Strategic Outlook for 2009—It's Not Just the Economy

Nathan Kaufman

Today hospitals and physicians are blaming the current economic downturn for their deteriorating operating performance. While the recent economic downturn accelerated the rate of deterioration, the negative forces impacting health care have been in place since the early part of the decade. Those who act as though this is a temporary phenomenon and do not permanently reposition their organization will have difficulty recovering. The following are the structural issues that must be addressed now.

Medicare Reimbursement: The Slow Boiling Frog

Medicare is the single largest payer for most hospitals and many physician practices. Since 2001, Medicare rate increases have been programmed to lag behind cost inflation by 1% to 2% per year. The government acknowledges that on average the hospital Medicare margin has declined from 5.4% in 2001 to -4.8% in 2006. During this same period, Medicare's physician fee schedule has increased by less than 2% per year while practice expenses have grown by 3% to 5% per year.

Hospitals have compensated for their deteriorating Medicare margin primarily with investment income and cost shifting to managed care payers. However, the economic downturn has limited the contribution from these compensatory strategies. Investments are under water. High unemployment is driving highly profitable managed care patients into the ranks of the uninsured. High deductibles and copayments are causing managed care patients to delay care, resulting in a 2% to 5% decline in admissions in the most profitable service lines. And the copayments and deductibles from the managed care patients that do receive care represent the fastest growing component of bad debt in many hospitals. Thus, the magnitude of cost shifting necessary to maintain margins to compensate for underfunding by Medicare and Medicaid may not be feasible for most hospitals in the near future. Our research shows that a hospital must increase its commercial margin by 2% for every 1% drop in its Medicare margin.

Physicians have compensated for the underfunded Medicare reimbursement by seeing more patients, cost shifting to managed care (if they have sufficient negotiating clout), and investing in the profitable ancillary services that were formerly provided by the hospital. These compensatory tactics are having limited impact. In many cases, physician practices are approaching capacity, so increasing patient volume is not an option. Few physicians have the negotiating clout to demand their fair share of the premium from the managed care patients. Office-based ancillary revenues are under the same reimbursement pressure as hospitals and physician visits; thus, the profit contribution from these services will decline over time.

At the exact time that hospitals can least afford to invest in their physician workforce, physicians are demanding emergency department call pay, joint ventures, and employment to stabilize their incomes. Fifty-six percent of the hospitals recently surveyed by the American Hospital Association reported a significant increase in the number of physicians seeking economic support from their local hospital. Given the undersupply of physicians, hospitals cannot afford to underinvest in their physicians. Nor can hospitals afford to invest in physician engagement strategies without expecting an incremental return on the investment. Physicians can add incremental value by improving the accuracy of coding, efficiently managing length of stay and resource consumption, participating in the hospital's pay-for-performance programs, and providing constructive input into process improvement efforts.

Lower Reimbursement: The Foundation of Health Care Reform

After reviewing the Congressional Budget Office's study of 115 op-

tions for reforming health care, it is clear that the impact of theoretical models such as consumer-directed health care, medical homes, and others will pale in comparison to the Centers for Medicare & Medicaid Services' (CMS') stated objective of "improving the quantity and quality of outcomes per unit of cost." That is, it is certain that increases in Medicare reimbursement per unit of service will not keep pace with provider cost inflation. Traditional means of subsidizing the underfunding may not be sufficient to achieve optimal performance in the future. Hospitals must begin resizing their "cost chassis" to approach breakeven on Medicare.

Minimizing the Impact of Declining Reimbursement

The key strategies that hospitals must employ to minimize the negative impact of declining reimbursement include the following:

- Invest in cost management systems and process improvement. Establish best practice metrics and reward staff that "get it."
- Divest of nonessential deficit-generating services.
- Continue cost shifting while it lasts. Maximize and rebalance payer contracts to generate more profits from inpatient services. If you do not have the clout to negotiate premium rates, then merge with an organization that does.
- Invest in physician recruitment.
- Invest in a coding and revenue cycle.
- Engage physicians in leadership and management of service lines.
- Invest in the development of a highly compensated embedded medical group that will collaborate to add value.
- Invest in clinical integration—information technology, hospitalists, and bundled programs.
- Selectively add fixed costs.
- Use metrics as the primary determinant of performance.

Recent experience has demonstrated that 100-year and older organizations like Bear Sterns and Lehman Brothers can disappear in a matter of weeks due to poor strategic focus. A major industry in Detroit is on the verge of extinction because it ignored the realities of the market. At the same time, Apple has demonstrated American ingenuity at its best by revolutionizing the music industry. The economic and market conditions affecting health care providers are of the magnitude that have affected the financial and automobile sectors. In their recent industry downgrade, Moody's said it best: "Sound management decisions about operating costs and capital investments, coupled with skilled oversight and direction from hospital boards will be of special importance." In 2009, health care providers must embrace innovation and efficiency—to provide more and better care with less—to create the "i-care." *MPM*

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Provider Action

Impact to You

Today hospitals and physicians are experiencing deteriorating operating performance, which is only partly fueled by our current economic downturn.

What You Need to Know

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- Use metrics as the primary determinant of performance.

What You Need to Do

In 2009, health care providers must embrace innovation and efficiency—to provide more and better care with less—to create the "i-care."