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Stephen C. Tool
Executive Director

November 1, 2005

The Honorable Abel Tapia, Chairman
Joint Budget Committee
200 East 14th Avenue, Third Floor
Denver, CO 80203

Dear Senator Tapia:

This letter is in response to footnote 38 within the FY 05-06 Long Bill, Senate Bill 05-209. Footnote 38 states:

> *The Department is requested to report on reimbursements for hospital providers and to offer recommendations for changes in this area, if any. Specifically, the Department is requested to provide cost estimates for rebasing hospital rates to the most recent audited Medicare cost reports.*

The current methodology for calculating Medicaid inpatient hospital base rates (Medicaid rates) involves using the Medicare inpatient hospital base rate (Medicare rate) effective October 1 of the previous fiscal year as the starting point for each hospital's Medicaid rate. Even though the Department sets Medicaid rates annually using the Medicare rates, the Medicaid rates are not set at one hundred percent of the Medicare rates due to budget neutrality.

Since audited Medicare cost reports are only used to calculate Medicaid rates for a few select hospitals that qualify under a rehabilitation or pediatric definition, the Department is interpreting footnote 38 as requesting cost estimates for setting Medicaid rates at one hundred percent of the actual Medicare rates. Calculating the Medicaid rates at one hundred percent of the Medicare rates would remove the budget neutrality calculation.

Included in the following report is detailed information on what the estimated additional cost would have been for FY 05-06 if the Medicaid rates had been set at one hundred percent of the Medicare rates. The amount of expenditures needed to bring Medicaid rates to one hundred percent of the Medicare rates is expected to increase every year since Medicare rates are tied to the hospital market basket percentage increase as detailed in the Medicare Prescription Drug, Improvement, and Modernization Act of 2003. Note that since Medicare rates are set to increase

every year by the hospital market basket and Medicaid rates are tied to the budget neutrality calculation, Medicaid rates will continue to decline as a percentage of the Medicare rates unless the rates are tied to a certain percentage of the Medicare rates. This is necessary to maintain budget neutrality at a specific expenditure level since increases in inpatient hospital rates are approved through the State's budget process.

Questions regarding footnote 38 can be addressed to John Bartholomew, Budget Director, John.Bartholomew@state.co.us. His telephone number is 303-866-2854.

Sincerely,

Stephen C. Tool
Executive Director

ST:JB/jlw

Enclosure(s)

Cc: Representative Tom Plant, Vice-Chairman, Joint Budget Committee
Senator Moe Keller, Joint Budget Committee
Senator Dave Owen, Joint Budget Committee
Representative Bernie Buescher, Joint Budget Committee
Representative Dale Hall, Joint Budget Committee
Senator Joan Fitz-Gerald, President of the Senate
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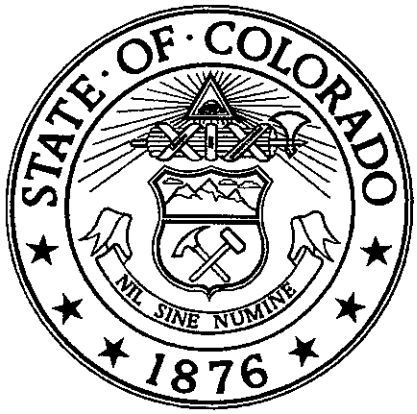

COLORADO DEPARTMENT OF HEALTH CARE POLICY AND FINANCING

REPORT TO THE JOINT BUDGET COMMITTEE ON FOOTNOTE 38 SENATE BILL 05-209

INPATIENT HOSPITAL MEDICAL SERVICES PREMIUMS

NOVEMBER 1, 2005

Table of Contents

Introduction

This report is presented to the Joint Budget Committee (JBC) of the Colorado General Assembly in response to footnote 38 of Senate Bill 05-209, which states:

> *The Department is requested to report on reimbursements for hospital providers and to offer recommendations for changes in this area, if any. Specifically, the Department is requested to provide cost estimates for rebasing hospital rates to the most recent audited Medicare cost reports.*

Interpretation of Footnote 38

The Medicaid inpatient hospital base rate (Medicaid rate) setting process utilizes the Medicare Prospective Payment System or Medicare inpatient hospital base rates (Medicare rates) as the starting point for rate setting process every year. The Medicare rates used are the rates effective on October 1 of the previous fiscal year for which the Medicaid rates are being calculated. It is important to note that only a percentage of the Medicare rates are applied due to budget neutrality restrictions. Each hospital for which Medicaid rates are being calculated receives the same percentage of their Medicare rate.

