



PRICING GUIDE:

A RESOURCE FOR COMMUNITY-BASED
ORGANIZATIONS TO VALUE AND PRICE SERVICES

PRICING GUIDE



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INTRODUCTION TO THE PRICING GUIDE

Dear Community Partner:

If you are like most community-based organizations, you receive the majority of your current funding from government contracts and foundation grants. Usually, these contracts are based on line-item budgets for a very specific scope of work. However, over the last few years new potential funding sources have materialized, primarily through the implementation of the new health care law. Certain provisions, particularly for older adults and people with chronic medical conditions, stress that the link between medical care and community-based services, such as meals, transportation, care transitions, etc., must be made more seamless ([Overview of Preparing Community-Based Organizations for Successful Health Care Partnerships](#) - Dr. Victor Tabbush, 2012). While this is an important recognition that will greatly benefit the clients we care about, implementation of such a seamless system is complicated. Why, you ask?

Funding mechanisms in the health care sector are quite different from those of most community-based organizations. There is the well-known fee-for-service system, whereby medical providers are reimbursed based on the number of specific services they deliver. Reimbursements can also be based on a bundled services model, such as DRG (Diagnosis Related Group) codes, which combine certain medical procedures for one service payment. And then there is the capitation system, whereby providers get paid a fixed amount per patient for a specified period of time, regardless of how many services the patient uses during that time, leaving the provider to assume the risk of those who use more services than was estimated.

Community-based organizations seeking to become contractual partners with the health care sector will likely have to move from traditional line-item budgets to a fee-for-service, capitation, bundled, or hybrid model. All of these reimbursement models require that community-based organizations know how to determine the cost of each of their services, and price these services in a way that make them market competitive.

The SCAN Foundation developed this Pricing Guide to provide community-based organizations a basic introduction to determining cost and establishing prices. The guide provides some narrative considerations, along with some helpful tools. We welcome your feedback on the utility of this resource so we can improve its effectiveness.

We look forward to traveling with you on this journey of developing integrated medical care and community-based services, which can lead to exciting social enterprises.



René Seidel
Vice President, Programs & Operations

SECTION 1: PRICING STRUCTURES

*“Pricing is the moment of truth – all of marketing comes to focus in the pricing decision.”
- Professor Raymond Corey, Harvard Business School*

*“Price is what you pay. Value is what you get.”
- Warren Buffett*

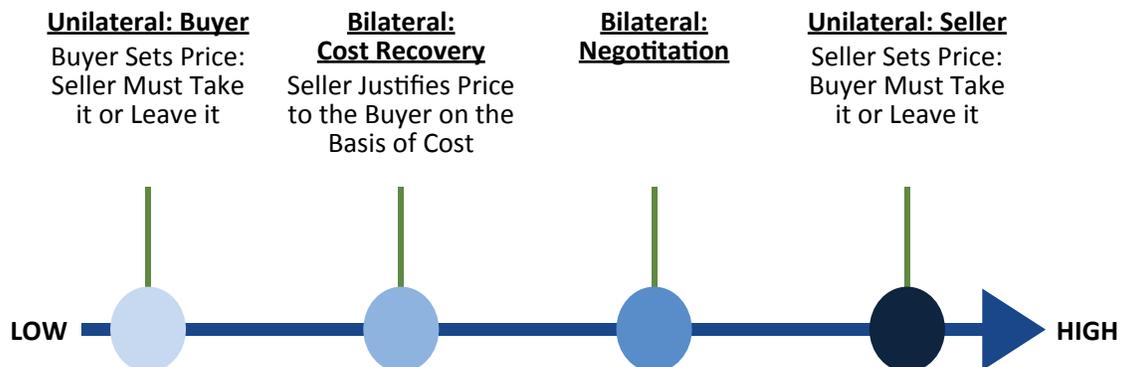
Pricing is complex. The goal of this guide is to provide an entry into pricing by combining both economics and marketing principles. Section 1 goes through the key pricing structures to determine which works best for the organization and service/product line. Section 2 covers how to determine the price for a specific service or product and assign value to it. Section 3 discusses some alternative strategies that are used in the market place to influence price.

Critical to the success of the development of any business line is determining the best pricing structure to achieve the necessary revenue. This section of the guide provides assistance in determining pricing structure through understanding market power and pricing models.

Market Power

The ability to set prices depends on how much “market power” a seller has. The more market power, the greater the ability to set prices. There are four levels of pricing control. (See Figure 1).

Figure 1: Seller’s Price Control



Source: Professor Emeritus Victor Tabbush, PhD UCLA Anderson School of Management

- **Unilateral (Buyer Power):** In this scenario, the buyer has all the power. A price is offered to the seller and the seller must take it or leave it. When this occurs, the seller must analyze their **costs** to determine whether or not to accept the offered price.

Example: A Community Based Organization (CBO) is a home delivered meal contractor for the local Area Agency on Aging (AAA). The AAA will pay the CBO a predetermined price for each meal delivered regardless of the cost to the CBO.

- **Bilateral (Cost Recovery):** Here, the buyer still has more power than the seller. The buyer is willing to cover the seller's costs and maybe provide some additional level of profit. The seller must analyze their **costs** and be able to justify them to the buyer.

Example: A CBO submits a grant proposal to a local foundation to provide home delivered meals to the community. In the application process, the CBO requests the total cost of the meals to be covered through grant funding.

- **Bilateral (Negotiation):** There is close to equal power between the seller and buyer. A negotiation occurs to determine the price. The seller will emphasize the **value** of their product relative to competitors. Buyers will want to know the sellers' **costs** and try to keep prices as close to cost as possible.

Example: A CBO has been providing home delivered meals as an AAA contractor. The AAA is developing a new contract with a hospital to provide meals to an identified set of patients upon discharge for a two-week period in order to reduce readmission to the hospital. The AAA knows the current reimbursement rate they have in place with the CBO. The CBO knows that the AAA cannot successfully engage in this new partnership without their agreement to be a meal provider. The CBO can use the value they provide to the AAA to negotiate a higher rate per meal, while the AAA can focus on the existing rates to anchor the negotiation.

- **Unilateral (Seller Power):** The seller has all the power. A price is offered to buyers and the buyer must take it or leave it. **Value** is the key driver of price, but the value proposition must still remain competitive with other sellers to the extent there is competition in the market.

Example: A family caregiver would like to have their parent receive home delivered meals. Their parent does not meet the income requirements for free services. The CBO offers to provide a meal at a set cost that the family will have to pay if they want their parent to receive home delivered meals.

Pricing Models

The Pricing Model is the overall scheme of how an organization captures revenue for its products or services. The model should make economic sense to the seller and be acceptable to the customers. There are many types of creative and sophisticated pricing models.

The three types of pricing models most relevant to CBOs are discussed in this guide:

1. Fee-for-Service
2. Capitation
3. Incentive Based

Each of these models yields different patterns of profits and has different risks.

Basic Cost Structures

The profit patterns for Fee-for-Service and Capitation are affected by cost structures. Basic categories of costs are Fixed and Variable Costs.

Fixed Costs: These are expenses that do not increase with volume. An example is office space.

Variable Costs: These are expenses that increase proportionally with volume. An example is ingredients for home-delivered meals.

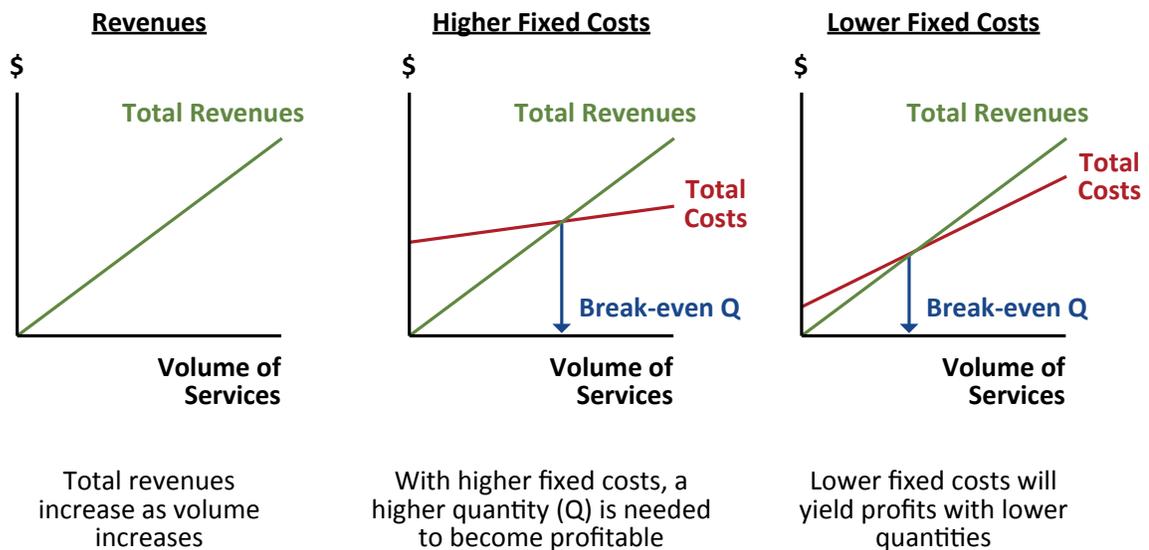
Note: A more advanced discussion on costs is presented in Section 2.

