Plan Management Navigator
Analytics for Health Plan Administration Late July 2013

Independent/Provider-Sponsored Plans' Administrative Costs Were 8.7% of Premiums in 2012

Summary

Independent/Provider-Sponsored Plans' (IPS) administrative expense growth accelerated in 2013. Notwithstanding, administrative expenses were 8.7% of premiums in 2012 unchanged from 2011. The as-reported median per-member administrative cost trends increased from 4.1% in 2011 to 7.1% in 2012 and, after eliminating the effect of product mix changes, the median rate of cost growth increased from 3.1% to 8.6%. These results are excerpted from the *2013 Sherlock Expense Evaluation Report* for Independent/Provider-Sponsored plans.

The key sources of expense growth were, in order of prominence, the cluster of Sales and Marketing, Information Systems and Medical Management. Notably these plans successfully increased their membership growth, especially in relatively low administrative expense cost products such as ASO and Medicaid.

Independent/Provider-Sponsored plans are a very important universe of health plans. To be clear, these organizations are regionally concentrated, usually focused on managed care products and frequently linked to health systems. The 16 participating plans served 6.9 million people for an average membership of 430,000. Organizations of this size and with these operating characteristics are sufficiently unusual to lead us to conclude the universe of participants comprises a very high share of them.

These organizations are especially interesting in the current environment because they are often an element of an integrated delivery system strategy. In the words of Alain Enthoven, such organizations hold the promise of, "eliminating waste…improving quality and reducing costs – and making the system financially sustainable." Accountable Care Organizations are said to be inspired by successful integrated delivery systems. Some of participants or their associated organizations already participate in CMS's Shared Savings Programs.

The median administrative expenses of comprehensive products of Independent/Provider-Sponsored plans participating in our performance benchmarking study in 2012 was $38.42 per member per month (PMPM), but varied greatly by product. In 2012, the commercial ASO product had administrative costs of $18.09. The insured product with the lowest administrative costs was Medicaid, at $27.60, while the highest was Medicare SNP, at $119.92. Insured commercial products ranged from $38-48 PMPM.

All values exclude investment and non-operating income and expense, income taxes and miscellaneous business taxes. Pharmacy, Mental Health and ICD-10 IS costs are included in total administrative cost calculations and specifically with the Account and Membership Administration cluster.

Figure 1. Benchmark Summary
Independent/Provider-Sponsored Costs by Functional Area Cluster, 2012 Data
Per Member Per Month

	25th PCTL	75th PCTL	Median	σ/ Mean
Sales & Marketing	$8.95	$12.48	$11.33	29.7%
Provider & Medical Management	4.72	8.39	6.25	32.9%
Account & Mem. Administration	9.83	17.70	12.49	40.9%
Corporate Services	4.77	7.45	6.14	39.5%
Total	$28.76	$44.21	$38.42	25.7%

Account & Membership Administration Includes Pharmacy, Mental Health and ICD-10 IS Expenses.

Administrative Costs and Trends

For convenience of presentation, we group various functional areas into clusters, and standardize for the size of the health plans by expressing expenses on a per member basis. (A far more granular presentation is found in the benchmarks themselves.) Cost values and rates of change are shown in Figures 1 and 2. For comparison, Appendix A provides values for plans participating in the 2012 survey, and comprises 2011 data. Of the 16 Plans participating in 2013, 15 participated in 2012. A total of 18 Plans participated in 2012.

Rates of change in costs are calculated for plans that participated in both of the comparison years. By contrast, PMPM values are actual for *all* plans in the universe. We employed median values in the figures throughout this analysis as the measure of central tendency because this measure minimized the effects of any outlier responses. By the way, these outliers are probably operational performance outliers – we have thoroughly scrubbed the results to achieve accuracy.

Sales and Marketing expenses were $11.33 PMPM and grew at an accelerating rate, 5.5% in 2012 versus 1.8% growth in 2011. (All rates of change hold constant the universe of participants.) After eliminating the effect of product mix changes, the Sales and Marketing cost acceleration was even greater: PMPM Sales and Marketing costs increased by 8.2% compared with 1.4% in 2011.

