Transcript

Independent / Provider - Sponsored Administrative Costs: A Review of 2014 Results

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<Slide 1>

Thanks for attending our presentation of the results of the Sherlock Benchmarking study for the results of the Independent / Provider - Sponsored benchmarking study. This is the second of a series of presentations on trends in health plan performance metrics reflecting 2014 results. This conference is timely because of health plans' need to adapt to the more challenging circumstances of the Affordable Care Act.

A few weeks ago four national health plans, Centene, Health Net, Aetna or Humana, announced that they intended to adapt by merging. Centene's announcement is explicit: "Synergies will come from areas including efficiencies in core G&A …and leveraging capabilities in IT systems and process management." Centene estimates that its synergies will total $150 million annually but that amounts to savings of only about 4% of combined administrative costs.

In addition, a number of media sources, such as the Wall Street Journal and CNBC suggest the possibility of an Anthem / Cigna merger. Any organization competing with Centene, Health Net, Aetna, Humana, Anthem or CIGNA, will now need to consider its competitive responses to these actions.

While there are economies of scale in administrative activities like Corporate Governance, Actuarial and so forth, operational improvements can be more important.

Independent / Provider - Sponsored plans posted *declines* in their per member administrative costs – 2.3% as reported and 0.4% once the effect of their membership mix changes is removed. But taxes are also increasing, which seem to directly add costs, and from overall cost perspective, increase uncertainty. Miscellaneous business taxes increased sharply, amplifying administrative cost increases to more than 11%.

By way of introduction, I am Doug Sherlock, President of Sherlock Company. We offer what are referred to by leading consultants as "the Gold Standard" for health plan benchmarks. Now in the midst of our 18th consecutive year of benchmarking, we benefit from 700 health plan years of experience, comprised of definitions, systems for compilation and checking as well as processes for reporting and drill-downs. In addition to Independent / Provider - Sponsored plans, we also have other universes.

What we mean by Independent / Provider – Sponsored plans is that they are local plans, often owned by health systems, sometimes enjoy a vestigial relationship with providers or they have some other important local tie. Thirteen are owned by health systems, five have a vestigial relationship with specific providers such as heavy board representation and three more have a local tie, with cooperative being a good analogy to these plans. For those of you who remember the implosion of provider-sponsored plans in the 1990s, be reassured that, at an average membership of 450,000, these are survivors that have avoided the serious business model problems of their failed peers.

Our universe of Independent / Provider - Sponsored plans is certainly the most robust universe in its history. Of the sixteen participating plans last year, all of them participated again this year. Also we added five additional ones.

This year's Independent / Provider – Sponsored universe is comprised of plans that serve 9.5 million people with comprehensive insurance, 25% more than the 7.6 million people served in last year's universe. The implication of having on average 450,000 members is that if you have heard of an Independent / Provider – Sponsored plan, it is likely that they will be participating in the Sherlock Benchmarks.

While I am makin the introductions, let me pause by thanking the plans that participated in this year's benchmarking study. While we know that it benefits your organization, we also think that, because of this web conference and related materials, a happy side-effect of your efforts is to benefit the health plan industry as a whole.

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Today, I want to highlight the decline in the rate of administrative cost growth in areas under management control, and the effect of taxes. Then I will touch on the groups of functions that led to the cost increase, called clusters, and key functional drivers that contributed to their growth. We then review costs by function and by product. We also include some exhibits from last year for reference purposes.

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As we'll develop, the expense growth sharply declined. The decline in growth was deep, wide and no matter how you measure it. This slide shows the overall trend in dark blue and the Account and Membership Administration trend in light blue. The chart eliminates the effect of any changes in participation and any changes in product mix between these continuing plans.

This year, the rates of growth in Account and Membership Administration and in total administrative expenses are lower than in any of the prior six years. Overall costs declined by 0.4%, something unprecedented over the seven year period. The 1.1% increase in Account and Membership Administration was similarly lower than any year since at least 2008.