Fee-for-Service

Fee-for-Service (FFS) contracts pay set rates each time the service is utilized. For example, pricing for cab service is based on the number of miles driven where the unit of service is the “mile.”

Figure 2 illustrates how FFS pricing performs under fixed and variable cost structures. Higher utilization increases profits for the seller as long as the fee covers the variable cost of the service. The seller has a financial incentive to provide as many services as possible. Utilization management and authorization systems need to be implemented to prevent over-utilization by the seller, while maintaining quality of care.

Figure 2: Fee-For-Service Model



An example of a high fixed costs service is a skilled nursing facility. The fixed costs for the building are greater than the variable costs for nursing staff and supplies. With a FFS pricing model, the facility needs to keep the rooms as close to full capacity as possible to cover their expenses and make a profit.

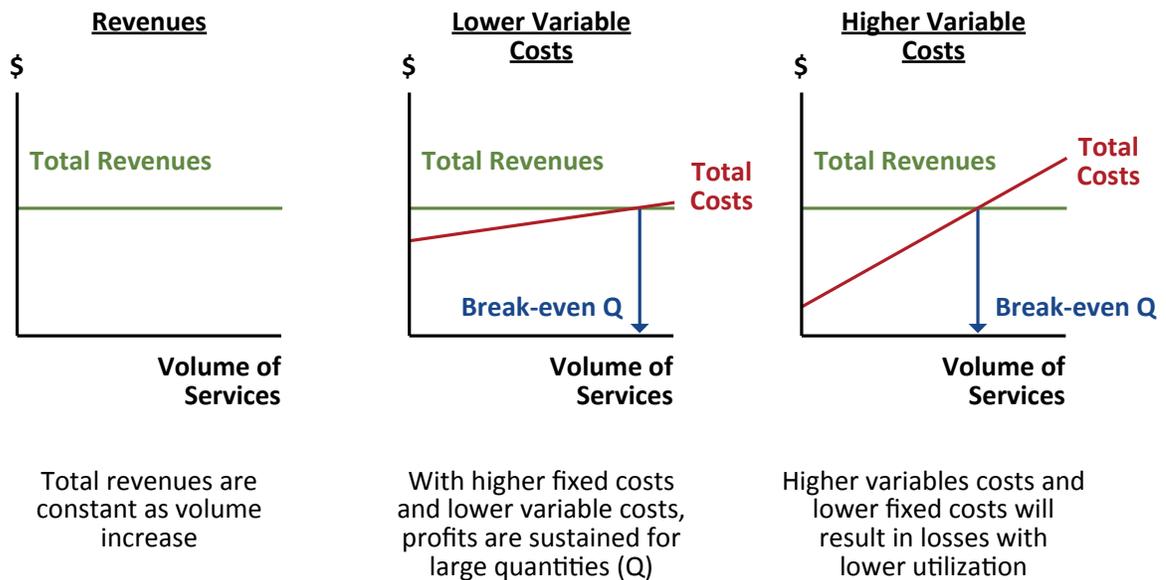
An example of low fixed costs service is at-home nursing care. Since a physical building to provide care is not required, the variable costs for nurses, supplies, and fuel are greater than the fixed costs. Under FFS, expenses will be covered and profitability occurs even at a lower volume of services. However, each home visit adds to the profit provided the fee exceeds the variable cost per unit.

Capitation

Capitation contracts pay a set periodic rate for each covered person. There is no fixed cap on the amount of services an individual can receive during a given period.

Figure 3 illustrates how Capitation pricing performs under fixed and variable cost structures. Contrary to FFS, high utilization decreases profits. The seller has a financial incentive to keep the number of services low. Utilization management and authorization systems need to be implemented to prevent unnecessary utilization from the buyer, while maintaining quality of care.

Figure 3: Capitation Model



In the skilled nursing facility example noted previously (lower variable costs), a capitation contract will relieve the pressure to keep the rooms fully-occupied. Instead, high occupancy could result in financial losses.

In the at-home nursing care example (higher variable costs), a capitation contract is only profitable at lower volumes. As volume of services increases, the organization may fall into a loss position and lose money with each additional visit.

Incentive Model

Also referred to as “pay-for-performance” or “royalty” models, incentive-based contracts pay a percentage of resulting revenues or profits, or a percentage of resulting cost savings (for example from reduced hospitalizations of a client). Revenue may not be directly related to the volume of services. The financial goal is to generate the largest incentive payment with the lowest total costs. The operational goal is to align the interests of the buyer with the seller so that both parties strive for the same results.

This model is high risk, high reward for sellers and low risk, low reward to buyers. Sellers only get paid if the buyer receives resulting benefits from the purchase. For the seller, this creates uncertain revenue, delays cash flows (as incentive payments are usually made long after the service has been delivered), and creates monitoring costs. Sellers will have to monitor and track resulting profits or cost savings. There is a risk that buyers will intentionally or unintentionally underreport the profits, revenues, or cost-savings for the incentive calculation. Sellers may also have to bear the upfront costs of generating a benefit to the buyer. On the other hand, a properly executed pay-for-performance contract can allow sellers to share in substantial successes. Buyers may also be more willing to accept this payment model since it reduces their risks.

Figure 4: Pricing Models - Advantages and Disadvantages from the Perspective of the Seller.

| Model | Advantages | Disadvantages |
|------------------------|---|--|
| Fee-For-Service | <ul style="list-style-type: none"> • Better for low fixed costs and high variable costs • Preferred when the volume of services to be delivered to the client/patient is not subject to the seller’s control | <ul style="list-style-type: none"> • Need higher volumes to generate profit • Financial incentive to over-utilize services |
| Capitation | <ul style="list-style-type: none"> • Better for lower variable costs and high fixed costs • Most predictable revenue stream • Preferred when the seller can exert control on the volume of services provided to the client/patient | <ul style="list-style-type: none"> • Higher utilization will generate losses • Financial incentive to under-utilize services |
| Incentive | <ul style="list-style-type: none"> • Potential for higher payoffs • Lowers risk to buyers • Aligns interests of buyer and seller | <ul style="list-style-type: none"> • Additional costs for monitoring • Highly volatile revenue stream • Delays in cash flow |

Hybrid Models

The pricing models described above do not have to be mutually exclusive. A hybrid or blend of the pricing models may be preferable to both buyers and sellers. Two examples are presented below:

FFS with an Incentive Model

- A lower FFS rate combined with an incentive payment for meeting certain milestones
- Improves cash flow for seller
- Higher risk to seller than FFS, but lower than an incentive only model
- Some potential for higher payoffs
- Some monitoring costs
- Less volatile revenue stream than an incentive only model

Example: A health plan finds that home meal deliveries following hospital discharges reduce readmission rates. It contracts with a meal delivery service and agrees to pay a FFS rate equal to the cost of providing the meals. If the patient readmission rates decline, the service provider will receive a percentage of the resulting cost savings from the reduced readmissions.

Capitation with FFS Model

- Cover most services under a capitation contract, but use FFS for certain costly services
- Less risk to providers of financial loss due to costly and highly variable services
- Generally a lower capitation rate for buyer
- Easier actuarial and historical evaluations if rare services are excluded
- Removes the financial incentive to restrict costly services

Example: Some health plans have capitated contracts with hospitals that exclude certain rare and costly services. These services are covered under a FFS arrangement, while all other services are capitated.

SECTION 2: SETTING A PRICE

In microeconomics, pricing depends on how much market power a company has. A series of charts and formulas will lead to a point of profit maximization. Another approach to pricing is found in marketing and is based on the 4 P's of the **Marketing Mix**: Product, Promotion, Place, and Price (this is described in Appendix A). The following combines concepts from both economics and marketing to help with pricing a product or service.

The Pricing Thermometer

The main factors to consider when determining a price are **value** and **cost**.

Value: The price must be lower than the value of the product to give customers a reason to buy. Buyers will not pay more than the value they place on the product. If price is equal to the value, then theoretically customers will be indifferent between buying and not buying. Value can be further delineated between “Economic Value to the Customer (EVC)” and the “Perceived Value.”

