



ADMINISTRATIVE COSTS FOR MEDICARE ADVANTAGE PLANS SOAR IN 2011

Summary

Administrative expenses, per member, grew by 7.0% in 2011 compared with 0.9% in 2010 and a decline of 4.1% in 2009. After adjusting to eliminate the effects of changes in product mix, per member costs increased by 6.7% compared with a decline of 3.9% in 2010 and a 4.1% decline in 2009.

While growth in Sales and Marketing costs were modest, all other clusters of functions posted double-digit increases in PMPM costs. Growth in Information Systems and Medical Management were the central factors in cost growth.

For the universe of Medicare plans submitting 2011 data, administrative expenses comprised 8.8% of premium equivalents, compared with 8.1% for plans submitting data in 2010. Administrative expenses of the Medicare Advantage product within this universe comprised 8.2% of premiums in 2011.

The administrative expenses of comprehensive products for Medicare plans participating in our performance benchmarking study was \$45.68 PMPM, but varied greatly by product. Medicare SNP expenses had a median value of \$174.73 PMPM while the commercial ASO costs were \$16.85 PMPM. Medicare Advantage administrative expenses were \$74.56 PMPM.

In 2010, the commercial ASO administrative expenses were 5.5% of premium equivalents, the lowest ratio for comprehensive products in this universe. Medicare SNP was at 12.7% of premiums and Medicare PFFS was at 14.2% of premiums.

All costs reported in this article exclude investment and non-operating income and expense, income taxes and miscellaneous

business taxes. Pharmacy and Mental Health administrative costs are included in the Account and Membership Administration cluster. These results are excerpted from the Medicare edition of the 2011 *Sherlock Expense Evaluation Report*, comprising 2011 data.

Background on Medicare

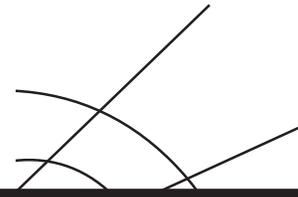
In March of 2012, Medicare Advantage plans served 12.7 million people, or 25.6% of the 49.4 million Medicare beneficiaries, including disabled people. Membership in Medicare Advantage increased by 9.8% compared with 3.7% growth in the program overall. Membership in Medicare's Fee for Service program increased by 1.8% in 2012.

Taking the longer historical view, since the Medicare Advantage participation nadir in 2004, Medicare membership has increased by 16.7%. During that period, Medicare Advantage membership increased by 147.4% and membership in FFS Medicare declined by 1.3%. The Medicare Advantage share of total Medicare beneficiaries increased from 12.1% to 25.6%. According to a September 19, 2012 HHS press release, Medicare Advantage membership is expected to increase by 11% in 2013, bringing its total share to 27%.

Figure 1. Medicare Advantage Benchmark Summary
Medicare-Oriented Costs by Functional Area Cluster, 2011 Data
Per Member Per Month

	25th PCTL	75th PCTL	Median	σ/ Mean
Sales and Marketing	\$8.37	\$22.89	\$15.18	47.9%
Provider & Medical Mgmt.	7.22	13.72	7.91	100.4%
Account & Mem. Admin.	11.17	24.83	15.39	71.2%
Corporate Services	5.35	18.00	8.52	85.4%
Total	\$37.74	\$77.04	\$45.68	67.4%

*Account & Membership Administration includes Rx, Mental Health, and ICD-10 Information Systems Costs.



The increasing attractiveness of Medicare Advantage to seniors can be understood in the context of how seniors finance their health care. The Medicare program covers much but not all health care costs for seniors. According to a 2009 Kaiser Family Foundation analysis of CMS Medicare Current Beneficiary Survey Cost and Use file by Tricia Neuman et al., the mean out-of-pocket expense for Medicare beneficiaries was \$4,052 in 2005. These out-of-pocket expenses include premiums for Medicare and also supplemental insurance. In that year, 13% reported use of a Medicare HMO, 15% reported Medicaid, 33% reported some form of employer-sponsored coverage, 26% reported self-purchased Medigap and 11% reported no coverage supplementing their Medicare benefits.

