For purposes of this report, we have defined "institutional capacity" as having the appropriate skills, expertise, and focus to regulate health plans. We were also asked to review and compare the responsibilities of Corporations with those of other state entities and determine if one or more of these entities has the institutional capacity to administer and enforce the Knox-Keene Health Care Service Plan Act of 1975. Our review did not include ascertaining the efficiency and effectiveness of the operations of either Corporations or these entities.

To gain an understanding of health plans and the health care environment, we reviewed federal and state laws, state regulations, related pending legislation, the task force report, and other background information.

To determine whether Corporations has the institutional capacity to regulate health plans appropriately, we conducted interviews with Corporations' officials and reviewed Corporations' mission, functions, staff qualifications, and allocation of resources related to health plan regulation.

To assess whether any other state entity has the institutional capacity to assume Corporations' regulatory responsibilities, we performed a preliminary survey of more than 10 entities. Our survey identified three departments with functions or skills that initially appeared to be comparable to Corporations: the

Department of Consumer Affairs, the Department of Health Services, and the Department of Insurance. We then subjected these departments to further review.

We compared the missions, functions, staff qualifications, and allocation of resources for each of these entities with those of Corporations to assess their congruity with the responsibilities of regulating health plans. We determined their health care focus by evaluating the resources each entity committed to activities related to health care.

Finally, to determine how California compares to other states regarding health plan regulation, we reviewed a 1997 report by the Reforming States Group Steering Committee titled *State Oversight of Integrated Health Systems* that identifies how each of the 50 states regulates managed care.

Chapter 1

To Address Industry Changes, the Regulation of Health Plans Should Be Moved From the Department of Corporations

Chapter Summary

Despite dynamic changes in the health care industry, regulation of health care service plans (health plans) continues to be performed by the Health Plan Division (division) of the Department of Corporations (Corporations), whose cardinal responsibilities include regulating certain investments and financial lenders. Corporations, in turn, is part of the large Business, Transportation and Housing Agency (agency), which focuses on financial markets and sound infrastructure for business and transportation. Consequently, health care issues hold a minority interest in the overall operations of both the agency and Corporations.

The placement of health plan regulation within Corporations may have been reasonable in the 1970s, when California created its regulatory structure for health plans; however, the plans have grown in number and complexity since then. Similarly, changes in law over the years have broadened Corporations' oversight of health plan operations by including more stringent requirements for Corporations to address the quality and delivery of care provided to health plan enrollees. If the current health plan environment had existed in the 1970s, and if the statutes had given as much weight to the quality and delivery of health care as they do today, more than likely health plan regulation would not be the responsibility of either the agency or Corporations. Because it faces ever-increasing changes in the health plan industry, the division could operate more effectively in a setting where health care is a primary mission.

In Response to Consumer Concerns, Health Plan Regulatory Requirements Are Increasing

Since the 1970s, when California created its regulatory structure for health plans such as health maintenance organizations (HMOs), significant changes have occurred within the industry and in the laws that govern the industry. Interest and concern over consumer protection, availability of services, and quality of care continue to grow. The Knox-Keene Health Care Service Plan Act of 1975 addressed quality of care and access to a certain extent by establishing standards for health plan services such as continuity of care and patient referrals and by requiring the health plans to review continuously the quality of care, performance of medical personnel, and utilization of services, as well as to maintain a grievance process for the plans' enrollees. Also, Corporations, as the regulator, performs medical surveys to verify that health plans are performing in accordance with established laws. Recently, there have been more stringent requirements governing health plan services and the manner in which the plans deliver these services to their enrollees.

Acknowledging consumer concerns with the quality and delivery of health plan services, the Legislature has increased health plan responsibilities.

Acknowledging consumer concerns with the quality and delivery of health plan services, the Legislature has increased health plan responsibilities. Through various amendments to existing law since 1990, it has required health plans to provide consumers with such services as increased maternity coverage for inpatient hospital care and independent reviews for experimental treatment coverage. Further, in 1995 and 1996, the Legislature increased Corporations' regulatory responsibilities by mandating additional consumer services, including a system allowing enrollees to file complaints with Corporations if the enrollees believe a health plan has not adequately addressed their initial complaints. Corporations is required to investigate and act upon these complaints.

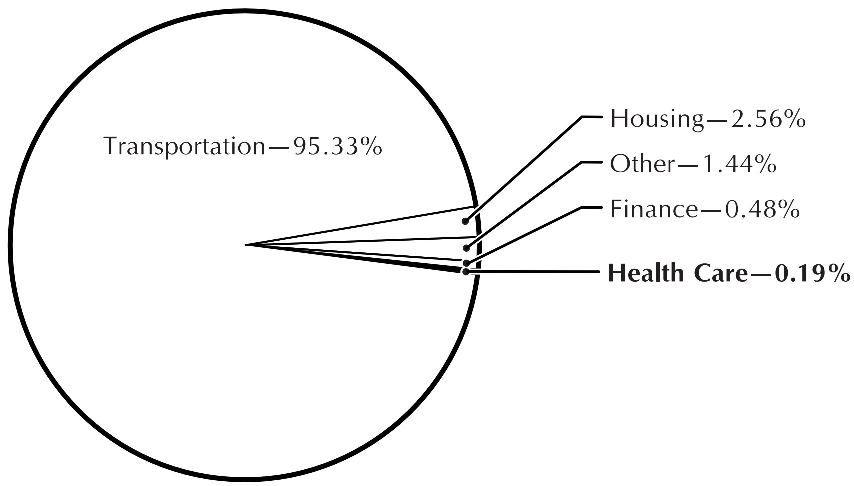
Health Care Issues Are a Minority Interest of the Business, Transportation and Housing Agency

California has chosen to place its regulation of health plans in one of the largest state agencies, the Business, Transportation and Housing Agency, which concentrates primarily on transportation issues rather than health care. The agency, which oversees 12 departments and approximately 39,000 employees, is charged with "maintaining the strength of California's infrastructure and the efficiencies of its financial markets." Specifically, the agency oversees the activities for several industries that have varied focuses and require differing expertise to monitor. These industries include transportation, housing, finance, and real estate. Transportation commands approximately 95 percent of the agency's program expenditures, totaling roughly $8 billion. The health care industry, represented by the division, accounts for less than 1 percent of the agency's approximately 39,000 employees.

Even at $15.5 million in expenditures (reflecting the division's fiscal year 1997-98 budgetary increase of $6.5 million), health care represents less than one-quarter of 1 percent of the agency's expenditures. (See Figure 4.) Given the current health plan environment and because health care holds a minority interest within the overall operations of the agency, it seems unlikely that the State would again decide today to have this agency regulate health plans.

Figure 4

Health Care Represents Less Than One-Quarter of 1 Percent of Agency Operations



Source: 1998-99 Governor's Budget, 1997-98 Authorized Expenditures

Health Care Focus Is Needed to Meet Future Challenges

Because of the high level of consumer interest, issues concerning the quality and delivery of services will probably continue to arise.

As previously discussed, the division's regulatory responsibility has expanded to address new issues concerning the quality and delivery of services provided to health plan enrollees. Similar issues will probably continue to arise given the high level of consumer interest. In addition, other areas of concern are emerging in the health care industry, such as provision of care to the uninsured population and the growth of new entities that may alter existing risk-bearing arrangements for providing services to enrollees. To meet the future challenges of an industry that is evolving at an ever-increasing rate, the division needs to be strategically placed in an organizational structure that has health care as a primary mission.

According to a recent report titled *California Health Care 1997 to 2005: A Millennium View of the Future—Transitions, Transactions and Transformations* by the California HealthCare Association, a sequence of trends, which begins with the State's slowly recovering economy, will drive changes in California's health care. The report's author expects economic growth and improving tax revenues to take some of the pressure off major employers, business coalitions, and state government to lower HMO and insurer prices. However, some purchasers will not be satisfied with the competitiveness of HMO prices and will shift to direct contracting with integrated provider-sponsored networks. These integrated provider-sponsored networks are new entities that are introducing alternative risk-bearing arrangements. For example, the California Public Employees' Retirement System is considering contracting directly with groups of doctors and hospitals, thus bypassing HMOs.