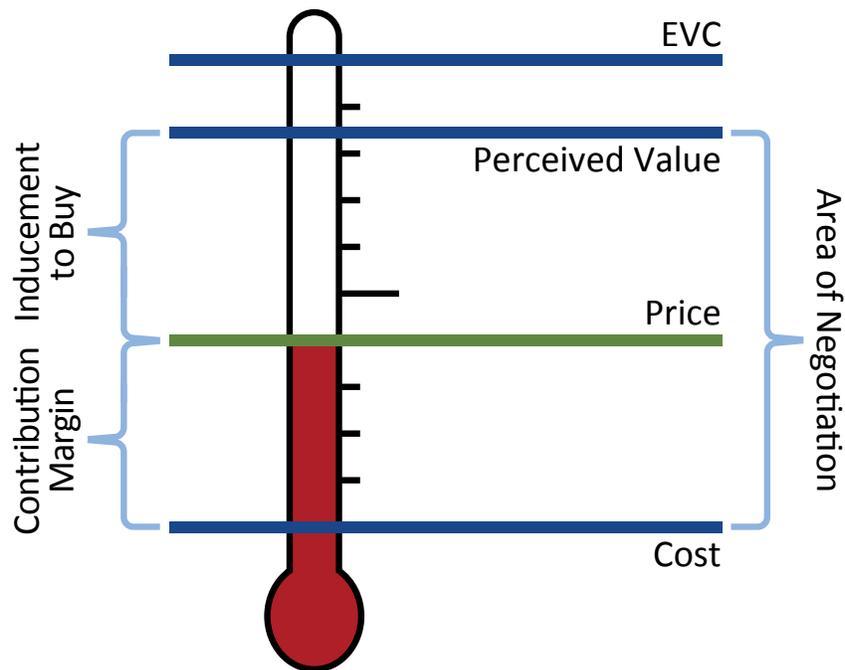
- EVC: is the true value of the product or service.
- Perceived Value: is what customers “think” the product is worth.

Often the customer is unaware of the EVC until they actually purchase and use the product. For example, customers probably did not know how much they valued their first smartphone until they bought it and became familiar with all of its features. There will always be a difference between the full EVC and the “Perceived Value” of a product.

Cost: The price must be greater than the cost to prevent a loss. However, there are several types of costs: fixed, variable, sunk, direct, and indirect. Only direct fixed and variable costs should be considered in pricing decisions. These costs are covered in more detail in the Costs section on page 16.

The “Pricing Thermometer” (Figure 5) gauges these key factors to help determine a price. Price should be somewhere between the perceived value of the product and its cost.

Figure 5: The Pricing Thermometer



Source: Professor Andres Terech, UCLA Anderson School of Management

Inducement to Buy (Value Proposition): The difference between the value and the price is the “Inducement to Buy” for a customer. If a refreshing bottle of water is valued at \$2 and it is on sale for \$1, then there is an economic reason to buy it. However, if the price was \$2.50, then customers would not buy it. This is also referred to as the “Value Proposition.”

Contribution Margin: The difference between cost and price is the “Contribution Margin.” This is how much each unit sold will add to profit or surplus.

Area of Negotiation: Price will be somewhere between the perceived value of the product and its cost. This is the “Area of Negotiation.”

The next part of the guide will go into each of the factors of the Pricing Thermometer in more detail.

Value

The value of a product or service can be hard to quantify. One method of estimating value is to use a competing product or service as a reference point. The price of the competing service will be the reference value. The customer's cost to make or perform the services themselves can also be used as another reference value. The value of a product will be based on this reference value plus or minus a differentiation value. The differentiation value is the value of the product features that are different from the competitor.

$$\text{Value} = \text{Reference Value} \pm \text{Differentiation Value}$$

Price can be more or less than a competitor's price. If the product is almost perfectly identical, then they should be the same price. Soda is a good example of this scenario. When products have more differentiation, prices will vary. A higher price is possible if a product has more value. Or, the seller may have to settle for a lower price if the value is lower. The television market is a good example of this situation. The most technologically advanced TVs are priced higher than the basic models.

Reference values can be:

- Competitor prices
- The customer's cost and ability to make the product or perform the service themselves instead of purchasing

Note: Competitor prices and customer costs may be hard to identify when prices are not publicly available. Creative market research techniques will be necessary to do so. Potential sources to get an estimate of this information are sellers and buyers in other geographical markets. These organizations may be open to sharing their prices and costs since they will not be in direct competition. IRS 990 Forms also reveal information that can be used to estimate these values.

Sources of differentiation value include:

- Cost savings generated from the product
- Convenience and time-saving benefits
- Brand recognition
- Reliability
- Customer service
- Performance
- Types and utilization of technology
- Other indirect benefits

It is important to identify the proper source of differentiation value. If the wrong features are used to determine value, the entire price analysis will be flawed.

In one example, a computer manufacturer thought that speed was the main driver of value. Since their new computer was faster than everything on the market, they increased the price accordingly. In reality, consumers valued software compatibility, reliability, and technical support above speed. The result was that sales stalled and the computer had to be redesigned to emphasize the true valuable features.

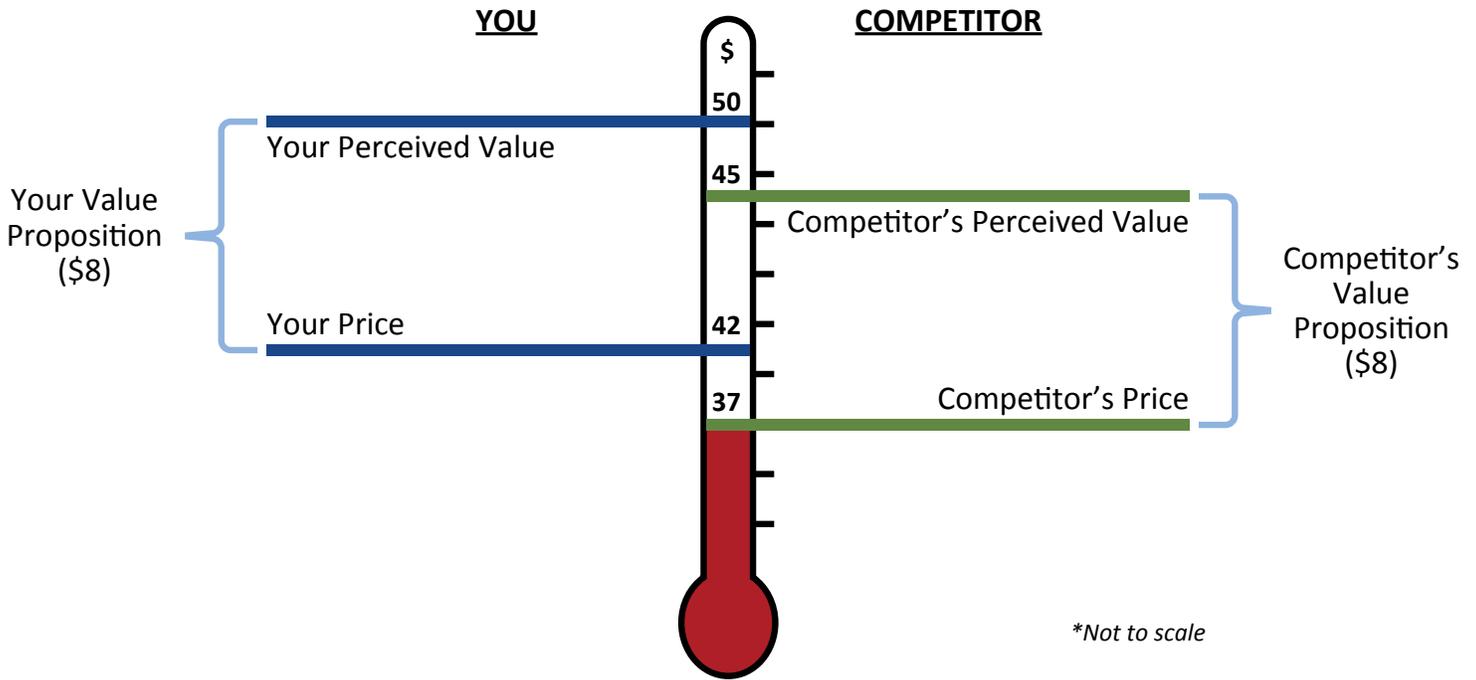
Remember that even if the value can be perfectly quantified, the product will still need to be promoted so that the “Perceived Value” is close to its true value (EVC). This is the goal of “Promotion” in the “Marketing Mix” (see Appendix A).