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Since we focus on the administrative costs under management control, all of our administrative expense levels and comparisons *exclude* Miscellaneous Business Taxes. This reporting convention includes all of the previous slides and all subsequent ones.

However, I want digress briefly to touch on the surge in Miscellaneous Business Taxes for a moment. There was a very significant increase in these costs, year over year. Those Miscellaneous Business Taxes surged by 922% or by approximately $4.35 to $4.82 PMPM.

The context is that, before Miscellaneous Business Taxes, the administrative costs were $42.14 and after they were higher by $4.82, adding 11.4% to administrative costs. So, once the surge in taxes is taken into account, costs increased by 11.1% rather than declining by 0.4%.

To be clear about the economics of this, the difference is not explainable by a reduction in broker commissions due to participation on exchanges. This reduction didn't occur. It is not overcome by anticipated recoveries under reinsurance – most plans experienced worse higher health benefit ratios in commercial products even after booking the recovery. Finally, I think consensus is that it is highly unlikely to be overcome by recoveries through risk corridors.

While not under the control of management, it is nevertheless part of the buildup to premiums. Moreover, I suspect that it will be included in CMS's National Health Expenditure Accounts as part of the Net Cost of Private Health Insurance.

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The balance of this presentation is focused on the true operating expense trends. The key thing is that trends declined: in total, administrative costs actually fell, they declined in most of the clusters and they declined no matter how you measure it.

All of the comparisons in this chart *hold constant* the universes. In other words, while there were 21 plans participating in 2015, the two 2014 columns show only the sixteen that participating in both 2014 and 2015. The "As Reported" column means just that, for those plans. So, there is *no* distortion in trend from the addition or removal of a plan from the universe.

The Constant Mix columns take this one step further by *reweighting* each plan's results in the prior year to their current year's product mix. Since the mix is held constant, there is no effect on trend stemming from a change in the mix products offered by the plans. I'm going to emphasize the Constant Mix format in this presentation since it reflects the actual, real changes in cost trends as far as it is possible to do so.

As you can see from the comparisons identified in the arching arrow, total PMPM costs *decreased* by 0.4%, sharply down from an increase of 6.5% last year.

Sales and Marketing, Medical and Provider Management and Account and Membership Administration each declined in their rate of growth both on a constant mix and an as-reported basis. Sales and Marketing costs actually fell from the prior year. The exception to this trend was the smaller Corporate Services cluster which grew by less than 1% on a constant mix basis.

Now I want to comment on the rates of change in each of the clusters. I'm going stay on this slide for a while so I want you to know that if the slide doesn't change it's likely not a failure of the web conference technology. I'll define these clusters as we proceed and they are also found in Appendix C of the slide deck.

The Sales and Marketing cluster's costs *decreased* at a median rate of 3.4% versus a 4.4% *increase* last year. When you look at the underlying functions, the median rates of increase for most functions in this cluster declined. Rating and Underwriting, Marketing and Advertising and Promotion actually declined. Sales and External Broker Commissions accelerated.

The decline in Rating and Underwriting was not only substantial but it was also it was unprecedented since 2004. Staffing ratios declined in this function. Advertising's decline was the sharpest since 2009. Marketing expense growth was the lowest since 2011. I was surprised to see that Broker Commissions grew at their highest level since 2010. I had thought that perhaps the Exchanges would have muted growth but that was not the case. Sales growth accelerated on a constant mix but even faster on an as-reported basis.

It is difficult to summarize the overall effect of mix shift since both Medicare and Medicaid accelerated. For instance, Sales and Marketing expenses were both amplified by Medicare growth and diminished by Medicaid growth.

While membership increased at a median rate of 8.3%, Medicaid HMO grew at a 17.1% median rate. Medicare Advantage and Medicare SNP (mainly dual-eligibles) increased by 8.8% and 13.1%, respectively. Commercial grew at a median rate of 2.4% but while ASO increased by 5.5%, commercial insured *declined* by 2.0%.

