

**MANAGING FOR SUSTAINABLE PROFITABILITY**

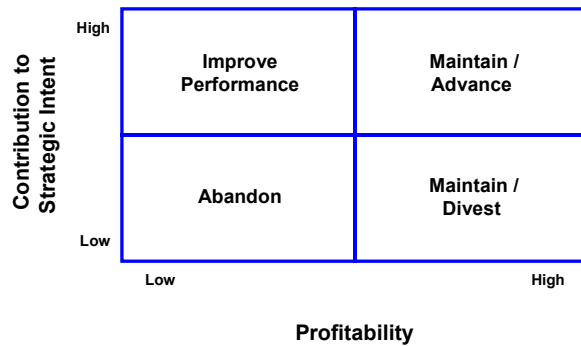
**BDC ADVISORS, LLC POINT OF VIEW**

Healthcare delivery systems across the United States continue to face significant financial pressures attributable to environmental and regulatory forces. These forces include:

- Medicare reimbursement reductions related to the Balance Budget Act of 1997
- Growth in the uninsured population
- Commoditization of managed care products resulting in lower payment levels to providers
- Sub-optimal horizontal integration strategies within multi-hospital systems
- Continued losses related to vertical integration strategies
- Significant Y2K and IT investments with limited results to date, in terms of advancing quality and reducing costs
- Increasingly sophisticated healthcare consumers rejecting traditional provider / patient role, and demonstrating limited loyalty to providers

In view of ongoing pressure on profitability and resource constraints facing most healthcare organizations, it is an appropriate time to examine whether or not major initiatives are performing optimally, and achieving the overall strategic intent. A framework for evaluating the efficacy of key initiatives is presented below:

**Evaluating Key Initiatives' Contribution to Health System Strategic Intent**



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Presented in this point of view article are six strategic initiatives that are familiar to provider organizations in many markets:

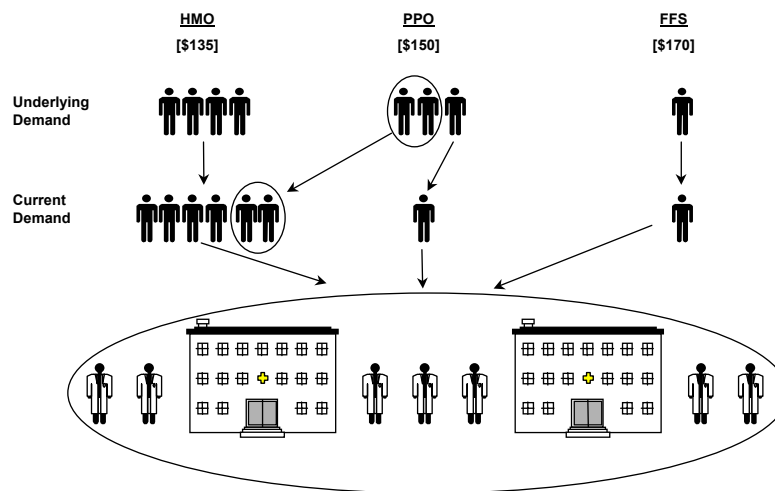
- Returning Differentiation to Managed Care Products
- Rethinking Participation in Risk Contracting
- Service Line Integration
- Clinical Performance Improvement
- Prioritizing Technology Investments
- Rethinking Physician Integration

These initiatives can significantly impact an organization's profitability. Each is presented as a case study, summarizing the issues presented and tactics to address.

**RETURNING DIFFERENTIATION TO MANAGED CARE PRODUCTS**

As depicted in the diagram below, many markets have witnessed a dissolution of differentiation between PPO and HMO products, as HMO provider panels have increased and evolved into open access products. Consumers who would ordinarily be willing to pay a premium for open access (e.g., PPO product) can now obtain the same product at a substantially reduced HMO premium level.

