



A Formula for Managed Care Contracting

By Nathan Kaufman

The cost coverage ratio helps hospitals determine how much to negotiate from private payers.



Nathan Kaufman

Health care providers deserve their fair share of the health care premium, but few know how to determine what is fair. While most health plans have a reasonably good idea what its competitors are paying each provider, hospitals face confidentiality restrictions and antitrust issues that prevent them from knowing “market rates.” Hospitals must do a better job of using data to formulate their managed care negotiating targets.

Because imperfect knowledge is far more dangerous than ignorance, hospitals need a reliable formula for figuring their managed care payment rates.

Cost Coverage Ratio

Cost coverage ratio (CCR) is the gold standard for evaluating the appropriate rate and thus the success of managed care contracting. The CCR is calculated by dividing the net revenue from a specific plan by the fully allocated expenses associated with delivering that care to that plan’s patients.

Hospitals that do not have the financial systems that can determine the expense delivered to a specific payer population can still use the ratio of cost to charges to estimate expenses for a payer. Note, however, that the CCR is a function of both revenue and expense. Hospitals can and should improve their CCR by lowering their expenses to best practice benchmarks as well as increasing the rates. You can find out how your cost structure compares with “peer hospitals” from Medicare cost report data published on the Web.

In most hospitals the CCR for Medicare, Medicaid and self-pay patients, who comprise 40 percent to 60 percent of gross revenue, is 70 percent to 80 percent. That is, the cost of providing care to these patients is 20 percent to 30 percent higher than the revenues generated. In order to generate reasonable profitability, it is essential that the hospital obtain rates from private payers that produce CCRs significantly greater than 100 percent.

CCR Targets

If you give the dominant payer(s) too good a deal, the CCR for the other payers will have to be too high, which will drive them out of the market. Should one plan in the market get a disproportionately low rate

from a hospital, it will be able to aggressively compete against other payers in the market that have an inflated cost structure due to their higher hospital rates. But there are also plans that are not as price sensitive because they cover a regional or national employer with a local site.

The following are “generic” CCR targets that are subject to some modification based on specific local factors:

<u>Type of Payer</u>	<u>% of Gross Revenue</u>	<u>CCR Target</u>
Dominant payer	15% or more	130% or more
Other significant market-focused payers	5% to 15%	145% to 160%
All other small payers	Less than 5%	180% or more

Note: a hospital that is unable to negotiate these rates may need to explore merging into a larger system so that it will have the critical mass to negotiate market rates.

Inpatient vs. Outpatient

It is also critical for a hospital to analyze its CCR for each payer by location of care--inpatient or outpatient. It is not uncommon to find that the CCR of a hospital’s managed care/commercial inpatient services is significantly lower than that of its outpatient services. This indicates that the hospital is overly dependent on its outpatient services for its profitability.

Hospital outpatient volume is being threatened on many fronts:

- Payers such as Blue Cross of California are providing financial incentives to physicians to perform outpatient procedures in freestanding facilities and not in hospitals.
- Since most freestanding providers have less negotiating clout than hospitals, their rates are 30 percent or more lower. With the introduction of high-deductible health plans, patients who have to pay cash will shop for lower-cost options to hospitals.
- Many referring physicians have an ownership interest in these free-standing providers and will continue to encourage their patients to use these facilities. Re-balancing the CCR around the hospital’s strongest franchise (i.e., inpatient services) is critical.

Finding the Appropriate CCR

In order to determine the parameters for successful managed care contracting, a hospital should do the following:

- Measure the CCR for inpatient and outpatient services for each payer.
- Ensure that the hospital’s expenses are at industry benchmarks.

- Demand CCRs within the target ranges provided earlier (subject to some local modifications).
- Rebalance rates so that the inpatient CCRs are equal to or greater than outpatient rates.

A final note for physicians: Few physicians have the ability to measure CCRs. The standard measure for evaluating managed care contracts for physicians is percent of Medicare. The following summarizes the contracting parameters for physicians:

<u>Type of Contract</u>	<u>Percent of Medicare</u>
Not acceptable	Less than 90%
Average contract	100% to 110%
Good contract	110% to 125%
Great contract	125% or more

Usually it is only the dominant single and multispecialty groups that can negotiate “good” and “great” contracts.

To successfully negotiate with payers for their fair share of the premium, a provider must be prepared to walk away. While this will inflict pain on the payer, it will be painful for the hospital, its physicians and its patients only in the short term. In the long term, it will benefit the provider. The CCR offers guidance on when to hold 'em and when to fold 'em.

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