

A COBLER'S FABLE

EXPLAINING A MEDICARE MYSTERY

MYSTERY: WHY MEDICARE PAYS MUCH LESS THAN BILLED CHARGES...

This fable was prepared for us lay persons to better understand Medicare payments and Health Provider billing, through the eyes of a cobbler.

ONCE UPON A TIME...

In a land called Cobland, there lived a cobbler named Cobb. He had a family and a Helper in his shoe shop.

Cobb earned a living by selling three services:

1. Shining shoes
2. Making custom street shoes
3. Making custom boots

Cobb sold his services to three types of customers:

1. Those that paid full price for Cobb's services because they did not have any shoe insurance
2. Those under 65 and have **Private Shoe Insurance (PSI)**, that Cobb accepts
3. Those that are over 65 and obligated by Cobland law to participate in **Cobland Senior Citizen Shoe Help Insurance (CSCSHI)**, Cobland's government shoe service subsidized assistance program for senior citizens, that Cobb accepts

Since Cobland is not large, Cobb had a fairly good idea how many of his customers would be in each of the three types, and Cobb determined: 20% are full pay, 40% have PSI insurance and 40% have CSCSHI insurance.

Cobb competed with other cobbler's in Cobland. All cobblers charged similar but different prices for the same services, and all of them, like Cobb, accepted shoe insurance.

Cobb uses superior quality shoe polish and shoe leather and his shoe making skills were pretty good. Other cobblers used cheaper lower quality shoe polish and leather and their shoe making skills were not as good as Cobb's (so many times his competitor shoes would wear out too soon or the cheap shoe polish would wash off in the rain) and those unhappy customers switching to Cobb.

Shoe Insurance Plans

Private Shoe Insurance (PSI) policy terms includes:

- The insured must pay the first \$2 (a deductible) for any shoe service cost,

- Then the insured would pay the first 10% (coinsurance) of the remaining balance and
- The insurance company would pay 70% of the balance
- With the remaining 20% being a discount of the shoe service charge and not paid to the cobbler.

As an example:

Shoe Service Charge:		\$100.00
Insured deductible:	-\$2.00	
Net:		\$98.00
Insured coinsurance (10%):	-\$9.80	
Insurance payment (70%):	-\$68.60	
Net (unpaid discount):		\$19.60
Total Amount paid by insured:		-\$11.80
Total Amount paid by insurance:		-\$68.60
Total Amount Paid To Cobbler:		\$80.40
Discount (not paid to Cobbler):		<u>\$19.60</u>
		\$100.00

Cobland Senior Citizen Shoe Help Insurance (CSCSHI), Cobland’s government shoe service subsidized assistance program for senior citizens, is an insurance policy containing regulated fixed price reimbursement of shoe service charges (described as an ‘**Allowable Payment**’). This policy pays only the following fixed amount Allowable Payments for shoe service charges regardless of the price charged by cobblers:

- Shoeshine: \$4.50
- Custom Street Shoe: \$140
- Custom Boots: \$475

Copland’s government updates annually the Allowable Payment amounts. The formula the government uses to determine the updated Allowable Payment is based on:

- Its own assessment of the cost of a shoe service (called **Relative Value Units or RVUs**),
- Multiplied by a **Conversion Factor (CF)** that considers various economic factors. Thus, the formula is:

$$\text{Allowable Payment} = \text{RVU} \times \text{CF}$$

RVUs can change annually by the government of Cobland, using government staff analysts and university contractors.

The CF factor, which is fixed by the government of Copeland and changes annually, is affected by:

- Cobland’s inflation index,
- Consumer price index for shoes,
- The overall economy of Cobland,

- Cobland government's budget available for CSCSHI plans, and
- A law that prohibits CSCSHI payment budget for any year to be greater than one million CoblandBucks from last year's budget.

Most policy analysts who review the Allowable Payment calculation, report that the Allowable Payment is not based on truthful shoe business cost and prices, but based on artificial predefined payment amounts that the Copeland government believes it can fund. Thus, the Allowable Amount is really based on Copland government budget limitations more so than shoe service competitive fee market business economics.