Value Proposition vs. Competitors

Once an estimate of the value is established, a compelling value proposition needs to be offered to the customers. This is also referred to as “consumer surplus” or “inducement to buy.” Numerically, the value proposition is the difference between the perceived value of the product and its price. To be competitive, the value proposition must be comparable to the competitor’s.

Even with service differentiation advantages, the price will still be constrained by the competitor’s value proposition. In Figure 6, the service is valued at \$50, which is more than the competition. However, the competitor’s price offers a value proposition of \$8. Therefore the organization must also offer a value proposition of at least \$8 and price accordingly at \$42. Otherwise, the product will be perceived as a bad deal and sales will suffer.

Figure 6: The Value Proposition Must be Competitive



Source: Professor Emeritus Victor Tabbush, PhD, UCLA Anderson School of Management

Example: A managed care organization has determined that they want to start providing meals to their patients for two-weeks post discharge. A large national company can drop ship two weeks of frozen meals to the patient for \$56. An organization in the community can provide hot home delivered meals. This service offers additional value, since the hot meals are healthier and the community-based organization can check on the patient during the deliveries. Based on this analysis, the CBO prices their meal delivery at \$100 for two weeks. However, the managed care organization is reluctant to contract with the CBO because they can call the patients to check on them, so the additional value of hot meal deliveries is not worth the higher price.

It may be tempting to offer a greater value proposition than the competitors in order to capture more of the market. However, this may lead to a “price war” that reduces the contribution margin for all sellers. Competitors may react by lowering their prices to match the value proposition and maintain their market share. If this happens, it would have been better to match the original value proposition with a higher price.

Costs

The costs of the product or service can be more precisely categorized into one of three types: Fixed Sunk Costs, Fixed Not-Sunk Costs, and Variable Costs.

Fixed Sunk Costs (“Sunk Costs”)

- These are fixed expenses that will be incurred by the organization regardless of whether or not the sales opportunity or contract is pursued.
- These expenses will not be affected by volume.
- Sunk costs SHOULD NOT be included in the Price Thermometer or when determining the price.
- Sometimes these costs are referred to as “indirect” costs and allocated via an indirect cost percentage.
- Examples include:
 - CEO salary
 - Human Resources
 - Management training
 - Accounting
 - Existing office space
 - Existing equipment
- For simplicity, this guide will refer to these costs as “Sunk Costs.”

Fixed Not-Sunk Costs (“Fixed Costs”)

- These are fixed expenses that will be incurred only if the sales opportunity is pursued.
- These expenses will not vary with volume.
- Fixed costs SHOULD be included in the pricing analysis.
- Examples include:
 - Supervisor salaries
 - Some types of equipment (e.g. vehicles)
 - Additional office space requirements
- For simplicity, this guide will refer to these costs as “Fixed Costs.”

Note: A common fallacy of the “economies of scale” concept is that increasing volume will always reduce average costs. This assumes that fixed costs are fixed irrespective of how high volume might go. However, at some large scale, fixed costs may have to increase to provide needed capacity. These increases will exhibit a “step” function. For example, one supervisor may be able to manage five nurses. Every 6th nurse will require an additional supervisor.

Variable Costs

- These are expenses that will directly increase with volume.
- Variable costs SHOULD be included in pricing analysis.
- Examples include:
 - Hourly wages of nurses or case managers
 - Supplies used in performing services
 - Fuel for transportation vans
 - Supplies needed to prepare home-delivered meals

The cost that should be considered in the Pricing Thermometer is the Cost per Unit of a product or service. This is a combination of Fixed Costs and Variable Costs, but excludes Sunk Costs. Fixed costs will have to be divided by the quantity produced in order to get the Fixed Cost per Unit.

$$\text{Cost per Unit} = \text{Variable Cost per Unit} + \left[\frac{\text{Total Fixed Costs}}{\text{Quantity}} \right]$$

Note: See Appendix F for a tool created by The SCAN Foundation to help calculate Cost per Unit.

A common error that occurs with pricing is the inclusion of Sunk Costs. Allocating Sunk Costs to the Total Direct Cost per Unit will drive up the costs, which could result in an apparent loss in net income. In these cases, new service proposals appear to lose money, but in reality they would still add to the bottom line of the organization. As long as the price is above the cost per unit, there will be a positive financial contribution that “contributes” to offsetting the sunk cost.

Sunk Cost Example: Figures 7 and 8 illustrate why sunk costs should not be considered. An organization is considering a new service with the following financial projections:

Figure 7: Financial Projection with New Service

| | Service A | Service B | New Service | Total |
|-------------------------------|--------------|--------------|-----------------|----------------|
| Fee per Unit | \$14.00 | \$10.00 | \$10.00 | |
| Units | 250 | 250 | 200 | 700 |
| TOTAL REVENUES | \$3,500 | \$2,500 | \$2,000 | \$8,000 |
| Variable Cost per Unit | \$9.00 | \$6.00 | \$6.50 | |
| Total Variable Costs | \$2,250 | \$1,500 | \$1,300 | \$5,050 |
| Fixed Costs of Service | \$300 | \$200 | \$200 | \$700 |
| TOTAL DIRECT COSTS | \$2,550 | \$1,700 | \$1,500 | \$5,750 |
| FINANCIAL CONTRIBUTION | \$950 | \$800 | → \$500 | \$2,250 |
| Total Sunk Costs | | | | \$2,000 |
| Indirect Allocation | \$714 | \$714 | \$572 | |
| Total Costs by Service Line | \$3,264 | \$2,414 | \$2,072 | \$7,750 |
| NET INCOME | \$236 | \$86 | → (\$72) | → \$250 |

Notice that the Net Income for the new service shows as negative after the allocation of Sunk Costs, but the Financial Contribution is positive before Indirect Allocations (Sunk Costs were allocated by unit volumes).

If Sunk Costs were included in the decision to offer the new service, then the organization may reject offering the service due to the projected losses. However, this leaves the following financial projection:

Figure 8: Financial Projection without New Service

| | Service A | Service B | New Service | Total |
|-------------------------------|----------------|----------------|-------------|------------------|
| Fee per Unit | \$14.00 | \$10.00 | \$0 | |
| Units | 250 | 250 | 0 | 500 |
| TOTAL REVENUES | \$3,500 | \$2,500 | \$0 | \$6,000 |
| Variable Cost per Unit | \$9.00 | \$6.00 | \$0 | |
| Total Variable Costs | \$2,250 | \$1,500 | \$0 | \$3,750 |
| Fixed Costs of Service | \$300 | \$200 | \$0 | \$500 |
| TOTAL DIRECT COSTS | \$2,550 | \$1,700 | \$0 | \$4,250 |
| FINANCIAL CONTRIBUTION | \$950 | \$800 | \$0 | \$1,750 |
| Total Sunk Costs | | | | \$2,000 |
| Indirect Allocation | \$1,000 | \$1,000 | \$0 | |
| Total Costs by Service Line | \$3,550 | \$2,700 | \$0 | \$6,250 |
| NET INCOME | (\$50) | (\$200) | \$0 | → (\$250) |

Without the new service line, Sunk Costs must be shared by only two service lines. This puts the entire organization in a loss position. The new service would have provided a Financial Contribution and absorbed some of the Indirect Sunk Costs. Focus on the total impact on the organization and become comfortable with the appearance of losses on single service lines.

Source: Professor Emeritus Victor Tabbush, PhD, UCLA Anderson School of Management

Full Cost Recovery

Knowing the full cost, including Sunk Costs, can still be useful for pricing. Presenting the full cost is advantageous in a Bilateral (Cost Recovery) situation, since the buyer only wants to pay enough to cover the seller’s costs. Sunk costs are still vital to an organization to ensure effective management and growth. Full cost should be used in the negotiations, but any price above the Direct Fixed and Variable Costs is acceptable as long as the organization as a whole is financially better off.

Full Cost Recovery Example: The Sunk Cost example is repeated in Figures 9-11 in the context of a Bilateral (Cost Recovery) negotiation.

