

**Memorandum**

Date . . . . . AUG 15 1995

From June Gibbs Brown  
Inspector General *June G Brown*

Subject Review of Capital-Related Cost Prospective Payment System's Base Year 1992  
(A-07-95-01127)

To Bruce C. Vladeck  
Administrator  
Health Care Financing Administration

Attached are two copies of our final report entitled, "Review of Capital-Related Cost Prospective Payment System's Base Year 1992." The objective of our review was to determine the accuracy of base year estimates used by the Health Care Financing Administration (HCFA) to calculate prospective rates for capital expenditures paid to hospitals. Although HCFA used the best data available at the time, current actual cost experience indicates HCFA's forecast estimates for base year costs are too high. Higher estimates will result in excessive payments to hospitals. By adjusting the estimates to reflect more current data, HCFA would reduce payment rates for capital-related expenditures by about 7.5 percent. In order to prevent overpaying hospitals in the future for capital costs, we are recommending that HCFA adjust rates to reflect more current cost data. We have kept your staff apprised of the status of our review as it progressed. In a meeting held on March 17, 1995, we informed HCFA officials of the preliminary results of our review and of our recommendations. Although basically agreeing with the contents of the report, HCFA deferred specifically commenting on our recommendations.

Our objectives were to review the accuracy of forecasts made by HCFA in attempting to establish 1992 costs using 1989 data. This included review of forecasts for (i) an audit adjustment factor and a re-open adjustment factor<sup>1</sup> and (ii) a 1989 to 1992 update factor. The evaluation is part of a series of reviews we will perform on the capital cost prospective payment system (PPS).

To accomplish our objectives, we used data from the Hospital Cost Report Information System (HCRIS) to analyze the accuracy of HCFA's forecasts for the two adjustment factors and the update factor. We also evaluated and used data supplied by HCFA relative to HCFA's initial estimates and HCFA's ongoing analysis of the accuracy of

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<sup>1</sup>To predict a final 1989 settled rate, HCFA had to compensate for changes which would result after audit and after re-opening of settled cost reports. As a result, HCFA developed these two estimation factors to apply to the submitted data.

the original estimates. This included numerous conversations with HCFA officials in the Bureau of Program Operations and the Office of the Actuary. The HCFA officials provided guidance in accessing the HCRIS databases as well as evaluating the results of our calculations. The HCFA was very helpful in assisting us with this review.

While HCFA has taken great pains to devise and implement an equitable PPS for capital costs, information now available indicates that HCFA's 1992 estimated base year rate is 7.5 percent higher than current actual costs. A 7.5 percent reduction would also correct all forecasting estimates that HCFA had to make in arriving at an anticipated rate to implement the capital costs PPS. The total effect of overpayments in relation to cost used as the basis for the capital cost PPS will gradually increase from 1996 until the capital cost PPS is fully implemented in 2002.

If HCFA makes such a reduction, it will have taken advantage of a window of opportunity to prevent overpayments before they occur. By continuously analyzing estimates in relation to actual experience as more and more actual data becomes available and making any necessary adjustments, HCFA will be in the position of minimizing the effects of any errors in estimates used to determine Federal rates used for making payments under the capital cost PPS.

We recommend that HCFA:

1. Consider reducing payment rates by 7.5 percent to more accurately reflect costs of the base year used for the capital cost PPS.
2. Continue to monitor the most current data (i.e., closing of unsettled cost reports for 36 percent of hospitals) and make any necessary further adjustments to the base rate.

In their response to our report, HCFA officials stated that they agreed with our analysis that the Federal capital rate reflects a known over-estimation of base year costs. While HCFA officials agreed with our analysis, they deferred specifically commenting on our recommendations until after receiving public comments on their proposed PPS rule for Fiscal Year (FY) 1996. The proposed rule discusses the overstatement of the PPS rate, and requests public comments on the appropriateness of making a 7.47 percent reduction to the rate based on current data on the FY 1992 capital cost per case. The HCFA's comments are presented as Attachment E to this report.

We would like to take this opportunity to thank HCFA staff for helping us during this review. Their efforts expedited the completion of our audit.

Page 3 - Bruce C. Vladeck

We would appreciate your views and the status of any further action taken or contemplated on our recommendations within the next 60 days. If you have any questions, please call me or have your staff contact George M. Reeb, Assistant Inspector General for Health Care Financing Audits, at 410-966-7104. Copies of this report are being sent to other interested Department officials.

To facilitate identification, please refer to Common Identification Number A-07-95-01127 in all correspondence relating to this report.