To meet future challenges, the division needs to be strategically placed in an organizational structure that has health care as a primary mission.

We cannot determine whether the division will be responsible for regulating new entities such as provider-sponsored networks. Nonetheless, the regulation of all entities bearing risk for health plan services logically belongs in one place.

Despite Its Less-Than-Optimal Placement, the Health Plan Division Attempts to Fulfill Its Regulatory Obligations

Corporations oversees the activities for industries that require differing expertise to regulate, such as securities and franchise investments, financial lenders, and health care. Similar to the agency, Corporations lacks the health care focus that would provide the optimal environment for health plan regulation.

Despite its less-than-optimal placement within Corporations and the agency, the division has key regulatory functions to fulfill its oversight responsibilities and consumer protection. These functions are licensing, monitoring licensee compliance with statutory requirements, resolving complaints, and enforcing compliance with laws and regulations for both its licensees and unlicensed health plans. See the appendix for details on specific tasks performed by the division.

The division has recently made changes to its operations to address consumer protection concerns. Although the division has always reviewed the quality and delivery of health plan services to some extent during its licensing of health plans and performance of medical survey audits, Corporations did not establish until October 1995 a toll-free number to receive complaints regarding its licensees. Currently, Corporations devotes approximately 25 percent of its resources to resolving consumer complaints, in contrast to the 6 percent it committed to this function before creating the 800 complaint number.

In addition, although it reduced staff who performed compliance functions by approximately 16 percent, Corporations contracted with two entities that have entered into a partnership to perform the fact-finding portion of medical surveys for full-service health plans. Since July 1996, this team has assisted with 18 medical surveys. Table 1 compares Corporations' allocation of staff as of June 1995, three months before Corporations created the 800 complaint number, with staff allocation in March 1998.

Table 1

Analysis of Resource Shift in the Regulation of Health Plans

Functions	June 1995	Percentage of Total Staff	March 1998	Percentage of Total Staff
Licensing	7.4	21%	15.9	16.0%
Compliance	17.0	48	32.3	32.5
Consumer complaints	2.0	6	24.7	25.0
Enforcement	5.0	14	16.6	16.8
Administrative [a]	4.1	11	9.6	9.7
Total Positions [b]	**35.5**	**100%**	**99.1**	**100%**

Source: Department of Corporations

[a] This function includes tasks such as special projects and research for legislative issues; training; and meetings with either staff, health plans, or other regulators.

[b] These figures include filled Health Plan Division positions as of June 1995 and March 1998, excluding executive and support staff, allocated to the various functions using the division's workload analysis. Also included are medical consultants used to handle requests for assistance received by the Consumer Service Unit created in October 1995. The full-time equivalent positions for these consultants in March 1998 was estimated using fiscal year 1996-97 actual hours. Enforcement Division positions allocated to the Health Plan Division, excluding support staff, are included. We used the budgeted fiscal year 1997-98 allocations for the March 1998 figures.

Another recent change was Corporations' obtaining a significant staffing increase for its health plan regulatory program. When it requested a budget increase, Corporations acknowledged that a significant increase in its regulatory and enforcement activities had occurred and that funds were necessary to eliminate a backlog of work and to meet current workload requirements. This 1997 budget increase of $6.5 million increased

Corporations' staffing levels for health plan regulation by more than 70 percent. Corporations believes these additional resources will enable it to provide an increased level of consumer protection through its regulatory activities.

Despite these recent efforts, we question whether Corporations can provide the division with the infrastructure necessary to allow it to achieve a leadership role in the health care industry. The regulation of the quickly evolving industry requires an entity with full knowledge and industry insight. Since the 1970s, an advisory committee composed of health care professionals, a certified public accountant, and members of the public has provided assistance and advice to Corporations on issues related to health care; however, this committee is unlikely to match the support an agency and department with a health care focus could provide.

Only recently has Corporations appointed an assistant commissioner with extensive health care experience to manage the day-to-day operations of the division.

Not until September 1996 did Corporations appoint an assistant commissioner with more than 20 years of experience and expertise in health care to manage the day-to-day operations of the division. Although this appointment was an important step, we again question whether this one change will be enough to ensure that the upper management of the agency provides the appropriate attention and leadership to the division given the minority interest it holds within overall operations and in light of the fact that the skills of executive management lie outside of the health care industry.

Conclusion

The placement of the division within an agency and department that do not have health care as their primary mission does not afford the division the benefit of broad expertise in health care issues nor the insight necessary for regulating health plans. In addition, the division's current placement in Corporations does not provide an environment that allows the division to effectively keep abreast of industry changes and actively guide health care innovations.

Recommendation

To optimize the regulation of health plans, we recommend that the Legislature move the Health Plan Division from the Department of Corporations.

Chapter 2

As an Alternative, the Health and Welfare Agency Provides an Appropriate Health Care Focus for Health Plan Regulation

Chapter Summary

Our review indicated that the State should place regulation of health care service plans (health plans) within the State's Health and Welfare Agency to capitalize on this agency's expertise and focus on health care matters. In assessing entities that may be suited to regulate health plans, the review identified whether each entity possesses two major characteristics: the skills necessary to perform key regulatory functions and a focus on health care issues. We compared the key regulatory functions for health plans in the Department of Corporations (Corporations) with the functions performed by three other state departments. Although the other departments performed these key functions in varying degrees, the Department of Health Services (Health Services) offered the best fit for health plan regulation. Nonetheless, it is important to note that although we were asked to assess the capabilities of existing departments, the option of creating a new entity that would perform regulatory functions for health plans also exists. Regardless of which option the State exercises, the Health and Welfare Agency is the most appropriate entity to oversee health plan regulation.

No Department Provides All the Functions Needed for Regulation, But Health Services Has the Best Fit

We considered more than 10 entities as potential health plan regulatory candidates, but only the Department of Consumer Affairs (Consumer Affairs), Health Services, and the Department of Insurance (Insurance) appeared to have regulatory functions or skills comparable to those of Corporations. Consumer Affairs, through boards such as the Board of Registered Nursing and the Medical Board of California (Medical Board), licenses health care practitioners. Health Services licenses medical facilities such as hospitals and nursing homes. Insurance licenses and regulates insurance agents, brokers, and companies, including those that offer health insurance.

Of these three departments, we found that Health Services has the best fit in terms of its experience with health care regulatory functions. In addition, when we looked at the mission and general health care focus of each department and its parent agency, we found that Health Services and the Health and Welfare Agency have the broadest health care focus.

Neither Consumer Affairs nor Insurance Provides an Appropriate Fit for Health Plan Regulation

We compared the functions and skills Corporations uses to regulate health plans with the functions and skills at the three other state departments. Neither Consumer Affairs nor Insurance provides a good fit for health plan regulation because either its functions or skills are not comparable to those of Corporations.

Corporations performs four major functions in regulating health plans: licensing, ensuring compliance with requirements, resolving consumer complaints, and enforcing rules.

As discussed in Chapter 1, Corporations performs four major functions in regulating health plans: licensing, ensuring compliance with statutory requirements, resolving consumer complaints, and enforcing existing requirements. Corporations' licensing function is designed to ensure that health plan applicants have a health care delivery system that provides enrollees with a range of services that is available and accessible, that health plans have a system in place to monitor the quality of care provided to enrollees, and that health plans are financially solvent. The focus of Corporations' compliance function is to ensure that health plans meet statutory requirements through Corporations' ongoing on-site medical and financial audits. Similarly, Corporations' consumer complaint and enforcement functions are designed to ensure that health plan enrollees' grievances are promptly resolved and that health plans receive prompt discipline when they violate laws and regulations.

