



*Transcript*

# 2016 Independent / Provider - Sponsored Administrative Cost Trends: Optimizing Costs in an Uncertain Environment

July 12, 2017

Douglas B. Sherlock, CFA

[sherlock@sherlockco.com](mailto:sherlock@sherlockco.com)

(215) 628-2289

<Title Page>

Thank you for participating in this year's review of the Sherlock Benchmarks for Independent Provider- Sponsored health plans. I am Doug Sherlock, President of Sherlock Company. We offer what leading consultants call "the Gold Standard" for health plan benchmarks.

I mentioned at our web conference in late June that Googling will yield you countless references to the word pairs of "uncertainty" and "health insurance", many of which are headlines of periodicals. While uncertainty is now a cliché, it remains abt. To plan appropriately in this environment 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. We intend that our benchmarks help inform this "no-regret move."

The plans reflected in this year's benchmarks are a very strong sample of organizations that can be loosely described as vertically integrated. The Sherlock Benchmarks for Independent/Provider-Sponsored health was created through surveys of 20 health plans, of which 13 are owned outright by hospital systems, and an additional three were formed by or continue to have substantial governance by health care providers. Most of the health plans in this universe thus loosely integrated delivery systems.

Page 1 of 12

COPYRIGHT © 2017 SHERLOCK COMPANY. ALL RIGHTS RESERVED.



Years ago, Alain Enthoven recognized that insurance and health care are linked, but in an imperfect way when provider panels are not unique or closely associated with an insurance product. He therefore advocated vertically integrated health plans to improve the efficiency of consumer choice, potentially allowing the consumer to better evaluate end-to-end quality.

The Blue Cross Blue Shield Plan Highmark and UnitedHealth's Optum have integrated backward into health care delivery, while the provider-sponsored plans in the Sherlock Benchmark universe are examples of forward integration. Accountable Care Organizations, which are encouraged as Medicare policy, can be thought of as precursors to clinical integration. Approximately 6.0 million Medicare members are now served through such ACOs.

While the potential for competitive advantage makes vertical integration an attractive strategy, its success can only be realized if execution is disciplined, including in management of administrative expenses. Sherlock Company's universe of Independent/Provider-Sponsored health plans has, we believe, a record that suggests the participating plans have been disciplined in their execution of a loose vertical integration strategy. With median revenues of \$1.7 billion and a median membership of 385,000, their size relative to their hospital systems makes it impossible to hide execution errors. Indeed, the fact of their survival suggests that operating discipline is a part of the culture.

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 Blue Cross Blue Shield Plans, Medicaid Plans and Medicare Plans. This has been possible through the efforts of my talented colleagues, some visionary health plan officers including an IPS CEO, a 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 values and a list of all of the functions in each of the products offered by these IPS 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.

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 Independent / Provider - Sponsored 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. Total Administrative Costs, in dark blue, declined in both 2014 and in 2015 but increased to still relatively low 2.4% in 2016. Account and Membership Administration growth, in light blue, declined to its lowest rate in 2014. While higher in 2016, cost increases are moderate relative to the past nine years.

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 two columns reflect continuous plans, whose cost values have been reweighted to eliminate differences due to product mix. The arced blue arrow is to draw your attention to the comparison with prior year's values.

You can see that Account and Membership costs grew less rapidly than did expenses overall. Circled in red, this chart shows the 2.4% per member Total administrative cost increase, and the 4.9% Account and Membership Administration increase is circled in blue. But the change is less dramatic for Account and Membership Administration, which growth increased by 0.9 percentage points compared with a 2.3 percentage point increase for Total administrative costs.



Corporate Services increased slowest at 1.2% but, at a 9.2 percentage point increase, had the greatest change in growth. This is among the smaller clusters of functions.

Medical and Provider Management also accelerated, by 8.7 percentage points, to 2.6%. The growth in Sales and Marketing accelerated by 2.4 percentage points to 4.9% from 2.5% last year. This cluster tied with Account and Membership Administration for growth.

The first and third columns, signified by the arced red arrow, show the changes that the continuously reporting plans actually reported to us. In other words, this is before the effect of reweighting to eliminate the difference in product mix for those continuous plans. Total administrative costs increased by 3.0% per member, 4.5 percentage points faster than the 1.5% decrease last year.

That growth is faster without reweighting is an indicator of faster growth in the more expensive product areas. While health plans participating during both 2016 and 2017 posted median membership growth of 3.7%, Medicare SNP increased by 10.3% as Medicare Advantage increased by 2.2%. While commercial total increased by 2.2%, the more expensive Insured products increased by 0.3% while the less expensive ASO increased by 3.1%. Membership in lower cost Medicaid increased at exactly the overall rate.

The growth patterns in Sales and Marketing and in Medical and Provider Management likely reflect the increased emphasis on Medicare. Medicare members, as individuals, have higher marketing costs. They also have greater health needs, necessitating greater medical management.