Attachments

**Department of Health and Human Services**

**OFFICE OF  
INSPECTOR GENERAL**

**REVIEW OF CAPITAL-RELATED COSTS  
PROSPECTIVE PAYMENT SYSTEM'S  
BASE YEAR 1992**



**JUNE GIBBS BROWN**  
**Inspector General**

**AUGUST 1995**  
**A-07-95-01127**

**Memorandum**

Date · AUG 15 1995

From June Gibbs Brown  
Inspector General *June G Brown*

Subject Review of Capital-Related Cost Prospective Payment System's Base Year 1992  
(A-07-95-01127)

To

Bruce C. Vladeck  
Administrator  
Health Care Financing Administration

This final report provides you with the results of our review of the accuracy of base year estimates used by the Health Care Financing Administration (HCFA) to calculate prospective rates for capital expenditures paid to hospitals. Although HCFA used the best data available at the time, current actual cost experience indicates HCFA's forecast estimates for base year costs are too high. Higher estimates will result in excessive payments to hospitals. By adjusting the estimates to reflect more current data, HCFA would reduce payment rates for capital-related expenditures by about 7.5 percent. In order to prevent overpaying hospitals in the future for capital costs, we are recommending that HCFA adjust rates to reflect more current cost data. We have kept your staff apprised of the status of our review as it progressed. In a meeting held on March 17, 1995, we informed HCFA officials of the preliminary results of our review and of our recommendations. We appreciate the help of HCFA's staff during our review. The HCFA generally agreed with our analysis, but deferred specifically commenting on our recommendations.

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**BACKGROUND**

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Under section 1886(d) of the Social Security Act (the Act), the Medicare program pays for the operating costs attributable to hospital inpatient services under a prospective payment system (PPS). A PPS pays for care using a predetermined specific rate for each discharge. As originally enacted, the Act excluded capital-related (capital) costs (those costs associated with the use of physical assets) from the definition of inpatient operating costs for hospitals before October 1, 1986.

Capital costs continued to be reimbursed on a reasonable cost basis. The HCFA initially proposed regulations to incorporate capital costs into a PPS effective Federal

Fiscal Year (FY) 1987. However, the Urgent Supplemental Appropriations Act of 1986 amended the Act to postpone including capital costs with operating costs for 1 year.

Subsequently, HCFA published a final rule to include capital costs in a PPS effective October 1, 1987. However, Public Law (P.L.) 100-203 voided this final rule and required the Secretary of Health and Human Services (the Secretary) to establish a PPS for capital costs for cost reporting periods beginning in FY 1992. The Secretary was given substantial freedom in implementing a PPS for capital costs.

Under this authority, HCFA developed a capital cost PPS, using 1992 as the base year. The HCFA took great effort to devise and implement an equitable PPS for capital cost. In developing the system, hospital industry comments relative to implementing an equitable PPS were considered in detail. The result is an extremely complex system for determining the amounts hospitals will be reimbursed under the capital cost PPS, especially during the 10-year transition to a full prospective system in 2002. This complex system is described in general terms below and illustrated in more detail in Attachment A.

At the time HCFA developed the 1992 base year rate, 1989 cost reports were the most current data available. The 1989 data consisted primarily of unaudited or "as submitted" cost reports. To predict a final 1989 settled rate, HCFA had to compensate for changes which would result after audit and after re-opening of settled cost reports. As a result, HCFA developed two estimation factors to apply to the submitted data: the audit adjustment factor and the re-open factor.

The audit adjustment factor is an estimate of changes that would occur to the submitted 1989 costs after review and settlement by the fiscal intermediaries (FI). The re-open adjustment factor is an estimate of changes that would occur to costs if the settled cost reports are re-opened to resolve any disagreements between hospitals and the FIs on final settled costs.

After estimating a final 1989 settled rate using these two factors, HCFA applied a factor to forecast inflation from 1989 to 1992. This inflation estimate is known as the update factor. The result was the 1992 estimated base year rate. This base year estimate became the starting point for determining payment rates for 1992 through 2001, as well as the rate for 2002 and beyond.

Other adjustment factors were subsequently applied to the 1992 estimated base year rate to fully consider all situations which could affect reasonable costs. Payment rates for 1992 through 1995 were also affected by a budget neutrality factor. This factor limited payment rates to 90 percent of the estimated 1992 actual costs.

## SCOPE

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We performed our review in accordance with generally accepted government auditing standards. Our objectives were to review the accuracy of forecasts made by HCFA in attempting to establish 1992 costs using 1989 data. This included review of forecasts for (i) an audit adjustment factor and a re-open adjustment factor and (ii) a 1989 to 1992 update factor. This review was performed at the Office of Audit Services' Kansas City regional office from January 1995 to March 1995. The evaluation is part of a series of reviews we will perform on the capital cost PPS.

