

Strategic Pricing Walking the Tightrope



In classic marketing strategy, pricing is important enough to be one of the four P's of the marketing mix along with product, promotion, and place. Pricing is a pivotal tool in determining volumes, profitability, and brand positioning. While pricing strategy is equally important in healthcare, it is subject to a more complex set of counterbalancing forces than in most other industries. In short, setting the right pricing strategy in healthcare is like walking a tightrope. The complexity of healthcare pricing also means that strategists are more dependent upon coordination with colleagues in finance, managed care contracting, and legal.



BY:

Defining Price in Healthcare

As with all industries, healthcare has a "list price" (gross charges) and a "net price" (payments). Hospital gross charges are frequently compared to the "rack rate" for a hotel room—listed but rarely paid. Over the past two decades, the difference between gross charges and payments has become, in the words of Moody's Investors Service, "essentially arbitrary."¹ The gap has grown so wide because the majority of net prices are either set by the government or contractually negotiated in large blocks with managed care companies. The primary groups affected by charge increases are self-pay patients and a handful of charge-based insurers. As a result, the typical charge increase for hospitals impacts only about 10 to 25 percent of revenues.²

Ironically, although gross charges have become less meaningful in terms of profitability, they have become more

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important than ever in public relations. Because uninsured patients are virtually the only ones subject to gross charges, this issue has become a lightning rod for public scrutiny. Furthermore, the growth of consumer-driven health plans has increased sensitivity to pricing among consumers.

Complexities of Healthcare Pricing

As strategic pricing has become more important in recent years, its complexity has become more apparent. To begin with, the sheer number of charge items can be

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staggering. Many hospital chargemasters contain 12,000 to 45,000 individually priced items.³ Without careful analysis, pricing of these items may have significant unintended consequences. For example, Medicare pays the lesser of gross charges or scheduled rates, so a reduction (or lack of increase) in individual charge items could reduce net payments. Alternatively, overly aggressive charging practices could

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Pricing continued ...

result in debilitating sanctions, such as the \$900 million settlement Tenet reached with the U.S. Department of Justice in 2006.⁴

Pricing Tips for Healthcare Strategists

Given the importance and complexities of healthcare pricing, what can strategists do?

1 Understand the changing forces in hospital pricing.

The priorities for hospital pricing strategy have evolved quickly over the past decade (figure 1). Understanding this evolution of counterbalancing forces is the best way to prepare for leading pricing strategies in the future. For instance:

◆ Traditional Pricing

Historically, hospital pricing strategy revolved around across-the-board charge increases to yield sufficient impact on net revenues and to “cost shift” in an effort to make up for fixed-payment payers. In an era when there were relatively few outpatient competitors, many commercial payers were charge-based, and information systems were more rudimentary; this approach was sufficient, although it ultimately led to the current “arbitrary” relationship between list and net pricing.

◆ Revenue Maximization

As the proportion of fixed-payment payers increased and the differences between gross charges and payments widened, providers began using more sophisticated tools to analyze pricing changes at a more granular level to maximize the impact of item-specific charge increases. With enhanced information systems, hospitals focused more on corporate pricing tools of cost-based pricing and market benchmarking to pursue traditional corporate pricing strategies of “penetration pricing” and “premium pricing” (figure 2). Others, such as specialty hospitals, were accused of the unethical but traditional corporate pricing strategy of “skimming.” The fourth traditional market stance for pricing, “economy pricing,” was more of a survival strategy for hospitals with poor payer mix.

◆ Defensive Pricing

As the number of uninsured rose and consumer-driven healthcare began to take hold, the era of “transparent pricing” shone a spotlight on hospital charge practices, particularly the discrepancy between net prices paid by the uninsured versus large insurers. Strategies for defensive pricing continued to focus on cost-based analysis and market

benchmarking, but the emphasis was more on defending prices than revenue maximization. Rather than just increasing prices where they mattered most, hospitals looked at decreasing charge rates where they were least defensible.

◆ Rational Pricing

Today, the prominent pricing paradigm is known as “rational pricing.” Essentially, this is a balanced solution that incorporates revenue maximization and defensive pricing. This approach focuses on rebasing pricing on actual costs, market comparisons, and contractual considerations. The goal is to ensure that all services are adequately priced to cover costs, strategically priced to support the desired market stance, and reasonably priced to withstand public scrutiny.

2 Beware the pricing transparency illusion trap.

Market-based pricing position for gross charges (list price) is becoming easier to gauge with increased pricing transparency laws, regulations, and practices. However, because public data on prices usually reflect gross charges (non-case mix or quality-adjusted) rather than payments, price transparency may be misleading to the public.

