

# Pricing of LTSS

September 2016  
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# Possible Pricing Motivations

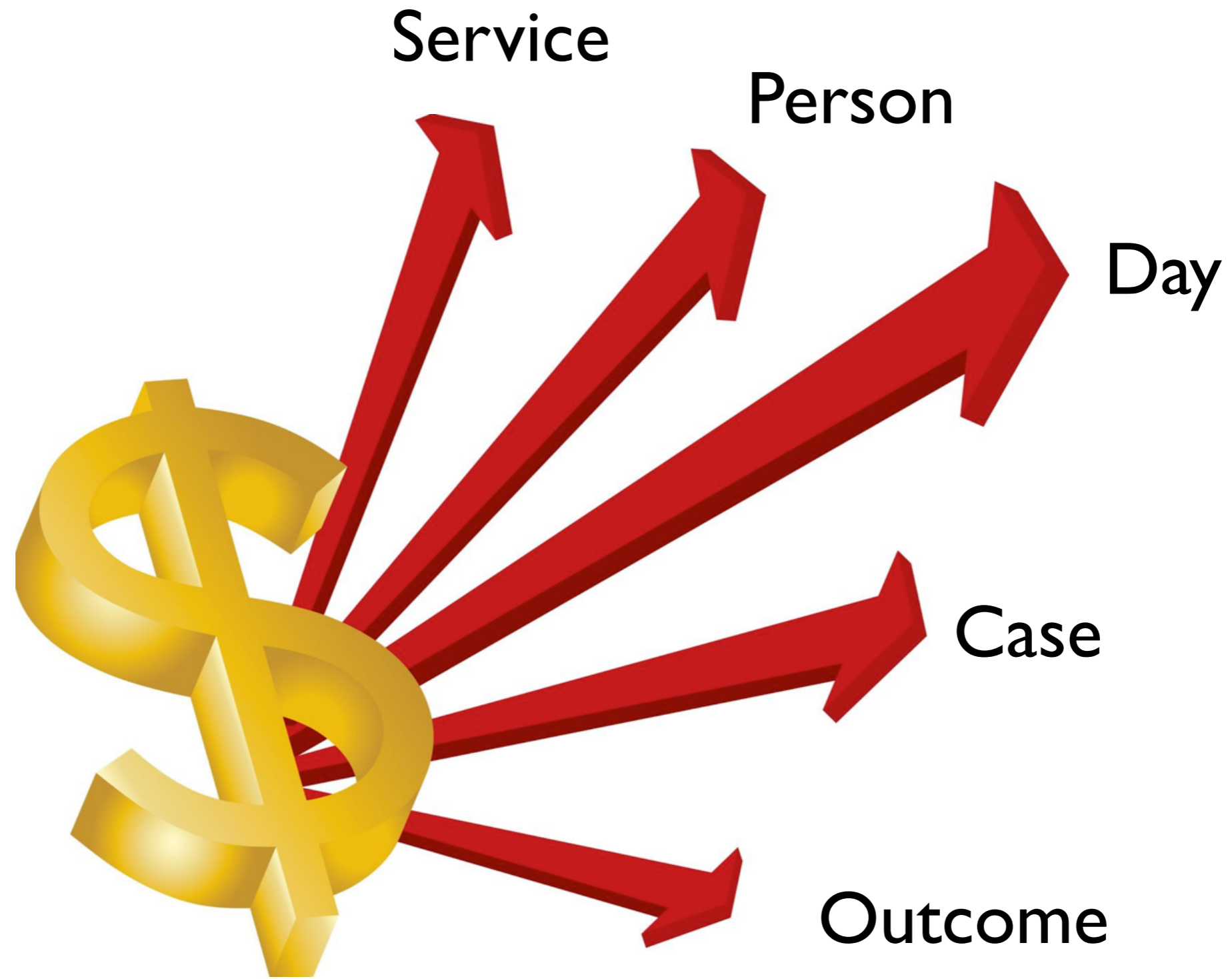
- Mission Driven
- Profit Driven
- Both: Double Bottom Line

# Price is Just One Part of the Marketing Mix

- Product: Creating Value
- Promotion: Demonstrating Value
- Place: Delivering Value
- Price: Capturing Value



# Price Per What?



# We Will Focus On Two Payment Systems

- Price for each unit of service
- Price for each person (irrespective of the number of services each receives)

*When the number of services is identical for all, the price is for a bundle of services. In that case, capitation and fee-for-service are equivalent.*

# CBO's Pricing Control Varies

Unilateral: Buyer  
Sets Price: Seller  
Must  
Take it or Leave  
it

Bilateral: Cost  
Recovery Where  
Seller Justifies  
Price to Buyer  
on the Basis of  
Costs

Bilateral:  
Negotiation

Unilateral: Seller  
Sets Price: Buyer  
Must Take it or  
Leave it

Low



High

# Questions

1. Where does your organization fall in the spectrum of control?
2. Is there an anticipated movement in one direction or another?

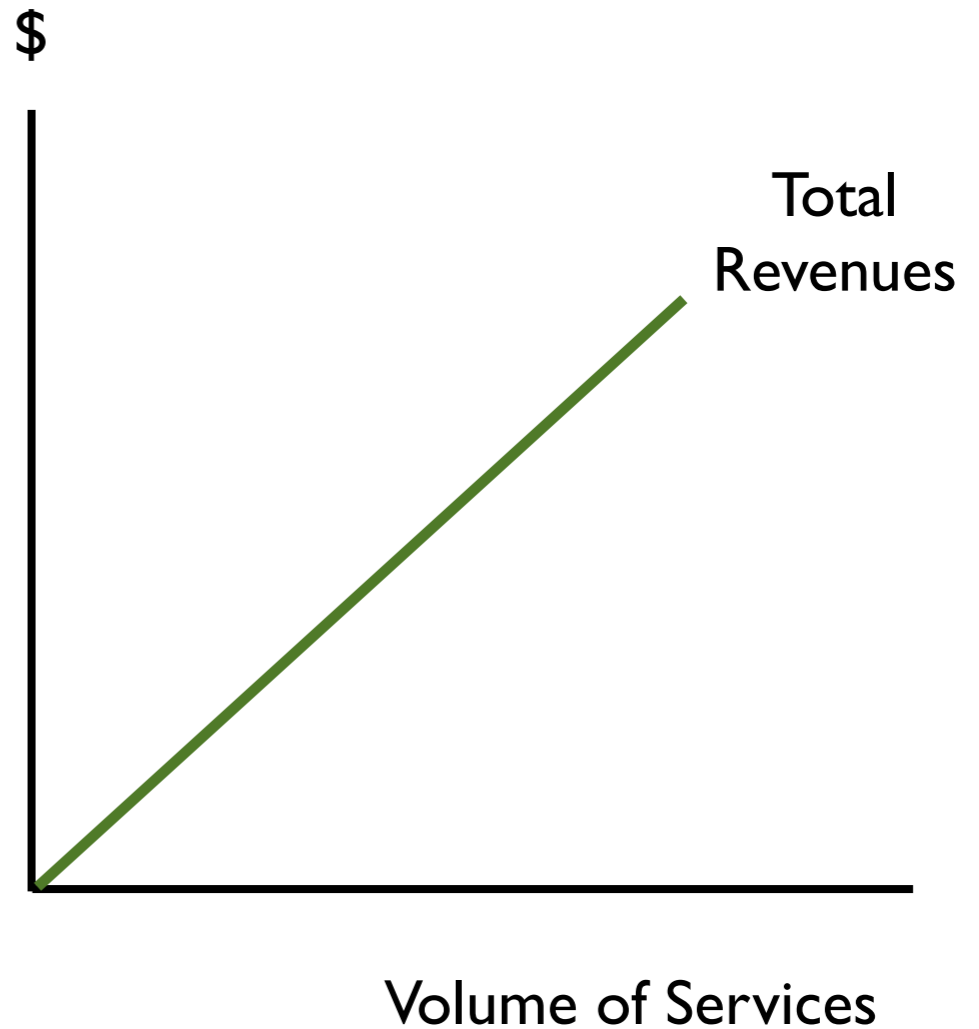
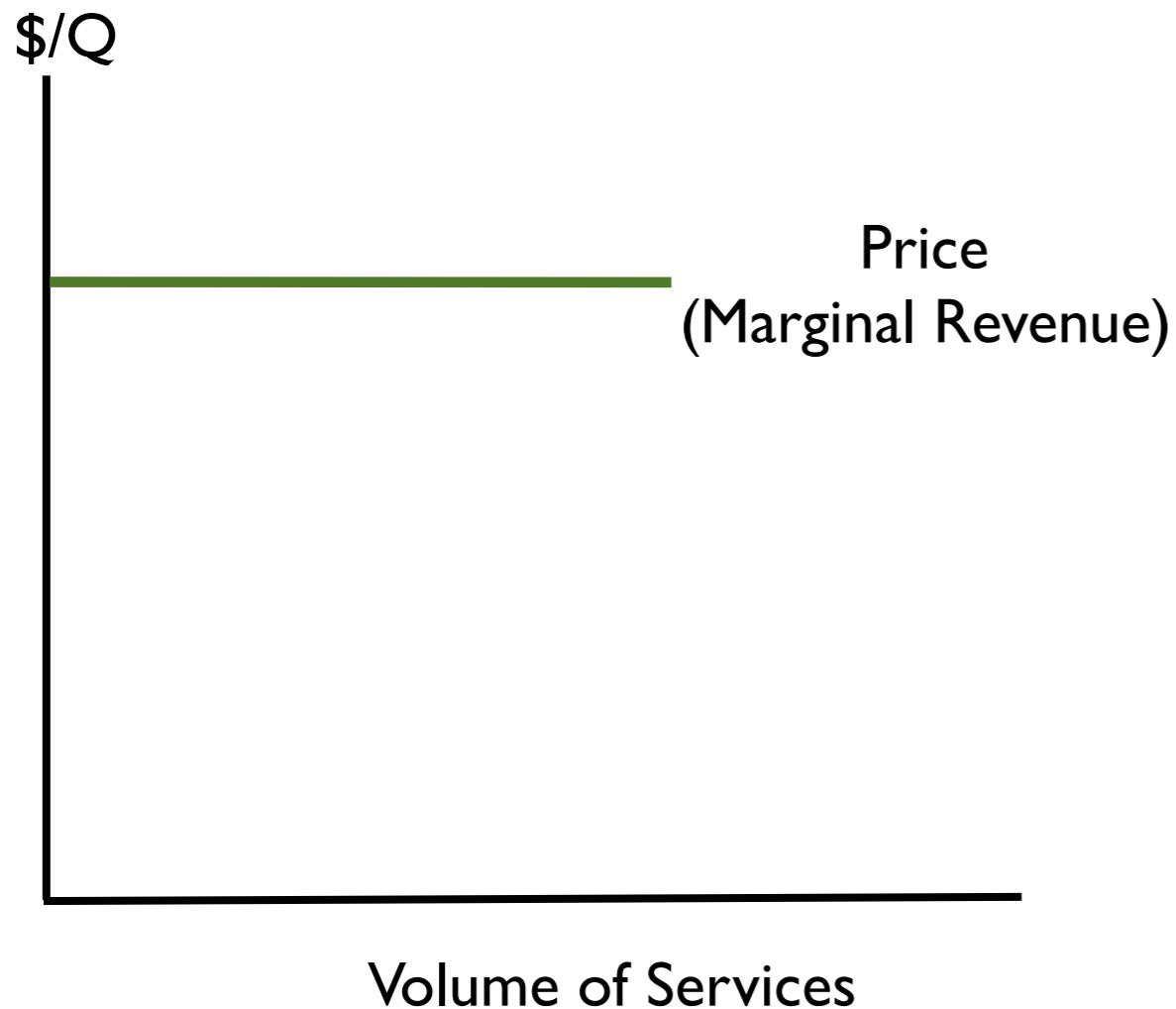
# Profits (Net Income) Equal Revenues Minus Costs

