APPENDIX A

Determining Medicare+Choice Payment Rates

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The Balanced Budget Act of 1997 (BBA) changed how Medicare pays managed care plans. Before BBA, Medicare set payments for managed care enrollees, in each county, at 95 percent of an estimate of what the program would have paid had these enrollees remained in the traditional fee-for-service program. Under this scheme, the Health Care Financing Administration (HCFA) updated payments for each county based on the estimated growth in Medicare fee-for-service spending per beneficiary in that county.

The BBA broke the direct link between the growth in county fee-for-service spending and Medicare managed care payments. Specifically, monthly payments are now the highest of:

- a floor—updated after 1998 based on nationwide growth in fee-for-service spending per capita, less specified statutory reductions for 1999 through 2002—beneath which payments cannot fall,
- a 2 percent increase from the prior year's rate, or,
- a blend of local and national payment rates, only if a so-called budget-neutrality condition is met.

This appendix describes how Medicare determined the 1997 payment rates upon which future payments are based. It then discusses how HCFA calculates the floor and blended payments, and the conditions under which they may be made.

How Medicare calculated the 1997 base rates

The 1997 base rates are the starting point for determining Medicare+Choice payment rates. From 1982 to 1997, HCFA calculated annual base rates separately for Part A and Part B for the elderly, disabled, and beneficiaries with end-stage renal disease. This process had several steps. First, for each county, HCFA estimated the average per person fee-for-service spending—the ratio of fee for service spending to the number of fee-for-service enrollees—based on spending data from the most recent five year period.

Second, for each county, HCFA standardized the average per person cost to account for differences in demographic characteristics (for example, age and sex) among counties. This standardization occurs by dividing the average per person cost by the demographic factor that measured these population differences. The result is the adjusted average per capita cost (AAPCC):

$$\text{AAPCC} = \frac{\text{average per person cost}}{\text{demographic factor}}$$

Finally, HCFA then multiplied the AAPCC by 95 percent to get each county's payment rate:

1997 County Base Rate = AAPCC x .95.

Calculation of the floor

The BBA established a floor below which monthly U.S. county payment rates cannot fall. For 1998, the floor was $367. For 1999 and subsequent years, HCFA is increasing the floor by its estimate of the current year's national growth rate of Medicare fee-for-service spending (minus a statutory reduction of 0.5 percentage point through 2002). Because the estimated growth in fee-for-service spending per capita from 1998 to 1999 was 4.0 percent, HCFA increased the floor by 3.5 percent, to $379.84, for 1999 ($367 x 1.035 = $379.84).

Calculation of blended payment rates

Calculation of the blended payment amounts involves four steps. First, HCFA adjusts local rates by removing a certain percentage of the 1997 base payment rate that is attributable to fee-for-service spending for graduate medical education (GME) payments. Second, HCFA updates this adjusted local rate to the payment year. Third, national rates are adjusted to account for variation in input prices across counties. Finally, HCFA calculates the blended payment as a weighted average of the updated adjusted local and input price adjusted national rates. Table A-1 shows the local and national weights mandated by the BBA to determine the blended rate.

TABLE A-1 **Blended rate formula**

Year	Local percent	National percent
1998	90%	10%
1999	82	18
2000	74	26
2001	66	34
2002	58	42
2003 and after	50	50

Source: Balanced Budget Act of 1997.

Calculation of updated adjusted local rates

HCFA calculates local rates by removing from the 1997 base rate a percentage of the amount attributable to Medicare's special payments to teaching hospitals and updating the result based on nationwide growth in fee-for-service spending per capita. Table A-2 shows sample calculations of local 1999 rates for three counties.

Under the old payment system, a county whose residents used more care in teaching hospitals would have a higher payment rate than an otherwise similar county because of Medicare's special payments to hospitals for GME. The Congress believed that Medicare managed care plans were less likely to use teaching hospitals to provide care and, when they did, paid them less than Medicare's fee-for-service payments. Accordingly, the Congress decided in the BBA to pay teaching hospitals directly when they serve Medicare+Choice enrollees and to adjust the 1997 base payment rate for GME payments.