### Enforcing Product Differentiation PPO Products at HMO Prices



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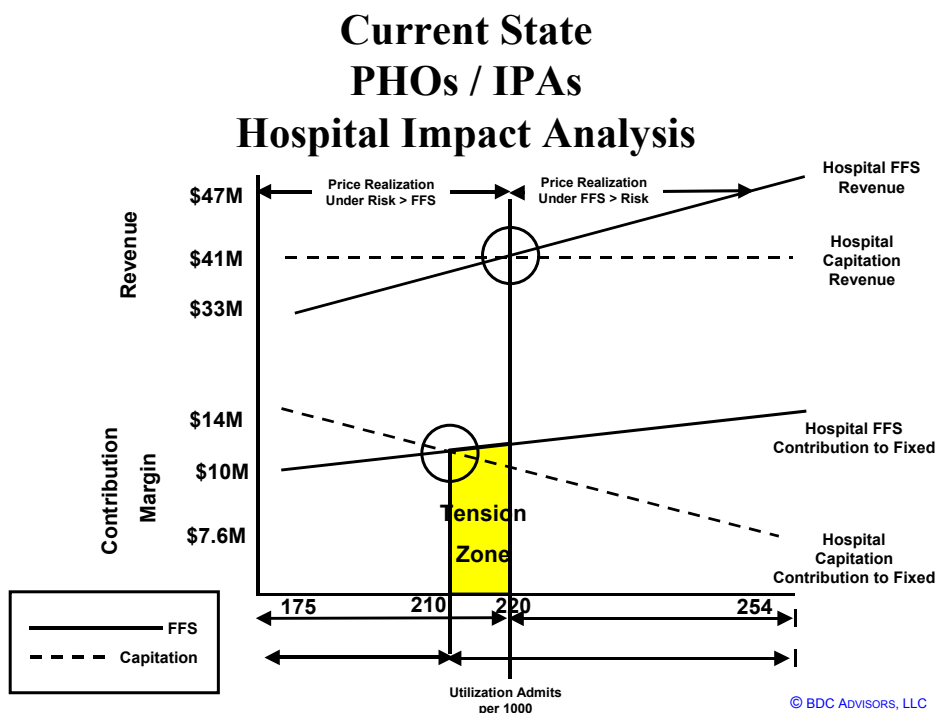
Through the following actions, BDC Advisors, LLC assisted a multi-hospital, integrated system in executing a strategy to influence market demand for PPO vs. HMO products. Key actions in this strategy include:

1. Canceling, renegotiating, or converting unprofitable risk contracts to non-risk agreements.
2. Establishing capacity limits for risk enrollment including maximum PCP panel size and reimbursement differentials for capacity in excess of established levels.
3. Making participation in risk contracts by PCPs voluntary.
4. Consolidating risk participation into a managed care network of providers who are willing and able to manage risk.

**RETHINKING PARTICIPATION IN RISK CONTRACTING**

Many vertically integrated healthcare organizations entered into risk contracts in order to secure loyalty from their medical staffs. Through creative funds flow mechanisms, hospitals were able to provide their physician partners with attractive risk sharing payments. As competition intensified for physician loyalty, more and more attractive physician risk sharing arrangements were offered and paid for by hospital partners.

The diagram below illustrates the tension created when a hospital structures a physician risk sharing arrangement that is detrimental to the hospital. The "tension zone" highlighted below occurs at a point at which utilization targets have been met, revenue targets are more favorable under capitation (i.e., risk), yet the hospital would have been more profitable under non-risk arrangements.



Alternative tactics that might be pursued by the hospital under this scenario include the following:

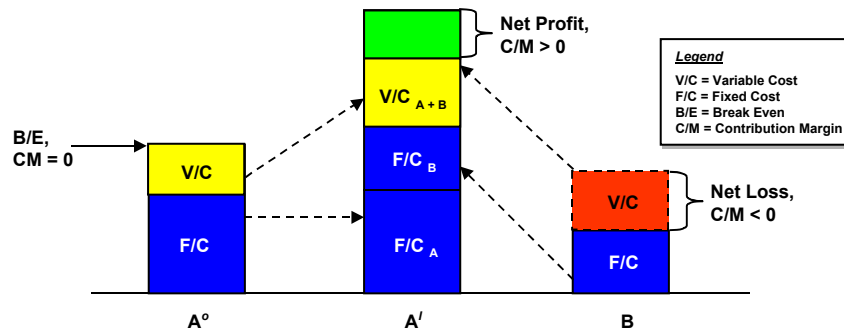
1. Further reducing inpatient utilization.
2. Reducing variable costs per discharge.
3. Revising the funds flow arrangement between the hospital, the physician organization, and the health plan.
4. If the hospital is exiting from risk business, converting the physician payment approach to a shared risk approach with the health plan.