An organization is applying for a grant to cover a new service with the following financial projections:

Figure 9: Break-Even Financial Projection for New Service

| | Service A | Service B | New Service | Total |
|-------------------------------|--------------|--------------|----------------|----------------|
| Fee per Unit | \$14.00 | \$10.00 | → \$10.36 | |
| Units | 250 | 250 | 200 | 700 |
| TOTAL REVENUES | \$3,500 | \$2,500 | \$2,071 | \$8,071 |
| Variable Cost per Unit | \$9.00 | \$6.00 | \$6.50 | |
| Total Variable Costs | \$2,250 | \$1,500 | \$1,300 | \$5,050 |
| Fixed Costs of Service | \$300 | \$200 | \$200 | \$700 |
| TOTAL DIRECT COSTS | \$2,550 | \$1,700 | \$1,500 | \$5,750 |
| FINANCIAL CONTRIBUTION | \$950 | \$800 | \$572 | \$2,322 |
| Total Sunk Costs | | | | \$2,000 |
| Indirect Allocation | \$714 | \$714 | \$572 | |
| Total Costs by Service Line | \$3,264 | \$2,414 | \$2,071 | \$7,750 |
| NET INCOME | \$236 | \$86 | → (\$0) | \$322 |

In a grant application, the organization should include the indirect “Sunk Costs” and ask for at least \$10.36 per unit or \$2,071 total. This enables the new service to break-even on its own.

However, the organization should accept an offer above \$8.75 per unit or \$1,750. Including Sunk Costs, the new service will appear to lose \$322, but the organization as a whole will break-even and be better off.

Figure 10: Break-Even Financial Projection for Organization

| | Service A | Service B | New Service | Total |
|-------------------------------|--------------|--------------|------------------|----------------|
| Fee per Unit | \$14.00 | \$10.00 | → \$8.75 | |
| Units | 250 | 250 | 200 | 700 |
| TOTAL REVENUES | \$3,500 | \$2,500 | \$1,750 | \$7,750 |
| Variable Cost per Unit | \$9.00 | \$6.00 | \$6.50 | |
| Total Variable Costs | \$2,250 | \$1,500 | \$1,300 | \$5,050 |
| Fixed Costs of Service | \$300 | \$200 | \$200 | \$700 |
| TOTAL DIRECT COSTS | \$2,550 | \$1,700 | \$1,500 | \$5,750 |
| FINANCIAL CONTRIBUTION | \$950 | \$800 | \$250 | \$2,000 |
| Total Sunk Costs | | | | \$2,000 |
| Indirect Allocation | \$714 | \$714 | \$572 | |
| Total Costs by Service Line | \$3,264 | \$2,414 | \$2,071 | \$7,750 |
| NET INCOME | \$236 | \$86 | → (\$322) | → \$0 |

If the new service contract was rejected, the financial results from the Sunk Cost example (Figure 8) will be seen again and the organization will have a net loss of \$250.

Figure 11: Financial Projection without New Service

| | Service A | Service B | New Service | Total |
|-------------------------------|----------------|----------------|-------------|------------------|
| Fee per Unit | \$14.00 | \$10.00 | \$0 | |
| Units | 250 | 250 | 0 | 500 |
| TOTAL REVENUES | \$3,500 | \$2,500 | \$0 | \$6,000 |
| Variable Cost per Unit | \$9.00 | \$6.00 | \$0 | |
| Total Variable Costs | \$2,250 | \$1,500 | \$0 | \$3,750 |
| Fixed Costs of Service | \$300 | \$200 | \$0 | \$500 |
| TOTAL DIRECT COSTS | \$2,550 | \$1,700 | \$0 | \$4,250 |
| FINANCIAL CONTRIBUTION | \$950 | \$800 | \$0 | \$1,750 |
| Total Sunk Costs | | | | \$2,000 |
| Indirect Allocation | \$1,000 | \$1,000 | \$0 | |
| Total Costs by Service Line | \$3,550 | \$2,700 | \$0 | \$6,250 |
| NET INCOME | (\$50) | (\$200) | \$0 | → (\$250) |

SECTION 3: OTHER PRICING STRATEGIES

Now that a better understanding of how to price to ensure break-even has been established, the discussion below introduces some alternative strategies that stray from the optimal pricing strategy. These strategies are more complex and less commonly used.

Loss Leader Pricing Model

A “loss leader” sells their product below their cost with a strategic purpose. There may be a more profitable complementary product or service that can be sold alongside that makes up for the losses of the other product. The sale may lead to a strategic partnership or be viewed as a marketing expense of promoting the company. As long as the losses on the leader are more than made up by profits on the related service, the strategy makes sense.

Example: An organization that provides a range of services – meals, transportation, care management, etc. – provides transportation services at a rate below their cost to build the relationship with the new payer with the hope that the payer will then purchase other services from the organization (e.g., care management, meals).

Introductory Pricing

When introducing a new product or service, it may be beneficial to sell below costs to encourage adoption. This works if the seller is confident in the value of the product or service. It will enable the seller to build their reputation and relationships. In marketing terms, introductory pricing enables buyers to try the product so that their “perceived value” increases closer to the “EVC.” Once the value has been demonstrated, sellers can raise the price.

Example: A medical group is uncertain if a chronic disease self-management program offered by a CBO will really improve member care. The CBO is confident that they can improve on existing metrics and offers a reduced rate for the first year of service. After the first year, the parties will review the results and renegotiate a higher rate if successful.

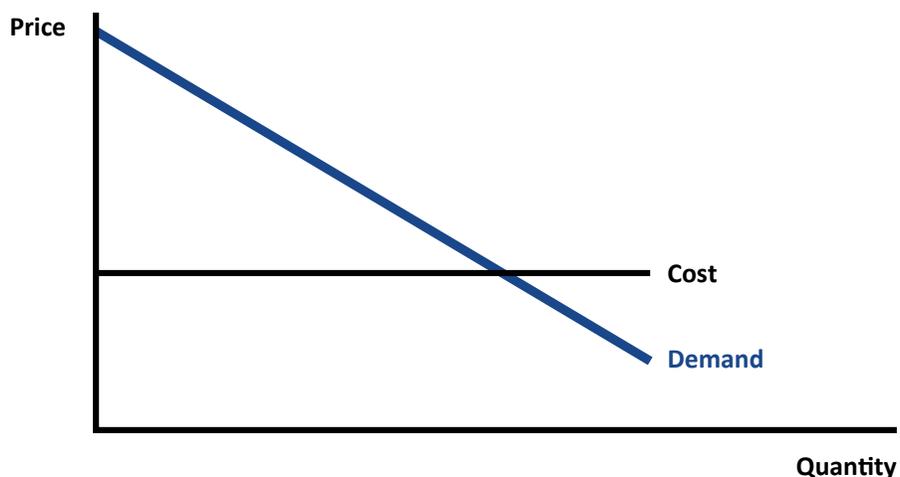
Exploiting the Learning Curve

This strategy is similar to the “loss leader” in the sense that the product is sold below cost or at a low profit margin. In this case, the seller anticipates that the cost of the product will decrease in the near future due to improved efficiency or decreases in the costs of inputs, and that profits will increase in the long run. The risk with this strategy is that prices may also fall in the future.

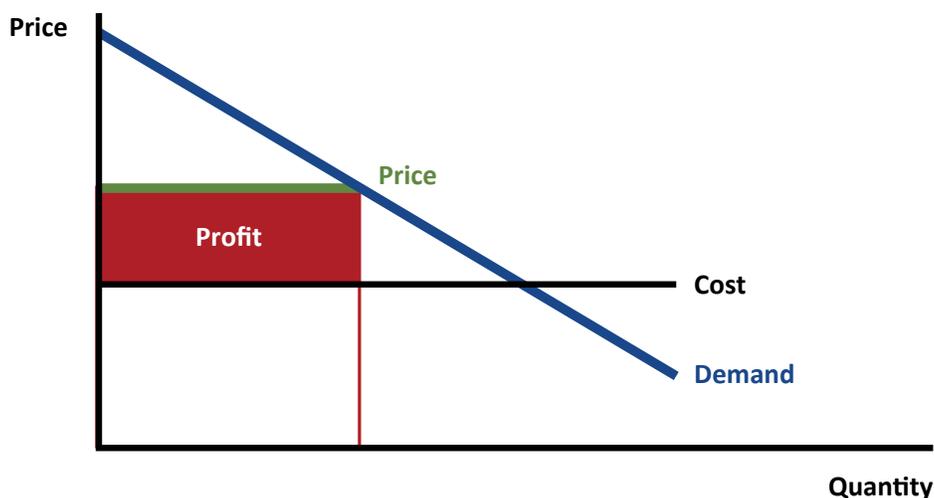
Example: Electronic health record (EHR) systems are costly to implement, but costs decrease significantly post-implementation. Implementation includes technical setup, staff training, and entering a backlog of data. Post-implementation costs are reduced to occasional technical support and updates. The high up-front costs are a significant barrier to sales. The EHR company can sell the system at a loss for the first year, then make up for it in future years with licensing fees that give a significant margin over ongoing costs.

