



A Guide to Strategic Cost Transformation in Hospitals and Health Systems

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Executive Summary

Exacerbated by the U.S. deficit and other economic challenges, the rising cost of health care is a front-and-center issue nationwide for patients, employers, providers, and governmental and commercial payers alike. As health care moves to a value-based business model, health care payments will likely be constrained, while care efficiency, quality, outcomes, and access will be expected to improve. To continue meeting community health care needs in this new delivery and payment environment, hospital and health system leaders will need to think and act strategically about managing cost. *Strategic cost transformation* will be required.

In this guide, we propose that such transformation must occur along three pathways (see figure 1 on page 7): Pathway 1 involves reducing costs of current operations; pathway 2 involves reducing costs through restructuring businesses and service lines, among other elements; and pathway 3 involves reducing costs through clinical transformation. This guide focuses on specific elements of pathways 1 and 2.

Hospitals and health systems can lay the groundwork for strategic cost management by:

- » Ensuring that the CEO drives the strategic cost transformation process
- » Developing and implementing a strategic cost transformation master plan
- » Bolstering the organization's business platform and ensuring its full functioning at all levels
- » Creating and supporting cultural change

Cost management pathway (pathway 1): Cost management is an approach to significantly reshape and reduce cost by (1) improving planning and execution of current operations and (2) attacking overhead and non-value-added functions, overhead costs, and costs "flying below the radar." Cost management opportunities can best be achieved in organizations through:

1. Understanding your organization's readiness for cost management
2. Defining cost-reduction goals based on the organization's capital shortfall
3. Using internal and external benchmarks to identify possible sources of savings
4. Supplementing benchmark data with other data analyses
5. Understanding and focusing on the key drivers of staffing and productivity problems
6. Drilling down on staffing methods
7. Streamlining overhead functions
8. Ensuring that cost-reduction targets are integrated with organizational plans and budgets

Business restructuring pathway (pathway 2): Forward-thinking organizations, whether freestanding hospitals, multihospital systems, or other provider entities, are evaluating all aspects of their business in light of changing market conditions and requirements for future success under the new business model. They are asking, "What businesses and services are core to our mission and vision going forward?" and "Where can we most effectively invest our limited capital and human resources to meet the continuing health care needs in our communities?"

Eight action items can help hospital and health system executives and boards define the business strategies appropriate to their organizations, and the plan by which those strategies can be executed.

1. Start with an evaluation of your organization's strategic options.
2. Evaluate each business unit and service line to identify core elements.
3. Use a structured process to analyze the core businesses and services.
4. Implement a business/service line analysis framework.
5. Understand when and why service distribution planning will be needed.
6. Initiate the process of defining the most efficient and effective distribution of services.
7. Use a structured framework for service distribution planning.
8. Ensure a solid fact base for the service distribution plan.

Hospital and health system leaders have an opportunity to make a significant contribution to health care delivery in their communities by moving their organizations to a value-based business model, using the strategies of strategic cost transformation outlined here. The time to move is now.

Introduction

Due to factors including the federal and state budget deficits, rising health care costs, and the large percentage of gross domestic product consumed by health care spending, health care must focus on value. This value proposition, which is improved quality at lowest-possible cost, will not be undone.

Under health care's value-based business model, health care payments will be constrained, while care efficiency, quality, outcomes, and access will be expected to improve. At the same time, quality and cost will be much more transparent to patients and purchasers. Indicators will be closely monitored and reported in public forums.

To continue meeting community health care needs in the new delivery and payment environment, hospital and health system leaders will need to think and act strategically about managing cost. In this guide, we propose that this process—strategic cost transformation—will be required and that such transformation must occur along three pathways (see figure 1): Pathway 1 involves traditional cost management, namely reducing costs of current operations; pathway 2 involves reducing costs through restructuring businesses and service lines, among other elements; and pathway 3 involves reducing costs through clinical transformation.

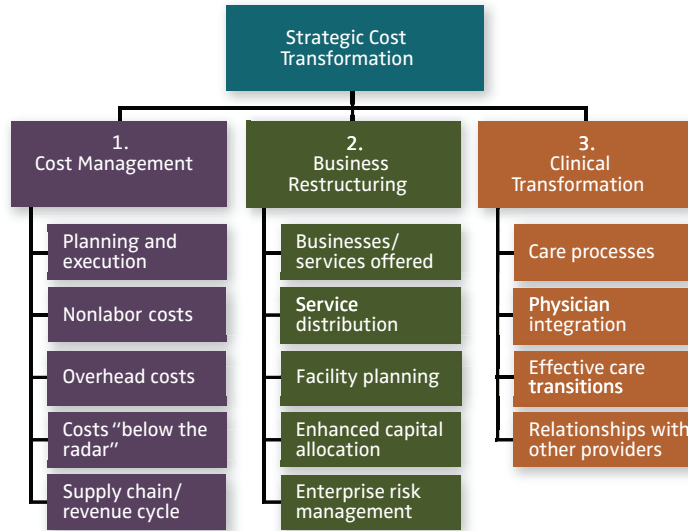
Most organizations have attacked or are currently attacking costs through pathway 1. But these savings may not be sufficient to achieve the overall cost reductions needed in the new environment. Furthermore, to ensure optimal long-term success, work occurring through pathway 1 must be carefully coordinated with work occurring through pathways 2 and 3. Some organizations have started to use pathway 2, business restructuring, as a means to reduce costs; but this work is much more difficult, and many organizations have not yet started it. Finally, though many providers talk about clinical transformation, many organizations have not started work in pathway 3, which takes the longest time to achieve but also has significant potential for true reduction of the cost of care.

This guide focuses on specific elements of:

- » Pathway 1. Cost management: Reducing costs of management operations, including planning and execution, nonlabor costs, overhead costs, and costs “flying below the radar”
- » Pathway 2. Business restructuring: Reshaping businesses and services offered and conducting service distribution planning

Future guides in this series will cover additional pathway elements.

Figure 1. Three Pathways for Strategic Cost Transformation



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Laying the Groundwork

For health care management teams and boards, four strategies will be critical to achieving strategic cost transformation.

Strategy 1. Ensure that the CEO drives the strategic cost transformation process.

Removing costs to increase efficiency across an organization, while improving quality, will require sustained effort and attention at the highest level.

Strategy 2. Develop and implement a strategic cost transformation master plan.

The plan articulates the order and sequencing of pursuit and achievement of the cost-transformation pathways. While pursuit of all three pathways is likely required, it may be beyond a management team’s resources to pursue initiatives in all areas simultaneously. Some CEOs are very unsure of what they should do first. Many are diving into clinical integration and care-model change. Others are pursuing initiatives to enhance services or secure partnerships.