In analyzing the accuracy of HCFA's forecasts for the first two factors, we used data from PPS-5 (FY 1988) and PPS-6 (FY 1989) Hospital Cost Report Information System (HCRIS) data bases. In analyzing the accuracy of HCFA's forecasts for the third factor, we used data from PPS-8 (FY 1991) and PPS-9 (FY 1992) HCRIS data bases. We have previously determined that HCRIS is generally an accurate data base for analysis purposes.

We also evaluated and used data supplied by HCFA relative to HCFA's initial estimates and HCFA's ongoing analysis of the accuracy of the original estimates. This included numerous conversations with HCFA officials in the Bureau of Program Operations and the Office of the Actuary. The HCFA officials provided guidance in accessing the HCRIS databases as well as evaluating the results of our calculations. The HCFA was very helpful in assisting us with this review. In a meeting held on March 17, 1995, we informed HCFA officials of the preliminary results of our review and of our recommendations.

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## RESULTS OF REVIEW

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While HCFA has taken great pains to devise and implement an equitable PPS for capital costs, information now available indicates that HCFA's 1992 estimated base year rate is 7.5 percent higher than current actual costs. We are recommending that HCFA adjust payment rates to reflect current experience. We are also recommending that HCFA continue to analyze data as it becomes available and make any necessary adjustments indicated by the additional data.

To implement the PPS system HCFA used the most current data available to forecast the anticipated rate for 1992. The importance of the accuracy of the estimated base year rate is summed up by the Prospective Payment Assessment Commission (ProPAC). The ProPAC stated in part:

*"it is critical that this per case payment rate...be set appropriately....any error, above or below the actual average costs per case, would be perpetuated in the payment system."*

The following schedule summarizes HCFA's use of forecasts in the establishment of a Federal FY 1992 estimated base year rate and our calculations which used more current data.

	Rate per Discharge		Difference
	HCFA 1/	OIG 2/	
Per submitted 1989 cost reports	\$ 560	\$ 560	\$ 0
Forecasted Audit and Re-open Adjustments	<u>-33</u>	<u>-53</u>	<u>20</u>
Forecasted 1989 Settled Federal Rate	<u>\$ 527</u>	<u>\$ 507</u>	<u>20</u>
Forecasted 1989 to 1992 Update 3/	+114	+86	28
1992 Estimated Base Year Rate	<u>\$ 641</u>	<u>\$ 593</u>	<u>48</u>

1/ Details are provided on Attachments A and B.

2/ Details are provided on Attachments C and D.

3/ Both calculations consider a subsequent reduction to the update factor of \$51.

### 1989 Audit and Re-Opening Adjustments

The HCFA combined cost report data for hospital FYs 1988 and 1989 to determine a cost per discharge of \$560 for Federal FY 1989. Because the FY 1989 cost report data was virtually unaudited, HCFA reduced the "as submitted" cost report data for the estimated effect of audits on the cost reports and re-opening settled cost reports. The HCFA final estimate of the 1989 settled rate was \$527.

We examined FY 1988 and FY 1989 cost reports on HCRIS in January 1995. At that time HCRIS showed that 99 percent of the cost reports had been settled. Using HCFA's calculation methodology and the current HCRIS information shows an actual settled rate of \$507 in comparison to HCFA's estimated rate of \$527. The \$20 difference needs to be eliminated in the PPS capital rate.

### Update Factor

Because 1992 was the first year of capital PPS, HCFA adjusted its estimated 1989 settled rate to provide for anticipated inflationary increases. This adjustment or update factor increased the estimated 1989 settled rate to arrive at a 1992 estimated base year rate. The Omnibus Budget Reconciliation Act of 1993 (OBRA) reduced the update

factor "...to correct inflation forecast errors that had accumulated by May 1993." The reduction in the update factor reduced the 1992 estimated base year rate to \$641.

Our examination of Federal FY 1992 cost reports on HCRIS in January 1995 showed that 64 percent of the cost reports had been settled. Using HCFA's calculation methodology and the current HCRIS information shows a settled rate of \$607 in comparison to the OBRA revised rate of \$641. Considering an audit and re-open adjustment factor based on historical experience in relation to the unsettled 1992 cost reports, we estimate that the cost per discharge for Federal FY 92 will eventually fall to about \$593, a cumulative reduction of \$48.