Net Income = Total Revenues - Total Costs

*We examine the revenue side first.*

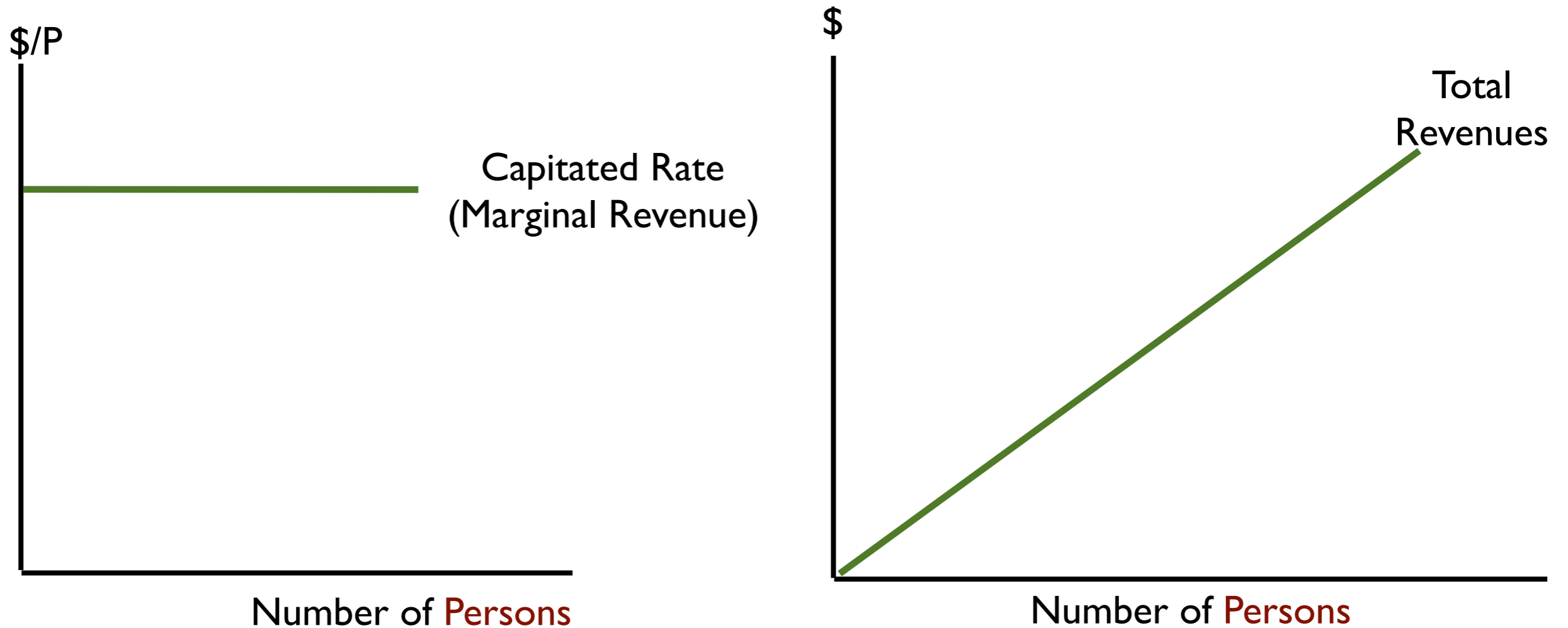
# Revenues Under Fee For Service

$$\text{Total Revenues} = \text{Price} \times \text{Quantity (Volume)}$$



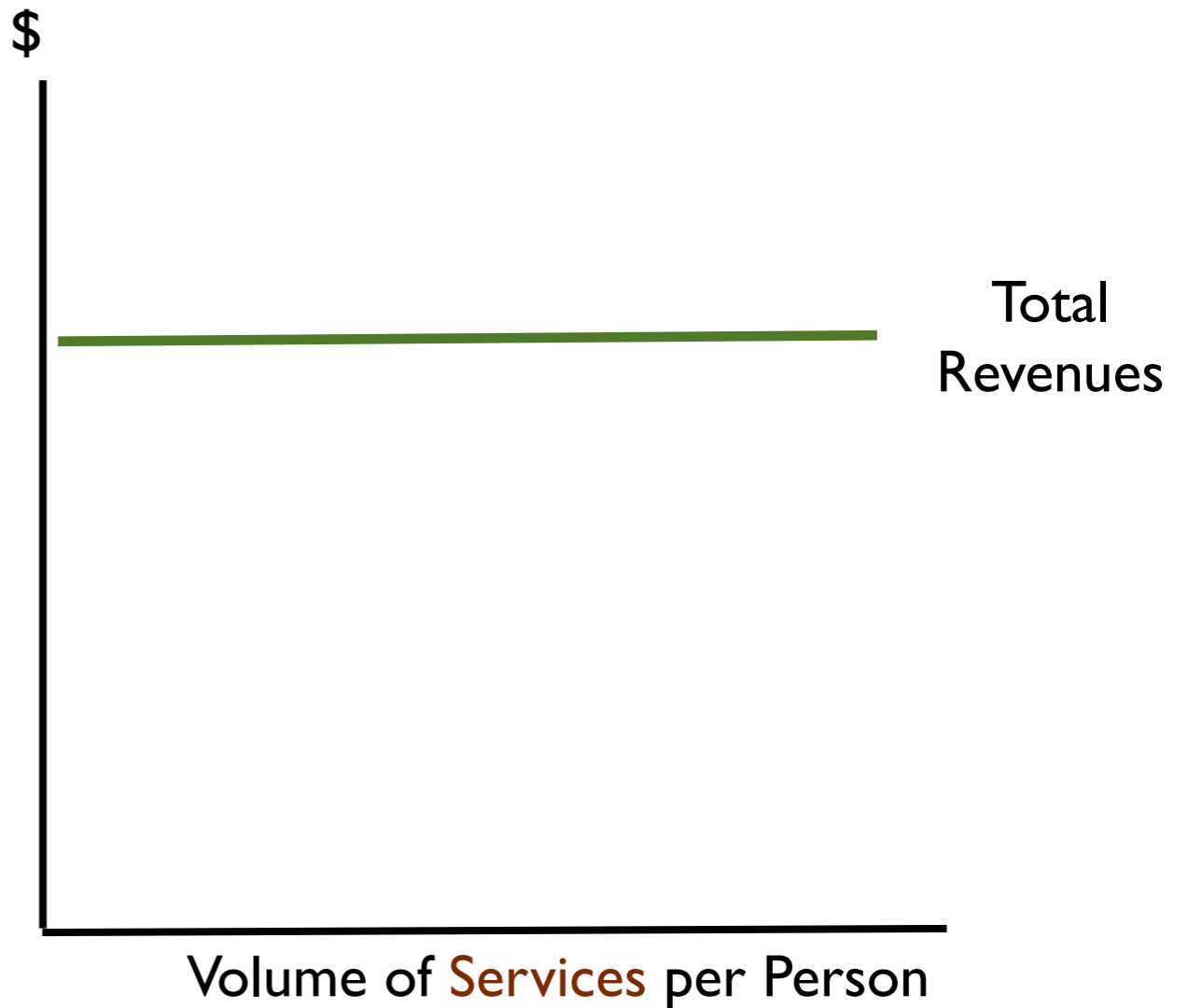
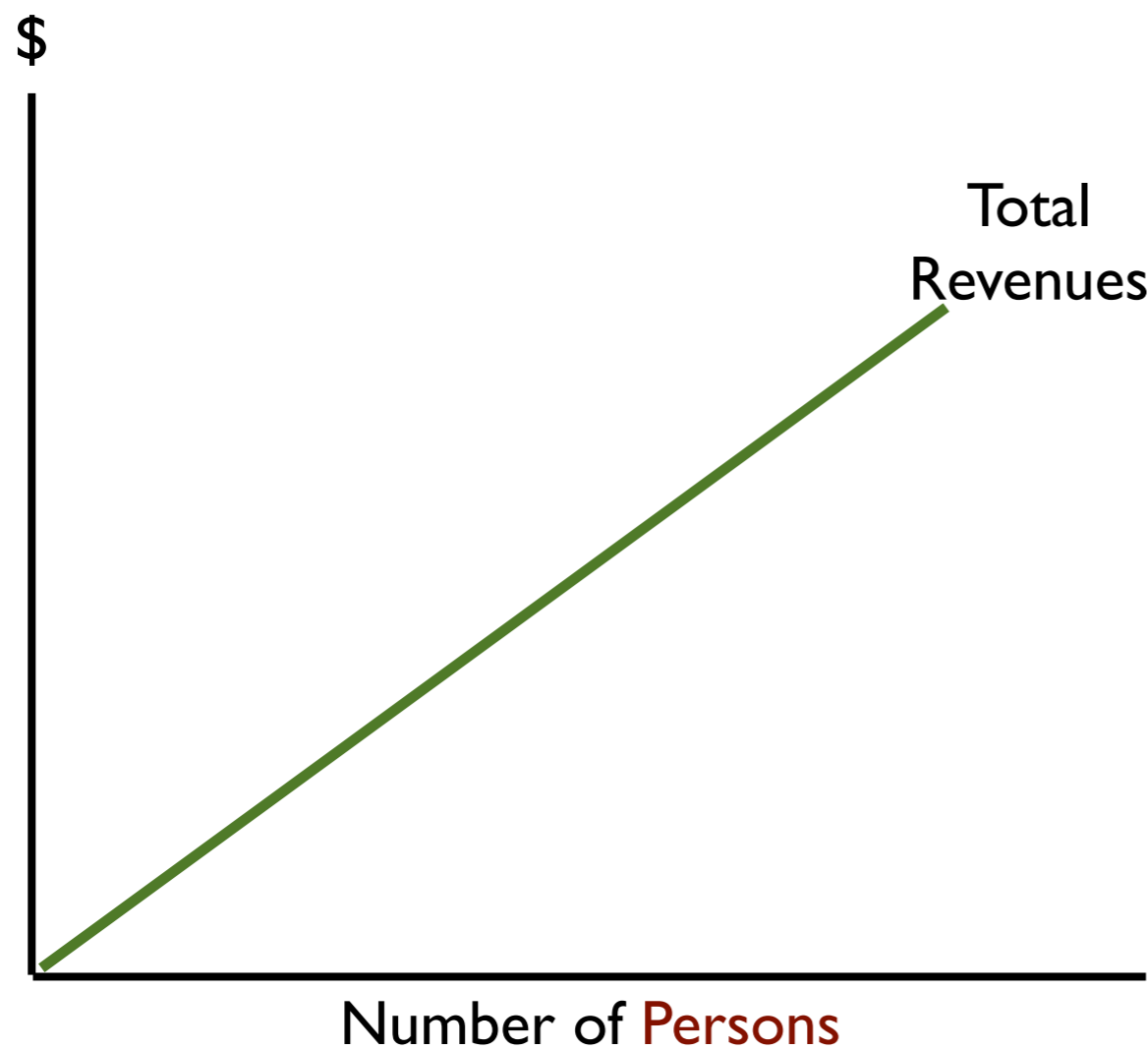
# Revenues Under Capitation

As a function of the number of persons covered

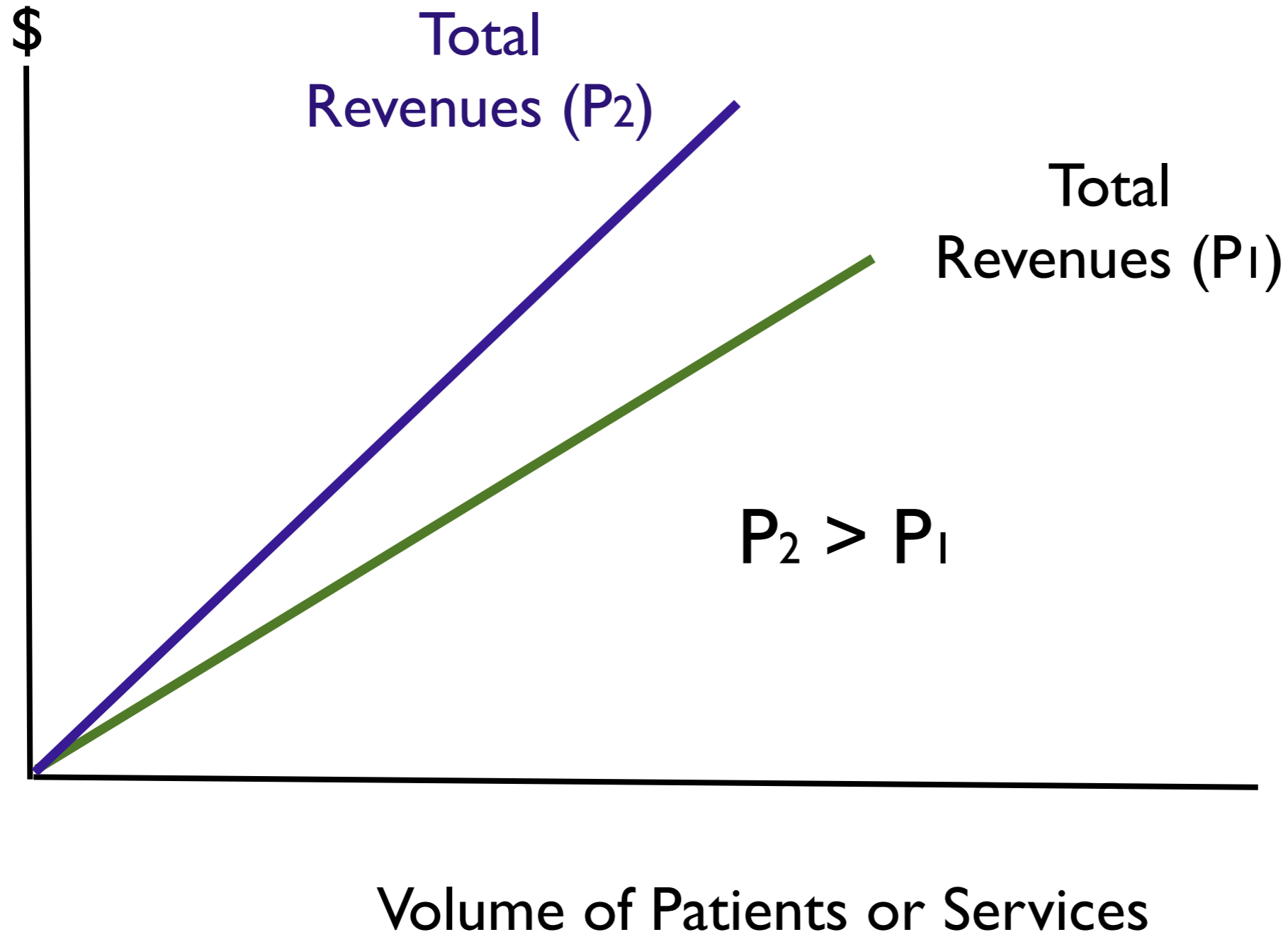


# Revenues Under Capitation

This time as a function of the volume of services per person.