You can see that Medical and Provider Management trend also declined to 2.3% from 3.3% in the prior year, in this instance to the lowest level since 2010. While Provider Network Management and Services accelerated, the growth in the far larger Medical Management area diminished to their lowest levels since 2005. Staffing surged in Provider Network Management and Services. While there was an increase in median staffing for Medical Management, it appears to have been concentrated in only a few of the plans. The Disease Management and Precertification sub-functions' costs actually *declined*, year over year.

Account and Membership Administration growth declined from last year's levels and, at 1.1%, posted the lowest rate of growth since 2010. This was firstly the result of an actual decline in Information Systems costs. This decline was unique since at least 2005. Application Acquisition and Development was central. The decline was sharp and two thirds of the plans reported declines.

The rate of growth in Claims also declined. Over the years, there appears to have been has been a migration to automation – Claims function costs are 18% higher than they were in 2009 but Information Systems costs are 51% higher.

Enrollment costs actually fell, year over year. While the trend accelerated, this was the third year in a row. As with long term Claims processing cost trends, this may have been affected by automation. By contrast, Customer Services accelerated, as staffing increased at a low double-digit rate. The rate of cost growth was the second highest in the past eight years. The Affordable Care Act's effects can perhaps be seen here: one of our participants calls this surge an example of "bulge" costs: since nearly all commercial members had new products, customer inquiries may have required higher levels of staffing.

I want to digress to flesh out staffing factors which are key drivers of these costs. To maintain an apples to apples comparison, these comments pertain to the staffing ratios of the commercial insured business. (My earlier comments about staffing are also focused on the commercial insured lines.) This of course was the set of products most dramatically impacted by ACA in 2014. Staffing ratios, with the effect of outsourcing, appeared to have been about 28 FTEs per ten thousand for these products. Staffing is higher this year but only loosely comparable to last year because of the increase of five new plans.

Approximately 15% of staff are outsourced but that ratio is higher in some areas such as Information Systems, where it is 24%. I earlier noted that plans may have observed what they call "surge" costs. In Customer Services staffing ratios, they climbed by over 10% to more approximately 2.5 FTEs per ten thousand. Outsourcing increased by the equivalent of a percent or so to just over 2%. Staffing in Provider Network Management and Services also increased.

The decline in staffing in Rating and Underwriting and Corporate Services was more than matched by increases in Provider Network Management and Services and Customer Services.

The median compensation for the IPS plans in this study was, preliminarily, $89,000 per internal employee. It was approximately $73,000 in the Account and Membership Administration cluster of expenses.

The costs in the cluster of Corporate Services increased by 0.6%, driven in large part by the 1.2% decline in the Corporate Services function. This function comprises more than one-half of the cluster. Legal expenses decelerated: Compliance costs actually declined.

The smallest function in this cluster, Actuarial, declined very sharply. The rate of growth in Finance and Accounting declined to low single digits from high double digits in the prior year, despite a surge in credit card fees. It is possible that in 2013 there were consulting engagements that did not recur during 2014.

Last year we had thought perhaps that, in 2013, the high cost increases would make that year both an inflection year and the baseline year for which costs for health plans will be compared in future years. This appears to have been the case.

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This slide expands some of the comments I've made earlier. As you know, to make the results actionable, for Independent / Provider - Sponsored plans, administrative costs are segmented into nearly 60 functional areas, summarized as shown in Appendix C into the four expense clusters.

Again, I am focusing on the "real" increases in expenses. In other words, it eliminates any effects of changes in product mixes between the plans being compared over the two year period. Because each of the plans participated in both of the comparison years, these rates of change were not affected by the addition or subtraction of any plans. As I earlier noted, this universe's growth was especially pronounced in Medicaid and Medicare so there was a shift in product mix.

This chart traces the components of the cost trends. It shows both the fastest growing functions and the most important changes as well. The latter is termed the "Highest

Weight" which means the dollar amount of the year over year change as a percent of the total change.

The arrows mean the direction of the change of the identified functions. Since there was a decline in the costs by 0.4% on a constant mix basis, it is not surprise that of the ten arrows on this page, seven point downwards.

