PROVIDER REIMBURSEMENT REVIEW BOARD
DECISION
On the Record

2022-D09

PROVIDER-
Medical Arts Hospital

Provider No.: 45-0489

vs.

MEDICARE CONTRACTOR –
Novitas Solutions, Inc.

RECORD HEARING DATE –
May 6, 2021

Cost Reporting Period Ended –
3/31/2012

CASE NO. – 17-0272

INDEX

ISSUE STATEMENT

Whether Medical Arts Hospital ("Medical Arts" or the "Provider") is entitled to a volume decrease adjustment ("VDA") for the fiscal year ending March 31, 2012 ("FY 2012").[1]

DECISION

After considering the Medicare law and regulations, arguments presented, and the evidence admitted, the Provider Reimbursement Review Board ("Board") finds that the Medicare Contractor improperly calculated Medical Arts' VDA payment for FY 2012, and that Medical Arts should receive a VDA payment in the amount of $68,699 for FY 2012.

INTRODUCTION

Medical Arts is a 22-bed Sole Community Hospital ("SCH") located in Lamesa, Texas.[2] The Medicare contractor[3] assigned to Medical Arts for this appeal is Novitas Solutions, Inc. ("Medicare Contractor").[4] The Provider filed a timely request for a VDA payment for FY 2012 on September 16, 2014.[5] On June 9, 2016, the Medicare Contractor denied the request because it concluded that Medical Arts' total reimbursement exceeded Medical Arts' fixed costs.[6] On August 5, 2016, Medical Arts submitted a Request for Reconsideration, which the Medicare Contractor denied on September 30, 2016.[7] The Board received Medical Arts' timely appeal request, which met all jurisdictional requirements for a hearing before the Board, on November 1, 2016.[8]

The Board approved the parties' request for a record hearing on May 6, 2021. Medical Arts was represented by Ronald K. Rybar of The Rybar Group, Inc. The Medicare Contractor was represented by Scott Berends, Esq. of Federal Specialized Services.

STATEMENT OF FACTS AND RELEVANT LAW

The Medicare program pays certain hospitals a predetermined, standardized amount per discharge under the inpatient prospective payment system ("IPPS") based on the diagnosis-related group ("DRG") assigned to the patient. These DRG payments are subject to certain payment adjustments. One of these payment adjustments is referred to as a VDA payment, and it is available to SCHs if, due to circumstances beyond their control, they incur a decrease in their

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[1] Provider Final Position Paper ("Provider's FPP") at 2; Medicare Contractor Final Position Paper ("Medicare Contractor's FPP") at 3.
[2] Stipulation of Facts ("Stipulations") at ¶ 1.
[3] CMS' payment and audit functions under the Medicare program were historically contracted to organizations known as fiscal intermediaries ("FIs") and these functions are now contracted to organizations known as Medicare administrative contractors ("MACs"). The term "Medicare contractor" refers to both FIs and MACs as appropriate.
[4] Stipulations at ¶ 1.
[5] *Id.* at ¶ 3.
[6] Medicare Contractor's FPP at 2.
[7] *Id.* at 2; Provider's FPP at 3-4.
[8] Provider FPP at 4; Medicare Contractor's FPP at 2.

total number of inpatient cases of more than 5 percent from one cost reporting year to the next.[9] VDA payments are designed to fully compensate a hospital for the fixed costs incurred providing inpatient hospital services in the period covered by the VDA, including the reasonable cost of maintaining necessary core staff and services.[10] The implementing regulations, located at 42 C.F.R. § 412.92(e), reflect these statutory requirements.

It is undisputed that Medical Arts experienced a decrease in discharges greater than 5 percent from FY 2011 to FY 2012 due to circumstances beyond its control, and that, as a result, Medical Arts was eligible to have a VDA calculation performed for FY 2012.[11] However, when the Medicare Contractor completed the FY 2012 VDA calculation, it determined that Medical Arts' total DRG payments exceeded its fixed program operating costs and, thus, Medical Arts did not qualify for a VDA payment.[12]

The regulation at 42 C.F.R. § 412.92(e) (2012) directs how the Medicare Contractor must determine the VDA once an SCH demonstrates it experienced a qualifying decrease in total inpatient discharges. In pertinent part, § 412.92(e)(3) states:

