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Insights into Hospital Retail Pricing Strategies

By Scott Houk and Sean Gardner

An analysis of the retail pricing strategies of 156 hospitals and health systems points to the need for a thoughtful approach to balancing prices, costs, and operating margins.

Hospital pricing strategies have become more complex in recent years due to mounting pressures from a number of parties—including patients, payers, physicians, and the business community—to compete on prices and reduce the cost to consumers.

We have recognized that, when developing a pricing strategy, many hospitals focus first on retail services, or frequently used patient services that are delivered by multiple providers in different settings.

Retail services are price-sensitive, meaning that some patients will choose

where to have the service performed based on price.

We conducted a survey of hospital executives to find out more about their retail pricing strategies, pressures, and concerns. We received responses from 58 hospital executives representing 156 hospitals and health systems. Most respondents (83 percent) indicate that addressing retail pricing is of moderate to high concern.

To dig deeper, we compared the executives' survey responses to their hospital charges and operating margins. Given the correlations that we saw, we can draw

three conclusions: First, retail services face strong market pressures. Second, prices for these retail services substantially exceed costs. Finally, hospitals must balance maintaining operating margins with establishing a retail pricing strategy.

Retail Price Pressures

When asked what services they identify as retail services, more than 80 percent of hospital executive respondents cited laboratory testing and diagnostic imaging (see the exhibit above).

Medicare cost report data helps shed some light on why many hospitals are looking to reduce prices for these

services. The price-to-cost relationship for hospital services is the highest for radiology and laboratory services with prices at 7.72 times cost and 7.19 times cost, respectively (see the top exhibit on page 3). Hospitals have arrived at this large mark up because these services are more often reimbursed on a percent-of-charge basis.

You will find the opposite of this in routine care where the mark up is 1.41 times cost because inpatient services have generally been paid under fixed payment terms, such as MS-DRGs or per diems.

Price Pressure Versus Charges

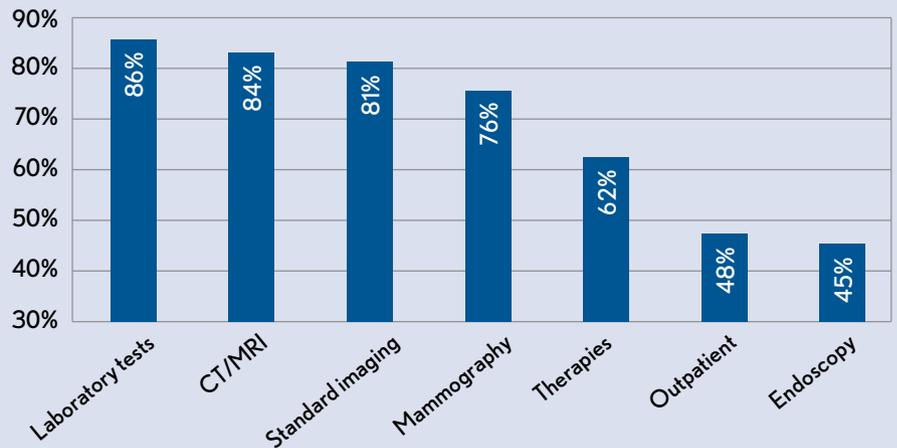
Our survey results suggest that the greatest pressure to reduce prices comes from patients, payers, and free-standing providers (see the bottom exhibit on page 3).

Retail services, such as lab and radiology, are typically performed in the outpatient setting. Since these patients are ambulatory, they are more likely to “shop-around” for the best value. With the continued growth in high-deductible health plans, we don’t expect this trend to subside.

To provide context to the survey responses, we looked at the 2013 Hospital Charge Index® (HCI) for each hospital that participated. The HCI compares the Medicare charge per discharge and Medicare charge per visit (both adjusted for case complexity and wage index differences) to the U.S. median hospital.

A higher HCI indicates higher prices. We found that survey respondents who reported feeling strong price pressure from patients work at hospitals with the highest HCI median of 105.8, compared

Where Hospitals Are Experiencing Retail Price Pressure



Source: Cleverley & Associates. Used with permission. Data from a 2015 survey of 58 hospital executives representing 156 hospitals and health systems.

Respondents associated retail offerings with laboratory and radiology services, followed by physical and occupational therapies, outpatient surgery, and endoscopy. Some respondents also said they are experiencing retail price pressure in other areas, including cosmetic surgery, dermatology, and urgent care.

to a median of 95.3 for all hospitals in the survey.

