The Importance of Revenue Resiliency

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As we emerge from the COVID-19 pandemic, we face a changed reality. Expenses—particularly labor expenses—have reset at a higher level. Inflation is rising at rates not seen since the early 1980s. As the Federal Reserve tightens monetary policy in response to inflationary pressures, borrowing costs, which have been at historically low levels, will rise. The Fed's efforts to deflate a balance sheet that has grown to nearly $9 trillion may make capital markets more volatile.

Given these headwinds, the integral role of revenue resiliency in maintaining hospital margin and cash flow generation will only intensify. When the pandemic's operational disruptions weighed down income statements, balance sheet strength served as a counterbalance. Now that the balance sheet faces volatility of its own, healthcare leaders must renew their focus on operations and revenue generation.

This effort will be complicated by factors that pose their own challenges to revenue growth. This article examines these factors and their potential impact and suggests strategies to help build revenue resiliency.

Volumes Have Recovered, but Remain Below Pre-Pandemic Levels

While volumes showed a rebound in 2021 from 2020's steep declines, they remain below pre-pandemic levels. Kaufman Hall data show that, in comparison to calendar year 2019, inpatient discharges were down 8 percent in 2021, operating room cases were down 8.8 percent, and emergency departments visits were down 10.6 percent (especially significant, as many hospitals' discharges have historically come from the emergency department). Patient days was the one volume metric that showed positive growth—with a 1.3 percent increase over 2019—likely driven by longer stays for hospitalized COVID-19 patients and a higher case-mix acuity from patients who had delayed care early in the pandemic.

Higher-acuity care was a likely factor behind the fact that, even though most volume indicators remained below pre-pandemic levels, gross operating revenue (without CARES funding) grew 10.4 percent in 2021 compared with pre-pandemic numbers from 2019. Add-on payments for COVID cases also contributed to this growth. Acuity may have begun trending downward in the second half of 2021, however, and the growth in gross operating revenue was almost matched by a 9.9 percent growth in total expenses in 2021 as compared with 2019.

As we move past the Omicron surge of infections, the question of future variants, their severity, and their potential impact on volume recovery remains an unknown, especially in areas with low vaccination rates. Also worth noting is that inpatient volumes were softening even before the pandemic struck: In 2019 the volume of discharges was down 1.5 percent over the previous year.

Changing Demographics Will Limit Price Elasticity

Demographic trends will create headwinds for revenue growth over the longer term. Since passage of Medicare legislation in 1965, life expectancy in the U.S. has increased from just over 70 years to almost 79 years. Medicare now pays for 14 years of a typical beneficiary's healthcare, as compared with five years when the law was passed. At the same time, birth rates have fallen and the percentage of the population age 65 and above has grown. By 2030, the U.S. Census Bureau projects that the U.S. will have crossed two demographic turning points: The percentage of the population 65 and older will pass 20 percent, and older adults will outnumber children for the first time in U.S. history.[1]

> **Key Board Takeaways**
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> - The balance sheet, which has served as a counterbalance to operational disruptions, now faces potential volatility as the Federal Reserve tightens monetary policy. A renewed focus on operations and revenue generation is required.
> - Volumes have recovered, but remain below pre-pandemic levels. At the same time, a demographic shift is underway that will limit price elasticity for hospitals and health systems.
> - With volumes and pricing both under pressure, boards must seek diversification of both revenue and payment models.

As the population ages, Medicare and Medicare Advantage will comprise a greater portion of hospital revenues, limiting price elasticity with rates that are largely non-negotiable. Growth in Medicaid and the move to Medicaid managed care by nearly all states also will foster greater price inelasticity. Kaufman Hall data show that the change is already underway: On a combined basis, Medicare, Medicaid, and their related managed care structures rose from 59 percent of hospitals' gross patient revenues in 2018 to 66 percent in 2021.

While Medicaid cuts were largely absent in recent state budget sessions due to increased federal funding, we anticipate that many states will revisit Medicaid budgets in coming legislative sessions. The anticipated Medicare sequestion of 2 percent was delayed through March 31, 2022, with the cut reduced to 1 percent through June 30, 2022, allowing hospitals three more

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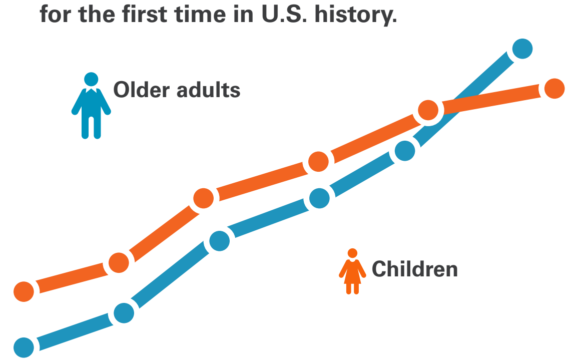

1 Jonathan Vespa, Lauren Medina, and David Armstrong, "Demographic Turning Points for the United States: Population Projects for 2020 to 2060," U.S. Census Bureau, March 2018, revised February 2020.

months before the sequester resumes.[2] At the same time, increased federal spending and a very high national debt raise the possibility of further material Medicare reductions, similar to the Balanced Budget Act of 1998.

As the population continues to age, health systems' ability to rely on commercial rates for revenue growth will wane. On average, commercial revenues represented only about one-fifth (20.5 percent) of gross patient revenues in 2021. Most hospitals are price takers, not price setters, which means that they have limited bargaining power when negotiating rate increases with commercial payers. Some hospitals anecdotally report recent, more favorable negotiations with commercial payers than in prior years, partially driven by the optics surrounding payer profitability levels during 2020. But as enrollees seek more care in 2022 and payer profit margins ebb, we expect the next round of negotiations to be tougher and more contentious.

Building Revenue Resiliency

Moving forward, a revenue strategy based on volume growth will be risky, especially if it is too reliant on recovering inpatient volumes. Building revenue resiliency will require diversification of both revenues and payments.

Revenue diversification. Revenue diversification will be key to revenue resiliency, especially growth in outpatient services such as ambulatory surgery, urgent care centers, imaging centers, and other sites of care. Several factors should give urgency to this effort. Kaufman Hall data show that the 2021 inpatient to outpatient adjustment factor actually contracted by nearly 1 percent compared to 2019 levels; this indicates that patients are either seeking outpatient services outside of the hospital's ecosystem or delaying outpatient care. We know the pandemic greatly increased telehealth use and intensified a trend toward "do-it-yourself" healthcare.[3] Non-traditional competitors have been active in these and other spaces; hospitals and health systems will need a speed-to-market approach as non-traditional competitors quickly build their presence in outpatient services, particularly in high-growth markets with large, commercially insured populations.

Payment diversification. Despite policies that have incented the industry to move to value-based payment, the industry remains largely fee-for-service, with providers paid based on volume and acuity. The pandemic exposed vulnerabilities of the fee-for-service system and we have seen new interest in diversification of the "payment portfolio." We anticipate accelerated movement toward value-based payment models that will lessen dependence on volumes as the primary revenue driver.

The two traditional drivers of revenue—volumes and price—are both under pressure. To build revenue resiliency, hospital and health system boards and senior leaders must seek new areas of growth and new payment models in the months and years ahead.

The Governance Institute thanks Lisa Goldstein, Senior Vice President in the Treasury and Capital Markets practice and Thought Leadership team at Kaufman, Hall & Associates, LLC, for contributing this article. She can be reached at lgoldstein@kaufmanhall.com.

2 The Protecting Medicare and American Farmers from Sequester Cuts Act, Public Law 117-71, December 10, 2021.
3 Betsy Morris, "The New Trend in Healthcare: Do-It-Yourself," *The Wall Street Journal*, January 11, 2022.