> (3) The intermediary determines a lump sum adjustment amount *not to exceed* the difference between the hospital's Medicare inpatient operating costs and the hospital's total DRG revenue for inpatient operating costs based on DRG-adjusted prospective payment rates for inpatient operating costs . . . .
>
> (i) In determining the adjustment amount, the intermediary considers— . . .
>
> (B) The hospital's fixed (and semi-fixed) costs, other than those costs paid on a reasonable cost basis under part 413 of this chapter. . . .[13]

The preamble to the final rule published on August 18, 2006[14] references the Provider Reimbursement Manual, Pub. No. 15-1 ("PRM 15-1") § 2810.1 (Rev. 371), which offers further guidance related to VDAs. This manual provision states, in relevant part:

> B. Additional payment is made . . . for the fixed costs it incurs in the period in providing inpatient hospital services including the reasonable cost of maintaining necessary core staff and services, not to exceed the difference between the hospital's Medicare inpatient operating cost and the hospital's total DRG revenue.

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[9] 42 U.S.C. § 1395ww(d)(5)(D)(ii).
[10] *Id.*
[11] Stipulations at ¶ 4. *See also* Provider's FPP at 3.
[12] Medicare Contractor's FPP at 2.
[13] (Emphasis added.)
[14] 71 Fed. Reg. 47870, 48056 (Aug. 18, 2006).

> Fixed costs are those costs over which management has no control. Most truly fixed costs, such as rent, interest, and depreciation, are capital-related costs and are paid on a reasonable cost basis, regardless of volume. Variable costs, on the other hand, are those costs for items and services that vary *directly* with utilization such as food and laundry costs.[15]

The chart below depicts how the Medicare Contractor and Medical Arts each calculated the VDA payment.

	Medicare Contractor calculation using fixed costs[16]	Provider/PRM calculation using total costs[17]
a) Prior Year Medicare Inpatient Operating Costs	$1,530,563	$1,530,563
b) IPPS update factor	1.0215[18]	1.0215
c) Prior year Updated Operating Costs (a x b)	$1,563,470	$1,563,470
d) FY 2012 Operating Costs	$1,259,295	$1,259,295
e) Lower of c or d	$1,259,295	$1,259,295
f) DRG/SCH payment	$1,095,310	$1,095,310
g) CAP (d-f)	$ 163,985	$ 163,985
h) FY 2012 Inpatient Operating Costs	$1,183,056[19]	$1,259,295
i) Fixed Cost percent	0.8838[20]	0.8838[21]
j) FY 2012 Fixed Costs (h x i)	$1,045,585	$1,112,965
k) Total DRG/SCH Payments	$1,095,310	$ 968,035[22]
l) VDA Payment Amount (The Medicare Contractor's VDA is based on the amount by which line j exceeds line k)	$ (49,725)	
m) VDA Payment Amount (The Providers VDA is based on the amount by which line j exceeds line k.)		$ 144,930

The parties to this appeal dispute the application of the statute and regulation used to calculate the VDA payment.[23]

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[15] (Emphasis added).
[16] Exhibits C-1, P-7.
[17] Exhibit P-1 at 1; Exhibit C-2 at 1.
[18] Exhibit C-1 at 3. Calculation = ((1.024 x 183 days) + (1.019 x 183 days) / 366 days = 1.0215). Update factors based upon Table 1A of FFY 2011 IPPS Final Rule (4/1/11 to 9/30/11) and FFY 2012 IPPS Final Rule (10/1/11 to 3/31/12).
[19] *Id.* at 5. The FY 2012 Operating amount of $1,259,295 was offset by Excess Staffing of $76,239.
[20] *Id.* at 3. Calculation = 8,661,505/9,799,789 = 0.88384607, rounded to 0.8838.
[21] Exhibit P-7 at 3. Calculation = 8,661,505/9,799,789 = 0.88384607, rounded to 0.8838.
[22] Calculation = 1,095,310*0.8838 = 968,034.978, rounded to 968,035.
[23] Provider's FPP at 5; Medicare Contractor's FPP at 6.

