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Maintain competitive cost structure in uncertain economic times

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REGARDLESS OF AN INSURER'S COMPOSITION – public or private, large or small, geographically diverse or regionally focused – reducing non-labor general and administrative (G&A) expenses can contribute greatly to margin improvement. While administrative costs constitute a much smaller percentage of total expenses than medical costs, they can be a great source of savings opportunities. By improving the G&A ratio by 0.5%, an organization can accomplish the same impact to EBITDA as a 10% increase in membership. These results are possible for all payers when applying the following benchmarks for a structured means to non-labor G&A cost reduction.

Challenge the Status Quo

The industry commonly uses the G&A ratio to compare payers to their peers in the market. However, when this is used alone, it can be misleading or can be used to substantiate market standing. For example, when payers are above their peer average ratio, the natural tendency is to make rationalizations to defend their position. Conversely, when payers are below the average, the comparison can be a comforting indication that the

organization is doing well. This, in turn, can lead to complacency or a suboptimal prioritization of improvement opportunities. Other benchmark statistics can be equally misinterpreted because they can invite conclusions on economies of scale, efficiencies of operating functions, and overall competitiveness. Ratios and other comparative tools are a great starting point for self-evaluation. Best performers will not only seek to understand their meaning, but will seek out ways to improve regardless of the interpretation.

Evaluate and Create Individualized Opportunities

While ratios and aggregate level information can be useful, the best way to determine opportunities for improvement is to roll up your sleeves, dive into the details, and let a payer's specific situation dictate whether costs can be reduced. For example, if a payer needs to be more competitive in the market, either due to increased competition or to offset rising costs, then that factor alone should be driving opportunities. In other words, effective G&A cost management should not be taken for granted – executives and managers alike need to constantly evaluate whether opportunities exist and recognize when they can be created.

Create a Manageable Process

To begin to gauge opportunity for improvement, it is useful to understand that based on Huron's experience, typically 40% to 60% of an organization's G&A expenses are the result of outside purchases. Moreover, for a typical insurer, these purchases can be made through thousands of vendor relationships.

While managing this volume of relationships is inherently complex, payers

can simplify the process by understanding that 60% to 80% of the associated costs are derived from a much smaller number of vendors (e.g., the top 100). By focusing on this group of vendors, managers can categorize these relationships and classify each vendor by the functional area to which they are providing products and/or services (e.g., information technology, facilities, human resources, legal, and corporate services). Payers may also choose to categorize to a more granular level, further distinguishing vendors by sub-categories. For example, IT's vendors may be broken out by hardware, software, telecom, and services. Upon reaching a level that makes sense for their organization, payers can then move toward evaluating savings opportunities, both overall and within each cost category.

Build the Business Case and Establish Cost Reduction Goals

When evaluating and prioritizing cost reduction opportunities, there are several clues that indicate where cost reduction opportunities exist. Payers can classify these signals as high level or detailed account observations.

HIGH LEVEL OBSERVATIONS:

Gather these through basic internet research, discussions with sales representatives, meetings with industry peers, and finance reports, among other means. General questions include:

- Is the contract term more than 75% complete?
- What industry changes have occurred since the contract was initiated, and will they positively or negatively affect the organization? (e.g., availability of temporary nurses)

■ How has the volume of business changed since contract inception? Has it increased or decreased at a pace greater than the vendor's organic growth? (e.g., is this account growing faster than the vendor's average?)

■ What has happened with the vendor's business during the contract term? (e.g., have there been acquisitions, divestitures, changes in market share?)

■ Does this vendor also serve the organization's competitors?

DETAILED ACCOUNT OBSERVATIONS:

High performing organizations typically have this information available for analysis.

■ What did the organization purchase during the contract term?

■ Was the line item pricing compliant with contract terms?

■ What pricing trends can be identified (e.g., higher, lower, unchanged)?

■ How does the organization's pricing compare to the contract provided to its competition? To other payers? To providers? To others outside the healthcare industry?

■ Are lower cost alternatives available?

■ What processes exist to manage demand internally?

After a payer completes both a high level and detailed analysis, the answers can serve as the basis for supporting savings targets. However, this is only half the equation. As previously stated, a payer must balance the business case findings with the specific requirements of the organization. For example, if a payer needs to be more competitive in the market, either due to increased competition or to offset rising costs, then that factor should be incorporated into the savings targets and strategy.

Create a Strategy

The most common mistake organizations make when working with vendors to reduce costs is the lack of an overall savings strategy. Going through the nec-

essary steps to build the business case will help to uncover facts that legitimize savings estimates. However, it is the strategy, including the timing and delivery method for introducing those facts, that will enable vendor agreement.

When developing a strategy, payers should consider the following:

■ Meeting Forums (e.g., face-to-face vs. teleconference)

■ Participants

■ Messages

■ Timelines

■ Anticipated Challenges

■ Escalation Options

Generally, vendors will likely agree to further discounts in exchange for more business. However this practice can perpetuate a misalignment to fair, market competitive pricing. The goal should be to achieve cost reduction based on current business and without additional commitments. The means to this is to come prepared with a well crafted strategy.

Also, when organizations control the negotiations, – by creating the agendas, controlling the timelines, and writing their own terms – they generally achieve more than those that depend on vendor-driven processes.

It is important to note that incumbent vendors do not have an incentive to move quickly and may use various delay tactics so they can continue to receive above market rates. Also, best performers tend to agree to an effective contract date early in the negotiation process to create an anchoring point that enables retroactive pricing and balances incentives for both sides.

Develop an Ongoing Cost Management Process

After new agreements and other cost reduction initiatives are complete, it is critical to ensure the estimated savings are realized. For example, without proper management, that new three-year agreement promising 25% savings may lose its relevance. In fact, without

adequate monitoring and controls, 50% to 120% of the benefits identified at contract inception can erode by the end of the contract term.

The following are a few steps that can help to optimize value from vendor agreements:

■ Perform a Business Case Analysis on an On-Going Basis: As done initially, the updated analysis should identify savings and provide details on purchase history, pricing trends, total spend amounts, etc. The updated analysis will support any need for future contract discussions or negotiations.

■ Schedule Regular Update Meetings with Key Vendors: This places responsibility on the vendors to stay current on business needs while adhering to contract terms.

■ Periodically Test the Market: Even when satisfied with a particular vendor and the associated contract, organizations should periodically test the market to ensure price competitiveness, and independently assess the market and its current conditions. Staying informed should help organizations know if and when a more formal request for proposal process is required.

In today's economic environment, payers are expected to apply constant, downward pricing pressure to help maintain or improve their competitive cost structure. As medical costs rise, economic forecasts are adjusted, and reserves are utilized, payers must challenge the status quo to improve. This starts with understanding high level metrics that may provide a glimpse of performance, but does not stop there. When applying a structured approach to administrative cost management, significant impact can be made to net income – and when applied to non-labor costs, benefits can be realized without resorting to reductions in headcount. **MHE**

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