Growth and a change in business mix affected comparisons. IPS plans had membership growth that averaged 3.9% for median growth of 1.1%. The strongest growth was in Commercial ASO, which increased at a median rate of 6.3% and mean rate of 13.5%. ASO comprised 23.9% of the membership of these plans on average. Medicaid membership growth was also rapid, at 5.7%, median, and 4.0% on average. Plans' average Medicaid mix was 12.9%. Medicare products grew quickly as well, at a mean rate of 7.4% and a median rate of 10.2% and its share also increased to an average of 11.6, or a median of 14.3%. Only seven plans offered Medicare Supplemental. Two had declines in membership but the ones that grew did so spectacularly so, overall, the mix shifted in favor of this product as well to 0.6% on average.

By contrast, the Commercial Insured products declined in importance, to an average of 51.0% of the membership, falling at a median rate of 3.1% and a mean rate of 0.2%. While the decline is modest, the effect on overall product mix is significant because of the growth in all other products. The effect of the mix change was that the IPS plans reported costs that were approximately 0.4% lower than they would have been had they had the 2011 mix.

Product Development and Market Research growth was quite robust. Marketing had high growth in FTEs and compensation. The sharp increase in commitment to Rating and Underwriting, evident only when adjusted for mix, was centered on Hierarchical Condition Categories for Medicare Advantage and SNP. Prominent drivers were a sharp increase in the proportion of expenses that were outsourced and an increase in non-labor costs.

Figure 2. Benchmark Summary
Independent/Provider-Sponsored Percent Change in Costs by Functional Area Cluster

	2011 Percent Change		2012 Percent Change	
	As Reported	Constant Mix	As Reported	Constant Mix
Sales & Marketing	1.8%	1.4%	5.5%	8.2%
Provider & Medical Management	9.8%	9.7%	1.9%	5.1%
Account & Mem. Administration	5.4%	3.5%	7.6%	6.8%
Corporate Services	3.5%	4.5%	8.8%	9.7%
Total	4.1%	3.1%	7.1%	8.6%

Account & Membership Administration Includes Pharmacy, Mental Health and ICD-10 IS Expenses.

Internal Sales and Marketing continued to outstrip broker Commissions, suggesting an increasing focus on internal distribution systems. Marketing growth was especially strong. Advertising growth was moderate. Overall staffing ratios in this cluster were higher after consideration of Medicare.

The 75th percentile value for this cluster was $12.48 and the 25th percentile value was $8.95 PMPM.

Provider and Medical Management, in contrast with Sales and Marketing, posted a sharp decrease in growth, from 9.8% to 1.9% last year, to $6.41 PMPM. On a constant-mix basis, per member cost growth decelerated but less sharply, from 9.7% to 5.1%. Overall staffing ratios increased.

The decline in Provider Network Management and Services growth was central to this. While staffing ratios increased slightly, staffing costs increased in sub-inflation levels. But non-labor and outsourced costs fell sharply.

Medical Management costs grew somewhat less than other costs on both a constant mix and as-reported basis. Increases were found in insured commercial lines but Medical Management costs actually declined in Commercial ASO and all of the senior products. Disease Management and Quality Components were exceptions to this. The costs of Provider and Medical Management at the 25th percentile was $4.72 PMPM and was $8.39 PMPM at the 75th percentile.

Account and Membership Administration costs increased to $12.49 PMPM, up 7.6% from last year. At the 25th percentile the cost of Account and Membership Administration was $9.83 PMPM, while the costs at the 75th percentile were $17.70 PMPM. In 2011, the rate of growth, on an as-reported basis, was 5.4% so cost growth increased in 2012. On a constant-mix basis, cost growth also increased, 6.8% as against 3.5% in 2011.

Costs and trends noted above include Information Systems-related ICD-10 expenses. These costs, which averaged $0.34 PMPM, doubled last year. Without the increase in these expenses, we estimate that Account and Membership Administration would have increased by 6.2%, as-reported and 5.3% on a constant-mix basis.

This cluster of functions includes Enrollment, Claims, Customer Service and Information Systems. On both an as-reported and constant-mix-basis Enrollment costs declined. On both bases, both Claims and Customer Services cost growth increased relative to the trends in recent years.

Once again, Information Systems costs increased at double digit rates. This was true however it was calculated, and was the second highest cost trend for this product since at least 2006 on an as reported basis and since 2008 on a constant mix basis. The focus of this growth appeared to be in Application Acquisition and Development. Growth appeared very strong in non-labor costs and staffing ratios.

Outsourcing appeared to decline for Information Systems and for all other functional areas in this cluster, except for Customer Services where it increased from a vanishingly small base. Overall, outsourcing is relatively unusual among Independent/Provider-Sponsored plans, equating to 15% of total FTEs. HCC Activities, Disease Management and Nurse-based Counseling all have more than 20% of their staffing costs outsourced, whether directly measured by costs or indirectly by estimated FTEs.

Corporate Services costs increased by 8.8% on an as-reported basis and 9.7% on a constant-mix basis. These growth rates were sharply higher than last year when this cluster increased by 3.5% on an as-reported basis and by 4.5% a constant-mix basis.

On an as-reported basis, Actuarial had the fastest growth. While growth was much more moderate, the larger Corporate Services function was the greatest contributor to growth. Finance and Accounting growth was moderate and Corporate Executive paced the cluster's growth.

Calculation of Premium Equivalents

Administrative services relationships, comprising just over 34% of all Independent/Provider-Sponsored commercial members, play havoc with the intuition that administrative costs, when expressed as a percent, are a proportion of the premium dollar. That is because, under ASO relationships, employers are only billed for the administrative services that health plans provide rather than for the cost of care, which is borne by the self-insured groups. In other words, under GAAP accounting, if expressed as a percent of revenues, administrative expenses under ASO arrangements will have a denominator that is a small fraction of the premium dollar, dashing the intuitive appeal of the administrative expense ratio. This is a common source of confusion that became increasingly apparent during health care reform debates.

Our solution to this potential misinterpretation is to express administrative expenses as a percent of premium equivalents. Since each of the plans provides the health care expenses for the self-insured groups (which they know since they process their groups' self-insured claims), by adding this amount to the administrative service fees actually billed, we are able to estimate what the premiums would have been had the groups been insured. These are called premium equivalents.

Note that, as with premiums, fees charged to ASO clients reflect a profit assumption. Since revenues less expenses equal profits, to estimate premium equivalents it is appropriate to add the fees rather than the administrative expenses to directly compare costs with the insured business.

Excluding the effect of mix differences, Corporate Executive appeared to grow based largely on a higher use of outsourced services and a surge in non-labor costs. This could be consulting arrangements perhaps related to the adaptation to a new health care environment. This function grew fastest in the cluster and was also the single greatest contributor to its growth. Actuarial was the fastest growing function, and its staffing ratios, compensation levels and non-labor costs all increased sharply. This too may reflect industry adaptation.

Corporate Services followed Corporate Executive in importance but grew far slower. In this function, staffing declined as outsourcing increased. Finance and Accounting growth was below inflation, PMPM.

Overall, staffing declined in this expense cluster, taking into account the decline in the share of the business focused on Medicare. Non-labor costs increased markedly.

Total costs for this cluster had a median value of $6.14 PMPM in 2012, while the 25th percentile value was $4.77 PMPM and the value at the 75th percentile was $7.45 PMPM.

Overall, it appeared that the Independent/Provider-Sponsored plans invested in their adaptation in several ways. Sales and Marketing expense were sharply higher, though this yielded higher membership. In this cluster, they committed more resources to Product Development/Market Research but also to HCC activities. Heightened investment in Information Systems, especially Applications Acquisition and Development, set the tone for growth in Account and Membership Administration. Non-labor costs were central in the growth in the Corporate Services cluster, suggesting the possibility of heightened investment in consulting. By contrast, Provider and Medical Management growth was modest by recent standards. Staffing increased for these organizations, as did non-labor costs.

Calculation of Constant-mix Rates of Expense Growth

To make the most useful comparisons of administrative expenses, it is helpful to eliminate the effects of product mix differences. This improves comparability both between organizations with different product mixes and among annual panels of plans between periods.

Accordingly, in comparing expenses between periods, we hold constant the product mix between the two years. This is especially important since Medicare Advantage and ASO products have increased in the product portfolios of Independent/Provider-Sponsored Plans. Medicare Advantage consumes far more resources per member than comparable products for people under 65 years of age, and marketing costs are sharply lower for ASO products versus their insured counterparts.

To calculate cost trends while eliminating the effect of mix changes, we take advantage of the fact that Independent/Provider-Sponsored plans report costs to us segmented by product. We can then employ their data to *reweight* their prior year expenses to match the product mix in the current period. We then calculate the rates of change in costs based on these reweighted estimates.

The adjustment to eliminate the effect of product mix changes is laborious, so we do not do this in all instances. Comments regarding function subcategories, and operational cost drivers, such as staffing ratios are not as thoroughly mix-adjusted in this analysis.

Accounting for Costs as a Percent of Premium Equivalents

Notwithstanding the ratio's important drawbacks, health plans and others often express administrative costs as a percent of premiums. Indeed, the insights believed available through the use of this metric is an underlying premise of the medical loss ratio provisions of the Patient Protection and Affordable Care Act.

As shown in Figure 3, administrative expenses were 8.7% of premium equivalents for comprehensive products sold by Independent/Provider-Sponsored Plans. The 25th percentile value was 8.3% and the value at the 75th percentile was 10.0%.

Comparing these results to those in Appendix B, 2012 administrative expenses were equal to the 8.7% reported in the prior year. Notwithstanding, ratios worsened for each product. Put a different way, had not the business mix not tilted in favor of low administrative expense to premium ratio products, such as ASO, the ratios would have increased by approximately 0.1 percentage point. Also complicating comparisons is that these organizations tend to offer a more diversified mix of products than last year, measured by the Herfindahl–Hirschman Index. Finally, our analysis is based on medians, which cannot be summed.

Accordingly, comparisons between the two years yields some counterintuitive results. Provider and Medical Management and Corporate Services each increased by 19 basis points, followed by Account and Membership Administration which increased by 15 basis points. Sales and Marketing and Corporate Services increased at 10 and 9 basis points, respectively.

Sales and Marketing costs comprised 2.6% of premium equivalents, with the 25th percentile value at 2.3% and the value at the 75th percentile was 3.1%. The comparable median percent in 2011 was 2.5%.

The value at the 25th percentile for Provider and Medical Management was 1.2% of premium, while 1.8% of premium equivalents represented the 75th percentile. The median value was 1.6% compared with 1.4% last year.

Figure 3. Benchmark Summary
Independent/Provider-Sponsored Costs by Functional Area Cluster, 2012 Data
Percent of Premium Equivalents

	25th PCTL	75th PCTL	Median	σ/ Mean
Sales & Marketing	2.3%	3.1%	2.6%	27.7%
Provider & Medical Management	1.2%	1.8%	1.6%	23.3%
Account & Mem. Administration	2.6%	4.0%	3.3%	32.8%
Corporate Services	1.2%	1.8%	1.5%	33.7%
Total	8.3%	10.0%	8.7%	16.5%

Account & Membership Administration Includes Pharmacy, Mental Health and ICD-10 IS Expenses.

The costs of Account and Membership Administration was 3.3% of premium equivalents, higher than last year's value of 3.2%. (Both 2012 and 2011 figures report the direct costs of Pharmacy, Mental Health administration and Information Systems expenses associated with ICD-10 implementation within these clusters.) The value at the 25th percentile was 2.6% of premium equivalents and 4.0% of premium equivalents at the 75th percentile.

The median proportion of premium equivalents due to Corporate Services was 1.5%, higher than last year's value of 1.4%. Twenty-five percent of plans had values below 1.2% of premium equivalents or above 1.8% of premium equivalents in 2012.

Administrative Expenses by Product

All health plans that participate in our benchmarking studies segment their costs by product as well as by over fifty functional areas. Our participants employ activity-based cost methodologies and sometimes full-blown activity-based cost accounting systems to make these allocations. This is important since costs actually vary quite a bit between products. As an example of the cost allocation process, members in Medicare Advantage products submit far more claims than commercial members so total claims processing costs may be allocated by claims processed rather than members. Similarly, ASO products have lower per member Sales and Marketing costs: those costs can be identified by product (since the products selected by the groups are knowable) and are allocated by the products they select.

These differences are manifest in their overall cost differences. The most expensive product offered by Independent/Provider-Sponsored Plans is their Medicare SNP product at $119.92, followed by Medicare Advantage, at $77.31 PMPM. Commercial Indemnity and PPO Insured follows at $48.38 The least expensive comprehensive product was Commercial ASO at $18.09 PMPM. Per Member Per Month product costs are shown in Figure 4.

Figure 4. Benchmark Summary
Independent/Provider-Sponsored Costs by Product, 2012 Data
Per Member Per Month

	25th PCTL	75th PCTL	Median	σ/ Mean
Commercial Insured				
HMO	$31.29	$47.03	$43.14	26.2%
POS	$28.05	$45.11	$38.06	34.4%
Indemnity & PPO	$39.14	$54.06	$48.38	19.0%
Commercial ASO	$16.33	$23.24	$18.09	34.9%
Medicare Supplemental	$29.18	$57.87	$46.94	38.0%
Medicare				
Advantage	$63.35	$83.54	$77.31	26.4%
SNP	$95.02	$131.41	$119.92	33.5%
Cost	$36.11	$49.97	$43.04	45.5%
Medicaid	$17.63	$32.99	$27.60	35.2%
Comprehensive Total	$28.76	$44.21	$38.42	25.7%
Medicare Part D	$16.44	$27.14	$26.76	60.3%

Figure 5. Benchmark Summary
Independent/Provider-Sponsored Costs by Product, 2012 Data
Percent of Premium Equivalents

	25th PCTL	75th PCTL	Median	?/ Mean
Commercial Insured				
HMO	9.5%	11.1%	10.8%	15.1%
POS	8.4%	10.3%	9.2%	21.6%
Indemnity & PPO	10.4%	16.0%	13.4%	26.4%
Commercial ASO	4.7%	6.8%	5.2%	32.6%
Medicare Supplemental	12.1%	26.2%	15.3%	65.8%
Medicare				
Advantage	6.6%	9.4%	8.3%	25.6%
SNP	6.4%	9.0%	8.8%	40.5%
Cost	11.9%	12.6%	12.2%	7.6%
Medicaid	7.9%	10.3%	8.7%	19.7%
Comprehensive Total	8.3%	10.0%	8.7%	16.5%
Medicare Part D	7.0%	17.4%	10.3%	83.2%

As shown in Figure 5, on a percent of premium equivalent basis, the product ranking of administrative expenses is different. Medicare Advantage, among the high cost plans on a PMPM basis, is lower than average measured as a percent of the premium dollar, at 8.3%. Medicare SNP is the high cost product on a PMPM basis and is just slightly higher than average measured as a percent, at 8.8%. The core HMO product is higher than average when measured as a percent of premiums, at 10.8%.

Background on IPS Universe and Sherlock Benchmarks

The universe in this analysis consisted of sixteen Independent/Provider-Sponsored plans collectively serving 6.9 million people. It represents a "who's who" of regional managed care focused health plans.