DISCUSSION, FINDINGS OF FACT, AND CONCLUSIONS OF LAW

Medical Arts disputes the Contractor's VDA calculation for three reasons: (1) the lack of a reciprocal adjustment removing the variable costs percentage from DRG payments in the calculation; (2) the classification as variable of non-salary expenses of particular cost centers; and, (3) the use of a "flawed" core staffing calculation.[24]

The Medicare Contractor counters that its methodology for removing variable costs is supported by *Lakes Regional Healthcare v. BlueCross BlueShield Assoc./Wisconsin Physician Services*, PRRB Decision No. 2014-D16 (July 10, 2014), *Unity Healthcare v. BlueCross BlueShield Assoc./Wisconsin Physician Serv's,* Adm. Review of PRRB Dec. No. 2014-D15 (Sept. 4, 2014), and *Unity Healthcare v. Azar*, No. 18-1316 (8th Cir. 2019), *St. Anthony Regional Hospital v. Azar*, No. 18-1703 (8th Cir. 2019) and *Lakes Regional Healthcare v. Azar*, No. 18-1704 (8th Cir. 2019).[25]

Applying the methodology adopted by the Board in previous decisions, Medical Arts reasons that, if variable costs are to be excluded from inpatient operating costs when calculating the VDA, there should also be a corresponding decrease to the DRG payment for variable costs.[26] This method, Medical Arts maintains, would assure an accurate matching of revenue with expenses, because the DRG payment is intended to cover both fixed *and* variable costs. Medical Arts also references the fact that CMS essentially adopted this approach when it prospectively changed the final rule for calculating VDA payments, starting in FFY 2018.[27]

Medical Arts disagrees with the methodology employed by the Medicare Contractor in removing variable costs from the Medicare Impatient Operating costs. The Medicare Contractor adjusted the Inpatient Operating Costs for variable costs through an analysis of costs on Worksheet A of Medical Arts' cost report. This resulted in a fixed (and semi-fixed) cost percentage.[28] Medical Arts claims that "the Medicare Contractor improperly classified fixed and semi-fixed costs as variable costs."[29] The Medicare Contractor dismisses this argument, noting the Provider has offered no separate analysis using its suggested methodology. The Medicare Contractor states "As previous Administrator and Board determinations have affirmed the determination of variable costs by cost centers and the Provider offers no evidence of impact from its suggested methodology, the MAC's determination should be affirmed."[30]

Medical Arts also disagrees with the Medicare Contractor's excess staffing calculation. They state that the 2009 Occupational Mix data "is not contemporaneous with the VDA period under review."[31] In addition, they state that the Medicare Contractor in its excess staffing calculation has incorrectly included "nursing staff from all areas of the hospital… such as Nursing

[24] Medicare Contractor's FPP at 6; Provider's FPP at 5-9.
[25] Medicare Contractor's FPP at 7-9.
[26] Provider's FPP at 5.
[27] *Id.* at 8.
[28] Exhibit C-1 at 2-3.
[29] Provider's FPP at 6.
[30] Medicare Contractor's FPP at 10.
[31] Provider's FPP at 7.

Administration, Nursery, Delivery & Labor Room and Emergency Room."[32] In regard to Occupational mix, the Board finds that the Medicare Contractor used the best available data in its excess staffing computation. The Board finds merit in the Medicare Contractor's argument that the use of older data benefits Medical Arts as "staffing levels are declining and people are doing more with less by employing technology and developing other efficiencies." [33] In regard to PRM 15-1 § 2810.1(C)(6) the Board notes that it states "[t]he intermediary's analysis of core staff is limited to those cost centers (General Service, Inpatient, Ancillary, etc.) whose costs are components of Medicare inpatient operating cost." As a result, the Board finds the Medicare Contractor correctly included nurses working in general service and ancillary areas in the excess staffing calculation. This calculation of excess staffing cost will be incorporated in the VDA calculations as appropriate.

In recent Board decisions addressing VDA payments, the Board has disagreed with the methodology used by various Medicare contractors, including the one in this appeal, to calculate VDA payments because this methodology compares fixed costs to total DRG payments and only results in a VDA payment if the fixed costs exceed the total DRG payment amount.[34] In these cases, the Board has recalculated the hospitals' VDA payments by estimating the fixed portion of the hospital's DRG payments (based on the hospital's fixed cost percentage as determined by the Medicare contractor), and comparing this fixed portion of the DRG payment to the hospital's fixed operating costs, so there is an apples-to-apples comparison.