Table 2 compares the skills used at Corporations to perform each regulatory function with those used at the three other state departments. See the appendix for greater detail of similarities and differences.

Table 2

Of the Three Departments, Health Services Provides the Best Fit for Health Plan Regulation

Function	Consumer Affairs	Health Services	Insurance
Licensing	○	◑	◑
Compliance Review	○	●	◑
Consumer Complaints	◑	●	◑
Enforcement	◑	◑	◑

● The skills or focus at this department are similar to those at Corporations.

◑ The skills or focus at this department are partially similar to those at Corporations.

○ The skills or focus at this department are not similar to those at Corporations.

As the table shows, we compared the mission, functions, and skills of Consumer Affairs, which administratively oversees a wide variety of professions, occupations, and businesses, and its Board of Registered Nursing and Medical Board, with the mission, functions, and skills of Corporations. Generally, some of the functions of Consumer Affairs and its boards appear to be similar to those of Corporations; however, Consumer Affairs' primary focus is substantially different and as discussed below, the functions are less extensive than those of Corporations.

Consumer Affairs and its boards primarily license individuals and thus focus on their competency and whether professional standards for education, examination, and training have been met, whereas Corporations assesses various financial and health care factors. Compliance efforts of both Consumer Affairs and its boards center on ensuring that licensees maintain their competency by meeting continuing education requirements and that those licensees who have been placed on probation for inappropriate behavior are fulfilling their probationary terms. In contrast, Corporations' compliance efforts consist primarily of extensive ongoing medical surveys and financial reviews. Additionally, although Consumer Affairs has a system for receiving and resolving complaints, the qualifications of the staff performing this function are less than those of Corporations.

Similarly, we compared the mission, functions, and skills of Insurance, which regulates the insurance industry in California, with those of Corporations. Although Insurance generally performs functions that are similar to Corporations' functions, its focus is primarily financial. In contrast, Corporations has both a financial and health care focus. For example, during its initial licensure of applicants and its ongoing financial examinations of licensees, Insurance assesses the financial capability of insurers to pay claims to policyholders. Additionally, although Insurance has a system in place to receive and resolve complaints, the nature of the complaints it receives is significantly different. Therefore, we concluded that Insurance's licensing, compliance, and consumer complaint functions are partially similar to Corporations' functions. However, Insurance lacks the expertise and focus on health care matters, and thus would not afford an improved organizational placement.

While both Consumer Affairs and Insurance conduct various enforcement activities, Corporations is one of the few state departments that has authority to represent itself in court.

Finally, the enforcement authority of both Insurance and Consumer Affairs and its boards is somewhat similar to that of Corporations. For example, both Consumer Affairs and Insurance conduct various enforcement activities against licensee violators. However, Corporations is one of the few state departments that has the authority, when regulating health plans, to represent itself in court. Generally, the Office of the Attorney General represents the State in court in criminal or civil matters. Both Consumer Affairs and Insurance must use the Office of the Attorney General to initiate such court actions when regulating their licensees. This is an important distinction because Corporations may achieve swifter action against health plan violators. Consequently, we considered Consumer Affairs' and Insurance's enforcement functions to be only partially similar to that of Corporations.

Health Services Has the Best Fit of the Three Departments We Evaluated

Of the three departments we evaluated, Health Services has the greatest focus on health care issues and has the most similarities in functions to Corporations, as illustrated in Table 2. During our review of the regulatory functions at Health Services, we noted certain similarities between the skills and focus of Health Services and those of Corporations. Specifically, we found that Health Services and Corporations have similar skills and focuses for the compliance and consumer complaint functions. For the remaining two functions, licensing and enforcement, Health Services has partially similar skills and focuses.

Both Corporations and Health Services conduct medical surveys or audits of health plans to assure the delivery of quality and accessible care.

For example, as part of their compliance functions, both Corporations and Health Services conduct medical surveys or audits of health plans to assure the delivery of quality and accessible care: Health Services audits health plans offering services to Medi-Cal beneficiaries, and Corporations is required to review all health plans it licenses. Both use health care professionals to perform the reviews and conduct them in accordance with the Knox-Keene Health Care Service Plan Act of 1975. Further, both Corporations and Health Services use staff with financial backgrounds to review the financial condition of health plans by examining financial statements and conducting on-site audits.

Finally, Corporations and Health Services use similar methods to resolve consumer complaints. Both use an ombudsman to respond to and resolve consumer complaints and grievances, have a process for complaint intake and assessment, and, when necessary, use health care professionals to assist in resolving these complaints.

For the remaining two functions, licensing and enforcement, Health Services and Corporations have partially similar skills and focus. Corporations licenses health plans, and Health Services licenses health providers, such as hospitals and nursing homes. Further, both evaluate availability of services and systems for monitoring quality of care; however, only Corporations conducts an extensive financial review of applicants before licensure. Specifically, Corporations assesses enrollment projections, financial solvency, and the financial arrangements between the plan and health providers. However, because Health Services performs financial audits during its compliance reviews of Medi-Cal providers, we believe that Health Services possesses the necessary skills to evaluate the financial condition of health plans.

Finally, both Corporations and Health Services conduct various enforcement activities against licensees who violate their laws and regulations. However, similar to Consumer Affairs and Insurance, Health Services must use the Office of the Attorney General when taking enforcement actions beyond the State's disciplinary processes for licensees. Because of this difference, we considered Health Services' enforcement function to be only partially similar to that of Corporations.

Both the Health and Welfare Agency and Health Services Have a Health Care Focus

As part of our review, we assessed the overall missions and health care focus of the three departments and two agencies to which they report. (Insurance does not report to an agency). We found that the Health and Welfare Agency, which oversees Health Services, has the greatest focus on health care issues. In addition, Health Services' mission and focus are clearly oriented to health care issues.

The Health and Welfare Agency's mission is to promote the health, well-being, and self-sufficiency of all Californians.

