CASE MODEL

MANAGED HEALTHCARE IN CAPITOL CITY

BACKGROUND AND OVERVIEW

Capitol City is a medium-sized, upper-Midwestern city. Although managed care has significantly affected the delivery of healthcare in surrounding markets, and nationally for several years, only recently has its influence begun to affect the local delivery system. In many ways, Capitol City was the “Brigadoon of Healthcare,” impervious to any challenge to its traditional fee-for-service reimbursement environment. The incursion of managed care into this market represents the introduction of competition for both local providers and purchasers.

PLAYERS

1. Hospitals

The are three hospitals located within the city:

a. Memorial Hospital — a 150-bed hospital, owned-controlled by a local board;

b. St. Joseph’s Hospital — a 300-bed Catholic hospital; and

c. St. Elizabeth’s Hospital — a 100-bed Catholic hospital.

Both St. Joseph’s Hospital and St. Elizabeth’s Hospital are owned and operated by a large Catholic system headquartered in another state. Memorial Hospital and St. Joseph’s Hospital are located next door to each other on the north side of town while St. Elizabeth’s Hospital is located on the south side of town. In an effort to reduce costs and improve the health of the community, Memorial Hospital and St. Joseph’s Hospital have had a long-standing agreement to avoid duplication of costly services in the community, e.g., St. Elizabeth’s Hospital operates the only local emergency room, Memorial Hospital has the only invasive heart surgery program, and all three hospitals collectively own the only MRI center.

Another large hospital system (the Regional Health System) has hospitals in most of the surrounding communities, and would like to enter Capitol City’s market.

2. Physicians

In response to the incursion of managed care, specifically the “gatekeeper” system, the area hospitals and Regional Health System have purchased nearly all of the primary care physician practices (FP, IM, OB/GYN), and employed these physicians.

The specialists and surgeons have remained mostly independent in single-specialty groups of generally two to five physicians. St. Joseph’s Hospital and St. Elizabeth’s Hospital’s physician organization, Healthy Physicians, includes a few employed surgeons and specialists.

3. Outpatient Centers

There are two ambulatory surgery centers (ASCs) in the community:

- Riverside ASC is located in a medical office building next to St. Joseph's Hospital and Memorial Hospital and is owned by several independent surgeons and specialists (OB/GYN, plastic and general surgeons).
- Goodcare ASC is a freestanding ASC located on the south side of town. Goodcare ASC is owned by a large group of ophthalmologists who handle about 90% of the cases.

4. Managed Care Plans

The third party payors in Capitol City have traditionally been large indemnity insurers. Two years ago, some insurers began offering a care plan similar to a preferred provider plan, with the panel open to all providers and reimbursement on a discounted fee-for-service basis.

Next, a managed care plan called HealthNet, owned and operated by hospitals and physicians in a neighboring community for several years, decided to enter the Capitol City market. Competition began to heat up as HealthNet offered partial ownership of their new Capitol City product to Memorial Hospital. HealthNet negotiated for drastic discounts of physician's usual charges, averaging 40 - 80% discounts plus 20% withholds and onerous utilization management and case management controls, in return for participation on their panels. Managed care had hit Capitol City.

APPLICATION OF PORTER'S FIVE FORCES TO CAPITOL CITY

The Threat of New Market Entrants

1. Hospitals

For many years, Memorial Hospital, St. Joseph's Hospital and St. Elizabeth's Hospital alone had served Capitol City. Now, Regional Health System was threatening to enter the market by purchasing primary care practices and opening walk-in clinics. In response to Regional Health System's threat, Memorial Hospital, lacking the capital of the Catholic hospitals, decided to enter into preliminary affiliation/merger discussions with Regional Health System as a defensive measure.

2. Physicians

The hospitals threatened to recruit physicians from other communities if they couldn't control the loyalties of local physicians through purchase, employment, or restricted managed care panels with drastic reductions in reimbursement. Once the local hospitals had purchased almost all of the primary care practices in the area, the specialists in small, independent practices felt it would only be a matter of time before the hospitals would "divide and conquer" the remaining independent area physicians. In response to these threats, a large portion of the specialists affiliated to form a large physician-owned and driven management services organization, "Physician Net."

3. Outpatient Centers

In order to compete with the freestanding ASCs, hospitals were closing inpatient operating rooms (ORs) and reclassifying them as outpatient ORs. Both freestanding ASCs sought to strengthen their support and financial positions. Riverside ASC actively sought offers from the hospitals to be purchased while Goodcare ASC offered ownership shares to a larger base of surgeons and specialists in the community.