The BBA phases in this adjustment over five years: 20 percent of GME payments were removed from the base in 1998, 40 percent are removed in 1999, and 100 percent of GME payments will be removed from local rates in 2002 and later years.

HCFA increases the adjusted 1997 base rates to the payment year based on nationwide growth in fee-for-service spending per capita minus specified statutory reductions of 0.8 percentage points for 1998 and 0.5 percentage points for 1999 through 2002. HCFA estimated national growth in fee-for-service spending per capita of Medicare to be 3.4 percent in 1998, so that adjusted local rates were increased by 2.6 percent for that year. For 1999, HCFA estimated national growth in fee-for-service spending per capita to be 4.0 percent; thus, adjusted local 1998 rates were increased by 3.5 percent. The adjustments include correcting past projection errors.

TABLE A-2 **Calculation of local rates for selected counties, monthly payment per member, 1999**

	Somerset, NJ	Orange, NC	San Francisco, CA
1997 Rate	$438.91	$452.84	$525.90
Percent of spending attributed to GME	.0625	.14	.0724
↓ GME carve-out proportion (40 percent of GME spending)	.4 x .0625 = .025	.4 x .14=.056	.4 x .0724=.0289
↓ 1997 rate x GME carve-out proportion	$438.61 x .025=$10.97	$452.84 x .056=$25.36	$525.90 x .02896=$15.23
↓ 1997 adjusted local rate	$438.91-$10.97=$427.94	$452.84-$25.36=$427.48	$525.90-$15.23=$510.67
↓ 1999 local rate	$427.94 x 1.0188[a] x 1.035[b]=$451.24	$427.48 x 1.0188[a] x 1.035[b]=$450.76	$510.67 x 1.0188[a] x 1.035[b]=$538.48

Note: The local rate is a component of the blended rate, as shown in Table A-3. Numbers may not sum to total due to rounding. GME (graduate medical education payments). BBA (Balanced Budget Act of 1997).

[a]1+(1988 corrected per capita rate of growth in Medicare minus BBA update reduction) = 1+ (.040-.005)=1.035.

[b]1+(1988 corrected per capita rate of growth in Medicare minus BBA update reduction)=1+(.040-.005)=1.035.

Source: MedPAC analysis of data from HCFA and the Balanced Budget Act of 1997.

TABLE A-3

Calculation of national standardized Medicare+Choice rates for selected counties, monthly payment per member, 1999

	Somerset, NJ	Orange, NC	San Francisco, CA
1998 hospital wage index	1.1111	0.9818	1.4091
↓			
Part A hospital wage index adjustment	(.7 x 1.1111) + .3 = 1.08	(.7 x 0.9818) + .3 = 0.99	(.7 x 1.4091) + .3 = 1.29
↓			
Input price adjusted Part A rate	1.08 x $276.16[a] = $297.64	0.99 x $276.16[a] = $272.64	1.29 x $276.16[a] = $355.24
1999 geographic adjustment factor	1.1028	0.9318	1.1484
↓			
Part B geographic adjustment factor proportion	.66 x 1.1028 = 0.73	.66 x 0.9318 = 0.61	.66 x 1.148 = 0.76
Hospital wage index adjustment	(.4 x 1.11) + .6 = 1.04	(.4 x 0.98) + .6 = 0.99	(.4 x 1.41) + .6 = 1.16
Part B hospital wage index adjustment	(.34 x 1.04) = 0.36	(.34 x 0.99) = 0.34	(.34 x 1.16) = 0.40
↓			
Part B geographic adjustment factor proportion	0.36 + 0.73 = 1.08	0.34 + 0.61 = 0.95	0.40 + 0.76 = 1.16
↓			
Input price adjusted Part B rate	1.08 x $205.46[b] = $222.50	0.95 x $205.46[b] = $195.70	1.16 x $205.46[b] = $237.01
1999 national standardized Medicare+Choice rate = Part A + Part B	$297.64 + $222.50 = $520.14	$272.64 + $195.70 = $468.35	$355.24 + 237.01 = $592.26

Note: Numbers, particularly interim calculations, may not sum to total due to rounding.

