CAPITOL ANALYSTS NETWORK, INC.

Stuart J. Sweet, President **April 2, 2002**

IT'S WAR! DOCTORS AND HOSPITALS STRUGGLE OVER MEDICARE FUNDS

The Bush Administration is provoking a war between hospitals, doctors, skilled nursing homes, and home health agencies, pitting them in a zero sum game over Medicare funds. Hospital investors have a stake in this battle. Hospitals could to lose the confrontation.

In his budget submission to Congress, President Bush stated that the Medicare system had an unfunded liability of *$14 trillion*. Despite this, the Administration proposed spending another $190 billion over ten years to subsidize seniors' pharmaceutical purchases. Ironically, fiscal hawks lauded this decision – when faced with the alternatives. Congressional GOP leaders want to spend $300 billion on seniors, and Democrats feel $500 billion is needed to pay for a more generous pharmaceutical benefit and to boost payments to Medicare service providers. However, the White House is standing its ground on the subject of expanding unit prices for doctors, hospitals, nursing homes, and home health agencies. The Administration has told Congress not to budget one dime more in total projected Medicare costs to boost provider payments. If Congress wants to help some providers, it will have to cut others by an identical amount.

Doctors are up in arms because Medicare payment rates will fall steadily under current law and cut their compensation by $128 billion over the next ten years. Under the "Sustained Growth Rate" (SGR) system, physician Medicare payments are set on a fee-for-service schedule based on the diagnosis of each patient, then updated annually. It would take a MIT mathematian to understand fully how the update system works, with some weight given to changes in GDP and other weight given to changes in the cost of inputs doctors use for treatments. The docs didn't complain when the jerryrigged update system delivered raises of 2 percent, then 3 percent, above inflation in 2000 and 2001. But this year, the formula produced a -5.4 percent fee-for-service rate cut, and projections for subsequent years are for more of the same, -5.7 percent, -5.7 percent, and -2.8 percent for 2003, 2004, and 2005, respectively.

Angry doctors appear to have found key allies on Capitol Hill. Perhaps most important is the influential Chairman of the House Ways and Means Committee, Bill Thomas (R-CA). In a March 21, 2002 letter to Thomas Scully, the Administrator for the Centers for Medicare and Medicaid (CMS) Services division inside HHS, Thomas asked that Scully use his administrative power to tinker with the estimates used in the SGR formula, thereby boosting payments to doctors – or, from their viewpoint, cutting their losses.

Scully probably won't do what Thomas wants. His bosses over at the White House are unenthusiastic about boosting Medicare spending above the $190 billion they seek for their seniors pharmaceutical package. In a joint letter to Thomas dated March 14, 2002, OMB Director Mitch Daniels and the Secretary of Health and Human Services, Tommy Thompson stated, "We agree with you completely that all of the new funding should be used for the President's top priority of improving the coverage options available to beneficiaries, including

prescription drugs, and *not for increasing payments to fee-for-service Medicare providers. ...We will not support any package of provider payment changes unless it is budget neutral in the short- and long-term."* Daniels and Thompson buried a comment in the back of the letter that should especially alarm hospital investors. Here is the telling paragraph: "... the stabilization of overall hospital margins in recent years suggests that, overall, the restrictions on market basket increases of recent years have not resulted in inadequate hospital payments. Reasonable and modest limits on hospital market basket updates would appear to provide adequate reimbursement for hospitals. ... The Administration believes that the savings from such measured changes in hospital payment updates could be more than adequate to finance reasonable net increases in total payments to physicians."

It's not as though the feds are handsomely overpaying for hospitals Medicare services. Like any good monopsonist, Washington keeps a close eye on how much they pay. That glare can be painful for hospital shareholders because the feds pay for just under 50 percent of all hospital care, and they aren't bashful asking for better pricing. Medicare revenues alone represent 36 percent of hospital revenue. Last month, the Medicare Payment Advisory Commission (MedPAC), whose influential reports circulate on Capitol Hill, issued its annual report. Here is what MedPAC reported on Medicare hospital margins.

Overall Medicare Margin by Hospital Group, 1999 and Estimated for 2002

Hospital Group	**1999**	**2002**
All Hospitals	**4.7%**	**3.8%**
In large urban areas	8.1%	6.8%
In other urban areas	2.7%	1.7%
Rural	-3.2%	-1.8%
Major teaching	13.0%	10.8%
Other teaching	5.1%	4.0%
Non-teaching	-0.1%	0.0%

Alas, those 3.8 percent projected 2002 margins mean that Congress can cut their $170 billion annual Medicare payments by $3 billion per year, give the proceeds to doctors, and still keep hospital doors open. Emergency rooms will still be open even if total hospital profits falls from $18 billion to $15 billion a year. Who's going to shed a tear, besides hospital investors?

