APPENDIX A

Review of CMS's estimate of the payment update for physician services

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Medicare makes payments for physician services according to a fee schedule that assigns relative weights to services, reflecting resource requirements. These weights are adjusted for geographic differences in practice costs and are multiplied by a dollar amount—the conversion factor—to determine payments. Thus, the conversion factor is a key element of the payment system. If it changes, there is a proportional change in the payment rates for all of the more than 7,000 services represented in the fee schedule.

The conversion factor is updated annually, based on a formula in law designed to control spending while accounting for factors that affect the cost of physician services. CMS issues a final rule on the update in November each year and implements the update on January 1 of the following year. To help the Congress and others anticipate the update, the Balanced Budget Refinement Act of 1999 (BBRA) requires CMS to prepare, by March 1 of each year, a preliminary estimate of the next year's update. The BBRA also requires MedPAC to review that estimate in the Commission's June report. This appendix fulfills the requirement that we review the estimate of the update for 2004.

For 2004, CMS provided both a point estimate and a range for the update. The point estimate is an update of −4.2 percent. Before November, a number of factors that determine the update are likely to change. To acknowledge this uncertainty, CMS allowed factors in the calculations to vary within limits based on experience.[1] The agency did so with stochastic forecasting techniques and projects that there is a 95 percent probability that the update will range between −5.8 and 0.6 percent.

Calculating the update is a two-step process. First, CMS estimates the sustainable growth rate (SGR). The SGR is the target rate of growth in spending for physician services and is a function of projected changes in:

- input prices for physician services,[2]
- enrollment in traditional fee-for-service Medicare,
- real gross domestic product (GDP) per capita, and
- spending attributable to changes in law and regulation.

For 2004, CMS's preliminary estimate of the SGR is 6.4 percent (Table A-1, p. 174).

Second, CMS calculates the update, which is a function of:

- the change in input prices for physician services,[3]
- a legislative adjustment required by the BBRA,[4] and

1 CMS allowed three factors in the update calculations to vary: growth in real gross domestic product (GDP) per capita, growth in use of physician services, and change in input prices for physician services.

2 For the SGR, physician services include services commonly performed by a physician or in a physician's office. In addition to services paid for under the physician fee schedule, these services include diagnostic laboratory tests and drugs covered under Medicare Part B. To estimate this factor, CMS uses a weighted average of the Medicare Economic Index (MEI), a measure of changes in input prices for physician services; the change in payment rates for laboratory services; and a weighted average of the change in payment rates for Part B-covered drugs.

3 For the update, physician services include only those paid for under the physician fee schedule.

4 This adjustment maintains the budget neutrality of a technical change in the calculation of the update intended to reduce year-to-year changes in the conversion factor.

TABLE A-1 **Preliminary sustainable growth rate, 2004**

Factor	Percent
Change in input prices	2.3%
Change in traditional Medicare enrollment	1.3
Change in real GDP per capita	2.7
Change due to law and regulations	0.0
Sustainable growth rate	6.4

Note: GDP (gross domestic product).

Source: Grissom 2003.

- an update adjustment factor that increases or decreases the update as needed to align actual spending with the target that is determined by the SGR.

Of these factors, the update adjustment factor has the largest effect on the estimate for 2004 (Table A-2). This is negative because actual spending for physician services is above and projected to stay above the target through 2003 (Figure A-1), for two reasons. First, actual spending for physician services grew in 2002—despite a reduction in the conversion factor for that year of 5.4 percent—because of an increase in use of services. Second, the update for 2003 was positive when, in retrospect, it should have been negative.[5] The result is a difference between actual spending and the target that is wide enough to require an update adjustment factor of −5.9 percent. When this negative adjustment is combined with the other factors that determine the update—a change in input prices and legislative adjustments of 2.0 and −0.2 percent, respectively—the result is an update of −4.2 percent.

On the technical issues of how CMS estimated the update, MedPAC finds no reason to question CMS's assumptions about factors that determine the update.

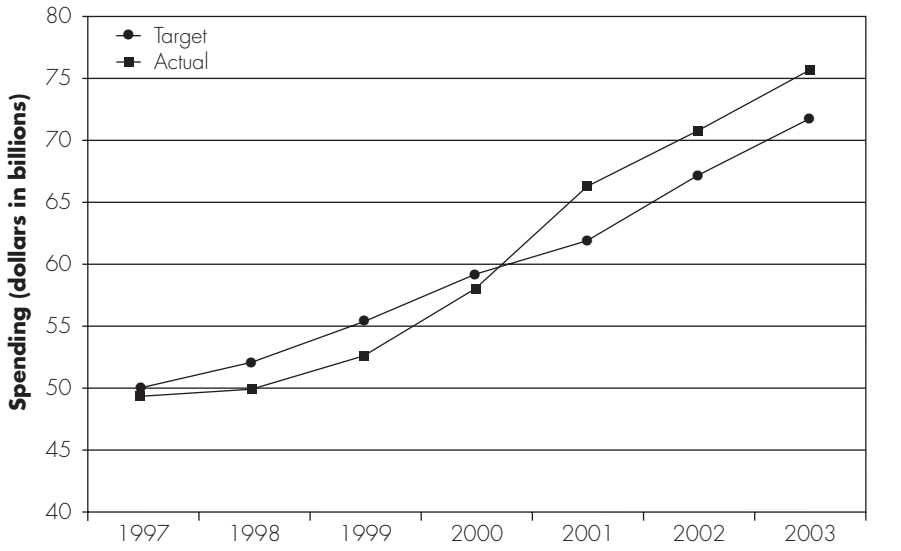
- The 2.0 and 3.0 percent changes in input prices for 2004 and 2003, respectively, (as measured by the Medicare Economic Index [MEI]) are similar to MEI changes for earlier years.[6,7]
- A change in fee-for-service enrollment of 1.3 percent is close to the projected overall increase in Medicare enrollment for 2004 of 1.0 percent and assumes some continued disenrollment of beneficiaries from Medicare+Choice plans.
- The projected change in real GDP per capita of 2.7 percent is based on the