Or, if the hospital or health system is experiencing relatively stable financial performance, some CEOs are focusing on revenue or integration initiatives in lieu of cost reduction because they believe what is commonly cited in the literature that “the low-hanging fruit has already been picked.” This may not be the case.

Very few organizations seem to have the time and human and economic resources to pursue all pathways concurrently. The order of priority for cost transformation for any organization will vary based on its market, clinical resources and environment, and financial position. In addition, political will within the organization, the strength of its management and clinical teams, its culture of measurement and accountability, and other factors will play a significant role in whether and how strategic cost transformation proceeds. An objective evaluation of these characteristics is strongly recommended.

Strategy 3. Bolster the organization's business platform and ensure its full functioning at all levels.

The systems and technology required for monitoring and managing progress in delivering health care value, defined with cost and quality dimensions, must be put in place, functioning, and used effectively. Requirements include:

- » Corporate finance-based business systems and tools for business planning, financial planning, capital allocation and management, budgeting and cost control, and capital structure and risk management
- » Clinical information systems and tools

High-quality IT and clinical information tools must support the monitoring and management of performance under changing financial and care delivery arrangements. Clinical and business data must be integrate-able and integrated. Analytic capabilities and disciplined use of quantitative techniques are required.

Strategy 4. Create and support cultural change.

At the most fundamental and pervasive level, strategic cost transformation will require cultural change. Supported by the board of trustees, executive leaders must create a culture of results and accountability.

Executive communication of the strategic cost transformation plan to all stakeholder groups will be critical. Visionary leaders will recognize and enable active participation organizationwide. This will be key to sustaining the required changes. Major initiatives will need to be led in a way that is cognizant of the larger framework and the power of participation to drive meaningful change.

Leaders also must understand that, after 40-plus years, the mindset of the fee-for-service business model permeates organizations. Sustainable success within the new business model will require new forms of governance, organizational and management structure, and performance measurement that will alter the basic approach to care delivery. As described by Atul Gawande, M.D., new values and new attitudes will be needed to move from a sickness model, characterized by physician and hospital autonomy, to a wellness model, characterized by independence and team-centric care delivery.¹

Takeaways

- » Due to rising health care costs, the industry's value proposition—best-possible quality of care at lowest-possible price—will not be reversed.
- » Taking costs out of the health care system will require the sustained effort and attention of health care leadership teams and boards across multiple dimensions. The CEO must drive this process.
- » The strategic transformation of a hospital or health system's cost structure involves rigorous cost management to reduce costs of current operations, careful consideration of businesses and services offered (and the ability to make and implement tough decisions related to this), and clinical transformation through redesign of clinical operations and structure for maximum efficiency and effectiveness of the care delivery process.
- » In some organizations, the low-hanging fruit has *not* already "been picked."
- » The systems and technology required for monitoring and managing progress in delivering health care value, defined with cost and quality dimensions, must be put in place, functioning, and used effectively.
- » At the most fundamental and pervasive level, strategic cost transformation will require cultural change.

¹ Gawande, A. "The Real Reform of Healthcare." *Kaufman Hall Report*, Winter 2010.

Cost Management Opportunities

Cost management is an approach to significantly reshape and reduce cost by improving planning and execution of current operations, attacking overhead and non-value-added functions, and addressing the major strategic drivers of cost. Eight strategies can help hospital and health system executives achieve solid results.

Strategy 1. Understand your organization's readiness for strategic cost management.

Specific organizational competencies are required for success with strategic cost management. These include target setting and tracking; scope of cost-management focus; systems thinking; alignment between plans, targets, and financial performance; accountability and execution; management controls; operational planning; and overhead management. Detailed awareness of your organization's current level of preparedness is critical to effective planning. A cost management "readiness assessment," completed by an objective party and summarized based on a comparison with national performance, is recommended. Figure 2 provides a sample tool.

Figure 2. Sample Tool for Strategic Cost Management Readiness Assessment

	<i>Unprepared Hospital</i>	<i>Well-Prepared Hospital</i>
Target Setting and Tracking	Most departments look great in current productivity and budget reports, but hospital performance is lagging X	Aggressive cost-management targets
Scope of Cost Management	Focus of cost-management effort is fairly limited X	Extensive scope of cost-management effort addressing all major drivers
Systems Thinking	Focus exclusively on individual departments and silos X	Decision making driven by the "greater good"
Alignment	Total disconnect between plans, targets, and financial performance X	Schedules, staffing plans, targets, budget, financial needs aligned
Accountability and Execution	Highly creative and unending excuses are the norm X	Demanding culture with little room for excuses
Management Controls	Lots of workarounds for managers to get the staffing and resources that they want X	Strong controls on hiring and use of premium labor
Operational Planning	Managers told to cut cost with no evidence that fundamental changes are being made X	Structured process in place to drive changes in how work is done
Overhead Management	Overhead services and functions "fly below the radar" X	Mechanisms in place to rationalize overhead and corporate/system expenditures
Composite Position	Weak X	Strong

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Strategy 2. Define cost-reduction goals based on the organization's capital shortfall.

An accurate analysis of the organization's capital position, as commonly prepared as part of an integrated strategic financial plan, enables organizations to identify their expected capital shortfall. In an era of flat-to-declining revenue, cost-reduction goals should be established to close as much of this capital shortfall as possible. The goals quantify the performance levels necessary to fund the organization's strategies and maintain its competitive financial performance. In this way, goals are connected directly to the organization's current financial position as well as its current and future strategic capital and other requirements.

All organizations should be thoroughly revisiting their integrated plan to examine the cumulative, projected impact of strategic initiatives and changes due to health care reform and the new business model. Projections of payment, volume, capital costs, capital investment needs, and other variables are changing and will likely continue to do so.

Strategy 3. Use internal and external benchmarks to identify possible sources of savings.

To define the sources and amount of possible savings, organizations can review historical trends, apply global and departmental benchmarks and peer department comparisons, and conduct supplementary drill-down data analyses.

Given operating characteristics that may be unique to the departments at any specific organization, there are limitations of, and sensitivity to, benchmarking. However, use of specific benchmarks, available within the organization or industry, is often entirely appropriate. Use of both internal and external benchmarks helps to build consensus within the organization around the level of cost reduction that may be available.

Strategy 4. Supplement benchmark data with other data analyses.

Other data analyses can be used to identify savings opportunities and validate cost-reduction estimates as realistic and achievable. A range of opportunities can be identified for each department using historical trends and budgeted performance, for example. While a department manager may not agree about the applicability of one benchmark source, use of three reference points will triangulate the savings and support the appropriateness of cost-reduction opportunities and targets.