**SERVICE LINE INTEGRATION**

While most have achieved administrative integration, many hospital mergers of the 1990s have yet to achieve effective program and service consolidation. Service line consolidation is often hampered by multiple factors including physician disruption, historical patient preferences, and convenience. As operating margins are further pressured, healthcare systems will be forced to address optimal program and service configuration.

The diagram below illustrates the potential economic impact on a system resulting from consolidation of a key program or service on one campus. Prior to consolidation, the system’s economics would be the sum of A + B. Subsequent to consolidation, system economics would be A', including improved profit margin.

**Service Line Integration**  
*Volume Redirection from Facility B to Facility A*



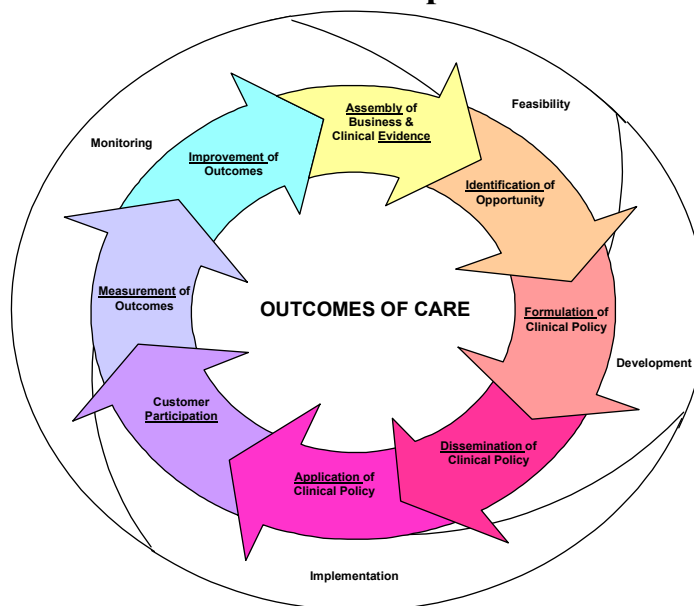
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Service line consolidation can, if properly executed, achieve the following:

1. Variable cost savings can be achieved through elimination of staffing duplications.
2. Routine capital expenditures can be reduced through a focus on a single campus.
3. Fixed cost burden of vacated space can be reduced through adding new volume or consolidating overhead services.
4. Increased volumes in one site enable clinical quality improvements and service differentiation.
5. Enhanced differentiation leads to improved brand and potential market share growth.

**CLINICAL PERFORMANCE IMPROVEMENT**

Clinical performance improvement initiatives are being aggressively pursued by many integrated healthcare systems located in mature managed care environments with the objectives of eliminating clinical variation, achieving consistent levels of quality, and reducing costs. Summarized in the diagram below is a framework BDC Advisors, LLC has employed to assist a large multi-hospital system in: a) identifying and prioritizing clinical performance improvement opportunities across the system, b) developing the clinical pathways to achieve performance improvement, and c) developing an ongoing monitoring process to ensure the benefits of the initial effort are sustained.

**Clinical Performance Improvement Process**

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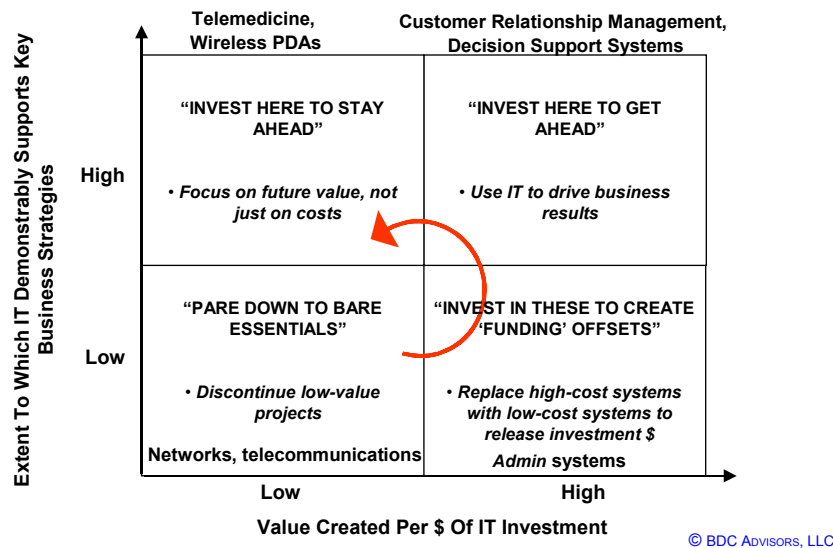
The critical steps in this process are as follows:

1. Feasibility analysis entails review of ancillary costs, specialty costs by physician and clinical process analysis, and quantification of overall opportunity based upon actual experience compared to targeted benchmarks.
2. Clinical pathway development and implementation entails formulating, disseminating, and applying revised clinical policies in targeted areas throughout the healthcare enterprise.
3. Ongoing monitoring entails measurement and continuous focus on improvement of outcomes.