### Summary

The \$48 (\$641 - \$593) reflects a reduction of the audit adjustment estimate by \$20 and the update estimate by \$28. Using current data will lower estimated costs by 7.5 percent and, if implemented, would result in lowering the 1996 Federal payment rate. Due to the budget neutrality adjustments, the difference has not, as yet, resulted in hospitals being paid more than costs under the capital cost PPS through 1995. However, if the rate is not reduced by 7.5 percent, the Federal payment rate per discharge will reflect \$35 more than costs considering actual base year costs in 1996. (See Attachments A and C for detailed descriptions for the difference between \$48 and \$35.) A 7.5 percent reduction also corrects all forecasting estimates that HCFA had to make in arriving at an anticipated rate to implement the capital costs PPS. The total effect of overpayments in relation to cost used as the basis for the capital cost PPS will gradually increase from 1996 until the capital cost PPS is fully implemented in 2002.

The 7.5 percent represents estimates using the most current available data. If HCFA makes such a reduction, it will have taken advantage of a window of opportunity to prevent overpayments before they occur. By continuously analyzing estimates in relation to actual experience as more and more actual data becomes available and making any necessary adjustments, HCFA will be in the position of minimizing the effects of any errors in estimates used to determine Federal rates used for making payments under the capital cost PPS.

### Recommendations

We recommend that HCFA:

1. Consider reducing payment rates by 7.5 percent to more accurately reflect costs of the base year used for the capital cost PPS.

2. Continue to monitor the most current data (i.e., settling of unsettled cost reports for 36 percent of hospitals) and make any necessary further adjustments to the base rate.

**HCFA's Comments**

In their response to our draft report, HCFA officials agreed with our analysis that the Federal capital rate reflects a known over-estimation of base year costs. While HCFA officials agreed with our analysis, they deferred specifically commenting on our recommendations until after receiving public comments on their proposed PPS rule for FY 1996. The proposed rule discusses the overstatement of the PPS rate, and requests public comments on the appropriateness of making a 7.47 percent reduction to the rate based on current data on the FY 1992 capital cost per case.

The HCFA also provided technical comments which we considered in preparing this final report. The entire text of HCFA's comments is contained in Attachment E to this report.

## HCFA Computation of Capital Cost PPS

FY	Description	Rate	Capital Cost per Discharge	Footnotes
1992	Unadjusted national capital cost		\$560.11	①
	Audit adjustment Factor	0.9380	525.38	①
	Re-open adjustment factor	1.0035	527.22	①
	National capital cost - FY 1989		527.22	①
	Update Factor for FYs 1989 - 1992	1.3130	692.24	②
	Transfer factor	1.0090	698.47	③
	Payment Parameter adjustments	0.6649	464.42	③
	Outlier factor	0.9497	441.06	④
	Exceptions reduction factor	0.9813	432.81	④
	Budget neutrality factor	0.9602	415.59	⑤
	Final 1992 Federal Payment Rate		\$415.59	
1993	FY 1989 cost per discharge updated to 1992		464.42	⑥
	Update factor	1.0607	492.61	⑥
	GAF/DRG budget neutrality factor	0.9980	491.63	⑥
	Outlier reduction factor	0.9496	466.85	⑥
	Exceptions reduction factor	0.9756	455.46	⑥
	Budget neutrality factor	0.9162	417.29	⑥
	Final 1993 Federal Payment Rate		\$417.29	
1994	Updated cost per discharge to 1993		491.63	
	P.L. 103-66 standard federal rate reduction	0.9260	455.24	⑦
	Update factor	1.0304	469.08	
	GAF/DRG budget neutrality factor	1.0053	471.57	
	Outlier reduction factor	0.9454	445.82	
	Exceptions reduction factor	0.9485	422.86	
	Budget neutrality factor	0.8947	378.34	⑦
	Final 1994 Federal Payment Rate		\$378.34	⑦
1995	Updated cost per discharge to 1994		471.57	
	Update factor	1.0344	487.79	
	GAF/DRG budget neutrality factor	0.9998	487.69	
	Outlier reduction factor	0.9414	459.12	
	Exceptions reduction factor	0.9734	446.90	
	Budget neutrality factor	0.8432	376.83	
	Final 1995 Federal Payment Rate		\$376.83	
	Budget Neutrality Factor Ends			
1996	Updated cost per discharge to 1995		487.69	
	Update factor	1.0233	499.06	⑧
	GAF/DRG budget neutrality factor	1.0000	499.06	⑧
	Outlier reduction factor	0.9414	469.81	⑧
	Exceptions reduction factor	0.9784	459.67	⑧
	Final 1996 Federal Payment Rate		\$459.67	

### HCFA Computation of Capital Cost PPS

Footnotes:

- ① The \$560.11 is an estimate made by OAS for illustration purposes. To determine the FY 1989 cost per discharge, HCFA adjusted the "as submitted" cost reports by -6.2 percent for anticipated audit effects and the "settled" cost reports that had not been re-opened by 0.35 percent for anticipated re-opening effects. The HCFA's final product, after adjustments, was a FY 1989 cost per discharge of \$527.22.

