

accordance with section 1886(b)(3)(B)(i) of the Act, the large urban average standardized amount is 1.6 percent higher than the other area average standardized amount.

Section 402(b) of Pub. L. 108-7 required that, effective for discharges occurring on or after April 1, 2003, and before October 1, 2003, the Federal rate for all IPPS hospitals would be based on the large urban standardized amount. However, for discharges occurring on or after October 1, 2003, the Federal rate will again be calculated based on separate average standardized amounts for hospitals in large urban areas and for hospitals in other areas.

Section 1886(d)(2)(D) of the Act defines "urban area" as those areas within a Metropolitan Statistical Area (MSA). A "large urban area" is defined as an urban area with a population of more than 1 million. In addition, section 4009(i) of Pub. L. 100-203 provides that a New England County Metropolitan Area (NECMA) with a population of more than 970,000 is classified as a large urban area. As required by section 1886(d)(2)(D) of the Act, population size is determined by the Secretary based on the latest population data published by the Bureau of the Census. Urban areas that do not meet the definition of a "large urban area" are referred to as "other urban areas." Areas that are not included in MSAs are considered "rural areas" under section 1886(d)(2)(D) of the Act. Payment for discharges from hospitals located in large urban areas will be based on the large urban standardized amount. Payment for discharges from hospitals located in other urban and rural areas will be based on the other standardized amount.

As discussed previously, on June 6, 2003, OMB announced revised definitions of MSAs and new definitions of Micropolitan Statistical Areas and Combined Statistical Areas. In order to implement these changes for the IPPS, it is necessary to identify the new area designation for each county and hospital in the country. Because this process will have to be extensively reviewed and verified, we were unable to undertake it before publication of this final rule. Therefore, we are continuing to use MSAs based on OMB's definitions of MSAs prior to June 6, 2003. Based on those definitions, 63 areas meet the criteria to be defined as large urban areas for FY 2004. These areas are identified in Table 4A of section VI. of this Addendum.

3. Updating the Average Standardized Amounts

In accordance with section 1886(d)(3)(A)(iv) of the Act, we are updating the large urban areas' and the other areas' average standardized amounts for FY 2004 by the full estimated market basket percentage increase for hospitals in all areas, as specified in section 1886(b)(3)(B)(i)(XIX) of the Act. The percentage change in the market basket reflects the average change in the price of goods and services purchased by hospitals to furnish inpatient care. The most recent forecast of the hospital market basket increase for FY 2004 is 3.4 percent. Thus, for FY 2004, the update to the average standardized amounts equals 3.4 percent for hospitals in all areas.

Although the update factors for FY 2004 are set by law, we are required by section 1886(e)(3) of the Act to report to the Congress our initial recommendation of update factors for FY 2004 for both IPPS hospitals and hospitals excluded from the IPPS. Our recommendation on the update factors (which is required by sections 1886(e)(4)(A) and (e)(5)(A) of the Act) is set forth as Appendix B of this final rule.

Comment: One commenter recommended an increase to the market basket that would account for large increases in the costs of malpractice, pensions, health benefits, pharmaceuticals, and new technology that hospitals are facing.

Response: The hospital market basket is structured to measure the change in prices for an exhaustive list of inputs used by hospitals in providing services. The index measures the "pure" price change of those inputs and appropriately does not measure changes in quantity or intensity. These nonprice factors include shifts in the skill mix of employees, increased amounts of labor purchased, increased malpractice coverage, the increased use of pharmaceuticals and technology in providing care, and movements toward more or less intensive pharmaceuticals and technology. Nonprice factors such as these may be contributing to the increases in cost that hospitals are currently facing.

In addition, the most recent data available are used to forecast the market basket price changes and are intended to reflect conditions that hospitals will face in the upcoming fiscal year. As it is intended, the hospital market basket measures the national average price increase and will not reflect geographic differences from one geographic area to another. In other words, while one area may see a large surge in the prices of inputs, another area may actually be experiencing much smaller increases in the prices of these inputs. This may also be contributing to the increased costs to which the commenter referred. Therefore, we believe that the market basket is an accurate representation of the national average price increase facing hospitals in providing services, and the 3.4 percent increase for FY 2004 provides an adequate update to hospitals to account for the inflationary increase in costs.

4. Other Adjustments to the Average Standardized Amounts

As in the past, we adjust the FY 2004 standardized amounts to remove the effects of the FY 2003 geographic reclassifications and outlier payments before applying the FY 2004 updates. We then apply the new offsets to the standardized amounts for outliers and geographic reclassifications for FY 2004.

We do not remove the prior year's budget neutrality adjustments for reclassification and recalibration of the DRG weights and for updated wage data because, in accordance with section 1886(d)(4)(C)(iii) of the Act, estimated aggregate payments after the changes in the DRG relative weights and wage index should equal estimated aggregate payments prior to the changes. If we removed the prior year adjustment, we would not satisfy this condition.

Budget neutrality is determined by comparing aggregate IPPS payments before and after making the changes that are required to be budget neutral (for example, reclassifying and recalibrating the DRGs, updating the wage data, and geographic reclassifications). We include outlier payments in the payment simulations because outliers may be affected by changes in these payment parameters. Because the changes to the postacute care transfer policy discussed in section IV.A. of the preamble of this final rule are not budget neutral, we included the effects of expanding this policy to additional DRGs prior to estimating the payment effects of the DRG and wage data changes.

a. *Recalibration of DRG Weights and Updated Wage Index—Budget Neutrality Adjustment.*—Section 1886(d)(4)(C)(iii) of the Act specifies that, beginning in FY 1991, the annual DRG reclassification and recalibration of the relative weights must be made in a manner that ensures that aggregate payments to hospitals are not affected. As discussed in section II. of the preamble, we normalized the recalibrated DRG weights by an adjustment factor, so that the average case weight after recalibration is equal to the average case weight prior to recalibration. However, equating the average case weight after recalibration to the average case weight before recalibration does not necessarily achieve budget neutrality with respect to aggregate payments to hospitals because payments to hospitals are affected by factors other than average case weight. Therefore, as we have done in past years, we are making a budget neutrality adjustment to ensure that the requirement of section 1886(d)(4)(C)(iii) of the Act is met.

Section 1886(d)(3)(E) of the Act requires us to update the hospital wage index on an annual basis beginning October 1, 1993. This provision also requires us to make any updates or adjustments to the wage index in a manner that ensures that aggregate payments to hospitals are not affected by the change in the wage index.

Section 4410 of Pub. L. 105-33 provides that, for discharges on or after October 1, 1997, the area wage index applicable to any hospital that is not located in a rural area may not be less than the area wage index applicable to hospitals located in rural areas in that State. This provision is required by section 4410(b) of Pub. L. 105-33 to be budget neutral. Therefore, we include the effects of this provision in our calculation of the wage update budget neutrality factor.

In addition, we are required to ensure that any add-on payments for new technology under section 1886(d)(5)(K) of the Act are budget neutral. As discussed in section II.E. of this final rule, we are approving two new technologies for add-on payments in FY 2004. We estimate that the total add-on payments for these new technologies will be \$14.4 million for FY 2004.

To comply with the requirement that DRG reclassification and recalibration of the relative weights be budget neutral, and the requirement that the updated wage index be budget neutral, we used FY 2002 discharge data to simulate payments and compared aggregate payments using the FY 2003