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## Sea of Stability in an Ocean of Turbulence

Outside of Kaiser Permanente, the California health care environment feels like a continuous seismic event," says **Larry Wilson, Senior Vice President, Kaiser Health Plan/Hospitals**, who was with Catholic Health Care West before joining Kaiser Permanente in 2001. "Coming to this organization from the outside feels like I'm back on firm ground. Stability is a rare and precious commodity in California today, and one that people looking for health care increasingly appreciate."

Stability is also what attracted the 10 physicians from the Alameda Medical Group to join TPMG in January 2002. "As the doctors in our group came up to speed as to what our situation really was, the security issue became overriding," explains **Mark Marrama, MD, Medicine, Oakland**. "I believe that joining TPMG was the only way for us to remain viable in the community. That was a big issue for us."

"For our patients who were in other HMOs, switching to Kaiser Permanente was also a very good deal. They were able to keep their doctor and could be confident that their health plan wasn't going to bail on them," Dr. Marrama continues. "And I sleep much better at night knowing that I can provide high quality medical care to my patients in this community for as long as I want."

### Ocean of Turbulence

"The turbulence in the health care market is rooted in the lack of collaboration that exists in the community-based medical system, in which hospitals, health plans and medical groups are constantly battling each other for their share of the health care dollar," says **Robert Pearl, MD, Executive Director and CEO, TPMG**. "So, rather than all of the parts being able to maximize how they work together to achieve the best quality and the best service for the patient, as we do at Kaiser Permanente, each of these entities is focused on how it can maximize its own success at the expense of the others."

"With the entry of the for-profit managed care companies in the mid-1990s, the community-based delivery system unraveled. Motivated by the bottom line and maximizing shareholder return, these for-profit companies spend as little as 80% of the member's premium on direct patient care. Because community-based physicians and hospitals are neither integrated nor work collaboratively with each other, the for-profits have resorted to beating up both physicians and hospitals in order to achieve their financial performance goals," Dr. Pearl continues. "As a consequence, not only has the quality and service they

provide to their patients suffered, but an environment has been created in which physicians do not want to practice and hospitals cannot make needed long-term capital investments."

"The health care system in California outside of KP is increasingly fragile and fragmented," says **Joe Houska, PhD, Vice President, TPMG**. "Many health plans have experienced or are experiencing financial difficulties. The most striking recent examples are Lifeguard merging with Blue Shield and Health Plan of the Redwoods filing for bankruptcy. According to the Office of Statewide Health Planning and Development, 66% of California hospitals are losing money. And depending upon whether you look at the numbers from the Department of Managed Health Care or the California Medical Association, anywhere from 40% to 60% of medical groups are on the verge of financial insolvency."

## **Sea of Stability**

In contrast, Kaiser Permanente in California has not only survived, but has thrived. One measure of our success has been our financial performance. As a not-for-profit health plan, KP does not earn profits, but we must retain some of our revenue to fund the building of new hospitals and medical office facilities, as well as to purchase the latest advances in medical technology. To this end, across California, we finished 2001 on target with an operating margin of 4.3%, which will help fund our building and technology needs. In addition, in spite of a recession, we grew by 78,445 members in Northern California last year.

"Today, we are the only health care organization in Northern California that can be confident about its long-term survival and success," says Dr. Pearl. "And because we are confident about our future, unlike our for-profit competition that focuses mainly on next quarter's financial results, we are able to focus on the investments needed to care for our members in the long-term. In addition to the building of new hospitals and medical offices, we will be expanding our chronic conditions and prevention programs and hiring hundreds of physicians, nurses and staff."

Outside of Kaiser Permanente, the contentious relationship among hospitals, health plans and employers is throwing physicians and patients into an ocean of turbulence.

## Hospitals

"The collective bottom line for California hospitals is negative," says Mr. Wilson. "And it comes at a time when hospitals are facing both an unprecedented demand for capital spending to meet the seismic mandate from the state and a severe nursing shortage."

Kaiser Permanente is not exempt from these two challenges, but we are in a much better position to deal with them than are our competitors. "In the next decade, not only do we plan to replace the five hospitals in Northern California that do not meet the 2013 seismic requirements, but we plan to add an additional four hospitals," reports **Margaret Lapiz, Vice President, TPMG**. With regard to the nursing shortage, under the direction of Marilyn Chow, we've developed what we call the "Nursing Pathways," a multi-faceted approach to recruit and retain nurses and to create a quality of work life that will position Kaiser Permanente as the health care organization of choice for nurses.

