SEQUESTRATION'S UNIFORM MEDICARE CUT WILL YIELD DISPARATE IMPACTS ACROSS PROVIDERS

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Introduction

Across-the-board spending cuts known as sequestration are expected to have disruptive effects across a spectrum of federal policies and programs. For Medicare providers, the true impact of sequestration's two percent reduction in payments will vary significantly across setting and type of service. This article provides background on the origins of the current sequestration and explores how Medicare cuts will affect providers differently. The article also relates the Medicare sequester to certain proposals within the President's recently released FY2014 Budget and discusses the broader economic implications of the sequester.

Background

After more than a year of efforts to avert it, sequestration — across-the-board spending cuts for federal agencies and programs — has gone into effect. The genesis of these cuts dates back to a legislative battle in the summer of 2011 over raising the federal debt limit. The ultimate agreement that resolved that debate, the Budget Control Act of 2011 (P.L. 112–25), set up the bipartisan, bicameral Joint Select Committee on Deficit Reduction, known commonly as the Super Committee. The Super Committee was tasked with achieving at least $1.2 trillion in deficit reduction over ten years, and its recommendations were assured timely consideration (without amendment) in the U.S. House of Representatives and the U.S. Senate. As a backstop, sequestration was scheduled to kick in on January 1, 2013, in the absence or defeat of Super Committee recommendations. When the Super Committee announced in November 2011 that it had failed to reach consensus, the threat of sequestration became real.[1]

Efforts to prevent sequestration only resulted in a short delay. The American Taxpayer Relief Act of 2012 (P.L. 112–240), the tax deal reached earlier this year to avert the fiscal cliff, postponed implementation of the majority of sequestration until March 1, 2013, and Medicare cuts until April 1, 2013.

Scheduled to be in effect through 2021, sequestration is equally divided between federal defense and nondefense spending. According to the Office of Management and Budget ("OMB"), defense and nondefense spending will each be cut $43 billion in FY2013, equal to a 7.8 percent reduction in defense-related budget authority and a 5.0 percent reduction in nondefense discretionary spending.[2] However, a February Congressional Budget Office ("CBO") report notes that actual spending cuts for the current fiscal year will be lower (likely $42 billion) since there is often a considerable lag between when a federal agency commits to an outlay and when that actual outlay occurs.[3]

Cuts in Medicare are limited to a two percent reduction in provider payments, while some Medicare activities are exempt from sequestration entirely. These include the Part D low-income subsidies and the Part D catastrophic subsidy, both of which reduce the cost of prescription drug coverage for Medicare patients, and the Qualified Individual premiums, which covers Part B premiums for certain low income Medicare beneficiaries. Certain other federal programs were exempt from sequestration by Congress. They include Social Security, Medicaid, all programs administered by the Department of Veterans Affairs, Supplemental Security Income ("SSI"), the Supplemental Nutrition Assistance Program, and various child nutrition programs.

Both Congress and the Administration have criticized the sequester generally and articulated a desire to repeal these indiscriminate cuts and replace them with alternative savings proposals.[4] At present, however, neither Congress nor the President is actively pursuing repeal.

Aggregate Medicare Impact

The two percent cut to Medicare payments applies to provider payments for services administered under Medicare Hospital Insurance (Part A), Medicare Medical Insurance (Part B), the contractual payments to Medicare Advantage Plans (Part C), and Medicare Prescription Drug Plans (Part D). Part A and Part B cuts will be made to each individual Medicare payment. Part C and Part D cuts will be implemented through the monthly payment from Medicare to the private plans that administer these programs.

It is important to note that for Part A and Part B claims, this cut is not directly comparable to a two percent reduction in the physician fee schedule conversion factor or to a two percent aggregate cut in a payment rule because patient cost-sharing payments are unaffected by sequestration. The difference is small but noteworthy. For example, for a $100 charge where the patient co-pay is 20 percent or $20, sequestration reduces the $80 Medicare payment to $78.40. Assuming the provider receives the full co-pay, total reimbursement drops to $98.40, not $98.00. The net effect

in this example is a 1.6 percent reduction.

As a share of total spending, the cuts in Medicare are more modest than the cuts to other programs. OMB estimates the aggregate impact of the Medicare portion of the sequester to be $11.35 billion in FY2013. CBO estimates that the total reduction in Medicare benefit spending will be about $100 billion over the nine years that sequestration is scheduled to be in effect. However, as discussed in greater detail in the examples below, the impact of these cuts may vary significantly across provider types.