In contrast, the Allowable Payment is viewed by Copland's government as an incentive for shoe cobblers, such as Cobb, to find ways to reduce their prices which is good for consumers (such as by reducing costs or finding more efficient construction processes, using cheaper labour, etc.).

Cobblers complain that shoe insurers have consolidated and are underpaying them relative to the value they generate.

Shoe insurers complain that cobblers have consolidated and are demanding unaffordable rates.

Cobb's Prices

Cobb spent many sleepless nights on how to determine his shoe service prices, in the local currency, CobdBucks. He knew he had to consider:

- The costs to provide the service
- Being competitive with other cobblers –
 - If the price too high
 - he would lose business
 - If too low
 - he could go out of business
 - If just right
 - He would be competitive, feed his family, pay his bills, and an occasional vacation
- Some prices will be discounted because of shoe insurance reimbursements

Cobb took a financial course at a local Community College and used what he learned to help him determine the price for his services.

Price Setting Technique 1

The first price setting technique Cobb used (Technique 1) involved Cobb spending long hours at night to prepare a detail cost analysis of how much it costs to produce each of his services. Then after determining the costs, establish how much extra he would charge for his profit margin. Cobb prepared the following cost chart for each of his services.

Cobb's Detail Cost of Services			
	Cost in CobbBucks (\$)		
Cost Category	Shoeshine	Custom Street Shoe	Custom Boots
Material cost	0.1-0.3	5	12
Labor time (hours)			
Helper 1	0.15	1	3
Cobb		3	7
Labor cost			
Helper 1 (\$20/hr)	3	20	60
Cobb (\$40/hr)	0	120	280
Shop tools	0.1	0.3	0.5
Shop utilities	0.05	0.15	0.25
Shop maintenance	0.05	0.15	0.25
Insurance	0.01	0.03	0.05
Accounting	0.01	0.03	0.05
Advertising	0.01	0.03	0.05
Taxes	0.02	0.06	0.1
Miscellaneous	0.1	0.3	0.5
TOTAL	\$3.45-\$3.65	\$146.05	\$353.75
Notes:			
Shoe Shine	Material cost varies if a shoe or boot; Helper 1 shines shoes		
Custom Street Shoe	Cobb spends more time on custom street shoe; average material cost regardless of shoe size		
Custom Boots	Cobb spends more time on custom boot; average material cost regardless of boot size		

Cost for a shoeshine is \$3.45-\$3.65 (shoe/boot); \$146.05 custom shoe; \$353.75 custom boot.

Cobb then completed a market survey across the world (he had internet) to determine what might be a good profit margin to charge above his costs to remain competitive. His investigation indicated profit margins of 100% for shoeshine, 50% for Custom Street Shoe and 100% for Custom Boots. Cobb prepared the below pricing sheet for each of his services.

	Cobb's Price: Cost Plus Profit Margin, CobbBucks (\$)		
	Shoeshine	Custom Street Shoe	Custom Boots
TOTAL COST	\$3.45-\$3.65	\$146.05	\$353.75
Price	\$7 - \$8	\$219.08	\$707.50
Notes:	100% profit margin	50% profit margin	100% profit margin

Based on the cost and profit margin analysis, Cobb could charge \$7 (shoe)/\$8 (boot) for Shoeshine, \$219.08 for Custom Street Shoe and \$707.50 for Custom Boots.

Cobb was convinced that a Technique 1 detail cost and pricing analysis is very time consuming and complex to repeat every year and his guesstimate of allocating costs to each of his services very speculative. So, while Technique 1 detail cost analysis is the more accurate process to use, Cobb felt like he had rather use another simpler price setting process in the future.

Price Setting Technique 2¹

A simpler price setting technique 2 used by Cobb considered:

1. What he *thought the market would bear* and remain competitive (knowing his competitors were making similar cost and price assessments as he)
2. Considering whatever price he charged, would be discounted by PSI and CSCSHI shoe insurance Allowable Payment reimbursements.