The Administrator has overturned these Board decisions, stating:

> [T]he Board attempted to remove the portion of DRG payments the Board attributed to variable costs from the IPPS/DRG revenue. . . . In doing so the Board created a "fixed cost percentage" which does not have any source of authority pursuant to CMS guidance, regulations or underlying purpose of the VDA amount. . . . The VDA is not intended to be used as a payment or compensation mechanisms that allow providers to be made whole from variable costs, i.e., costs over which providers do have control and are relative to utilization. The means to determine if the provider has been fully compensated for fixed costs is to compare fixed costs to the total compensation made to the provider . . . .[35]

At the outset, the Board notes that the CMS Administrator decisions are not binding precedent, as explained by PRM 15-1 § 2927(C)(6)(e):

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[32] *Id.*
[33] Medicare Contractor's FPP at 12
[34] *St. Anthony Reg'l Hosp. v. Wisconsin Physicians Servs.*, PRRB Dec. No. 2016-D16 (Aug. 29, 2016), *modified by*, Adm'r Dec. (Oct. 3, 2016); *Trinity Reg'l Med. Ctr. v. Wisconsin Physicians Servs.*, PRRB Dec. No. 2017-D1 (Dec. 15, 2016), *modified by*, Adm'r Dec. (Feb. 9, 2017); *Fairbanks Mem'l Hosp. v. Wisconsin Physicians Servs.*, PRRB Dec. No. 2015-D11 (June 9, 2015), *modified by*, Adm'r Dec. (Aug. 5, 2015).
[35] *Fairbanks Mem'l Hosp. v. Wisconsin Physicians Servs.*, Adm'r Dec. at 8 (Aug. 5, 2015), *modifying*, PRRB Dec. No. 2015-D11 (June 9, 2015).

> e. Nonprecedential Nature of the Administrator's Review Decision.—Decisions by the Administrator ***are not precedents*** for application to other cases. A decision by the Administrator may, however, be examined and an administrative judgment made as to whether it should be given application beyond the individual case in which it was rendered. If it has application beyond the particular provider, the substance of the decision will, as appropriate, be published as a regulation, HCFA Ruling, manual instruction, or any combination thereof so that the policy (or clarification of policy [*sic*] having a basis in law and regulations may be generally known and applied by providers, intermediaries, and other interested parties.[36]

Recently, the U.S. Court of Appeals for the Eighth Circuit ("Eighth Circuit") upheld the Administrator's VDA calculation methodology that was applied in *Unity HealthCare v. Azar* ("*Unity*") and stated that the "Secretary's interpretation was not arbitrary or capricious and was consistent with the regulation."[37] The Board notes that Medicare Arts is not located in the Eighth Circuit, and, thus, the *Unity* decision is not binding precedent in this appeal. The Board further finds that 42 U.S.C. § 1395ww(d)(5)(D)(ii) and 42 C.F.R. § 412.92(e)(3) only provide a framework by which to calculate a VDA payment[38] and the Board is not bound to apply the *specific* VDA calculation methodology that the Administrator applied in *Unity* and the Eighth Circuit upheld.[39]

Further, the Board notes that § 412.92(e)(3) makes it clear that the VDA payment determination is subject to review through the Board appeals process.[40] Thus, the Board finds that the Eighth

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[36] (Bold and italics emphasis added).

[37] *Unity HealthCare v. Azar*, 918 F.3d 571, 579 (8th Cir. 2019), *cert. denied*, 140 S. Ct. 523 (2019).

[38] With regard to 42 U.S.C. § 1395ww(d)(5)(D)(ii), *see, e.g., St. Anthony Reg'l Hosp. v. Azar*, 294 F. Supp. 3d 768, 779 (N.D. Iowa 2018) (stating that § 1395ww(d)(5)(D)(ii) contains a gap as it directs that "the Secretary shall provide for such . . . payment . . . as may be necessary" and that "[t]he Secretary has filled that gap in a manner that I find to be reasonable in light of the statutory framework and purposes."), *aff'd*, *Unity HealthCare v. Azar*, 918 F.3d 571 (8th Cir. 2019). With regard to 42 C.F.R. § 412.92(e)(3), *see, e.g., id.* at 772, 780 (adopting the Magistrate's report which found that "'[t]he regulations promulgated by the Secretary in effect during the relevant time period did not provide a specific formula for calculating the VDA payment[,]'" and "'[i]nstead, the regulation directed that the following factors be considered in determining the VDA payment amount . . . .'"). The Board's plain reading of the regulation is confirmed by the Agency's discussion of this regulation in the preamble to rulemakings. *See, e.g.*, 52 Fed. Reg. 33034, 33049 (Sept. 1, 1987) (stating that "[w]e determine *on a case-by-case basis* whether an adjustment will be granted and the amount of that adjustment." (emphasis added)); 48 Fed. Reg. 39752, 39781-82 (Sept. 1, 1983).

