

Act requires the Secretary to reduce the average standardized amounts by a factor to account for the estimated proportion of total DRG payments made to outlier cases. Similarly, section 1886(d)(9)(B)(iv) of the Act requires the Secretary to reduce the average standardized amounts applicable to hospitals in Puerto Rico to account for the estimated proportion of total DRG payments made to outlier cases.

In the August 1, 2002, IPPS final rule, we established the FY 2003 outlier fixed-loss threshold at \$33,560 (67 FR 50122). This was a nearly 60-percent increase over the FY 2002 threshold of \$21,025. The primary reason for this dramatic increase was a change in our methodology to use the rate of increase in charges rather than the rate-of-increase in costs to determine the threshold. That is, because we use FY 2001 cases to project the threshold for FY 2003, it is necessary to inflate the charges on the FY 2001 bills to approximate the charges on a similar claim for FY 2003. Prior to the calculation of the FY 2003 outlier threshold, we used the rate-of-cost increase from the most recent cost reports available to inflate actual charges on the prior year's bills to estimate what the charges would be in the upcoming year.

Our analysis indicated hospitals' charges were increasing at a much faster rate than costs. Therefore, in the August 1, 2002, IPPS final rule, we changed our methodology to inflate charges (67 FR 50122). Rather than using the observed rate-of-increase in costs from the cost reports, we inflated the FY 2001 charges by a 2-year average annual rate of change in actual charges per case from FY 1999 to FY 2000, and from FY 2000 to FY 2001, to estimate what the charges would be in FY 2003 for a similar claim.

The provisions of this final rule make several changes to better target outlier payments to the most costly cases. As a result, outlier payments to the hospitals that have been most aggressively increasing their charges to maximize outlier payments will be dramatically reduced. However, we are concerned that unrestrained charge increases have continued to occur during FY 2003 prior to the implementation of these final changes, and will likely result in outlier payments in excess of the 5.1 percent offset established by the August 1, 2002, IPPS final rule. (We now estimate FY 2003 outlier payments are equal to 6.1 percent of total DRG payments.) For example, hospitals intending to maximize outlier payments during FY 2003 could continue to do so by increasing charges enough to outpace the increase in the threshold. In fact,

given the public attention on this behavior over the past few months and the potential for other hospitals to begin to aggressively increase their charges, and consequently their outlier payments, it is possible this type of aggressive gaming of the outlier policy has become more widespread in recent months.

Because of the extreme uncertainty regarding the effects of aggressive hospital charging practices on FY 2003 outlier payments to date, we did not propose any change to the FY 2003 fixed-loss threshold (\$33,560) in the March 5, 2003, proposed rule. However, we noted that data for the first quarter of FY 2003 inpatient claims would be available soon and these data would allow us to evaluate whether outlier payments to date appear to be approximately 5.1 percent of total DRG payments. We solicited comments and data from hospitals with respect to the recent trends in hospital charges and the implications for outlier payments if the fixed-loss threshold were to remain at \$33,560. We indicated in the March 5, 2003, proposed rule that, based upon that analysis and the comments we received in response to the proposed rule, we would adjust the threshold accordingly in the final rule.

B. Summary of Public Comments and Departmental Responses

Comment: Many commenters recommended that we lower the outlier threshold to ensure that hospitals have access to these special payments to cover extremely high-cost Medicare patients. In addition, they argued that because the threshold was raised from \$21,025 in FY 2002 to \$33,650 in FY 2003 based on policies in place at the beginning of the year, the threshold should now be lowered to reflect these mid-year changes.

Some commenters suggested that if a new threshold cannot be calculated by the publication date of the final rule, we should apply the FY 2002 threshold until a new threshold could be calculated. They argued that use of this threshold would enable all legitimate claims to qualify for cost outlier status.

MedPAC noted that failing to adjust the threshold would continue to deny additional payments to hospitals that have extraordinarily costly cases, thwarting the legislative purpose of the policy. One commenter suggested we lower the threshold close to the FY 2002 amount because it was not the intent of the Congress to have such a high outlier threshold for those hospitals that did not try to manipulate the outlier system and have sustained high losses for true outlier cases.

One commenter argued that last year, for purposes of setting a FY 2003 outlier threshold, CMS inflated charges using a 2-year average annual rate of change in charges per case from FY 1999 to FY 2000, and from FY 2000 to FY 2001, because CMS analysis demonstrated that charges have been growing at a much faster rate than recent estimates of cost growth. The commenter argued that, based on the new proposals in the proposed rule, this methodology was now unnecessary because the assumption of a lag in cost reports no longer applies.

One commenter recommended that we lower the threshold to the FY 2002 amount and implement this threshold retroactively to October 1, 2002. The commenter explained that many hospitals did not game the system and have had their outlier payments reduced over the years because the threshold has increased dramatically over the last 3 years due to a limited number of hospitals who gamed the system.

Response: We reestimated the fixed-loss threshold reflecting the changes implemented in this final rule that will be in effect during a portion of FY 2003. To do that reestimation, we inflated charges from the FY 2002 Medicare Provider Analysis and Review (MedPAR) file by the 2-year average annual rate of change in charges per case to predict charges for FY 2004. We believe the use of charge inflation is more appropriate than our previous methodology of cost inflation because charges are increasing at a much faster rate than costs. Therefore, we disagree that we should return to using the previous methodology based on cost inflation. Originally, when the FY 2003 threshold of \$33,560 was set, we used FY 2001 MedPAR records. Because more recent data are now available, we believe it would be appropriate to use FY 2002 data to reestimate the FY 2003 threshold, taking into account the changes implemented by this final rule.

As noted previously, we continued to pay substantially more than was projected for outlier payments in FY 2002. Our most recent estimate is that we paid approximately 7.9 percent of total DRG payments in outliers, well in excess of our original projection of 5.1 percent, and higher than the percentage of total DRG payments for outliers in FY 2001. That percentage was 7.7. Therefore, using FY 2002 cases to estimate the outlier threshold for FY 2003 would result in a threshold of \$42,300. However, after accounting for the changes implemented in this final rule, we estimate the threshold would be only slightly higher than the current threshold (by approximately \$600).