For Doctors to be Happy and Hospital Shareholders to Lose, Congress will have to Act

If Congress decides to follow Bush's lead and reallocate Medicare funds from hospitals to doctors, an important signal will come when the House Ways and Means Committee meets soon

to decide its position on the issue. Although the schedule could slip, Chairman Thomas wrote to Tommy Thompson and Mitch Daniels on February 8, 2002, asking for detailed responses to questions he posed that would assist the Committee in making funding choices, stating " Given the short legislative year and our intention *to act on Medicare legislation this spring*, we would appreciate a prompt and detailed response to these requests." **For our money, CAN recommends lightening up on hospital exposure now and waiting out the Committee's decision, then buying back your position. If you must retain exposure now, overweight rural hospitals. Congress is unlikely to hit them as hard as those in large urban areas.**

MedPAC Thinks Skilled Nursing Homes have been Nursed Back to Health

Following passage of the Balanced Budget Act of 1997, the Clinton Administration used its discretionary authority granted by the Act to reduce Medicare payments to skilled nursing facilities (SNFs) by twice what Congress, or the industry, expected. The sharp loss in revenue sent the industry reeling, with several publicly traded national chains forced to seek protection of the bankruptcy courts. Industry lobbyists swarmed over Capitol Hill and succeeded in reversing some of the damage when Congress passed both the Balanced Budget Refinement Act of 1999 and also the Medicare, Medicaid, and SCHIP Benefits Improvement and Protection Act of 2000. Just in time for Washington's cherry blossom festival, industry lobbyists are back again this year.

Prior year legislative patches created three payment "add ons" to the rates first established by Clinton when implementing the Act: a 4 percent per diem increase; a 16.67 percent increase in the base rate for the nursing component of care; and a 20 percent increase in payments for high-cost medically complex patients. The first two patches fall off without Congressional action on October 1, 2002. On January 17, 2002, MedPAC staff recommended to the Commission that they be allowed to do so, sending equity prices of some providers down that day by 13 percent to 16 percent. Last month, the Commission agreed with their staff's January recommendations and also recommended to Congress that SNFs unaffiliated with hospitals, so-called free standing SNFs which enjoy over 9 percent margins on Medicare business, also not receive an inflation adjustment. MedPAC did say however, that the third "add-on," worth $10 billion over ten years to the industry, should be continued.

There is a 70 percent chance this year that Congress will adopt something similar to MedPAC's SNF recommendations. Still, the Administration's March 14 letter showed a willingness to review fuzzy government data before it made a final determination.of SNF payment adequacy. Watch what Chairman Thomas does later this spring for telling clues on how all this will turn out. He's unlikely to deviate far from the White House's private thinking. Hospital funding cuts may also be used to retain the third "add on."

Home Health Care Providers Fear No One is Home

The White House is especially unlikely to help the home health industry. In its March 14 letter, Daniels and Thompson state that Medicare financed home health spending will still grow by 12 percent in fiscal 2003, 8.3 percent in 2004, and 7.8 percent in 2005, *even after a twice*

delayed 4.9 percent price cut is imposed this October. Apparently, the White House feels any industry that will see its federal case load grow by 37 percent over three years can afford to absorb a quantity discount on all of its Medicare services. Thus, the Administration opposes MedPAC's suggestion that the 4.9 percent cut be delayed or canceled.

When Government is Your Customer ...

Watch Congress and the White House. We have focused this report on hospitals, skilled nursing homes, and home health care for a reason. What Washington decides to pay them has an immediate and long lasting impact on their financial fortunes. The table below documents that 50 percent to 60 percent of total revenue to these health care providers comes in the form of government checks. For those who fear nationalization of the health care system, consider this: government already pays for 45 percent of the tab – and this will grow substantially as baby boomers reach retirement age. To soften the blow to 400,000 doctors in an election years this year's most likely target for payment cutbacks is hospitals. Plan accordingly.

2000 NATIONAL HEALTH CARE EXPENDITURES

2000 ($ billions)	Total	Consumer Out of Pocket	Private Health Ins.	Other	Federal	State	Gov't %age
National Health Expenditures	1,299.5	194.5	443.9	73.8	411.5	175.7	45.2
Public Health	44.2	0	0	0	4.9	39.3	100.0
Other Personal Health Care	36.7	0.0	0.0	4.2	18.9	13.7	88.8
Research and Construction	43.9	0	0	16.7	20.3	7.0	62.2
Nursing Home	92.2	24.9	7.4	4.0	37.8	18.2	60.7
Hospital Care	412.1	13.0	133.9	22.0	192.9	50.3	59.0
Home Health	32.4	6.4	7.6	1.5	12.6	4.3	52.2
Physician/Clinical Services	286.4	33.2	136.7	21.3	79.2	16.0	33.2
Administrative Costs	80.9	0	53.1	1	15.9	10.8	33.0
Durable Medical Equipment	18.5	9.6	3.6	0	5.1	0.2	28.6
Other Professional Services	39.0	11.7	15.0	2.9	5.9	3.4	23.8
Prescription Drugs	121.8	39.0	56.3	0.0	15.2	11.3	21.8
Dental Services	60.0	26.9	30.1	0.2	1.6	1.1	4.5
Other Non-Durable Med Products	31.2	29.8	0	0	1.3	0	4.2

Source: Health Care Financing Administration; www.hcfa.gov/stats/nhe-oact/tables/t3.htm

4405 Bradley Lane
Chevy Chase, Maryland 20815
© 2001 Capitol Analysts Network, Inc. All rights reserved
Phone: 301-951-9161
Fax: 301-652-5831
Email: capnet@erols.com
Web site: www.capitolanalysts.com