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MANAGING ADMINISTRATIVE EXPENSES FOR PUBLIC SECTOR HEALTH BENEFIT PROGRAMS

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<Slide 1: Title Page>

Thanks for attending this presentation.

I am often asked about our use of sailboats for our cover art so I want to begin by noting that they are usually not pleasure craft. Rather they are Chesapeake Bay fishing boats. A Maryland state law promoting conservation limits oyster dredging to sailboats. Interestingly, the watermen also race these boats when they are not working. There are of course parallels between the key role of state governments in Chesapeake Bay fishing practices and your own organizations. But the real reason we use the sailboat theme is we think that racing work boats is a nice metaphor for the performance improvements desired by health plans and administrators.

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The premise of this presentation is that health plan cost information can help you better understand and manage the administrative costs in your health benefit programs. While we intend that this conversation remain within the reasonable constraints of time, we also hope that it answers many questions. What are the product, activity and total costs of health plans? How fast do they grow? What's the right way to measure them?

How do you apply this knowledge to better understand the costs of your organization? Finally, are their important caveats that should help to inform any conclusions we would draw from making this application?

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I've organized this to touch on our background, trends in administrative costs for health plans and the application of health plan metrics to the cost structures of public employee health benefit programs.

Just to be clear, when I say "health plans" I am referring to entities bearing insurance risks, like Blue Cross Blue Shield Plans or Aetna. Blue Cross Blue Shield Plans, which we will discuss, are a robust sample of relatively similar organizations. A second universe we will discuss are organizations that are similarly local organizations that are often owned by health systems. Geisinger and Harvard Pilgrim are organizations that would fit into this category. We call these Independent / Provider – Sponsored health plans.

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Sherlock Company is not a household name. But we occupy a unique niche in our focus on the capturing the administrative costs of health plans and reporting back to them actionable analyses. We are now in our 18th consecutive year doing this, and will have cumulative experience of 700 health plan years. Our plans span several product or organizational characteristics and are in extremely broad use. Our work is accepted because we avoid conflicts of interest, our analyses are highly granular and our model is voluntary. Our data comes from our surveys of health plans.

Notably absent from our qualifications is extensive experience with health benefit programs for government employees. We've served as a consultant to one state program, provided benchmarks to assist a state university health system and supported the efforts to better manage a program for teachers. That's it. So I ask that view this presentation with charity, as a genuinely different perspective.

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I am under the impression that state governments are under some significant financial pressures, though you would know better than I. We know that in one instance in which we were involved a subcommittee of a state legislature was very much concerned with the administrative costs of its health benefit program.

If you were tasked to reduce health benefit costs for your beneficiaries, you might start with the largest form of costs, the cost of hospital and medical care. Unfortunately, the only practical way to negotiate lower prices is through the promise of greater volume, and that can be assured only by narrowing the panel. Alternately, cost sharing can lower health costs but employees will experience a greater burden. Employees may resist these approaches or at least be unhappy with them.

So managing administrative costs of your health benefit program may be more attractive as it has less of an impact on the experience of employees as patients. It may also be the first step you need to take before you address the larger health care cost issue. The disadvantages are that administration is small relative to health care costs and sometimes cutting administrative expenses leads to lower quality service or higher cost health care.

In any event, it may be that, even if the ultimate goal is to reduce health costs, reducing administrative costs may be a necessary first step.

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I gather that state and local government health benefit programs are overwhelmingly self-insured. In other words, they bear the cost of their employees' health care cost variances rather than paying an insurer to do so.

The burden of administering the programs also falls on the governments but these responsibilities may be executed in a variety of ways – by

outsourcing substantially all activities, by outsourcing selected activities and finally and most rarely operating pretty much as a health plan.

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Since health plans are themselves required to offer the entire spectrum of services to meet the needs of the people they serve, they provide a uniquely attractive model for comparison with your health benefit program. In fact, to the degree that you outsource, the underlying costs of outsourcing should in part reflect the underlying costs borne by the health plans.

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So now I'd like to expand on this notion of using health plan costs as a model for your health benefit program. Specifically, I'll touch on the trends and levels of costs that we see among health plans. One subtext of this slide is that, if your program's administrative costs have increased, you are not alone.

