



Everything Has Its Price

How Incremental Economics Lures You Into Thinking You Can Get Something for Nothing

By Dexter Braff

YOU'RE PREPARING A BID for a large managed care contract. Competition is fierce, and you suspect that pricing is likely to be the deciding factor. You figure that your core business pays for the company's basic operations. If you can just cover your direct product costs, any price above that will drop right down to the bottom line—after all, this contract represents “incremental” business. You conclude that

you can afford to offer a substantial discount. You further reason that the increased volume of business you will gain will more than justify the reduction of margin you will experience.

The theory seems reasonable, but in fact, it is severely flawed.

The concept behind incremental economics is that once the fixed costs of a business have been covered

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and as long as price exceeds the variable, or direct, cost of any other products and services, the sale will generate incremental profits. For example, once Microsoft covers its fixed product-development costs, for each additional sale, anything charged above the direct variable cost of a

disk and packaging drops right down to the bottom line.

To apply these concepts correctly, it is critical that the fixed and variable cost structures of the company are identified. This is where home medical equipment (HME) providers frequently go wrong. A substantial portion of the industry's costs are misidentified as fixed costs when they are, in fact, a special type of variable cost.

Consider the liquid oxygen business. Liquid oxygen is required for each patient served. Liquid oxygen is a pure and easily identifiable variable cost. But what about the therapist required to



monitor and support the patient? Most managers consider therapists a fixed cost. After all, you don't need to hire additional therapists for each patient served. The problem is that as your patient base grows, you eventually need to hire additional therapists. And it doesn't take many new patients to make new hires necessary.

Costs that vary with activity level, albeit at greater intervals of activity, are known as step-variable costs. Such costs, which include customer service, delivery, billing and collections, and clinical personnel expenses, are a major component of the traditional HME company's cost structure. By misidentifying step-variable costs

as fixed costs, managers underestimate the variable cost of the services they provide. In applying incremental analysis to pricing these products and services, managers often under-price contracts, mistakenly believing they are still making a profit.

Consider again our liquid oxygen example. If a manager using an incremental approach to pricing a managed care contract considers the liquid contents and the depreciation expense of the system as the only variable costs, he or she might conclude that a substantial discount can be offered, with the company still making money. In fact, before increased activity levels trigger additional step-variable costs, the company might make money. Flushed with the initial success, the company might even be seduced into aggres-

sively seeking more managed care business at similar discounts. Eventually, however, the firm will need to add another therapist ... and another customer service representative ... and another biller ... and another driver. This will quickly and mercilessly drive the managed care business into the red.

HME providers can employ several strategies to address these problems. For starters, step-variable costs must be considered in developing appropriate pricing strategies. Historically, contracts have been awarded to the lowest bidder, who frequently underestimates costs. With several high-profile contracts proving unprofitable and unsustainable, however, managed care providers are beginning to take a second look at more reasonable proposals. HME companies should also strive to maintain as much full-margin business as possible. For most, managed care—with its bottom-line mentality—should be only part of the mix—not the entire focus.

Finally, providers should continue to explore ways to reduce variable costs through investment in fixed costs. The most exciting opportunities revolve around information technology. The use of telemedicine, handheld computer devices used by nurses and clinicians, and concentrators that can be monitored via modem are all designed to reduce the often redundant work flow of step-variable laden costs such as customer service and delivery. With a reduced variable-cost structure, companies will be better able to leverage their investment in fixed costs to wring incremental profits from their managed care business. **HC**

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