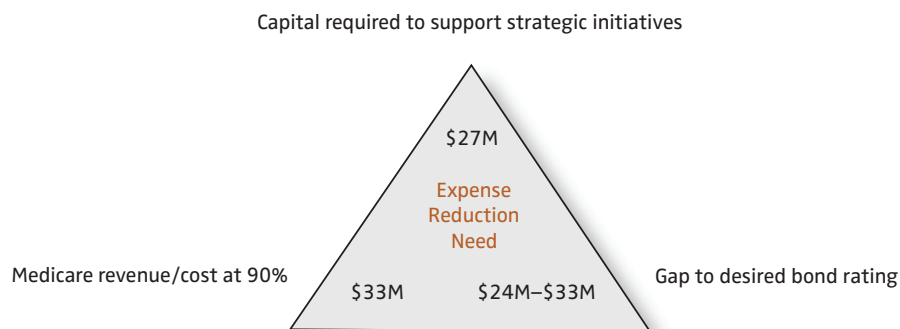
Example: A community hospital and a small multihospital system each used data from the following three separate analyses to quantify their expense reduction needs and opportunity:

- » The operating performance improvement that would be required to support their strategic capital needs
- » Cost reductions that would be required to bring the hospital or each facility within the organization to a 90 percent Medicare revenue-to-cost ratio (which was then extrapolated to Medicaid and commercial business)
- » Potential cost savings based on application of industry cost benchmarks (median ratios for health care bond ratings, as published by the rating agencies)

Figure 3 illustrates how triangulation of data from these three sources helped the health system to identify a preliminary expense-reduction target of \$30 million or more and the community hospital to identify a global cost-reduction target of \$7 million. Analyses related to each source quantified the level of improvement (i.e., cost reductions) needed to position the organizations to support a greater level of capital investment, enhance operating performance, and improve their balance sheets.

To achieve the target, the example health system identified staffing and productivity initiatives centered on the following: better alignment of staffing levels to patient demand; better targeting of workloads and assignments; reduced use of overtime and premium labor through cross-training; and reduced functional redundancies across the facilities. The hospital identified similar initiatives.

Figure 3. Understanding Cost-Reduction Needs



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Strategy 5. Understand and focus on the key drivers of staffing and productivity problems.

The types of cost-reduction opportunities and their drivers vary by organization, but many of these are common to hospitals and health systems nationwide, independent of size (see sidebar 1). Staffing and productivity drivers should be a key focus, as labor costs often constitute more than half of an organization’s operating expenses.

Example: By addressing both cost structure (doing the right things) and cost management (doing things right), an independent community hospital identified 10 labor cost-reduction initiatives. Figure 4, a high-level mapping of the financial impact expected of these initiatives, can be used for all types of improvement opportunities.

In the cost-management domain, the “align staffing plans and schedules” initiative—number 1 in the graph—ensures that staff work schedules appropriately reflect patient and workload demands and staffing plans. This initiative can yield significant financial return and thus appears at the top of the high-impact quadrant for cost-management efforts.

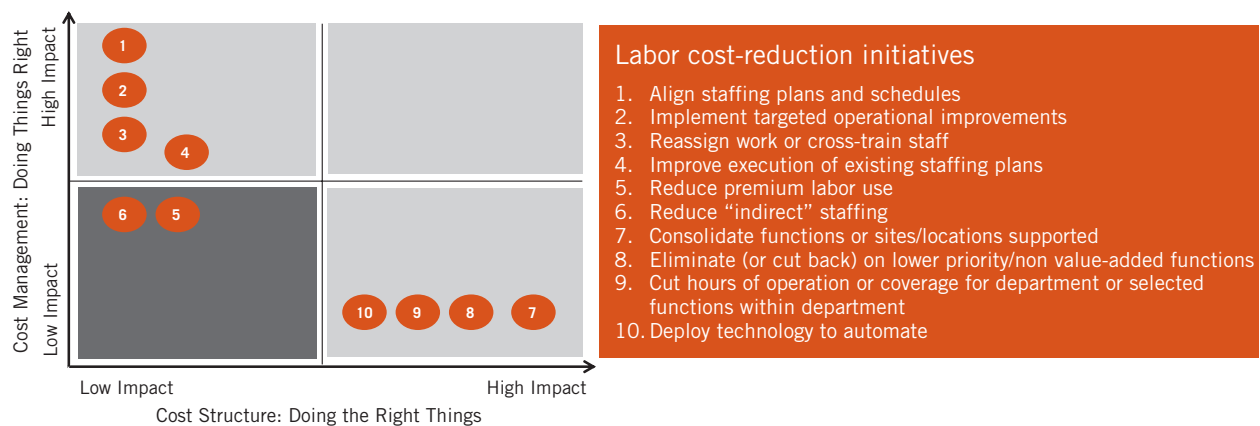
Cost-structure initiatives, such as “consolidate functions or the sites/ locations supported” (number 7 in the graph), also can be expected to yield a high return. Such initiatives could include, among other things, eliminating duplicative services in over-served markets and consolidating the number of satellite laboratory locations. Similarly, initiatives to “eliminate or cut back on lower priority/non–value-added functions”—number 8 in the graph—can provide considerable savings. A structural approach to scrutinize all work and functions for their cost/benefit “value” can be used, looking at both the importance of the functions and how well they are being performed.

Sidebar 1. Key Drivers of Staffing and Productivity Inefficiencies

- » Inadequate plans/ alignment
- » Poor execution of staffing plans
- » Inappropriate/unclear staffing roles, target workloads, and assignments
- » Service and functional redundancy/excess capacity
- » Insufficient management controls
- » Use of overtime/premium labor

Source: Kaufman, Hall & Associates, Inc. Used with permission.

Figure 4. Labor Cost-Structure and Cost-Management Opportunities



Source: Kaufman, Hall & Associates, Inc. Used with permission.

Strategy 6. Drill down on staffing methods.

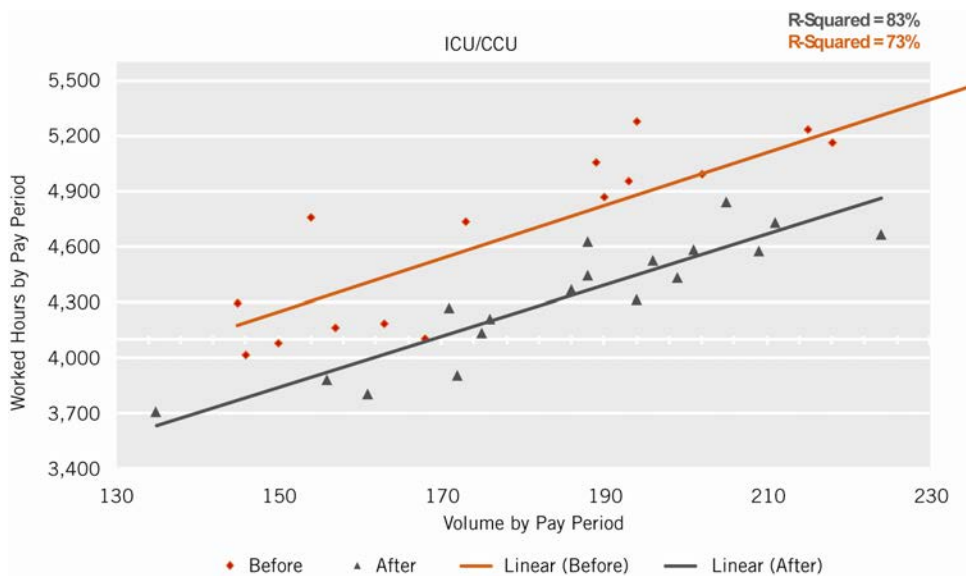
Poor alignment of staffing with patient volume, coupled with poor execution of existing staffing plans, can be among the more common contributors to high labor costs. While organizations may believe that their current staffing methods are highly effective in matching staffing and volume, such assumptions should be rigorously tested.