Defense Strategies

When asked how their hospitals are defending their current pricing strategy (see the top exhibit on page 4), the majority of respondents report using one or more of these three strategies:

- > By comparing their prices to peer prices
- > By showing a cost-based relationship
- > By using a value proposition (i.e., higher-quality) argument

Only 21 percent use an ROI approach, which is similar to how public utilities set their rates.

Looking again at HCI, we found that the hospitals using the value proposition and cost-based relationship defenses had the lowest median HCIs of 92 and 96, respectively, while those that use the ROI approach had the highest average HCI of 100.8.

Interestingly, those that use the cost or value defenses also had the lowest average operating margins of 5.6 percent, compared to those that use a peer-pricing (6.6 percent) or ROI approach (8.2 percent).

Those hospitals that have kept their prices lower likely have a lower price-to-cost relationship because we were unable to find significant differences in cost position among the hospitals that use different methods to defend their current pricing position.

We also asked executives if they believed their hospitals’ current pricing position was defensible. Sixty-four percent responded “yes,” while 36 percent said “no.” The “no” responses came from hospitals with a higher-average HCI of 101, compared to the average HCI of 96 at hospitals with executives who said their prices were defensible.

Pricing Strategies

Some of the hospitals surveyed had already implemented retail pricing strategies, while others are in the planning stages (see the bottom exhibit on this page). Strategies being used include:

- > Reducing outpatient price to compete for volume
- > Reducing inpatient and outpatient prices
- > Building, purchasing, or entering into a joint venture to retain some of the volume and profit from services that have migrated out of the hospital
- > Promoting the value and quality of hospital services as a differentiator for being higher priced in some areas

Those facilities that had already created lower outpatient prices had the highest average 2013 HCI scores among the survey participants. We assume these hospitals recognized their position and responded by lowering prices.

Concerns About Margins/Revenue

When asked what was preventing a hospital from implementing a retail service strategy, the top response (80 percent) was pressure to maintain or improve operating margins.

The next two reasons (tied at 62.5 percent) were uncertainty that volumes would increase enough to offset losses in net revenue and concerns that contracts would need to be renegotiated so that the hospitals did not take a hit to net revenue from reducing prices.

Interestingly, about 14 percent of respondents indicated that they could charge more than free-standing providers for their services because of better quality and/or reputation. These hospitals also had an operating margin (9.6 percent) that was almost twice the average of the group (5.4 percent).

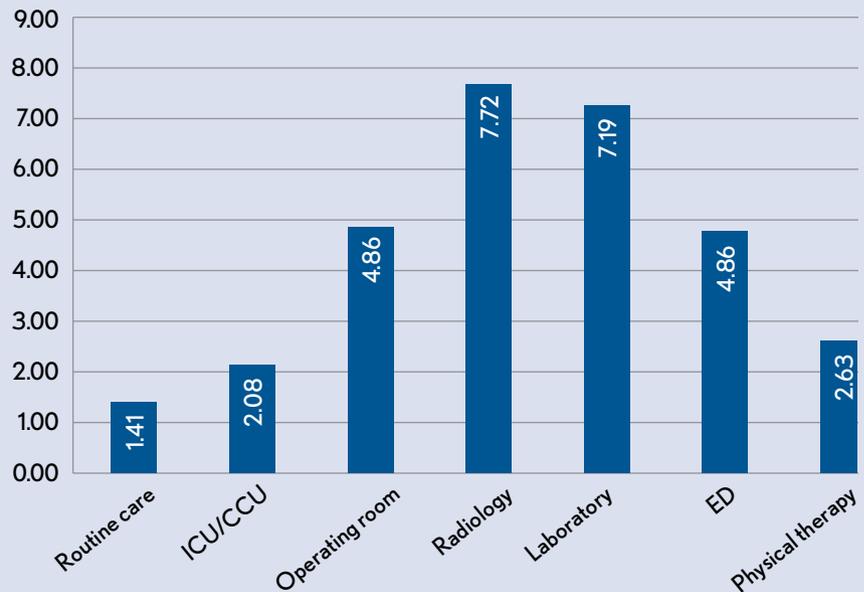
Regarding hospitals' desires related to retail services, 86 percent of those responding to the survey hope to experience an increase in volumes, 66 percent hope to minimize or eliminate negative publicity related to their prices, and 59 percent want to see an enhancement to net revenue as a result. Other anticipated outcomes include appeasing

referring physicians (45 percent) and establishing better relationships with payers (41 percent).