[39] *See, e.g., Allina Health Servs. v. Sebelius*, 746 F.3d 1102, 1107-08 (D.C. Cir. 2014) (discussing regulatory interpretations adopted through adjudication versus through rulemaking).

[40] Moreover, the Board notes that, subsequent to the Eighth Circuit's decision in *Unity*, the U.S. Supreme Court issued its decision in *Azar v. Allina Health Servs*, 139 S. Ct. 1804, 1810, 1817 (2019) ("*Allina II*") where the Supreme Court ruled on the scope of Medicare policy issuances that are subject to the notice and comment requirements under 42 U.S.C. § 1395hh(a)(2) by making clear that the "the government's 2014 announcement of the 2012 Medicare fractions [to be used in DSH calculations for FY 2012 where the Agency] 'le[t] the public know [the agency's] current . . . adjudicatory approach' to a critical question involved in calculating payments for thousands of hospitals nationwide" was a "statement of policy . . . that establishes or changes a substantive legal standard" as that

Circuit's *Unity* decision was simply adjudicating a dispute regarding the reasonableness of the Administrator's interpretation of the statue and regulations governing VDAs that the Administrator applied in rendering her decision in *Unity* and, as such, the Eighth Circuit's decision in Unity did not create a binding precedent that the Board is obligated to follow.

Significantly, *subsequent to the time period at issue in this appeal*, CMS essentially adopted the Board's methodology for calculating VDA payments. In the preamble to the FFY 2018 IPPS Final Rule,[41] CMS prospectively changed the methodology for calculating the VDA to one which is very similar to the methodology used by the Board. Under this new methodology, CMS requires Medicare contractors to compare the estimated portion of the DRG payment that is related to fixed costs, to the hospital's fixed costs, when determining the amount of the VDA payment.[42] The preamble to the FFY 2018 IPPS Final Rule makes this change effective for cost reporting periods beginning on or after October 1, 2017, explaining that it will "remove any conceivable possibility that a hospital that qualifies for the volume decrease adjustment could ever be less than fully compensated for fixed costs as a result of the application of the adjustment."[43]

Pursuant to 42 C.F.R. § 405.1867, the Board must give great weight to interpretive rules and general statements of policy. As set forth below, the Board finds that the Medicare Contractor's calculation of Medical Arts' VDA methodology for FY 2012 was incorrect because it was *not* based on CMS' stated policy as delineated in PRM 15-1 § 2810.1 and the Secretary's endorsement of this policy in the preambles to the relevant Final Rules.

The Medicare Contractor determined Medical Arts' VDA payment by comparing its FY 2012 fixed costs to its total FY 2012 DRG payments. However, neither the language nor the examples[44] in PRM 15-1 compare only the hospital's *fixed* costs to its *total* DRG payments when calculating a hospital's VDA payment. Similar to the instructions in PRM 15-1, the preambles to both the FFY 2007 IPPS Final Rule[45] and the FFY 2012 IPPS Final Rule[46] reduce the hospital's cost *only* by excess staffing (not variable costs), when computing the VDA. Specifically, both of these preambles state:

> [T]he adjustment amount is determined by subtracting the second year's MS-DRG payment from the lesser of: (a) The second year's cost minus any adjustment for excess staff; or (b) the previous year's costs multiplied by the appropriate IPPS update factor minus any adjustment for excess staff. The SCH or MDH receives the difference in a lump-sum payment.

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phrase is used in 42 U.S.C. § 1395hh(a)(2) and, thus, was subject to the notice and comment requirements under 42 U.S.C. § 1395hh(a)(2). (Citations omitted.)