For-Profit vs. Not-For-Profit Providers

Standard & Poor's predicted in a March 5, 2013 report that sequestration's effect on for-profit and not-for-profit healthcare companies could differ drastically.[5] In particular, healthcare companies with over 50 percent of revenue from Medicare are especially vulnerable. However, access to credit and adequate or strong liquidity significantly reduce this vulnerability. For companies with impaired liquidity and/or limited credit, the sequester will be more of a problem. For these companies, especially those with significant Medicare exposure, a two percent cut could lead to bank covenant violations and/or cash flow deficits that require third-party support.[6]

While for-profit healthcare companies face significant exposure, their credit ratings likely will not be lowered as a result of the cuts. Some not-for-profit healthcare companies, however, face a more ominous outlook. Over time, for-profit and not-for-profit healthcare companies will face the same cash flow compression. But, unlike their for-profit counterparts, not-for-profit healthcare companies — acute care hospitals and health systems in particular — are already at or near the top of the credit cycle, and the only way to go is down. Not-for-profit healthcare companies find themselves atop the credit cycle – i.e., the expansion and contraction of access to credit over time – due to their aggressive cost cutting, mergers and acquisitions, restrained capital spending, a lower cost of capital, and new sources of revenue, such as state provider taxes and federal funding for meaningful information technology use in accordance with the Meaningful Use Incentive Program.[7]

Standard & Poor's notes that the impact of the Medicare cuts will not be felt immediately, as most providers have already budgeted for flat Medicare revenue for FY2013 in preparation for the cuts. However, the impact of compressed earnings and cash flow could hurt a company's credit rating and ability to obtain credit on the margin over time. Though many not-for-profit hospitals and health systems have built-in financial cushions, the incremental pressures associated with sequestration, when combined with other health reform and recessionary economic pressures on providers, could result in rating downgrades or negative outlooks.

Skilled Nursing Facilities

The impact of sequestration on skilled nursing facilities ("SNFs") may be particularly negative. This is due in large part to the way these facilities use Medicare payments to cover the losses they incur in providing care to Medicaid patients. Medicaid relies on payment rates set at the state level. In nearly all states, these rates are not adequate to cover the cost of long-term nursing home care. Nursing facilities have faced Medicaid funding shortfalls for more than ten consecutive years, and this trend appears likely to continue.[8] Even though Medicare patients are a minority of nursing facility residents at any point in time, most facilities use Medicare payments to help offset the shortfall from the unreimbursed cost of caring for Medicaid-funded residents.[9] Accordingly, Medicare payment levels are disproportionately important for nursing facilities.

The Administration's FY2014 Budget, released on April 11, 2013 advocates for the repeal of the sequester but proposes a three percent reduction in payments to certain SNFs with high rates of hospital readmissions.[10] While the aggregate impact on this sector would be $2.2 billion over the decade – less than the impact of the sequester – certain SNFs would experience larger cuts. To highlight the magnitude of this proposal, note that the Centers for Medicare & Medicaid Services ("CMS") estimates that Medicare will pay SNFs approximately $30 billion in 2014.[11]

De Facto Adoption of ASP Cut for Part B Drugs

The impact of the sequester on reimbursement for Part B drugs is equivalent to a policy change that some lawmakers have been debating in recent years. Current reimbursement for these products was established in the Medicare Modernization Act (P.L. 108–173) at 106 percent of a product's average sales price ("ASP"). This reimbursement structure is known as ASP+6. The +6 percent portion of the payment is generally intended to compensate for operational expenses (handling, storage, etc.) and in recognition that not all physicians can necessarily acquire a drug at its reported ASP. In multiple budget negotiations, lawmakers have proposed reducing reimbursement for these products from 106 percent of ASP to 103 percent of ASP. These efforts have been aggressively rebuffed by pharmaceutical manufacturers as well as frequent prescribers of high-cost Part B drugs, in particular medical oncologists.[12] Nevertheless, President Obama's FY2014 Budget proposes replacing ASP+6 with ASP+3. This proposal has not previously appeared in the President's

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Budget. The Administration estimates that such a change would save $4.5 billion over a decade.[13]

However, the two percent sequester of Medicare payments has already created a *de facto* ASP+4.3 reimbursement policy for Part B drugs. Because a patient's 20 percent co-pay is unaffected by the sequester, the cut affects only 80 percent of the reimbursement, yielding a net effective reimbursement rate for Part B drugs of 104.3 percent of ASP. In light of this impact, the American Society of Clinical Oncologists and others have recently warned of serious consequences to cancer providers.[14] The Administration's Budget, in effect, would replace the current ASP+4.3 with ASP+3, an additional cut to reimbursement for Part B drugs.