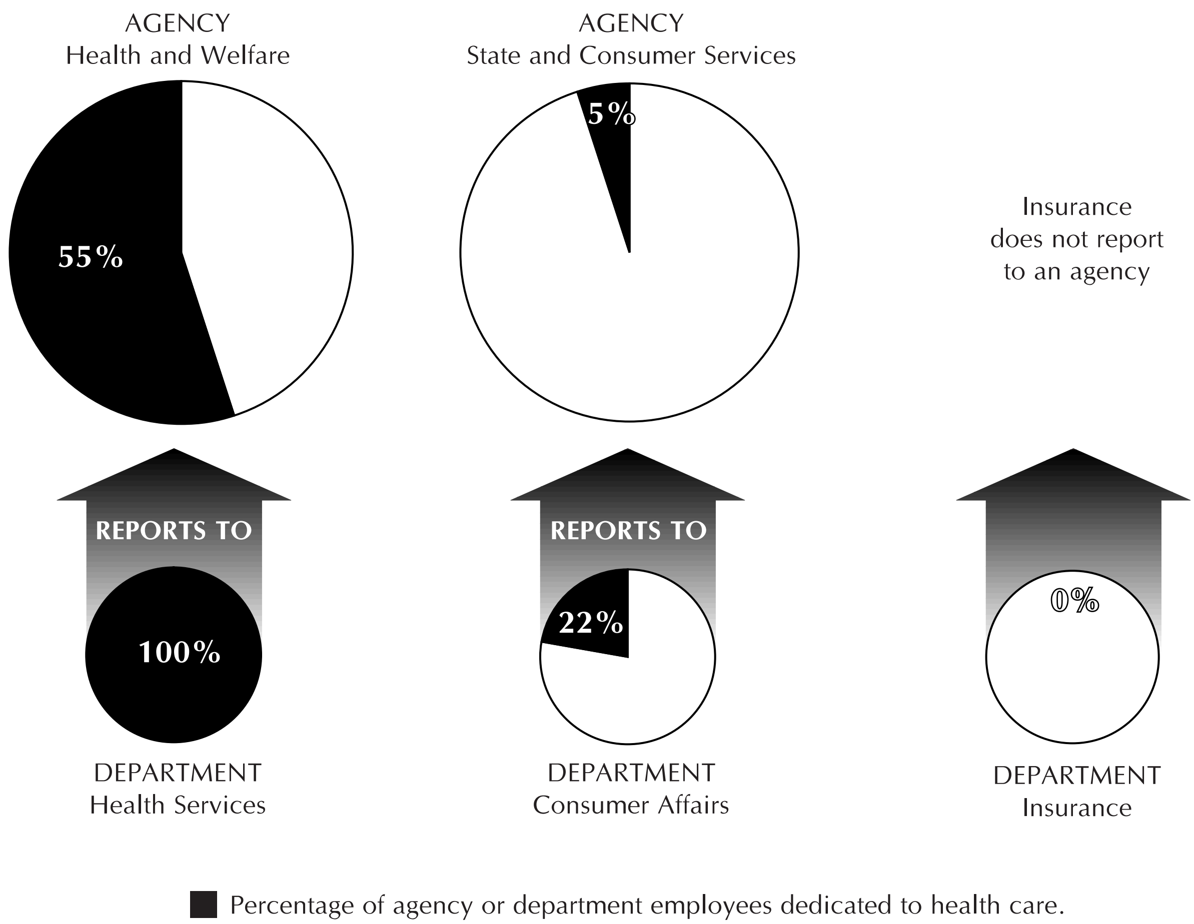
The mission of Health Services is to protect and improve the health of all Californians. This stated purpose is similar to the Health and Welfare Agency's mission to promote the health, well-being, and self-sufficiency of all Californians. Both missions are clearly focused on health matters, in contrast to the missions of the other two departments and agency, which focus on consumer protection. For example, Consumer Affairs' mission centers on fostering competitiveness; protecting consumers; and promoting high standards of competence, quality, and ethical behavior. Similarly, the State and Consumer Services Agency's mission is to protect and inform consumers. Finally, the mission of Insurance emphasizes protecting consumers, enforcing laws, and regulating the insurance industry in a fair and equitable manner.

We compared the general health care focus of each department and agency by determining the ratio of employees devoted to health care to total employees. As Figure 5 illustrates, the Health and Welfare Agency and Health Services have the greatest focus on health care issues. Specifically, 55 percent of the Health and Welfare Agency's efforts are devoted to health care issues, and 100 percent of Health Services' efforts center on health care.

In comparing these entities, we found that the mission and focus of the Health and Welfare Agency best fits the needs of the changing health care industry, as discussed in Chapter 1. Interest in and concern over such areas as consumer protection, availability of services, and quality of care continue to grow in the health care industry. With changes occurring at an ever-increasing rate, it is important that the regulator have full knowledge and insight of the health care industry. Thus, we believe that the regulation of health plans could operate more effectively in a setting where health care is a primary mission.

Figure 5

Health Care Focus of Selected Departments and Their Agencies



The Threat of a Possible Conflict of Interest Is Minimal

During our review, we were told by the executive director of the Managed Health Care Improvement Task Force that a potential conflict exists if Health Services regulates health plans. The concern is that, as a purchaser of health plan services, Health Services would be interested in obtaining the lowest prices for the services it buys for Medi-Cal beneficiaries. Its interest in obtaining low prices may directly conflict with its obligation to regulate the health plans in that Health Services could be tempted either to lessen its regulatory efforts in order to maintain the low prices or to strengthen its regulatory efforts in retaliation against a health plan that refused to offer low prices.

Although in concept conflicts may exist, we believe mitigating conditions may minimize the possibility of such conflicts occurring. First, Health Services' purchasing of health plan services would be limited to certain Californians, such as Medi-Cal beneficiaries who represent 10 percent to 15 percent of all Californians with full-service health plan coverage. Other public and private employers, or consortiums of employers in California, would represent the vast majority of purchasers and would still independently negotiate with health plans to obtain health coverage for their employees. As a result, Health Services as a consumer would compete with other independent purchasers in the State. Second, appropriate separation and oversight of Health Services' purchasing and regulating activities could minimize potential conflict. Finally, Health Services currently faces similar conflicts in its oversight of nursing homes and hospitals but has regulated these entities for many years.

A "Stand-Alone" Entity Is Another Option for Providing Health Plan Regulation

Although we were asked to assess the capabilities of existing departments to regulate health plans, we noted that another option exists. Instead of placing health plan regulation in an existing department, the health plan regulatory functions of Corporations could move to a "stand-alone" entity. Certain proponents of this option cite size and complexity of the health care industry as well as the high degree of public interest as reasons why health plans ought to have their own regulatory entity.

Choices also exist for the placement and structure of a stand-alone entity. It could be either at the cabinet level where it would report directly to the governor, or it could be a new department within an existing agency.

If the Legislature chooses to create a stand-alone entity, placement within the Health and Welfare Agency would be optimal.

We believe that if the Legislature chooses to create a stand-alone entity, placement within the Health and Welfare Agency would be optimal. This agency already has a significant voice within the governor's cabinet and has made an impact in the health care arena. Such a setting would afford the new entity the most strength and depth of health care knowledge. Moreover, the $15.5 million budget and relatively few staff of the Health Plan Division would not seem to justify creating a new, cabinet-level entity. An existing cabinet-level entity like the Health and Welfare Agency could provide traditional cabinet-level activities, such as advising the governor on major policy matters and coordinating an effective environment to resolve health care issues, with less duplication and cost.

Conclusion

We believe that the Health and Welfare Agency is the best location for the State's health plan regulatory program. The Health and Welfare Agency's mission and health care focus make the agency best suited to deal with the changing environment within the health care industry. In addition, if the Legislature chooses to place the regulating duties within an existing department, Health Services provides the best setting for the duties because it has the greatest focus on health care issues in general and because its current regulatory functions are most similar to those currently used by Corporations.

Regardless of whether the Legislature moves the Health Plan Division to a stand-alone entity or to an existing department, the Legislature should provide the entity that regulates health plans the enforcement authority that currently exists at Corporations.

Recommendations

To optimize the regulation of health plans, the Legislature should move to the Health and Welfare Agency the Health Plan Division, which is currently part of the Department of Corporations within the Business, Transportation and Housing Agency. Further, if it decides to place in an existing department responsibility for regulating health plans, the Legislature should consider the Department of Health Services because it has regulatory functions that are similar in skills and focus to those of the Health Plan Division.

To ensure that the State continues to have the ability to take swift legal action against health plan violators, the Legislature should give to the entity responsible for health plan regulation a set of enforcement powers equivalent to those the Department of Corporations currently possesses.

We conducted this review under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,

KURT R. SJOBERG
State Auditor

Date: May 5, 1998

Staff: Karen L. McKenna, CPA, Audit Principal
Joanne Quarles, CPA
Bill Shepherd, CPA
Ed Eldridge
Claire Hur
Jerry Lewis

Appendix

A Comparison of the Department of Corporations' Regulatory Functions and Staff Qualifications to Those of the Department of Consumer Affairs and the Department of Insurance

Although Table 2 of Chapter 2 shows how the functions of the Department of Consumer Affairs (Consumer Affairs) and the Department of Insurance (Insurance) differ from those of the Health Plan Division (division), this appendix provides a more thorough explanation of these differences. By highlighting the variations between these entities' tasks, this appendix delineates why the two departments do not provide the best setting for California's health plan regulatory functions.

For the purposes of our review, we identified two major factors that determine whether an entity is suited to regulate health plans. These factors are a focus on health care issues and the skills necessary to perform key regulatory functions. We compared the division's focus and skills with those of three state departments: Consumer Affairs, the Department of Health Services (Health Services), and Insurance. Our evaluation of Consumer Affairs also included an assessment of its Board of Registered Nursing and the Medical Board of California (Medical Board), both of which license health care practitioners.

