

The Buckeye Connection

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Pricing Strength—Realizing the Value of Your Pricing Structure

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“While it is rarely possible to find the perfect or optimal price, a manager who understands the forces that determine success in pricing can make more profitable decisions than one who does not.” (1)

Because of the complexity and uncertainty surrounding pricing structures, many hospitals delay in performing pricing analyses. However, to ensure optimal profitability and financial strength, it is imperative that hospitals review their pricing structure. Hospitals can ill afford to avoid this important analysis because community hospital profit margins are very low, hovering around 1.2% as opposed to an optimal 4%. An understanding of key concepts can help hospital Chief Financial Officers (CFOs) discern how effective their current pricing structure is and how to ensure effective pricing in the future. This type of analysis should be done at least annually to ensure optimal pricing levels.

The purpose of this article is to express the importance of the pricing structure and to describe how it can be molded into a functional tool for improving financial performance. A key tool in undertaking this assessment is the Pricing Strength Index (PSI), which will be, described in detail. The PSI

Pricing Strength (cont'd)

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▲ is a measurement tool that will help hospital CFO's understand the outcomes of their current pricing strategy. It will give them an idea of how they are performing today and can be used in the process of planning for the future. Proper CDM analysis and formulation of policy are also discussed, as they are the essential keys to ensuring a strong pricing structure in the future.

Functionality of the Current Pricing Structure:

Pricing Strength Index

Recent studies of hospital profitability suggest that pricing differences, rather than cost differences, are the distinguishing characteristic between high-performing and low-performing hospitals. Although pricing is only one element of a hospital's overall strategic plan, pricing clearly is one of the key elements of a hospital's financial well-being. With community hospital margins hovering at about 1.2% in recent years, well below a desirable level of 4%, hospitals cannot afford to price below optimal levels. One of the reasons hospital executives and managers do not always price optimally is due to the sheer volume of data. Just as executives use financial ratios, such as return on equity and profit margin, to help focus their attention on crucial financial data, combining key pricing data into a composite measure, the PSI, could help to reduce the complexities normally associated with analyzing a firm's pricing. The PSI provides a measure from which to determine whether a hospital has concerns with regard to pricing.

Pricing in the hospital industry is undeniably complex. Basic economic theory suggests that pricing should be a function of demand elasticity and marginal cost. Empirical data are unconvincing that those factors explain much of hospital pricing. Clearly, hospital pricing involves myriad other factors, including, but not limited to, the

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President's Message

Craig Bjerke

I hope everyone is having a good Spring and is looking forward to the Spring Golf Outing on May 27th at High Lands Golf Club. Since our last newsletter several things have gone on in our chapter.

Central Ohio chapter officers recently traveled to Chicago for the annual HFMA Leadership Training Conference. Additionally, we recently held an educational session at the McConnell Heart Health Center. Ward Hill of Stonehaven Strategic Solutions presented **FINANCIAL, REVENUE and CHANGE MANAGEMENT: PRACTICALITY, THEORY and MISSION SUCCESS**. The program was well attended and focused on management fundamentals including discussions on competitive advantage, management pillars,

communications and motivational techniques and goal theory. Special thanks go to Ernst & Young for their sponsorship of the program and to Luke Brown and Karin Cain for their efforts in organizing the program.

In the upcoming months, our chapter will have the Spring Golf Outing, chapter officers will be attending the annual HFMA Annual National Institute & Idea Exchange in Baltimore in June and the chapter will have its annual mini-LTC planning session for chapter officers and committee chairs. I would like to personally thank all of the chapter officers and committee chairs for their help this past year and I hope to see all of you at High Lands.

Craig Bjerke
Chapter President

President's Message

Pricing Strength (cont'd)

hospital's market share, management's ability to negotiate contracts, the degree of managed care penetration, and the quality of the hospital's services.

The ideal measure of overall strategic pricing would be intuitive, easy to calculate from readily-available data, easy to use or apply, and should be reliable and valid over time and across firms. A summary measure that

satisfies these criteria could be invaluable to managers, board members, and others as they seek to understand the firm's pricing position. The Pricing Strength Index provides this structure

The concept of strategic pricing goes beyond reporting merely historical pricing-related ratios. The Pricing Strength Index (PSI) includes the six components of pricing that appear consistently in the literature as either reflecting the current pricing strength or identifying those factors that give the greatest potential for future pricing flexibility (see Table 1.).

