



*Transcript*

# 2016 Blue Cross Blue Shield Administrative Cost Trends: Optimizing Costs in an Uncertain Environment

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<Title Page>

Thank you for participating in this year's review of the Sherlock Benchmarks for Blue Cross Blue Shield Plans. I am Doug Sherlock, President of Sherlock Company. We offer what leading consultants call "the Gold Standard" for health plan benchmarks.

If you search for the words "uncertainty" and "health insurance" you will see countless references, many of which are headlines of periodicals. That the word "uncertainty" has become a cliché reinforces the truth of it. How *does* a senior manager of a health plan budget for 2018 when regulation of rating bands, federal subsidies of Exchange policies, mandated benefit designs and other key aspects of health insurance remain in play?

Planning under uncertainty entails strategies that are applicable under any scenario. Cost optimization has been called a "no-regret move" for this reason. After all, superior performance can be translated into growth in market share or earnings under any environmental outcome since optimal costs can either be deployed to achieve low prices or superior quality.

One tool to inform this "no-regret move" is to employ benchmarks. We know that health plans serving most Americans use Sherlock Benchmarks, and maybe others too. Benchmarks have the virtue of identifying the existence of variances, then pinpointing and prioritizing causes. So it is not unexpected that there is actually a body of academic literature that empirically demonstrates a relationship between benchmarks and organizational performance, improved processes, generation of broad-based change



and effectiveness in decision making. After all, as Joseph Swedish, CEO of Anthem observes, “if you don’t measure it, you can’t manage it.”

The 14 Blue Cross Blue Shield plans that are the subject of this presentation serve 38.3 million people with comprehensive insurance. These plans collectively serve about 55% of the membership of Blue plans that are not publicly traded.

Before I begin though, I want to offer some appropriate thanks. This year is a significant milestone since it marks the 20<sup>th</sup> year of the Sherlock Benchmarks. Cumulatively, it reflects the experience of approximately 780 health plan years, and includes Independent / Provider – Sponsored Plans, Medicaid Plans and Medicare Plans. This has been possible through the efforts of my talented colleagues, one very visionary Blue Cross Blue Shield CFO and the professionalism of the participating plans especially our primary contacts within those plans. The word “gratitude” only faintly expresses my view. Indeed, since the subject matter of this web conference is free of charge and beneficial even to more casual analysts, I hope you share my appreciation.

<Slide 2>

I’m going to breeze through this slide. It shows the topics that I will address, and lists the appendices. Note that the appendices contain last year’s value and a list of all of the functions in each of the products offered by these Blue Plans. That means that administrative expenses are segmented into nearly 800 expense/product cells, each of which are separately analyzed. We only summarize broad trends here.

We have also included some Market Segment cost information in the Appendix.

I will be posting the slides and the transcript of this within the next 24 hours. I very much welcome your questions at the end of this presentation and the audience will be muted during the presentation itself.

<Slide 3>

This slide summarizes long term administrative cost trends for Blue Cross Blue Shield Plans. As you can see, costs sharply increased as the Affordable Care Act came into implementation in 2012 and 2013. Information Systems expenditure increases were central to this. The rate of growth in per member costs has declined since then and Total



and Account and Membership Administration costs actually fell in 2015. While higher in 2016, cost increases are low relative to the past eight years. The dark blue line, Total Administration, at 0.6% is at its second lowest level, and Account and Membership Administration is at 0.9%, its third lowest level.

By the way, when I speak of growth in costs in this presentation, it will generally be in *per member* terms.

<Slide 4>

The comparisons on the prior slide are detailed in this one, in the second and fourth columns. These columns reflect continuous plans, whose cost values have been reweighted to eliminate differences due to product mix. The arced arrow is to draw your attention to the comparison with prior year's values.

You can see that Account and Membership costs changed more dramatically than did expenses overall. Circled in red, this chart shows the 0.6% per member Total administrative cost increase and the 0.9% Account and Membership Administration increase is circled in blue. Medical and Provider Management also accelerated. While Corporate Services is among the smaller clusters of functions, it was the fastest growing. By contrast, uniquely among clusters, the growth in Sales and Marketing actually declined to 0.2% from 2.1% last year.

The first and third columns show the changes that the continuously reporting plans actually reported to us. Costs increased by 0.8% per member, very slightly faster than the 0.7% increase last year. But their product mixes have not been reweighted. That means that their changed mix of products has affected their rates change in costs. That change in mix was that lower cost Medicaid and ASO grew rapidly, as did high cost Medicare Advantage. The fact that as-reported growth rates were faster than the constant mix trends suggests that the growth of the high-cost Medicare products may have dominated the as-reported trends.