We identified each department's current functions related to licensing, compliance, consumer complaint resolution, and enforcement. Further, as the following pages show, we compared the positions and minimum qualifications of staff who perform these functions with positions at the division.

Our review disclosed that of the three departments, Health Services is best suited to administer and enforce health plan regulation because it has both a health care focus and staff with skills comparable to those of Corporations. We present a separate analysis of Health Services in Chapter 2.

LICENSING FUNCTION for HEALTH PLAN REGULATION

Key Licensing Tasks →	***Minimum Qualifications and Knowledge for Staff Performing These Tasks***
Review initial applications for licensure, examine subsequent material modifications, and review amendments to determine plan compliance with the Knox-Keene Health Care Service Plan Act of 1975 (Knox-Keene Act).*	*Active membership in the State Bar. Zero to six years experience in the practice of law. Knowledge of legal principles and their application with particular reference to laws administered by Corporations, such as the Knox-Keene Act.*
Review financial information related to assessing enrollment projections and determining prepaid charges, financial viability, and fiscal arrangements of plans applying for licensure, material modification, or amendment to determine the financial soundness and stability.	*Varying degrees of education with specialization in the field of accounting. One to five years of professional accounting or auditing experience. Knowledge of accounting and auditing principles and procedures, and the laws, policies, rules, and regulations administered by Corporations, such as the Knox-Keene Act.*

*Health care plan analysts and medical consultants assist with this task when necessary.

HOW DOES THE DEPARTMENT OF CONSUMER AFFAIRS COMPARE?

○ **Focus and Skills Are Not Similar**—Consumer Affairs is not similar to the division in this area because its licensing function focuses on whether facilities meet quality standards and whether individuals meet certain professional standards, not whether the licensee is financially solvent or provides quality service, as is the primary focus of the division. Further, unlike the division, which uses staff with legal, financial, and health-related backgrounds, Consumer Affairs uses staff with mostly administrative backgrounds.

The licensing functions of the Board of Registered Nursing and the Medical Board focus on reviewing applications to ensure that licensees are competent and meet education, examination, postgraduate training, and continuing education requirements. These boards use staff with varying qualification levels, ranging from an office technician at the clerical level to an analyst. For highly specialized tasks, the boards use medical or nursing education consultants.

HOW DOES THE DEPARTMENT OF INSURANCE COMPARE?

◑ **Focus and Skills Are Partially Similar**—Insurance is partially similar to the division because both conduct extensive financial reviews to determine financial solvency of their applicants and use staff with comparable qualifications to perform this task. However, Insurance lacks the health care focus and expertise to review the division's initial applications, subsequent material modifications, and amendments. Specifically, the division's staff assesses the adequacy of health care provider arrangements by reviewing the applicant's individual physicians, hospitals, and provider-enrollee ratios. In addition, staff determines whether the applicant has adequate internal control procedures for reviewing such areas as the access, continuity, and quality of care provided to health plan enrollees.

COMPLIANCE FUNCTION for HEALTH PLAN REGULATION

Key Compliance Tasks →	*Minimum Qualifications and Knowledge for Staff Performing These Tasks*
Review complaints from consumers and providers as well as plan documents and other information sources to determine plan compliance with the Knox-Keene Act. Conduct compliance projects on a particular plan or similarly situated plans to determine compliance with the Knox-Keene Act.	*Active membership in the State Bar. Zero to six years experience in the practice of law. Knowledge of legal principles and their application with particular reference to laws administered by Corporations, such as the Knox-Keene Act.*
Conduct on-site medical surveys of the plans to determine compliance with the Knox-Keene Act.*	*Graduation from college in a field related to public health if the applicant does not have prior state service experience. One to five years of professional experience in the field of health, including the development of health plan policies, design and formulation of plan operation programs, or plan evaluation activities. Knowledge of health care service plan principles, problems, procedures, and operations, as well as methods of preparing reports.*
Analyze plan financial statements to identify significant changes in financial conditions. Conduct on-site financial examinations of the plans to validate financial condition and to follow up on the status of any systemic financial problems. Conduct any necessary on-site investigations before licensure and any necessary on-site 12-month reviews of newly licensed plans.**	*Varying degrees of education with specialization in the field of accounting. One to five years of professional accounting or auditing experience. Knowledge of accounting and auditing principles and procedures, and the laws, policies, rules, and regulations administered by Corporations, such as the Knox-Keene Act.*

*The division uses a contractor to gather information for medical surveys of the full-service plans. Medical consultants work with the division for medical surveys of the specialized plans.

** Staff with minimum qualifications cited in the previous tasks also perform this task.

HOW DOES THE DEPARTMENT OF CONSUMER AFFAIRS COMPARE?

○ **Focus and Skills Are Not Similar**—Consumer Affairs does not routinely conduct on-site surveys and audits, as the division does. The division reviews consumer complaints on an ongoing basis, is required to conduct on-site medical surveys at least every three years and as frequently as necessary, and analyzes financial statements that plans are required to submit annually, quarterly, and, under certain conditions, monthly. In contrast, Consumer Affairs only audits two of its six programs, the Cemetery and Funeral programs, every one to five years, and it inspects cemeteries and crematories once a year.

Further, the focus of compliance functions at the Board of Registered Nursing and the Medical Board is dissimilar to the division's focus. Although the division determines whether health plans are complying with financial and quality-of-care requirements through its extensive ongoing medical surveys and financial reviews, both boards focus on ensuring that licensees maintain their competency by meeting continuing education requirements and on monitoring those licensees that have been placed on probation for inappropriate behavior. In addition, while the division performs audits of all licensed health care service plans, the boards conduct random annual audits of continuing education for only 1 percent to 2 percent of their total licensee population.

The division uses financial examiners to conduct financial audits of plans. Further, in addition to its regular compliance staff, the division receives assistance from medical consultants to gather information for the on-site medical surveys. In contrast, audits of continuing education at the boards are conducted by an office technician, who has substantially lower qualifications.

HOW DOES THE DEPARTMENT OF INSURANCE COMPARE?

◑ **Focus and Skills Are Partially Similar**—Insurance is only partially similar to the division in this function. The focus of Insurance is dissimilar to that of the division, and it lacks the health care expertise needed to conduct medical surveys. While both the division and Insurance are required to evaluate financial solvency periodically, the division also evaluates the delivery of health care services through its ongoing on-site medical surveys of health plans. In addition, the division uses staff with legal, financial, and health-related backgrounds, while Insurance's staff members have financial and actuarial backgrounds.

COMPLAINT RESOLUTION FUNCTION for HEALTH PLAN REGULATION

Key Complaint Tasks →	*Minimum Qualifications and Knowledge for Staff Performing These Tasks*
Receive complaints and direct callers to the proper follow-up. Enter into the data system information to track the number of calls received.	*No education requirement. One to two years of clerical experience involving substantial public contact and exposure to laws, rules, regulations, and policies relating to consumer complaints.*
Review complaints to determine jurisdiction and resolve first-level complaints that do not require referral to an attorney, health care plan analyst, and/or medical consultant.*	*Education equivalent to college graduation. One to three years of experience in management, personnel, fiscal planning, program evaluation, and report preparation.* *OR* *Education equivalent to high school graduation is desired. Two to three years experience involving substantial public contact, interviewing complainants, and receiving, resolving, and adjusting complaints.*
Review and resolve second-level complaints that require the expertise of an attorney, health care plan analyst, and/or medical consultant.**	*Active membership in the State Bar. Zero to six years experience in the practice of law. Knowledge of legal principles and their application with particular reference to laws administered by Corporations, such as the Knox-Keene Act.* *OR* *Graduation from college in a field related to public health if the applicant does not have prior state service experience. One to five years of professional experience in the field of health, including the development of health plan policies, the design and formulation of plan operation programs, or involvement in plan evaluation activities. Knowledge of health care service plan principles, problems, procedures, and operations, as well as methods of preparing reports.*
Respond to and resolve individual inquiries regarding Corporations' health care service plan complaint and grievance program.***	*Graduation from college in a field related to public health if the applicant does not have prior state service experience. One to three years of professional experience in the field of health. Knowledge of health care service plans.*

* Either a Staff Services Manager or Consumer Services Representative performs the task. These positions have different education requirements.