Case Example

As seen in the survey results, multiple retail solutions exist for hospitals. But it is vital to analyze the potential outcome before pursuing any strategy.

U.S. Hospital Price-to-Cost Relationships



Source: Cleverley & Associates. Used with permission. Data from 2013 Medicare cost reports for U.S. acute care hospitals.

Considering how far radiology and laboratory services have moved from a relationship to cost, it is no surprise that many hospitals are feeling pressure to address price reductions in these areas.

Sources of Hospital Price Pressure

| Source of Pressure | Strong Pressure | Some Pressure | Total |
|-----------------------------|-----------------|---------------|-------|
| Patients | 42% | 49% | 91% |
| Payers | 41% | 48% | 89% |
| Free-standing providers | 35% | 42% | 77% |
| Physicians | 18% | 55% | 73% |
| Business/employer community | 20% | 50% | 70% |
| Media | 17% | 42% | 59% |
| Hospital providers | 9% | 40% | 49% |

Source: Cleverley & Associates. Used with permission. Data from a 2015 survey of 58 hospital executives representing 156 hospitals and health systems.

Patients, payers, and free-standing providers are putting the most pressure on hospitals to reduce prices.

We recently performed a procedure-pricing study for a rural hospital client. The hospital leaders asked us to estimate the volume increase for CT and MRI procedures that would be required to remain net revenue neutral if they reduced their prices to the state average for free-standing imaging centers.

This hospital has a majority of commercial contracts that pay on

discount-from-billed charges so the net revenue impact was significant. To reduce current charges to the free-standing imaging center state average, the hospital would see an average price reduction of almost 60 percent.

We then determined that this hospital would need to increase CT/MRI volume by an estimated 33 percent to break even from such a significant price decrease.

Hospital leaders were left questioning if there was even enough volume in the market to make this a reality.

A Careful Balance

This is the type of analysis that hospitals should be performing before making large price reductions. Some hospital leaders think that price reductions will have little, if any, impact to net revenue because many of their contract terms are fixed payment arrangements. But then an analysis shows that significant price reductions would cause prices to fall below the commercial fee-schedule payment rates. The hospitals would then be paid at their charge rate because it is lower than the fee-schedule payment, leaving a gap in net revenue.

Hospitals must balance the need to respond to market pressures and maintain margins with the reality of contracted payment arrangements. All three must be carefully coordinated to avoid a financial shock. ☞

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Hospital Pricing Defenses

| How do you defend your pricing position? | Responses* | Hospital Charge Index ^{®**} | Operating Margin |
|--|------------|--------------------------------------|------------------|
| ROI | 21.0% | 100.8 | 8.22 |
| Cost-based | 56.1% | 96 | 5.58 |
| Value proposition | 56.1% | 92 | 5.64 |
| Peer pricing relationships | 59.6% | 98.5 | 6.62 |

*Respondents could select more than one answer, which is why the results do not add up to 100 percent.
 **The Hospital Charge Index (HCI) compares the Medicare charge per discharge and Medicare charge per visit (both adjusted for case complexity and wage index differences) to the U.S. median hospital.

Source: Cleverley & Associates. Used with permission. Survey data from a 2015 survey of 58 hospital executives representing 156 hospitals and health systems. Operating margin data from 2013 Medicare cost reports.

Hospitals that use a cost-based or value proposition (i.e., higher-quality) argument to defend their prices also had the lowest median HCI and lowest average operating margins.

Hospital Pricing Strategies

| Solution | Already Implemented | Plan to Implement | Not Sure | Never |
|---|---------------------|-------------------|----------|-------|
| Reduce inpatient and outpatient prices | 25% | 18% | 49% | 8% |
| Create a reduced outpatient price to compete for volume | 22% | 30% | 41% | 7% |
| Build, purchase, or enter joint venture with competition to retain some of the volume and profit from services that have migrated out of the hospital | 21% | 28% | 45% | 6% |
| Promote value/quality as a differentiator for higher pricing | 34% | 36% | 28% | 2% |

Source: Cleverley & Associates. Used with permission. Data from a 2015 survey of 58 hospital executives representing 156 hospitals and health systems.

The most common pricing strategy reported by hospital executives is differentiating services based on quality, thus justifying the higher prices.