<Slide 5>

This slide explains the *reported* rates of change, that is, the values with no adjustments for changes in product mix.



The greatest change in the Sales and Marketing cluster of expenses was the sharp decline in Advertising and Promotion. This is the third year in a row of declines in this function. External broker Commissions declined not nearly so rapidly compared to being essentially flat in 2015. But because Commissions are such an important expense, the low single digit decline was the plurality of the expense difference. In four of the past five years, including 2016, Rating and Underwriting has increased at double digit rates. Rating and Underwriting involves matching pricing with health care costs. Traditional Rating and Underwriting allows plans to price appropriately to employee groups. However, this function is also responsible for appropriately *describing* the health status of enrolled members to Medicaid, Medicare and other benefit programs that adjust payments to reflect member health. Interestingly, the rate of growth in this function is about the same whether you adjust for product mix, suggesting that the increase is across products. Marketing, containing Product Development and Market Research, grew relatively rapidly.

The Medical and Provider Management cluster declined in its growth, 2.6% versus 4.0% last year. While Medical Management declined slightly, Provider Network Management and Services increased at mid-to-high-single digit rates. Medical Management, since it is much larger than Provider Network Management and Services, reduced growth. But the growth in Provider Network Management and Services is so strong that this function dominates the cluster's growth.

Account and Membership administration increased very modestly, growth of 0.5% *down* from 1.3% growth last year. Information Systems was the fastest growing function, and because it is the largest function in the cluster, is the most important source of growth. Claim and Encounter Capture and Adjudication was effectively flat. Customer Services and the diminutive Enrollment function costs accelerated.

The Corporate Services cluster accelerated to a 3.8% increase compared with a 0.8% increase in 2015. Finance and Accounting was the most important source of increase and the most rapid. This is the fourth consecutive year that this function has growth faster than its cluster. Actuarial was the second fastest function in the cluster, in concord with the growth in Rating and Underwriting.

In summary, Advertising and Promotion declined sharply, repeating a recent pattern. While Information Systems costs increased, the magnitude of the function made its trend the most important for the Plans.



<Slide 6>

Slide 6 shows the rates of change and the most important reasons for the changes, *after eliminating the effect of product mix differences*. These are the “real” rates of increase. The increases are faster than on an as-reported basis, except for Sales and Marketing. Because of the magnitude of Sales and Marketing, total cost growth is slightly lower than the growth on an as-reported basis. The faster growing products were lower cost products like Medicaid and Commercial ASO and the higher cost: The faster growth on an as-reported basis suggests the possibility that the effect of the higher cost products that dominated.

Slide 6 shows many of the same trends as are evident in Slide 5. However, I would like to highlight a few differences. Note that Rating and Underwriting is now, replacing Advertising and Promotion as the fastest growing function within Sales and Marketing, and overall. This suggests the breadth of the Rating and Underwriting effort across many products.

Also broker Commissions have been replaced by Advertising and Promotion as the greatest weight in cost drivers for Sales and Marketing. Recall that there was a shift away from the more broker intensive insured to ASO/ASC, and that we view insured and ASO/ASC as different products.

Provider Network Management and Services and Finance and Accounting are both more important to overall trend, though still at the top of their clusters. Both Customer Services and Enrollment accelerated but this became especially visible after eliminating product mix differences.

The growth in Corporate Services function became more visible in the constant mix presentation. By far, the most reason for the increase in the Corporate Services function was a high, double-digit surge in Legal expenses.

In summary, Rating and Underwriting costs were the fastest growing area, and Information Systems was the most important function contributing to cost growth.

<Slide 7>



Up until now, I have focused solely on the administrative expenses that managers can control. For instance, we have excluded from the discussion capital costs such as interest and dividends because they are the result of financing decisions made at the board level or at least beyond the purview of the operating managers.

For that same reason, we have excluded Miscellaneous Business Taxes from this analysis. These taxes, which are primarily associated with the Affordable Care Act, layer in additional costs. Unless the plan restructures to consolidate government business in one non-profit, these taxes are unaffected by management, especially operational management. From an operating perspective, perhaps the central attribute of such taxes is to amplify the need to manage administrative costs.

On a constant-mix basis, per member Miscellaneous Business Tax costs decreased by 1.7% down from an increase of 17.5% last year and a surge of 369.1% in the prior year. The median value of such taxes is \$12.57, or approximately 25% of all administrative costs once you add the taxes back in.