[41] 82 Fed. Reg. 37990, 38179-38183 (Aug. 14, 2017).

[42] This amount continues to be subject to the cap specified in 42 C.F.R. § 412.92(e).

[43] 82 Fed. Reg. at 38180.

[44] PRM 15-1 § 2810.1(C)-(D).

[45] 71 Fed. Reg. 47870, 48056 (Aug. 18, 2006).

[46] 73 Fed. Reg. 48434, 48631 (Aug. 19, 2008).

It is clear from the preambles to these Final Rules that the only permissible adjustment to the hospital's cost for calculating the VDA is for excess staffing. Therefore, the Board finds that the Medicare Contractor did not calculate Medical Arts' VDA using the methodology laid out by CMS in PRM 15-1 or the Secretary in the preambles to the FFY 2007 and 2009 IPPS Final Rules.

Rather, the Board finds that the Medicare Contractor calculated Medical Arts' FY 2012 VDA based on an otherwise *new* methodology that the Administrator apparently adopted through adjudication in her decisions. This new methodology is best described as follows: the "VDA [payment] is equal to the difference between its fixed and semi-fixed costs and its DRG payment . . . subject to the ceiling[.]"[47] The Board suspects that the Administrator developed this new methodology using fixed costs because of a seeming conflict between the methodology explained in the FFY 2007 and 2009 IPPS Final Rules/PRM and the statute. Notably, in applying this new methodology through adjudication, CMS did not otherwise alter its written policy statements in either the PRM or Federal Register until it issued the FFY 2018 IPPS Final Rule.[48]

The statute at 42 U.S.C. § 1395ww(d)(5)(D)(ii) is clear that the VDA payment is intended to fully compensate the hospital for its fixed costs:

> In the case of a sole community hospital that experiences, in a cost reporting period compared to the previous cost reporting period, a decrease of more than 5 percent in its total number of inpatient cases due to circumstances beyond its control, the Secretary shall provide for such adjustment to the payment amounts under this subsection (other than under paragraph (9)) as may be necessary to fully compensate the hospital for the fixed costs it incurs in the period in providing inpatient hospital services, including the reasonable cost of maintaining necessary core staff and services.

In the Final Rule published on September 1, 1983 ("FFY 1984 IPPS Final Rule"), the Secretary further explained the purpose of the VDA payment: "[t]he statute requires that the [VDA] payment adjustment be made to compensate the hospital for the fixed costs it incurs in the period . . . . An adjustment will *not* be made for truly variable costs, such as food and laundry services."[49] However, the VDA payment methodology as explained in the FFY 2007 and 2009 IPPS Final Rules and PRM 15-1 § 2810.1 compares a hospital's total cost (reduced for excess staffing) to the hospital's *total* DRG payments and states in pertinent part:

> C. Requesting Additional Payments.—. . . .
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> 4. Cost Data.—The hospital's request must include cost reports for the cost reporting period in question and the immediately

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[47] *Lakes Reg'l Healthcare v. BlueCross BlueShield Ass'n*, Adm'r Dec. 2014-D16 at 8 (Sept. 4, 2014).; *Unity Healthcare v. BlueCross BlueShield Ass'n*, Adm'r Dec. 2014-D15 at 8 (Sept. 4, 2014); *Trinity Reg'l. Med. Ctr. v. Wisconsin Physician Servs.*, Adm'r Dec. 2017-D1 at 12 (Feb. 9, 2017).
[48] 82 Fed. Reg. at 38179-38183.
[49] 48 Fed. Reg. 39752, 39781-39782 (Sept. 1, 1983) (emphasis added).

