

We used this revised update factor to compute the Federal portion of the SNF PPS rate shown in Tables 1 and 2.

*Comment:* The majority of commenters strongly supported the proposed rule's provision for a full market basket adjustment for FY 2004. However, a few commenters cited a MedPAC analysis indicating that an across-the-board update may not be appropriate. These commenters recommended either a zero update or an update targeted to specific types of providers, such as hospital-based SNFs.

*Response:* We are required by statute to implement a full market basket adjustment for FY 2004. In the proposed rule, we published a preliminary market basket factor of 2.9 percent, based on the Global Insights Inc., DRI-WEFA, 4th Quarter, 2002 update. For this final rule, we are using an updated market basket forecast amount of 3.0 percent, based on the Global Insights Inc., DRI-WEFA, 2nd Quarter, 2003 update, which is the most recent data available.

*Comment:* The vast majority of commenters supported our proposal in the supplemental proposed rule to incorporate a market basket forecast error adjustment into the SNF PPS rate-setting system. These commenters urged us to implement the 3.26 percent cumulative market basket adjustment for the FY 2004 rates. They indicated that the cumulative adjustment is a necessary stabilizing factor, and reflects actual market conditions. A few commenters questioned the necessity of this cumulative adjustment, and suggested that the money could be used more effectively if targeted to specific programs. However, all commenters agreed that, if we proceeded with the cumulative market basket forecast error adjustment, we should apply the forecast error adjustment in subsequent rate years, even in situations where an overstatement of the forecasted market basket adjustment could result in a later downward adjustment.

*Response:* We carefully considered the implications of adopting this market basket forecast error adjustment. We concluded that, in making the 3.26 percent adjustment, we are not providing a source of new industry funding. Instead, we are correcting an underforecast of pricing levels that resulted in lower payments than we would otherwise have made if actual, instead of forecast, data were used. To a great extent, this underforecast reflects the faster-than-expected growth in wages and benefits for nursing home workers since the start of the SNF PPS, as a result of continued rapid growth in the health sector and the shortage of nurses. As a result of these market

conditions, SNFs have already incurred expenses at a higher-than-forecasted level. Our overarching Medicare integrity goal is to pay the appropriate amount, to the correct provider, for the proper service, at the right time. Adjusting for this difference between the forecasted and actual market basket values is consistent with that goal. Therefore, we will implement the 3.26 percent cumulative adjustment for FY 2004. For future years, as actual market basket data become available, we will apply the forecast error adjustment to subsequent rate years. As explained in our supplemental proposed rule, this annual adjustment will be applied on a two-year lag basis (that is, the time period for obtaining final market basket data), and will reflect both upward and downward adjustments, as appropriate.

*Comment:* Several commenters expressed concern about the proposed use of a 0.25 percentage point threshold for application of the annual forecast adjustments. Some commenters maintained that every forecast error, however small, should be corrected, and that the use of a threshold would build over time, resulting in increasing inaccuracies in the rates. Other commenters said that the adjustment should be meaningful, and that the 0.25 percent threshold was consistent with similar CMS rate-setting provisions. A few commenters suggested increasing the threshold.

*Response:* In the supplemental proposed rule, we discussed establishing an adjustment for forecast error that would take account annually a forecast error that was at least 0.25 percentage points above or below the actual market basket performance. For the capital PPS update and in the hospital PPS update framework, a forecast error adjustment is reflected only when the forecast and actual market basket percent changes differ by more than 0.25 percentage points. To apply this methodology to the SNF PPS would follow an established practice. In addition, our experience with those PPS frameworks suggests that the forecast errors are relatively small, and generally clustered around zero, so we do not anticipate an accumulation that would significantly affect the rates over time. We are more concerned that the forecast error in any given year is large enough that the SNF PPS base payment rate does not adequately reflect the historical price changes faced by SNFs. Therefore, we will use the 0.25 percentage point threshold to determine whether a forecast error adjustment is appropriate.

*Comment:* A few commenters expressed concern about the market basket and its methodology and urged

us to institute a thorough review of all of the weight and price proxy components in the market basket, particularly wages, capital, and malpractice insurance. These commenters proposed a collaborative effort between the Federal government and private industry to review the market basket methodology.

*Response:* We agree that it is important to review the market basket weights and price proxies regularly to ensure that they adequately reflect the requirements of section 1888(e)(5) of the Act. It has always been our policy to regularly revise and update the market basket when appropriate, and we did so most recently in 2001, when we rebased the market basket to reflect 1997 cost data. In addition, we have discussed issues related to the market basket with interested parties since the implementation of the SNF PPS, and continue to do so in order to have a technically and conceptually sound market basket that satisfies the legislative requirement explained in section 1888(e)(5) of the Act.

In the July 31, 2001 final rule introducing the 1997-based market basket, we fully explained our criteria for choosing price proxies for market basket cost categories. We use four criteria for this process: timeliness (published and available on a regular basis, preferably at least quarterly, with little lag), reliability (consistent historical time-series as well as being technically and methodologically sound), representativeness (reflecting or proxying actual provider experience), and relevance (holding non-price factors constant, such as skill mix and quality shifts). The current price proxy for wages and salaries, the Employment Cost Index (ECI) for nursing home workers, meets all four of these criteria. We believe that the ECI better meets our criteria than the two other government statistics for nursing home wages, the Average Hourly Earnings (AHE) for nonsupervisory workers in nursing homes and the Employer Cost for Employee Compensation (ECEC) for workers in nursing homes. Although the ECI represents total nursing home wages and salaries, SNFs comprise over 75 percent both of employment and payroll totals for the nursing home industry and, with this representation, SNF wages and salaries are the drivers for changes in the ECI for nursing home wages and salaries. Thus, given available data, we continue to believe that the ECI for nursing home workers is the most appropriate price proxy for growth in wages in SNFs, and we will continue to use it in the SNF market basket. It should be noted that the use