[a]Medicare Part A national weighted average rate.

[b]Medicare Part B national weighted average rate.

Sources: MedPAC analysis of data from HCFA and the Balanced Budget Act of 1997.

Adjustment of national payment rates for variation in input prices

The BBA defines the national Medicare+Choice rate in general, mandates input price adjustment, provides the method for calculating input price adjustments for 1998, and gives HCFA the authority to apply these rules for 1999. The law does not specify the details of how to implement the input price adjustment for 2000 and beyond. Table A-3 shows sample calculations of the 1999 national Medicare+Choice rate for three counties.

In general, the national Medicare+Choice rate is a weighted combination of the national standardized payment rates for services under Medicare Parts A and B. The weights correspond to the contribution of each part to total spending. Specifically, the national Medicare+Choice rate is equal to:

Part A x [(0.7 x HWI) + 0.3] +

Part B x [((0.66 x GAF) + 0.34) x ((0.4 x HWI) + 0.6)]

where:

- Part A is the national weighted average of local Part A rates for the payment year,
- Part B is the national weighted average of local Part B rates for the payment year,
- HWI is the hospital wage index, which measures differences in hospital wages across metropolitan and statewide rural areas for the payment year, and
- GAF is the geographic adjustment factor, which measures differences in physicians' costs across physician payment areas for the payment year.

A separate update calculation is not necessary because the local Part A and Part B rates already incorporate growth in fee-for-service spending per capita.

Blending local and national rates

The blended payment for a county is a weighted average of the adjusted updated local rates and the input price adjusted national rate. As shown above in Table A-1, in 1999, local rates have an 82 percent weight, and the standardized national rate has an 18 percent weight. The weight assigned to local rates will decrease each year until 2003, when local and standardized national rates will each have a weight of 50 percent. Table A-4 shows what blended rates would have been for three selected counties had the budget-neutrality condition been satisfied.

Budget neutrality

Counties will receive blended payments only in years when the budget-neutrality condition is satisfied. This condition requires that total Medicare+Choice spending, including blended payments, equals what would be paid if only local rates had been used.

TABLE A-4 **Calculation of blended rates for selected counties, monthly payment per member, 1999**

	Somerset, NJ	Orange, NC	San Francisco, CA
1999 local rate (from Table A-2)	$451.24	$450.76	$538.48
↓ Local portion (.82 x local rate)	.82 x $451.24 = $370.02	.82 x $450.76 = $369.62	.82 x $538.48 = $441.55
1999 national standardized Medicare+Choice rate (from Table A-3)	$520.14	$468.35	$592.26
↓ National portion (.18 x national rate)	.18 x $520.14 = $93.63	.18 x $468.35 = $84.30	.18 x $592.26 = $106.61
↓ Blend	$370.02+$93.63 = $463.64	$369.62+$84.30 = $453.93	$441.55+$106.61 = $548.16

Note: Numbers may not sum to total due to rounding.

Source: MedPAC analysis of data from HCFA and the Balanced Budget Act of 1997.

To satisfy the budget neutrality condition in a particular year, HCFA compares what projected total Medicare+Choice spending would be if county rates were based on the highest of the floor, minimum update, or blended rates, with what spending would be if payments were made on the basis of local rates only. If projected total spending on the basis of blended payments, floors, and minimum increases was not equal to projected spending on the basis of local rates only, then HCFA multiplies the blended amounts by a factor (but not less than zero) so that the budget neutrality condition is satisfied.

In 1998 and 1999, spending based on the highest of the floor, minimum update, or blended rates would have exceeded spending based only on local rates even with a budget-neutrality factor equal to zero. Consequently, no county received blended payment rates, and the payment rate for each county in those years was the greater of that county's prior year rate increased by 2 percent or the floor rate ($367 in 1998 and $379.84 in 1999). ■