> preceding period. The submittal must demonstrate that the Total Program Inpatient Operating Cost, excluding *pass-through costs, exceeds DRG payments*, including outlier payments. *No adjustment is allowed if DRG payments exceeded program inpatient operating cost*. . . .
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> D. Determination on Requests.— . . . . The payment adjustment is calculated under the same assumption used to evaluate core staff, i.e. *the hospital is assumed to have budgeted based on prior year utilization and to have had insufficient time in the year in which the volume decrease occurred to make significant reductions in cost*. Therefore, the adjustment allows an increase in cost up to the prior year's total Program Inpatient Operating Cost (excluding pass-through costs), increased by the PPS update factor.
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> EXAMPLE A: Hospital C has justified an adjustment to its DRG payment for its FYE September 30, 1987. . . . Since Hospital C's FY 1987 Program Inpatient Operating Cost was less than that of FY 1986 increased by the PPS update factor, *its adjustment is the entire difference between FY 1987 Program Inpatient Operating Cost* ***and FY 1987 DRG payments***.
>
> EXAMPLE B: Hospital D has justified an adjustment to its DRG payment for its FYE December 31, 1988. . . . Hospital D's FY 1988 Program Inpatient Operating Cost exceeded that of FY 1987 increased by the PPS update factor, so *the adjustment is the difference between FY 1987 cost adjusted by the update factor* ***and FY 1988 DRG payments***.[50]

At first blush, this would appear to conflict with the statute and the FFY 1984 IPPS Final Rule which limit the VDA to fixed costs. The Board believes that the Administrator tried to resolve this seeming conflict by establishing a new methodology through adjudication in the Administrator decisions, stating that the "VDA is equal to the difference between its *fixed and semi-fixed costs* and its DRG payment . . . subject to the ceiling."[51]

Based on its review of the statute, regulations, PRM 15-1 and the Eighth Circuit's decision, the Board respectfully disagrees that the Administrator's methodology complies with the statutory mandate to "fully compensate the hospital for the fixed costs it incurs."[52] Under the Administrator's reasoning, a hospital is fully compensated for its fixed costs when the total DRG payments issued to that hospital are equal to or greater than its fixed costs. This rationale necessarily assumes that the entire DRG payment is payment ***only*** *for the* ***fixed*** *costs* of the services actually furnished to Medicare patients.

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[50] (Emphasis added.)
[51] *St. Anthony Reg'l Hosp.*, Adm'r Dec. at 13; *Trinity Reg'l Med. Ctr.*, Adm'r Dec. at 12.
[52] 42 U.S.C. § 1395ww(d)(5)(D)(ii).

However, the statute at 42 U.S.C. § 1395ww(a)(4) makes it clear that a DRG payment includes payment for both fixed *and* variable costs of the services rendered because it defines the operating costs of inpatient services as "**all** routine operating costs . . . and includes the ***costs** of all services* for which payment may be made[.]" The Administrator cannot simply ignore 42 U.S.C. § 1395ww(a)(4) and deem all of a hospital's DRG payments as payments solely for the fixed cost of the Medicare services actually rendered, when the hospital in fact incurred both fixed and variable costs for those services.

Indeed, the Board must conclude that the purpose of the VDA payment is to compensate an SCH for all the fixed costs associated with the qualifying volume decrease (which must be 5 percent or more). This is in keeping with the assumption stated in PRM 15-1 § 2810.1(D) that "the hospital is assumed to have budgeted based on prior year utilization and to have had insufficient time in the year in which the volume decrease occurred to make significant reductions in cost." This approach is also consistent with the directive in 42 C.F.R. § 412.92(e)(3)(i)(A) that the Medicare contractor "considers . . . [t]he individual hospital's needs and circumstances" when determining the payment amount.[53] Clearly, when a hospital experiences a decrease in volume, the hospital should reduce its variable costs associated with the volume loss, but the hospital will always have some variable cost related to furnishing Medicare services to its *actual* patient load.

Critical to the proper application of the statute, regulation and PRM provisions related to the VDA, are the undeniable facts that: (1) the Medicare patients to which a provider furnished *actual* services in the current year are not part of the volume decrease, and (2) the DRG payments made to the hospital for services furnished to Medicare patients in the current year is payment for *both* the fixed and variable costs of the *actual* services furnished to those patients. Therefore, in order to fully compensate a hospital for its fixed costs in the current year, the hospital must receive a payment for the variable costs related to its *actual* Medicare patient load in the current year, *as well as* its full fixed costs in that year.

The Administrator's methodology clearly does not do this, as it takes the portion of the DRG payment intended for variable costs incurred in the current year and impermissibly characterizes it as payment for the hospital's fixed costs. The Board can find no basis in 42 U.S.C. § 1395ww(d)(5)(D)(ii) allowing the Secretary to ignore 42 U.S.C. § 1395ww(a)(4) – which makes it clear that the DRG payment is payment for both fixed and variable costs – and deem the entire DRG payment as payment solely for fixed costs. The Board concludes that the Administrator's methodology does not ensure that a hospital, eligible for a VDA adjustment, has been fully compensated for its fixed costs and, therefore, the Administrator's methodology is not a reasonable interpretation of the statute.

