Transcript

Blue Cross Blue Shield Administrative Costs Nudge Upward in 2018

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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.

Today, I would like to speak about the administrative cost trends of Blue Cross Blue Shield Plans in 2018. To jump to the chase, Information Systems cost growth was central to trends in 2018. We have a large and representative sample of the Blues that are not publicly traded, and I suspect that the trends for these organizations approximate those of other health plans serving similar populations. After all, they all compete in the same markets for health benefits, they compete for the same human and other resources and they operate under the same technical constraints.

The 14 Blue Cross Blue Shield plans that are the subject of this presentation serve 36.7 million people with comprehensive insurance. The average Plan participating in the Sherlock Benchmarks this year served 2.6 million people and the median membership was 1.6 million. The Plans were geographically disbursed, serving 19 states. These plans collectively serve about 52% of the membership of Blue plans that are not publicly traded.

All of the results that we will discuss today are the results of surveys. We have made significant efforts to validate plan responses.

As you might gather, the participating Plans make significant efforts as well. So, I thank the participating plans especially our primary contacts within those plans. Since the subject matter of this web conference is free of charge and beneficial to health plans that do not or cannot participate in the study, I hope you share my gratitude. I also thank my talented colleagues for their professionalism and one very visionary Blue Cross Blue Shield CFO for his inspiration.

I want to offer a framework for today's discussion. Much of the work that we do surrounds the administrative activities of health plans, though we also analyze health care utilization and medical management metrics. We stress administrative expenses since, while health plans may manage the care for many of their members, they provide administrative services in support of all of them.

This year marks the 22nd year of the Sherlock Benchmarks, and the 21st for the Blue universe. Cumulatively, I estimate that by year end our cumulative experience will be more than 855 health plan years, and will include Independent / Provider – Sponsored Plans, Medicaid Plans and Medicare Plans.

The goal of *Sherlock Benchmarks* is to aid in plans' achievement of optimal costs, that is, to incur only those costs that are necessary to meet plans' strategic objectives. In that way, the Benchmarks establish a norm so that, above those levels, expenses should be justified with an ROI. The measurement of a return on investment is challenging but may ultimately be linked to with more rapid growth or a decline in health benefit trends.

There are at least two other reasons why optimizing administrative expenses is a high priority for health plan managers. First, the surge in expenses of adapting to the Affordable Care Act and onboarding Exchange and Medicaid members have passed. Second, administrative expense visibility has been heightened by the rhetoric of presidential candidates.

<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. It also lists of all the functions in each of the products offered by these Blue Plans. By the way, that means that administrative expenses are segmented into nearly 800 expense/product cells, each of which are separately analyzed. We have also included some Market Segment cost information in the Appendix.

I will be posting the slides and the transcript of this within 24 hours. I very much welcome your questions at the end of this presentation. To speed through this, 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. The percent changes that you see here, and elsewhere in this presentation, are generally in *per member* values.

In 2018, excluding the effect of Miscellaneous Business Taxes, Blue Cross Blue Shield Plans had *real* administrative cost increases of 6.7%, up from 5.9% last year. This is shown as the dark blue line. The participating Plans are the same in both comparison years that give rise to these changes. You can see trend spiked higher in 2017, then continued to grow in 2018. By "real", I mean the growth in expenses within a constant set of Plans, standardized by members, after having reweighted the 2017 results to exactly match the product mix offered by those plans in 2018.

As we'll develop later, the actually reported per member administrative trend for the same Plans is 5.5%, up from 5.1% in the previous year, a more moderate acceleration in growth from 2017 and a lower increase in 2018 than after the effect of mix adjustment.

Since the focus of this discussion is administrative expenses that, once measured, can in fact be managed, we are displaying trends before the effect of the Miscellaneous Business Taxes. Excluding the effect of any changes in product mix total administrative expense increased by 17.9% PMPM compared with a decline of 2.3% in the prior year. That increase in excess of the 6.7% shown in this slide is due to the restoration of the Annual Fee on Health Insurance Providers.

Again, the big change in overall cost growth took place in 2017. You can see that growth in Account and Membership Administration lagged, growing by only 3.0% as against 5.9% overall. By contrast, in 2018 the growth in Account and Membership Administration outstripped the total increase, 8.8% versus 6.7%. Therefore, growth in functions other than Account and Membership Administration must have grown slower.