** The minimum qualifications for medical consultants have not been presented.

*** This position is exempt from state civil service and subject to appointment by the Governor.

HOW DOES THE DEPARTMENT OF CONSUMER AFFAIRS COMPARE?

◑ **Focus and Skills Are Partially Similar—**Although both Consumer Affairs and the division focus on resolving consumer complaints, members of the consumer complaint resolution staff at Consumer Affairs differ in qualification levels from their counterparts at the division. The division uses attorneys and health care professionals to resolve complaints requiring legal or medical expertise that is specific to the health care industry, and Consumer Affairs uses administrative staff with expertise in mediating complaints. However, the division and the boards have similar complaint resolution processes. For example, both the division and the boards use medical health care professionals for reviewing complaints requiring medical expertise and employ the services of an attorney to review complex legal matters.

HOW DOES THE DEPARTMENT OF INSURANCE COMPARE?

◑ **Focus and Skills Are Partially Similar—**Insurance receives and resolves complex complaints. However, the division's complaints are significantly different in nature and require the use of health care consultants and counsel. In contrast, Insurance resolves complaints using rate analysts or policy officers, and occasionally legal counsel, who are knowledgeable in a variety of insurance issues including health insurance.

ENFORCEMENT FUNCTION for HEALTH PLAN REGULATION

Key Enforcement Tasks →	*Minimum Qualifications and Knowledge for Staff Performing These Tasks*
Select, provide information for, and oversee investigations of health care service plans and disciplinary actions for hearings and litigation.	*Active membership in the State Bar. Zero to six years experience in the practice of law. Knowledge of legal principles and their application with particular reference to laws administered by Corporations, such as the Knox-Keene Act.*
Review complaints to determine jurisdiction, action warranted, and the existence of prior or pending investigations. Proceed with disciplinary or enforcement action if warranted.*	*Active membership in the State Bar. Zero to six years experience in the practice of law. Knowledge of legal principles and their application with particular reference to laws administered by Corporations, such as the Knox-Keene Act.*
Perform investigations to obtain detailed facts through interviews, gather documentary evidence, coordinate with other agencies, and access public and private databases.*	*Education equivalent to a four-year college degree with a major preferably in criminal justice, administration of justice, or political science. One to five years of experience in civil or criminal investigative work.*

*The division uses staff from Corporations' Enforcement Division to perform these tasks.

HOW DOES THE DEPARTMENT OF CONSUMER AFFAIRS COMPARE?

◑ **Focus and Skills Are Partially Similar—**Although both the division and Consumer Affairs use staff with experience in performing investigations and can impose administrative sanctions such as fines or license suspensions, Consumer Affairs does not have the same enforcement authority as the division. Generally, the Office of the Attorney General represents departments such as Consumer Affairs in court in criminal or civil matters; however, Corporations, when regulating and supervising health plans, is one of the few departments that can represent itself in court. Likewise, neither the Board of Registered Nursing nor the Medical Board has enforcement authority comparable to that of the division.

HOW DOES THE DEPARTMENT OF INSURANCE COMPARE?

◑ **Focus and Skills Are Partially Similar—**Although both Insurance and the division use staff with similar qualifications to investigate and enforce their respective laws, Insurance, like Consumer Affairs, does not have the same enforcement authority as the division.

Agency's response to the report provided as text only:

State of California
BUSINESS TRANSPORTATION AND HOUSING AGENCY
980 9th Street, Suite 2450
Sacramento, CA 95814-2719
(916) 323-5401
FAX (916) 323-5402

Dean R. Dunphy
Secretary

April 28, 1998

Kurt R. Sjoberg
State Auditor
Bureau of State Audits
660 J Street, Suite 300
Sacramento, CA 95814

Dear Mr. Sjoberg:

The Business, Transportation and Housing Agency submits this response to the Draft Report entitled "Department of Corporations: To Optimize Health Plan Regulation, This Function Should Be Moved to the Health and Welfare Agency."

For the reasons set forth below, we cannot concur with the conclusions or recommendations embodied in the Report, except as they relate to the Department of Consumer Affairs and the Department of Insurance.

Unclear Scope and Methodology

The Report, indicates the Bureau of State Audits ("BSA") was asked: (a) "to determine whether Corporations has the institutional capacity to regulate health plans as required by statute and in a manner that promotes consumer protection as a top priority," and (b) "to review and compare the responsibilities of Corporations with other state entities and determine if one or more of these has the institutional capacity to administer and enforce the Knox-Keene Health Care Service Plan Act of 1975." (Int-5.) The Report indicates the BSA, among other things, defined "institutional capacity" as "having the appropriate skills, expertise, and focus to regulate health plans." (Int-5.) Health care "focus" was determined "by evaluating the resources committed to activities related to health care." (Int-6.)

The Report expressly states that the BSA's review "did not include ascertaining the efficiency and effectiveness of the operations of either Corporations" or other entities (Int-5), but rather, "whether these entities have the appropriate skills, expertise, and focus to regulate health plans." (S-1.) In recent correspondence with the Department of Corporations, the BSA indicated such a review is not scheduled to be completed until 1999 or 2000. 1*

*California State Auditor's comments on this response begin on page 37.
Note: Page numbers in the report have changed.

The scope of review does not appear to include or require normative judgments.
1 However, it is not clear whether the scope of the BSA's review was indeed limited to whether the Department of Corporations and other agencies reviewed have the "institutional capacity" to regulate health plans as required by statute and in a manner that promotes consumer protection as a top priority.

Given the narrow scope and methodology as set forth in the Report, it appears numerous
1 statements, conclusions, and recommendations rest on what must be assumptions that: (i) the Department of Corporation's regulation of Health Plans is not efficient and effective; (ii) any lack of efficiency or effectiveness is a function of the existing oversight structure at the department and agency levels; and (iii) regulation would be optimal under the Health and Welfare Agency.

CHAPTER 1

Several statements in Chapter 1 require clarification. For example, the Report states that "the concerns of health care issues hold a minority interest in the overall operations of both the agency and Corporations"(p. 1-1), that "health care focus is needed to meet future challenges," (p. 1-3.), and "Corporations lacks the health care focus that would provide the optimal environment for health plan regulation." (p.1- 4) Since the Report indicates that "health care focus" has been determined "by evaluating the resources committed to activities related to health care," (Int-6), it is
2 unclear whether these statements suggest that additional financial resources should be devoted to health plan regulation.

In addition, with regard to the Department's Health Plan Division, Chapter 1 concludes:

> The placement of the division within an agency and department that do not have health care as their primary mission does not afford the division the benefit of broad expertise and the insight necessary for regulating health plans. In addition, its current placement in Corporations does not provide an environment that can effectively keep abreast of industry changes and actively guide health care innovations.

Without having evaluated the efficiency and effectiveness of DOC or other entities,
1 it seems the BSA has made assumptions that the Department lacks necessary broad expertise and insight, and that it has not "effectively" kept abreast of industry changes or actively guided health care innovations. These appear to be assumptions absent any precise findings as to what expertise or insight is necessary or wanting, or precisely what

changes the Department has not effectively kept abreast of, or how any failures or shortcomings in this regard are measured.

