COVINGTON & BURLING

1201 PENNSYLVANIA AVENUE NW
WASHINGTON, DC 20004-2401
TEL 202.662.6000
FAX 202.662.6291
WWW.COV.COM

WASHINGTON
NEW YORK
SAN FRANCISCO
LONDON
BRUSSELS

May 18, 2004

The Honorable Charles E. Grassley
Chairman, Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Senator Grassley:

Our firm represents a large number of states and state agencies in their dealings with the federal government on Medicaid program issues. Several of our clients have forwarded to us a copy of the letter that was recently sent to you by Mark McClellan, the new Administrator of the Centers for Medicare & Medicaid Services ("CMS") on the subject of intergovernmental transfers ("IGTs"). We know of and are working with many states that are trying to grapple with CMS's heightened focus on IGTs as they seek to establish predictable and secure funding practices in their Medicaid programs. They and we are concerned with the approach to IGTs, and to Medicaid funding generally, that is set forth in Dr. McClellan's letter. We have written separately to CMS to express these concerns, but since the letter to your office sets forth interpretations that are more restrictive than any previously voiced by CMS, we felt it appropriate to provide you a more complete discussion of the legal framework than is included in Dr. McClellan's letter.

Over the past year or so, states have heard a number of different theories from CMS as to why some IGTs are inappropriate or unlawful. These theories have taken a number of different approaches and have been expressed in a variety of formats, including discussions with agency staff, letters or e-mails to individual state officials, and congressional testimony. From these communications, state decisionmakers have been trying to ascertain what the federal policy actually is, make judgments as to its validity, and predict how the policy as currently articulated would or would not apply to particular situations in each of their states. Not surprisingly, this has been a very unsatisfactory situation for the responsible state officials, particularly when many believe that the governing federal regulation permits intergovernmental transfers of all types. (That regulation, 42 C.F.R. 433.51, states that public funds may be considered as the State's share if the funds are "transferred from other public agencies . . . to the State or local agency.")

Dr. McClellan's April 28 letter to you attempts to set forth an agency position based on a new reading of section 1903(w)(6) of the Social Security Act, which was added to the statute by the Medicaid Voluntary Contribution and Provider-Specific Tax Amendments of 1991,

Pub. L. No. 102-234. The new approach suggests an agency view that the law considers IGTs to be permissible only if derived from state or local taxes (or funds appropriated to state teaching hospitals) and only if made by a "unit of government" as distinguished from public entities generally. The letter further suggests that any IGT not meeting these criteria would be an unlawful "donation." Finally, the letter applies these new, narrow interpretations to certified public expenditures ("CPEs"), a long-recognized means of meeting the state contribution requirement for public providers. This newly articulated position is not only inconsistent with the governing law and regulations, it is also directly contrary to the agency's previous explanations as to the scope and meaning of section 1903(w)(6).

Dr. McClellan's statement that section 1903(w)(6) prohibits intergovernmental transfers unless they are derived from state or local taxes is neither the meaning nor the intention of the statute. Until now, the provision has been understood to mean that *if* CMS were to adopt regulations limiting the use of IGTs, it could not restrict IGTs derived from state or local taxes, unless those taxes were impermissible under the statute. That is all that the terms of the statute provide. In addition, there is an uncodified provision in the 1991 amendments that recognizes the continued viability of the pre-existing regulation on IGTs (now contained in 42 C.F.R. 433.51) and specifically prohibits the agency from "chang[ing] the treatment" of IGTs by interim final regulation. Pub. L. No. 102-234 § 5(b), 105 Stat. 1793 (1991). The prohibition on "interim final regulations" means that the agency cannot change its regulation without first publishing a proposed rule and soliciting public comment. In addition, the 1991 Amendments have an unusual provision that requires the Secretary to "consult with the States before issuing any regulations under this Act." Here, there has been no consultation with the State nor any change in regulations that would support CMS's new approach to IGTs.

It is highly doubtful that CMS could, even if it followed the prescribed process, restrict IGTs in the manner set forth in Dr. McClellan's letter. CMS (and its predecessor agency, the Health Care Financing Adminstration or "HCFA") has consistently advised states that under the 1991 statute they could continue to make intergovernmental transfers regardless of the source of the transferred funds. In 1993, in conjunction with the final rules under the 1991 law, it stated that the rules prohibiting donations **"do not interfere with the State's use of intergovernmental transfers** unless the transferred funds are derived by the unit of government from donations or taxes that would not otherwise be recognized as the non-Federal share of Medicaid." (57 Fed. Reg. 55118). In more recent years, CMS has also repeatedly described the language in the 1991 amendments as limiting its authority to restrict IGTs, not as independently prohibiting some types of those IGTs that are not derived from state or local taxes. See 66 Fed. Reg. 3148, 3164 (2001) (noting, in modifying Upper Payment Limit regulations, that "IGTs have their own statutory basis and those provisions are not being interpreted or modified by this regulation"); 65 Fed. Reg. at 60157 (noting that "the use of IGTs to move funds between government entities makes it possible to generate enhanced Federal matching payments" but that "there are statutory limitations placed on the Secretary which limit the authority to place restrictions on IGTs.").