Price Discrimination

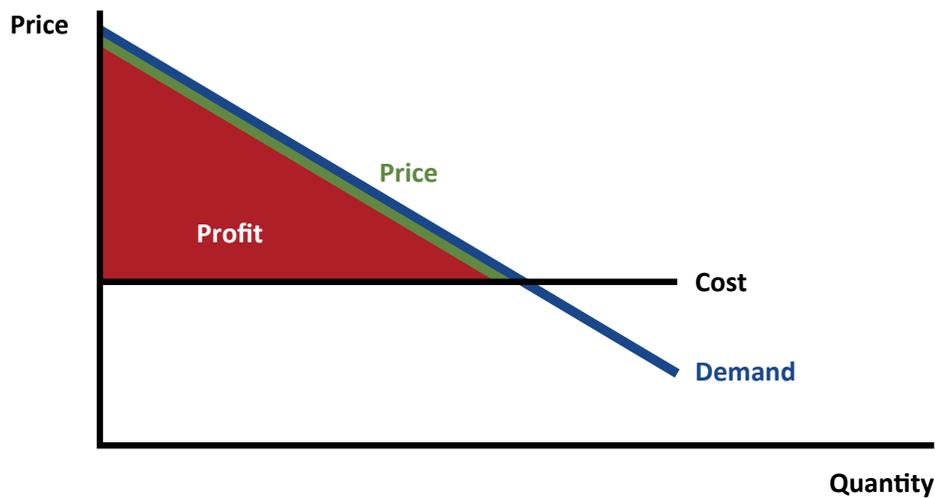
Price discrimination is the ability to charge different prices for the same or similar product to each individual customer. The strategies presented so far assume an average or market value for a product or service. In reality, each individual customer is unique and will value products differently. If the seller can recognize these differences in valuation, then the price can be tailored to each buyer to increase both the quantity of sales and the total revenue from sales. Sales will be made to every buyer who is willing to pay a price above its costs. This can be seen graphically:



Demand is “downward sloping,” which means the quantity demanded increases as price decreases.



Without price discrimination, a single price must be charged to all buyers and every item is sold at the same price. Buyers that demand the product at a lower price would not purchase the item. On the other hand, some buyers would have been willing to pay a higher price, so this leaves some revenue on the table. Profit is represented by the red rectangular box.



With price discrimination, a different price is charged to each buyer. This enables the seller to capture more revenues from the buyers that are willing to pay a higher price, and sell to more customers at lower prices. Profit is now represented by a larger red triangle.

The difficulty with this strategy is that the seller must know the values placed on the service by each buyer and charge the corresponding price. Buyers may not reveal the unique value they possess for a service, and sellers may encounter difficulties in discovering it. The risk of price discrimination is that buyers do not like to pay different prices for the same product or service and will feel taken advantage of. Buyers may retaliate by going to competitors or demanding the lowest price. Hiding prices from the market is key to effective price discrimination.

NEXT STEPS

We hope you find this guide useful in your pricing decisions. We covered the basic concepts of pricing and introduced some more complex strategies. The Appendices provide additional resources to assist you with pricing:

- Appendix A:** **The Marketing Mix** – Pricing is only one aspect of the broader “Marketing Mix.” This appendix provides an overview of how the “Marketing Mix” helps you develop, promote, price, and sell your product or service.
- Appendix B:** **Root Cause Analysis** – This appendix describes how to do a Root Cause Analysis to help develop a product or service that addresses a particular problem.
- Appendix C:** **Potential Partners Matrix** – This appendix describes potential partnership opportunities for CBOs. Additionally, it includes potential product offerings, competitors, and key drivers.
- Appendix D:** **Additional Resources** – Additional reading on various topics discussed in the guide.
- Appendix E:** **Definitions** – Definitions to key terms used throughout the guide.



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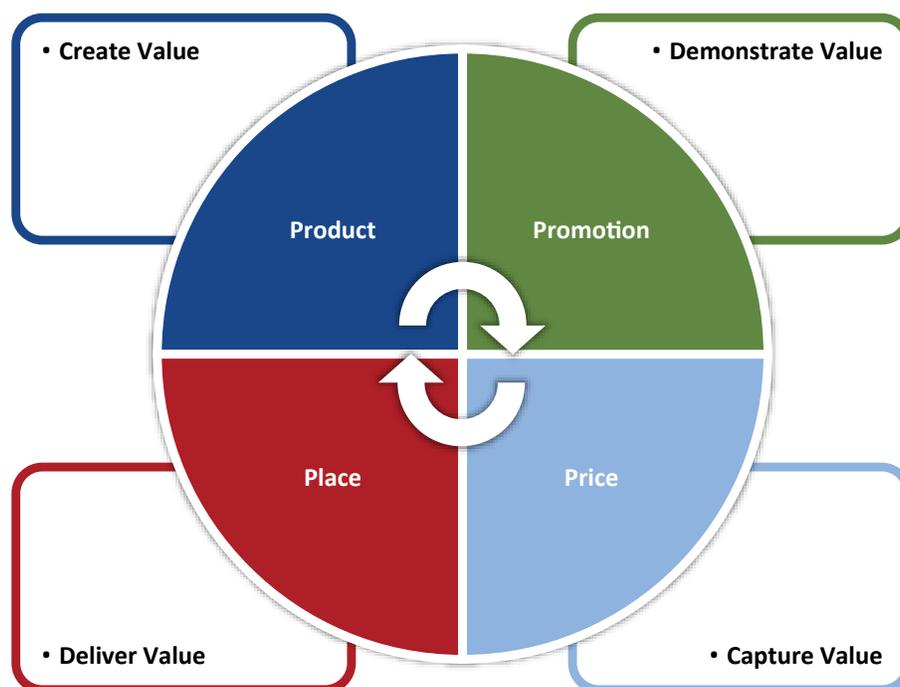
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APPENDIX A

The Marketing Mix

The “Marketing Mix” is a business concept used to describe the different kinds of choices organizations have to make to develop an effective marketing strategy. These elements are also known as the “**4 P’s of Marketing**.” Pricing is only one of the **Four P’s** of the marketing mix (product, promotion, place, and price). The entire marketing mix should be utilized to effectively produce and sell a product or service. The following graphic shows these four essential elements.



- **Product:** A product or service must offer some value to the buyers. It can address a need or fulfill a desire. Root Cause Analysis can help in the development of a product or service that will resolve a particular problem (See Appendix B).
- **Promotion:** The value of the product must be promoted to the buyers so that they become aware of it. The true value of a product is the Economic Value to the Customer (EVC). There will always be a difference between the full EVC and the “Perceived Value” of a product. The role of promotion and advertising is to educate consumers so that their perceived value increases and approaches the EVC.
- **Place:** This is how the product is distributed to the customers. It is where and how you will sell the product. In the non-profit healthcare sector, services are typically directly distributed to the end consumers or via partnerships with a medical group or health plan.
- **Price:** The price determines how much of the value is captured by the sellers as revenue. This Guide focused on this aspect of the marketing mix.

APPENDIX B

Root Cause Analysis

Before a price can be set, a product or service must be developed that offers some value to the buyers. A Root Cause Analysis (RCA) is one method used in product development. An RCA seeks to identify the origin of a problem: to answer “why” the problem occurred in the first place. This approach to problem solving operates under the assumption that all systems and events are interrelated. Therefore, one problem impacts the entire system or sets off a series of events and tracing back these events to the root problem is essential.

To work through the underlying cause of the problem, first there needs to be an understanding of what happened, followed by why it happened. Once the “what” and “why” are clear, then a plan can be developed to reduce the likelihood of the problem occurring again.

Below are three types of causes:

- Physical – something tangible failed.
- Human – a person or people did something wrong or failed to do something.
- Organizational – a system, process or policy for service delivery or decision making failed.

There are a number of tools and resources available to conduct RCA. The following five-step process to RCA was taken from MindTools.com.* While each of the steps appears simple and straightforward they can take some time to complete, and often require resources and/or a group of people working together to get to the root cause.

Step 1: Define the problem – assign a title to the problem and describe in as much detail as possible.

Example:

Title: High Hospital Readmissions

Describe the problem: People discharged from the hospital who are over the age of 80 have higher readmission rates than those under that age.

Step 2: Collect data – what is the proof that the problem exists? The data can also be used to measure change post solution.

Example:

Data Sources: Electronic health records, Medicare Utilization

*MindTools.com (n.d.) Retrieved June 12, 2013. http://www.mindtools.com/pages/article/newTMC_80.htm

Step 3: Identify possible causal factors – what is contributing to the problem? It may be worth rank ordering these factors to narrow down Step 4.

Example:

| Causal factor | Rank |
|----------------------------------|------|
| Increased frailty | 1 |
| Lack of support in the home | 2 |
| Discharge medications not filled | 3 |
| No transportation | 4 |
| Follow-up appointments not made | 5 |

Step 4: Identify the root cause(s) – which causal factors are having the largest impact on the problem, and what are the deeper issues?

