Economic Impact Analysis
Virginia Department of Planning and Budget

12 VAC 30-70 –Methods and Standards for Establishing Payment Rates-Inpatient Hospital Services
Department of Medical Assistance Services
September 23, 2004

The Department of Planning and Budget (DPB) has analyzed the economic impact of this proposed regulation in accordance with Section 2.2-4007.G of the Administrative Process Act and Executive Order Number 21 (02). Section 2.2-4007.G requires that such economic impact analyses include, but need not be limited to, the projected number of businesses or other entities to whom the regulation would apply, the identity of any localities and types of businesses or other entities particularly affected, the projected number of persons and employment positions to be affected, the projected costs to affected businesses or entities to implement or comply with the regulation, and the impact on the use and value of private property. The analysis presented below represents DPB's best estimate of these economic impacts.

Summary of the Proposed Regulation

Pursuant to Chapter 4, Item 326 XX of the 2004 Acts of the Assembly, the proposed change will set the adjustment factor used in the fee-for-service reimbursement methodology for private inpatient hospital services at 75% of base year costs.

Estimated Economic Impact

These regulations establish the reimbursement methodology for operating costs incurred by hospitals for providing Medicaid fee-for-service inpatient hospital services. The reimbursement rates are determined using data from a base year, which is the most recent year for which data is available to calculate rates for future years. Base rates are calculated for each hospital utilizing statewide average rates adjusted by the wage index to take into account hospital-specific labor cost differences. Then, the rate is adjusted by the application of an adjustment factor. The base rate is recalculated at least every three years using more recent data,

a process generally referred to as rebasing. For the typical two years subsequent to a rebasing (and prior to the next rebasing), the base rate is adjusted for inflation according to regulations.

The proposed change will amend the adjustment factor used in the methodology. The adjustment factor is a tool used to artificially adjust reimbursement rates. It was first implemented in 1996 when the inpatient hospital methodology was revised. Prior to the 1996 revision, the rates were based on average/median costs and did not explicitly take into account the severity of the illness treated (although patient severity would have been inherent in the costs used to calculate the per diems). While the new methodology was being developed, an adjustment factor was made part of the methodology to ensure the budget neutrality of the methodology change. Effective July 1, 1996, the adjustment factor was 0.6247 meaning that the reimbursement rate was approximately 38% lower than the statewide average operating costs of serving Medicaid patients. Currently, the regulations define the adjustment factor as the ratio of total operating payments to total Medicaid allowable costs. The most recent adjustment factor is 0.7194, which was calculated using cost report data for provider years ending in state fiscal year 2002 and would be effective for fiscal years 2005 – 2007.

Pursuant to the statutory changes, the proposed regulations will replace the calculation of the adjustment factor for private hospitals as the ratio of two numbers with an exact numerical figure of 0.75. The new adjustment factor will be effective on July 1, 2005. The last rebasing was done for rates effective July 1, 2004 (SFY 2005). DMAS has indicated that there are no plans to rebase the rates again until SFY 2008 (rates to be effective July 1, 2007), which corresponds to the regular three year rebasing cycle. Thus, setting the adjustment factor to 0.75 will increase the base rates by approximately 4.26% for two years (FY 2006 and FY 2007).

The estimation of the likely effect beyond FY 2007 requires knowledge of what the adjustment factor would have been under the existing methodology for the rebasing scheduled for FY 2008. That, in turn, requires the data for reimbursements and operating costs for a more recent base year, which has not yet ended. Therefore, no data is currently available, nor will it be available in any time frame that would allow us to estimate the adjustment factor under the existing methodology for FY 2008 and beyond for this regulatory action.

The estimated fiscal effect of the 4.26% increase in the base payment rates to private hospitals is $18.3 million annually for fiscal years 2006 and 2007 (including both the FFS and

Managed Care program effects). One half of the increased reimbursement is going to come out of state funds and the other half through federal matching funds. These federal matching funds are additional money being injected into the state and are likely to produce benefits through the multiplier process.

The increased reimbursement rates will reduce private hospitals' average operating losses from serving Medicaid patients from 28% to 25% based on data from SFY 2002 cost reports. The effect of this increase in payments to hospitals on access to health care and on provision of services to Medicaid recipients is not expected to be significant. The hospitals' profit margin from serving Medicaid recipients is already in negative territory and the proposed increase will not change that. So, we will not see a swing from a negative profit margin to a positive profit margin, which would, in competitive markets, affect a firm's decision on whether to participate in the Medicaid program. However, because of certain institutional and regulatory arrangements, the hospital industry participating in the Medicaid program is far from competitive.

For example, hospitals are obligated to accept patients at the emergency rooms regardless of whether they participate in the Medicaid program. Instead of providing uncompensated care at emergency rooms for Medicaid patients, they are better off participating in the program and providing these services at a discount. Also, certificate of public need (COPN) requirements make entry in to the inpatient hospital industry difficult, thus, providing an umbrella for incumbents against competition. Protected under the COPN, hospitals are able to shift their losses from Medicaid program on to privately paying patients. There is no available information on how much discount the hospitals are willing to accept to avoid uncompensated care at emergency rooms and on their ability and willingness to shift Medicaid losses to private patients. Without this information, it is not possible to accurately assess the effects (if any) of the 4.26% increase in payments on Medicaid recipients' access to health care and on the quality of care provided. It is likely, however, that the increased reimbursements will not have any significant affect on access to and quality of care, but merely improve private hospitals' profit margin.

Businesses and Entities Affected

The proposed regulations will affect Medicaid inpatient hospital payments to 112 private hospitals.

Localities Particularly Affected

The proposed regulations apply throughout the Commonwealth.

Projected Impact on Employment

The effect of the proposed changes on employment cannot be reliably assessed, as there is no information on what the hospitals would have done if the increase had not been provided. For example, if hospitals had continued to shift their Medicaid losses to private payers, there would be no change in their labor demand. On the other hand, if hospitals had discontinued their participation in the Medicaid program, there would have been a reduction in their demand for labor. The likely scenario, however, seems to be one in which hospitals would have continued to participate in the Medicaid program, in which case, no significant employment effect can be attributed to the proposed change.

Effects on the Use and Value of Private Property

Similarly, the effect of the proposed changes on the use and value of private property cannot be reliably assessed, as there is no information on what hospitals would have done if the payment increase were not provided. The likely effect of the proposed change will be to improve private hospitals' stream of future revenues and increase their asset values.