Faced with financial woes, other hospitals have consolidated to gain size and marketshare to negotiate more effectively with health plans. Over the past decade, the number of hospitals systems in California has gone from 21 to 9. "As a result, hospitals are starting to exercise their clout, which is one of the reasons we're seeing their prices increase as much as we are right now," notes Mr. Wilson.

Having fewer hospitals to choose among makes it more difficult for health plans to drop a hospital that won't give them the rates they desire, so they are beginning to employ a new tactic to steer business away from higher-priced hospitals. Both Blue Shield and PacifiCare have introduced a two-tiered system with patients paying a \$100 to \$400 co-pay per day if they wish to go to a higher-priced hospital, but no co-pay if they are admitted to a

## What People Are Saying

*"One big challenge for the health care system in California is that key stakeholders — including purchasers, plans, hospitals and medical groups — far too often see themselves as sitting across the table from one another than as sitting on the same side of the table."*

— Peter Lee, President, Pacific Business Group on Health (Managed Care, January 2002)

*"Doctors love to work for [the Permanente Medical Groups]. They get a good income and it's stable. Most of the medical graduates coming out of school [in California] have gone to Kaiser, and the rest have left the state. That says a lot about Kaiser."*

— Walter Kopp, Principal, Medical Management Services (San Francisco Business Times 4/8/02)

*"Most-respected competitor: Kaiser. They have really started to improve and they are demonstrating that they can produce quality outcomes."*

— Bruce Bodaken, Chairman, CEO, Blue Shield of California (San Francisco Business Times 3/4/02)

*"[Kaiser Permanente is] winning the game. And this game is over soon if we don't mount some sort of defensive. They really have become a standard against which we have to compete."*

— Steve McDermott, CEO, Hill Physicians at a meeting of health care professionals (San Francisco Chronicle 3/31/02)

lower-priced hospital. Other health plans, such as HealthNet, are considering following suit.

## Health Plans

Managed competition was the buzz word of the 1990s as the for-profit health plans entered the HMO market with the promise of lower prices by increasing efficiency in the system. They did lower prices for a while -- not by improving the delivery system, but by consolidating to gain enough leverage to reduce payments to physicians and hospitals. And rather than reinvesting their profits in health care in California, they dispersed them in the form of dividends to their stockholders.

During the last decade, the number of health plans in California went from 22 to 7. Despite using their consolidation to limit payments to physicians and hospitals, their need for profitability has caused them to raise prices to their major purchasers – employers. Even CalPERS (California Public Employees' Retirement System), the second largest purchaser of health care in California (behind the federal government), had to accept 25% increases in premiums for 2003. In response, CalPERS decided to drop two for-profit plans, HealthNet and PacifiCare, while keeping Kaiser Permanente and Blue Shield (both not-for-profit) as its statewide plans.

In recent years Kaiser Permanente has demonstrated its ability to manage challenging cost issues without compromising our commitment to delivering quality care to our members.

"Other health plans have come to recognize that Kaiser Permanente is so much better at providing quality care, particularly to those who are sick or who have chronic illness, that they've decided to stop competing with us for the care of these patients," says Dr. Pearl. "In fact, they're using benefit manipulation and other tactics to encourage those with chronic illnesses to quit their health plans, and selectively attract just the healthy."

The latest tactic is to offer a variety of low-cost, low-coverage policies with high co-pays and deductibles. These offerings are designed to appeal to healthy individuals who believe their risk of serious illness is low and to attract employers seeking to lower their costs. At the same time, they discourage patients who know they will require medical attention in the upcoming year from joining that plan.

## Employers

Employer purchasers have been bearing the burden of recent premium increases, but according to **Christine Paige, Vice President of Marketing, KFHP**, "One of the main things employers are trying to achieve right now is cost sharing with their employees, because it's the only thing that's going to keep their health care premiums down."

In 2002, Kaiser Permanente found it necessary to make benefit changes in response to both purchaser demands and the extreme changes made by the other health plans. These changes included two-tier prescription plans, ambulance and DME co-pays and a higher emergency co-pay. However, overall, our benefits remain the most comprehensive in Northern California.