While we do not question the general proposition that the State's regulation of health
plans needs improvement, any sound conclusions and recommendations for improvement must
be based upon a thorough evaluation of nature and reasons for any lack of efficiency or 1
effectiveness under the existing structure. Clear distinctions should be made between perceived
weaknesses in the substantive provisions of law, the aptitude of regulatory personnel, and
internal management of the regulatory entities. A thorough assessment of the perceived
"problem" must also consider the nature of perceived consumer dissatisfaction and whether
complaints are fueled by market forces, inadequate care on the part of particular medical
providers, or shortcomings in the regulatory structure and process. Moreover, the increased
resources provided to the Department as a result of the recent budget augmentation, must be
considered, which BSA has indicated will be considered in its review to be conducted in 1999 or
2000.

<u>CHAPTER 2</u>

Chapter two concludes that the H & W Agency "is the best location," and is "best suited" to
deal with the changing environment within the health care industry. (p. 2 - 9) Such conclusions
also reflect assumptions about the efficiency and effectiveness of DOC and the H & W Agency, 1
although such issues are expressly beyond the scope of the current review of whether DOC or
other entities have the "institutional capacity" to regulate Health Plans.

<u>Significance of Oversight Structure</u>

In addition, the Report reflects assumptions about the significance of what is deemed
California's "unique" oversight structure and the degree to which it adversely affects the
institutional capacity to regulate health plans. For example, the BSA apparently relied on a 1997
report entitled, "State Oversight of Integrated Health Systems" to compare California's regulatory
structure to that of other states. In discussing the fact that "states have primarily chosen their
insurance or health departments, or a combination of both, to address their licensing
responsibilities" (Int-4), the Report suggests California's failure to do so presents a weakness in 3
health plan regulation. However, the Report fails to note that *all* state regulators, be they
insurance or health departments, report facing questions about "oversight management
capacity."

Indeed, the 1997 study on which the BSA relies found that oversight management capacity is an issue common to all state regulators, including insurance and health departments. The study finds, "the capacity of public agencies to carry out their oversight responsibilities effectively" is an issue common to state regulators, who are "concerned . . . about the number of entities that are being monitored and the ability of these governmental agencies to perform their oversight functions." (State Oversight of Integrated Health Systems, p. 9.)

<u>Need to Clarify Meaning of "Focus" and "Resources"</u>

The BSA report is also unclear to the extent conclusions are based on what is perceived as enhanced "focus" at the Health and Welfare Agency. As noted above, the Report is based on the premise that "focus" is determined by "resources," which is not clearly defined. The Report appears to give significant weight to a comparison of the amount of fiscal resources devoted to health care regulation at the Business, Transportation and Housing Agency and the Health and Welfare Agency. Accordingly, one might infer that moving the regulatory function to the Health and Welfare Agency would necessarily result in a greater financial resources devoted to health
2 plan regulation. However, it seems unclear whether this is the intended conclusion reached by the BSA.

<u>Inadequate Consideration of Solvency Concerns</u>

Although the report notes the tremendous growth in the number of health plans and
4 enrollees, it says little about the solvency issues which remain a core concern of the Knox-Keene Act, and the importance of understanding and regulating the complex business transactions and structures under which health plans are variously organized. Health plans and providers are organized in a variety of business structures, including for-profit and non-profit corporations, general and limited partnerships, limited liability companies, professional associations and corporations, and joint ventures, the regulation of which rests within the expertise of the Business, Transportation and Housing Agency, but not the Health and Welfare Agency.

<u>Inadequate Assessment of Conflicts of Interest</u>

Regarding the recommendation to transfer oversight to the Health and Welfare Agency, we also believe further consideration should be given to the likely conflict of interest that would result. The Report merely opines that the "threat of a possible conflict of interest in minimal," and that "mitigating conditions may minimize the possibility." (p. 2-8.) Although the Report acknowledges certain facets of the study completed by experts serving on the Managed Health
5 Care Improvement Task Force, it's not clear whether full consideration has been given to the experts' conclusion that the regulator should not be a purchaser of health care.

Conclusion

In short, it seems the Report is premature in that the conclusions and recommendations are based on a review of missions, functions, staff qualifications, and allocated resources and are not informed by a thorough evaluation of the efficiency or effectiveness of any of the entities discussed in the Report. 1

Experts on the Managed Health Care Improvement Task Force recently completed an exhaustive review of these issues. We concur with the recommendation that a regulatory entity focused solely on the regulation of managed care should be created. We concur with the Task Force's recommendation that the regulator should not be a purchaser, and for reasons identified in the Task Force report, and in the BSA's report, we also concur that the regulatory function should not be transferred to the Departments of Insurance or Consumer Affairs. Therefore, the Business, Transportation and Housing Agency believes the responsibility for regulating health plans should be assigned to a new department within the oversight of this Agency. 6

Sincerely,

DEAN R. DUNPHY
Secretary

Comments

California State Auditor's Comments on the Response From the Business, Transportation and Housing Agency

To provide clarity and perspective, we are commenting on the Business, Transportation and Housing Agency's (agency) response to our audit report. The numbers correspond to the numbers we have placed in the response.

1 Contrary to the agency's statement, we believe that the scope of our audit, as discussed on page 5 of the report, is clearly stated. Additionally, the agency has incorrectly asserted that our conclusions and recommendations rest on assumptions. Rather, we based our conclusions and recommendations on our assessment of changes in the health care industry and regulatory requirements, as well as the skills, expertise, and health care focus of the Department of Corporations (Corporations) and the agency in comparison with the skills, expertise, and focus of other state departments and agencies.

Further, the agency comments that any sound conclusions and recommendations for improvement must be based upon a thorough evaluation of the nature and reasons for any lack of efficiency or effectiveness under the existing structure. We believe that although an efficiency and effectiveness review is useful for recommending improvements to individual functions within the State's health plan regulatory program, it is unnecessary to perform such a review to conclude that the program is not currently located in the optimal environment for such regulation. Moreover, we have started an efficiency and effectiveness review of the health plan regulatory program, but its completion has been delayed at the request of Corporations. Specifically, Corporations recognized that it was not fulfilling its regulatory responsibilities in an efficient and effective manner and therefore requested in 1997 a significant staffing increase that we discuss on page 11 of our report. Corporations asked in testimony before the Joint Legislative Audit Committee that we delay our efficiency and effectiveness review until it had an opportunity to fully deploy its new staff. As a result, the review is not scheduled to be completed until 1999.

2. The agency identifies statements in the report that address health care focus and contends that it is unclear whether these statements suggest that additional financial resources should be devoted to health plan regulation. Further, it indicates that one might infer from our report that moving the regulatory function to the Health and Welfare Agency would necessarily result in greater financial resources devoted to health plan regulation. The agency misses the point of our discussion of health care focus. We identified the resources the entities committed to activities related to health care as well as examined their missions because resource focus and mission alignment are the appropriate items to assess when determining the optimal environment for health plan regulation. Additionally, it was not within the scope of our audit to evaluate the adequacy of existing resources for health plan regulation, and thus our report neither states nor implies that additional resources are needed.

3. The agency mischaracterizes our discussion of California's oversight structure relative to other states. As we point out on page 3 of our report, California is unique in that its licensing and primary oversight responsibilities for health plans lie entirely within Corporations instead of within its insurance or health department. However, contrary to the agency's assertion, the report does not suggest that California's uniqueness in comparison to other states presents a weakness in its health plan regulation. Our conclusion that the current placement of health plan regulation in California is not optimal and our recommendation that the Legislature move the Health Plan Division (division) from Corporations is based on the reasons we discuss in Chapter 1, not the comparison to other states presented in the introduction to the report.

4. Our report does not diminish the importance of the financial solvency and other business-related issues involved in health plan regulation. In fact, on pages 24 and 25 of the report, we identify financial reviews to be key tasks performed by the division during its licensing and compliance functions. However, as we state on page 7, changes in law over the years have broadened Corporations' oversight of health plan operations by including more stringent requirements for Corporations to address the quality and delivery of care provided to health plan enrollees. Thus, our report concludes that the division could operate more effectively in a setting where health care is a primary mission. Further, it is important to note that because the recommendation calls for the division to be moved from Corporations, the skills and expertise of the current regulatory staff would also transfer to wherever the division is moved.