As you can see in the lower right corner, the most important reason for the decline in administrative costs in this panel stemmed from a decline in Advertising and Promotion. In fact, as footnoted, Advertising and Promotion also declined nearly as sharply as Rating and Underwriting. Both declined at mid-to-high double-digit rates.

Medical and Provider Management increased by 2.3%. Again, this is on a constant mix basis so what you are looking at is a genuine increased commitment to these functions. The increase in Provider Network Management and Services was greatest. While Medical Management did not increase as rapidly, because it is so much larger than Provider Network Management and Services, it dominated the change.

Account and Membership Administration increased by 1.1%. Customer Services increased, as did Claims. But the much larger Information Systems function declined, as did Enrollment / Membership / Billing, muting the overall increase.

The increase in the Corporate Services cluster of functions was quite modest and, at 0.6%, the same rate as last year. Both Actuarial and Corporate Services functions declined with Actuarial at the highest rate. Corporate Services declined more slowly but it comprises a large share of the overall costs for this cluster. Both Finance and Accounting and Corporate Executive and Governance increased but they are both relatively small functions.

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By and large the same observations that applied to the constant mix values also apply to the as-reported comparisons as well. I've highlighted the differences with gray arrows.

Corporate Executive, which increased at low single digits, was the greatest change in the Corporate Services cluster. And Claims was the fastest changing function on an as-

reported basis in the Account and Membership administration area. Its growth was in the mid single digits.

The growth of Medicaid and Medicare make it complex to tease out the as reported trends since Medicaid is a low cost product while Medicare is a high cost product.

Overall though you can see that overall expense growth was lower before mix adjustment than after mix adjustment. As we will show on slide 9, the particularly dramatic growth of Medicaid was likely the reason for this since Medicaid products tend to have very low costs.

Both Medicare and Medicaid have a very high commitment to Medical Management activities. This likely explains why the as-reported expenses so exceeds the constant mix trend.

Corporate Services tend to be higher in both Medicare and Medicaid. Finance and Accounting is a notable example. Accordingly, the greater increase on an as reported basis likely stems from the increase in their increased proportion of the total product offerings.

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The median costs to administer comprehensive products for Independent / Provider - Sponsored plans was $42.14. I have highlighted the median with a gray arrow. It is 9.2% higher than last year's reported costs of $38.59, shown in Appendix A.

Of that 9.2% increase in total expenses, we think that the additions to the universe likely explained 5.8 percentage points. As noted earlier, the real change was a decline in costs of 0.4 percentage points. The mix effect is about 2.5 percentage points. About 1.2 percentage points remains unexplained. The comparisons are finally imperfect because the plans differed.

Sales and Marketing costs at $11.49 was 6.4% above last year's costs of $10.80, smaller than average growth corresponding with the decline on a constant mix basis. Account and Membership Administration was, at $16.03, higher by 4.9%, also corresponding with the very low increase in that cluster when you hold constant the universe.

Medical and Provider Management and Corporate Services differed from last year in ways that were opposite to the real trends. So Medical and Provider Management, which was the fastest growing cluster was, at $6.48, only 1.7% higher than that of last year. Corporate Services, which grew by only 0.6%, had the greatest difference from last year. This year's value of $6.70 was 8.6% higher than last year.

A change between this and the prior year is the increased clustering of values. The total coefficient of variation is 27%, down from 28% last year. This appears largely attributable to the decline in the coefficient of variation in Account and Membership Administration by five percentage points. Similar results are evident when you compare the spread between the 25th and 75th percentiles year over year.

The gap between the new plans and the plans that joined this year is consistent with the aphorism that you manage what you measure. The sixteen plans that participated in both years had, on average, 7.2 years of experience with the benchmarks.

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This slide shows the costs for each of the products offered by the participating plans. In general, the relationships are fairly similar to the patterns we've seen before in prior years, and also across universes. In short, insured products cost much more than administer than their ASO counterparts. Medicare Advantage, at $83.60, costs much more to administer than do the equivalent commercial products, say Commercial HMO Insured at $44.93 for example.