Table 1. PSI Dimensions and Measures

Dimensions of Pricing Strength	Measured by
<i>Existing Pricing Strength</i>	
Prices above cost	Markup ratio
Successful negotiation	Deduction percent
Payer mix management	Private payer percent
<i>Strength of Pricing Potential</i>	
Contract negotiation leverage	Market share
Payer advantage in negotiations	Managed care penetration
Product differentiation/quality	JCAHO overall evaluation score

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Each of the six measures is “normalized” around a predefined average for the measure. The averages reflect national data for well-performing hospitals. Using normalized data permits us to add the six measures to create a composite indicator of total strategic pricing level for the hospital. Thus, the formula for calculating the PSI is as follows:

$$\text{PSI} = \frac{\text{Markup Ratio} - 1.75}{1.75} + \frac{\text{38-Deduction\%}}{38} + \frac{\text{PrivatePayer\%} - 35}{35} + \frac{\text{Market Share} - 55\%}{55\%} + \frac{\text{25\%-Managed Care Penetration}}{25\%} + \frac{\text{Quality JCAHO-90}}{90}$$

The PSI is easily comprehended. Hospitals that are pricing strategically and that will be able to continue doing so in the future:

- Price above costs
- Avoid over-discounting
- Arrange an attractive payer mix
- Garner a competitive market share
- Are in a market where managed care has not penetrated to a high degree and
- Deliver high-quality services

A poor showing along one or two of these measures does not preclude the hospital from pricing appropriately in the future. Low performance in several categories, however, suggests that the firm is headed toward a position of not being able to price above costs. It must reverse the trend in the low categories or risk its future viability.

Due to the completeness of the PSI in capturing multiple dimensions of an organization’s pricing strength—market conditions, quality and contract negotiations—the PSI avoids the limitations of one-dimensional measures of pricing, such as markup alone. If management were to improve one dimension of the firm’s finances at the expense of another area, the PSI will properly reveal and account for the tradeoff. For example, if a firm attempted to increase market share by offering overly generous discounts, the improvement in market share percentage will be offset by the higher deduction percentage.

What constitutes a good PSI value? Table 2 provides a general indication of how to interpret a given hospital’s PSI.

Table 2. PSI Values and Interpretation

PSI	Pricing Strength
> 3	Excellent
0 to 3	Good
-2 to 0	Fair
< -2	Poor

Undoubtedly, some of the components are interrelated. For example, one of the key advantages of having a high market share is greater pricing leverage. Increased market share should allow hospitals to recover a greater percentage of their costs from payers through better

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Pricing Strength (cont'd)

Pricing Strength (cont'd)

contract terms. One cannot presume, however, that hospitals have negotiated better terms as a result of a high market share. By having both components in the PSI, a weakness in either market share or in using market share to negotiate better prices will provide a more accurate overall assessment.

Flexibility of the Pricing Structure:

Price Elasticity and Market Analysis

Factors for consideration when updating your CDM include price elasticity and the market environment in which the hospital competes. It is important to analyze the elasticity of demand for the service being priced. A price elasticity of demand is the percentage change in the quantity demanded that is associated with a one percent change in the price of the service. [$e = (\% \text{ change in quantity}) / (\% \text{ change in price})$]

Understanding a product's price elasticity allows managers to make strategic decisions quickly. They are also useful for making sales forecasts and pricing decisions. (the effect that your prices have on your demand) when considering the price of a service or procedure. For example, when analyzing the price for an angioplasty, the current market must be addressed in order to make projections on the demand for this service. When budgeting for this service it is important to realize this elasticity and make adjustment to the price accordingly.

Table 3.

Fixed costs	\$300,000
Variable costs	\$350

Price (P)	Volume (Q)	Revenues	Expenses	Profit
0	3,304	\$ -	\$1,456,400	\$(1,456,400)
100	2,952	\$295,200	\$1,33,200	\$(1,038,000)
200	2,600	\$520,000	\$1,210,000	\$(690,000)
300	2,249	\$674,700	\$1,087,150	\$(412,450)
400	1,897	\$758,800	\$963,950	\$(205,150)
500	1,546	\$773,000	\$841,100	\$(68,100)
600	1,194	\$716,400	\$717,900	\$(1,500)
700	843	\$590,100	\$595,050	\$(4,950)
800	491	\$392,800	\$471,850	\$(79,050)
900	140	\$126,000	\$349,000	\$(223,000)
			Optimal Price:	\$600
			Expected Volume at the optimal price:	1,194

As shown in Table 3, the most likely patient volume is 1,194. The patient volume numbers are derived from historical trend analysis and market analysis of demand. Since it is difficult to predict the exact level of patient volume, the best chance of meeting budget goals will be at \$600.

