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reimbursement principles as described in CMS's regulations and instructions.

(b) *Purpose.* Contained in this subpart are—

(1) The basic requirements that a State reimbursement control system must meet in order to be approved by CMS;

(2) A description of CMS's review and evaluation procedures; and

(3) The conditions that apply if the system is approved.

§ 403.302 Definitions.

For purposes of this subpart—

Chief executive officer of a State means the Governor of the State or the Governor's designee.

Existing demonstration project refers to demonstration projects approved by CMS under the authority of section 402(a) of the Social Security Amendments of 1967 (42 U.S.C. 1395b-1) or section 222(a) of the Social Security Amendments of 1972 (42 U.S.C. 1395b-1 (note)) and in effect on April 20, 1983 (the date of the enactment of Pub. L. 98-21 (Social Security Amendments of 1983)).

Federal hospital means a hospital that is administered by, or that is under exclusive contract with, the Department of Defense, the Veterans Administration, or the Indian Health Service.

State system or *system* refers to a State reimbursement control system that is approved by CMS under the authority of section 1866(c) of the Act and that satisfies the requirements described in this subpart.

§ 403.304 Minimum requirements for State systems—discretionary approval.

(a) *Discretionary approval by CMS.* CMS may approve Medicare payments under a State system, if CMS determines that the system meets the requirements in paragraphs (b) and (c) of this section and, if applicable paragraph (d) of this section.

(b) *Requirements for State system.* (1) An application for approval of the system must be submitted to CMS by the Chief Executive Officer of the State.

(2) The State system must apply to substantially all non-Federal acute care hospitals in the State.

(3) All hospitals covered by the system must have and maintain a utilization and quality control review agreement with a Quality Improvement Organization, as required under section 1866(a)(1)(F) of the Act and § 466.78(a) of this chapter.

(4) Federal hospitals must be excluded from the State system.

(5) Nonacute care or specialty hospital (such as rehabilitation, psychiatric, or children's hospitals) may, at the option of the State, be excluded from the State system.

(6) The State system must apply to at least 75 percent of all revenues or expenses—

(i) For inpatient hospital services in the State; and

(ii) For inpatient hospital services under the State's Medicaid plan.

(7) Under the system, HMOs and competitive medical plans (CMPs), as defined by section 1876(b) of the Act and part 417 of this chapter, must be allowed to negotiate payment rates with hospitals.

(8) The system must limit hospital charges for Medicare beneficiaries to deductibles, coinsurance or non-covered services.

(9) Unless a waiver is granted by CMS under § 489.23 of this chapter, the system must prohibit payment, as required under section 1862(a)(14) of the Act and § 405.310(m) of this chapter, for nonphysician services provided to hospital inpatients under Part B of Medicare.

(10) The system must require hospitals to submit Medicare cost reports or approved reports in lieu of Medicare cost reports as required.

(11) The system must require—

(i) Preparation, collection, or retention by the State of reports (such as financial, administrative, or statistical reports) that may be necessary, as determined by CMS, to review and monitor the State's assurances; and

(ii) Submission of the reports to CMS upon request.

(12) The system must provide hospitals an opportunity to appeal errors that they believe have been made in the determination of their payment rates. The system, if it is prospective may not permit providers to file administrative appeals that would result

in a retroactive revision of prospectively determined payment rates.

(c) *Satisfactory assurances.* The State must provide to CMS satisfactory assurance as to the following:

(1) The system provides for equitable treatment of hospital patients and hospital employees.

(2) The system provides for equitable treatment of all entities that pay hospitals for inpatient hospital services, including Federal and State programs. Under the requirement, the following conditions must be met:

(i) Both the Medicare and Medicaid programs must participate under the system.

(ii) The State must assure equitable and uniform treatment under the system of third-party payors of inpatient hospital services in terms of opportunity. Equitable opportunity must include, but need not be limited to, participation in the system and availability of discounts. Criteria under which discounts are made available must be equitably and uniformly applied to all payors, except for discounts negotiated by HMOs and CMPs. Discounts available to HMOs and CMPs as result of their statutory right to negotiate payment rates independently of a State system, as described in paragraph (b)(7) of this section, need not be available to other payors.

(iii) The State must assure that all third-party payors that participate under the system share in the system's risks and benefits.

(3) The amount of Medicare payments made under the system over 36-month periods may not exceed the amount of Medicare payment that would otherwise have been made under the Medicare principles of reimbursement for Medicare items and services had the State system not been in effect. States must submit the assurance and supporting data as required by § 403.320 to document that the payment limit is not exceeded. States that have an existing Medicare demonstration project in effect on April 20, 1983, and that have requested approval of a State system under section 1886(c)(4) of the Act, may elect to have the effectiveness of the State system under this paragraph judged on the basis of the State system's rate of increase or inflation in

Medicare inpatient hospital payments as compared to the national rate of increase or inflation for such payments during the three cost reporting periods of the hospitals in the State beginning on or after October 1, 1983.