But if you compare this slide with the equivalent slides for last year (they are available on our website), you'll notice a sharp change in the differences between the costs of Insured versus ASO products. The median cost of the ASO product was $22.03, only 1.8% higher than last year's administrative cost of $21.63. But for instance median HMO costs were 15.6% higher to $44.93.

One hint at the reason for this is that individual members comprised a median of 5.6% of members in 2013 but 9.4% in 2014. The few plans that reported individual segment expenses to us reported expenses that were at Medicare Advantage levels. Plans reported that expenses were higher on, rather than off, of public exchanges.

We suggested last year that, if employers capable of self-insurance increasingly elect to do so, the cost differences between insured and self-insured will increase further. Based on the change in the group / individual split and the increased differences between insured and ASO, we cannot rule out this factor.

Medicare Advantage and Medicare SNP are the high cost products, by far. Their administrative expenses track the high health care needs of the seniors that they serve. Medicaid products are relatively low cost because of the low marketing expenses often required of these products.

Before I leave this slide I want you to know that this content is conveniently available as an application on our website. Go to our website, look for "Benchmark Calculator" and populate it with your membership. You can, if you wish, also supply your administrative expenses. The application will tell you how your plan's costs compare to this peer group after adjusting for the mix differences that are so important. It works even if you only know your total administrative costs and you don't segment your administrative activities by product. If you have questions about this when you try it, please give us a call and we'll be delighted to talk you through it.

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This slide is similar to the previous one, except that we've expressed administration relative to premium equivalents. (This includes the non-GAAP treatment of the ASO products to include health benefits in revenues. This is necessary for comparability with insured products.) In some respects, the relative values of the products are similar: ASO percents are considerably lower than their insured counterparts. And the differences are similar as well, with ASO running about one-half the costs of the insured products. Insured product percents range from 9.1% to 13.2% but ASO is much lower at 6.2%. Medicaid is relatively low cost in either of the ratios.

But they do differ in the products for seniors. Medicare Supplemental, at $41.66 PMPM, is an average cost product. But at 18.6% of premiums, it is among the highest cost products when calculated in this way. This stems from the fact that many administrative activities for this population are incurred for events in which Medicare Supplemental is the secondary payer.

The Medicare Advantage cost ratios are also reversed. On a PMPM basis, SNP and Advantage are the highest cost products but, at 9.2% and 8.4%, these ratios are lower than or equal to the average.

By the way, the percents of premium ratio values cluster more than the PMPMs. This may be due to the implicit reflection of local cost of living differences in the numerator and denominator using the percent approach.

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Note that the overall costs are 9.2%, lower than the 9.7% last year, shown in Appendix B. This is probably in part related to mix. In fact, if each of the percent of premiums are weighted by product mix served by the panel in 2014, the ratios are almost exactly the same, 10%, in both years. The equivalent tables for last year are found on our website at the link for *Navigator* Late July 2014.

Again, administrative costs for Independent / Provider - Sponsored plans were 9.2% of premiums. Paralleling the modest growth in each of the functional area clusters shown in Slide 5, more times than not the administrative expense portion of premium equivalents falls.

Now is a pretty good time to remind everyone that since medians are the 50th percentile values, you can't add them. It is even more the case with the 25th and 75th percentile values since they are calculated by function, not plan. We employ the medians since they are, in our view, more representative of the typical plan.

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Administrative costs in 2014 actually declined, by 2.3% as reported and by 0.4% after adjusting to exclude the effect of product mix differences. This was the lowest trend, the only decline, in at least the past seven years. With the exception of a less than one percent increase in Corporate Services the decline in trend was across the board, and irrespective of how it is measured.

The Affordable Care Act introduces important new taxes to administrative costs. On a base cost level of $42.14, the additional taxes of $4.35 (for a total of $4.82) must

ultimately be baked into the premium rates. Administrative expense growth was 11.0% after the effect of the new taxes.

In order of importance, Advertising and Promotion, Rating and Underwriting and Information Systems contributed to the favorable trend. But partially offsetting this were the surge costs of Customer Services.

