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Health Policy

Psych Hospitals: Medicare Starts Pay Reforms

The Biden administration proposed initial steps in a preliminary FY25 payment rule last night to overhaul the Medicare pay formula for inpatient psych hospital care to squeeze profitability, especially among freestanding for profits (UHS, ACHC). Govt. fact sheet.

The proposal, which will be subject to comment and lobbying before a final pay rule is issued around Aug. 1, may amount to no more than a redistribution of Medicare inpatient psych spending in FY25 starting Oct. 1 that has minimal impact and investor implications. That's what CMS's impact analysis suggests in the proposed rule. The government Medicare agency projects that total Medicare payment would rise 2.2% in FY25 to for-profit freestanding facilities in urban areas, only 40 bps less than the estimated increase in total payments to all psych hospitals, excluding volume and case mix changes. **Under the proposal, these for-profit facilities would lose 90 bps in projected Medicare payments from revisions to reimbursement adjustments made based on a patient's primary diagnosis, secondary diseases, length of stay, and age. The money for this and for a proposed 71% increase in payment for electroconvulsive therapy would come out of the base per-diem rate. To be sure, the negative impact to freestanding for profits in urban areas, where about 94% of the facilities are located, would be mitigated by favorable wage-index adjustments, leading to the net estimated 2.2% increase vs. 2.9% this year, according to CMS.**

However, the proposed rule also aims at freestanding for profits by starting to address concerns about possible improper payment for ancillary services such as drugs -- a proposal that probably has no immediate reimbursement impact. And the administration makes clear in the regulation that more changes in the payment formula are under consideration for future rate cycles. It seeks comment on potential future facility-specific adjustments that would reduce reimbursement by 3% to for-profit freestanding facilities in urban areas. This would come from a combination of adjustments that would include creating a safety-net variable to compensate hospitals treating the poor and updates to teaching and rural facility adjustments. The impact of these changes on for-profit units of acute-care hospitals would be positive (See Table 21 on pages 118-119 of the proposed rule).

Exposure to Medicare of the publicly traded psych hospital operators isn't large, but the Medicare profit margins for freestanding for-profit facilities are high. MedPAC advisory panel to Congress said last June that for-profit freestanding psych facility profit margins were 21.7% in 2021. UHS, the operator of acute and psych hospitals, gets less than 5% of its revenue from Medicare behavioral health reimbursement (43% of its net revenue from behavioral health, with 11% of the psych segments revenue coming from Medicare and Medicare managed care). ACHC, which runs behavioral health facilities, gets less than 10% of revenue from Medicare reimbursement for inpatient psych hospital care (51% of revenue from its acute inpatient psych hospitals and 15% of its overall revenue from Medicare). On average, Medicare patients comprise more than 15% of total inpatient psych hospital days.

As we wrote yesterday, the proposed regulation seems about in line with our expectation, based on CMS impact estimates. But the proposed changes or refinements to the pay formula make it hard to determine whether industry will view the net impact more negatively, especially the for-profits. More below on proposed FY25 reimbursement impacts, related forecast chart and regulatory risk.

Please see important disclosures at the end of this report.

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Fig. 1: Inpatient Psych: Medicare Proposed FY25 % Base Pay Increase

	FY16F	FY17F	FY18F	FY19F	FY20F	FY21 Final	FY22 Final	FY23 Final	FY24 Proposed	FY24 Projected	FY24 Final	FY25P	FY25 Proposed	FY26P
	Actual	Actual	Actual	Actual	Actual	Final	Final	Final	Proposed	Projected	Final	Projected	Proposed	Projected
Inflation Update (Market Basket)	2.4	2.8	2.6	2.9	2.9	2.2	2.7	4.1	3.2	3.5	3.5	3.1	3.1	2.9
ACA cut	-0.7	-0.5	-1.35	-1.55	-1.15	0	-0.7	-0.3	-0.2	-0.2	-0.2	-0.4	-0.4	-0.4
Base Pay Change, ex budget neutrality adjustments	1.7	2.30	1.25	1.35	1.75	**2.2**	2.0	3.8	3	3.3	3.3	2.7	2.7	2.5
BN adjustments for wage index and 3-year phaseout of 17% rural adjustment for 37 facilities	0.4	0.07	0.06	0.13	0.26	-0.1	0.17	0.12	0.11	0.11	0.17	0	0	0
Base Rate Change after budget neutrality adjustment	2.10	2.37	1.31	1.48	2.01	2.10	2.17	3.92	3.11	3.41	3.47	2.70	2.70	2.50
	FY16F	FY17F	FY18F	FY19F	FY20F	FY21 Final	FY22 proposed	**FY22 Final**	**FY23 proposed**	**FY23 Final**	**FY24 Proposed**	**FY24Final**	**FY25 Proposed**	FY25P % Change
Per diem before 2% sequester cut.	$743.73	$761.37	$771.35	$782.78	$798.55	$815.22	$833.50	**$832.94**	**$856.80**	**$865.63**	**$892.58**	**$895.63**	**$874.93**	**-2.31%**

Sources: CMS FY25 prelim Medicare inpatient psych rule; CMS final and preliminary FY24 and FY23 rules; CMS final rules FY16-FY22; CARES Act; Affordable Care Act; CMS 3Q 2023 MB and productivity forecast data for FY25 and FY26 projections; Nephron Research.