<Slide 5>

This slide explains the *reported* rates of change, that is, the values with no adjustments for changes in product mix. That's the red arrow columns from the previous slide.

Total expenses increased by 3.0% PMPM. The fastest growth was in Sales and Marketing, with a 5.2% growth. The greatest change in that cluster of expenses was a sharp increase Rating and Underwriting. With the exception of 2014, Rating and Underwriting has increased, and in all but one year faster than the cluster. 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 status. 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.

External broker Commissions also grew but slower than the cluster. But because Commissions are such an important expense, the low single digit increase was the plurality of the expense difference. The functions of Marketing and Advertising and Promotion declined as Sales increased.

The Medical and Provider Management cluster accelerated in its growth, 4.5% versus a *decline* of 7.2% last year. Both Medical Management and Provider Network Management and Services increased at mid single-digit rates. Medical Management, since it is much larger than Provider Network Management and Services, dominated this cluster's growth.

Account and Membership administration increased by 3.8% *down* from 5.3% growth last year. Customer Services and Claim and Encounter Capture and Adjudication increased at mid-single-digit rates, and both accelerated over last year. The diminutive Enrollment function costs declined. Other than Enrollment, Information Systems was the slowest growing function, and because it is the largest function in the cluster, is the most important source of growth.

The Corporate Services cluster increased by only 0.7% compared with a 9.5% *decline* in 2015. Excluding the tiny Association Dues and License/Filing Fees, the Corporate Services function was the fastest growing and by far the greatest contributor to overall growth. Actuarial was the second fastest function in the cluster, in concord with the rapid growth in Rating and Underwriting. Growth in Finance and Accounting and Corporate Executive were at modest levels.

In summary, Rating and Underwriting growth was the fastest. The Corporate Services function grew nearly as rapidly but because of its size, made its trend the most important for the Independent/Provider-Sponsored 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*. This are the “real” rates of increase in my view. Sales and Marketing and Medical and Provider don’t grow quite as fast but Account and Membership Administration and Corporate Services grow more rapidly on this basis.

The faster growing products were lower cost products like Medicaid and Commercial ASO and the higher cost Medicare SNP: 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. First note that Medical Management has displaced Provider Network Management in its rate of growth. Also, Claims is now the fastest growing function, replacing Customer Services for rate of growth in Account and Membership Administration. It also replaces Information Systems for the size of the overall contribution to growth in the cluster. In the Corporate Services cluster, Actuarial displaces Corporate Services in leading its rate of growth.

Rating and Underwriting seems to be a key area for these plans, however trends are calculated. This suggests the breadth of expanded effort in Rating and Underwriting across many products. Risk adjustment activities are central.

The Corporate Service function is key to understanding the growth in expenses, either As-Reported or on a Constant Mix basis. Within that function, the growth in the Legal area is especially rapid, at low double digit rates. There is less of an increase in Compliance and more in Other Legal.

Within Medical Management, there are nine different sub-functions, including Precert, Case Management, Disease Management and so forth. Quality Components stuck out because it grew twice as fast as any other sub-functions.

While not material to overall trend, we were fascinated to see the growth in credit card fees. This may have something to do with the growth in the individual market in part due to the Exchange business.



In summary, Rating and Underwriting costs were the fastest growing area, and Corporate Services 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.

Similarly, 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 cannot be affected by management, especially operational management. From an operating perspective, perhaps the central attribute of such taxes is to leverage the need to manage administrative costs.

On a constant-mix basis, per member Miscellaneous Business Tax costs decreased by 6.4% down from an increase of 14.6% last year and a surge of 922.3% in the prior year. The median cost of such taxes is \$10.51 per commercial insured member, or approximately 20% of all administrative costs after the effect of the taxes. In 2010, that cost was \$1.80 PMPM.

These taxes are primarily focused on insured products. The median Annual Fee on Health Insurers is \$4.55 PMPM and the median Exchange User Fee is \$17.97 for Exchange members.

<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 \$38.23, 6.9% lower than the median value of \$41.04 last year.



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

There is very little correspondence with the overall administrative cost trends on Slide 4 and the decreases shown here, notwithstanding that 3/4<sup>th</sup> of the plans participating this year also participated last year. Recall that each cluster increased in Slide 4, irrespective of whether they were as-reported or constant mix. Here, every cluster has lower values.

Recall that Corporate Services grew slower than the other clusters and here, with costs of \$6.17, there is a decrease by 6.1% from last year. Also, Medical and Provider Management grew relatively modestly among the clusters in Slide 4 but the costs were 3.8% lower than last year's at \$6.82.

Account and Membership Administration was the fastest growing function on a constant mix basis on Slide 4 and was lower by 3.6% to \$17.16.