This slide focuses on Blue Cross Blue Shield Plans. Collectively, they comprise the single largest segment of the health insurance industry. The cost values for 2012 and 2013 for about one-half of them are shown in the first two columns. Sales and Marketing costs are broker Commissions, Rating and Underwriting, Sales, Marketing and Advertising and Promotion. You likely incur very little of this cluster of expenses.

Medical and Provider Management are comprised of Medical Management and Provider Network Management and Services. Provider Network is likely imbedded in the cost of your services and Medical Management, such as case management, may or may not be part of your benefit design.

Account and Membership Administration costs are likely fully reflected in your costs since they include Enrollment, Customer Services, Claims and Information Systems. These are the core administrative activities of your benefits program.

Corporate Services includes Actuarial, Finance and Accounting, HR, Corporate Executive, Facilities and similar activities. I imagine that benefit programs vary quite a bit in whether they incur such costs and how they are delivered. Sometimes these activities are provided by sister agencies to yours.

Later in this presentation, we'll show you how to apply these values to help you assess the costs of your health benefits program.

The far right column shows rates of change in costs. Per member per month costs increased by 6.2% in 2013 in the run up to full implementation of the Affordable Care Act in 2014. Sales and Marketing and Account and Membership Administration cost growth was especially high. We'll expand on the reasons for this later.

By the way, while the PMPM cost values are medians for the entire universe, the rate of growth is calculated with two important adjustments. We've eliminated the effect of changes that are due to either changes in the composition of the universes between years, and we've eliminated the effect of changes due to changing business mix later. We'll expand on the effect of business mix changes as well. In any event, the rates of change do not correspond with the PMPM cost values.

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For those of us of a certain age, the existence of provider-sponsored health plans is ironic. After all, once upon a time, Blue Cross Blue Shield Plans were effectively provider sponsored, complete with the logo of the American Hospital Association superimposed on the cross. The hospitals of Baylor University formed a prepayment mechanism with Texas teachers that ultimately became Blue Cross – now Baylor is the owner of its own health plan serving hundreds of thousands of members. We don't disclose our participants but this universe is comprised of the leading organizations of this kind and is broad enough to embrace the organizations like Baylor's health plan, Harvard Pilgrim and certain regional plans with narrow customer niches.

Costs are segmented into the key clusters and they vary to the degree that they apply to your organization. Once again, the rates of growth are shown to the far right and, as with the Blues, they show Sales and Marketing and Account and Membership Administration cost growth especially high.

If you compare the costs in this slide with the ones for Blue Cross Blue Shield Plans, you'll note that these costs are considerably higher. While Blue plans have membership of 1.5 million on average and IPS plans have membership averaging 450,000, scale is not the principle reason for the difference. Rather, the mix of business for IPS plans favors high cost products such as Medicare while Blue plans favor low cost plans such as Administrative Service type arrangements.

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Administrative expenses are commonly expressed as a percent of revenues. Medical Loss Ratio minimums are examples of this. I won't go as far as White House advisor Larry Summers did calling it "stupid" or "dumb. " But conceptually, expressing administrative expenses as percents introduces a complicating factor, the effect of the competitive environment on pricing. By contrast, the PMPM values solely reflect costs.

A notable aspect of this is what a small share of the health care dollar is attributable to administrative costs. Profits in health plans are 2-3% and health benefits comprise 80-90%.

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If you recall slides 8 and 9, we showed cost growth trends for Blue and IPS plans. In both instances, we noted that Sales and Marketing and Account and Membership Administration were the groups, or clusters, of expenses whose growth in 2013 was especially pronounced.

This slide provides some further insight to the functions that drove growth. This chart shows the function that contributed most to the increase, in other words growth weighted by their costs. For Blues, Information Systems, followed by broker Commissions were key.

Information Systems, Customer Services and Actuarial and Advertising each grew in mid to high teens.

For IPS plans, there was a similar pattern. Advertising and Promotion and Information Systems were chiefly responsible for the increases. Like with Blues, Information Systems costs increased in mid-double digit rates as well, but for this universe, this is after a succession of similar IS increases in prior years. Finance and Accounting grew especially rapidly.

One of our participants suggested that the way to think about these increases is "bulge and adaptation expenses." An example of a bulge expense is the surge in Customer Services costs, as well as Advertising and Broker Commission costs, which was necessitated by the need to inform health plan customers of the changes due to ACA. Adaptation costs included Application Acquisition and Development expenses in Information Systems, as well as the sharp increase in Finance and Accounting, Actuarial and the Product Development subcategory of Marketing expenses.