Currently, the Medicaid rates for eight of the seventy-seven Colorado Medicaid hospitals are not based on their corresponding Medicare rate. These hospitals fall under the rehabilitation or pediatric definition, and the starting point for their rate is a cost-per-discharge calculation derived from their most recently audited Medicare cost report. However, a Medicare rate is then estimated for these hospitals by using the Medicare cost-per-discharge amount and dividing it by the hospital's Medicaid case mix index. The rehabilitation and pediatric hospitals then receive a percentage of their estimated Medicare rate equal to the same percentage that all of the other hospitals receive.

Since the majority of the Medicaid rates are calculated using a percentage of the actual Medicare rates, the Department is interpreting footnote 38 as requesting cost estimates for setting Medicaid rates to 100 percent of the Medicare rates. FY 05-06 Medicaid rates were set at 90.0 percent of the Medicare rates, while FY 04-05 Medicaid rates were set at 92.6 percent of the Medicare rates.

Medicaid Rate Setting Process and Budget Neutrality

Before discussing the amount of additional expenditures that would be required to set Medicaid rates at 100 percent of the Medicare rates, it is important to first understand how the rate setting process is tied to both a budget neutrality calculation and increasing Medicare rates. Budget neutrality must be maintained at a specific expenditure level, since increases (decreases) in Medicaid rates are approved through the State's budget process. If through the State's budget process additional funds are directed towards inpatient hospital services, then those funds increase (decrease) the budget neutrality figure by the same amount.

The beginning step in calculating each hospital's Medicaid rate is to initially set their Medicaid rate equal to 100 percent of their Medicare rate. In order to outline how the Medicaid rates are established, assume that each hospital's Medicaid rate is set only by using their Medicare rate[1]. Once each hospital's Medicaid rate has been set at 100 percent of their Medicare rate, total inpatient hospital expenditures for the upcoming fiscal year are estimated.

Table 1 below shows an example scenario of this first step in the rate setting process and is applicable to setting the FY 05-06 Medicaid rates. Column A shows Medicare rates effective on October 1, 2004 for three artificial hospitals. Column B demonstrates that the Medicaid rates for these hospitals are being set at 100 percent of their Medicare rates. In order to estimate FY 05-06 inpatient hospital expenditures, column B is multiplied by column C (the most current Medicaid case mix index for each hospital taken from the Colorado Foundation for Medical Care's (CFMC) annual report) and by column D (forecasted Medicaid discharges from Budget's February case load forecast). As can be seen in Table 1, this example shows that FY 05-06 inpatient hospital expenditures are estimated to be $6,912,500 using 100 percent of the Medicare rates, the most current Medicaid case mix index figures and forecasted Medicaid discharges for FY 05-06.

Table 1: Initial FY 05-06 Medicaid Rate Calculation

	A	B	C	D	E = B*C*D
	Medicare Rate effective Oct 1, 2004	**FY 05-06 Medicaid Rate at 100% of Medicare rate**	**FY 03-04 Medicaid Case Mix Index**	**Forecasted FY 05-06 Medicaid Discharges**	**Estimated FY 05-06 Expenditures at 100% of Medicare Rate**
Hospital 1	$7,000	$7,000	2.0	100	$1,400,000
Hospital 2	$5,750	$5,750	1.5	500	$4,312,500
Hospital 3	$6,000	$6,000	1.0	200	$1,200,000
TOTAL					**$6,912,500**

The next step in setting Medicaid rates involves the budget neutrality calculation. As outlined in the State Plan, Medicaid rates are tied to FY 02-03 Medicaid rates during the annual rate setting process for the purposes of budget neutrality since FY 02-03 was the first year that Medicaid rates were established as a function of Medicare rates. In order to calculate budget neutrality expenditures, FY 02-03 Medicaid rates are multiplied by the same Medicaid case mix index and forecasted Medicaid discharges that were used in the first step of the rate setting process. The budget neutrality calculation essentially determines the maximum amount that inpatient hospital expenditures can be for the upcoming fiscal year by using the FY 02-03 Medicaid rate (or baseline rates).