Example: Top two causal factors

1. *Increased frailty – during hospital stay, patients experience loss of mobility and strength (due to being in bed), confusion and disorientation (due to lack of sleep - woken through the night for medications or other checks).*

2. *Lack of support in the home – when patients are discharged, they go home alone or with a caregiver who is a spouse that cannot provide needed support.*

Step 5: Recommend and implement solutions - what changes need to be made to impact the issue?

Example: Top two causal factors

1. *Increased frailty – during hospital stay, patients experience loss of mobility, strength, confusion, and disorientation*

a. *New policies:*

i. *Encourage patients to do things for themselves: bathe, toilet, go to cafeteria for meals;*

ii. *Patients walk around the ward twice a day; and*

iii. *Only check vitals and pass medications at night when medically necessary.*

2. *Lack of support in the home – when patients are discharged they go home alone or with a caregiver that cannot provide needed support.*

a. *Partner with CBO to support transition.*

i. *CBO to provide in home assessment prior to transition*

ii. *CBO to do assessment day of transition*

iii. *CBO to coordinate needed support*

From the example, it would be fair to assume that as a result of implementing activities that maintain function and ensure that there is ample support in the home, readmissions for the population 80 and over would decrease. However, it is critical to develop evaluation metrics to verify that the solutions are in fact having an impact on readmissions.

APPENDIX C

| Matrix of Potential Partners and Opportunities | | | |
|--|---|--|---|
| Potential Partners | Potential CBO Offerings | Competitors | Key Drivers |
| Hospitals | <ul style="list-style-type: none"> Care Transitions | <ul style="list-style-type: none"> Hospitals Home Health Agencies For-Profit Entities Other CBOs | <ul style="list-style-type: none"> Readmission penalties Fee for service and capitated pricing models Payers – CMS, health plans, private pay ACA – hospital readmissions |
| Dual Eligible Plans <ul style="list-style-type: none"> Dual – Special Needs Plan (D-SNP) Program for All-Inclusive Care of the Elderly (PACE) Duals Demo/Coordinate Care Initiative (CCI) | <ul style="list-style-type: none"> Care Coordination Long Term Services and Supports | <ul style="list-style-type: none"> Provider (Managed Care) Organizations Home Health Agencies For-Profit Entities Other CBOs | <ul style="list-style-type: none"> Utilization Capitated pricing model Payer – CMS ACA – care coordination, improved outcomes/ lower costs |
| Accountable Care Organizations (ACO) | <ul style="list-style-type: none"> Care Transitions Care Coordination Long Term Services and Supports | <ul style="list-style-type: none"> ACO Providers Home Health Agencies For-Profit Entities Other – CBOs | <ul style="list-style-type: none"> Utilization Capitated pricing model Payer – CMS ACA – testing new models |
| Medicare Advantage Plans (MA)/Managed Care Organizations (MCO) | <ul style="list-style-type: none"> Limited Long Term Services and Supports based on qualifying factors – home delivered meals and transportation | <ul style="list-style-type: none"> MA Plans Home Health Agencies For-Profit Entities Other CBOs | <ul style="list-style-type: none"> Utilization Capitated pricing model Payer – CMS ACA – improved outcomes lower costs |
| Medical/Physician Groups | <ul style="list-style-type: none"> Care Coordination | <ul style="list-style-type: none"> Medical/Physician Groups Home Health Agencies For-Profit Entities Other CBOs | <ul style="list-style-type: none"> Fee for service and capitated pricing models Payer – CMS, health plans, private pay ACA – improved outcomes lower costs |

APPENDIX D

Additional Resources

PRICING MODELS

- **The American College of Healthcare Executives - *Capitation, Rate Setting, and Risk Sharing*** – This is an article on setting price, as well as introducing risk into the pricing mix. http://www.ache.org/pubs/hap_companion/gapenski_finance/online%20chapter%2020.pdf

VALUE

- **Price Intelligently - *Developing Your Pricing Strategy*** – Short and easily understood, this e-book discusses an important factor in the pricing decision – value. <http://www.priceintelligently.com/>
- **Price Intelligently - *Value Based Pricing 101: The Necessities and Your Pricing Strategy*** – This is an article on Value Pricing, emphasizing the pros and cons of this type of pricing. <http://blog.priceintelligently.com/blog/bid/162160/Value-Based-Pricing-101-The-Necessities-and-Your-Pricing-Strategy>

FULL COST RECOVERY

- **ACEVO – *Full Cost Solutions*** – ACEVO offers a tool to properly calculate the full cost. A common practice is to use an indirect cost rate percentage to estimate overhead costs. This tool helps perform a more precise calculation. However, the tool is limited in allocation methods and does not distinguish “sunk costs.” The paid full version is more refined and also includes a business plan writing tool. <http://www.fullcostrecovery.org.uk/main/>

THE MARKETING MIX

- **Mind Tools - *The Four P's of Marketing*** – Mind Tools is a website with a wealth of resource information. This article provides a discussion of how to position an organization in the market place. http://www.mindtools.com/pages/article/newSTR_94.htm
- **Marketing91.com: *The Marketing Mix and 4 Ps: Understanding How to Position Your Market Offering*** – This article will assist the reader in further understanding the 4 Ps of Marketing by exploring those questions that are necessary in pricing services appropriately. <http://www.marketing91.com/marketing-mix-4-ps-marketing/>

NEW OPPORTUNITIES FOR CBOs

- **The SCAN Foundation - *Overview of Preparing Community-Based Organizations for Successful Health Care Partnerships*** - Read how community organizations can be successful in developing relationships in the California healthcare sector. http://www.thescanfoundation.org/sites/thescanfoundation.org/files/track__3__--_victor_tabbush_handout_scan_class_brief_meta_analysis_080112.pdf
- **California HealthCare Foundation - *Health Care Unplugged: The Evolving Role of Wireless Technology*** - Read why mobile technologies are quickly becoming a valuable part of health care for seniors and the chronically ill. <http://www.chcf.org/~media/MEDIA%20LIBRARY%20Files/PDF/H/PDF%20HealthCareUnpluggedTheRoleOfWireless.pdf>
- **National Council on Aging - *Health Care and Community-Based Organizations: A Win-Win Partnership*** - This article emphasizes all of the compelling reasons why there are so many new opportunities for Community Based Organizations in partnering with health care systems and how to successfully create those partnerships. An email address is required to access the article. <http://www.ncoa.org/improve-health/center-for-healthy-aging/content-library/health-care-and.html?print=t>
- **McKinsey & Company - *The Big-Data Revolution in US health care: Accelerating Value and Innovation*** - Healthcare stakeholders are now using big data to revolutionize the way healthcare will be paid for in the future. However, some believe that stakeholders will only benefit from big data if they take a more holistic, patient-centered approach to value, one that focuses equally on health-care spending and treatment outcomes. http://www.mckinsey.com/insights/health_systems_and_services/the_big-data_revolution_in_us_health_care

APPENDIX E

Glossary

Accountable Care Organizations (ACOs) - are groups of doctors or physician groups, hospitals, and other health care providers, who come together voluntarily to give coordinated high quality care to their patients.

Bilateral Negotiation – two legal entities coming to an accord through discussions and compromises.

Capitation – a pricing model where a fixed payment is made per person for all medical services delivered during a fixed period of time.

Care Coordination – the coordination of services provided by various physicians and members of a multidisciplinary treatment team to ensure patients, especially the chronically ill, receive the care they need at the time they need it, while avoiding unnecessary duplication of services and preventing medical errors.

Care Transitions - refers to the movement of patients between health care practitioners and settings (e.g., from hospital to nursing home) as their condition and care needs change during the course of a chronic or acute illness.

Centers for Medicare and Medicaid Services (CMS) – a federal agency within the US Department of Health and Human Services (HHS) that administers the Medicare, Medicaid, and State Children’s Health Insurance Program (CHIP) programs.

Contribution Margin – see **Financial Contribution**.

Coordinated Care Initiative (CCI) – the California plan approved by the Legislature, to integrate the delivery of medical, behavioral, and long-term care services and supports. CCI also provides a roadmap to integrate care under Medicare and Medi-Cal for “dual eligible” beneficiaries.

Cost per Unit – the combination of variable costs and fixed expressed on a per unit basis. For pricing decisions, this should exclude sunk costs.

Direct Costs – expenses that will only be incurred if a sales opportunity is pursued. These expenses are easily traced and attributed to a single service or product line.

Dual Special Needs Plans (D-SNPs) – special Medicare Advantage health plans that enroll beneficiaries who are entitled to both Medicare and Medicaid benefits.