# How Revenues Change When the Price Changes



# Profits Equal Revenues Minus Costs

*Now we examine the cost side.*

# There Are Three Types of Costs

- Sunk
- Fixed
- Variable

# Definition of Sunk Costs

- Sunk: A cost that has been incurred already and cannot be avoided no matter whether the CBO accepts a proposed contract or not.
- A sunk cost should not be relevant in assessing the terms of a contract.

*Examples: Building lease, CEO salary, liability insurance*

# Definition of Fixed Costs

- A fixed cost of a contract is fixed with respect to the volume of services delivered, but a necessary additional expense for accepting the contract.
- A fixed cost is a relevant cost in assessing the terms of a contract. It can be avoided if the contract is not signed.

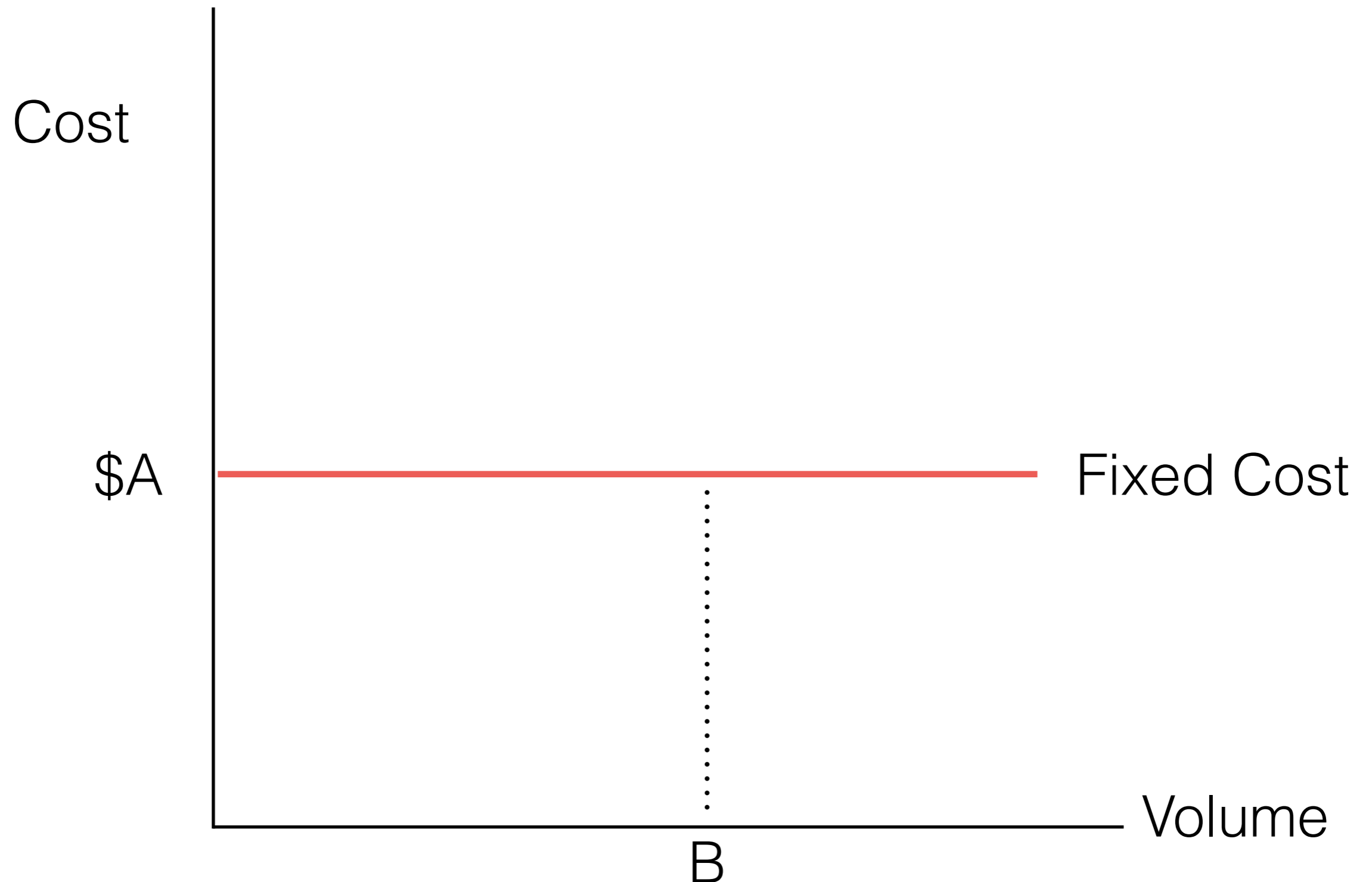
*Examples: The salary of the Contract administrator. Costs of recruiting, training and supervising the nurses.*