"Unfortunately, as the cost-sharing trend continues, it is likely that there will be a rapid acceleration away from the comprehensive coverage of the past," Dr. Pearl explains. "First, our competition will continue to diminish the benefits they provide, eliminate all drug coverage and force the patient to pay more of their medical expenses. Second, they will increase their efforts to encourage their members to shift from an HMO to a PPO. Unlike HMOs, PPOs have fewer regulations and limitations and permit the insurance companies to manipulate their product design more easily, so as to attract the healthy and discourage those individuals with chronic illnesses."

Employers are becoming more interested in plans that allow them to make a "defined contribution" to their employees' health care costs, while their employees pay whatever additional costs are necessary to get the level of coverage they desire. "Blue Cross' Flexscape program is a suite of products with different deductibles, co-insurance levels and monthly premiums," explains Ms. Paige. "With a program like this, the employer can decide, for example, that they're going to devote \$150 per single employee per month for health care coverage, end of story.

Employees have to choose among the various benefit levels, basing their decision on how much they want to contribute out of their paycheck, how much risk they want to take and how much they are willing to pay at the point of service when they receive health care."

If costs go up the following year, the employer can continue to pay their "defined" \$150 per month, leaving the employee to either choose a lower level of coverage or pay more in order to retain the same level they had the year before.

"Our challenge at KP is how to facilitate cost sharing in as responsible a way as is humanly possible," says Ms. Paige. "In many ways, achieving this balance may prove to be the greatest challenge to our current stability," notes Dr. Pearl.

## Medical Groups

While hospitals, health plans and employers have found strategies to help shield them from some of the turbulence in the health care environment, physicians in medical groups outside of TPMG continue to be badly buffeted. "A lot of other physician groups are in the same position we were in last year at the Alameda Medical Group," says Dr. Marrama. "We were being squeezed by the insurance companies. Even though we were part of an IPA,

## HMO vs PPO

**Health Maintenance Organization (HMO):** An organization that assumes responsibility for providing health care to members in a geographic area for a fixed payment without regard to the amount of actual services provided to an individual enrollee. HMOs provide more comprehensive coverage than PPOs, both in terms of the services they cover and the share of the cost they assume, but require members to receive service from a defined group of providers and hospitals. Members pay co-payments for most services, but generally are not subject to deductibles.

**Preferred Provider Organization (PPO):** A network of private practice physicians and hospitals who agree to discount their fees in return for potential business from PPO members. PPO plans include yearly deductibles, as well as co-payments for services received. Members who choose from the network of preferred providers/hospitals pay lower co-payments than if they choose a provider/hospital outside of the network.

PacifiCare decided they were not going to renew their contract with us. We had about two-thirds of our Medicare HMO patients in PacifiCare, so it was a big hit."

Even when physicians don't get dropped by a health plan, they have little bargaining power when it comes to reimbursement rates. And next year, a number of HMO plans in California are going to pit doctors and medical groups against each other by designating some as "not preferred" -- meaning patients who go to them pay higher co-payments and deductibles than if they get care from physicians labeled "preferred."

"It is likely that the sole criteria for inclusion in the preferred group will be willingness to be paid less by the health plan," notes Dr. Pearl. "Not only will this designation not correlate with added quality, it may in fact be associated with less excellent physicians."

Although physician recruitment is a challenge for Kaiser Permanente, according to Dr. Pearl, "It is a crisis in the communities around us, since few, if any, excellent, newly trained physicians are opening practices in Northern California. In contrast, 22% of the graduating residents in the entire nation last year applied for a position in TPMG."

The inability to recruit physicians is taking a toll on the Palo Alto Medical Foundation, which is currently accepting no new patients to its primary care departments in Palo Alto. At Hill Physicians Group, the second largest medical group in Northern California, a dearth of younger physicians has raised the average age of their physicians to approximately 54 years old, compared to 44 years old in TPMG.

"TPMG recruited 500 physicians in 2001 and the latest Physician Opinion Survey had the highest ratings in its history," reports **Connie Wilson, VP for Human Resources, TPMG**. "In addition, for the past two years, approximately 40% of our new hires have been physicians coming out of community-based, private and academic practices."

