



# CostPerform – delivering bottom line benefits

## Measuring profitability in a UK private hospital group

A UK private hospital group assessed that the healthcare market would be undergoing rapid and radical change. Over the next four years, it predicted the following trends:

- Downward pressure on prices and lower margins
- Increased capacity as the private sector undertakes NHS work, and as new entrants from abroad appear - often cherry-picking profitable business
- Changes in clinical practice and technology that lead to shorter lengths of stay in acute settings, and more day-case, ambulatory and mobile treatments
- Shrinkage in the private healthcare market as the NHS waiting times reduce
- A shift in 'buying power'

The group had positioned itself strategically to develop its business with both the NHS and private patients. This meant not only a change to the mix of products, services and customers, but also changes to corporate culture and the complex web of relationships which had evolved in the healthcare market over many years - between the NHS and the private sector, between hospitals and consultants, and between patients and their healthcare providers. Every single change was expected to have cost and profitability implications. However, the organisation had no credible, consistent information on net profitability at any more detailed level than hospital profitability. Basically, it was flying blind.

“Margin management is our key weakness in a sound over-arching strategy.”

CEO

## The solution

The group decided to develop an Activity Based Costing (ABC) model of net product, service and customer profitability. The project was seen as vital to meeting the group's strategic objectives through having a material impact on the group's ability to:

- develop appropriate pricing strategies for the different markets in which it operates;
- evaluate financial risk when bidding for contracts;
- negotiate profitable contracts with current and potential customers, including insurers, corporate clients, self-pay consumers, and the NHS in all its forms;
- inform ad hoc pricing decisions;
- plan and manage capacity by identifying bottlenecks, and separately to evaluate the costs of usable spare capacity;
- counter cherry-picking by new entrants;
- compete successfully with other providers;
- understand its operational costs, and thereby to control them better and to reduce them;
- benchmark costs and profitability internally and to identify opportunities for operational improvement, within the bounds of best clinical practice;
- optimise the operating margin, by modeling the cost implications and the profitability of different case mixes and volumes of business.

The Activity Based Costing initiative was designed to deliver the costs and profitability of:

- episodes of care, patient pathways (by OPCS codes and for HRGs);
- service elements ('components' of care, such as imaging, physiotherapy, theatre time, accommodation, and drugs);
- individual customers and different customer groupings (insurers, self-pay and different categories of NHS work);
- different payment agreements within customer groupings;
- consultants;
- care settings - in-patient, out-patient, day-care.

## Typical results from the Activity Based Costing model

For each HRG the 'contribution' or net profit was defined as revenue less direct costs and its accurately-assigned proportion of overhead costs. A curve of cumulative contribution was plotted with the highest contributing HRG on the left through to the lowest (in fact negative) contribution on the right (see Figure 1 right).

Because the cost model contains the complete hierarchy of costs that were assigned to the HRG it is a simple matter to travel back through the model to find the procedures, activities and other costs that have contributed to the final cost.

The results are often counter intuitive. Old favourites thought to be very profitable were found to have zero net margins or worse, so the strategy of increasing the volume of these HRGs needed to be revisited.

Likewise, other HRGS turned out to be real profit generators - largely ignored in the past, but offering real opportunities in the future.

Calculating the costs of servicing each customer or groups of customers, and comparing this total cost with revenue gave the net profitability for individual customers.

Sorting customers on the basis of the return on sales, highest on the left, and then plotting the curve of cumulative customer profitability against cumulative sales showed where the best returns were being made (see Figure 2 right).

It showed, for example, that for one customer (insurer 'B') who provided the largest increment of sales revenue, the return on sales was very small.

In a highly competitive market such large volumes of zero margin business can pose a risk. The company was keen to replace some of this with customers providing a higher return.

Armed with the outputs of the analysis of costs and profitability the hospital group was able to focus management attention on many areas and actions that would lead to overall increases in profitability from better pricing, discounting, treatment mix, specialization, and improvements to processes in both the clinical and support functions.