Membership growth was strong among the plans. While commercial products grew, especially those in the ASO area, Medicaid and the Medicare Advantage products were especially strong.

The recent announcements of potential mergers by some of the largest national health plans suggest that some of the plans are adapting to the Affordable Care Act by endeavoring to increase their scale. While economies of scale exist for health plans, they are limited in breadth and in amplitude. So we believe that these potential business combinations are best understood as emblematic of the "incentives for efficiency" imbedded in the ACA. After all, it is not uncommon for smaller plans to outperform larger ones in cost management, and there many examples of recent new entrants.

Many thanks for your attention to this dry, but I hope informative, presentation on a matter of critical importance to your organization. I have attached to the end of this presentation some appendices in support of this presentation. They include 2013's costs and the functions found in the clusters we have been speaking.

Today we've gone through a lot of numbers and if you're like me, this is very hard to digest at one sitting. So this presentation, (transcript and slides) will become available on our web site in the next few hours. Please feel free to call us at any time. Those of you who have called in the past know I normally pick up our telephone personally but if I am not there, my colleagues Chris, Erin and John will be able to help.

Finally, there are 21 Independent / Provider - Sponsored plans that participated in this year's benchmarking study, and the overwhelming proportion of them have at least one representative on this call today. Let me thank you all for the hard work that goes into the 13th annual edition of the Independent/Provider-Sponsored benchmarks. We know, because we measure this, that participation pays off in lower costs. But the "bi-product" is something that benefits the industry as a whole. Thank you!

A month or so from now we will summarize the Medicare and Medicaid universes results. I don't know whether we'll have a presentation on the Larger plans but their benchmarks are available now. All of these presentations, including this one, will be posted on our web site. Additional information, including tables of contents on the benchmarks themselves are found on the website. Call me if we can elaborate.

Now I would like to open this for questions.

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Questions and Answers

Q. You said that if you weight the percent of premiums by the average product mix for 2014, you get 10% but the actual values are 9.2%. What is the reason for the difference?

A. The 9.2% represents the actual ratios. In other words, it is the average of each of the companies, each of which have different business mixes. The 10% value assumes a homogeneous mix of products across the panel. The later approach is an approximation that, effectively, simplifies the weighting.

Q. How much of the drop of sale and marketing segment is due to an increase in low cost payer mix, such as Medicaid....can you share how that plays into the calculations? On a PMPM basis?

A. Not very much. On slide 5 you can see that costs declined at approximately the same amount whether you reweight last year's costs for this year's mix or use the actual, as reported values.

Q. Did size of plan make a difference?

A. We haven't evaluated this yet for this year's results but plan to do so in September. However, we have in the past found that the effects of scale are modest. Certain areas are subject to scale like Corporate Executive, Actuarial and Finance and Accounting (if you are single state) but 80% of administrative expenses do not appear to be scalable. Moreover, the amount of scalability is limited. A doubling of the size of a plan leaves the scalable functions at 80% of their pre-doubling values. Again, we'll analyze this further in September.

Q. Did you say that re-participating plans were more cost efficient than new participants?

A. It appears to be this way. It appears that the effect of the new plans was to increase costs by about 5%. There is some estimation involved in this though.

Q. I missed the early slides (in case you answered this), but do you attribute the reduction in PMPM to be due to completion of developing and building-out of the exchange-based products?

A. I can't directly answer this since we capture costs by activity not by strategic initiative. But we do have some evidence that you may be on to something. Recall one of the key reasons for the modest cost growth was the decline in Information Systems costs. This is an especially large function. One of its sub-functions, Application Acquisition and Development had a very sharp decline in 2014 versus 2013. I think it is very possible that the completion of the exchanged-based products and other adaptions completed in 2013 could have been responsible for this.

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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.

Note that our earlier analysis of the Blues is already available and on our website. 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.

Again, thank you who participate in our various benchmarking studies. While participating plans realize a return on their investment in the benchmarking process, it is nevertheless the case that the summary benchmarks that we discussed today benefit consumers and the health plan industry as a whole.

This is Douglas Sherlock of Sherlock Company.