It may be possible to strengthen the relationship between staffing and patient demand. Staff schedules may not be geared to when patients arrive at the operating room or emergency department, for example. Planning for staff “flexing”—i.e., adjustment upward or downward with changes in volume—may not be occurring as expected. A close review of census-based staffing grids for inpatient units can reveal a less-than-ideal correlation between staffing and volume.

Figure 5 illustrates the results of a concerted effort by one hospital to more closely align staffing to demand in its intensive care and critical care units. The diamond-shaped points are the values for hours worked by pay period at specific patient-volume levels *before* alignment. The triangle-shaped points reflect staffing *after* focused alignment efforts were implemented. The effectiveness of this effort can be seen in the improved statistical alignment of staffing to demand as measured by the correlation (R-squared value), which increased to 83 percent from 73 percent.

Additionally, the data demonstrate the department’s ability to improve the efficiency of staffing at every volume level. This is illustrated by the fact that the black “after” line is lower at all points on the chart than the orange “before” line. This productivity improvement/staff alignment initiative saved the organization nearly 600 hours of staffing cost per pay period.

Figure 5. Aligning Staffing to Volume Demand



Note: The red line is performance before the initiative; the black line is performance after the initiative.

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Strategy 7. Streamline overhead functions.

Opportunity exists in most multifacility organizations to achieve greater “system-ness” by eliminating redundancy of functions across facilities. Cost savings can be achieved through selective centralization or regionalization of administrative and/or overhead services and functions. These include human resources (HR), accounting and finance, revenue cycle, information technology, marketing, legal/risk management, and materials management, among others. Consolidation at the appropriate level can improve operations and yield large savings.

Example: Figure 6 illustrates how one health system reallocated HR functions, resulting in FTE savings of \$6 million. The system achieved such savings by reducing the duplication of HR services and reducing excess capacity. A large portion of the savings resulted from the health system’s decision to relocate several HR functions to regional or system-level offices.

A data-driven and objective evaluation of system services from a “total spend” perspective, regardless of where such services may currently reside, is highly recommended.

Figure 6. Integration of Systemwide Human Resource Functions

Human Resources Current Structure								
	Hospital A	Hospital B	Hospital C	Hospital D	Hospital E	REGIONAL	SYSTEM	TOTAL
Current FTES	11.2	7.4	16.1	18.0	13.0	0.0	6.3	72.1
Organizational Development	X	X	X	X	X			
Human Resources Info Systems (HRIS)	X	X	X	X	X		X	
Employee Relations	X	X	X	X	X			
Benefits	X	X	X	X	X			
Compensation	X	X	X	X	X			
Employee Health	X	X	X		X			
Staff Training	X	X	X	X	X			
Labor Relations	X	X	X	X	X			
Employment Recruiting	X	X	X	X	X			
Workers' Compensation	X	X						
Human Resources Proposed Structure								
	Hospital A	Hospital B	Hospital C	Hospital D	Hospital E	REGIONAL	SYSTEM	TOTAL (1)
Recommended FTES	5.2	3.6	8.0	8.8	6.4	20.0	11.2	63.2
Organizational Development						X		
Human Resources Info Systems (HRIS)							X	
Employee Relations	X	X	X	X	X			
Benefits							X	
Compensation							X	
Employee Health						X		
Staff Training						X		
Labor Relations						X		
Employment Recruiting						X		
Workers' Compensation							X	
FTE Savings Due to Rationalization of H.R. Functions	6.0	3.8	8.1	9.2	6.6	-20.0	-4.9	8.9

Note: As evident from the many red boxes on the top portion of this illustration and the comparatively fewer boxes on the bottom portion, this organization was able to significantly reduce duplication of overhead HR functions.

Source: Kaufman, Hall & Associates, Inc. Used with permission.

Sidebar 2. Lessons from the Trenches

- » Targets *without* specific improvement initiatives will produce unsatisfactory cost savings.
- » Improvement initiatives *without* targets may enable or support various organizational priorities but will produce unsatisfactory cost savings.
- » Leaders must understand the political will or appetite to pursue cost reduction in traditionally sensitive areas before undertaking such a strategy.
- » Periodic “look backs” are helpful in evaluating how the organization’s cost structure has evolved and whether opportunities exist to use resources more effectively in support of mission and strategy.
- » Results must be tracked meticulously.

Source: Kaufman, Hall & Associates, Inc. Used with permission.

Strategy 8. Ensure that cost-reduction targets are integrated with organizational plans and budgets.

To realize cost reductions, the specific initiatives identified through the processes just described must be thoroughly integrated with the organization’s strategic financial plan, annual budget, and operating plan. Targets and reports must be aligned with financial statements so that the impact of initiatives is reflected in overall organizational performance. To ensure that progress toward specific goals can be monitored and measured, the initiatives also must be readily identifiable within these plans.

Additionally, productivity reporting systems and target metrics must integrate appropriately with the organization’s budget. Staffing plans with aligned staffing schedules should be reflected in the budget as well. If “disconnects” occur among any of these elements, cost efficiencies and reductions will be very difficult to achieve and will result in expenses that are higher than expected or warranted.

Target setting and achievement are critical leadership functions. But, targets alone are not sufficient. They must be monitored, readjusted, and reported upon departmentwide and/or organizationwide. The best results are achieved when targets are assigned to specific improvement initiatives and specific executives. Stretch targets must allow for “slippage” in planning and execution. Beware of an unwillingness to set targets! Sidebar 2 provides lessons from the trenches.

Takeaways

- » Detailed awareness of your organization’s current level of preparedness for strategic cost management is critical to effective planning.
- » In an era of flat-to-declining revenue, cost-reduction goals should be established to close as much of the organization’s capital shortfall as possible.
- » Staffing and productivity cost drivers should be a key focus, as labor costs often constitute more than half of an organization’s operating expenses.
- » To realize cost reductions, the specific savings initiatives identified by the organization must be specifically identified **and** integrated components of the strategic-financial plan, annual budget, and operating plan.