5 We disagree with the agency's statement that it is not clear whether we have given full consideration to the Managed Health Care Improvement Task Force's (task force) conclusion that the regulator should not be a purchaser of health care. Because the extent of the task force's discussion of this potential conflict was only one sentence, we sought further explanation from the task force's executive director. That discussion is reflected on page 19 of the report, followed by our discussion of conditions that may mitigate the potential conflict. Additionally, although the agency expressed concern about a potential conflict, it did not articulate any potential conflict that could not be minimized by the conditions discussed in our report.

6 The agency states that it concurs with the task force's recommendation that a regulatory entity focused solely on the regulation of managed care should be created. However, we find it interesting that although the agency criticizes our report for making recommendations as to the placement of the State's health plan regulation without performing an efficiency and effectiveness review of Corporations, it has embraced the recommendation of the task force which also reached its conclusions without performing such a review.

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Agency's response to the report provided as text only:

State of California
HEALTH AND WELFARE AGENCY
Office of the Secretary
1600 Ninth Street, Room 460
Sacramento, CA 95814
(916) 654-3454
FAX (916) 654-3343

Sandra R. Smoley, R.N.
Secretary

Department of Aging
Department of Alcohol and Drug Programs
Department of Community Services and Development
Department of Developmental Services
Emergency Medical Services Authority
Employment Development Department
Department of Health Services
Health and Welfare Data Center
Managed Risk Medical In´surance Board
Department of Mental Health
Department of Rehabilitation
Department of Social Services
Office of Statewide Health Planning and Development

April 28, 1998

Mr. Kurt R. Sjoberg
State Auditor
Bureau of State Audits
660 J Street, Suite 300
Sacramento, California 95814

Dear Mr. Sjoberg:

Thank you for the providing the Health and Welfare Agency the opportunity to respond to your report, "Department of Corporations: To Optimize Health Plan Regulation, This Function Should Be Moved to the Health and Welfare Agency." The report suggests that the regulation of managed care organizations be subsumed under the auspices of the Health and Welfare Agency instead of the Department of Corporations.

The Health and Welfare Agency concurs with the response provided by the Department of Health Services (DHS), which references the discussion of the Managed Care Improvement Taskforce that the same organization should not be both the regulator and the direct purchaser 1* of health services. The Health and Welfare Agency shares the interests of the Managed Care Improvement Taskforce regarding the prevention of conflict of interest and for that reason believes that DHS or any other entity within the Health and Welfare Agency would not be the best placement for the regulatory oversight of health care service plans.

Governor Wilson specifically proposed that the sole mission of the new regulatory entity would be to "... provide high quality of care and ensure solvency." While ensuring high quality 2 care is consistent with the mission of the Health and Welfare Agency, ensuring solvency of health plans is not directly related to the Agency's core objectives. For this reason in conjunction with concerns about the potential for a conflict of interest, it is our conclusion that regulatory oversight should be performed by another Agency.

*California State Auditor's comments on this response begin on page 43.

Again, thank you for providing us your analysis on this issue as well as the opportunity to respond.

Sincerely,

SANDRA R. SMOLEY, R.N.
Secretary

Comments

California State Auditor's Comments on the Response From the Health and Welfare Agency

To provide clarity and perspective, we are commenting on the Health and Welfare Agency's (agency) response to our audit report. The numbers correspond to the numbers we have placed in the response.

1 The agency states that it concurs with the position of the Department of Health Services, which cites the Managed Health Care Improvement Task Force's concern that "the same organization should not regulate plans and be one of their largest customers." Thus, the agency states that prevention of a conflict of interest is the reason that the Department of Health Services, or any other entity within the agency, would not be the best placement for regulatory oversight of health plans. We discuss the potential conflict on page 19 of the report as well as conditions that may mitigate it. Further, as we state in our report, the Department of Health Services, which the agency oversees, currently faces similar conflicts in its oversight of nursing homes and hospitals but has regulated these entities for many years.

2 The agency states that while ensuring high quality care is consistent with the mission of the agency, ensuring solvency of health plans is not directly related to the agency's core objectives. While we do not diminish the importance of the financial solvency and other business-related issues involved in health plan regulation, as we state on page 7, changes in law over the years have broadened the oversight of health plan operations by including more stringent requirements to address the quality and delivery of care provided to health plan enrollees. Further, it is important to note that because the recommendation calls for the Health Plan Division to be moved from the Department of Corporations, the skills and expertise of the current regulatory staff, including those related to ensuring the solvency of health plans, would also transfer to the agency. Moreover, as we discuss on page 17 of our report, the Department of Health Services, which the agency oversees, currently uses staff with financial backgrounds to review the financial condition of health plans.

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Agency's response to the report provided as text only:

State of California – Health and Welfare Agency
DEPARTMENT OF HEALTH SERVICES
714/744 P Street
P.O. Box 942732
Sacramento, CA 94234-7320
(916) 657-1431

April 27, 1998

Mr. Kurt R. Sjoberg
State Auditor
Bureau of State Audits
660 J Street, Suite 300
Sacramento, CA 95814

Dear Mr. Sjoberg:

Thank you for the opportunity to comment on your report, "Department of Corporations: To Optimize Health Plan Regulation, This Function Should Be Moved to the Health and Welfare Agency." This report recommends that the regulation of managed care entities should be transferred to the Health and Welfare Agency and that the Department of Health Services be considered for the assumption of the Department of Corporation's current health plan regulatory responsibilities.

The Managed Care Improvement Task Force considered the issue of health plan regulation and concluded that "the same organization should not both regulate plans and be one of their largest customers." This recommendation reflects a concern which the Department of Health Services shares regarding the potential for conflict of interest. As the largest purchaser of managed health care services in the State of California, the Department of Health Services recognizes the potential for difficult quality of care regulatory enforcement dilemmas if we knew that, for instance, a given fine against a managed health care company might negatively impact our budget through potential premium increases for the health care that we purchase. 1 *

We further agree with the California Managed Care Improvement Task Force's recommendation that it makes sense to have an oversight entity whose single duty is regulating the rapidly evolving managed health care industry. To that end, Governor Wilson proposed such consolidation in January of this year stating the following:

> " **(1) Concentrated Oversight:** To improve quality control, accountability and efficiency, a new department whose sole focus is managed care oversight should be established. This new entity should be led by an individual regulator, whose sole mission would be to improve accountability, provide high quality of care and ensure solvency. Such an entity would be able to more flexibly respond to innovations in the rapidly evolving managed care marketplace. The department should work closely with the best minds in the medical community to ensure that the highest standard of medical science is practiced."

Please feel free to call me if you have any questions about this matter.

Sincerely,

S. Kimberly Belshé
Director

*California State Auditor's comments on this response begin on page 47.

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Comments

California State Auditor's Comments on the Response From the Department of Health Services

To provide clarity and perspective, we are commenting on the Department of Health Services' (Health Services) response to our audit report. The number corresponds to the number we have placed in the response.

1 Health Services states that it shares the concern of the Managed Health Care Improvement Task Force (task force) that "the same organization should not regulate plans and be one of their largest customers." Because the extent of the task force's discussion of this potential conflict was only one sentence, we sought further explanation from the task force's executive director. That discussion is reflected on page 19 of the report, followed by our discussion of conditions that may mitigate the potential conflict. Additionally, although Health Services expressed concerns about a potential conflict, it did not acknowledge that it currently has a conflict in its oversight of nursing homes and hospitals, as discussed on page 20. Finally, it did not articulate any conflict that could not be minimized by the conditions discussed in our report.

cc: Members of the Legislature
Office of the Lieutenant Governor
Attorney General
State Controller
Legislative Analyst
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps