

Health System Improvement

# How to Make Reference Pricing Work for Consumers

Reference pricing programs can help counter the wide variation in prices for health care services that exist across the country.

In our current health care system, prices for medical care often vary greatly—even for the same services from providers in the same network. This variation in health care prices often does not reflect the quality of the care provided. Instead, it reflects the fact that some providers have greater market power and can negotiate higher prices with insurers.

Moreover, information on prices is usually not available, so consumers usually do not have the information they need to choose providers based on both price and quality. As a result, consumers often pay too much for health care, and there is little pressure on overly expensive providers to set fairer prices for care.

In an effort to control costs, health care payers—including employers, state employee health plans, and private insurers—are increasingly implementing reference pricing. Reference pricing is a practice health care payers use in which they set a threshold price (above which they will not pay) for a particular health care service in a given area. If a consumer receives care from a provider that charges his or her health plan more than the reference price, the consumer is responsible for paying the difference.

If implemented effectively, reference pricing programs can give consumers the information they need to compare providers based on both price and quality, and they can encourage consumers to receive care from providers that deliver the best care at the best price (high-value care). More importantly, reference pricing programs have the potential to pressure overly expensive providers to set more competitive prices.

This brief explains price variation and reference pricing and discusses how reference pricing can be used to minimize variation in health care prices. It then outlines the key elements that reference pricing programs must include to be effective and consumer-friendly.

## **Why prices for health care services vary so widely**

How do health care providers and private health insurers typically set prices? Each provider negotiates with individual insurers to set prices that the provider is willing to accept as payment for specific services from that particular health plan. Providers of equal quality may charge very different prices for the same services. We end up with widely varying prices<sup>1</sup>—but little to no correlation between price and quality.

What does this mean for consumers? It means that they can face vastly different prices for the same care,

Reference pricing programs use financial incentives to encourage consumers to shop for health care based on price and quality, and to pressure overly expensive providers to set fairer prices.

These programs can help minimize price variation. But they must follow certain guidelines to ensure that they protect consumers' access to high-quality, affordable care and give consumers the understandable, up-to-date price information they need to make informed decisions.

depending on their provider and their health plan. It also means that consumers cannot use higher prices as a reliable proxy for higher-quality care. Providers who charge more may simply have greater negotiating power because they control a larger share of the market or have brand recognition in that region.

For example, recent research has found that, while high-priced hospitals tend to have some unique characteristics that could affect prices (such as offering more specialized health care services and being involved in medical education), these hospitals also enjoy significantly larger market shares than low-priced hospitals. This enables them to negotiate higher prices. Research also found that high-priced hospitals do not consistently perform better on outcome-based measures of quality compared to low-priced hospitals.<sup>2</sup>

### **Lack of price transparency makes it difficult for consumers to make informed decisions**

This immense price variation persists, in some part, because there is limited public information available about the prices that providers negotiate with insurers (often referred to as “price transparency”). While many states require providers to report what their “charges” are for certain services, these charges are almost always hypothetical list prices that are typically higher than the negotiated prices insurers actually pay providers (see “Key Terms”).

Without price transparency about the negotiated prices health plans and providers set, consumers are unable to select health care providers based on price and quality. And providers and insurers have little incentive to set competitive, fair prices.

### **How does reference pricing work?**

The goal of reference pricing is to promote greater price transparency, to encourage consumers to shop for care based on price and quality, and to pressure overly expensive providers to set fairer prices for care.

A reference pricing program targets health care services where there is significant variation in the prices that different providers charge—but little to no correlation between higher-priced providers and the delivery of higher-quality care. Reference pricing programs target only “shopable” health care services for which consumers have the opportunity to select a provider (not emergency care). For these services, the insurer sets a “reference price,” which is the most that the health plan will pay for that particular health care service. When an insurer is establishing this maximum price, it must make sure that it has an adequate number of high-quality providers whose prices for that service fall within the reference price threshold.

If consumers receive a service from a provider that is within the reference price, they are responsible for paying only the regular out-of-pocket costs they would typically pay under their plan. A plan could also waive

### **Key Terms**

**Charge:** The amount a provider bills for a particular service. This number is often much higher than the negotiated amount a provider accepts as payment from an insurer (the price). Some parties may also refer to a “chargemaster,” which is a list of a provider’s charges for numerous services.

**Price:** The negotiated amount that a provider has agreed to accept as payment for a service from a particular insurer. This is sometimes referred to as the “allowed amount.”

**Price transparency:** The availability of provider-specific information on the price of a specific health care service or set of services.<sup>3</sup>

or reduce cost-sharing for a service that is subject to reference pricing when consumers receive that care from a provider that charges within the reference price.

But if consumers receive a service from a provider that charges *more than* the reference price, they are responsible for paying the full difference between the reference price and the price the provider charges their plan. This cost is *in addition* to any cost-sharing they must pay.

Lets say a health plan sets a reference price of \$1,200 for a standard colonoscopy. A consumer in that plan opts to get a colonoscopy from a provider that has negotiated a price of \$2,000. That consumer would be responsible for covering the additional \$800 that his or her provider charges the health plan for the colonoscopy, in addition to any cost-sharing.

Reference pricing can be applied to individually billed health care services (such as the hospital fee for a colonoscopy), or a bundle of services for a particular episode of care (such as all care for a routine knee replacement surgery, including hospital and physician fees).

Reference pricing can also be set for groups of substitutable medications that are equally effective but that have significant price variation, such as medications with multiple brand-name and generic equivalents.

## Reference pricing can encourage providers to set fair prices

One of the most significant benefits of reference pricing is its potential to drive health care savings by pressuring providers to lower their prices. When consumers have understandable information about price and quality and a financial incentive to shop for care within a reference price, providers that want their business may

### California's Reference Pricing Saved \$2.8 Million in 2011

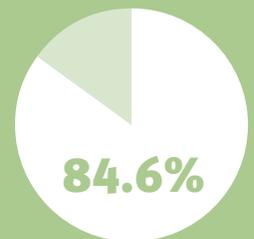
California's experience shows how reference pricing can generate savings when providers lower their prices for care. In 2011, the California Public Employees Retirement System (CalPERS), which provides health insurance to California's public employees, retirees, and family members, established a reference pricing program for knee and hip replacement surgeries.

Internal analysis of the program found that the program led to \$2.8 million in savings in 2011.<sup>4</sup> The vast majority of this savings—84.6 percent—resulted from hospitals lowering their prices (including hospitals that charged more than the reference price and those that already charged within the reference price). Across all hospitals, the average price charged to CalPERS members for knee and hip replacements declined by 26 percent in 2011. And among hospitals that originally charged more than the reference price, the average price for these services dropped by 34.3 percent.<sup>5</sup>



California's CalPERS reference pricing program saved

**\$2.8 million**



**of this savings resulted from hospitals lowering their prices**

be motivated to set more competitive prices. Providers that charge more than the reference price face pressure to lower their prices to within the reference price. And even providers that charge within the reference price may feel pressure to lower their prices to stay competitive with other high-quality providers in the area.

Reference pricing programs that are implemented by payers that insure a large number of consumers will likely be most effective at driving providers to lower prices.

## Potential risks of reference pricing

If not implemented properly, reference pricing programs also have the potential to create serious barriers to affordable care. For example, if a program sets its reference price too low, it could be difficult for consumers to get care from providers who charge within the reference price. Thus, the program would simply be shifting costs to consumers. Setting a reference price too low could also encourage providers to avoid complex patients in order to keep costs low, or it could lead them to raise their prices for other health care services in order to make up lost revenue.

Below, we identify eight key elements a reference pricing program must include in order to be effective and consumer-friendly.

## Principles for creating a consumer-friendly reference pricing program

### 1 Build the program around price transparency

Before a health care payer can implement a reference pricing program, it must obtain information about the prices providers charge for certain services and be able to share this information with consumers in their plan. This information should be specific to the negotiated prices that providers charge the payer that is implementing reference pricing.

Programs must ensure that this price information is presented to consumers in easy-to-use formats that help consumers compare providers and help them understand their share of costs and the total cost of care. (Also see “Provide consumers with resources that explain how reference pricing works and tools to compare providers based on quality and price,” on page 8.)

Health care payers need this information to identify services where there is significant price variation and where it is appropriate to apply a reference price. And consumers need this information to compare and shop for providers based on price and quality once the program is in place.

Payers should obtain price information for as many health care services as possible. This will enable them to monitor

whether a reference pricing program targeted at one service successfully drives providers to charge fairer prices across the board, or whether providers lower their prices only for services that are subject to a reference price and raise their prices for other services in order to make up that lost revenue.

Obtaining this information may not always be easy. Contracts between health plans and health care providers may include “gag clauses” that prohibit health plans from sharing this type of information, even with employers that contract with their health plan.

Some states have passed legislation to ban these types of contract agreements, opening the door for health plans to make price information more available to payers like employers, as well as to consumers. A handful of states also have efforts underway to develop all-payer claims or multi-payer claims databases that systematically collect claims data across payers. Whether these claims databases can provide the price information necessary for reference pricing will depend on the scope of data they collect and make available.

## **2 Establish reference prices for targeted services**

Reference prices should be set only for health care services that have significant price variation across providers in a region, and where little to no correlation exists between more expensive providers and the delivery of better-quality care. This ensures that

consumers have the opportunity to shop for care and are able to compare providers based on predictable estimates of out-of-pocket costs.

This strategy should also be limited to standard and scheduled health care procedures, like colonoscopies or scheduled hip or knee replacement surgeries, and only in situations where there are no complications related to providing that care (see “Has accessible exceptions and appeals processes” on page 8).

Some procedures, like surgery, involve multiple health care services that are typically billed separately, like a facility fee from the hospital and a separate physician’s fee. A program could set a reference price only for the hospital facility fee, or a program could set a reference price that covers multiple or all billed services provided during the surgery. It is important that reference pricing programs clearly define and explain to plan members the scope of services a reference price is meant to cover.

## **3 Set fair reference prices based on the local market**

Reference pricing should be used to increase transparency and minimize unfair price variation, not to limit access to care or shift costs to consumers. To this end, it is paramount that programs set fair reference prices reflecting what the majority of high-quality providers within that region charge for care.

Reference prices should be based on prices within a local region. The range of prices providers charge for a particular service can be very different from state to state,

and even between different regions within a state, depending on how competitive the health care market is across those regions.

In a state or region where health care providers generally have significant market power and can negotiate higher prices, all providers in that area may charge higher prices compared to a region with a generally more competitive health care market. Because of this, programs should never apply a single reference price to consumers across different states and should be very cautious if considering applying a uniform reference price statewide.

#### **4 Offer an adequate network of high-quality providers whose prices fall within the reference price**

Programs must ensure that an adequate network of providers across all geographic regions that the program serves, including rural and underserved regions, charge prices that fall within the reference price. The plan must also have an adequate number of providers who charge within the reference price that are equipped to meet the cultural and linguistic needs of diverse consumers.

In some cases, patients may need to travel longer distances to obtain care from providers that best meet their needs and charge within the reference price. In these situations, programs should cover transportation costs for both the patient and a family member or caregiver to ensure that consumers can get access to patient-centered care within a reference price. (See “Unique Challenges Facing Centers of Excellence.”)

## **Unique Challenges Facing Centers of Excellence**

Some health insurers also have Centers of Excellence programs. These programs identify a few providers across the country that excel at delivering high-quality care for specific health conditions, like hip or knee replacements or cardiac surgeries. Centers of Excellence programs will reduce or waive consumers’ cost-sharing altogether and pay for both travel and lodging expenses if consumers receive these types of care from a Centers of Excellence provider.

Centers of Excellence programs face unique challenges to maintaining the continuity of patients’ care, because patients may be traveling long distances from home for treatment. It is important that Centers of Excellence programs cover travel and lodging expenses for both patients and a caregiver and cover lodging for as long as is necessary to ensure that a patient can safely travel home. Programs should also have sufficient strategies to ensure that Centers of Excellence providers work closely with patients’ local health care providers to seamlessly coordinate patients’ care once they return home.

Generally, if a plan already has an inadequate network of providers within a particular specialty, reference pricing should never be applied to services delivered by those providers. This would further limit an already insufficient network of affordable providers.

#### **5 Prioritize quality when designing the program**

Programs should encourage consumers to choose providers that are both fairly priced and high-quality. Programs can do this in two ways. First, reference prices should be set high enough to include an adequate number of high-quality providers. This should be an upfront factor that is used to determine the reference price. Second, programs can create incentives to

encourage consumers to seek care from providers that are within the reference price and that also perform well on a range of quality measures. For example, a program could reduce or waive cost-sharing altogether for care from these providers.

Programs should always use up-to-date and robust measures of provider quality.

## **6 Provide consumers with resources that explain how reference pricing works and tools to compare providers based on quality and price**

Programs should develop rigorous outreach and education strategies to inform consumers about how the reference pricing program works, including which services have a reference price, what the reference price is, in what situations it applies, and a list of which local providers fall within the reference price.

This education strategy should include regularly sending notices to all plan members about the program. It also should include targeted outreach to consumers who may require a health service that is subject to reference pricing in the future. For example, CalPERS' reference pricing program for knee and hip replacement surgeries sent targeted communications about the program to plan members who had visited an orthopedist for knee or hip issues in the past year.<sup>6</sup>

Programs should also have tools (such as online provider comparisons tools) that give consumers easily understandable information about provider price and

quality. These tools should allow consumers to search and compare providers based on price, quality, and other factors so they can find providers that best meet their needs. Ideally, programs should also provide consumers with easily understandable information about what their personal out-of-pocket costs would be for care from different providers based on any cost-sharing they must pay, like deductibles or copayments, and, if applicable, the portion of a provider's price that exceeds the reference price.

## **7 Have accessible exceptions and appeals processes**

It is inappropriate to apply reference pricing to care when consumers either do not have the opportunity to shop for care or when consumers require more specialized and costly care due to complications. Broadly, reference pricing should never apply to services when they are received during a course of emergency care, or when patients require more complex care during the course of treatment due to unforeseen complications. In these situations, programs should automatically exempt patients from paying any outstanding balance above a reference price.

Patients with one or more diseases or disorders may also need more complex treatment for what would otherwise be a standard health care procedure. This may mean that that they need to see highly specialized providers that charge more than the reference price or that they need additional services that make the price of their care more expensive.

It is inappropriate to apply reference pricing to care when consumers either do not have the opportunity to shop for care or when consumers require more specialized and costly care due to complications.

Reference pricing programs should have simple processes for granting exceptions to ensure that consumers in these situations do not have to pay any outstanding balance above the reference price. These programs should also offer an appeals process for consumers who believe that they were wrongly required to cover excess costs due to reference pricing, given their circumstances.

These exceptions and appeals processes should be clearly outlined in consumer notices about the program. Since providers are uniquely suited to identify patients with special circumstances, programs should also educate providers about how they can help patients receive an exception from paying excess costs.

### **8 Evaluate the program regularly**

Reference pricing programs should annually evaluate whether they encourage consumers to seek care from providers who charge within the reference price, and whether they drive more expensive providers to lower their prices for care. If an evaluation shows that a high proportion of consumers are continuing to seek care from providers that charge more than the reference price, it may be a sign that the program needs to strengthen its outreach and education, or that the reference price is set too low and consumers are having trouble finding providers who charge within the reference price.

It is also important to evaluate how the program affects utilization of care to ensure that the program does not inadvertently create barriers to necessary care or lead consumers to stop treatments. For example, if reference pricing is implemented for medications, programs should monitor how the program affects medication adherence. This is critical to ensure that consumers who originally used versions of a drug that cost more than the reference price do not stop taking necessary medications altogether.

Reference pricing programs should pay particular attention to how they affect access to care and health outcomes among lower-income consumers, who will be most sensitive to price increases.

Programs should also survey consumers about their experience with the program. This should include questions about whether:

- » Consumers found it easy or difficult to obtain care from providers who charged prices that fell within the reference price
- » Consumers who received services subject to reference pricing knew about the program prior to receiving care
- » Consumers used shopper tools created for the program
- » Consumers felt they could use the exceptions process to get fair coverage for the care they needed

## Conclusion

Reference pricing aims to minimize price variation in our health care system by providing more transparent information about the prices providers charge, and by creating financial incentives for consumers to shop for care based on both price and quality. This, in turn, can put external pressure on overly expensive providers to charge more competitive, fair prices.

To succeed at these goals, reference pricing programs must be built on a foundation of price transparency and must be limited to shopable health care services that have wide price variation. It is also critical that these programs be designed so that consumers can easily obtain care from providers who charge within the reference price and not simply become a tool to shift costs to consumers. Only then will these programs succeed at pressuring providers to set fairer prices.

When designed in consumer-friendly ways, reference pricing programs can help control health care costs by encouraging providers to set fairer prices for care. These programs can also give consumers the resources they need to compare providers based on both price and quality and can encourage consumers to choose providers that deliver the best care at the best price.

## Endnotes

1 Paul B. Ginsburg, *Wide Variation in Hospital and Physician Payment Rates Evidence of Provider Market Power* (Washington: Center for Studying Health System Change, November 2010), available online at <http://www.hschange.com/CONTENT/1162/>.

2 Chapin White, James D. Reschovsky, and Amelia M. Bond, “Understanding Differences between High- and Low-Price Hospitals: Implications for Efforts to Rein in Costs,” *Health Affairs* 33, no. 2 (February 2014): 324-331.

3 Government Accountability Office (GAO), *Meaningful Price Information Is Difficult for Consumers to Obtain Prior to Receiving Care* (Washington: GAO, September 2011), available online at [www.gao.gov/products/GAO-11-791](http://www.gao.gov/products/GAO-11-791).

4 James C. Robinson and Timothy T. Brown, “Increases in Consumer Cost-Sharing Redirect Patient Volumes and Reduce Hospital Prices for Orthopedic Surgery,” *Health Affairs* 32, no. 8 (August 2013): 1,392-1,397.

5 Ibid.

6 Amanda E. Lechner, Rebecca Gourevitch, and Paul B. Ginsburg, *The Potential of Reference Pricing to Generate Health Care Savings: Lessons from a California Pioneer* (Washington: Center for Studying Health System Change, December 2013), available online at <http://www.hschange.org/CONTENT/1397/>.

A selected list of relevant publications to date:

*Principles for Consumer-Friendly Value-Based Insurance Design* (December 2013)

*Key Differences between Wellness Reward/Penalty Programs and Value-Based Insurance Design* (October 2013)

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Publication ID: 000HSI060914

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