Inpatient Psych Pay

The chart above shows a 2.7% preliminary increase in the FY25 base rate ***before factoring in budget neutrality adjustments*** and the same as our forecast vs. 3.3% this year.

After factoring in a preliminary 10 bp pay cut in outlier reimbursement, total estimated Medicare payments to inpatient psych facilities would rise by $70 million, or 2.6%, to $2.762 billion in FY25, excluding projected changes in case mix and volume. That's 30 bps higher than the 2.3% increase this year projected by CMS when it announced final FY24 reimbursement last July. CMS revised downward total Medicare spending on inpatient psych care since its last estimate in July, possibly due at least in part to continued movement of beneficiaries out of traditional Medicare into Medicare Advantage managed care plans. In its June 2023 report to Congress, MedPAC said traditional Medicare fee-for-service volume in inpatient psych facilities has been dropping for years.

Outlier Cut: The projected FY25 cut in outlier add-on payments is 10 bps compared to a 90 bp negative adjustment in add-on payments for outlier or extraordinarily expensive cases for this year. This shows CMS has a hard time hitting the target for 2% of total Medicare psych payments covering outlier costs, which the government Medicare agency tries to do by annually adjusting the dollar spending threshold that care of a patient must exceed to trigger the add-on payments.

The base rate, while rising 2.7% *before budget neutrality adjustments*, would fall 2.31% to $874.93 on Oct. 1 *after budget neutrality adjustments* that would redistribute money from the base rate into other areas of the payment formula. That includes money for proposed changes in patient-specific adjustments for determining reimbursement and a 71% increase to $660.30 in the per-treatment payment for electroconvulsive therapy (ECT). The ECT impact is minor because the treatment is used in 1.7% of Medicare inpatient psych stays, according to the rule.

The proposed 2.31% cut in the base rate *after budget neutrality adjustments* compares to a 3.47% increase this year.

Impact Various For Profits: Urban v Rural; Freestanding v Hospital Units

Rural freestanding for-profits would see their total estimated payments rise 4.1% vs. 2.0% this year due to wage-index related changes. For general hospital-based psych units, for-profit urban units would see a 2.4% increase vs. 2.2% this year and rural for-profit units a 4.1% raise vs. 2.0% this year. As we wrote above, for-profit freestanding hospitals in urban areas would see estimated total

payments rise 2.2% next fiscal year vs. 2.9% in FY24 before factoring changes in volume or case mix. See table 29 starting on page 169 of the preliminary rule.

Concerns about Improper Billing for Ancillary Services

The regulation includes a proposed change effective Oct. 1 in how psych hospitals are classified for purposes of payments that could prove negative for freestanding for-profit facilities in urban areas that might have a negative impact in future rate cycles. This is related to CMS concerns about a percentage of inpatient psych hospitals, especially for profits, not reporting that they provided ancillary services such as drugs and diagnostics that are widely used by inpatient behavioral health patients and about whether these services are improperly being billed separately instead of being covered by the fixed DRG payment rate or maybe being underused.

"Ongoing analysis has found that certain providers, especially for-profit freestanding IPFs, are consistently reporting no ancillary charges or very minimal ancillary charges," CMS wrote in the final FY24 pay rule last July, also referring to MedPAC data. CMS said in the FY24 rule it is considering requiring psych hospitals to report ancillary services on claims and rejecting payment if none are reported.

In the FY25 rule, CMS proposed limiting the "all-inclusive rate classification" to government- and tribal-owned hospitals. The classification, which applied to 50% of for-profits in 2021, exempts hospitals from reporting ancillary costs. The would be effective for cost reports starting during the FY25 cost reporting year and could prove a first step in future rate-setting cycles for rejecting Medicare claims for payment that exclude ancillary services, in our view.

Legislation & Mental Health Parity Regulation

Congress and President Biden continue to be interested in more money for mental health services, including in the Medicare program, but new money is unlikely to be enacted anytime soon, in our view.

Biden reintroduced in his FY25 budget proposal initiatives designed to widen access and raise reimbursement for mental health services. The budget revived a legislative proposal that would lift the 190-day lifetime limit for Medicare benefits at a stand-alone inpatient psychiatric hospital (psych units in general hospitals are exempt from this limit). The administration estimates in its FY25 HHS budget-in-brief that the proposal would cost Medicare $2.89 billion over 10 years. Based on data from Medicare actuaries, the $2.89 billion would amount to an 8.0% increase in projected Medicare spending on inpatient psych care over the 10 years through 2034. Biden also reintroduced a proposal to include beginning in 2026 requiring Medicare to cover three behavioral health visits without requiring beneficiaries to pay any portion of the bill out of their own pockets. The administration estimates this would cost taxpayers $1.5 billion over 9 years.

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