This leads me to the key take-aways from this year's results.

- Most clusters of expenses declined in growth.
- However, Account and Membership Administration accelerated.
- Growth in Information Systems was the single most important reason for administrative expense increase in 2018.
- The shift in favor of products and market segments that are lower cost to administer muted the real growth.

<Slide 4>

I mentioned that the growth in clusters other than Account and Membership Administration must have been slower and this slide details this. The comparisons on the prior slide are detailed in this one, in the second and fourth columns. I have circled in blue the 6.7% and 8.8% increases from Slide 3, and the blue-*filled* arced arrow shows the comparison values from the prior year on a constant mix basis. In other words, the second and fourth columns reflect the twelve continuous plans, whose cost values have been reweighted to eliminate differences due to product mix.

The first and third columns reflect the as-reported values, that is, before the effect of reweighting to eliminate year-over-year product mix differences. The blue *outlined* arced arrow shows the comparisons between the same continuous Plans without that reweighting.

We have spoken about the increase in Account and Membership Administration, which at 3.0% went from about one-half the total trend, to 8.8% which is higher than the total trend. By contrast, the red arrows show the clusters whose growth declined. For instance, Sales and Marketing growth declined from 10.7% to 8.1%. In order of steepness, Corporate Services, Sales and Marketing and Medical and Provider Management all declined.

On an as-reported basis you see a similar though not identical pattern. Overall, growth was more rapid in 2018 than in 2017. The biggest increase in expense growth was in Account and Membership Administration. And Corporate Services costs growth sharply declined. But Sales and Marketing costs appeared to accelerate while Medical and Provider followed suit more modestly.

Note however that the as-reported growth in 2018 was overall much lower and in fact did not increase much from 2017. This more modest growth is the result of changes in product mix. Because of the migration to lower cost products, the growth in expenses are muted in this rendering.

Specifically, while Commercial *Insured* membership declined by 3.0%, commercial ASO / ASC increased by 0.6%. Self-insured relationships represent about two-thirds of commercial members. Since Commercial represents a median of 81.3% of the total comprehensive membership of these Plans, it dominates the effect of the mix shift. Medicaid also increased, though it was only offered by three of the Plans. Offsetting this was that higher cost Medicare Advantage continued to grow though it is only 2.8% of membership, it is 11% of revenues of comprehensive products.

The shift away from individual products likely dampened growth as well. Of the twelve continuously participating plans, eleven segmented their commercial membership into individual and group, and of those, eight reported declines in the proportion of members that were individual. This effect is partially captured in the constant mix trends.

<Slide 5>

This 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 so I will spend a lot of time on this and discuss trends in order of their importance.

While Account and Membership Administration was not the most rapidly growing function, because it represents the single largest cluster, it was the greatest source of increase. Put a different way, while in 2017, the modest growth in this cluster muted the faster growth in other clusters, in 2018, that counterweight was no longer present, and total costs grew faster.

Information Systems was by far the fastest growing function in the Account and Membership Administration cluster, which cluster increased by 8.8%. Growth was extremely broad: of the twelve continuously participating Plans only two had single-digit growth rates in this function.

Security Administration and Enforcement grew especially rapidly but Operations and Support and Application Maintenance were also extremely rapidly growing. Staffing ratios were higher, as was compensation. Outsourcing appeared more prevalent as well.

Somewhat unusually, in 2018, all of the other functional areas in this cluster also grew. Claim and Encounter Capture and Adjudication grew faster than in recent years and was the second largest contributor to cost growth in this cluster. A higher staffing ratio appears to have been the driver. Enrollment grew through increases in non-labor costs. Higher staffing ratios also contributed to growth in Enrollment costs.

The Sales and Marketing cluster increased by 8.1%, slower than last year but still faster than in other recent years. Marketing costs were both the most rapidly growing function and the most important contributor to this cluster's growth. Much of the growth is centered on a subfunction that includes strategic planning of a purely marketing nature, retail store marketing activity, product leadership and strategy relating to digital marketing. Staffing ratios increased in Marketing.

More broadly, this cluster experienced a significant rotation in the functions that drove of its costs. In addition to Marketing, Sales and Advertising and Promotion also surged, replacing Rating and Underwriting as the growth leader. Rating and Underwriting cost growth remains robust though.

For the third year in a row, broker Commissions grew more slowly than for the cluster as a whole. But because it is the largest function in the cluster, it was the second highest contributor to its cost growth.

Staffing in all functions increased and, except for Marketing, outsourcing also increased.

Over the years, high growth in Information Systems and Marketing have sometimes occurred together. We saw this in 2012 and 2013, this year and to a lesser degree in 2016.

The cluster of Medical and Provider Management grew by 10.6%, a very slight decline compared with 2017. Growth in the past two years was nearly double that of any of the previous eight years, suggesting a high commitment their activities.

Medical Management growth was down somewhat from 2017. The still impressive growth was paralleled by higher staffing and greater outsourcing. Higher outsourcing was especially notable in Disease Management and Health and Wellness. Case Management was the most important source of cost growth in this cluster, followed by Utilization Review. Both also experienced high growth in staffing ratios.

Provider Network Management and Services is a much smaller function and while its cost growth declined more sharply. It is composed of Provider Contracting, Provider Services, Provider Audit and a function composed largely of provider educational activities. Costs in this function grew but far less than in 2017 chiefly due to actual declines in these latter two sub-functions. Provider Contracting and Provider Services continued their robust growth.

Outsourcing increased overall in this function, and staffing ratios also increased, especially in Provider Contracting.

The cluster of Corporate Services costs increased by 1.8%, a sharp decline from the 9.3% pace in 2017. The most important source of growth was the Corporate Executive and Governance function which, while much slower than in 2017, was the fastest growing function other than Actuarial. Staffing in the Corporate Executive and Governance function increased while compensation increased modestly. This function includes strategic planning and similar direct reports to the CEO, as well as the CEO and COO themselves.

For the third year in a row, Actuarial has been growing faster than the rest of expenses, and staffing ratio growth is the driver.

Finance and Accounting was unique in that its costs accelerated compared with 2017. Nevertheless its cost growth was in low single-digits.

The modest growth for this cluster was driven by the decline in the rate of growth in the Corporate Services function, by far the largest function in this cluster. The Corporate Services function includes such activities as HR, Legal, Audit, Purchasing, Printing and Mailroom and the like. Staffing growth appeared high in HR, Legal and Purchasing.

<Slide 6>

This slide shows the *reported* rates of change, that is, the values with no adjustments for changes in product mix. These trends, again, are based on continuous plans. Because there is a correspondence between the relative rates of growth and their importance between the constant mix and as-reported renderings, I won't spend a lot of time on this slide.

Again, growth was slower in 2018 on an as-reported basis, 5.5% compared with 6.7% when adjusted to eliminate mix effects. While not visible here, there were nevertheless differences in individual functions within these clusters.

In the Sales and Marking cluster, on an as-reported basis, broker Commissions were actually down for the third year in a row. Also, Rating and Underwriting trends were sharply lower. These two differences illustrate the effect on cost trends of the large, self-insured groups increasingly served by these Plans. In other words, because these costs are less prominent in ASO/ASC products, the shift in favor of ASO/ASC led to the appearance of lower trends. Most Sales and Marketing cost trends were more modest on an as-reported basis.

Medical and Provider Management cost trends were also lower on this basis, especially in Medical Management.

A few functions, Marketing, Actuarial and Customer Services, grew faster on an as-reported basis than on a constant mix basis, which may be linked to innovations and adaptations to the increasingly important ASO / ASC product and the large group market segment.

Let me close this part of my presentation with a few summary observations. All my trend comments are based on continuously participating plans and includes the effect of staffing and costs performed on an outsourced basis. Overall, it appears that staffing ratios are higher than last year among continuing plans. Over all participating plans, Blue Cross Blue Shield Plans have approximately 20 FTEs per 10,000 members, though we believe that it differs between products and market segments: we estimate that there are 19 FTEs per 10,000 members in the commercial products. Of the 14 functional areas with staff, all had ratio increases. *Key* areas of staffing growth included Information Systems, Medical Management and Customer Services.

Compensation was typically higher. Seven of the 14 primary functional areas with staff increased. They were about evenly split between the functions that are high and low on the Plan compensation spectrum. Marketing and Finance and Accounting appeared to have a decline in compensation, but this may be related to staffing growth.