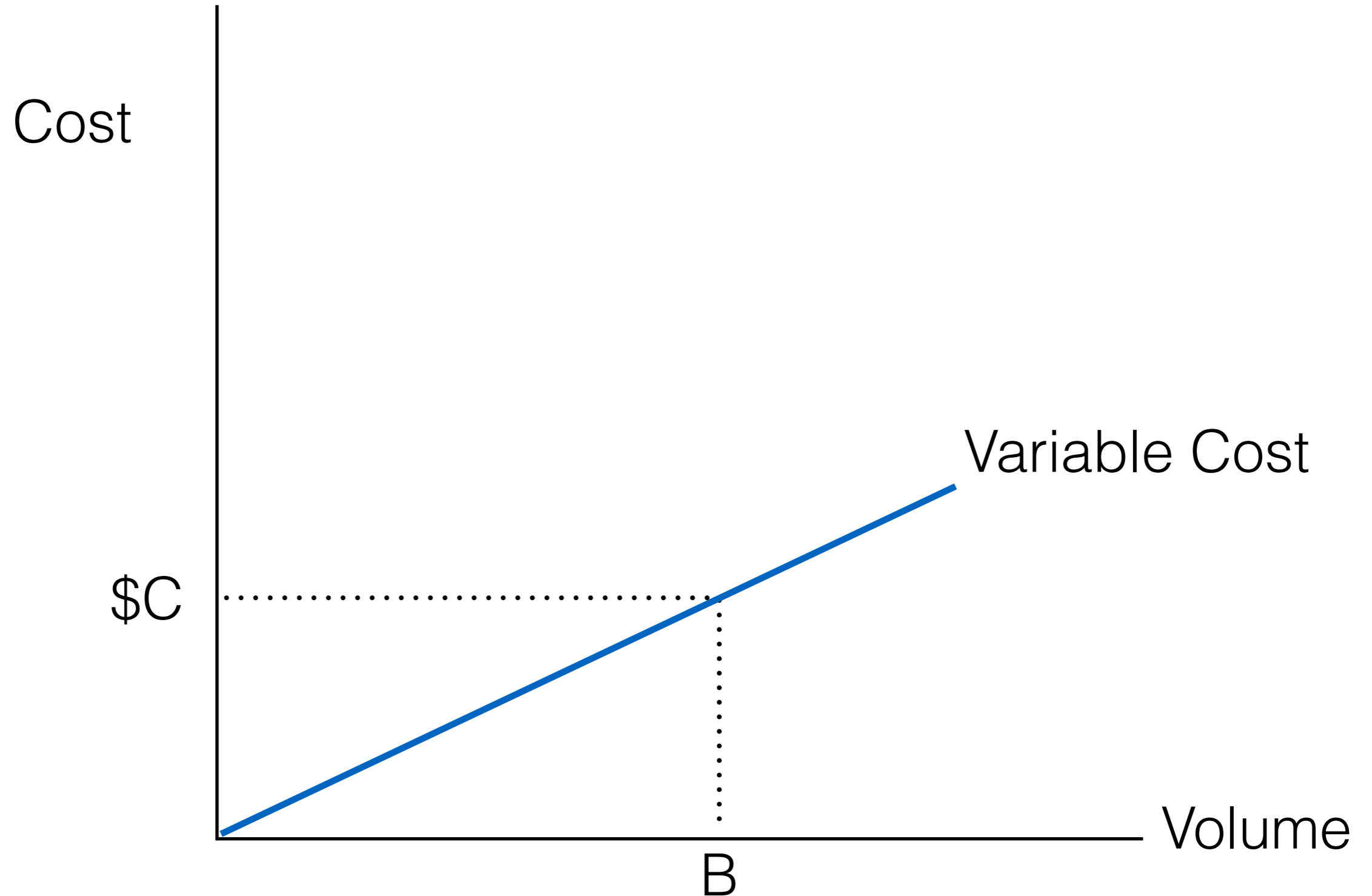
# Excel Simulation

The Folly of Considering Sunk (True Overhead) Costs

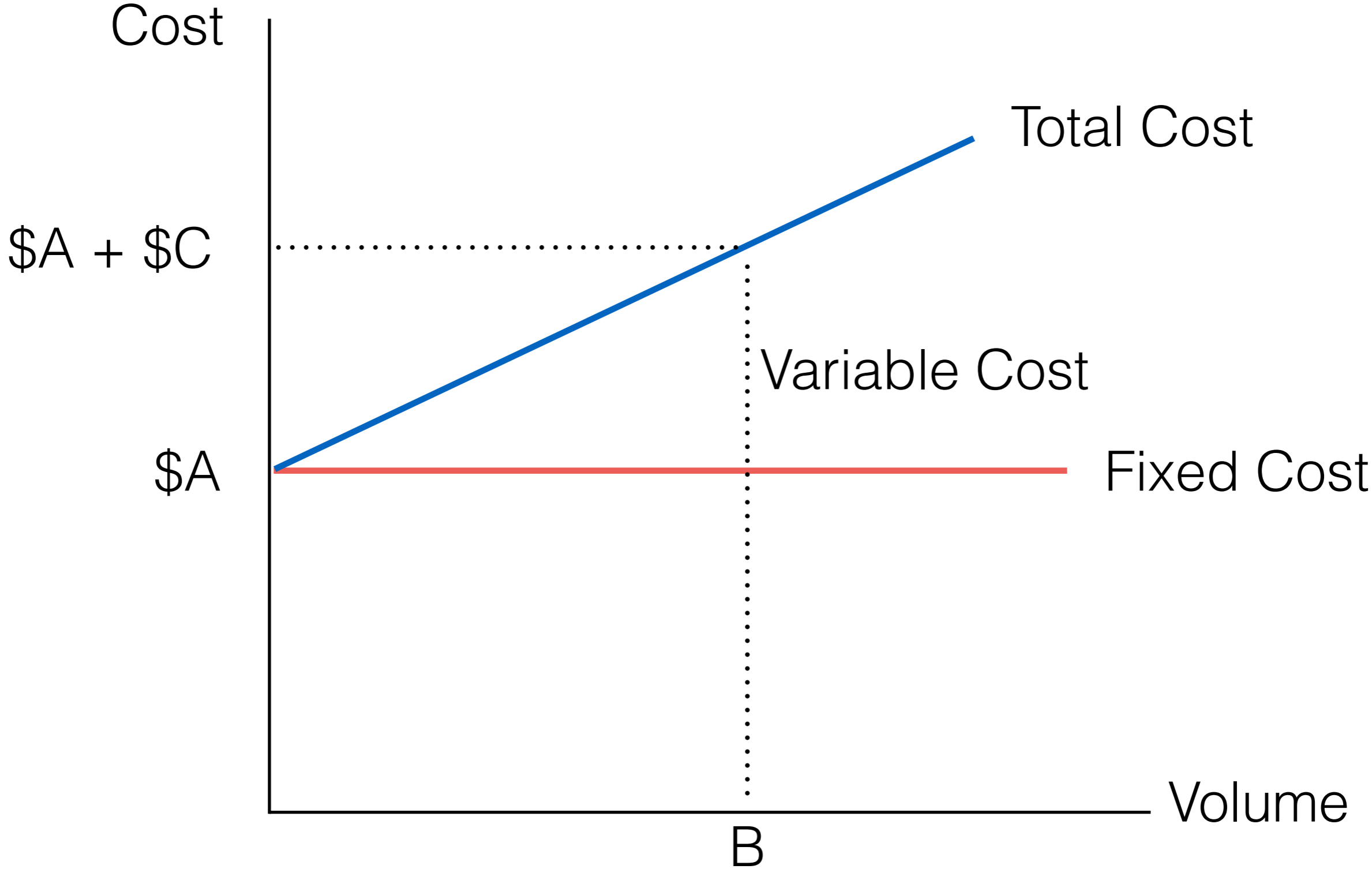
# Fixed Costs



# Variable Cost



# Total Cost



# Putting Revenues and Costs Together: Making Decisions

# Pricing Scenario One: Take it or Leave It

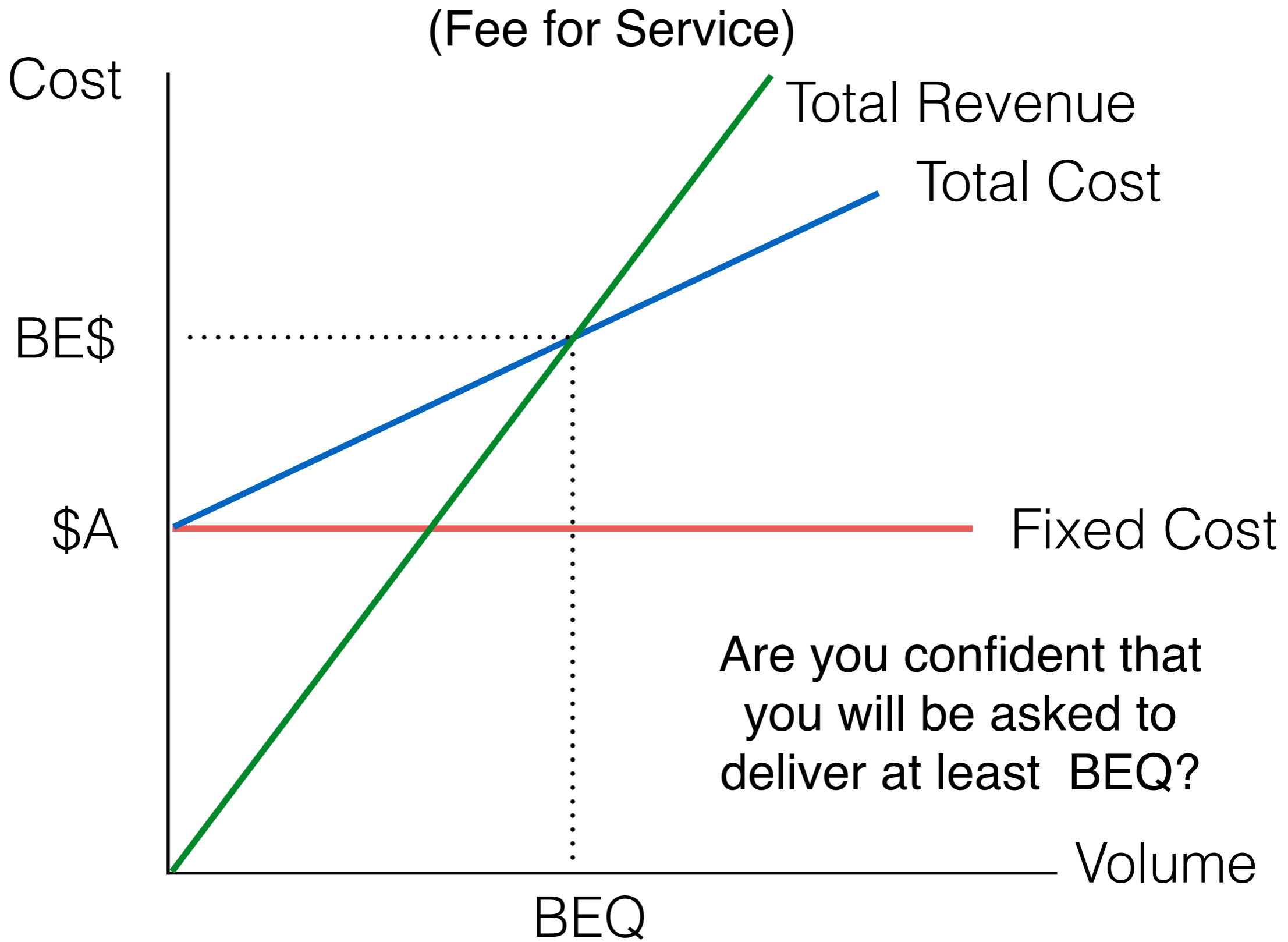
Buyer unilaterally sets  
the Price  
(Fee or Capitated rate)

Seller cannot influence it.

Should you accept it?



# Will You at Least Break-Even?



# Calculating Breakeven

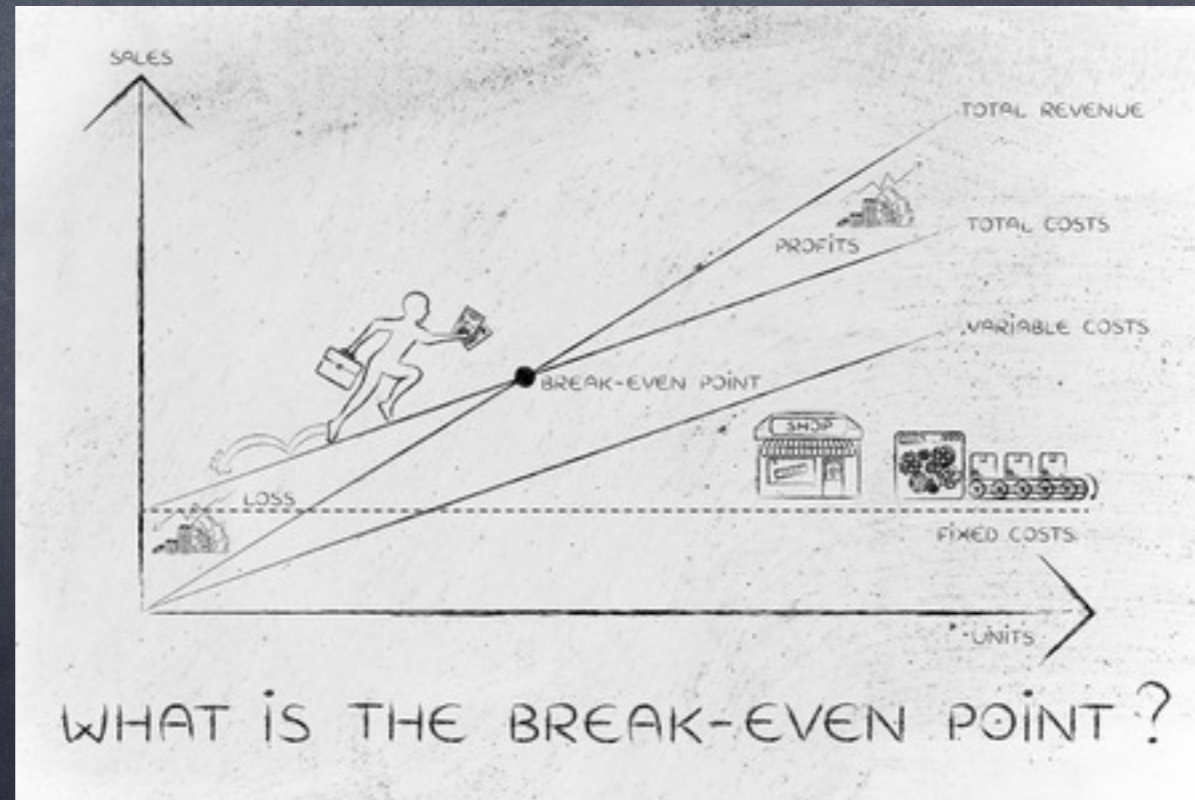
Service	Reimbursement Rate	Total Fixed Cost	Unit Variable Cost
Transitions	\$250	\$5,000	\$150

$$BEQ = \frac{FC}{P - VC} = \frac{\$5,000}{\$250 - \$150} = 50$$

You need to provide 50 transitions to breakeven.

# Lab Book Exercise: Calculating Breakeven

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# Chief Risk Under FFS

Low Volume

# How Much Risk Under FFS?

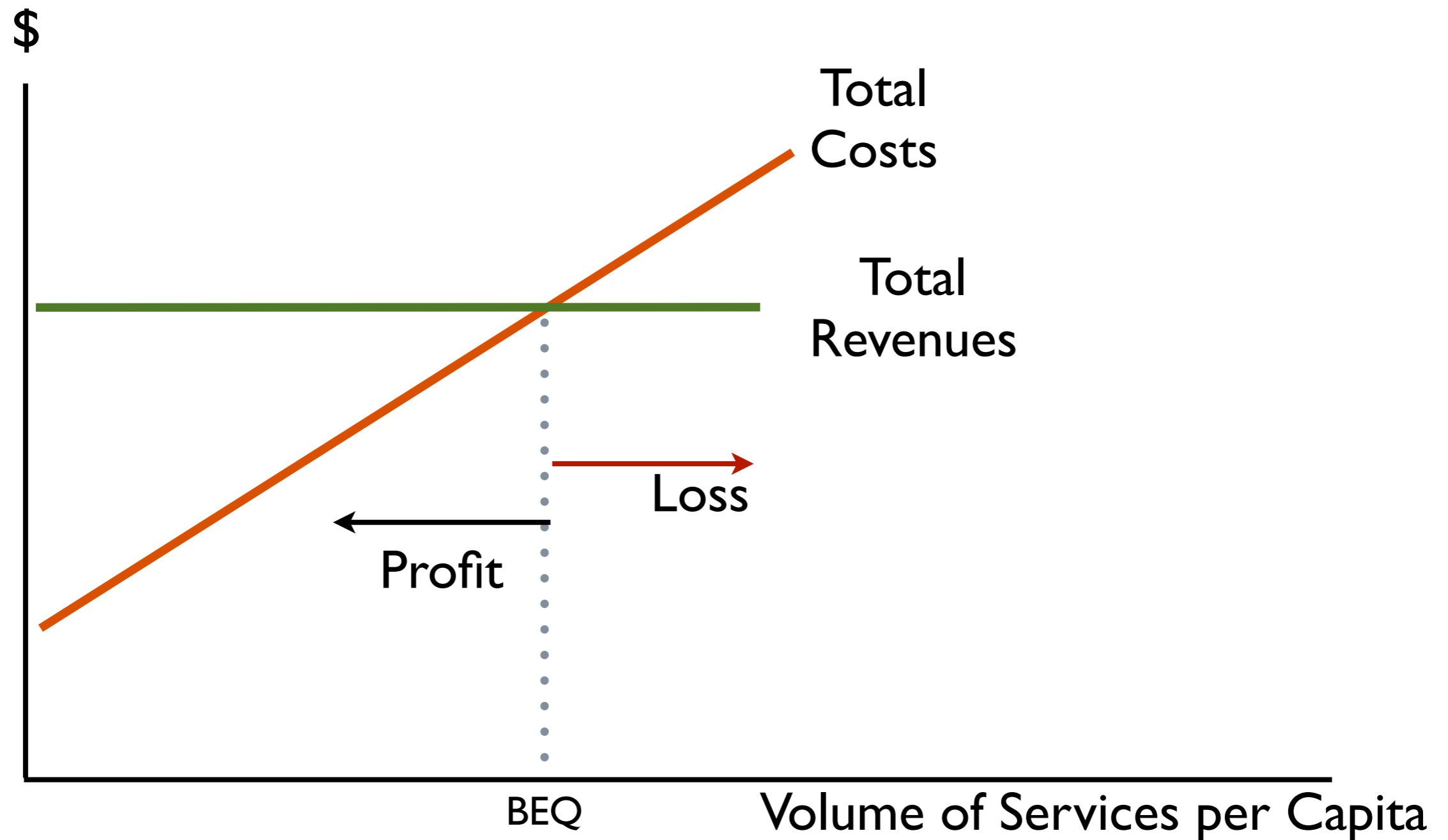
- Depends on the mix of fixed versus variable costs
- The more important are fixed costs, the higher the risk
- Capitation may make more sense when fixed costs are high