Duals Demonstration Project – a partnership between California’s Medi-Cal program, CMS, and local health plans for a three-year demonstration beginning in 2014. The goal of the demonstration, called Cal MediConnect, is to promote coordinated health care delivery to seniors and people with disabilities who are dually-eligible for both programs.

Economic Value to Customer (EVC) – the true and full economic value of a product or service.

Fee-for-Service – a pricing model (primarily used in the medical field) where there is a charge for each individual service.

Financial Contribution – the excess of revenues over direct costs during a given period of time. May also be referred to as a **Contribution Margin**.

Fixed Costs – costs that do not change with an increase or decrease in the amount of goods or services provided.

Full Cost Recovery – a pricing strategy that attempts to recover both direct and indirect costs of providing a service or product.

Home Health Agencies – an organization that is primarily engaged in providing skilled or paraprofessional care to individuals in out-of-hospital settings, such as private homes, boarding homes, shelters, etc.

Hybrid Payment Model – a combination of two or more healthcare payment models.

Indirect Costs – see **Sunk Costs**.

Long-Term Services and Supports – the services and supports used by individuals of all ages with functional limitations and/or chronic illnesses.

Loss Leader – a business strategy in which a business offers a product or service at a price that is not profitable for the sake of offering another product/service at a greater profit, or to attract new customers, with the intent to increase the price once a loyal customer base has been built.

Managed Care Organization – A general term that refers to health plans that attempt to control the cost and quality of care by coordinating medical and other health-related services.

Market Power – the ability of an organization to profitably raise the price of a good or service over cost.

Medical Group – the practice of medicine by an association of physicians and other health professionals who share resources and work together, usually in one suite of offices.

Medicare Advantage Plan – a type of Medicare health plan offered by a private company that contracts with Medicare to provide the beneficiary with all Medicare Part A and Part B benefits.

Net Income – the excess of revenues and gains of a business over expenses and losses during a given period of time.

Perceived Value – the amount that customers “think” a product or service is worth.

Price Discrimination – the practice of charging a different price for the same good or service to different customers.

Root Cause Analysis – a method used to address a problem or non-conformance, in order to get to the “root cause” of the problem. It is used as part of an effort to correct or eliminate the cause, and prevent the problem from recurring.

Incentive Model – results-based payment model, where the buyer pays a percentage of revenues, profits, or cost savings for the right to ongoing use of an asset or service.

Sunk Costs – Fixed costs that have to be paid by an organization, independent of the level of overall business activity. These are fixed expenses that will be incurred regardless of whether or not an additional sales opportunity is pursued. Also referred to as **Indirect Costs**.

Value – a monetary measure of the benefits received from consuming a product or service.

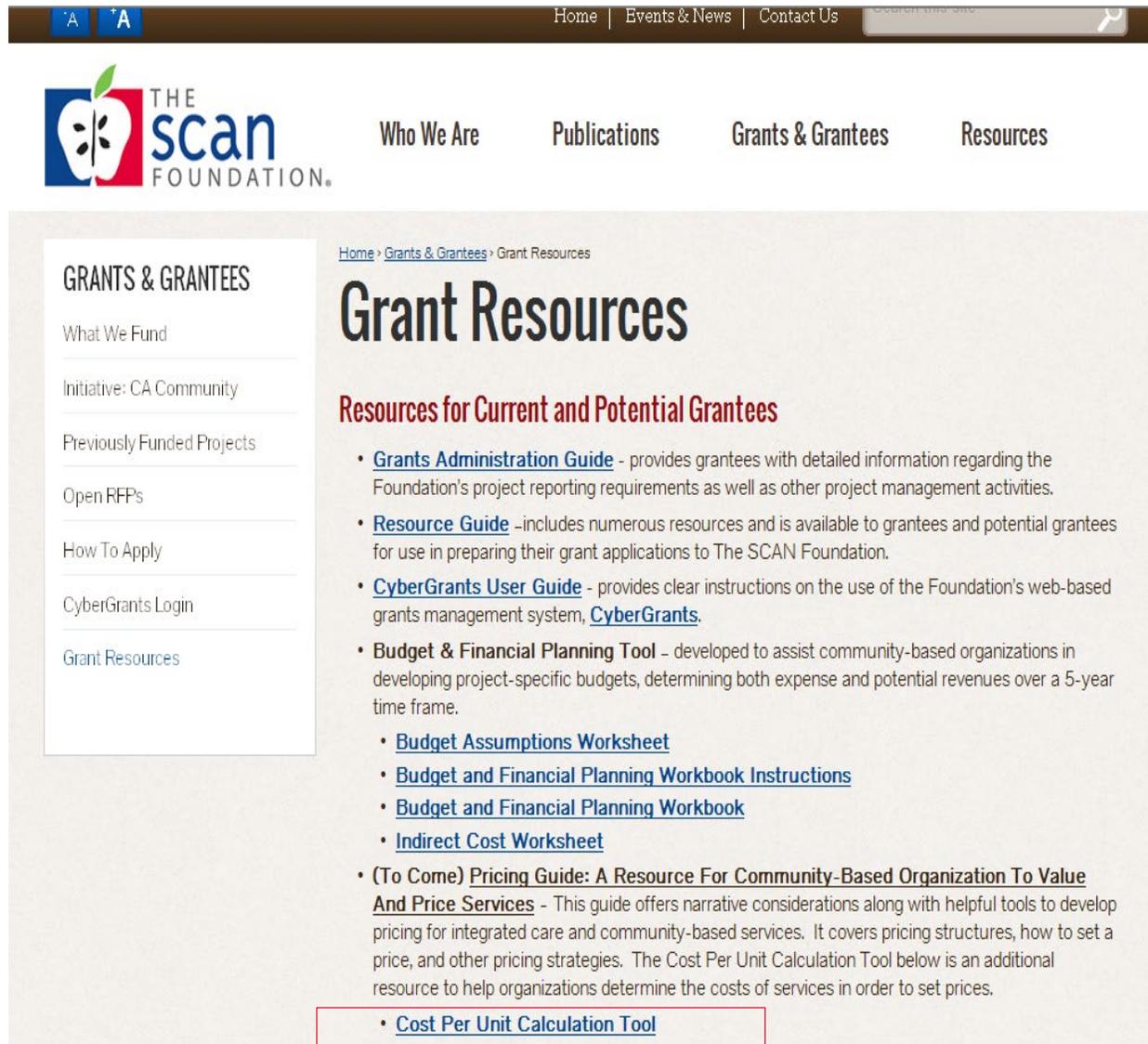
Value Proposition – a promise of value to be delivered and a belief from the customer that value will be experienced.

Variable Costs – costs that increase or decrease in proportion to the volume of goods or services provided.

APPENDIX F

Cost Per Unit Calculation Tool

This calculation tool (Excel format) can be found on The SCAN Foundation's website at www.TheSCANFoundation.org or by clicking on the following: [Cost Per Unit Calculation Tool](#).



The screenshot shows the website header with navigation links: Home, Events & News, Contact Us, and a search bar. The logo for The SCAN Foundation is on the left. The main navigation menu includes: Who We Are, Publications, Grants & Grantees, and Resources. The page content is titled 'Grant Resources' and includes a breadcrumb trail: Home > Grants & Grantees > Grant Resources. A sidebar on the left lists 'GRANTS & GRANTEEES' with sub-links: What We Fund, Initiative: CA Community, Previously Funded Projects, Open RFPs, How To Apply, CyberGrants Login, and Grant Resources (highlighted). The main content area lists several resources:

- [Grants Administration Guide](#) - provides grantees with detailed information regarding the Foundation's project reporting requirements as well as other project management activities.
- [Resource Guide](#) - includes numerous resources and is available to grantees and potential grantees for use in preparing their grant applications to The SCAN Foundation.
- [CyberGrants User Guide](#) - provides clear instructions on the use of the Foundation's web-based grants management system, [CyberGrants](#).
- [Budget & Financial Planning Tool](#) - developed to assist community-based organizations in developing project-specific budgets, determining both expense and potential revenues over a 5-year time frame.
 - [Budget Assumptions Worksheet](#)
 - [Budget and Financial Planning Workbook Instructions](#)
 - [Budget and Financial Planning Workbook](#)
 - [Indirect Cost Worksheet](#)
- [\(To Come\) Pricing Guide: A Resource For Community-Based Organization To Value And Price Services](#) - This guide offers narrative considerations along with helpful tools to develop pricing for integrated care and community-based services. It covers pricing structures, how to set a price, and other pricing strategies. The Cost Per Unit Calculation Tool below is an additional resource to help organizations determine the costs of services in order to set prices.
 - [Cost Per Unit Calculation Tool](#)