We suspect that these plans are stronger than average for their universe of perhaps 90 IPS plans nationwide. They appear to be considerably larger than average, they are the survivors after a significant weeding-out of weaker participants and, by virtue of their participation in our studies, we know they thoroughly measure their performance. On the grounds that you manage what you measure, this suggests our subset of IPS plans share a culture of superior performance.

There is another reason why this universe is especially interesting. Because many of the plans in this universe are linked to providers, these organizations in this universe can be naturally associated with Accountable Care Organizations. In fact, at least three of the participating plans are associated with organizations that are participants in CMS's Shared Savings Program for ACOs.

Fifteen of this year's participants participated in the previous year. More than one-half of the participants have five or more years of participation in our benchmarks and 75% of this year's participants have four or more years of experience.

Approximately 1.8 million of the commercial members were served under some form of self-insurance arrangement, comprising approximately 34.4% of their total commercial members. The various Medicare products, offered by 12 plans, comprised 11.7% of their total comprehensive membership. In all of those plans, Medicare comprised more than 20% of their total revenues. Medicaid, offered by 10 of the plans, comprised 11.7% of combined membership and, in four cases, comprised more than 20% of their total revenues.

Including all of our benchmarks, those published in 2013 will comprise the experience of approximately 620 health plan years. We also have universes of Blue Cross Blue Shield Plans, Larger Health Plans, Medicare Advantage Plans and Medicaid Plans. Earlier this month, we published results on Blue Cross Blue Shield Plans and we will be reporting on the rest of the results in the months that follow.

Why Administrative Costs Matter Now

Optimizing administrative costs is central to health plan industry strategies.

- The intention of the ACA MLR rules is to "create incentives for" health plans "to become more efficient" in the execution of their administrative activities.
- The economy remains fragile, creating price pressures and employer interest in self insurance.
- Weak state budgets pressure Medicaid programs, while rate review pressures commercial products.
- The need for earnings has increased to invest in exchange-based and Medicaid products under the ACA. Since savings from medical costs may be limited, only administrative efficiencies remain.

For these reasons, health plans serving most Americans are users of Sherlock Benchmarks.

Health plans use the Sherlock Benchmarks to:

- Assess whether their plan is operating at optimal cost levels.
- Improve operating cost structure by identifying highest ROI opportunities for performance improvements.
- Estimate the contribution to corporate objectives of functions that are high quality, but also high cost.
- Evaluate outsourcing of selected health plan operations, and the value-added of management consultants.
- Develop a realistic and cost-effective budget.
- Execute business combinations including due diligence, estimation of the effect of synergies and development of a plan for successful integration.
- Learn what attributes are associated with superior performance.

Additional information can be found at http://www.sherlockco.com/seer.shtml. Alternately, we hope you will not hesitate to contact us if you are interested in licensing these materials or if we can answer any further questions.

Appendix A. Benchmark Summary
Independent/Provider-Sponsored Costs by Functional Area Cluster, 2011 Data
Per Member Per Month

	25th PCTL	75th PCTL	Median	σ/ Mean
Sales & Marketing	$8.04	$11.28	$10.16	30.0%
Provider & Medical Management	4.66	7.11	5.99	30.3%
Account & Mem. Administration	8.79	15.20	11.90	38.9%
Corporate Services	4.18	6.90	6.02	43.8%
Total	$27.64	$40.65	$35.06	25.0%

Account & Membership Administration Includes Pharmacy, Mental Health and ICD-10 IS Expenses.

Appendix B. Benchmark Summary
Independent/Provider-Sponsored Costs by Functional Area Cluster, 2011 Data
Percent of Premium Equivalents

	25th PCTL	75th PCTL	Median	σ/ Mean
Sales & Marketing	2.0%	2.9%	2.5%	28.0%
Provider & Medical Management	1.1%	1.8%	1.4%	24.5%
Account & Mem. Administration	2.6%	3.7%	3.2%	27.6%
Corporate Services	1.1%	1.8%	1.4%	40.0%
Total	7.7%	9.4%	8.7%	16.2%

Account & Membership Administration Includes Pharmacy, Mental Health and ICD-10 IS Expenses.