We divided \$527.22 by 1.0035 to reverse the estimated re-opening effect. The result was a cost per discharge of \$525.38. We estimated the total re-opening effect at approximately \$2 (\$527 - \$525).

We then divided the \$525.38 by 0.9380 to reverse the estimated audit effect. The result was a cost per discharge of \$560.11. We estimated the total audit effect at approximately -\$35 (\$525 - \$560).

The total effect was a -\$33 (+\$2 and -\$35) resulting in a cost per discharge of \$527.

- ② Because FY 1992 was the first year of the capital PPS, HCFA updated the FY 1989 data for expected inflation. For FYs 1990 through 1992, HCFA expected capital-related costs to increase by 31.30 percent. This adjustment increased the 1989 cost per discharge to \$692.24. We estimated the total effect at approximately \$165 (\$692 - \$527).

(OBRA 1993 effectively reduced the 1992 cost per discharge from \$692 to \$641, see Footnote ⑦ and Attachment B for further discussion.)

- ③ The HCFA increased the Federal rate "by 0.9 percent for patients who are transferred before reaching the geometric mean length of stay." This increased the cost per discharge to \$698.47.

The Federal rate was adjusted by 0.6649 for payment parameter adjustments. The purpose of the parameter adjustments was to standardize the national average. It considered six factors: (1) the case-mix index, (2) large urban areas, (3) geographic wage index, (4) disproportionate share, (5) indirect medical education, and (6) cost-of-living. The parameter adjustments reduced the cost per discharge to \$464.42.

- ④ The HCFA then adjusted for the outlier and exceptions reduction factors. These factors were not cumulative and only affected the current year's Federal rate. The HCFA allows for additional outlier and exceptions payments for certain hospitals. The cost per discharge is adjusted to account for the expected payments. For FY 1992, the cost per discharge was reduced with factors of 0.9497 and 0.9813 respectively. The effect reduced the cost per discharge to \$432.81.

### HCFA Computation of Capital Cost PPS

Footnotes:

- ⑤ To determine the final Federal rate for 1992, HCFA applied the budget neutrality factor. The budget neutrality factor was set "so that estimated aggregate payments for inpatient hospital capital costs will equal 90 percent of the estimated payments that would have been made for capital-related costs on a reasonable cost basis during the fiscal year." This factor ends after 1995.

Like the outlier and exceptions reductions factors, the budget neutrality factor was not cumulative and only effected the current year. In FY 1992, the budget neutrality factor was 0.9602, which reduced the capital cost per discharge to \$415.59.

- ⑥ HCFA recalculated the Federal rate each year. From the 1992 adjustments, the outlier, exceptions reduction, and budget neutrality factors did not carry forward into FY 1993. In other words, HCFA used the cost per discharge of \$464.42 as the basis for 1993.

Each fiscal year, HCFA applied an update factor and a geographic adjustment factor / diagnosis related group (GAF/DRG) budget neutrality factor to the previous year's rate. These factors were cumulative and the cost per discharge after applying these factors was the basis for the next year. The FY 1993 Federal rate after these adjustments was \$491.63.

HCFA applied new outlier, exceptions reduction, and budget neutrality factor adjustments to the Federal rate. As in FY 1992, these adjustments did not carry forward to the next year. The FY 1993 Federal rate after these adjustments was \$417.29.

- ⑦ Through P.L. 103-66 (OBRA 1993), Congress corrected forecasting errors in the original update factor (for FYs 1990 through 1992 of 31.30 percent). This lowered the FY 1994 Federal rate to \$455.24. HCFA then applied the same type of adjustments as 1993. The final FY 1994 Federal rate was \$378.34.

Because of the budget neutrality factor, the correction of the update factor in OBRA 1993 will not have an effect until FY 1996. Had the correction not have been made, the budget neutrality factor would have changed. The final FY 1994 Federal rate would still have been \$378.34.

**HCFA Computation of Capital Cost PPS**

Footnotes:

- ③ The factors for FY 1996 are estimates that were published in the September 1, 1994 Federal Register. These factors could change and do not include a budget neutrality factor. However, based upon these factors, the Federal rate will be \$459.67 for FY 1996.