According to Medicare Payment Advisory Commission's March 2012 *Report to the Congress: Medicare Payment Policy*, payments to MA plans exceed FFS spending for each of the various types MA plans. But their *bids* for Medicare covered services are 98% of what Medicare pays, and for MA HMOs, that ratio is 95%. (HMOs served two-thirds of all Medicare Advantage beneficiaries in 2011.) This suggests that, for the FFS services that Medicare HMOs provide, Medicare HMOs provide it at a cost advantage to the regular Medicare program.

If this apparent cost advantage is accurate, much of the additional Medicare program payments to MA plans went to supplemental services that the beneficiary would otherwise have to pay for through Medicare Supplemental insurance or out-of-pocket. Thus, according to an analysis prepared for the Blue Cross Blue Shield Association by Atherly and Thorpe in 2005, "Beneficiaries with under \$20,000 in income are more likely to enroll in Medicare Advantage than to buy Medigap."

While the costs of the Medicare program and its long-term deficits may lead policy-makers to pressure providers of Medicare Advantage services, the nature of the actual beneficiaries creates a commonality of interest: MA is well-regarded by those favoring a consumer choice based, competitive solution to managing Medicare costs and quality, and also by those who may be agnostic as

to efficacy of competitive markets but are interested in assuring that low income seniors receive the additional benefits at the least possible out-of-pocket costs.

Membership Trends and Mix Changes

Of the eleven plans participating in our benchmarking study this year, six also participated in 2011. These continuing plans grew more rapidly in their Medicare products than the overall Medicare Advantage program. Our plans grew at a median rate of 11.1%, compared with Medicare membership growth of 5.0% between March 2010 and March 2011, and 9.8% between March 2011 and March 2012.

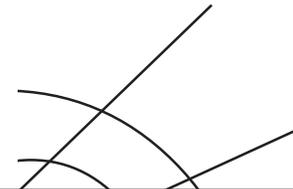
Collectively, the Medicare-focused plans served, on average, 1.0 million Medicare beneficiaries during 2011. Our Medicare benchmarks also include, in a separate exhibit, the MA cost attributes of plans offering, but not focused on, MA. These Blue Cross Blue Shield and Independent / Provider-Sponsored plans served 1.0 million and 0.2 million members, respectively. In all, *SEER* reports on a total of 2.2 million Medicare Advantage beneficiaries, or approximately 18% of total Medicare Advantage beneficiaries. This is summarized in Figure 6.

For plans included in the core benchmarks, Medicare products comprised, on average 67.9% of premiums and fees, and comprised a median mix of 53.8%. Commercial comprised a mean mix of 27.0% and a median of 35.5% of premium equivalents.

Administrative Costs and Trends

For convenience of analysis, we group various functional areas into clusters and standardize for size by expressing expenses on a per-member basis. As we develop later, we also standardize by percent of premiums or equivalents. Values for 2011 and rates of change for these clusters and overall are shown in Figures 1 and 2. Appendix A provides values for all plans participating in the 2011 benchmarking study and reflects 2010 data.





Costs comparisons are based on the results for plans that participated in both of the comparison years. PMPM and percent values are for all plans that reported this year. We employed median values throughout this process as the best measure of central tendency.

Sales and Marketing expenses were \$15.18 PMPM an increase of 1.2% compared with a decline of 5.1% in 2010. Holding these plans' product mix constant, Sales and Marketing expenses declined by 1.1% PMPM compared with a decline of 5.2% in 2010. At the 25th percentile, Sales and Marketing costs were \$8.37 and at the 75th percentile were \$22.89 PMPM.

Rating and Underwriting declined at double-digit rates on an as-reported and constant-mix basis. For the second year in a row, this function's decline in per member costs was the greatest of all functions for this cluster, using either as-reported or constant-mix convention. Broker Commissions also declined using either approach, though at a double-digit pace on an as-reported basis. Product Development / Market Research also declined on a constant mix basis but grew slightly on an as reported basis. Advertising and Promotion grew by double-digits rates under both reporting conventions. By contrast, Sales and Marketing grew somewhat on a constant-mix basis, and faster on an as-reported basis.

Medical and Provider Management increased by 18.4% compared with a decrease of 1.3% in 2010 and an increase of 8.8% in 2009 to \$7.91 PMPM. On a constant-mix basis, costs increased by 14.7% versus a *decline* of 5.4% in 2010 and an increase of 8.8% in 2009.