Cobb prepared the below revised pricing table

	Shoeshine	Custom Street Shoe	Custom Boots
Cost to provide	\$3.45-\$3.65	\$146.05	\$353.75
Technique 1 Price	\$7 - \$8	\$219.08	\$707.50
Price paid by:			
Full pay customers	\$7 - \$8	\$219.08	\$707.50
PSI customers			
Customer deductible	\$2.00	\$2.00	\$2.00
Customer coinsurance (10%)	\$0.60	\$21.71	\$70.55
Insurance Allowable Payment (70%)	\$4.20	\$151.95	\$493.85
Discount (20%)	\$1.20	\$43.42	\$141.10
Cobb's payment	\$6.80	\$175.66	\$566.40
CSCSHI customers	\$4.50	\$140	\$475
Technique 2 Price - Special Price	\$12-\$14	\$300	\$1,000
Price paid by:			
Full pay customers	\$12-\$14	\$300	\$1,000
PSI customers			
Customer deductible	\$2.00	\$2.00	\$2.00
Customer coinsurance (10%)	\$1.20	\$30	\$100
Insurance Allowable Payment (70%)	\$8.40	\$209	\$699
Discount (20%)	\$2.40	\$60	\$200
Cobb's payment	\$11.60	\$240.40	\$800.40
CSCSHI customers	\$4.50	\$140.00	\$475.00

Based on the simpler Technique 2 price setting, Cobb decided (admittedly somewhat arbitrarily) to charge the **Special Prices** of: \$12-\$14 for Shoeshine, \$300 for Custom Shoe and \$1,000 for Custom Boot.

Cobb also considered that some of his full pay customers could not afford the full price of his shoe service. In those instances, he could voluntarily give them an agreed discount at his discretion.

¹ **MORE THAN YOU EVER WANTED TO KNOW BUT FOR THE SAKE OF COMPLETENESS:** When Cobb sells a shoe service to a customer and prepares his Financial and tax statements, before he actually receives any cash payment from insurance, he reports the outstanding charge for that sale as an **accrued revenue** in his **income statement** and an **account receivable** in his **balance sheet**. Both of these entries result in Cobb's financial statements appearing to be strong and financially stable. Later when he actually receives cash payments from an insurance company, he updates his financial statements by reducing the accrued revenue and account receivable with a **Contract Adjustment** (and not a bad debt) being the difference or shortfall between what he billed and what he actually received from insurance payments (a contractual obligation also known as an **explicit price concession**).

Although many Cobland citizens need shoes for a variety of reasons, some do not need or wear-out shoes because they are either (i) at the beach and barefoot or (ii) sitting in their drone-mobiles or in traffic and not using their shoes for traveling or (iii) sleeping.

Cobb’s Cost

Last year, Cobb had 900 customers, 300 purchased Shoeshine, 300 purchased Custom Shoes and 300 purchased Custom Boots. Each group of customers were made up of: 20% full pay, 40% PSI insurance and 40% CSCSHI insurance. Based on this information, Cobb prepared the below Total Aggregate Cost and Total Aggregate Charge accounting statement for that year.

	Shoeshine (300)	Custom Street Shoe (300)	Custom Boots (300)	Aggregate Cost
TOTAL COST	\$1,095.00	\$43,815.00	\$106,125.00	\$151,035.00
Charge				
Full pay (20%)	\$840.00	\$18,000.0	\$60,000.0	
PSI (40%)	\$1,392.00	\$28,848.00	\$96,048.00	
CSCSHI (40%)	\$540.00	\$16,800.00	\$57,000.00	Aggregate Charge
TOTAL CHARGE	\$2,772.00	\$63,648.00	\$213,048.00	\$279,468.00
Cost-To-Charge Ratio = \$151,035.00/\$279,468.00				0.54

Dividing Total Aggregate Costs (\$151,035.00) by Total Aggregate Charges (\$279,468.00), Cobb calculated a **Cost-To-Charge Ratio** of 0.54 for his shoe business.

This simple Cost-To-Charge Ratio can be used in the future to estimate the cost of producing his services by merely multiplying the Special Price charged times the ratio. This is quicker and simpler than doing a detail time consuming cost analysis. Of course, while the use of this ratio is simple, it may or may not represent an accurate cost of services, especially since the ratio is also multiplied by a speculative Special Price number.

Cobb’s Insurance Complaints

When Cobb has lively discussions and debates with the insurance companies, concerning whether or not the insurance company is paying enough for Cobb’s shoe services, Cobb’s argument could look like:

Cobb: *You are not paying me enough for my shoe services*

Insurer: *Sure we are, we did an analysis, and we think we are paying you justifiable market rates.*

Cobb: *That cannot be true, my Special Pricing is based on a competitive market rate.*

For PSI insurance,

You only pay me \$11.60 for my \$14 Shoeshine, a 19% discount
You only pay me \$240.40 for my \$300 Custom Shoe, a 20% discount
You only pay me \$800.40 for my \$1,000 Custom Boot, a 20% discount

For CSCSHI insurance,

You only pay me \$4.50 for my \$14 Shoeshine, a 68% discount
You only pay me \$140 for my \$300 Custom Shoe, a 54% discount

You only pay me \$475 for my \$1,000 Custom Boot, a 53% discount

Further based on my Cost-To-Charge Ratio (0.54) analysis

For PSI insurance

You only pay me \$11.60 for Shoeshine, but my cost is \$7.00 (\$14.54)*

A 32% profit margin is too low (\$11.60-\$7)/\$14)

You only pay me \$240.40 for Custom Shoe but my cost is \$162

A 26% profit margin is too low

You only pay me \$800.40 for Custom Boots but my cost is \$540

A 26% profit margin is too low

For CSCSHI insurance,

You only pay me \$4.50 for Shoeshine but my cost is \$9.50

You only pay me \$150 for Custom Shoe but my cost is \$195

You only pay me \$800.40 for Custom Boot but my cost is \$650

Your Allowable Payments are below my costs

Insurer: *Remember you are bound by our insurance contract which you accepted that includes payment of our Allowable Payments as full reimbursement to you regardless of what you billed.*

And your Special Pricing and cost determination procedure is complex and not transparent

Cobb: *Oh yeah, well your Allowable Payment procedure is complex and not transparent*

Here is a conversation Cobb has with his Customers:

Shoe Customer:

Your shoe service Special Pricing seems high to us, and we do not understand how you set your prices. Thank goodness some of us have shoe insurance that helps immensely with paying for your shoe service, however, the premiums we pay for our shoe insurance and other out-of-pocket costs (such as deductibles and coinsurance) keeps going up because of your ever escalating high shoe service Special Prices.

Cobb: *I am confident my Special Prices are based on competitive market rates.*

For my customers without shoe insurance and having difficulty paying their bills, I offer a mutually agreed discount based on the needs of my customer.

Also, my analysis indicates that insurance companies are underpaying me, and the payment does not in many cases even cover my costs. However, I have agreed to accept insurance contracts and consider any shortfall (called a Contract Adjustment) as a Community Benefit from me to the community and my absorbing some of the costs since everybody needs shoes. So, at the end of the day, I am a community minded cobbler helping the community.

Shoe Customer:

I would like to have the last word as a consumer in this most interesting and entertaining debate.

At the end of the day, the most prominent issue is that us shoe wearers obtain shoeshine, custom shoe, and custom boots at a fair and reasonable price.

That cobblers and insurance companies make a reasonable profit and return on their investment.

That cobblers and insurance companies simplify their procedures, eliminate complexity regarding costing and pricing and make them transparent so even the most casual observer can readily understand the process and results.

That political agendas and objectives that have nothing to do with shoe services are not used to hold ransom shoe insurance decisions that affect us consumers.

Us customers are confident there is a resolution to the high cost of shoe services, over-priced shoe insurance concerns, with a compromised answer lying somewhere with the bubble in the middle. Extreme solutions to either have our feet removed or increase the premium, copay, coinsurance, deductible limits as well as reduce coverage of shoe insurance, are easy but unrealistic answers.

Since cobblers regularly and readily accept shoe insurance as payment for their services, it must be because it is in the cobbler's best economic interest to do so.

Not only has this discussion given me a headache, my feet hurt.