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MEMORANDUM

To: Chief Financial Officers

From: Dennis N. Phelps - Associate Director, Audit & Compliance

Date: January 18, 2012

Re: Pricing of Medical/Surgical Supplies and Drugs

The purpose of this memorandum is to reaffirm that the HSCRC methodology for pricing of disposable Medical/Surgical Supplies (M/SS) and Drugs, approved at its January 4, 1995 public meeting (see attached), continues to be in force. In brief, the methodology directs hospitals to charge the invoice cost, plus mark-up; plus the applicable amount of approved overhead; plus an allocation of the total invoice costs of all disposable M/SS or drugs with low invoice cost (less than $5 or $10 at the hospital's discretion).

In addition, the methodology mandates that hospitals develop charges for M/SS and drugs that are reasonably related to the cost of providing supplies and drugs to patients. Also mandated is the use of a tiered charge structure, whereby the amount of approved overhead added to the invoice cost of a M/SS or drug varies inversely with the invoice cost, i.e., the higher the invoice cost the lower the percentage of approved overhead allocated and vice versa.

In conclusion, disposable M/SS and drugs utilized by a patient must either be charged as a separate line item to that patient, using the approved methodology, or, if a low invoice item is involved, charged as an add-on to separately charged M/SS or drugs. It is never appropriate to charge patients an average daily or average per patient amount or any other average amount for M/SS or drugs.

If you have any questions, you may contact me at 410-764-2565.

ATTACHMENT A

Technical Application of Proposed Methodology

With each hospital's inflation adjustment staff will rate realign MSS/CDS revenue based on the hospital's most recent cost report. To accomplish this rate realignment EIPA's or EIPD's will serve as the unit of measure. Rate realignment will bring current approved revenue back in line with current costs. For this purpose, EIPA's would be calculated by multiplying Admissions or patient days times Total Revenue divided by Inpatient Revenue. Rate orders will direct the hospital to charge the invoice cost plus markup and allocation of the approved overhead amount as derived from the cost report. The amount of overhead approved for the rate order will be the Level IV Revenue from the most recent cost report divided by the mark-up used in the cost report minus the Direct (invoice) cost of MSS and CDS. The overhead cost allocated includes the cost of the Central Services and Pharmacy departments as well as Building and Equipment costs allocated and other financial considerations for the current fiscal year. In addition, the amount of GIR reward allocated to each center from column 65 of the inflation adjustment will be included as part of the approved overhead. This is necessary to spread the GIR to the revenue centers in which it was earned and as well as appropriately price level the GIR base.

Price compliance will be monitored using the OPS methodology. The balance of actual charges less markup minus invoice cost is the amount of overhead collected. The proportion of the under or over collected overhead related to outpatients will be adjusted prospectively. If a hospital over collects the approved overhead by more than thirty percent (30%), the hospital will payback 100% of the overage and an additional 40% of the amount in excess of a 30% overcharge through a prospective adjustment to the approved overhead. Undercharges in excess of thirty percent (30%) will result in a prospective adjustment of the 30% undercharge with only

60% of the amount in excess of 30%. Approved overhead will be treated as 100% variable and inflated by supply inflation.

This approach will allow the Commission to monitor the charging practices of hospitals on a monthly basis. At the same time, the Commission will continue to pass through the cost of outpatient MSS and CDS. By collecting invoice cost for MSS and CDS on an inpatient and outpatient basis, the Commission will be able to track for each hospital, and industry wide, volume changes for MSS and CDS as well as pricing policies of hospital relative to MSS and CDS.

As a condition of going to invoice cost plus overhead plus markup, the staff believes that hospitals should be directed to develop charges for MSS and CDS that are reasonably related to the cost of providing supplies and drugs to patients. Staff believes that a tiered charge structure, whereby the amount of overhead added varies inversely to the invoice cost, is appropriate. The cost of procurement, delivery and storage is not dependent on invoice cost and, therefore, should represent a proportionately larger add-on to low cost supplies and drugs. The modeling of tiered charging indicates that hospitals can collect their approved revenue with markups of less than 300% on low invoice cost items by controlling the amount of unbilled MSS and CDS. Surveys of hospitals indicate that most hospitals bill for all drugs and supplies with invoice costs greater than $5.00 is reasonable when the patient understands that he or she was not charged for items less than $5.00. More expensive items should be inversely tiered based on invoice cost with the most expensive items requiring markups of under 100%.

Letters of complaint received from the public will be followed up with an investigation of hospital invoice cost and inpatient/outpatient pricing. What appear to be inappropriate markups

may be reported to the Commission. Hospitals may be required to explain and defend their pricing methodology to assure the Commission that it results in M/SS and CDS that are reasonably related to costs.

Full rate reviews will be completed using current methodology to develop approved MSS/CDS revenues. The amount of the approved revenues will be used in the price leveling of the new rate base. The rate order amount with the full rate setting will require the charging of the invoice cost of the supply or drug with markup and an allocation of overhead. The overhead will equal the amount of overhead from the rate application and will be treated as 100% variable.