The Provider Network Management and Services functional area declined in 2011 on both an as-reported and a constant-mix basis. By contrast, Medical Management/Quality Assurance/Wellness grew by double-digits on an as-reported and constant-mix basis. Medical Management cost increases comprised the single largest portion of the overall increase on an as-reported basis.

The costs of Medical and Provider Management at the 25th percentile was \$7.22 PMPM and \$13.72 PMPM at the 75th percentile.

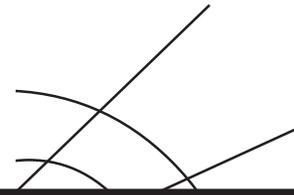
Account and Membership Administration expenses increased to \$15.39, up 31.1% from last year and compared to a 7.7% PMPM increase in 2010. On a constant-mix basis, growth accelerated from a 5.4% rate last year, to 29.8% in 2011. The value at the 25th percentile was \$11.17 PMPM, while the costs at the 75th percentile were \$24.83 PMPM.

Information Systems costs increased at double-digit rates and comprised the overwhelming proportion of the increase in this cluster of expenses on a constant-mix basis. Enrollment / Membership / Billing costs and Customer Services costs each increased at a double-digit pace on both

Figure 2. Medicare Advantage Benchmark Summary
 Medicare-Oriented Percent Change in Costs by Functional Area Cluster

	2010 Data		2011 Data	
	Percent Change	Percent Change, Mix-Adjusted	Percent Change	Percent Change, Mix-Adjusted
Sales and Marketing	-5.1%	-5.2%	1.2%	-1.1%
Provider & Medical Mgmt.	-1.3%	-5.4%	18.4%	14.7%
Account & Mem. Admin.	7.7%	5.4%	31.1%	29.8%
Corporate Services	-2.8%	-6.7%	11.4%	8.7%
Total	0.9%	-3.9%	7.0%	6.7%

*Account & Membership Administration Includes Rx, Mental Health, and ICD-10 Information Systems



an as-reported or a constant mix basis. By contrast, Claim and Encounter Capture and Adjudication costs increased only marginally on both a constant-mix and as-reported basis.

Corporate Services costs increased, as-reported, by 11.4% compared with a decline of 2.8% in 2010 and a slight increase in 2009. On a constant-mix basis, costs increased by 8.7% compared with a decline of 6.7% in 2010 and a smaller decline in 2009. The costs in this cluster include such support areas as Finance and Accounting, Actuarial, Corporate Services (e.g., Facilities, Legal, Printing and Mailroom and OPEB), Corporate Executive/ Governance and Association Dues and License / Filing Fees.

All functions increased on an as-reported and on constant-mix bases except for the tiny Association Dues and License / Filing Fees. Actuarial and Corporate Executive/ Governance grew at low double-digit rates. The cost of consulting activities can be found in these functions so it is possible that this surge reflects the need to adapt to the changes required under health care reform. The Corporate Services *function* (as opposed to the cluster) grew at high single-digit rates and was by far the largest factor in the growth of this cluster. Finance and Accounting also grew at high single-digit rates.

Total costs for this cluster was \$8.52 PMPM in 2011, while the 25th percentile value was \$5.35 PMPM and the value at the 75th percentile was \$18.00 PMPM.

Expressing Costs as a Percent of Premium Equivalents

Notwithstanding its important drawbacks, health plans and others often express administrative costs as a percent of premiums. Indeed, the MLR rules under PPACA employ this percent as a driver for rebates paid to commercial customers.

As shown in Figure 3, administrative expenses were 8.8% of premium equivalents for comprehensive products sold by Medicare plans. The 25th percentile value was 7.6% and the value at the 75th percentile was 10.6%. Comparing these results to those in Appendix B, administrative expenses were 74 basis points higher as a percent of premium equivalents.

Sales and Marketing costs comprised 2.5% of premium equivalents, with the 25th percentile value at 2.2% and the value at the 75th percentile at 3.2%. The comparable median percent in 2010 was 2.7% or 19 basis points lower.

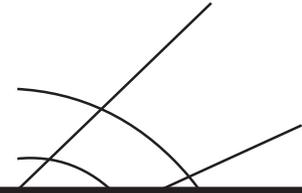
The value at the 25th percentile for Provider and Medical Management was 1.4% of premium equivalents, while 2.0% of premium equivalents represented the 75th percentile. The median value, at 1.8%, was 24 basis points higher than the 1.5% posted last year. (Rounding affected these comparisons.)

The cost of Account and Membership Administration was 2.8% of premium equivalents, a slight increase of 8 basis points from last year's reported median of 2.7%. The value at the 25th percentile

Figure 3. Medicare Advantage Benchmark Summary
 Medicare-Oriented Costs by Functional Area Cluster,
 as a Percent Premiums or Equivalents, 2011 Data
 Percent of Premium Equivalents

	25th PCTL	75th PCTL	Median	σ / Mean
Sales and Marketing	2.2%	3.2%	2.5%	23.7%
Provider & Medical Mgmt.	1.4%	2.0%	1.8%	53.8%
Account & Mem. Admin.	2.5%	3.4%	2.8%	38.0%
Corporate Services	1.0%	2.6%	1.4%	53.3%
Total	7.6%	10.6%	8.8%	29.6%

**Account & Membership Administration includes Rx, Mental Health, ICD-10 Information Systems Costs.*



Calculation of Premium Equivalents

Administrative services relationships comprise a relatively small part of the business mix of Medicare Advantage plans. On average, they comprise 14% of members and their median mix was only 4.0%. Nevertheless, to the extent such relationships exist, they 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 they provide rather than for the cost of care, which is borne by the self-insured groups.

Our solution to this is to express expenses as a percent of premium equivalents. Since each of the plans submits the health care expenses for the self-insured groups (which they know since they process their self-insured claims), by adding this amount to the administrative service fees actually billed, we are able to estimate the premium equivalents of the ASO arrangements.

Note that, as with premiums, fees charged to ASO clients reflect a profit assumption. Therefore, to estimate premium equivalents it is appropriate to add the fees, rather than the administrative expenses, to the reported health benefits to directly compare costs with the insured business.

was 2.5% of premium equivalents and 3.4% of premium equivalents at the 75th percentile.

The median proportion of premium equivalents due to Corporate Services was 1.4%, 22 basis points lower than last year's value of 1.6%. Twenty-five percent of plans had values below 1.0% of premium equivalents and twenty-five percent of plans had values above 2.6% of premium equivalents in 2011.

Calculation of Constant-Mix Rates of Expense Growth

To make the most useful comparisons of administrative expenses between years, it is illuminating to eliminate the effects of product mix differences. This is beneficial both between organizations with different product mixes and also between periods. Accordingly, in comparing expenses between periods, we hold constant the product mix between the two years.

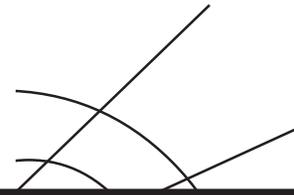
To do this, since Medicare plans report to us by product, we reweight their expenses so that the product mix applied in the prior year is the same as in the current one. We then recalculate the constant-mix rates of change based on these reweighted values.

Administrative Expenses by Product

All participants in our benchmarking studies segment their costs by product as well as by over forty functional areas. Overall, the resources required to serve customers of these products differ quite sharply between them. Our participants normally have strong cost allocation methodologies to facilitate this, including sometimes quite robust activity-based costing systems, so that costs are not normally allocated by member.

For example, suppose commercial HMO members have, on average, 40% of the number of annual claims as members in Medicare Advantage products. Commercial products' per member claims adjudication expenses will be correspondingly lower as well. Similarly, ASO products have lower overall costs than their insured counterparts since ASO arrangements are normally provided only to larger groups that tend to require fewer marketing resources per group.





These differences are manifest in their overall cost differences. The most expensive product offered by Medicare plans is their Medicare SNP product at \$174.73 PMPM. PFFS followed at \$124.68 though only one company submitted cost information on this product. Medicare Advantage cost \$74.56. The least expensive comprehensive product offered by these health plans was the ASO product at \$16.85 PMPM. The stand-alone Medicare Part D cost \$20.94 PMPM to administer. This is shown in Figure 4.

As shown in Figure 5, the ranking of administrative expenses by product is different on a percent of premium basis. The ASO product remained among the lowest cost on a percent basis, at 5.5% of premium equivalents, but it was followed by Medicaid and Medicare Advantage at 8.0% and 8.2%, respectively. The high cost products, calculated based on a percent of premium equivalents, were Medicare SNP at 12.7% of premium equivalents, followed by Indemnity and PPO Insured at 11.3%.

Figure 4. Medicare Advantage Benchmark Summary

Medicare-Oriented Costs by Product, 2011 Data

Per Member Per Month

	25th PCTL	75th PCTL	Median	σ / Mean
HMO	\$31.50	\$48.87	\$35.44	26.4%
POS	29.18	38.55	31.87	30.1%
Indemnity & PPO	31.93	49.14	45.42	24.1%
Total Comm. Ins.	\$31.66	\$43.52	\$33.72	23.4%
ASO	16.73	24.68	16.85	40.2%
Total Commercial	\$25.42	\$34.68	\$27.31	22.2%
Medicare Advantage	66.44	103.00	74.56	36.6%
Medicare Advantage PFFS	124.68	124.68	124.68	NM
Medicare SNP	151.45	196.17	174.73	25.8%
Medicare Total	\$68.11	\$104.16	\$77.14	36.2%
Medicaid	18.10	23.59	20.87	26.4%
Comprehensive Total	\$37.74	\$77.04	\$45.68	67.4%
Medicare Part D	\$16.41	\$25.29	\$20.94	42.7%

Figure 5. Medicare Advantage Benchmark Summary

Medicare-Oriented Costs by Product, 2011 Data

Percent of Premium Equivalents

	25th PCTL	75th PCTL	Median	σ / Mean
HMO	9.4%	10.6%	10.2%	17.8%
POS	7.7%	10.0%	9.1%	22.4%
Indemnity & PPO	9.3%	14.7%	11.3%	35.7%
Total Comm. Ins.	9.2%	12.0%	10.1%	27.0%
ASO	4.0%	6.7%	5.5%	42.3%
Total Commercial	7.3%	9.9%	8.7%	24.2%
Medicare Advantage	7.3%	11.3%	8.2%	32.7%
Medicare Advantage PFFS	14.2%	14.2%	14.2%	NM
Medicare SNP	10.5%	13.5%	12.7%	26.6%
Medicare Total	7.4%	11.4%	8.2%	31.9%
Medicaid	7.5%	8.6%	8.0%	14.5%
Comprehensive Total	7.6%	10.6%	8.8%	29.6%
Medicare Part D	7.3%	12.2%	7.4%	53.2%

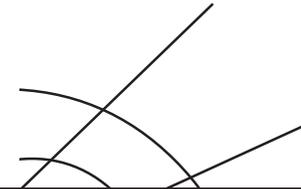


Figure 6. Medicare Advantage Benchmark Summary
Medicare-Oriented Characteristics by Universe, 2011 Data

	Medicare	Independent/ Provider- Sponsored	BCBS	Combined Universes
Administrative Expenses PMPM				
25th PCTL	\$66.44	\$56.05	\$65.48	\$65.32
Median	74.56	78.80	80.84	79.10
75th PCTL	\$103.00	\$89.23	\$94.62	\$97.60
σ / Mean	36.6%	34.3%	31.1%	33.3%
Administrative Expenses as a Percent of Premiums				
25th PCTL	7.3%	6.8%	7.3%	7.2%
Median	8.2%	8.0%	9.1%	8.4%
75th PCTL	11.3%	10.0%	10.0%	10.8%
σ / Mean	32.7%	35.2%	35.0%	33.2%
Plans Offering Medicare Advantage	11	6	14	32
Medicare Members (Millions)	1.02	0.16	1.06	2.24
Medicare Revenues (\$ Billions)	\$12.0	\$1.8	\$11.8	\$25.6
Comprehensive Total Revenues (\$ Billions)	\$20.5	\$20.7	\$116.7	\$158.0

Comparisons Across Universes

Health plans in other Sherlock Company benchmark universes also offer Medicare products. In fact, the combined Medicare membership in the Independent/Provider-Sponsored and Blue Cross Blue Shield universes exceeds that of the Medicare universe itself. Together, the three universes are comprised of health plans serving 18% of all of the Medicare Advantage beneficiaries.

Figure 6 compares the median results for the Medicare products of the three universes. While Medicare plans have the lowest PMPM costs, they have lower costs than BCBS plans on a percent of premium basis and are slightly higher than Independent/Provider-Sponsored plans by that ratio.

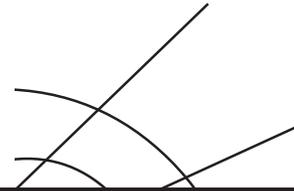
The Medicare Advantage products offered by the three universes operate somewhat differently, as discussed below.

Sales and Marketing: Medicare-focused plans have much higher Sales and Marketing costs than Blue plans and slightly higher costs than IPS plans. Blue and IPS plans rely more heavily on external brokers, reflected by higher Commissions than Medicare-focused plans. Advertising costs are much higher in Medicare than for the other universes. Rating and Underwriting (which contains the HCC costs) is highest for the Medicare-focused plans, distantly followed by the IPS and Blue plans.

By contrast, for the Medicare universe, the internal Sales and Marketing function (as opposed to cluster) is approximately the same as for Blue plans but lower than the IPS plans.

Provider and Medical Management: Medicare plans have considerably higher costs in this cluster than their Blue or IPS peers. Medical Management costs are the dominant costs in this function and they are much higher for the Medicare universe, followed by IPS and Blues, in that order. The Medicare universe's Provider Network Management and Services costs were slightly lower than in the other two universes.





Account and Membership Administration: Blues had the highest costs in this expense cluster by a wide margin over the Medicare plans. In order of importance, Blue plans had higher costs than their peers due to Information Systems, Claims, Customer Services and Enrollment.

IPS and Medicare plans had similar costs for this cluster. But the resource mix was different. IPS plans had higher Information Systems costs but all other functions were lower than their Medicare counterparts,

Corporate Services: Medicare-focused plans' Medicare Corporate Services costs were somewhat higher than those of IPS plans but lower than those of Blue plans. Medicare plans had lower Actuarial and Finance and Accounting costs than the other universes. The smaller Medicare plans had higher Corporate Executive/Governance costs than their counterpart universes. This function is often scalable, and the Medicare plans are typically smaller than those in the other universes. But the Medicare plans' Corporate Services *functional* costs were much lower than Blue plans and much higher than IPS plans.

Background on SEER

Sixty-two health benefit organizations participated in this year's studies, and they collectively serve more than 48 million beneficiaries of comprehensive health programs. These participants are segmented into peer groups of Independent / Provider-Sponsored Plans, Larger Health Plans, Third Party Administrators, Blue Cross Blue Shield Plans, Medicaid Plans and Medicare Plans.

Now completing our fifteenth year benchmarking health benefit organizations, the 2012 benchmarks (containing 2011 data) comprise the cumulative experience of 576 health plan years. Summary results of the various universes may be found on our web site www.sherlockco.com.

The *Sherlock Expense Evaluation Report* is a compilation of the results of surveys completed by each participant, who receives a copy of the report in exchange for its participation and other consideration. The benefit of the report to participants is its application for internal cost management; this voluntary participation promotes the accuracy of participant reporting. Sherlock Company reinforces accuracy through a series of checks and analyses intended to identify responses that are not in accordance with *SEER* definitions.

Appendix A. Medicare Advantage Benchmark Summary				
<u>Medicare-Oriented Costs by Functional Area Cluster, 2010 Data</u>				
<i>Per Member Per Month</i>				
	25th PCTL	75th PCTL	Median	σ / Mean
Sales and Marketing	\$8.41	\$25.47	\$14.63	55.7%
Provider & Medical Mgmt.	5.49	13.36	7.60	53.3%
Account & Mem. Admin.	9.08	26.63	12.67	66.8%
Corporate Services	5.65	12.78	10.25	66.5%
Total	\$32.21	\$86.36	\$44.73	54.7%

**Account & Membership Administration Includes Pharmacy and Mental Health*

Appendix B. Medicare Advantage Benchmark Summary				
<u>Medicare-Oriented Costs by Functional Area Cluster, as a Percent Premiums or Equivalents, 2010 Data</u>				
<i>Percent of Premium Equivalents</i>				
	25th PCTL	75th PCTL	Median	σ / Mean
Sales and Marketing	2.4%	3.3%	2.7%	29.7%
Provider & Medical Mgmt.	1.3%	1.8%	1.5%	19.6%
Account & Mem. Admin.	2.1%	3.0%	2.7%	33.8%
Corporate Services	1.1%	2.3%	1.6%	41.4%
Total	7.6%	10.7%	8.1%	21.5%

**Account & Membership Administration Includes Pharmacy and Mental Health*

