

Complexity's Challenge to Integrated Health Delivery

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As with all companies, health systems grow organically and through acquisition by pursuing horizontal and/or vertical strategies. All growth strategies fall within this four-corner matrix:

Health System Investment Matrix

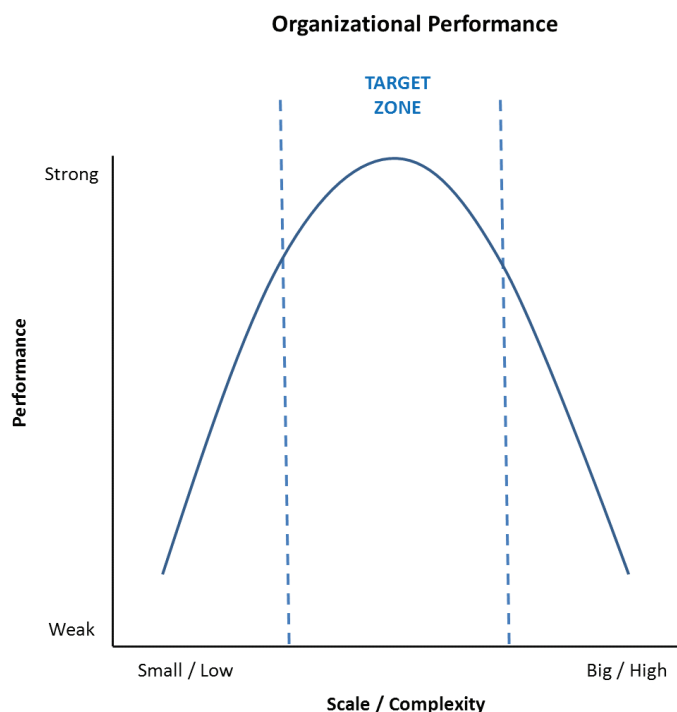
Growth Strategies

		HORIZONTAL	VERTICAL
Types of Growth	ORGANIC	Invest in Acute Facilities	Hire Physicians; Invest in Non-Acute Facilities / Businesses
	ACQUISITION	Purchase Acute Care Facilities / Businesses	Purchase Physician Practices and Non-Acute Facilities / Businesses

Historically, health systems have largely pursued horizontal growth by building or acquiring acute care facilities. As reform marches forward, many health systems are growing vertically by expanding their care continuum to become integrated delivery systems (“IDSs”), capable of managing care for distinct populations. Growth creates economies of scale by spreading fixed-costs over larger operating platforms, eliminating duplicative functions and increasing negotiating leverage. Growth also increases organizational complexity by blending cultures, introducing new business/regulatory risks and requiring more expansive oversight. As companies grow, diseconomies of complexity offset and sometimes overwhelm beneficial economies of scale. Vertical growth is more complex than horizontal growth. Managing complexity is particularly challenging for health systems developing IDSs.

Performance and the Inverted “U” Curve

In *David and Goliath*, Malcolm Gladwell discusses the “inverted U curve” phenomenon where performance improves, levels and declines as a measurable index increases¹. This relationship applies to parenting and wealth (too little wealth makes parenting difficult but so does too much); wine consumption (a little wine is healthy, too much isn’t) and school classroom size (performance suffers when classes are too small and too large). The chart below displays an inverted performance U curve relative to a company’s scale and complexity:



As companies grow, their performance improves with increasing economies of scale. This continues until they reach a “target zone” where diseconomies of complexity offset further economies. As scale and complexity push beyond equilibrium, performance declines. Mergers fail when complexity and its associated costs exceed accretive value. Most acquired hospitals underperform for this reason². Performance curves related to scale and complexity vary by industry and company. Managing the inherent tension between scale and complexity is a key determinant of organizational success.

JP Morgan Chase and Wells Fargo: A Tale of Megabanks

Contrasting America’s two largest banks, JP Morgan and Wells Fargo, illustrates how operating complexity, not just organizational size, determines a company’s level of managerial challenge and influences its performance. In October, JP Morgan posted its first quarterly loss since 2004, due largely to litigation costs and regulatory settlements. In June, Wells Fargo passed the Industrial and Commercial Bank of China to become the world’s largest bank as measured by market capitalization.

2012 Revenues	\$97 Billion	\$86 Billion
2012 Total Assets	\$2.5 Trillion	\$1.4 Trillion
2012 Net Income	\$21.3 Billion	\$18.9 Billion
Market Capitalization *	\$217 Billion	\$234 Billion
Major Legacy Companies	Bank One Bear Stearns Chase Manhattan Bank Chemical Bank JP Morgan & Co. Manufacturers Hanover Bank Texas Commerce Bank Washington Mutual	Norwest Wachovia