Additional Sequestration Cuts at HHS

It should be noted that cuts at the Department of Health and Human Services ("HHS") may also adversely affect healthcare providers. According to OMB, sequestration will result in a 5.1 percent reduction in nonexempt nondefense budget authority.[15] At CMS, the net impact of these cuts is approximately a $500 million reduction in the program management budget, the healthcare fraud and abuse budget, state grants and demonstration funding, and other discretionary accounts. The Food and Drug Administration's ("FDA") budget authority will be reduced $209 million. National Institutes of Health ("NIH") funding will be reduced $1.55 billion. Such cuts could affect various providers, including medical schools, teaching hospitals, and others that receive NIH grant funding. Medical device and pharmaceutical companies engaged with the FDA for product approvals may experience longer delays. Reduced funding of these entities and institutions can reasonably be expected to adversely affect providers' ability to provide patient care if, for example, teaching hospitals experience funding cuts or new FDA approvals are delayed.

Potential Mitigating Effects: Volume Increases

Because the Medicare cuts are administered at the payment level as opposed to the program level, it is possible that the net impact on total Medicare spending will be less than two percent if certain providers respond to the cuts by increasing volume and/or service intensity. It should be noted, however, that the ability to offset the cuts with more services varies considerably across providers. For example, dialysis providers are unable to offset payment cuts with additional services, as providers receive a fixed, bundled payment and are not reimbursed on a fee-for-service schedule. Additionally, dialysis patients are on a fixed cycle of weekly visits. Conversely, some physicians reimbursed through the physician fee schedule may mitigate the reimbursement cut by providing additional services. Payment cuts related to Part C (Medicare Advantage) and Part D (prescription drug coverage) cannot be offset with volume increases, as those are payments to private plans that administer these programs.

Macroeconomic Impact

Economists debate the broader macroeconomic impact of the sequester. According to a September 2012 report released by the American Hospital Association, the American Medical Association, and the American Nurses Association, the two percent sequester of Medicare spending will cost more than 750,000 healthcare jobs over the next decade.[16] In late February, the Obama Administration released state-by-state reports on the likely impact of the sequester, noting numerous examples of the impact on federal programs, including budget cuts for NIH, FDA's Center for Drug Evaluation and Research, and mental health services. However, others have noted that the $42 billion actual decline in federal outlays in FY2013 is quite modest relative to the $16 trillion economy.[17]

Moreover, healthcare providers face smaller cuts than they would have under either the Administration's proposals or the counterproposals offered by Congressional Republicans to reduce the deficit. As previously noted, the sequester seeks to reduce Medicare spending by about $100 billion over 10 years. During deficit negotiations, the Administration proposed $400 billion in healthcare cuts, with a large majority coming from Medicare.[18] Republicans countered with nearly $600 billion in healthcare cuts, also largely from Medicare.[19] While those proposals were shelved, they are almost certain to come to the forefront in the near future as the debate about healthcare costs and their role in the overall federal deficit continues. Specifically, the President's FY2014 Budget contains $371 billion in federal savings over ten years from Medicare legislative proposals. While many of these proposals will never be adopted by Congress, some will, and more broadly the President's proposal is reflective of the magnitude of Medicare cuts that lawmakers are considering.

Conclusion

Providers across the healthcare industry need to take proactive steps to mitigate the impact of the Medicare sequester, given that Medicare patients comprise a significant portion of revenue for many providers. To offset the expected decrease in revenue, providers

may look to cut costs and/or increase volume. The former will likely result in employee terminations, wage freezes, and postponement of new equipment acquisition or facility upgrades. The latter may be more attractive to providers, as it involves capturing a larger share of the patient market. However, some providers will be unable to increase volumes, either because of constraints related to how they are reimbursed or because the patient market is relatively static. Those providers who are unable to increase market share will likely be forced to cut costs or accept lower margins. Amplifying this possibility is the fact that many healthcare providers have already taken the easy-to-implement cost-saving measures, and finding new cost-cutting initiatives each year is increasingly difficult. To combat this, providers would be wise to look to newly created payment incentives, such as Electronic Health Records Incentive Programs and various quality initiatives (which, ironically are themselves subject to a two percent haircut.)

While healthcare providers and others affected by the sequester work to adjust their businesses in light of these new cuts, Congress continues to debate repealing the sequester, in part or in whole. However, given the sustained budget pressures, any repeal of the sequester will likely be replaced with alternative cuts. For some Medicare providers, those alternative cuts likely would be more severe than the sequester itself.

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