By bringing the outputs from the cost model through the intranet direct to managers' desks and by providing the tools to analyse the data and tunnel back through the cost allocations, managers felt they were now in control of profitability.

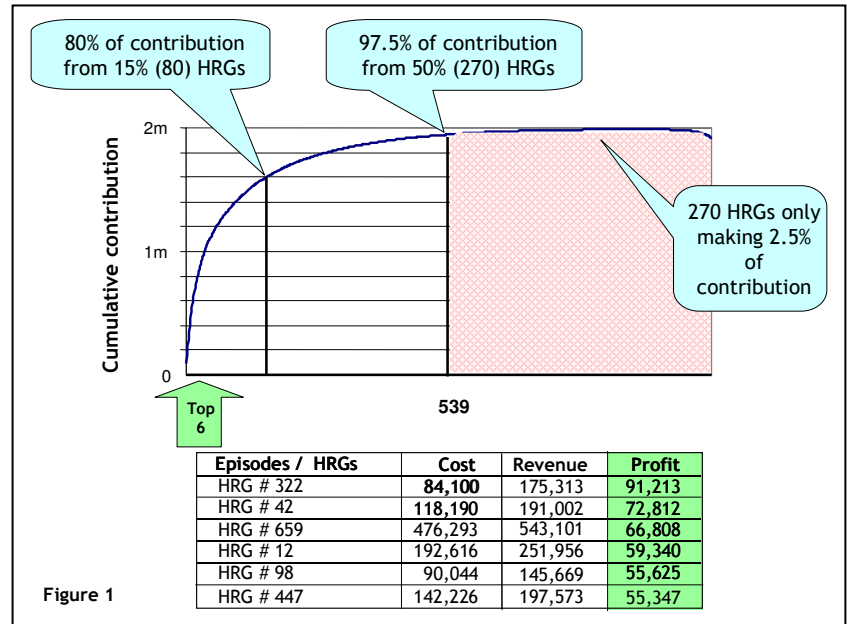


Figure 1

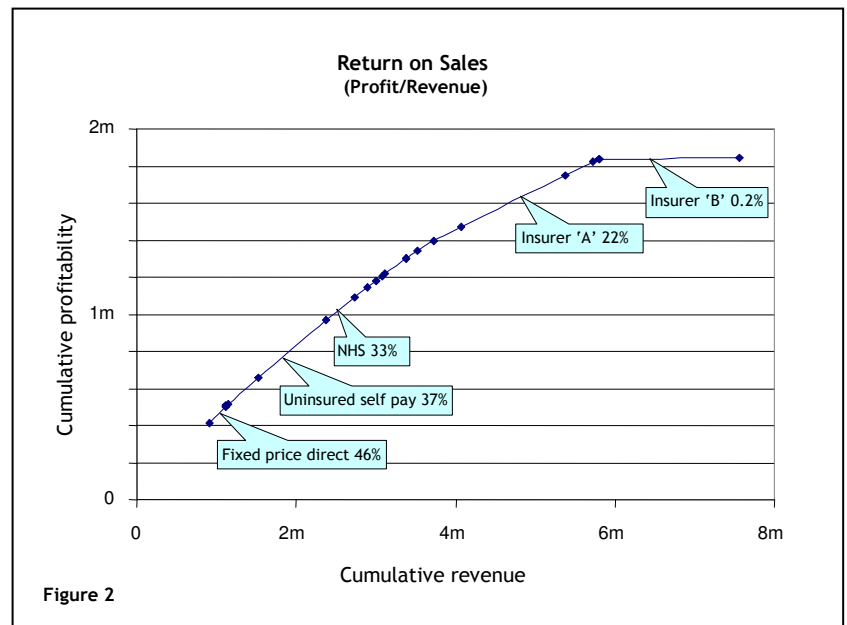


Figure 2

"The added bonus was the use of the cost data to drive process improvements which gave us another source of profit improvement.

Benchmarking across the group found Best Practice which was disseminated to all hospitals"

CEO