These taxes are primarily focused on insured products. The median Annual Fee on Health Insurers is \$7.72 PMPM and the median Exchange User Fee is \$13.97.

<Slide 8>

To this point, we have focused on rates of change rather than the underlying values of the components of administrative costs. The next few slides speak to the values of these activities, though it is necessarily a summary.

A very rough gauge of trend is difference in the raw numbers between last year's values and this year's. The median PMPM value of \$32.00, 3.2% greater than the median value of \$31.00 last year.

The prior year values are shown in Appendix A, and are also excerpted on this page. While the total medians are higher, the components vary. Note that the universes vary as well.

There is some correspondence with the overall administrative cost trends on Slide 4 and the increases shown here. Recall that Corporate Services grew rapidly and here, with costs of \$5.27, there is an increase by 10.7% from last year. Also, Account and



Membership Administration increased very modestly in Slide 4 and was lower by 2.3% to \$14.55.

On the other hand, Medical and Provider Management grew faster than total costs in Slide 4 but the values were 0.7% lower than last year's at \$4.04. The greatest difference between the trend presentation is growth in the Sales and Marketing cluster was modest – here it increased by 2.8% to a median value of \$8.45 PMPM.

Interestingly, the cluster values are slightly more clustered. The differences between 25<sup>th</sup> and 75<sup>th</sup> percentile values are less, and the coefficients of variation tend to be less as well.

<Slide 9>

I have been emphasizing the effect of product mix changes on trend and this slide shows what I mean. Note that the ASO/ASC products have costs that are about half of that of the insured commercial products. The overwhelming reason for the differences stem from Sales and Marketing cost differences.

Median ASO/ASC PMPM costs range from \$21.73 in the Commercial POS product to \$24.57 in the Indemnity and PPO. The latter is the single largest product offered by the Plans, comprising a median of 43% of the comprehensive membership, on average. (Last year it was 39%.) Insured product costs ranged from \$39.80 for POS to \$42.62 for Indemnity and PPO.

Other low-cost products included FEP at \$23.01, Medicare Supplemental at \$31.63 and Medicaid (relative to other insured products) at \$38.79. The highest cost in Blue Comprehensive products is Medicare Advantage at \$93.69. For the first time, we are capturing a split between group and individual. We would normally expect to see lower costs for group because of lower Sales and Marketing expenses but this is not year's result.

This panel has elected not to include Medicare SNP as a comprehensive product but it costs \$208.57. The specialty insurance products, Medicare Part D and Stand Alone Dental are low cost products at \$15.41 and \$3.28, respectively.



For continuously participating plans, while commercial declined, and that which remained increasingly focused on ASO/ASC relationships. Medicare Advantage, Medicaid and FEP grew, though Medicare Supplemental declined.

<Slide 10>

The median administrative expense relative to premiums was 8.3% while the equivalent value for last year was 8.6%. (By the way, we are using premium equivalents here.) There were a number of factors that contributed to this decline. While there is been a shift in favor of relatively low ratio businesses, such as ASO/ASC and Medicaid, we know through reweighting that the effect of this was minimal. Instead, the chief effect appears to be the decline in the percents for many of the products. Six of the ten comprehensive products had declines in percents and the decline in Indemnity and PPO, for instance, was one percentage point. In a sense, it could hardly be otherwise given the modest growth in per member administrative costs along with the more rapid increase in medical trend. Please look at last July's *Navigator* for last year's ratios. Of course, this is qualified by the fact that the universe was different as well.

In many respects, the relationships between the costs of various products measured in percents parallel those measured in PMPM values. The ASO/ASC products range from 5.8% to 6.7% for HMO and Indemnity and PPO, respectively. These values are substantially lower than the ratios for insured products that go from 8.6% for HMO to 10.3% for Indemnity and PPO. Another low ratio product is FEP, at 4.7%.

The highest ratio product, Medicare Supplemental at 15.1% is also among the lowest values measured on a PMPM basis. That this product is secondary to Medicare while many of the claims paying activities of Medicare are borne by this product likely explains this paradox.

The Medicare products are much more similar to commercial products on a percent than on a PMPM basis. In a way, this demonstrates that administrative requirements of insured people tend to track their health needs.

<Slide 11>

This slide shows the administrative expenses by cluster of functions. As in the previous page overall costs were at 8.3% of premium equivalents, lower than the 8.7% last year.

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The median values for three of the clusters, Sales and Marketing, Corporate Services and Account and Membership Administration, all declined or were flat in comparison to the 2015 values shown in Appendix B. Only Medical and Provider Management increased.