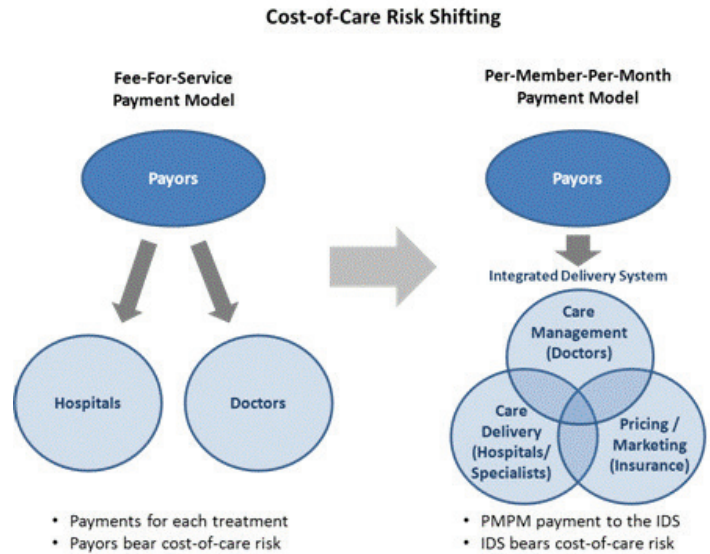
* as of November 25, 2013

Despite lower revenues, significantly lower total assets and equivalent profitability, Wells Fargo has a higher market valuation than JP Morgan (\$234 billion versus \$217 billion). Wells Fargo's superior performance is due in large measure to its less-complex operating structure. Wells Fargo operates primarily as a U.S. commercial bank. Its principal business is cross-selling banking products to corporate and individual clients. Most of Wells Fargo's growth has been organic. By contrast, JP Morgan operates global franchises in commercial banking, investment banking, asset management and proprietary trading. It must comply with nation-specific regulatory requirements in over sixty countries. JP Morgan has grown substantially through acquisitions. Its global operations, diverse businesses and numerous legacy cultures make its scale/complexity challenges greater than Wells Fargo's. Consequently, JP Morgan has greater *diseconomies of complexity* than Wells Fargo and their respective market valuations incorporate this operating reality.

Applying this analytic framework to healthcare, it's clear that IDSs have more operating complexity than hospital management companies. On a relative basis, it's likely that IDSs experience greater diseconomies of complexity.

Shifting Cost-of-Care Risk

As reform unfolds, many health systems are developing integrated delivery systems to manage the care of distinct populations. While this is not new (Kaiser Permanente has operated IDSs for decades), IDSs represent a major business model shift for treatment-focused health systems accustomed to fee-for-service payments. The following chart displays the risk-shift that accompanies the IDS business model:



Former Senator Bill Frist believes the cost-of-care risk shift to consumers and providers is the major force driving health reform. The consequences of this risk-shift manifest themselves in the following ways:

- As consumers accept more payment responsibility, they become more price conscious. Early health exchange enrollment suggests that consumers prefer lower-cost narrow network insurance products.
- Narrow network contracts with employers are increasing.
- Some employers are contracting directly for specialty care services.
- Medical inflation is at its lowest levels in fifty years
- Health insurance companies are investing in care management capabilities
- Health systems are negotiating more risk-based contracts, including shared-savings agreements, bundled payments and full-risk contracts
- Public pressure for greater price and outcomes transparency is intensifying

IDSs manage their customers' entire care experience. Per-member-per-month payments incentivize early disease detection, pro-active treatment and medical error reduction. IDSs manage individual care, reduce total care costs and price/market their services within one integrated company. Increasingly IDSs will engage customers closer to home and rely on virtual technologies to advance health. To succeed, health systems developing IDSs must do the following:

Acknowledge the Primacy of Care Management: Effective care management is the essence of population health. Primary care physicians, supported by aligned care professionals and real-time data, make sure customers receive the right care at the right time in the right place. Care management systems assess, monitor and guide customers in living healthier. Unfortunately, few health

systems have the care management capabilities necessary to operate effective and profitable IDSs. Moreover, implementing population health requires health systems to overturn ingrained behaviors developed over decades in “treatment-first” cultures – not impossible but not easy either.

Embrace Comparative Effectiveness: understanding organizational competencies and outsourcing to cost-effective partners are necessary to provide the highest quality, lowest-cost care. Outsourcing is difficult in hospital cultures that own all aspects of care delivery (e.g. facilities, operations). Brand impact, customer experience and cost-effectiveness are the relevant measures in making resource allocation decisions.

Rationalize Facilities and Services to Match Treatment Demand: in fee-for-service payment models, physicians and hospitals receive payment for services independent of need or outcomes. Activity-based payment limits preventive care, incentivizes overtreatment and pays for medical errors. As the payment model shifts, IDSs must rationalize facilities and consolidate clinical services to meet market demands for efficient, high-quality care. Care centers will move closer to customers and remain open longer. Implementing customer-centric businesses will challenge health systems wedded to hospitals and dependent on favorable reimbursement contracts.

Operating IDSs is complex and increases health systems’ performance risk. Integrated delivery requires companies to run their care management, delivery and insurance businesses in ways that complement, not cannibalize, one another. The interconnectivity of these businesses increases the negative impact of managerial errors. Mispricing insurance could diminish revenue available to fund necessary care. Overtreatment could generate unexpected operating losses. Ineffective care management could lead to excessive medical admissions.

Managing integrated delivery, aligning incentives and optimizing performance will challenge health systems as they adapt to new market realities. Expect high performance variation as companies gain experience with new payment models and changing customer needs. As Charles Darwin observed, *“It is not the strongest of the species that survives, nor the most intelligent that survives. It is the one that is the most adaptable to change.”* What is true in nature is also true in markets. Winning health companies will adapt their business models to meet customer demands by delivering better care at lower prices.

1 [David and Goliath](#) by Malcolm Gladwell See Chapter Two: “Teresa DeBrito”, sections 4 and 5 for a complete discussion of inverted U curve dynamics.

2 See my June 2013 article “Scale Matters: Bigger and Better Health Systems”. It references studies by Deloitte and Booz & Co. that support this conclusion.