# Excel Model of Break Even

Model

# Will You Break Even?

(Capitation)



# Chief Risk Under Capitation



High Utilization

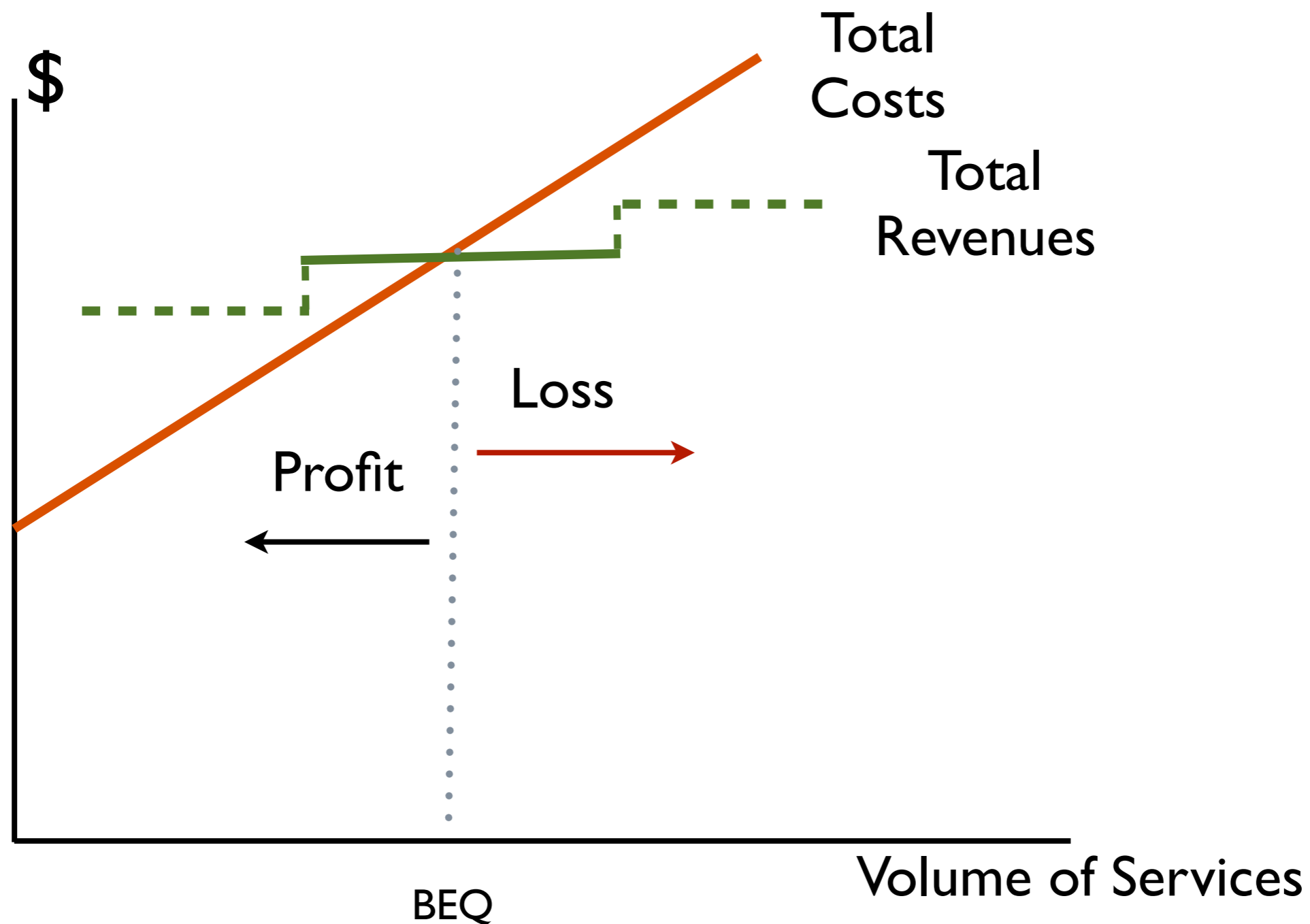
# How Much Risk?

- The higher are variable costs relative to fixed costs, the greater is the risk
- Fee for service may make more sense when variable costs are high
- Risk mitigation strategies:
  - Copayments
  - Risk sharing

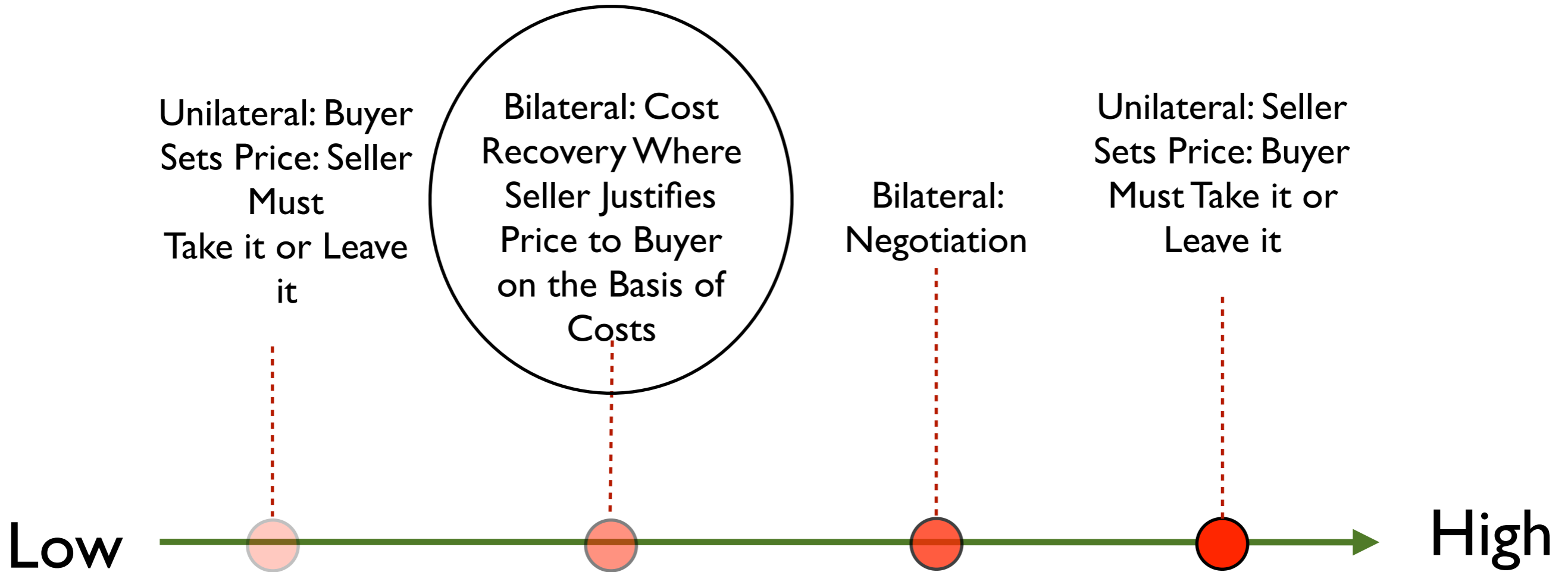
## Team Discussion

1. Do you see opportunities in the future to bear financial risk?
2. Is your organization willing to assume risk?
  2. If so, how would you manage risk?

# Risk Sharing Under Capitation: Risk Corridor



# CBO's Pricing Control Varies





# Full Cost Recovery (FCR)

- Benefits
  - FCR allows reimbursement for certain indirect costs
  - Allows more accurate cost data for internal purposes
  - Direct costs plus 30% - no longer acceptable, but you need be sustainable
- Method
  - Convert as many indirect to direct costs as possible by linking indirect costs to project activities that cause them.
  - Allocate these costs to the project in accordance with their importance in the project
  - Limit: Cannot allocate the CEO. That is what the (lower) overhead rate is for

# Example: Allocation Bases

<b>Costs to Allocate</b>	<b>Allocation Basis</b>
Billing Office	Number of bills
Laboratory	Weighted average cost of tests
Medical records	Number of records pulled
Purchasing	Number of purchasing orders
HR Department	Number of employees
IT Support	Number of Computers

# Example

- Medical Records expense is \$30,000 annually
- During the year, 1,500 charts pulled
- Cost per chart is \$20.00
- This project requires 300 charts to be pulled
- Allocate \$6,000 to this project

# Lab Book Exercise: Full Cost Recovery

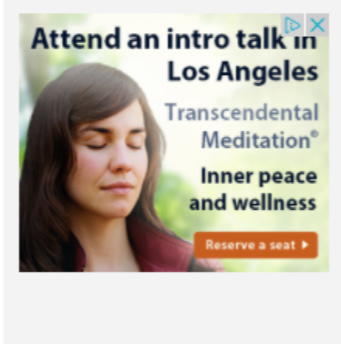
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# Free Software