4. Managed Care Plans

Because of its undeveloped managed care system and low market penetration, national managed care companies began to identify Capitol City as a potentially lucrative market. To attract area physicians to participate in its panel, HealthNet increased its proposed provider reimbursement. Meanwhile, the Healthy Physicians organization developed its own health plan in partnership with a national insurance company and the two hospitals with which it was affiliated.

5. Application to Case Model Analysis

New entrants into a market are a threat to existing organizations because they intensify competition for customers. The level of the threat from the entry of new competitors into a market depends on the strength of entry barriers to the market. The Capitol City healthcare market was very fragmented, without any clearly defined delivery system, leaving it very susceptible to the threat of new market entrants. The barriers to entry that normally protect existing organizations serving a market were low, specifically:

- High existing provider service costs and prices are easily matched or undercut.
- The state does not require a Certificate of Need (CON) to build or develop additional healthcare products or services.
- The managed care penetration is only 8% of the Capitol City healthcare market, and most plans had open panels (if providers were willing to accept the terms they offered).

The Bargaining Power of Suppliers

1. Hospitals

The hospitals were purchasing Capitol City physician practices and threatened to recruit physicians from other communities to be employees in their respective health systems. The hospitals utilized their employed primary care physicians, under the “gatekeeper” managed care plans, as a bargaining chip in negotiations with the specialists and surgeons, who traditionally relied upon the PCPs for many of their referrals.

2. Physicians

The hospitals rely upon the specialists and surgeons, whose services comprise the majority of their admissions and utilization in their ORs. In response to the hospitals’ control of the PCPs, the specialists and surgeons network recruited the membership of the independent emergency physicians who were under contract with St. Joseph’s Hospital’s ER and served as a patient “access mechanism” into their network of services.

3. Outpatient Centers

The outpatient centers were able to offer the same product as the hospitals, at a lower price, with higher physician and patient satisfaction. Even with the low cost of their services, compared to their competition, the outpatient centers offered discounts to managed care plans in order to participate on their panels.

4. Managed Care Plans

The managed care plans control the access to covered lives and therefore the distribution of medical premium dollars. Physicians who wanted to participate in their preferred provider organization (PPO) products (which provided for better physician reimbursement and, at that time, had the majority share of the Capitol City market) were required to participate in their health maintenance organization (HMO) products as well (which included deep discounts and withholds of physician fees). The managed care plans then began to offer equity ownership to area physicians in their Capitol City-based products.

5. Application to Case Model Analysis

Suppliers affect competition through their control of prices and the quality of the products and services they supply. In healthcare, it is very difficult to measure differences in the quality of physicians, procedures, or hospitals. What information is available is owned by the hospitals and managed care companies who do not readily share it with the community or their provider panels. In Capitol City, there were large discrepancies between the fee schedules of competing physicians and the hospitals (as much as a 75% difference for some services). These issues prevented patients and purchasers of these services from making informed decisions based on price or quality. In the healthcare industry, as in most service industries, labor is the primary cost. Because of the low unemployment rate in Capitol City, the competition among healthcare organizations to attract and retain quality workers was high.

Threats From Substitute Products and Services

1. Hospitals

More and more invasive surgeries are requiring less, if any, inpatient admissions. The outpatient centers became licensed for 23-hour stays, which enabled them to perform procedures that they couldn't as recent as five years prior, e.g., lumbar laminectomies, anterior cruciate ligament (ACL) repairs, etc. The hospitals were opposed to physicians participating in any revenue stream other than their professional fees, e.g., ASCs, physical therapy, and other ancillary service technical component (ASTC) revenues. With their relationships with local leaders and media, the hospitals portrayed the physicians as "skimming the cream" from healthcare through their development of ASCs and other ASTC services that the charitable, not-for-profit hospitals rely upon in serving their mission in the community.

2. Physicians

The emergence of allied health professionals, such as nurse practitioners, physician assistants and chiropractors, as an increasingly accepted alternative to some types of physician care has happened in Capitol City as well as nationwide. In response to this development and the need to control their own "access mechanisms," Physician Net developed a "telephone triage" system that was staffed 24 hours a day by registered nurses that referred patients to the network of specialists.