If you are self-insured you may have been somewhat insulated from these cost trends but if you have seen an increase in administrative costs, you are among good company.

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This slide shows the importance of understanding benefit design and demographics in understanding costs. When health plans report expenses to us, its costs are segmented by product. The total costs for all the plans' products, is the same as each product's costs weighted by the proportion of membership that is in each product. So you can see from the closeness of the product costs means that the comprehensive cost differences between the two universes noted earlier are largely due to the differences in mix – Blues have proportionally fewer Medicare and proportionally greater ASO.

Note also product cost characteristics track demographics and benefit design. Products sold to seniors are far more expensive since the higher costs to administer trace the higher costs of the benefits themselves. On the

other hand, what we know about ASO products is that they are sold to large groups and so their lower per member Sales and Marketing costs give rise to far lower costs overall.

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I won't dwell on this slide for the reasons I expressed earlier but it expresses the administrative expenses as a percent rather than PMPM. But do note that the expensive Medicare Advantage fall into line with other products when expressed as a percent of premiums.

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The balance of this presentation is on how you apply the information that we've been discussing to the case of your health benefit program. We'll also touch on some qualifications to any conclusions you may draw.

While this process is rough and ready, the nice thing about it is its ease: The process is simple and the comparative data that you need is readily available. You do need to consider how comparable you are to the organizations for which information is available. But once you do, applying the comparisons is very straightforward.

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To apply the cost metrics, the first thing you do is get a rough sense of your own costs. I've adapted this slide from the breakouts we use for health plans. The key number you need to calculate equates to the $19.50 for benefit program values shown here. While the bracketed values for "your benefit plan" sum to $19.50, this step actually requires no segmentation of costs into the various activities. The only thing you do is to take your total administrative costs and divide it by the *beneficiary months* of your health benefit program.

While the segmentation by function is not important in this step, on the grounds that you manage what you measure, it can be a good idea to do this segmentation.

Towards the top of this chart are marketing expenses. Your benefit program would not bear these expenses, but health plans would. The $7.00 value is loosely based on the Sales and Marketing cost information found on slides 8 and 9. I've included them simply to force a comparability between total administrative costs of health plans with what might be borne by a health benefit program.

Finally, while reliable comparisons require taking your mix into account, you don't really have to segment costs by the sorts of products that your beneficiaries enjoy. I'll explain why in the next slide.

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The reason you don't need to segment your costs into the sorts of members that you have is because you can adjust the *comparison universe* to exactly match your group. This slide reflects that you've decided that your benefit program best resembles a Blue Cross Blue Shield Plan. You've concluded that, of your total beneficiaries, 20% are retirees and dependents with what amount toMedicare Supplemental benefits and 80% are active employees and their dependents who have an Indemnity and PPO type self-insured product.

So, in the first column, you'll see the Blue Cross Blue Shield values for these two products drawn from slide 12. The second column shows your mix. The third column shows the cost values weighted by your mix.

The sum of the weights is directly comparable to your program. In other words the $25.99 is directly comparable with the $26.50 on the previous slide, representing the sum of your program costs and what you have estimated value for Sales and Marketing. Again, the Sales and Marketing expenses are estimated from slides 8 and 9. When you subtract the $7.00 from the $25.99 weighted comparable value, you get $18.99. This is directly comparable to the $19.50 which is your average monthly per beneficiary cost.

The bottom line, in this example it is reasonable to conclude that the program administrative costs are in the ballpark.

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So we're all here in Ft. Myers and it is much prettier here than in Philadelphia, and perhaps where you come from too. So, suppose you return home and, in your tropical revery, have misplaced this presentation and still wish to perform the analysis.

No worries! Tools to do this available online. And what is even better, an online version of the values actually does most of the work for you.

To find the application, just Google the name "Sherlock" along with something like "health plan" or "administrative" or "costs". "Sherlock" is an easy name to remember – like Holmes!

We'll be on the first page you'll find. On the left menu there is an application called Benchmark Calculator. If you click on it, you'll invoke a page that will look like this.