As noted earlier, these differences won't track with the values shown in Slide 4 because the universe and mix has changed.

<Slide 12>

The overall cost trends were modest, with less than a one percent growth in expenses. This extended to Account and Membership Administration as well: both growth rates were near record lows.

However, the mix of expenses is sharply different. So, while Sales and Marketing cost growth was especially modest, Rating and Underwriting costs were among the most, if not the most, rapidly growing function. Perhaps aligned with this, Finance and Accounting and Actuarial also grew much faster than the overall trends.

Sales and Marketing expenses paid for external services, Advertising and broker Commissions, were sharply lower in 2016.

Reflecting changes in the way Blue Cross Blue Shield plans interact with providers, while Medical Management declined, Provider Network Management and Services continued to grow. Information Systems continues to grow, and its size means it has a powerful effect on overall trends.

I began this presentation observing that health plans operate, and must plan, in an environment of uncertainty. Though the word "uncertainty" seems to be the most common word in headlines concerning health plans, the fact remains that rate filings are coming due and budgets need to be prepared for 2018.

Since a health plan cannot know what the future of subsidies for exchange members, what the rating brackets will look like, what federal contributions will be available for expanded Medicaid and many other factors, how does it position itself for competitive success?



Optimizing costs is, as a leading management consultant puts it, a “no regret” move. It forwards the mission of health plans since lower costs can ultimately be redeployed to fund growth, to offer superior quality or to broaden the product portfolio once the current “uncertainty” is resolved.

This presentation, (transcript and slides) will be posted on our web site in the next few hours. In addition to these slides, we include last year’s values, some descriptive materials and, perhaps most interesting, a slide analyzing costs by segment. By segment, I mean On-Exchange, Off-Exchange and Compliant, Grandfathered, and small, medium and large groups.

Two weeks from now we will summarize the Independent / Provider - Sponsored plan universe results, and we expect to host similar web conferences for Medicare and Medicaid plans later this summer. Additional information, including tables of contents on the benchmarks themselves are found on the website. Call me if we can elaborate.

Thank you for your attention to our presentation. Now I would like to open this for questions.

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### *Questions and Answers*

Q: What is the average size of these organizations?

A: The average plan had 2.7 million people and with a median membership of 1.7 million.

Q: Does the universe turnover affect trend?

A: No – we hold constant the particular plans, and we reweight to eliminate product mix differences.

Q: Within the Corporate Services Functions, which sub-functions were chiefly responsible for growth?



A: Legal was far and away the most important factor. Within that sub-function, the growth in Compliance activities comprised 85% of the difference. Regulatory activities came in a distant second.

Q: What activities are included with Information Systems?

A: Please see Appendix G for a list of the sub-functions within this function. Note that all information systems activities that require a level of expertise only found in this function are assigned to that function. For instance, while autoadjudication automates a traditional activity of Claims, because it is run in Information Systems it remains there.

In the Sherlock Benchmarks, we actually do present costs of the functional areas with an information systems cost allocation, providing an end-to-end view. This is based on results of only a subset of the plans since only they could provide it.

Q: If I compare the 2015 results of last year's Figure 2 to this year's, the values changed. Why?

A: The main reason for this is our error. The values were drawn from averages in the 2016 edition, but medians in the 2017 edition. That was an error since we normally report medians which tend to mute the effect of performance outliers.

The second reason was a revision by one of the plans. We apologize for the error.

Q: Why do you think that Medicare Group costs were more than Medicare Individual.

A: Normally we would expect lower costs for group Medicare since distribution costs should be less. We think that two plans' results may have been responsible for the outcome. One plan lost a major group so that its per member costs increased. In addition, a second plan's group business had health care costs, and the administrative costs that normally follow it, that were higher than for its individual business.

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I want to again thank you for your participation in this web conference. More in depth and actionable information is available in the Sherlock Benchmarks themselves, which anyone can license. Please contact me directly if you are considering licensing these materials.

In late July, in two weeks actually, we will have a similar web conference on the results of the Independent / Provider - Sponsored plans. In late summer, we will have similar web conferences on the results of the Medicare and Medicaid plans. We hope that you will consider participating in those web conferences as well.

Let me thank you all for the hard work that goes into the 19th annual edition of the Blue benchmarks. We know, because we measure this, that participation pays off in lower costs. But the “by-product” is something that benefits the industry as a whole. Thank you!

This is Douglas Sherlock of Sherlock Company.