(d) *Additional cost-effectiveness assurance.* If the assurances and supporting data required under paragraph (c)(3) of this section are insufficient to provide assurance satisfactory to CMS regarding the cost-effectiveness of a State system, the State may additionally submit one of the following assurances in order to meet the cost-effectiveness test:

(1) *State responsibility for excess payments.* The State must agree that each month Medicare intermediaries will disburse to the State's hospital Federal funds that in the aggregate equal no more than would have been disbursed in the absence of the State system. Any additional funds necessary to pay hospitals for Medicare services required by the State system will be paid to the intermediaries by the State. These additional amounts will be refunded to the State by the intermediaries to the extent that, in subsequent months, the State system requires a smaller aggregate payment for Medicare services than would have been paid in the absence of the State system.

(2) *Limitations on payments.* (i) The State must agree that if its projections exceed what Medicare would pay in any particular period, the State and CMS will establish and agreed upon payment schedule that will limit payments under the State system based on a predetermined percentage relationship between projected State payments and what payments would have been under Medicare.

(ii) If deviation from the predetermined relationship described in paragraph (d)(2)(i) of this section occurs, the State must further agree that—

(A) Medicare payments would be capped automatically at payment levels based on the rates used for the Medicare prospective payment system and the State would be required to pay the difference to individual hospitals in its system; or

(B) The State may provide by legislation or legally binding regulations that

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any reduced payments to hospitals under the system that result from this cost-effectiveness assurance will constitute full and final payment for hospital services furnished to Medicare beneficiaries for the period covered by these reduced payments.

§ 403.306 Additional requirements for State systems—mandatory approval.

(a) *General policy*—(1) *Mandatory approval.* HFCA will approve an application for Medicare reimbursement under a State system if the system meets all of the requirements of § 403.304 and of paragraph (b) of this section.

(2) *Exception.* CMS may approve an application if the State system meets all of the requirements of § 403.304 but only some of the requirements of paragraph (b) of this section.

(b) *Additional requirements*—(1) *Operation of system.* The system must—

(i) Be operated directly by the State or by entity designated under State law;

(ii) Provide for payments to hospitals using a methodology under which—

(A) Prospectively determined payment rates are established; and

(B) Exceptions, adjustments, and methods for changes in methodology are set forth;

(iii) Provide that a change by the State in the system that has the effect of materially changing payments to hospitals can take effect only upon 60 days notice to CMS and to the hospitals likely to be materially affected by the change and upon CMS's approval of the change.

(2) *Satisfactory assurances*—(i) *Admissions practice.* The State must assure that the operation of the system will not result in any change in hospital admission practices that result in—

(A) A significant reduction in the proportion of patients receiving hospital services covered under the system who have no third-party coverage and who are unable to pay for hospital services;

(B) A significant reduction in the proportion of individuals admitted to hospitals for inpatient hospital services for which payment is less, or is likely to be less, than the anticipated charges for or cost of the services;

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(C) A refusal to admit patients who would be expected to require unusually costly or prolonged treatment for reasons other than those related to the appropriateness of the care available at the hospital; or

(D) A refusal to provide emergency services to any person who is in need of emergency services, if the hospital provides the services.

(ii) *Consultation with local government officials.* The State must provide documentation that it has consulted with local government officials concerning the impact of the system on publicly owned or operated hospitals.

§ 403.308 State systems under demonstration projects—mandatory approval.

CMS will approve an application from a State for a State system if—

(a) The system was in effect prior to April 20, 1983 under an existing demonstration project; and

(b) The minimum requirements and assurances for approval of a State system are met under § 403.304 (b)(1)–(10) and § 403.304(c), and, if appropriate § 403.304(d).

§ 403.310 Reduction in payments.

(a) *General rule.* If CMS determines that the satisfactory assurances required of a State under § 403.304(c) and, if applicable, § 403.304(d) have not been met, or will not be met, with respect to any 36-month period, CMS will reduce Medicare payments to individual hospitals being reimbursed under the State's system or, if applicable, under the Medicare payment system, in an amount equal to the amount by which the Medicare payments under the system exceed the amount of Medicare payments to such hospitals that otherwise would have been made not using the State system. The amount of the recoupment will include, when appropriate, interest charges computed in accordance with § 405.378 of this chapter.

(b) *Recoupment procedures.* The amount of the overpayment will be recouped on a proportionate basis from each of those hospitals that received payments under the State system that exceeded the payments they would