Table 2 below demonstrates how the budget neutrality expenditure figure is calculated and continues the example scenario for the rate setting process of FY 05-06 Medicaid rates using the same three artificial hospitals depicted in Table 1. Column F shows each hospital's FY 02-03 Medicaid rate (or baseline rate). The budget neutrality figure is arrived at by multiplying the rates in column F by columns G and H. Columns G and H are the same figures for Medicaid case mix index and forecasted Medicaid discharges that were used in Table 1. As can be seen below in Table 2, total expenditures for budget neutrality purposes are estimated at $6,325,000.

Table 2: Budget Neutrality Calculation

	F	G	H	J = F*G*H
	FY 02-03 Medicaid Rate	**FY 03-04 Medicaid Case Mix Index**	**Forecasted FY 05-06 Medicaid Discharges**	**Estimated FY05-06 Expenditures using FY 02-03 Medicaid Rates**
Hospital 1	$6,000	2.0	100	$1,200,000
Hospital 2	$5,500	1.5	500	$4,125,000
Hospital 3	$5,000	1.0	200	$1,000,000
TOTAL				**$6,325,000**

The estimate for total inpatient hospital expenditures in Table 2 is less than the total expenditures of $6,912,500 estimated in Table 1. Since both the Medicaid case mix index numbers and the forecasted Medicaid discharges are the same for each expenditure calculation, the estimated expenditures in Table 1 are higher due to the fact that the Medicaid rates used to generate the budget neutrality expenditure in Table 2 (column F) are lower than the Medicaid rates based on 100 percent of the Medicare rates in Table 1 (column B). Hence, the Medicaid rates as a percentage of the Medicare rates have to be reduced until the total estimated expenditures for the budget neutrality calculation match the estimated inpatient hospital expenditures for the upcoming fiscal year.

This final step is depicted on the following page in Table 3. In order to have total inpatient hospital expenditures for FY 05-06 match the budget neutrality expenditure calculation in Table 2, the Medicaid rates have to be set to 91.5 percent of the Medicare rates as shown in column L.

Table 3: Final FY 05-06 Rate Calculation

	K	L	M	N	P = L*M*N
	Medicare Rate effective Oct 1, 2004	**FY 05-06 Medicaid Rate at 91.5% of Medicare Rate**	**FY 03-04 Case Mix Index**	**Forecasted FY 05-06 Discharges**	**Estimated FY 05-06 Expenditures at 91.5% of the Medicare Rate**
Hospital 1	$7,000	$6,405	2.0	100	$1,281,000
Hospital 2	$5,750	$5,261	1.5	500	$3,946,000
Hospital 3	$6,000	$5,490	1.0	200	$1,098,000
TOTAL					**$6,325,000**

Table 3 is set up exactly like Table 1 except the Medicaid rates are now a lower percentage of the Medicare rates (column L is different than column B). As can be seen in column P, reducing the Medicaid rates from 100 percent to 91.5 percent lowers total FY 05-06 estimated expenditures to the budget neutrality amount of $6,325,000.

Reducing each hospital's Medicaid rate to a certain percentage of the Medicare rate accomplishes the two main pieces of the rate setting process: (1) each hospital's Medicaid rate is based on their Medicare rate and (2) it satisfies the budget neutrality calculation.

Medicare Prescription Drug, Improvement, and Modernization Act of 2003

Based on legislation from the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (MMA)[2], Medicare rates have been increasing every year and will continue to increase in the future. As per the MMA, hospitals that participate in Medicare's quality reporting initiative receive the hospital market basket percentage increase[3] for hospitals in all areas (for each federal fiscal year from 2004 through 2007). Those hospitals that do not submit data according to the initiative receive the hospital market basket percentage reduced by 0.4 percentage points. However, the Centers for Medicare and Medicaid Services (CMS) anticipates that the majority of acute care hospitals will be receiving the full hospital market basket percentage increase in federal fiscal year 2006 as was the case in federal fiscal year 2005. CMS just recently announced that acute care hospitals participating in the quality reporting initiative will receive a 3.7 percent increase in the federal fiscal year 2006 Medicare rate. During federal fiscal year 2005, Medicare rates increased by 3.3 percent for those hospital reporting the specific quality data. Beginning with federal fiscal year 2008 and each subsequent year, the percentage increase for all hospitals will be the hospital market basket percentage increase.