TABLE A-2 **Estimate of the update for physician services, 2004**

Factor	Percent
Change in input prices	2.0%
Legislative adjustment	–0.2
Update adjustment factor	–5.9
Update	–4.2

Source: Grissom 2003.

FIGURE A-1 **Target and actual spending for physician services, 1997–2003**



Source: Office of the Actuary 2003.

5 CMS recently revised some of the factors that determined the update for 2003, including the SGRs for 2002 and 2003 and actual spending for physician services in 2002. Recalculating the update with this new information results in an update for 2003 of –1.6 instead of the +1.6 percent update implemented on March 1.

6 For a historical perspective on changes in the MEI, see MedPAC's June 2001 Report to the Congress: Medicare in rural America. Washington (DC), MedPAC. June 2001, p. 129.

7 CMS's estimate of the change in input prices includes a productivity adjustment of 1.0 percent, which makes the estimate a measure of changes in cost and not just a measure of the change in input prices. Thus, the estimate is lower than MedPAC's estimate of the change in the cost of providing physician services for 2004, which is 2.5 percent (MedPAC 2003). There are two reasons for the difference between CMS's and MedPAC's estimates. First, CMS's productivity adjustment is slightly larger than MedPAC's (0.9 percent). Second, CMS uses a retrospective measure of changes in cost, while MedPAC uses a projection. For further discussion of this issue, see MedPAC's March 2001 Report to the Congress: Medicare payment policy. Washington (DC), MedPAC. March 2001, p. 25.

President's budget proposal for fiscal year 2004. This estimate equals the forecast of real GDP growth for 2004 (adjusted for population growth) from the Congressional Budget Office (CBO 2003).

- An estimate of no change in spending due to law and regulation is valid as long as the Congress does not change the Medicare benefit package and there are no other relevant changes in law and regulation.

The difficulty comes in assessing CMS's estimates of actual spending for physician services. The estimate of actual spending in 2002 is based on nearly complete information for the first three quarters of the year but incomplete data for the last quarter. Therefore, this estimate may vary somewhat before CMS issues the final rule on the update in November. A bigger change is possible in the estimate of actual spending for 2003, however, because CMS currently has no relevant information for 2003. This lack is a reason why CMS chose to acknowledge the uncertainty in the update estimate for 2004 and to project a range for the update.

The estimate of actual spending in 2003 is $75.8 billion. Compared to 2002, this is an increase of 6.9 percent. This implies a rise in use of physician services per beneficiary of about 4.3 percent.[8] Such growth would be lower than CMS's estimate for 2002 of 6 to 8 percent. A 4.3 percent increase is consistent with the experience before 2002, however.

If the actual increase in use of physician services in 2003 is greater than 4.3 percent, the payment reduction in 2004 will be larger than the −4.2 percent update CMS estimates, assuming no other changes in the factors that determine the update. That is, the update could approach the 5.8 percent reduction CMS calculated when projecting a range for the update. On the other hand, if the rise in use of physician services is less than 4.3 percent, the payment reduction will be less than the agency's estimate and, according to CMS's projected range, the update could even be a small positive increase.

Other questions concern actual spending: Why did actual spending go up in 2002 despite the 5.4 percent reduction in the fee schedule's conversion factor, and will a similar increase occur in 2003? There are a number of possible explanations for the 2002 increase, but two have received much attention (Hawryluk 2003). According to CMS, physicians offset the reduction in the conversion factor by increasing the number of services provided to Medicare beneficiaries. The opposing view, from the American Medical Association and other physician groups, is that much of the growth was due to medical research, quality improvement programs, and other initiatives aimed at improving patient care. In addition, there is evidence that the spending increase started in 2001, and that it was not limited to physician services (American Medical Association et al. 2003).

The uncertainty about what happened in 2002 only adds to the difficulty of projecting actual spending for 2003, a problem that CMS can only overcome with data on actual spending. Partial information, for the first and second quarters of 2003, will be available before November of this year, when CMS will issue a final rule with the update for 2004. ■

8 We calculated the implied increase in use of services per beneficiary as the increase in actual spending of 6.9 percent minus an increase in payment rates of 1.4 percent and minus an increase in fee-for-service enrollment of 1.2 percent. The increase in payment rates is a weighted average of the change in the physician fee schedule's conversion factor (no change in rates for the first quarter of the year and a 1.6 percent increase for the last three quarters), the payment update for laboratory services (1.1 percent), and an estimate of the change in the payment rates for Medicare Part B-covered drugs from CMS actuaries (3.3 percent).

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