**PRIORITIZING TECHNOLOGY INVESTMENTS**

The rapid evolution of information technology applications in healthcare, combined with changing business requirements implies that healthcare organizations should prioritize IT investments based upon value created and the extent to which IT can enable current and future business strategies. Presented below is a framework for evaluating and prioritizing IT investments.

**Information Technology  
Framework For Prioritizing IT Investments**

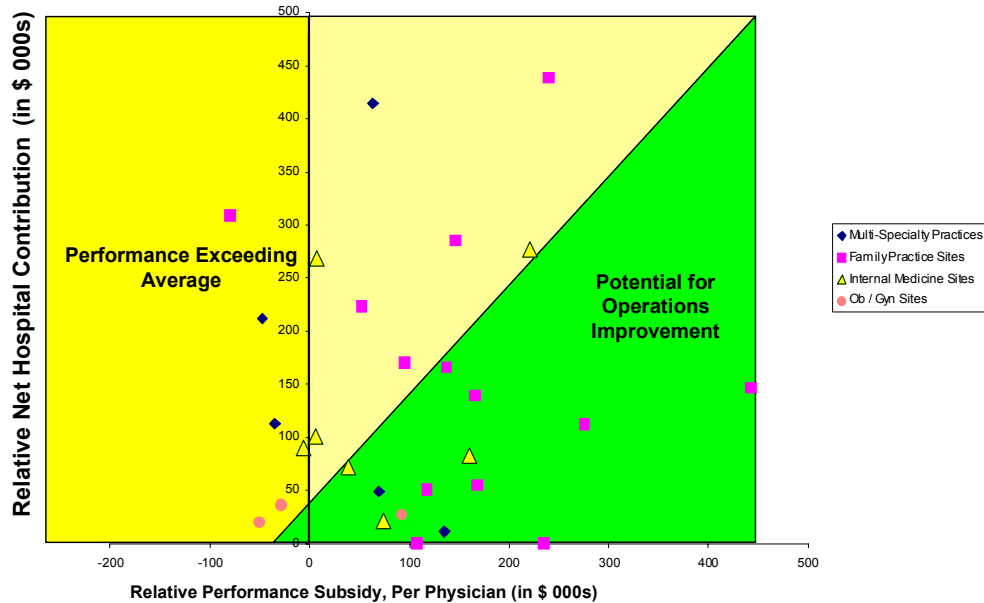


**RETHINKING PHYSICIAN INTEGRATION**

Investment in integrated delivery systems was pursued by many healthcare organizations in the 1990s. Most investments have not yielded the originally anticipated returns, and organizations must now assess the following:

1. Do the benefits of vertical integration continue to be of strategic value to the organization?
2. If yes, are maximum benefits being achieved? If no, what "fix" is required?
3. If vertical integration does not continue to be of strategic value, then how should divestiture be considered?

## Physician Integration Clinic Performance Analysis



Note: Subsidy equals net revenue less operating expenses and physician compensation per physician.

Source: BDC Advisors, LLC; Based on a Midwestern health system

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Mapping hospital contribution against performance subsidy on a per physician basis will identify those practices whose operating performance must be improved to ensure that the system is achieving an appropriate level of return from the practice. Key tactics for improving operational performance of hospital-sponsored physician practices include:

1. Eliminating unproductive practices.
2. Revising physician compensation to market-based and production-based formulae.
3. Consolidating practices and moving practices to closer proximity.
4. Minimizing additional practice acquisitions / under take only to access new patient markets.
5. Divesting of practices that provide only tertiary referrals.
6. Building additional revenue sources (e.g., participate in clinical trials).
7. Maximizing cost reduction opportunities through technology (e.g., billing, accounts receivable, and clinic staffing).

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