



RESEARCH REPORT

Payment Methods and Benefit Designs: How They Work and How They Work Together to Improve Health Care

Reference Pricing

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Payment reform promises to substitute value for volume. Yet, value- and volume-based approaches typically are implemented together. All payment methods have strengths and weaknesses, and how they affect the behavior of health care providers depends on their operational design features and, crucially, on how they interact with benefit design. Those seeking greater value for their health care dollar are also turning to innovation in benefit design, which also typically involves the implementation of more than one approach at a time—each with its own strengths, weaknesses, and effect on consumer health care behavior. Although payment and benefit design each has received significant attention independently, the intersection between the two has received little if any. The Urban Institute partnered with Catalyst for Payment Reform to explore how established and proposed payment methods and benefit design options work on their own and together. We also examined how payment and benefit design can be blended to improve health care delivery. This chapter is one of the seven benefit designs discussed in the report *Benefit Designs: How They Work*. All reports and chapters can be found on our project page: [Payment Methods and Benefit Designs: How They Work and How They Work Together to Improve Health Care](#).

Reference Pricing

When implementing reference pricing, a payer establishes a standard price for a drug, procedure, service, or bundle of services and requires that plan members pay any allowable charges above this price (rather than fixing patients' out-of-pocket costs). Therefore, consumers' out-of-pocket costs are the difference, if any, between the actual price of services received and the established reference price. Generally, the payer provides consumers with a list—sometimes through a consumer-oriented Web site—that reflects providers' prices and whether they meet or exceed the reference price. This allows consumers to make a value-based choice concerning their care, enabling them to weigh the trade-offs between their expected out-of-pocket costs and the provider from whom they wish to receive health care services.

Reference pricing can apply to services that vary substantially in price, yet are commonly perceived to have little variation in quality. These “commodity-like” services are always non-emergent and offered by multiple providers in the market. They may include laboratory services, imaging, colonoscopies, MRIs, and drug prices. While many reference pricing designs are based solely on price, some programs feature high-cost, more complex services, such as hip and knee replacements, for which quality can vary. These programs highlight providers that not only deliver a service at or below the reference price, but

also meet certain quality criteria, which can steer patients away from providers with high complication and readmission rates. As well, these designs can deflect criticism from those who perceive reference pricing as purely an attempt to shift the cost of care to the consumer.

While reference pricing provides consumers with strong incentives to choose lower-cost providers for services, it does not restrict consumers from receiving care from particular providers. Even if there is a large difference between the reference price and the allowable charge (the consumer's out-of-pocket costs), consumers can receive care from any provider as long as they pay the difference.

To establish a reference price that will be functional in the market, the payer must consider whether enough providers are offering a selected service at or below the price to ensure adequate access for patients. Without an adequate number of providers at or below the reference price, patients may not be able to get care promptly. On the other hand, if the reference price is set too high, there may be little to no effect on spending.

Key Objectives of Reference Pricing

Many services vary substantially in price within and across regions of the country. A major objective of reference pricing is to eliminate the vast variation in payment amounts (prices) by setting a “cap,” or a reference price, that reflects what health plans and other purchasers think is a reasonable price for that particular service.

Another objective of reference pricing is to encourage consumers to obtain services that vary substantially in price from less-expensive providers. If consumers are seeking those services from less-expensive providers, other providers in the market may lose patient volume and attempt to renegotiate prices with health plans. This could have a downward effect on prices.

Strengths

- Reference pricing has the potential to save the plan, the purchasers, and the system money if incentives are structured so that consumers seek care from lower-cost providers, or if providers lower their negotiated payment amounts to meet or beat the reference price in an effort to maintain or increase patient volumes.

- When reference pricing is used to highlight providers based on price and adherence to quality criteria, it could direct consumers to higher-quality, lower-price providers.
- The reference price chosen can send signals to providers about what the plan and its employer-purchaser customers think is a reasonable price for a particular service. This reference can also inform future negotiations between the health plan and providers; providers may seek renegotiation with health plans to stem the loss of patient volume from exceeding the reference price.
- Because reference pricing is generally established for services that vary widely in price, it can educate consumers about how much prices can vary in health care.
- Reference pricing still allows consumers to have a choice of providers for a given service, letting them weigh the trade-offs between seeing their desired provider and their share of the cost of the service.

Weaknesses

- The applications for reference pricing are typically limited to shoppable “commodity” services—services for which price information is available—that represent a small share of total costs. While reference pricing lends itself well to other, more complicated services for which quality can vary, like hip and knee replacements, it hasn’t often been applied for complex or extremely high-cost services, as it can disrupt care for patients and be more complicated to administer.
- Educating consumers on how to make decisions using available price and quality information can take significant time and resources, but it is necessary to implement a reference pricing program successfully.
- Transparency could also lead providers to raise their prices if the reference price is higher.
- In a market with a dominant health system, implementers may face obstacles in establishing a reference pricing program. Dominant providers may agree to meet the reference price for services for which they compete for patients, but raise prices for services where they have less competition.

- Regardless of the market environment, if a provider lowers its price to meet the reference price, it could try to make up the difference by increasing how often it performs the service or by raising the price of other services not subject to the reference price.

Design Choices to Mitigate Weaknesses

Selecting the Services

Reference pricing can be used with “commodity” services that have significant price variation, but are considered to have little to no variation in quality. For example, the concept was first applied to drug pricing, as pharmaceuticals—particularly brand versus generic—vary significantly in price. Commodity services are typically offered by multiple providers in the market and may be high margin, making providers more willing to compete on price. Additionally, some research suggests consumers are more likely to shop around for these services. However, reference pricing has also been used successfully on complex, high-cost procedures such as total joint replacements, where quality is more likely to vary and the potential for savings is far greater.