Figure 1

Evolution of Healthcare Pricing Strategy Priorities

Changing focus of hospital pricing priorities over the past decade

	Traditional Pricing	Revenue Maximization	Defensive Pricing	Rational Pricing
Driving Force	Cost-based or prospective government payment and charge-based commercial payment	Limited effectiveness of across-the-board increases	Public scrutiny of pricing, lawsuits, and “transparency”	Need to balance revenue maximization and defensive pricing
Strategies	<ul style="list-style-type: none"> ◆ Across-the-board increases ◆ Cost-shifting to charge-based payers 	<ul style="list-style-type: none"> ◆ Selective charge increases ◆ Bundling charges ◆ Net impact analysis 	<ul style="list-style-type: none"> ◆ Market and cost-based justification ◆ Formal discount policies for uninsured 	<ul style="list-style-type: none"> ◆ Balanced market, cost, and contractual considerations ◆ Rebasing the pricing system

Source: Noblis, 2007

From a net pricing perspective, the most important market-based comparisons to communicate are those for uninsured patients and for insured patients with large co-pays or deductibles. Net prices for self-pay patients are under the greatest public scrutiny, and patients in consumer-driven health plans with large co-pays or deductibles are the most price-sensitive.

3 Understand differences in price sensitivity across services.

Price sensitivity for healthcare services is influenced by payer type and competitor type. Outpatient services, in general, are more price-sensitive because they represent a higher proportion of charge-based payers and face competition from a broader number of providers, including physicians. Given the greater price sensitivity for these services,

hospitals should devote additional effort to gathering market pricing information from non-traditional competitors to ensure that pricing is competitive.

4 Improve your market stance for managed care negotiations.

Strategists can improve the organization's ability to pursue a premium pricing strategy or realize other favorable pricing by strengthening its strategic position and building the brand. Maintaining a strong strategic position in the market has the greatest benefit in negotiating payment rates for managed care. Clearly demonstrating unique capabilities and consumer preferences may help with general payment negotiations or "carve-outs" for specialty services. Measurable quality data also provide additional support for premium pricing.

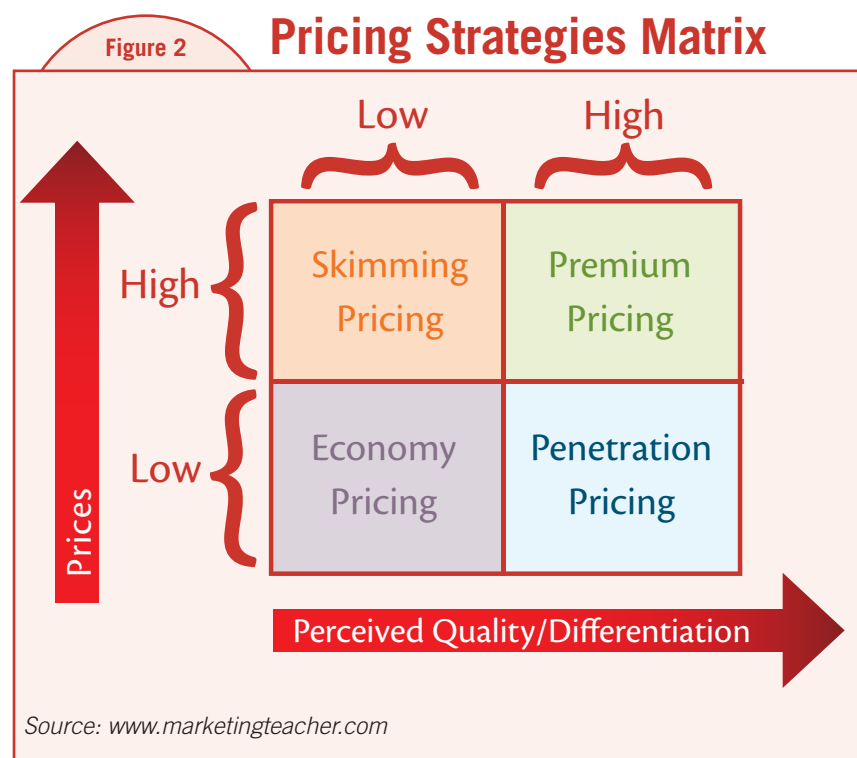
5 Continually improve communication about pricing.

As healthcare consumerism grows, communication with consumers on a "retail" basis will become increasingly important. Healthcare organizations must be able to provide convenient and accurate pricing estimates to consumers. In fact, some have already started to offer estimate services on their websites.

Public scrutiny about pricing for the uninsured will continue to be an issue, and hospitals must ensure that they have clear and appropriate discounting policies for this population.

Walking the Tightrope

By staying up-to-date on the changing pricing priorities in the industry, the hospital's price positioning among evolving competitors, sensitivity to pricing for the uninsured, and the growing impact of consumer-driven health plans, healthcare strategists can provide the necessary market-based intelligence needed to walk the tightrope of strategic pricing. ^m



Endnotes

¹ "Pricing Transparency Unlikely to Influence Patient-Consumer Behavior Over the Next Several Years, Minimizing Credit Impact." *Moody's Investors Service*. October 2006.

² "Effective Hospital Pricing Strategy." *William O. Cleverly, PhD*, 2003.

³ "Reconstructing Hospital Pricing Systems." *Healthcare Financial Management Association*, 2007.

⁴ "Tenet Healthcare Corporation to Pay U.S. More Than \$900 Million to Resolve False Claims Act Allegations." *U.S. Department of Justice press release*, June 29, 2006.

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