The Sales and Marketing cluster grew fastest, or was tied for fastest, on Slide 4. Its decline was slowest, by 3.1% to \$10.49.

Overall, costs are slightly more disbursed, as measured by coefficient of variation. And Account and Membership Administration and Corporate Services are somewhat more disbursed and Sales and Marketing is more clustered. Medical Management is far more clustered this year versus prior years.

<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 product has 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. Enrollment is also lower for ASO products, probably related to group size.

Median ASO PMPM costs were \$21.62. Administrative Services Only relationships composed 26.6% of commercial membership.



Other low-cost products included Medicaid at \$24.23 and CHIP at \$25.60 PMPM. These products offered to the poor and disabled composed 18.5% and 0.8% of Comprehensive members. Medicare SNP, often serving dual Medicare and Medicaid eligibles as a comprehensive product but it costs \$131.03, the most expensive product in IPS product portfolios.

Medicare Advantage at \$81.14 PMPM serves seniors at costs essentially double that of comparable insured products for those of working age.

There are three additional products that provide a portion of the senior benefits. Medicare Cost is a product that is truly insured for only Part B and, at \$59.12, its costs are relatively low compared with MA since the services required are less. Similarly, Medicare Supplemental is a secondary payor to the regular Medicare program, and its costs at \$45.14 are less as well. Stand-Alone Medicare Part D covers only drug costs and its costs are only \$15.96 PMPM.

Health plans participating during both 2016 and 2017 posted median membership growth of 3.7%, but there was a shift in favor of ASO, Medicaid and Medicare SNP.

<Slide 10>

This slide shows the percent of premiums (or equivalents in the case of ASO) for all of the products. At the Comprehensive row, you can see that administrative expenses are 8.7% of premiums.

However, note that the senior products covering only a subset of their benefits have relatively high ratios. Medicare Cost is 13.9%, Medicare Supplement is 22.4% and Stand-Alone Part D is 14.8%. In these cases, some of the activities, like enrollment, occur regardless of the scope of benefits delivered to the members.

Also note that Medicare Advantage and Medicare SNP products, at 9.6% and 8.8% respectively, are much more similar to commercial products on a percent than on a PMPM basis. This fact illustrates how administrative requirements of insured people tend to track their health needs.

In other respects, the relationships between the costs of various products measured in percents parallel those measured in PMPM values. The ASO products are 5.7% of



premium equivalents, similar to the low PMPM value. It is substantially lower than the ratios for insured products that go from 10.0% for HMO, 9.6% for POS and to 11.4% for Indemnity and PPO.

The sources of the overall improvement from 8.9% to 8.7% are impossible to gauge without qualification. But, in looking at the mix differences, the emphasis on ASO likely contributed something to lower comparisons. (I should add that the mix I am referencing pertains to all participating plans in each year, rather than the continuous ones in Slide 4.) But once this effect is eliminated, it appears that there is a residual of lower costs. Since we know that there was growth in costs by the continuing participating plans, we can suppose the possibility that the plans participating this year tended to have lower costs than those participating the year before. Of course, this is qualified by the fact that we cannot know the performance of organizations that didn't participate. Please look at last July's *Navigator* for last year's ratios.

<Slide 11>

This slide shows the administrative expenses by cluster of functions. As in the previous page overall costs were at 8.7% of premium equivalents, lower than the 8.9% last year. The median values for three of the clusters, Sales and Marketing, Medical and Provider Management and Corporate Services all were flat or increased marginally in comparison to the 2015 values shown in Appendix B. Only Account and Membership Administration decreased, and it by 0.3 percentage points so that cluster seems central to the lower ratios.

<Slide 12>

Total administrative costs this year were \$38.23 PMPM, lower than last year's costs of \$41.04.

The overall cost trends were modest, with a 2.4% increase in administrative costs PMPM, after backing out the effect of product mix differences. Without the adjustment for mix, the costs increased by 3.0%. Both trends were about the middle of trends that we have seen over most of the past decade.

This is an acceleration in trends from last year, and each cluster accelerated. While Account and Membership Administration grew fastest, it accelerated least. Growth was



more modest for Corporate Services and Medical and Provider, but these clusters had greater changes from prior years.

Rating and Underwriting was the fastest growing functional area and, on a constant mix basis, the Actuarial function, which is often linked with that function, grew fastest in the Corporate Services cluster. The Corporate Services function includes a small but very rapidly growing Legal sub-function.

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. You will also find the presentation we did last month on Blue Cross Blue Shield trends. Later in the summer, we will report on trends for Medicare and Medicaid plans. Please contact me for participation information on these universes. 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.

• • •

*Questions and Answers*

Page 11 of 12

COPYRIGHT © 2017 SHERLOCK COMPANY. ALL RIGHTS RESERVED.



• • •

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 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 15th annual edition of the IPS benchmarks. We believe 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.