3. Outpatient Centers

Both the local hospitals and physicians began to aggressively pursue the development of outpatient centers, with the hospitals converting inpatient surgical units to outpatient operating rooms, and physicians exploring the option of placing surgical suites within their medical offices. The outpatient centers made it more attractive for physicians to perform surgeries at their centers, e.g., block scheduling, advertising (Internet, television, and radio) to include medical staff, and forming committees of the medical staff to involve them in decision making. The convenience and patient-friendliness of the freestanding outpatient centers was a substantial competitive advantage.

4. Managed Care Plans

The independent providers began to negotiate with national managed care companies to jointly develop a specialty-driven point-of-service (POS) product for Capitol City. The managed care plans responded by offering equity ownership in their Capitol City products to area physicians in exchange for their exclusive participation on their panels.

5. Application to Case Analysis

By definition, substitute products and services perform the same or similar functions and provide equivalent utility and benefit as existing, established products and services. Technology has affected the healthcare industry as much, if not more, than most other industries and has provided both substitutes for traditional health services and new services, which in turn require more specialized devices and labor. Substitute products and services that evolved in the Capitol City market over the past few years include

- outpatient surgery centers as a substitute for inpatient surgery and overnight stays;
- managed care as a substitute for indemnity, fee-for-service insurance;
- allied health professionals (nurse practitioners, physician extenders, chiropractors), as a preferred alternative to primary care physicians in some delivery systems;
- other specialists and providers who traditionally provided non-invasive services (podiatrists, optometrists, etc.), are being licensed to perform surgeries; and
- telephone triage and urgent care walk-in clinics provided a substitute to primary care and emergency room visits.

The Bargaining Power of Buyers

In addition to the players discussed below, the description of buyers must include patients and employers. Patients in Capitol City have had little or no information on the quality of competing providers and no organization to provide leverage in negotiating managed care contracts except for the employer purchasing of health insurance. The local employers were largely in the same situation, without information or organization. An employer coalition had been formed but its close ties with the hospitals and lack of strong leadership prevented it from effectively commanding power or leverage on behalf of local employer members.

1. Hospitals

The development of the outpatient centers diluted the hospitals' power as suppliers and meant managed care plan "buyers" had another "supplier." In response to the physician ownership of outpatient centers, the Healthy Physicians system continued to recruit and employ specialists and surgeons, while Memorial Hospital and Regional Health System worked to foster a formal relationship with the independent surgeons and specialists. This competition between the hospitals with their employed physicians and the specialists with their outpatient centers was for both physician services and outpatient services and provided the managed care "buyers" with greater choice as consumers. Thus the competition in suppliers increases the power of buyers, who are then able to play one organization against the other and turn to a substitute provider if the usual supplier is uncooperative about meeting their needs.

2. Physicians

The managed care company payors controlled not only the expenditure of premium dollars, but also the selection of which doctors had access to treat their plan members. In response, the independent surgeons and specialists of Physician Net further integrated into a single contracting medical group and were then able to finalize a deal with a national managed care plan to partner with them in the development of a POS plan in Capitol City.

3. Outpatient Centers

The opening of outpatient surgical suites within the hospitals gave local surgeons a choice of where to bring their patients (as long as their insurance covered the service). Goodcare ASC sold its ownership to the new Physician Net, the consolidated medical group of surgeons and specialists, who took the name Goodcare. Goodcare then designed and began construction of another identical outpatient center on the other side of town, to further cultivate its physician ownership's loyalty.

4. Managed Care Plans

Despite the creation of a healthcare "coalition" by employers in the community to educate their employees and leverage better pricing and service, the managed care plan still retained significant market power. Healthy Physicians, with subsidization from the deep pockets of its affiliated large hospital system, was able to price its product at an artificially low rate. They also were able to attract the employers in the community through their long cultivated, close ties with the existing leadership of the employer coalition. HealthNet continued to try to build closer ties with physicians by offering them ownership investments at a low price.

5. Application to Case Model Analysis

Like powerful suppliers, buyers can affect the intensity of competition through their attempts to obtain the lowest price possible while demanding high quality and better service. The hospitals and outpatient centers have different customers (physicians and their referrals) than do the physicians and managed care plans (employers and patients). By forming an MSO, the specialists and surgeons of Goodcare were able to exert their bargaining power more effectively than the employers and patients who were not so tightly organized. The leverage a buyer can exert increases if they

- purchase in large volumes through the merger or affiliation of smaller or fragmented buyers. The employer coalition that was formed exerted little leverage as each member employer continued to make its own independent decisions regarding the purchase of health insurance services.
- have low switching costs. In the case of Capitol City, if patients change managed care plans, they most likely have to change their physicians.
- have enough information to make informed purchasing decisions. Only the suppliers in Capitol City (hospitals and managed care companies) had the information necessary to support those decisions.