## 1992 Adjusted Federal Rate per Discharge HCFA Computation

The HCFA's forecast of a Federal FY 1992 base year rate using prior data can be generally summarized as follows:

Per 1989 submitted cost reports		\$ 560
Forecasted:		
Audit Adjustment Factor	(-6.20%)	- 35
Re-open Adjustment Factor	(+.35%)	<u>+ 2</u>
	(-5.85%)	33
Forecasted Final 1989 Federal Rate		<u>\$ 527</u>
Forecasted:		
Update from 1989 to 1992 Factor	(+31.30%)	<u>+ 165</u>
Forecasted 1992 Rate		<u>\$ 692</u>

(Details are shown in Footnotes ① and ② on Attachment A)

In OBRA 1993, the then current information showed the update factor from 1989 to 1992 should have been 21.57 percent instead of 31.30 percent. To reduce the Federal rate to the appropriate level, the following calculation was used:

$$\frac{1.2157}{1.3130} = 0.9260 \text{ or } -7.4 \text{ percent}$$

Reducing the Federal rate by 7.4 percent ( $\$692 * .9260$ ) resulted in a product of \$641. This, in effect, reduced the update factor from \$165 to \$114 ( $\$641 - \$527$ ).

Also see Footnote ⑦ on Attachment A.

OIG Computation of Capital Cost PPS

FY	Description	Rate	Capital Cost per Discharge	Footnotes
1992	Unadjusted national capital cost		\$560.11	①
	Audit and Re-open adjustment factors	0.9055	507.20	①
	National capital cost - FY 1989		507.20	
	Update Factor for FYs 1989 - 1992	1.3130	665.95	
	Transfer factor	1.0090	671.95	
	Payment Parameter adjustments	0.6649	446.78	
	Outlier factor	0.9497	424.30	
	Exceptions reduction factor	0.9813	416.37	
	Budget neutrality factor	0.9981	415.59	②
	Final 1992 Federal Payment Rate		\$415.59	②
1993	FY 1989 cost per discharge updated to 1992		446.78	
	Update factor	1.0607	473.90	
	GAF/DRG budget neutrality factor	0.9980	472.95	
	Outlier reduction factor	0.9496	449.11	
	Exceptions reduction factor	0.9756	438.15	
	Budget neutrality factor	0.9524	417.29	②
	Final 1993 Federal Payment Rate		\$417.29	②
1994	Updated cost per discharge to 1993		472.95	
	P.L. 103-66 standard federal rate reduction	0.9260	437.95	
	Update factor	1.0304	451.26	
	GAF/DRG budget neutrality factor	1.0053	453.66	
	Outlier reduction factor	0.9454	428.89	
	Exceptions reduction factor	0.9485	406.80	
	Budget neutrality factor	0.9300	378.34	②
	Final 1994 Federal Payment Rate		\$378.34	②
1995	Updated cost per discharge to 1994		453.66	
	Update factor	1.0344	469.26	
	GAF/DRG budget neutrality factor	0.9998	469.17	
	Outlier reduction factor	0.9414	441.68	
	Exceptions reduction factor	0.9734	429.93	
	Budget neutrality factor	0.8765	376.83	②
	Final 1995 Federal Payment Rate		\$376.83	②
	Budget Neutrality Factor Ends			
1996	Updated cost per discharge to 1995		469.17	
	Update factor	1.0233	480.10	
	GAF/DRG budget neutrality factor	1.0000	480.10	
	Outlier reduction factor	0.9414	451.97	
	Exceptions reduction factor	0.9784	442.20	
	Correct Update Factor for FYs 1989 - 1992	0.9613	425.07	③
	Final 1995 Federal Payment Rate		\$425.07	③

OIG Computation of Capital Cost PPS

Footnotes:

- ① Our recalculation of the Federal rate showed an actual cost per discharge of \$507.20. The \$507.20 represents cost report data that has already been settled.

HCFA estimated the 1989 cost per discharge, after an estimated audit and re-opening effects, to be \$527.22. As shown on Attachment B, we estimated that HCFA adjusted the cost reports for estimated changes by -\$33 (\$560 - \$527). Our review, as summarized on Attachment D, shows the adjustment should have been -\$53 (-\$33 - \$20) or (\$560 - \$507).

- ② For FYs 1992 - 1995, we made the same adjustment factors as HCFA, except for the budget neutrality factor. As shown in HCFA regulations and illustrated by HCFA personnel, the federal rates for FYs 1992 through 1995 would not have changed. We adjusted the budget neutrality factor to equal the payment rates as shown on Attachment A for FYs 1992 through 1995.