Strategic Businesses and Services and Their Distribution

Forward-thinking health care organizations, whether freestanding hospitals, multihospital systems, or other provider entities, are evaluating all aspects of their business in light of changing market conditions and requirements for future success under the new business model. They are asking, “What businesses and services are core to our mission and vision going forward?” and “Where can we most effectively invest our limited capital and human resources to meet the continuing health care needs in our communities?”

The costs involved in building competencies for the new business model, including tight physician integration, care-management infrastructure, a sophisticated health information technology platform, and partnerships across the care continuum, will be considerable for all organizations. For small community hospitals, it may not be possible to continue being “all things to all people.” Rather, community access to needed services may have to be accomplished through referral or partnership arrangements. Eight strategies can help hospital and health system executives and boards define the business strategies appropriate to their organizations and the plan by which those strategies can be executed.

Strategy 1. Start with an evaluation of your organization’s strategic options.

Identification and assessment of strategic options under alternative scenarios, supported by integrated strategic-financial planning related to these options, are more important than ever before in order to get to sustainable organizational positioning. Evolving incentives will force inefficiencies out of the broader health care system; those organizations unwilling or unable to make necessary strategic changes are at risk of being marginalized in their markets.

Strategy 2. Evaluate each business unit and service line to identify core elements.

Criteria for this evaluation should include, fit with strategic mission and vision in community or communities served, current market attractiveness, competitive landscape, current financial performance, and projected financial performance under new delivery and payment models. Sidebar 3 provides the key questions that health care boards and management teams must ask and answer.

Strategy 3. Use a structured process to analyze the core businesses and services.

Using a structured approach, the efficiency and effectiveness of each business and service should be evaluated, as should the organization’s ability to sustain the business or service’s relevance in a changing market (see figure 7).

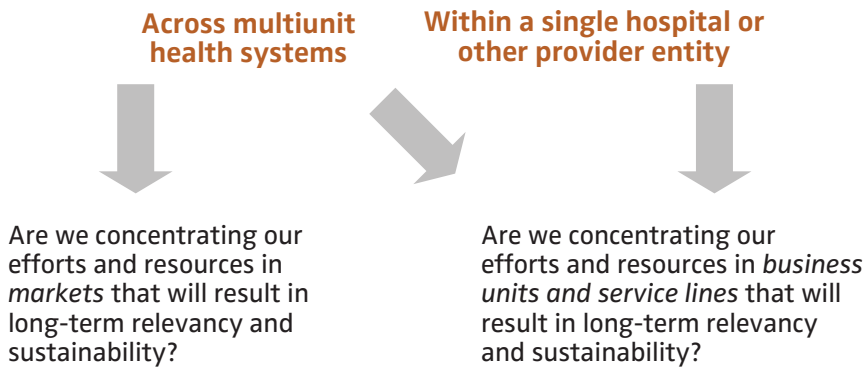
The multistep approach involves the following: articulating organizational goals; identifying the businesses and services for consideration; evaluating the geographic market; assessing each business/service within that market; identifying how services could be better distributed across the delivery system; formulating strategy for achieving more optimal distribution; preparing and evaluating volume and financial projections for individual businesses/services and the hospital or health system; making and implementing decisions for desired future delivery system.

Sidebar 3: Five Questions to Guide Leadership Thinking About Essential Businesses and Services

- » Is this an *essential* business/service that is required to deliver upon our mission?
- » Is this business/service fully integrated into the fabric of our organization and its care delivery model?
- » Will this business/service become more or less relevant as success requirements under reform and the new business model evolve?
- » Is our organization best positioned to own and operate this business/service or could another organization provide these services more effectively and efficiently for our community or communities through contractual and other relationships?
- » How can our resources be most effectively deployed to maintain and further advance our mission and strategic position?

Source: Kaufman, Hall & Associates, Inc. Used with permission.

Figure 7. Approach to Assessing Businesses and Services



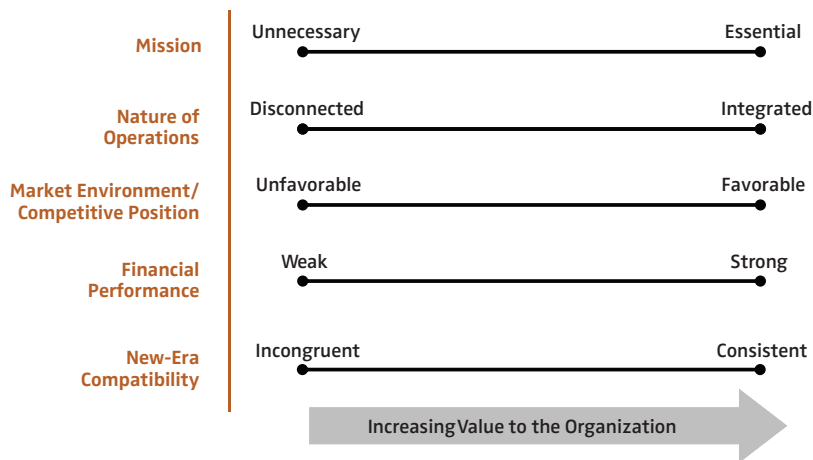
Source: Kaufman, Hall & Associates, Inc. Used with permission.

Strategy 4. Implement a business/service line analysis framework.

The framework should consider mission, nature of operations, market environment/competitive position, financial performance, and compatibility with new-era needs and competencies (see figure 8). Appendix A includes a full description of each framework element.

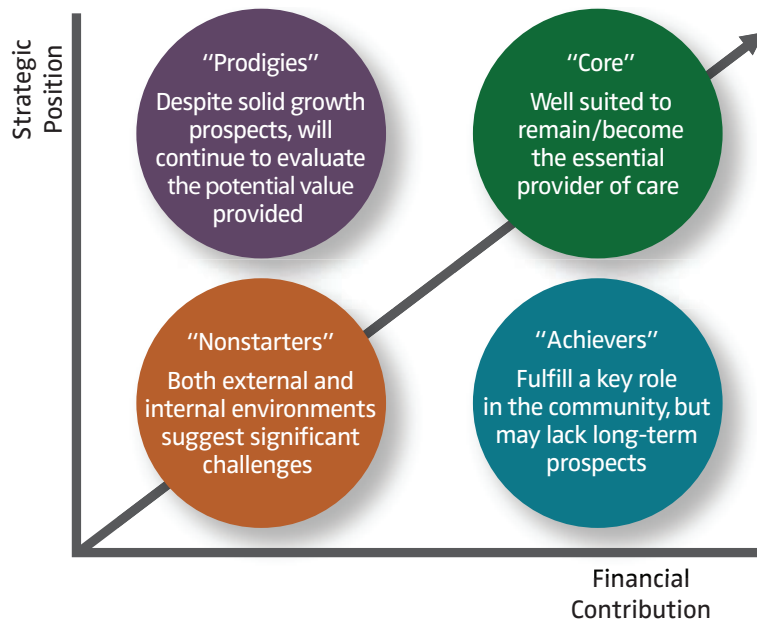
Ultimately, discussions related to an organization’s businesses and services must openly address total value of the business to determine if it is the best use of scarce resources available to meet community needs. Figure 9 provides an appropriate evaluation matrix, with four categories of businesses and services—core, achievers, nonstarters, and prodigies—as defined along strategic-position and financial-contribution axes. Tough decisions will need to be made and implemented by hospital and health system boards and executives teams.