software.informer Like Search

## Full Cost Recovery Softwar... Free


Home > Developer Tools > Webmaster Tools




Attend an intro talk in Los Angeles  
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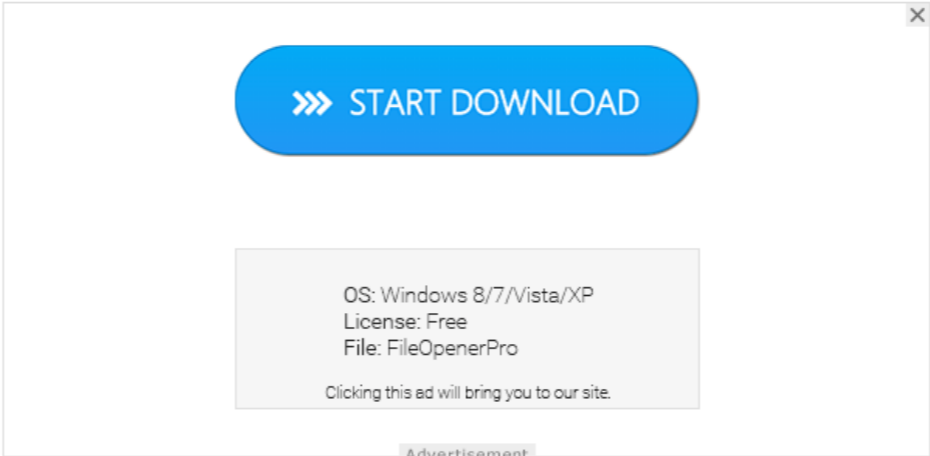
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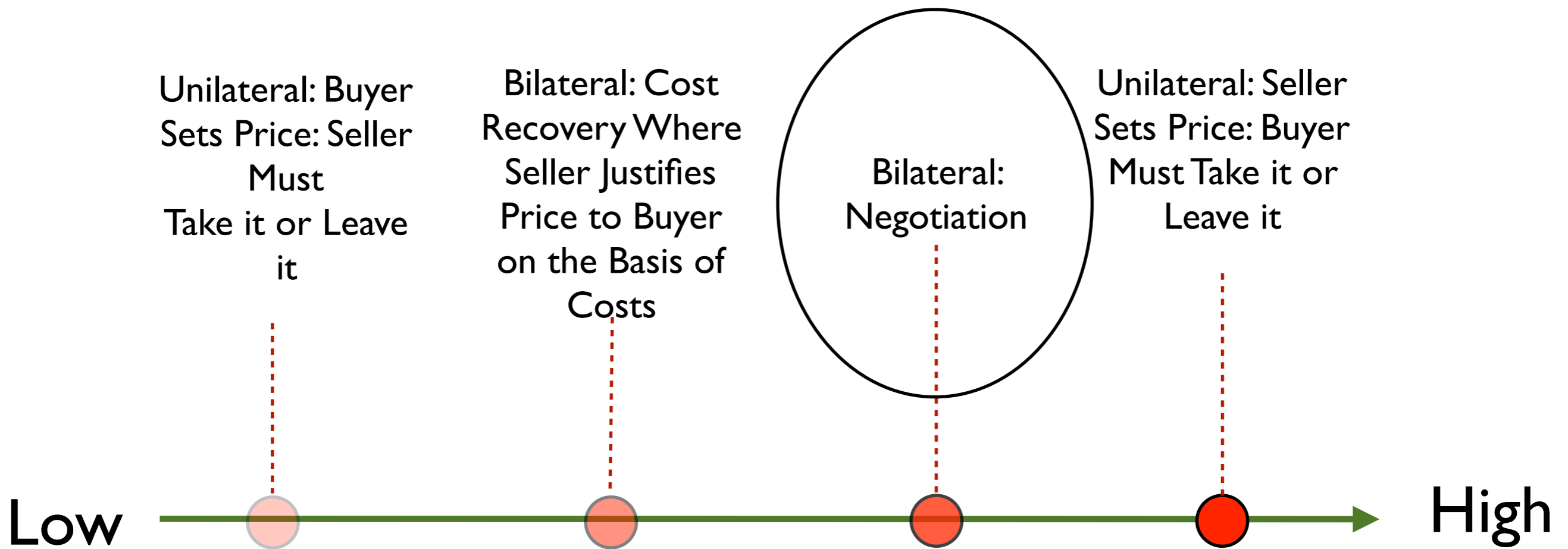
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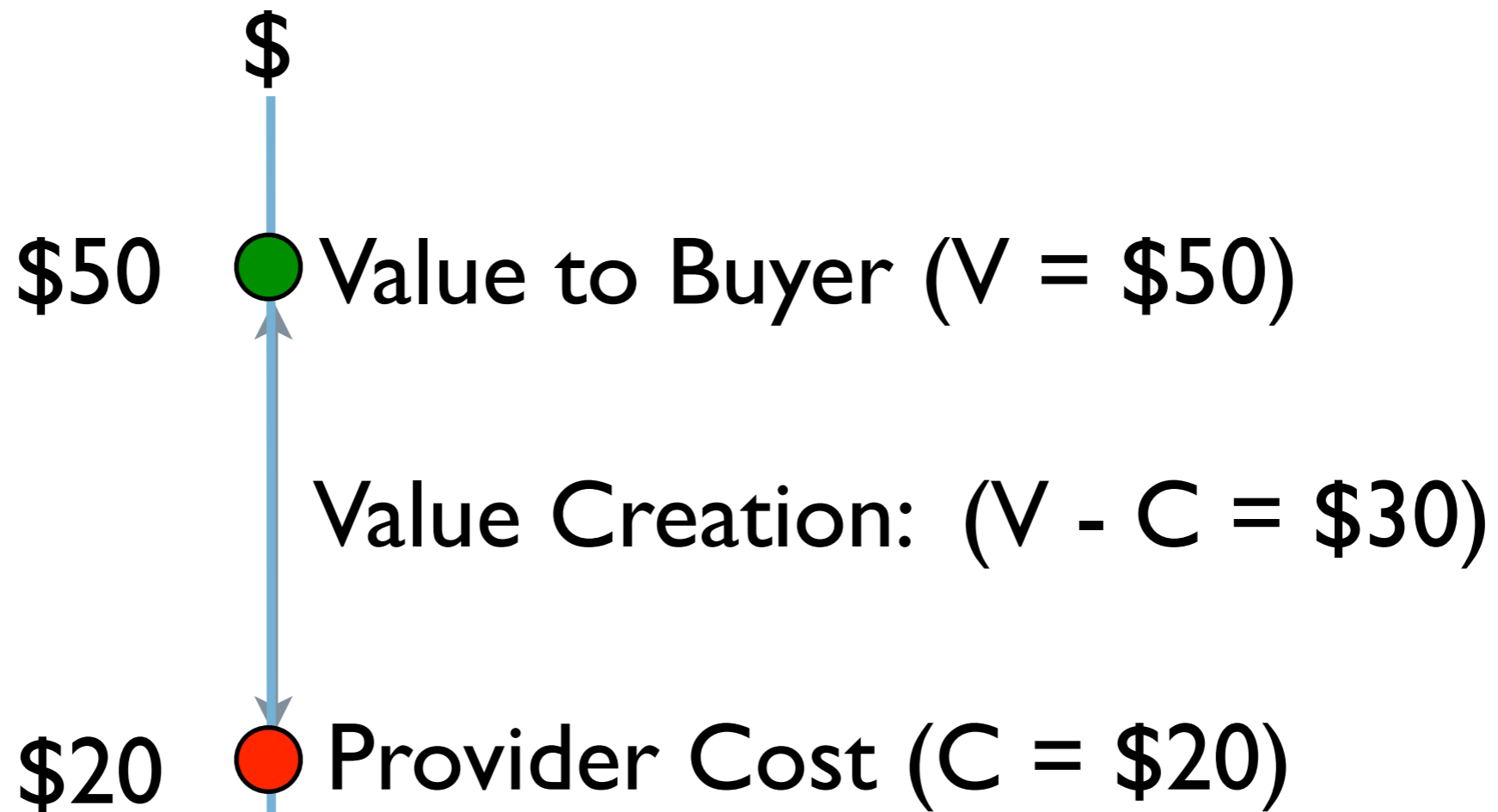
## **Team Discussion**

Do you see opportunities for your organization to change the accounting and proposal system to FCR?

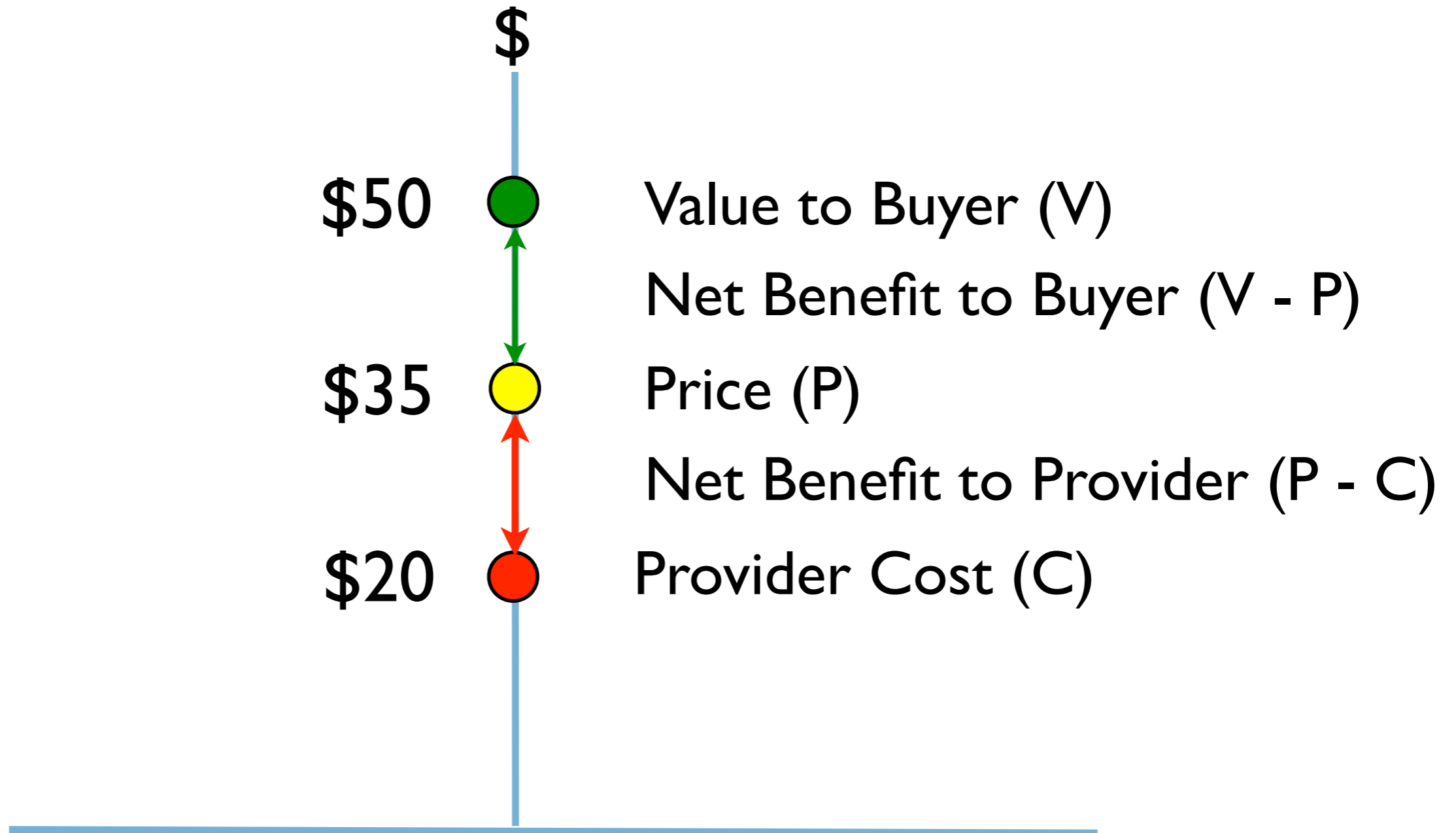
# CBO's Pricing Control Varies



# Price Must Be Within These Limits

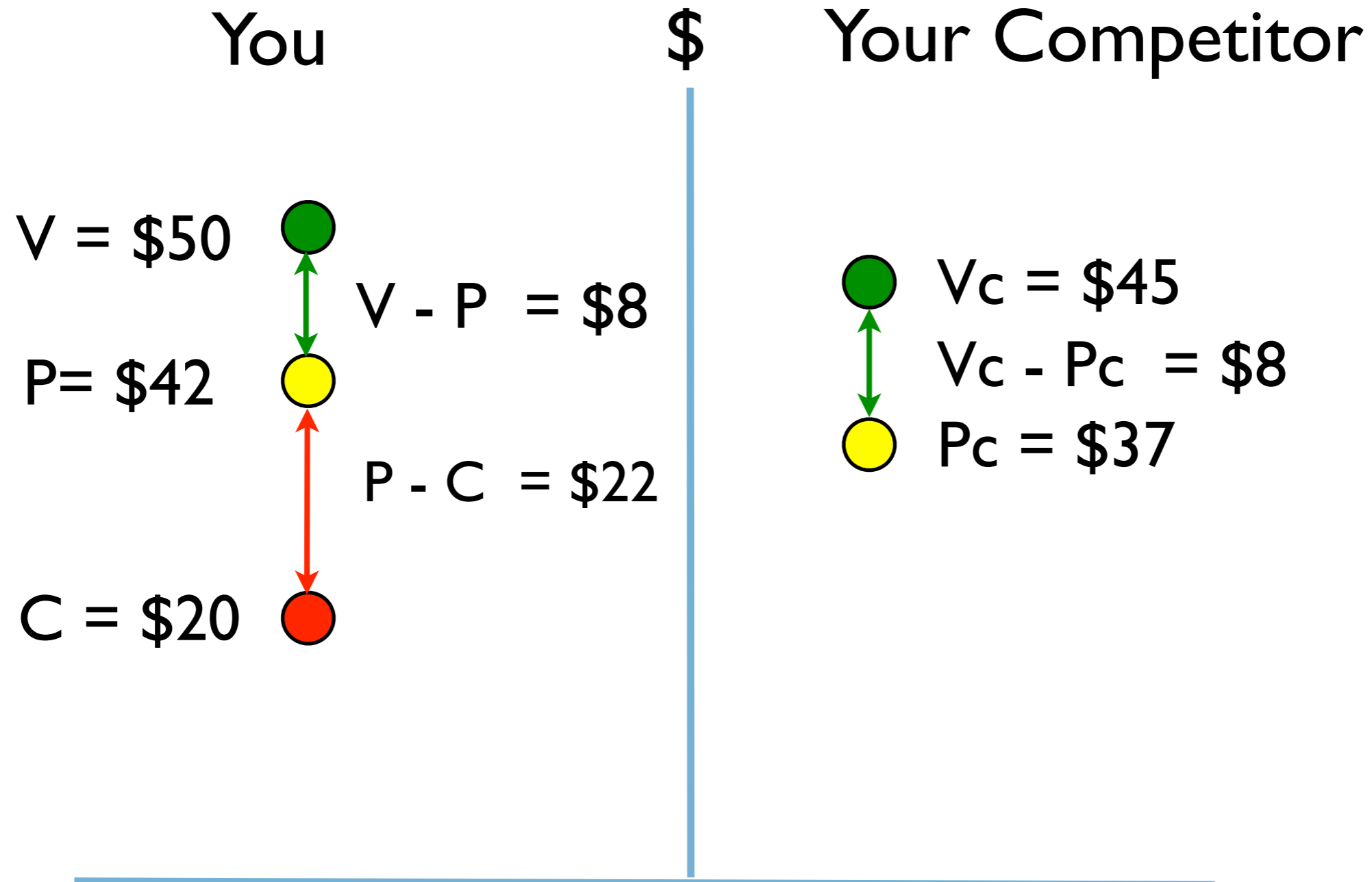


# Price Must Be Mutually Beneficial: Value Created Must be Shared



*Without competition, Price could be set as high as \$50*

# Your Value Proposition Must be Competitive



With service differentiation, a premium price of no more than \$42 can be charged,