TPMG physicians don't have to worry about being dropped by the health plan or lose sleep about how they're going to pay their office overhead. And there are other advantages, including as Dr. Marrama notes, "an integrated information technology system that is almost chartless. It's wonderful to be able to see patients and look up their history, medications and laboratory results on CIPS. We didn't have anything like that; no one has the capital to develop such a system outside of TPMG. The insurance companies certainly aren't going to fund it, and the IPAs are starved for money, living month to month."

"Because of our relationship with Kaiser Foundation Health Plan and Hospitals, we have the ability to make such long-term investments in information technology and the Internet, as well as in bricks and mortar projects," notes Ms. Lapiz. "It's a relationship unique in health care and it's growing even more stable over time."

Some physicians are trying to remain solvent by refusing to care for patients insured by lower paying health plans. According to a March 28, 2002 report in the *Santa Rosa Press Democrat*, "dozens of physicians, many affiliated with Memorial Hospital, are shunning medical contracts with Blue Cross in a move that could push several thousand patients to switch doctors or health plans." And on March 18, 2002, *The New York Times* reported that for the first time a significant number of doctors are refusing to take new Medicare patients because of a recently enacted 5.4% cut in reimbursement rates. Although this approach may

work for a limited number of physicians, the majority are trapped and uncertain about their future.

## Patients

Although times are tough for many physicians, it is the patients who bear the full brunt of the health care storm. When PacifiCare dropped the Alameda Medical Group, their Medicare patients received a letter giving them the news and assigning them to new doctors, some of whom were located 20 miles away. CalPERS dropping HealthNet and PacifiCare means that 350,000 people will have to get new insurance coverage and at least 35,000 will have to find new doctors. Likewise, when health plans sever relationships with hospitals or physicians refuse to accept certain insurance plans, it's the patients who have to scramble to find alternatives.

"Just as physicians are attracted to the stability TPMG can offer, we are hearing from some of our new members that the main reason they joined KP is that they were sick and tired of the instability, where month-by-month they would have to change insurance companies, change hospitals, change doctors," says Dr. Pearl. "They know we have been providing medical care for 50 years and are confident that we will continue to do so for the next half century."

The turbulence for patients also comes in the form of increased complexity and greater financial risk. As employers shift more choice and costs to employees through defined contribution plans, Mr. Wilson explains, "Some people will gamble that they're not going to need health care services, so they'll put out fewer dollars and take the lowest benefit their employer offers them. If they gamble right, it works out; if they don't, they may find out that they didn't have enough protection against a catastrophic event and that they're faced with horrendous medical costs."

## KP's Challenges

"As a consequence of our outstanding quality of medical care, the comprehensiveness of our benefits and the increasing problems of our competitors, we will be increasingly attractive to patients with chronic illnesses and those with significant medical problems. It will be essential that we build new facilities at a rapid pace while continuing to hire excellent physicians, nurses and staff. In addition, we must continue to focus on the medical and service needs of all of our members, if we want to have a balanced membership that includes our fair share of both the sick and healthy," cautions Dr. Pearl.

"We need to recognize that while providing comprehensive, high quality care is fundamentally important, it also makes us particularly attractive to the segments of the population with greater medical need," says Ms. Paige. "In order to be healthy as a business, we have to figure out distinct ways of being more appealing to people whose medical needs are less. For example, we need to enhance the convenience associated with using KP, through a continued focus on access and service; and we need to continue to promote the convenience of our integrated system and such features as KP Online."

"With the lack of stability in the marketplace, there also is a threat that we might grow more rapidly than our capacity to manage the growth," notes Dr. Houska. "When this happened in

the mid-1990s, the added costs and inefficiencies of having to send patients outside for care, rather than caring for them ourselves, contributed to a major financial disaster. However, we are currently in such a strong position that I'm more worried about the forces around us that will eventually have an impact on us than I am about Kaiser Permanente."

"There is no one in health care today who would not choose to trade positions with us," concludes Dr. Pearl. "While almost all of the other companies are getting battered, we are stable, growing, recruiting excellent physicians and continually differentiating ourselves as the quality leader in Northern California. I am confident that if we can retain our cohesiveness and the excellence of our physicians and staff, innovate and learn from each other, and continue our quality and service excellence, we will overcome these newest threats and become even more stable in the future."

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