Figure 8. Framework for Business/Service Analysis



Source: Kaufman, Hall & Associates, Inc. Used with permission.

Figure 9. Business/Service Evaluation Matrix



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Example: Given the significant capital investment requirements of the new business model, one academic medical center evaluated its options in the changing landscape. The evaluations started with the development of a financially oriented business plan for each service line and business unit currently owned and operated by the organization. The medical center owned a home health business and a reference laboratory business, among other entities.

Each business plan was supported by fact-based assumptions about volume, revenue, expense, and associated capital costs going forward. Sensitivity and scenario analyses were completed for the key drivers to understand the range of possible outcomes. Each plan was integrated into the organization’s long-term strategic financial plan in order to understand the impact of the businesses on the organization’s strategic and financial success going forward.

Home health business. The academic medical center needed access to high-quality post-acute care in order to manage patients’ health following discharge, thereby minimizing readmissions. But the economics of its home health business were difficult. Competition was intense in its market. The business was not profitable, and its losses were expected to increase. The medical center was concerned about its ability to sustain the business in the long run and provide the necessary capital and resources to maintain ongoing quality services. It decided to divest the home health business to one of the major players in the market, which could continue providing quality services more effectively and efficiently in the community. The divestiture would mitigate the medical center’s losses and enable the organization to redirect capital capacity to initiatives in its core competency and mission-driven areas.

Reference laboratory business. The academic medical center’s reference laboratory business, on the other hand, was very profitable, having been significantly capitalized over the years. But the business did not meet leadership’s criteria for core services, as identified through the key questions outlined in sidebar 3. Two large laboratory companies, which already provided services in the community, proposed to purchase the medical center’s business to increase their market penetration. The medical center decided to divest its reference lab business and use the proceeds to build its balance sheet in support of core strategic initiatives.

Sidebar 4. Critical Questions for Defining Your Organization's Position in the New Landscape

- » What services should we be offering in each location (and to what scope and scale), with consideration of the population's care needs and of access, cost, and quality objectives?
- » Are there services that we currently provide in multiple locations that could or should be concentrated at fewer sites (for example, specialty-based ambulatory services, resource-intensive services)?
- » Are there other services that require broader access (for example, primary care) and services that should be covered in lower-cost intensity settings?
- » If we were able to start fresh, what would be an optimal care delivery system across our inpatient and outpatient offerings?
- » How can we migrate from our current situation toward this more optimal system?

Source: Kaufman, Hall & Associates, Inc. Used with permission.

Strategy 5. Understand when and why service distribution planning will be needed.

Service distribution planning is structural work that reshapes the programs and services offered by an organization across its geographic markets. Given the strategic and capital challenges posed by the new business model, such work will likely be required of many types of organizations and for many different reasons, including the following:

- » Community hospitals that wish to remain independent will need to redefine their service offerings, including inpatient and ambulatory sites, to maintain competitive performance.
- » Community hospitals that wish to partner with another community hospital to form a system or to join an existing health system will want to determine the fit of their business and service offerings.
- » As community hospitals partner with or join regional health systems, parent systems will need to integrate hospitals, outpatient facilities, and physician networks to deliver a coordinated system of care and gain scale efficiencies.
- » Before proceeding with transactions, partnering organizations will need to be certain of marketplace synergies for effective operations going forward.
- » Smaller multihospital community health systems will need to refine their service offerings to strengthen their market position.
- » Regional and super-regional systems will begin focusing beyond aggregation of providers to increase the efficiency and effectiveness of delivery system resources.

Service distribution planning is aimed at determining the appropriate level of care, access, and quality to achieve desired outcomes at a cost that considers the needs of patients and payers. At the same time, such planning aims to maximize capital capacity and to ensure that the organization remains financially competitive. The end product is a plan that drives improved operating performance through efficient care delivery across a geographic area, without compromising quality and outcomes, and often improving both.

Strategy 6. Initiate the process of defining the most efficient and effective distribution of services.

Health care executives and boards are now working to define their roles in local communities, to ensure that their organizations deliver value-based care, and to manage the transition. They are asking and answering critical questions that often require difficult decision making (see sidebar 4).

Given the speed with which health care is expected to change, delay in answering these questions increases the probability that markets will shift *around* organizations that are not redefining or refining their service distribution. As relationships between payers, physicians, hospitals, health systems, and other providers are secured in the new environment, organizations must have a clearly articulated service distribution strategy to remain relevant.

Additionally, inefficient service distribution stresses an organization's clinical, facility, technological, human, and capital resources, making the organization less viable as a value-based provider.

Strategy 7. Use a structured framework for service distribution planning.

Similar to the process used to evaluate and analyze the organization's core business and service offerings described earlier, the service distribution planning process should be a structured one, using a solid framework.

Educating the board, management, and physicians about why it is important to restructure the service delivery system provides the starting point. All key constituents need to understand the changes that are occurring in the environment and why this effort is essential to reposition the organization for sustained success. A clear and concise objective statement should be crafted and then reaffirmed on almost a continuous basis throughout the planning effort.

Strategy 8. Ensure a solid fact base for the service distribution plan.

A solid fact base provides a foundation that helps better contextualize barriers or challenging issues going forward. The fact base includes data related to the organization’s markets, strategic and financial positions, and the impact of current and possible future trends on those markets and positions. Within the planning framework, key realities and assumptions must be defined related to payment mechanisms, the competitive environment, physician market characteristics, and core competencies required for provider success (see figure 10).

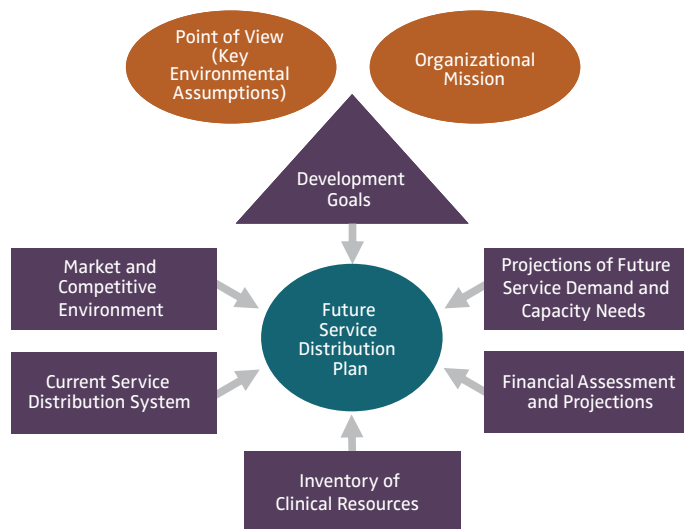
A comprehensive financial fact base must also be developed, quantifying the organization’s capital position, future financial position, and debt capacity. In the current uncertain environment, scenario modeling and sensitivity analyses are imperative in order to understand how changes in utilization, payment, capital, and other assumptions will impact future strategic and financial performance.

The final plan that is developed for the service delivery system, based on the above-described process, fully defines:

- » How the organization will serve the market
- » How each of the organization’s operations and service lines will relate to other operations and service lines
- » How clinical resources will be organized and deployed
- » The financial impact of the service distribution plan on the overall organization

Most organizations will not be able to be all things to all people. They will need to define and re-scope core community service offerings as appropriate to overall capital, management, and clinical resources.

Figure 10. Service Distribution Planning Framework

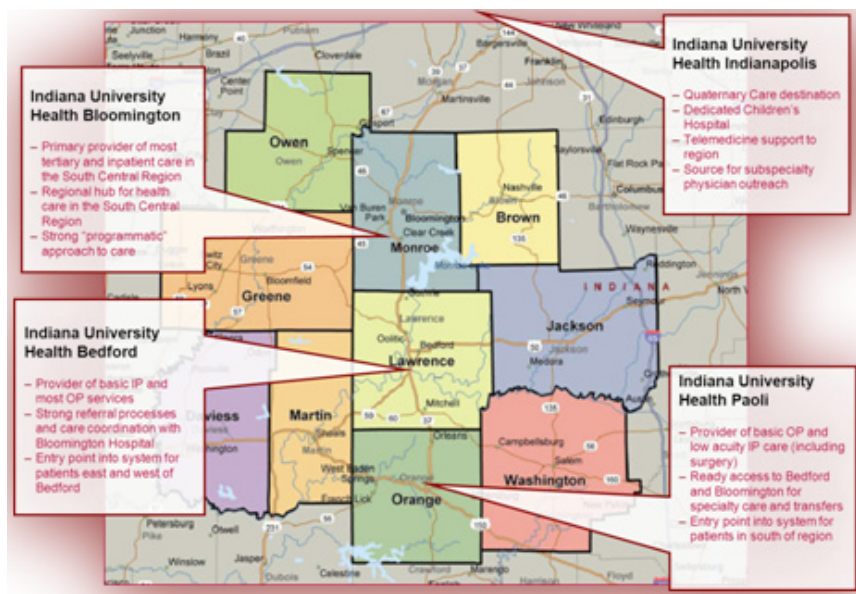


Source: Kaufman, Hall & Associates, Inc. Used with permission

Example: To effectively deliver high-value and high-quality patient care, i.e., the right care (at the appropriate level/scope) at the right locations, and at the right cost, Bloomington Hospital in Bloomington, Indiana, and Indiana University Health, headquartered in Indianapolis, initiated service distribution planning in connection with the affiliation of Bloomington Hospital with the IU Health system. The organizations wanted to have in place a regional service delivery plan that would optimize the delivery of the combined entity's services in South Central Indiana. A regional plan would enable the combined organization to serve patients as close to their homes as possible, improve referral processes and physician support, improve care coordination, enhance the quality of services being provided, and ensure a seamless care delivery system.

Figure 11 provides a high-level look at the strategic roles envisioned for entities within Bloomington Hospital and IU Health. By focusing and optimizing their combined geographic footprint once the affiliation was completed, Bloomington Hospital and IU Health ensured appropriate coverage to serve their service areas, without unnecessary saturation or overextension of clinical, human, or technological resources in ambulatory or inpatient settings. Appendix B provides additional information on this example.

Figure 11. A Service Distribution Plan for the South Central Indiana Region



Source: IU Health and Kaufman, Hall & Associates. Used with permission.

Takeaways

- » Forward-thinking health care organizations, whether freestanding hospitals, multihospital systems, or other provider entities, are evaluating all aspects of their business in light of changing market conditions and requirements for future success under the new business model. They are identifying core businesses and services using concrete criteria.
- » Hospitals and health systems should use a structured process and fact-based framework to analyze their core businesses and service lines. Discussions must openly address total value of each entity to determine if each is the best use of scarce resources.
- » Most organizations will not be able to be all things to all people. They will need to define and re-scope core community service offerings as appropriate to overall capital, management, clinical resources, and community need.
- » Tough decisions will need to be made and implemented by hospital and health system leadership.
- » Given the strategic and capital challenges posed by the new business model, service distribution planning will likely be required of many types of organizations and for many different reasons.
- » The end product of service distribution planning is a plan that drives improved operating performance through efficient care delivery across a geographic area without compromising quality and outcomes, and often improving both.

Concluding Comments

The transformation of U.S. health care to a very different delivery and payment system is underway. Proactive executives are moving forward aggressively to reshape and streamline their costs in anticipation of this new health care environment. Hospital and health systems leaders have an opportunity to make a significant contribution to health care delivery in their communities by moving their organizations toward value-based care, using the strategies of strategic cost transformation outlined here. The time to move is now.

Appendix A

Components of an Analysis Framework for Businesses and Service Lines

Essentiality of a business to an organization's mission

This element is exceedingly difficult to measure. As with most social goods, there is a nearly insatiable appetite for the services that hospitals and health systems provide for the benefit of their communities. Mission considerations include, among others: benefit provided to, and support provided by, the community; whether a void would be created if the business/services were not provided; and whether other organizations would appropriately fill that void.

Nature of operations

Considerations include: whether patients/customers flow across the businesses and services or whether the operations are detached and separate; the extent to which the business/service functions as a stand-alone operation (i.e., systems, management, funding of operations, utilization of shared services); the alignment of associated strategic requirements and financial incentives with the core operations of the organization; and the downstream or upstream implications of eliminating this business/service.

Market environment and competitive position

Considerations include: attractiveness and demand for this business/service; the key industry drivers and requirements for success of this business/service; the intensity of competition and the organization's ability to differentiate from others; and whether the organization has a competitive position that is relevant and sustainable in its market.

Financial performance

Considerations include: the historical financial performance of the business/service; the level of financial performance generally achieved within the industry for this type of business/service; future capital requirements and the level of performance that can be expected; the estimated valuation of the business/service; the impact divestiture would have on the overall credit profile and the financial position of the organization; and the impact development of a new business/service or acquisition would have on the credit profile/financial position of the organization.

New-era compatibility

Considerations include: whether the business/service supports longitudinal patient management across the continuum of care; whether this business/service creates or supports strong physician-hospital alignment; its impact on the organization's brand and image; whether this business/service has a material cost structure advantage or disadvantage relative to competitors; and whether the organization can be an essential provider of this business/service with sufficient scale of operation to succeed.

Appendix B

Example of Effective Distribution of Services at Indiana University Health

Objectives

To effectively deliver high-value, high-quality patient care, i.e., the right care (at the appropriate level/scope) at the right locations, and at the right cost, Bloomington Hospital in Bloomington, Indiana, and Indiana University Health, headquartered in Indianapolis, initiated service distribution planning in connection with the affiliation of Bloomington Hospital with the IU Health system.

The organizations wanted to have in place a regional service delivery plan prior to their integration in 2010 so that the delivery of services would be optimized once the affiliation was completed. A regional plan for South Central Indiana would enable the combined organization to serve patients as close to their homes as possible, improve referral processes and physician support, improve care coordination, enhance the quality of services being provided, and ensure a seamless care delivery system.

Processes

Bloomington Hospital and IU Health sought to gain a comprehensive understanding of their service areas, their strategic and financial positions, and the impact of current and possible future trends on those areas. A thorough fact base was developed for the two organizations. Key strategic analyses included a service delivery profile, physician and key clinician resource inventory, facilities assessment, competitive evaluation, and an internal performance profile.

For planning to be successful, a team-based approach was used. Board members, executives, physicians, and staff provided needed information and perspectives to help ensure success at the implementation stage. A facilitated committee structure proved effective. A thorough schedule of activities and a timeline kept the teams moving toward goals within a tight time frame.

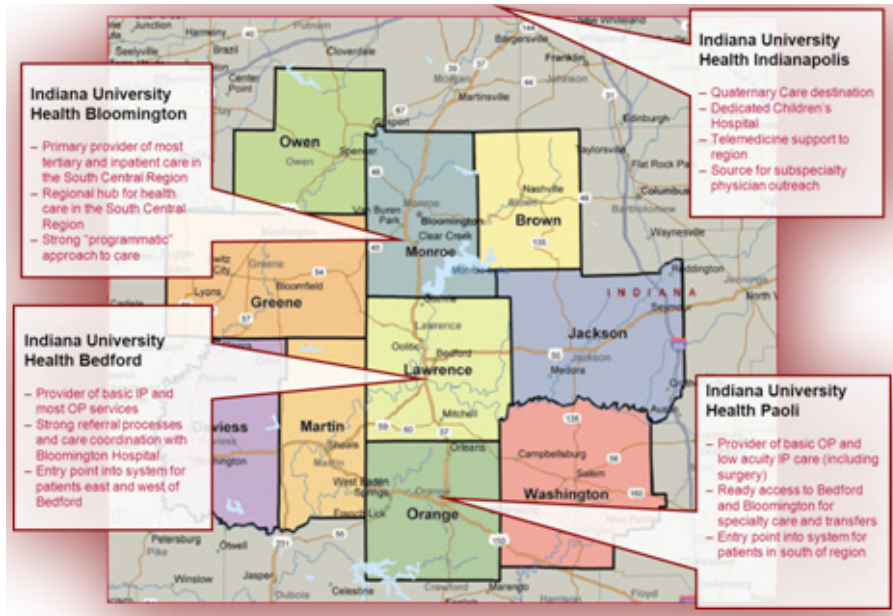
A management steering committee, whose members included systemwide leadership and executive management from each of the organization's hospitals or major facilities, provided oversight throughout the process.

At the conclusion of the planning process, the roles for each of the system's major hospitals and medical centers were as follows:

- » IU Health Bloomington (290 beds) would serve as the primary provider of most tertiary and inpatient care to the South Central Region.
- » IU Health Paoli (25 beds), formerly Bloomington Hospital Orange County, would provide basic outpatient and low-acuity inpatient care (including surgery) for patients in the southern portion of the region.
- » IU Health Bedford (25 beds), which was owned by IU Health prior to the merger, would provide routine inpatient and outpatient services for patients east and west of Bedford.
- » IU Health Indianapolis (2,000 beds) would provide sophisticated quaternary care throughout the region, including a dedicated Children's Hospital, telemedicine support, and subspecialty physician outreach.

Figure 1 provides a high-level look at the strategic roles envisioned for entities within Bloomington Hospital and IU Health.

Figure 1. A Service Distribution Plan for the South Central Indiana Region



Source: IU Health and Kaufman, Hall & Associates. Used with permission.

Clinical task forces, comprised of key physician and administrative leaders representing each service line and clinical site, served as the core planning groups for service lines. Through an iterative facilitated process, they developed preliminary plans defining which services will be offered at which sites and to what scale, considering both existing and potential new locations.

A *facility planning task force* reviewed facility priorities and investment needs and provided direction on how the investments should be prioritized. The team based its recommendations on the volume/capacity, operating impacts, and associated capital requirements of specific strategies or initiatives identified by the other teams, for example, ambulatory services joint ventures, inpatient programs, and others.

Based on the work accomplished by the teams, the financial impact of the regional strategic plan on the combined organization was assessed. The resulting service distribution plan included: definition of the service delivery system; service area, program/service, physician, operating, and other strategies; facility impacts; organizational structure and implementation considerations; and financial goals.

Outcomes

By focusing and optimizing their geographic footprint, Bloomington Hospital and IU Health ensured appropriate coverage to serve their service areas, without unnecessary saturation or overextension of clinical, human, or technological resources in ambulatory or inpatient settings.

For example, Bloomington Hospital Orange County (in Paoli) would focus on basic outpatient and low-acuity inpatient care, while Bedford Regional Medical Center, 20-plus miles north of Paoli, could also offer more complex treatments in a few selected areas. This would allow patients in surrounding counties to receive certain care locally, rather than having to drive 20 or more miles further north to Bloomington Hospital. By providing a more sophisticated level of selected services at one of its small hospitals, the system could also avoid operating an underperforming program at each of the locations.

IU Health Indianapolis and Bloomington Hospital were able to complement each other's services. A coronary artery bypass graft surgery program, which had been in place at Bloomington Hospital since the mid-1990s, would continue at that site, reserving the quaternary Indianapolis-based hospital for the most complex, critical heart cases requiring the highest level of clinical and technological sophistication. The cardiovascular surgery group at IU Health Indianapolis was able to help Bloomington Hospital by placing two full-time surgeons at Bloomington Hospital, as and when needed by that hospital.

This plan enabled the higher-cost Indianapolis hospital to avoid overbuilding its facilities to accommodate volume that actually required a lower level of sophistication. The plan totally reshaped the way the organization was looking at plans for major facility renovations, enabling the organization to make the best possible use of scarce capital and clinical resources.