It is obvious that conducting price elasticity analysis on all of the prices in your charge description master (CDM) would be too time consuming. New services, large volume and high revenue producing services should, however, be analyzed on a periodic basis (either annually or biannually). The remaining prices will be collectively evaluated based on the proper analysis of the CDM.

Charge Description Master Analysis

An imperative step in proper strategic pricing analysis is a careful and accurate review of the Charge Description Master (CDM). Many hospitals neglect the CDM for years, without considering its impact on profitability and financial viability. It is important to review and update the hospital CDM at least biannually, especially when contracts are renewed.

Understanding the Effects of Contracting

Contracting can play a significant role in your pricing structure and should be considered when updating the hospital's CDM. For example, if a contract is negotiated as paying a percent of charges, then an old CDM will lower your reimbursement rates. But if careful negotiations are made for contracts using an updated CDM, then there will be room to increase your prices, to an agreed-upon level, during the contract period. This will help define the boundaries for price reassignment while increasing awareness of CDM accuracy.

Limiting Payer Denials

Another key step to the analysis of the hospital CDM is the assessment of payer denials. When reviewing billing and collection practices, management must pay attention to commonalities in denied claims. If a code is commonly denied, then there may need to be adjustments made to the charge assigned. For instance,

many organizations that have not reviewed their CDM lately may find that they are billing codes that are obsolete or that do not accurately reflect the service provided. The CDM should be updated routinely to reflect the Centers for Medicare & Medicaid Services' (CMS) changes published in the *Federal Register* and in program transmittals. These updates will help to lower claim denial rates.

Integrating Analysis into Practice

To ensure that efficient analysis of the CDM is performed regularly, policies and procedures need to be developed and implemented. Policies and procedures addressing the following issues will provide structure and accountability for the performance of the CDM and ultimately your prices:

- The designation of someone with ultimate responsibility for overseeing CDM and its performance.
- The inclusion of periodic claims review.
- The formulation of guidelines that will detail when it is appropriate to add new charges, delete unused or obsolete charges and update existing charges.
- Provide a process of review that will prompt the reviewer to:
 - Look for invalid or inadequate CPT/HCPCS codes
 - Identify invalid or inadequate revenue center codes
 - Identify mismatched CPT/HCPCS and revenue center codes
 - Identify inadequately defined procedures or tests
 - Confirm the validity of a service
 - Verify the appropriateness of bundled CPT/HCPCS codes
 - Identify charges set below Medicare fee schedule amounts

Conclusions

1. Companies should be engaged in strategic pricing exercises annually.
2. Without this review they are at risk for financial ruin because of the tight margin and the dynamic nature of the system.
3. The PSI provides an easy and comprehensive tool by which to begin undertaking such a strategic pricing analysis.
4. In addition to PSI, other tools come into play. These include the CDM, key contracts and price elasticity analysis.

As reviews and updates of the CDM are made it will be

easier to identify the strengths and weaknesses of the pricing structure. The pricing strength index will remain a constant measure of overall pricing performance, but identifying key improvement areas is essential to increasing the bottom line. CFOs and their staff need to stay focused on the six components of pricing and remain aware of their interrelations. Remember that this is only the beginning of a healthy pricing structure; it takes constant reviewing and updating to remain current in today's dynamic healthcare environment.

References

- (1) Nagle, Thomas T., Holden, Reed K. "Profitable Pricing: Guidelines for Management." *Global Management*, Annual Review of International Management Practice, Vol. 8, 1992

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Pricing Strength (cont'd)

Top Ten Things NOT to do After April 15th: According to HIPAA Privacy

By Karin Cain and Scott Houk

1. Allow your children to use patient records as coloring paper.
2. Put your patient records up for auction on E-bay, for “research purposes”.
3. Encourage physician didactics to occur in public elevators, with open discussions about patient names and conditions.
4. Drive down I-71 with stacks of completed billing forms in the back of a pick-up truck
5. Take patient records home, and as a late night joke, start “prank calling” patients on the records.
6. Donate a patient billing file-cabinet to the Goodwill including all of the “scrap paper” inside
7. Decide that the person who is already the head of IT, Compliance and Patient Accounts can handle the “privacy officer” responsibilities. He has plenty of time.
8. Fail to tell your patients that you are paying for your new hospital wing by selling their records to the highest bidding pharmaceutical company.
9. Refuse to give patients their own medical records, telling them that you plan on wallpapering the office with them.
10. Name one password for the entire hospital, so that no one forgets it.



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