Finally, the Board recognizes that, while PRM 15-1 § 2810.1 and 42 U.S.C. § 1395ww(d)(5)(D)(ii) do not fully address how to remove variable costs when calculating a VDA adjustment, it is clear that the VDA payment is *not* intended to fully compensate the hospital for its variable costs.[54] Additionally, based on 42 U.S.C. § 1395ww(a)(4), the Board finds that the DRG payments are

[53] The Board recognizes that 42 C.F.R. § 412.92(e)(3)(i)(B) (2012) instructs the Medicare contractor to "consider[]" fixed and semifixed costs for determining the VDA payment amount but this instruction does not prevent payment through the DRG of the variable costs for those services *actually* rendered.
[54] 48 Fed. Reg. at 39782.

intended to pay for both variable and fixed costs for the Medicare services *actually* furnished. Therefore, the Board concludes that, in order to both ensure the hospital is fully compensated for its fixed costs and be consistent with the PRM 15-1 assumption that "the hospital is assumed to have budgeted based on the prior year utilization," the VDA calculation must compare the hospital's fixed costs to that portion of the hospital's DRG payments attributable to fixed costs.

As the Board does not have the IPPS actuarial data to determine the split between fixed and variable costs related to a DRG payment, the Board opts to use the Medicare Contractor's fixed/variable cost percentages as a proxy. In this case, the Medicare Contractor determined that Medical Arts' fixed costs (which includes semi-fixed costs) were 88.38 percent[55] of Medical Arts' Medicare costs for FY 2012. Applying the rationale described above, the Board finds the VDA in this case should be calculated as follows:

Step 1: Calculation of the Cap

2011 Medicare Inpatient Operating Costs	$1,530,563[56]
Multiplied by the 2011 IPPS update factor	1.0215[57]
2011 Updated Costs (max allowed)	$1,563,470
2012 Medicare Inpatient Operating Costs	$1,259,295[58]
Lower of 2011 Updated Costs or 2012 Costs	$1,259,295
Less 2012 IPPS payment	$1,095,310[59]
2012 Payment CAP	**$ 163,985**

Step 2: Calculation of VDA

2012 Medicare Inpatient Fixed Operating Costs	$1,113,023[60]
Less Excess Staffing	$ -76,239[61]
2012 Medicare Inpatient Fixed Op. Costs less Excess Staff	$1,036,784
Less 2012 IPPS payment – fixed portion (88.38 percent)	$ 968,085[62]
Payment adjustment amount (subject to Cap)	**$ 68,699**

Since the payment adjustment amount of $68,699 is less than the Cap of $163,985, the Board concludes that Medical Arts' FY 2012 VDA payment should be $68,699.

[55] Exhibit C-1. Calculation = 8,661,505/9,799,789 = 0.88384607, rounded to 0.8838.
[56] *Id.*
[57] *Id.* Calculation = ((1.024 x 183 days) + (1.019 x 183 days) / 366 days) = 1.0215.
[58] *Id.*
[59] *Id.*
[60] Calculation = 1,259,295 * 0.88384607 = 1,113,022.94, rounded to $1,113,023.
[61] Exhibit C-1. Calculation = Total Fixed Operating Costs from p. 3 (1,259,295) less Operating Costs net of Excess Staffing from p. 5 (1,183,056) = Excess Staffing (76,239).
[62] Calculation = 1,095,310*0.88384607 = 968,085.439, rounded to $968,085.

DECISION

After considering Medicare law and regulations, arguments presented, and the evidence admitted, the Board finds that the Medicare Contractor improperly calculated Medical Arts' FY 2012 VDA payment, and that Medical Arts should receive a VDA payment in the amount of $68,699 for FY 2012.

Board Members

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Robert Evarts, Esq.
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Ratina Kelly, CPA

FOR THE BOARD:

2/16/2022

X Clayton J. Nix

Clayton J. Nix, Esq.
Chair
Signed by: PIV