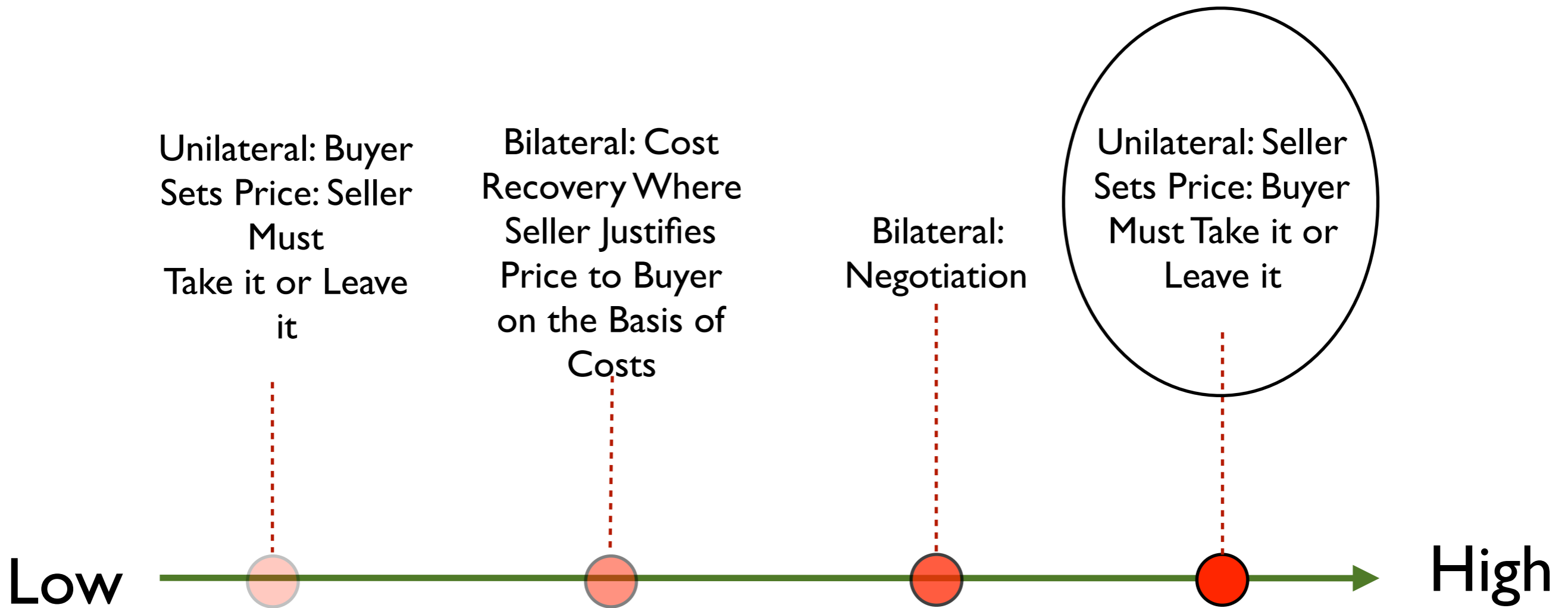
# Implications: You Can Charge More When ...

- You raise the value of your service
- The value of your competitor's services is lower than yours (as long as their price is no lower than yours)
- The competition charges a higher price than yours (as long as their value is no higher than yours)

# Lab Book Exercise: Value Proposition

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# CBO's Pricing Control Varies



# Freedom To Price

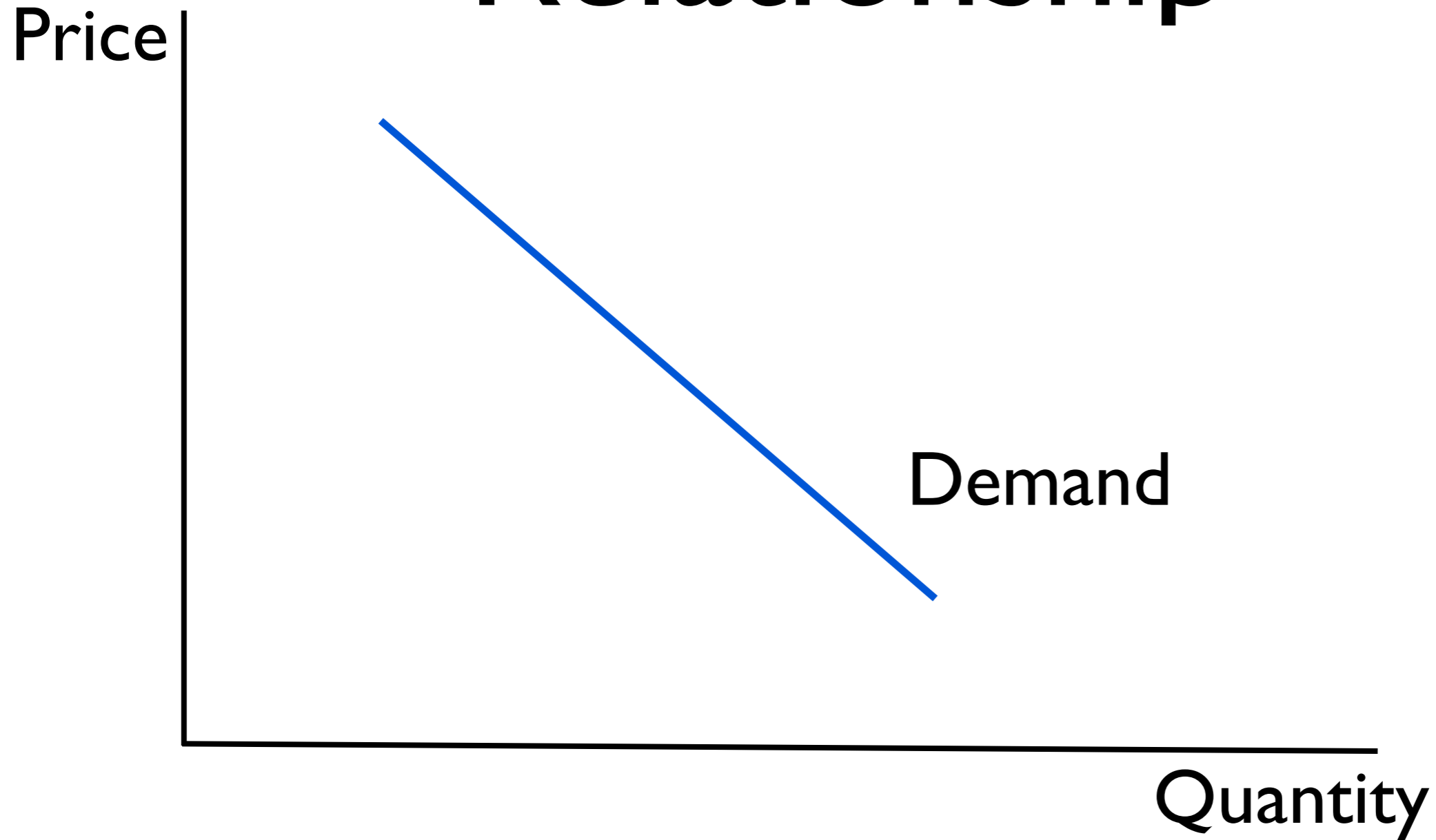
(You can set your price  
at whatever level the  
market will bear.)



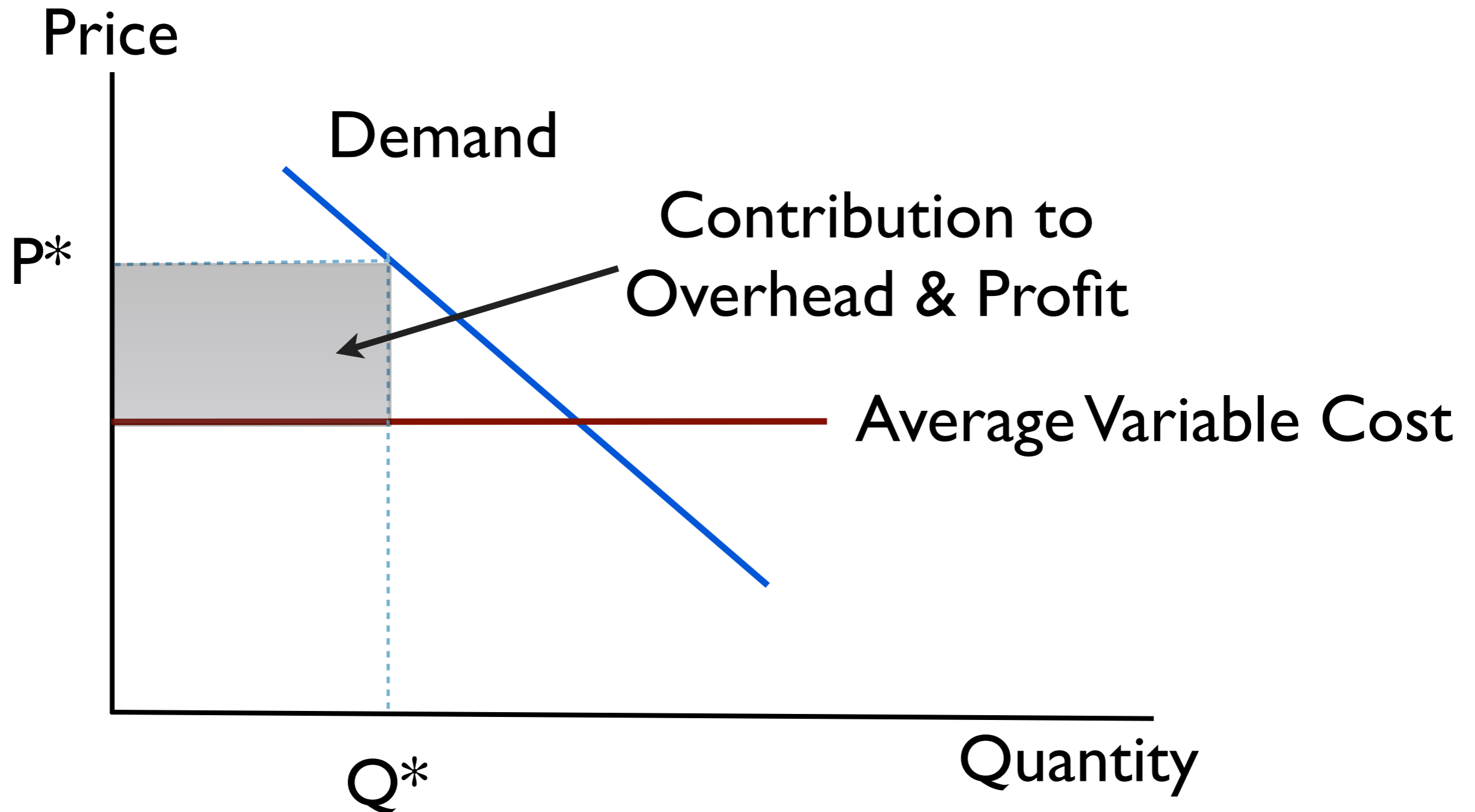
# Do Not Use Cost+ Pricing (Unless Forced)

- Costs depend on Volume but Volume depends on Price!
- The Death Spiral
- Consider Demand (Value)

# The Price Volume Relationship



# Optimal Price is Where Contribution to Profit is Maximized



# Advanced Pricing Considerations

- Price discrimination
- Loss leadership pricing
- Limited entry pricing
- Exploiting the learning curve
- Price-based costing



# Price Discrimination

*Different prices for different customers*



If



more price sensitive than



charge



higher price than



- Necessary conditions
  - Must know the prices the segments are willing to pay
  - Must separate the segments
- Consider “versioning” as a strategy

# Loss Leadership

*Losing money on one service in order to make more on another*

- Applicable when provider offers an array of services and when they are complementary.
- It may be profitable to drop the price on one service and lose money if it drives a sufficiently larger volume of related services.