However, it is important to note that the cost per discharge amount that we carried forward to subsequent years was different than HCFA. For FY 1993, HCFA carried \$464.41 forward while we carried \$446.79 forward. Because of the budget neutrality factor, the \$446.79 would eventually have been adjusted to \$417.28, the same rate used by HCFA.

- ③ Using more current actual data for estimations, we calculated the 1992 cost per discharge at \$592.70 (see Attachment D). After OBRA 1993 (as explained on Attachment B), the HCFA's estimated 1992 cost per discharge is \$641. Thus, the Federal rate is overstated by 7.52 percent ( $\$640.92 - \$592.70 = \$48.22$ ) ( $\$48.22 / \$640.92 = 7.52$  percent).

As shown in Footnote ①, we have already allowed for the correction of the forecasting errors for the estimated audit and re-opening adjustments. This correction lowered the 1989 cost per discharge from \$527.22 to \$507.20, or -3.8 percent (or a factor of 0.9620 (1.0 - 0.0380)). We carried this correction all the way through to FY 1996.

As shown in the first paragraph of this Footnote, the total adjustment needed is a reduction of 7.52 percent, or a factor of 0.9248 (1.0 - 0.0752). Because a portion of the 7.52 percent has been corrected, we applied the following formula:

$$\frac{0.9248}{0.9620} = 0.9613$$

Therefore, we included an adjustment of 0.9613 to correct the update factor for FYs 1990 through 1992.

## 1992 Adjusted Federal Rate per Discharge OIG Computation

Our estimates, which used more current data, are generally summarized in the following schedule. (Specific details of our calculations are shown on Attachment C.)

Per submitted cost reports		\$ 560
Forecasted Audit and Re-open Factors	(-9.46%)	- 53
Forecasted Final 1989 Federal Rate		<u>\$ 507</u>
Forecasted Update from 1989 to 1992 Factor	(+16.97%)	<u>+ 86</u>
Forecasted 1992 Rate		<u>\$ 593</u>

As shown on Attachment C, we calculated the 1989 cost per discharge rate to be \$507 and estimated the 1992 cost per discharge rate at \$593. Therefore, appropriate update factor from 1989 to 1992 should have been 16.97 percent ( $\$86 / \$507$ ).

As shown on Attachment B, OBRA 93 set the 1992 cost per discharge at \$641. Our revised estimates, which include corrections for both the 1989 audit and re-opening adjustments and the update factor for 1990 through 1992, show a 1992 cost per discharge of \$593.

Going from the \$640.92 to \$592.70 represents a 7.52 percent reduction which due to uncertainties involved in making estimates, we have rounded to 7.5 percent in making our recommendations.



DEPARTMENT OF HEALTH & HUMAN SERVICES

The Administrator  
Washington, D.C. 20201

DATE **JUL 5 1995**

FROM Bruce C. Vladeck  
Administrator

A handwritten signature in black ink, appearing to read "Bruce C. Vladeck", written over the typed name.

SUBJECT Office of Inspector General (OIG) Draft Report: "Review of Capital-Related Cost Prospective Payment System's (PPS) Base Year 1992," (A-07-95-01127)

TO June Gibbs Brown  
Inspector General

We reviewed the above-referenced report which reviews the accuracy of estimates used by the Health Care Financing Administration to calculate the capital Federal payment rate for fiscal year 1992. Attached are our comments on the report findings.

Thank you for the opportunity to review and comment on this report.

Attachment

Comments of the Health Care Financing Administration (HCFA)  
on Office of Inspector General (OIG)  
Draft Report "Review of Capital-Related  
Cost Prospective Payment System's (PPS)  
Base Year 1992  
(A-07-95-01127)

OIG Recommendation

OIG recommends that HCFA consider reducing payment rates by 7.5 percent to more accurately reflect costs of the base year used for the capital cost PPS.

OIG Recommendation

OIG recommends that HCFA continue to monitor the most current data (i.e., settling of unsettled cost reports for 36 percent of hospitals) and make any necessary further adjustments to the base rate.

HCFA Response

We defer comment on the report's recommendations pending possible further development of health care reform proposals and public comment on a possible reduction to the PPS rate.

Although, we agree with the OIG's analysis that the Federal capital rate reflects a known over-estimation of base year costs, we are not prepared to implement a further reduction to the PPS rate at this time. We believe reductions in Medicare spending should generally be addressed in the context of health care reform. A provision to reduce the capital Federal rate by 7.31 percent, reflecting data available at the time, was included in the proposed Health Security Act in October 1993. We included a discussion of the available information about the overstatement of the PPS rate in the proposed PPS rule for Fiscal Year (FY) 1996. We also requested public comment on the appropriateness of making a 7.47 percent reduction to the rate on the basis of the current data on the FY 1992 capital cost per case.