Rivalry Among Existing Firms

1. Hospitals

Rivalry among existing firms led to strategic discussions, in some form, between almost all interested parties. When affiliation discussions between Memorial Hospital and Regional Health System broke off, Regional Health System, still interested in the market, entered into discussions with Goodcare. An affiliation was then formed for the development of a new hospital and ownership in Goodcare's outpatient centers. Healthy Physicians continued to build their system by purchasing the practices of the few independents that did not merge with Goodcare. By this point, almost all local providers had aligned with one of the health systems and the market had fully consolidated.

2. Physicians

With this market consolidation, rivalry among individual practices escalated to rivalry among health systems. Most of the remaining independent physicians either sold their practices or moved out of town.

3. Outpatient Centers

Goodcare's affiliation with Regional Health System meant that they had, in effect, entered the hospital business and would be competing as a direct rival with the inpatient hospital and their systems. The last independent outpatient center, Riverside ASC, and its physicians merged with Healthy Physicians at this time.

4. Managed Care Plans

This competition and resulting "shake-out" resulted in three major managed care payors operating in the market:

- Healthy Physicians
- HealthNet (co-venture with Memorial Hospital)
- Goodcare (co-venture with a national managed care company)

5. Response

The response of the providers to competition was consolidation and integration into three competing health systems. The informal, but longstanding agreement for coordination of services for community benefit had ended. Memorial Hospital's invasive cardiology program, the only one in the area, now came under competition. Healthy Physicians recruited a cardiac surgeon and opened a high-end cardiac program within St. Joseph's Hospital. Healthy Physicians also closed the majority of the inpatient ORs at St. Elizabeth's Hospital for the construction of outpatient surgical suites. Meanwhile, Memorial Hospital converted its 40 hours per week walk-in clinic to a 24-hour emergency unit. Goodcare and Regional Health System broke ground on a 150-bed tertiary care hospital, the first new competition for inpatient hospital services that Capitol City had seen in many years, and the first for-profit hospital venture in the state.

6. Application to Case Analysis

The strategy of one organization within an industry affects and is dependent on the strategy of the others, resulting in rivalry between competitors striving to improve their position (market share). Typically, an action by one competitor results in reactions from the others. The following are illustrations of the intensive rivalry among competitors in the Capitol City example:

Each of the three healthcare systems committed to competing in the local market by investing large amounts of capital into building their respective delivery systems. Their reluctance to abandon a project after making such a high investment, is a notable internal exit barrier.

Each managed care plan, co-owned and sponsored by a hospital system, required exclusivity for both hospital and physician providers contracting for inclusion on their panels. This resulted in “splitting” families when some family members were forced to choose a different insurance plan than others.

Healthcare, like most service industries, is heavily reliant on labor, which is typically a fixed cost. High fixed costs increase the difficulties in competing based on cost differentiation.

Where agreements once existed between systems to allot responsibility for, rather than duplicate, expensive services (e.g., MRI, high-end cardiac programs, Level III certified trauma emergency rooms), the market began to develop three independent, full-service integrated delivery systems.

CONCLUSION

This case model illustrates how the rapid incursion of managed care into a medium-sized community can dramatically affect competition. As has occurred in markets throughout the country, the market matured very rapidly with the development of increased competition in one area spurring competition in others. The incursion of managed care acted as a catalyst for the consolidation of physicians’ services, which in turn led to the development of additional outpatient centers, ASCs, and eventually a new hospital that increased competition for hospital services. This gave the managed care organizations increased bargaining power, fueling the cycle of competition anew. Where once there was an “infinite” amount of revenue to be shared (through fee-for-service indemnity payors) collaboration and cooperation existed between competitors. Now, there is intense rivalry between systems for a finite amount of premium revenue because of managed care competition and capitated reimbursement.

KEY ISSUES

Who benefited most from the increase in competition:

— hospitals?

— physicians?

— HMOs?

— insurance companies?

— patients?

What were the disadvantages of increased competition?