THE ASSISTANT SECRETARY OF DEFENSE
1200 DEFENSE PENTAGON
WASHINGTON, DC 20301-1200

HEALTH AFFAIRS

AUG 14 2007

The Honorable Carl Levin
Chairman, Committee on Armed Services
United States Senate
Washington, DC 20510-6050

Dear Mr. Chairman:

Section 736 of the John Warner National Defense Authorization Act for Fiscal Year 2007, Public Law 109-364, directs the Secretary to submit a report regarding contracting mechanisms under consideration for future contracts for health care support. The provision directs that an assessment be undertaken of the advantages and disadvantages of a single five year contract and a single optional extension term of five years. The enclosed report presents a detailed discussion of our review.

It should be noted that section 736 also authorizes the Department to extend the current TRICARE regional contracts for one or two years, provided that such an extension "is in the best interests of the Department of Defense, is cost effective, and will facilitate the effective administration of the TRICARE program or ensure continuity in the delivery of health care under the TRICARE program." At this time, the Department does not intend to exercise this authority to extend the contracts. Delay is likely to be costly to the Government, owing to the need to extend contracts on a sole-source basis, and would defer the opportunity to make significant improvements to future contracts. It is our view that while the current contracts are working well, there are compelling reasons to proceed with follow-on contracts.

A new acquisition has the promise of renewed competition from the health care industry for the TRICARE business with attendant benefits in cost and performance. We intend to include several enhancements in the new contracts, including more finely-tuned performance standards, better alignment of financial risks, appropriate financial rewards for excellence in contractor performance, and a heightened focus on customer service. As a result of these enhancements, we believe we will achieve improved performance and increased efficiency in the delivery of critical services for our military families.

Thank you for your continued support of the Military Health System.

Sincerely,

Sir:
Hoping you concur that open competition on a level playing field will promote quality of care, innovation, service portion, and eventually cost-effectiveness.
With respect
Ward

S. Ward Casscells, MD

Enclosure:
As stated

cc:
The Honorable John McCain
Ranking Member

Report to Congress

Contracting Mechanisms
for
Health Care Service Support Contracts

REPORT TO CONGRESS

CONTRACTING MECHANISMS FOR HEALTH CARE SERVICE SUPPORT CONTRACTS

Overview

Section 736 (b) of the John Warner National Defense Authorization Act for Fiscal Year 2007, Public Law 109-364, directs the Secretary of Defense to submit a report regarding contacting mechanisms under consideration for future contracts for health care support. Our assessment of the advantages and disadvantages for the Department and our beneficiaries of establishing a contract for a single term of five years with a single option period of an additional five years, depending on performance, is included.

This report describes the current contracting approach utilized for health care in the three TRICARE regional contracts, as well as the approach planned for the next contracts to provide the framework for a robust competition, improve program efficiency, and encourage superior performance.

Current Contracting Approach

The overarching aim of our TRICARE contracts is to assist the military treatment facility (MTF) commanders and our TRICARE regional directors in operating an integrated health care delivery system—combining resources of the military's direct medical care system and the contractor's regional health care support—to provide health, medical, and administrative support services to our eligible beneficiaries. We make every effort to optimize this partnership for the benefit of all Military Health System (MHS) beneficiaries: active duty personnel, MTF enrollees, civilian network enrollees, and non enrollees. Beneficiary satisfaction at the highest level possible is a key goal. At the same time, we seek to attain the best value health care services in support of this mission, using commercial practices when practical.

Our regional contractors must provide all services necessary to fully support the Department's primary wartime readiness mission while supplementing the services provided through Department-owned and/or operated health care facilities. The regional contractors must offer a specified uniform health care benefit while at the same time providing the expertise of health care organizations and health benefit administrators in incorporating and operating the best practices of the private sector in support of the Department's health care delivery system. Additionally, the regional contractors must provide the Department with clinical and administrative services that are comparable to the best offered in the civilian community. Ultimately, the contractors must fulfill the objectives of the contract while complying with the scope and structure of TRICARE, as outlined in statute and in regulation in order to deliver all services in a manner that

achieves a fully integrated health care delivery and financing system for all MHS beneficiaries.

Assessment of a Contract Approach with a Single Term of Five Years with a Single Option Period of an Additional Five Years

The following is our assessment of the advantages and disadvantages of providing contracts for a single term of five years with a single option period of an additional five years as the framework by which health care services are procured for our beneficiaries:

Advantages

A longer-term contract with a base period of five years might provide greater opportunity for cost savings by encouraging contractor development and implementation of longer-term programs and business approaches that would otherwise not have sufficient opportunity to mature under a shorter-term contract. Budget stability might be enhanced due to greater operating efficiencies in the implementation of program requirements. For example, a longer contract might decrease the government's administrative expense by reducing the frequency of procurement actions and allowing for a longer-term relationship with a contractor, enabling better cost predictability, at least in the case of administrative costs.