Budget Impact of Utilizing 100% of the Medicare Rates

The Medicaid rate calculation process is directly impacted by the fact that the Medicare rates are set to increase by the hospital market basket percentage every year. Since the Medicaid rates are tied to FY 02-03 Medicaid rates for budget neutrality purposes and Medicare rates are increasing, Medicaid rates are becoming a smaller percentage of Medicare rates every year:

FY 02 – 03: Baseline year for budget neutrality calculation
FY 03 – 04: Medicaid rate as percentage of Medicare rate = 97.9%
FY 04 – 05: Medicaid rate as percentage of Medicare rate = 92.6%
FY 05 – 06: Medicaid rate as percentage of Medicare rate = 90.0%

It should be noted that for FY 05-06, the Medicaid rates would have fallen below 90 percent to approximately 88 percent in order to fit the budget neutrality calculation. However, there was an additional one time two percent increase applied at the discretion of the Executive Director to the FY 05-06 Medicaid rates so that the Medicaid rates as a percentage of the Medicare rates would equal 90 percent. It was expected that there was some room to do so within budget neutrality to address utilization growth.

Next year it is anticipated that the Medicaid base rate as a percentage of the Medicare rate will fall below ninety percent, potentially around eighty-five or eighty-six percent of the Medicare rate due to the increase in Medicare rates.

Therefore, while this report estimates the additional expenditures needed in order to bring FY 05-06 Medicaid rates to 100 percent of the Medicare rate, this estimate is expected to grow every year as long as Medicare rates are tied to the hospital market basket increase.

After calculating FY 05-06 inpatient hospital rates without the budget neutrality calculation (setting Medicaid rates to 100 percent of the Medicare rates), the additional expenditures that would be needed are shown below in Table 4. For comparison purposes, note that according to budget figures from the Medical Services Premiums exhibits page EM-2, expenditures for inpatient hospitals services totaled $266,011,447 for FY 04-05.

Table 4: Estimate of Expenditures Required to Set Medicaid Rates at 100% of Medicare Rates

	Original Estimate of Inpatient Hospital Expenditures	Estimate of Inpatient Hospital Expenditures using 100% of Medicare Rates	Difference in Expenditures
FY 05-06	$309,226,533[4]	$335,072,443[4]	$25,845,910

Inpatient hospital expenditures for the purposes of rate setting are calculated by multiplying the Medicaid rates for the upcoming fiscal year by the most current Medicaid case mix index from CFMC and by forecasted Medicaid discharges for the upcoming fiscal year. For example, FY 05-06 inpatient hospital expenditures were calculated by multiplying FY 05-06 Medicaid rates by FY 03-04 Medicaid case mix index and by FY 03-04 Medicaid discharges forecasted forward two years using Budget's February 2005 case load forecast. The difference between the first column and the second column in Table 4 is that the first column utilizes only a percentage of the Medicare rates for budget neutrality purposes while the second column utilizes 100 percent of the Medicare rates.

Conclusion

Medicaid rates are tied to FY 02-03 Medicaid rates for the purposes of budget neutrality. At the same time, the Medicaid rate setting process utilizes Medicare rates as the starting point every year. Due to the annual increase in the Medicare rates, the amount of expenditures needed to set Medicaid rates to 100 percent of the Medicare rates will continue to grow every year. As long as Medicaid rates are not tied to a certain percentage of Medicare rates, Medicaid rates as a percentage of Medicare rates will continue to decrease every year and stand to fall below 90 percent of Medicare rates for FY 06-07. This is necessary to maintain budget neutrality at a specific expenditure level since increases in Medicaid rates are approved through the State's budget process.

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[1] This is a simplified demonstration of the rate setting process. In reality, after applying the Medicare rate, various hospitals get add-ons for neonatal, Graduate Medical Education (GME), and nursery in addition to some hospitals receiving the average rate of their peer group and a few other steps which are outlined in 10 CCR 2505-10, Section 8.356.2.

[2] Source: 42 U.S.C. 1395ww(b)(3)(B)

[3] The hospital market basket refers to the projected rate of inflation for goods and services used by hospitals treating Medicare beneficiaries. The Office of the Actuary, which is within CMS, is responsible for producing the hospital market basket.

[4] Estimate includes the 2% budget increase that was applied to FY 05-06 Medicaid rates.