Technical Comments

HCFA has continuously monitored the data on the FY 1992 capital cost per case used to establish the PPS rate. As a result, there has already been one reduction to the Federal rate. Section 13501(a)(3) of Public Law 106-66 amended section 1886(g)(1)(A) of the Social Security Act to require that, for discharges occurring after September 30, 1993, the unadjusted standard Federal rate be reduced by 7.4 percent. As we discussed in the September 1, 1993, final rule for FY 1994 (58 Federal Register 46316ff.), the purpose of that reduction was to correct for revised inflation forecasts, as of May 1993, for the increases in Medicare capital cost per discharge during FY 1989 through FY 1992.

Page 2

By that time, the estimate of increases in Medicare inpatient capital costs per discharge from FY 1989 through FY 1992 had declined from 31.3 percent to 21.57 percent. The 7.4 percent reduction to the Federal rate was calculated to account for these revised forecasts ( $1.2157/1.313 = .926$ , a 7.4 percent decrease).

As a result of the reduction required by Public Law 103-66 (Omnibus Budget Reconciliation Act (OBRA) 1993), the standard Federal rate is now based on an estimated FY 1992 Medicare inpatient capital cost per case of \$641.01 ( $\$692.24 \times .926$ ). At the time of the OBRA 1993 reduction to the Federal rate, actual cost report data on the FY 1992 Medicare capital cost per discharge was not yet available. The reduction was based on cost report data for FY 1990 and FY 1991, and a revised projection of the rate of increase in Medicare capital costs per discharge during FY 1992. We now have extensive cost report data for FY 1992. The December 1994 update of Hospital Cost Report Information System (HCRIS) data shows an audit-adjusted FY 1992 Medicare inpatient capital cost per discharge of \$593.15, or 7.47 percent lower than the estimate on which the Federal rate is currently based. The difference in the estimates (OIG's 7.52 percent versus HCFA's 7.47 percent) is insignificant.

Appendix C of the report presents reconstruction of the Federal rates for FY 1992 through FY 1995, based on the correct FY 1992 cost per case. In the footnotes to the Appendix, the report states that in reconstructing the rates OIG "made the same adjustments as HCFA, except for the budget neutrality factor . . . the Federal rates for FY 1992 through FY 1995 would not have changes." That statement is not quite accurate. It is true, as the report notes, that aggregate payments for FY 1992 through FY 1995 under the capital PPS transition system would not have changed if the capital Federal rate had been set on the basis of current data on the FY 1992 cost per case. This is because of a statutory budget neutrality provision, which required that estimated aggregate payments equal 90 percent of estimated Medicare costs for FY 1992 through FY 1995. A budget neutrality adjustment was applied to the capital Federal and hospital specific rates during each year for FY 1992 through FY 1995 in order to meet this requirement. It is also true that, if the base rate had been determined on the basis of current FY 1992 data, the budget neutrality would have changed in order to meet the budget neutrality target. It is not true, however, that the Federal rate would therefore have been identical because of the budget neutrality requirement.

On this point, the report misses some subtle interactions in the transition system. For example, since the same budget neutrality adjustment is applied to the Federal and the hospital-specific rates, a lower base Federal rate would result in a relatively higher hospital-specific rate in order to meet the budget neutrality target. In addition, changes to the Federal rate would have had an effect on the amount of exceptions payments, thus changing the value of the exceptions reduction factor applied to the rates.

Page 3

Nevertheless, the OIG is absolutely correct to emphasize that reductions to the Federal rate to correct for more current data on the FY 1992 cost per case, including the reduction already implemented as a result of OBRA 1993, could have no effect on aggregate payments prior to FY 1996. Because the budget neutrality provision expires at the end of FY 1995, savings from the OBRA 1993 reduction will begin to be realized in FY 1996. Any further reduction to the rate would also realize savings in FY 1996 and beyond.

The data used by OIG in determining the 1989 Settled Federal Capital Rate may have been significantly affected by provider appeals to the Provider Reimbursement Review Board (PRRB). Because a large number of appeals pertaining to capital-related costs have been filed, any adjustment HCFA may make to the Federal rate based on the report's findings may require additional changes in the future as the results of PRRB hearings are implemented.

Finally, we note one spelling error. In the "To" line on page 1, and in the header on each page thereafter, "Vladek" should be spelled "Vladeck."