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Here's how it works. Let's return to the benefit program example. Again, let's assume and 80/20 split of active and retirees. In this case, we'll assume that we have a 100,000 beneficiaries and the annual administrative costs are $23.4 million. ($19.50 x 100,000 x 12)

So, what you do is insert your attributes to the Benchmark Calculator application. You place the 80,000 active employees and dependents in the Indemnity and PPO ASO/ASC box and the 20,000 retirees and dependents into the Medicare Supplemental box. By the way, the Calculator allows you to select what you view as your most applicable universe such as IPS or Blue or some other peer group. You can also populate your administrative costs into the appropriate box. This slide reflects $23.4 million in your administrative costs.

Now what instantly appears is an analysis that exactly parallels that found on slides 15 and 16. Your PMPM administrative expenses are again shown at $19.50 PMPM. The Benchmark Value of $25.44 is also shown. A variance of $6.49 is also shown.

You do need to deduct from the universe the cost of the activities that your benefits program does not provide. In our case, we've assumed that all of the Sales and Marketing costs, and nothing else, should be eliminated. So what would remain would be an unfavorable variance of $0.51. In a word, you're in the ballpark.

We periodically update this for the best available information from our survey participants. We expect much of this content to be updated in July.

Again, the attractive thing about this application is that it is very easy to apply and it is available after only the very simplest of Google searches. Remember, Google "Sherlock" and "health plans" or "administration" and we'll be on the very first page, probably ranked first too.

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I want to briefly shift gears back to an earlier slide. Recall that slide 8 had administrative expenses segmented by cluster. The values for Blue Cross Blue Shield plans from that slide are shown in the column on the right called Benchmark Values. Thus Account and Membership Administration costs are $13.94. Your program administrative costs are found in the first column, again assumed to be $19.50 PMPM.

Suppose you have a sense of what that $19.50 is comprised of, and you can populate your costs to more or less comport with our functional classifications. Then you can identify possible *sources* of variance. So while your Account and Membership Administration costs are relatively low - $9.00 versus $13.94, your Corporate Services costs of $5.50 are relatively high compared with the Benchmark values of $4.44.

The one drawback of this approach is that it does not take differences in product / benefit design mix into account.

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I want to end this presentation with the observation that not all cost reductions necessarily lead to superior performance.

This is a regression analysis with data points from some of the plans that participate in our Benchmarking study. On the vertical axis is Gross Profits defined as Premiums less Health Benefits. The horizontal axis shows the amount expended for Medical Management activities. It shows that the more you spend on Medical Management, the lower health care costs are relative to the premium dollar.

The cautionary note here is that if you reduce your administrative costs for medical management activities, you may run the risk of increasing your costs in the far larger health care deliver expense.

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Measuring quality in health care is a black art but the government nevertheless gives it a good try through the Star Ratings for Medicare Advantage plans. This shows a regression analysis that we performed a couple of years ago. The horizontal axis is once again Medical Management expenses but, in this instance, just for Medicare Advantage. The Star Ratings are on the vertical axis.

So an interpretation that arises from this is the less you spend on Medical Management, the lower your quality may be, at least insofar as it is measured by the Star Ratings.

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Finally, it is important to be careful with cost analyses so that you fully consider the unique qualities of the population in your health benefit program. For instance, you may discover that your costs are high, but the needs of the population you serve require it.

So, imagine the costs of administering a benefit program are high. Also imagine that one factor that you have identified is higher staffing ratios resulting from lower than average productivity. According to this analysis, your worry concerning the productivity issue should consider the effect of the population your program serves. It shows that the greater the percent of your population that are Medicare, the lower the number of annual inquiries per FTE are likely to be. Seniors make longer phone calls, by about 20% as it happens.

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The purpose of my presentation is to provide some tools to enable you to get a better sense of the relative costs of your health benefit program. We endeavor to show how information that is publicly available from health plans can be used for this purpose. As Drucker is sometimes credited, you manage what you measure.

The Sherlock Benchmark information, depending on how you use it, is granular to the level of expense clusters or may be adjusted to match the products that your beneficiaries require.

Of course, while controlling costs is central, these efforts should be conducted with an eye on the legitimate expectations of your beneficiaries. So appropriate care is appropriate.

Thank you once again for listening to my presentation. As I mentioned earlier, I suspect that it is a genuinely different perspective. But then the metaphor of racing workboats likely applies in health benefit programs as much as to health plans.