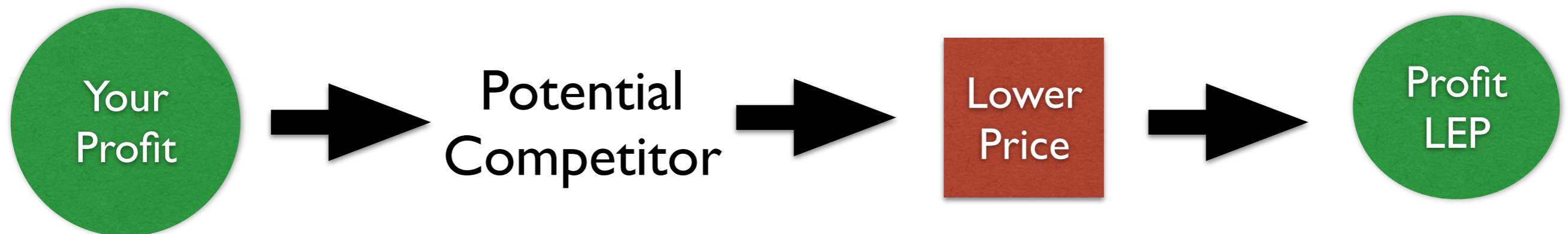
Lower Price of Service X



Higher Demand for Service Y

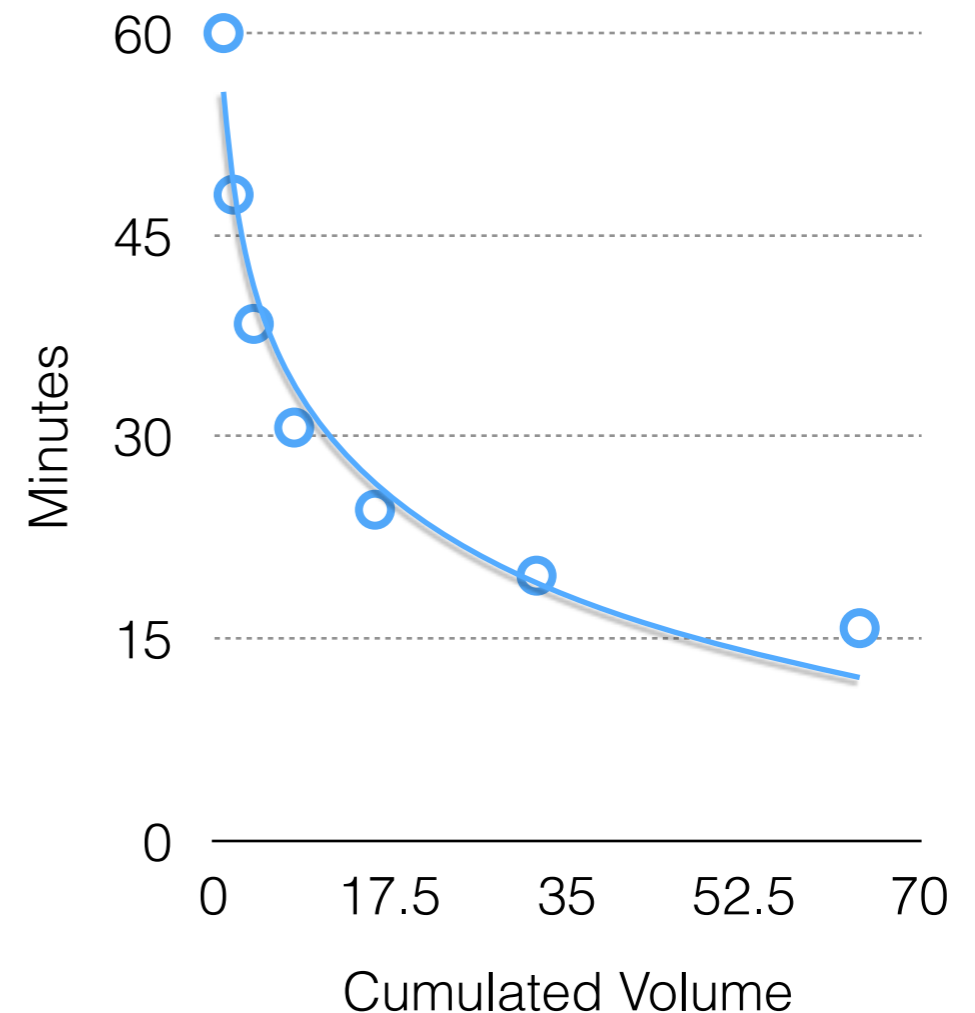
# Limit Entry Pricing

- When you dominate a market
- Are concerned about new entrants
- Set a (lower) price that makes that entry unattractive
- Short term loss may be smaller than the long term gain



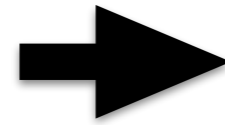
# Exploit the Learning Curve

- Proficiency increases with experience
- It takes less time to accomplish tasks
- Experience is related to cumulated volume
- Doubling volume reduces per unit cost by 20% on average
- The learning effect for a new service can be dramatic
- When you price - set it lower in order to drive volume and lower future costs



# Price-Based Costing

Price



Cost



# Value Analysis Can Be Used to Contain Costs Appropriately



*Result: Lower costs and possibly better outcomes and greater value.*

# Value Analysis Step 1: List the Components That Produce Outcomes

<b>Transportation</b>	<b>Medication Management</b>	<b>Nutrition</b>	<b>Caregiver Education</b>	<b>Other</b>
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# Value Analysis Step 2: Identify Outcomes & Rank Relative Importance

Service Outcomes	Weight
Lower 30-Day Hospital Readmissions	45%
Fewer ED Visits	35%
Senior Independence	10%
Caregiver Satisfaction	5%
Other Outcomes	<u>5%</u>
Total	100%

# Value Analysis Step 3: Assess the Degree Each Component Contributes To Outcomes

<b>Service Outcomes</b>	<b>Service Components</b>				
	<b>Transport</b>	<b>Medication Management</b>	<b>Nutrition</b>	<b>Caregiver Education</b>	<b>Other</b>
Lower 30-Day Hospital Readmissions	3	5	2	2	2
Fewer ED Visits	3	5	2	2	1
Senior Independence	2	3	4	3	2
Caregiver Satisfaction	1	3	4	5	2
Other Outcomes	2	1	3	1	2

# Value Analysis Step 4: Score Each Component

		Transport		Medication Management		Nutrition		Caregiver Education		Other	
Service	Weight	Imp	Score	Imp	Score	Imp	Score	Imp	Score	Imp	Score
Lower Readmissions	45%	3	1.35	5	2.25	2	0.9	2	0.9	2	0.9
Fewer ED Visits	35%	3	1.05	5	1.75	2	0.7	2	0.7	1	0.35
Senior Independence	10%	2	0.2	3	0.3	4	0.4	3	0.3	2	0.2
Caregiver Satisfaction	5%	1	0.05	3	0.15	4	0.2	5	0.25	2	0.1
Other Outcomes	5%	2	0.1	1	0.05	3	0.15	1	0.05	2	0.1
		<b>2.8</b>		<b>4.5</b>		<b>2.4</b>		<b>2.2</b>		<b>1.7</b>	

*To calculate the Component Score, multiply the Importance of the Component in producing the Outcome times the Weight of that Outcome.*

# Value Analysis Step 5: Convert Scores to Relative Contributions to

		Transport		Medication Management		Nutrition		Caregiver Education		Other	
Service	Weight	Imp	Score	Imp	Score	Imp	Score	Imp	Score	Imp	Score
Lower Readmissions	45%	3	1.35	5	2.25	2	0.9	2	0.9	2	0.9
Fewer ED Visits	35%	3	1.05	5	1.75	2	0.7	2	0.7	1	0.35
Senior Independence	10%	2	0.2	3	0.3	4	0.4	3	0.3	2	0.2
Caregiver Satisfaction	5%	1	0.05	3	0.15	4	0.2	5	0.25	2	0.1
Other Outcomes	5%	2	0.1	1	0.05	3	0.15	1	0.05	2	0.1
<b>Contribution to Value</b>		<b>21%</b>	2.8	<b>33%</b>	4.5	<b>18%</b>	2.4	<b>16%</b>	2.2	<b>12%</b>	1.7

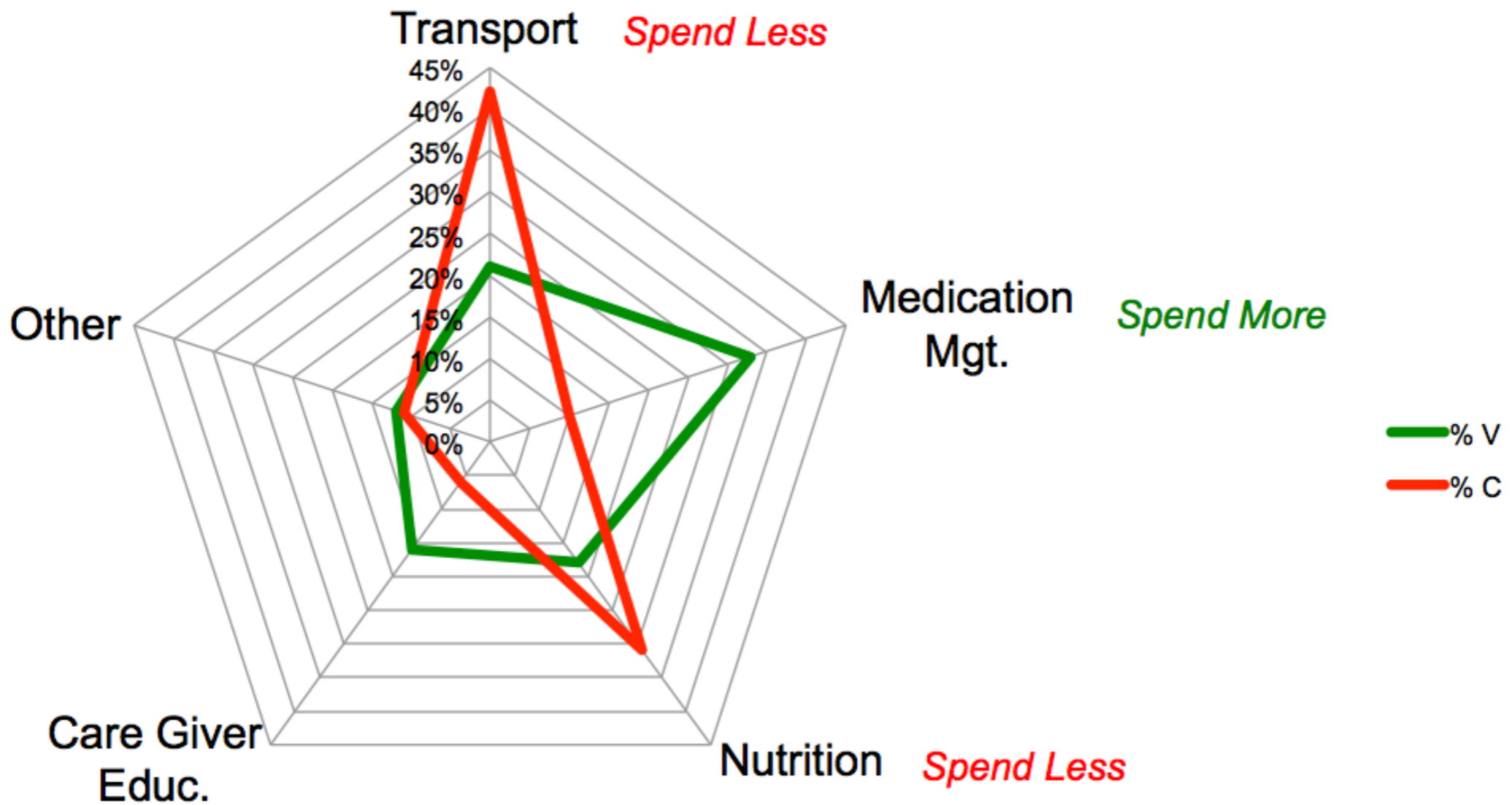
# Value Analysis Step 6: Calculate Costs for Each Component

		Transport		Medication Management		Nutrition		Caregiver Education		Other	
Service	Weight	Imp	Score	Imp	Score	Imp	Score	Imp	Score	Imp	Score
Lower Readmissions	45%	3	1.35	5	2.25	2	0.9	2	0.9	2	0.9
Fewer ED Visits	35%	3	1.05	5	1.75	2	0.7	2	0.7	1	0.35
Senior Independence	10%	2	0.2	3	0.3	4	0.4	3	0.3	2	0.2
Caregiver Satisfaction	5%	1	0.05	3	0.15	4	0.2	5	0.25	2	0.1
Other Outcomes	5%	2	0.1	1	0.05	3	0.15	1	0.05	2	0.1
Contribution to Value		<b>21%</b>	2.8	<b>33%</b>	4.5	<b>18%</b>	2.4	<b>16%</b>	2.2	<b>12%</b>	1.7
Contribution to Cost		<b>42%</b>	\$30	<b>10%</b>	\$7	<b>31%</b>	\$22	<b>6%</b>	\$4	<b>11%</b>	\$8

# Value Analysis Final Step: Create the Value Index

	Transport	Medication Management	Nutrition	Caregiver Education	Other
Contribution to Value (%)	21%	33%	18%	16%	12%
Contribution to Cost (%)	42%	10%	31%	6%	11%
Value Index	0.5	3.4	0.6	2.9	1.1

# Graphing the Index



# Implications from the Value Index

- Targets for cost containment - when the Value Index is significantly less than 1.0
- Consider spending more on those activities that have a Value Index significantly more than 1.0
- Results can be lower overall costs and higher service value