Setting the Price

Various factors must be considered when setting a reference price. The payer starts by analyzing the range of prices it is currently paying, at the local, regional or national level, and determining what it believes to be a reasonable price that won't create unintended negative consequences. An adequate number of providers must be at or below the established price to ensure that enough patients have access to the targeted service or procedure. If the price is too low, patients may have a hard time finding a provider at or below the reference price. Providers also have the potential to increase their prices for other services to make up for the loss in revenue. CalPERS (the California Public Employees' Retirement System) set its reference price for knee and hip replacement to include two-thirds of the hospitals in its PPO network. However, if the price is too high, reference pricing will have little to no effect on spending.

Another factor to consider when establishing the reference price is geography. Most reference pricing programs set the reference point locally or regionally, because health care prices vary

significantly across (as well as within) markets, but this can be difficult to explain to a population of employees spread out across the country.

Availability of Price and Quality Information

Transparency can help consumers see the vast variation in price and quality that exists for particular procedures. In addition, price transparency, in the form of provider lists or online tools, can inform consumers about which providers are at, below, or above the reference price, which can help them weigh the trade-offs between the price and the provider. Additionally, for more complex care involving more than a single service or procedure (such as an isolated lab or imaging test), transparency tools can inform consumers about what services are and are not included in the reference price (e.g., all aspects of a hip replacement including rehabilitation, or just the surgery itself). This way, patients will know if they need to pay an additional share for elements of their care not included in, or subject to, the reference price.

Quality Performance

Health care providers' performance on the quality and safety of care they deliver can also be built into the design of a reference pricing program. Ideally, providers willing to accept the reference price can deliver acceptable quality and access. A variety of reference pricing benefit designs incorporating quality can be considered, from a quality threshold providers must meet to earn reference pricing incentives, to lower consumer cost-sharing for higher-quality providers (even if they do not charge the lowest price).

Environment

Reference pricing may not function well in highly consolidated markets where dominant providers could pressure payers to not implement this approach, or could use their leverage to negate its benefits by generating more revenue with other services. Second, the laws regarding price and quality transparency can have an effect. Such transparency is critical for reference pricing. Whether reference pricing is in place due to state laws and programs, or because the private sector fulfills the need, it cannot operate without transparency.

Compatibility with Other Benefit Designs and Payment Approaches

Reference pricing could be used in high deductible health plans (HDHPs). Consumers with HDHPs that receive an expensive procedure, such as a hip or knee replacement or maternity care, could have their deductible kick in only if the cost of care is above the established reference price. Therefore, the health plan would cover the cost of the procedure up until the reference price, with any charges above it subject to the deductible.

Reference pricing is most often used to constrain the cost of shoppable “commodity” services, which involve a discrete service or procedure (e.g., a lab or imaging test). It therefore pairs well with fee schedules, which associate a specific price with each discrete service or procedure. Reference pricing puts downward pressure on prices, which could help counter the inherent inflationary incentives of fee schedules. However, reference pricing does nothing to counter the volume incentives of fee schedules; thus, physicians may respond to reference prices by simply doing more of the procedure or service to account for reduced prices.

It is easier to pay fee schedules for commodity services (rather than complex services) through reference pricing because there is one single service performed. For a single-day encounter (e.g., a colonoscopy) it is much easier to control the patient’s out-of-pocket costs than it would be for a complex procedure with related services (e.g., hip replacement with physical therapy). A provider performing more complex procedures could reflect the price of the procedure by itself as meeting the reference price, but tack on additional high-cost services to the patient’s bill. Patients would then face bills that did not reflect the original price offered them and would be subject to more costs than expected. Additionally, for complex high-price procedures, patients could easily reach their deductibles or even their out-of-pocket maximums.

Reference pricing can pair well with bundled payment from both the consumer’s and the provider’s perspective. For the consumer, it means that the reference price is all-inclusive, referring to the entire episode of care as opposed to an individual service within an episode of care. As a result, the consumer should not experience any unexpected additional costs associated with the episode. For the provider, higher patient volumes could be a welcomed reward for agreeing to accept bundled payment and adhering to the reference price. However, reference pricing does nothing to counter the volume incentives of bundled payments; thus, providers may respond to reference prices by simply doing more procedures to receive more bundled episode payments to make up for reduced prices.

Focus of Performance Measurement

Reference pricing is often established for services that vary substantially in cost but are perceived as having little to no variation in quality. Therefore, quality has not generally been a consideration in designing a reference pricing program. Other programs, such as those not designed for commodity services, may address vast variation in both prices and quality. For these programs, the health plan can do one of two things: (1) use quality metrics specific to the service selected, so that the consumer can make informed choices about the trade-offs between different providers, or (2) highlight providers or facilities that not only deliver a service at or below the reference price, but also meet certain quality assurance standards. If quality becomes an integral part of a reference pricing program, the implementer can use it to highlight particular providers who meet the reference price.

Potential Impact on Provider Prices and Price Increases

In a competitive market, if reference pricing successfully incentivizes consumers to make cost-effective decisions about a service, it may draw some consumers away from higher-priced providers and toward lower-priced providers. The threat of lower patient volumes could lead to price negotiations between the payer and providers in the market, which could lead to lower prices. However, providers may raise prices for other services to make up the difference.

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