Provision of a longer investment recapture period might increase competition by allowing offerors a longer period to recover investment costs and implement cost-reduction plans. A longer-term contract might be more attractive to a new offeror since they would be given more time to adapt business plans and delivery systems and would have a longer period under which to operate.

Assuming "excellent" performance would result in the exercise of a five-year option, the contractor would be in place for a longer term, resulting in enhanced continuity of services with less disruption to TRICARE beneficiaries.

Disadvantages

By statute (10 USC 1072(7)), TRICARE contractors must agree to underwrite health care costs. This requirement is an impediment to competition as it requires contractors to assume risk for highly volatile health care costs over which they do not have complete control. This statutory mandate requires that contractors be as accurate as possible in estimating costs, since many millions of dollars would be at risk if their estimates were to prove inaccurate. This contract approach would require offerors to propose ten years of health care costs. Predicting health care costs that far in the future is extremely difficult. Instituting this requirement would certainly discourage potential

offerors from participating in the process and/or require significant contingency plans to address the risks associated with a ten-year period.

It is likely that a five-year contract with an option period of five years would inhibit competition for a contract at the end of the ten-year period. This contract mechanism would limit the health care industrial base for DoD by entrenching the incumbent regional contractors through the contract performance period of ten years. It would likely reduce the number of potential offerors, since their exposure to TRICARE would have occurred some ten to twelve years earlier.

In order to exercise of the option, a contractor would be required to maintain an "excellent" performance rating, which is undefined, but likely higher than the standard of performance currently required or needed by the government. In order to assess a contractor's "excellent" level of performance, an additional level of quality surveillance would be required for the government to evaluate, document, and monitor performance, resulting in increased administrative effort and costs to the government. Additionally, it is likely that a contractor would incur additional related costs to be "excellent" and that any increased costs would be passed on to the government through higher overhead and administrative costs.

Assessment of a Contract Approach with a Single Term of One Year with One-Year Options

The following is our assessment of the advantages and disadvantages of providing contracts with a single term of one year with five one-year options as the framework for procuring health care services for our beneficiaries:

Advantages

The contract structure of a one-year base period and five one-year option periods allows for periodic updates of health care costs, thus permitting better budget predictability and less risk for contractors.

A shorter base period with shorter option periods reduces the length of the government's contractual obligation and therefore permits the government much greater latitude if the contractor's performance is unsatisfactory.

A one-year contract with five one-year option periods provides the maximum impetus for encouraging competition, because potential offerors can expect a re-competition after the exercise of the option periods, or in the case of the regional contracts, a least every five to six years. Importantly, under this arrangement, contractors have much greater incentive to perform, as each year of the contract is awarded separately.

Disadvantages

Conversely, a one-year contract with one-year options may result in greater costs to the government due to added costs incurred for more frequent re-procurements and transitions.

Contractors potentially have less time to recover significant investments including the large investment required to compete for contract award. As a result, cost to the government may increase in order to ensure that contractor investments are recovered in a shorter time period. Additionally, re-competing every five or fewer years may result in more frequent contractor turnover and increased disruption to the program and its beneficiaries.

Approach for Follow-on Contracts

A thorough assessment of the current contracts was the basis to modify the approach for the follow-on contracts. The basic contract type will be changed to cost-plus-fixed fee (CPFF) to better reflect risk associated with the contract and the ability of the contractor to influence costs. Costs controlled by the contractor will be separated from uncontrollable costs. Fees will be reduced from both earned fee and potential losses, and cost incentives will be put in place to encourage savings where the contractor has control, and the government will appropriately assume risk for uncontrollable factors.

Health care will be separated into two groups: civilian network enrollees over whom the contractor has control; and, MTF-enrolled Prime and non-Prime beneficiaries (extra and standard beneficiaries) over whom the contractor has little, if any, control.

Conclusion

Our analysis of these and other factors has led us to conclude that our ability to hold contractors accountable improves greatly with the one-year base and one-year options approach. The Department believes that the opportunity to make significant improvements in the contracts should not be deferred. While the current contracts are working well, there are compelling reasons to proceed with acquisition of follow-on contracts.

A new acquisition has the promise of renewed competition from the health care industry for the TRICARE business, with attendant benefits in cost and performance. We intend to include several enhancements in the new contracts, including more finely-tuned performance standards, better alignment of financial risks, appropriate financial rewards for excellence in contractor performance, and a heightened focus on customer service.

As a result of these enhancements, we believe we will achieve improved performance and increased efficiency in the delivery of health care services for our military families.