Overall, outsourcing was higher than last year. Seven of the 14 functions increased in outsourcing notably the substantial Information Systems functional area and Rating and Underwriting. No function tended to decrease.

<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 those with an interest in investment theory, this cost segmentation also comports with the observation that financial leverage is independent of operating performance and works the same way whether the firm or the investor employs the debt.)

For that same management control 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.

This Miscellaneous Business Tax expense is not part of the expenses that give rise to the 6.7% total increase after mix adjustment, but those costs surged with the expiration of the Moratorium on Annual Fee on Health Insurance Providers. The whole Miscellaneous Business Tax expense more than doubled to a median of $16.09 for commercial insured products, representing about 25% of all administrative costs. So, if we were to have included that expense in trend, total costs would have increased by 17.9% rather than by 6.7%.

<Slide 8>

To this point, we have focused on rates of change rather than the underlying values of the components of administrative costs. They were based on a constant set of plans over each two-year comparison period.

The next few slides speak to the values of these activities for the entire set of Plans: two Plans joined this universe and two Plans withdrew. Because of the difference between the two sets of plans, changes between the values is only a very rough gauge of trend. The median PMPM value of $38.51, 10.0% greater than the median value of $34.99 last year. The prior year values are shown in Appendix A of this slide deck and are also excerpted on this page. As you can see, the total medians are higher, and the cost mixes differ.

There is only a loose correspondence with the overall administrative cost trends on Slide 4 and increases that resulted in the values shown here. The decline Corporate Services values to $5.92 corresponds with the modest growth reported earlier. The increase in Account and Membership Administration to $16.10 PMPM corresponds with the actual acceleration in this cluster. The modest increase in Sales and Marketing, to $9.21 PMPM parallels the decline in the rate of its actual growth. Medical and Provider Management showed the greatest increase to $5.03 similar to the high actual growth discussed earlier.

Interestingly, the cluster values in 2018 are more "clustered" than in 2017. The differences between 25th and 75th percentile values are usually smaller. The total is smaller and the increase in dispersion in Account and Membership Administration is the key exception. Similarly, the coefficients of variation tended to be smaller as well, again except for Account and Membership Administration.

<Slide 9>

I have noted 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 60% of that of the insured commercial products. I have circled this. The overwhelming reason for the differences stem from Sales and Marketing cost differences. What this means is that, when there is a shift in favor of these products, reported cost trends decline.

Median ASO/ASC PMPM costs range from $26.89 in the Commercial POS product to $33.39 in the HMO. The single most important product offered by the Plans is

Indemnity and PPO which, at $28.29, approximates the median for all ASO / ASC products.

ASO/ASC represented a median of 45% of the comprehensive membership. (Last year it was also 45%, before that it was 43% and before that it was 39%.) Insured product costs ranged from $49.84 for Indemnity and PPO to $52.09 for HMO. Insured POS was $49.86.

Other low-cost products included FEP at $25.51, Medicare Supplemental at $33.61 and Medicaid (relative to other insured products) at $46.08. The highest cost in Blue Comprehensive products is Medicare Advantage at $112.08. Drilling further, we would normally expect to see lower costs for group because of lower per member Sales and Marketing expenses but this is not year's result. We think that there are two explanations for this: first, Group Medicare is still unusual for Blue Plans; second, the health care costs for the population served under Medicare Group are about 20% higher than for Individual.

This panel has elected not to include Medicare SNP as a comprehensive product, but it costs $206.27 PMPM. This population has health benefit costs that are more than 60% higher than those of Medicare Advantage for Individuals. These are primarily dual-eligible members and there is no exposure to any long-term care for these members. The specialty insurance products, Medicare Part D and Stand Alone Dental, are low cost products at $14.24 and $3.19, respectively.

For continuously participating plans, membership grew overall at a median rate of 0.4% and an average decline of 1.3%. Six of the 12 posted declines. Commercial membership grew at a median rate of 1.1% - the 3.0% decline in commercial insured was offset by the 0.6% increase in commercial ASO/ASC. Medicare Advantage was the fastest growing product at 6.0%, while Medicare Supplemental remained static. Medicaid increased by 3.1% as FEP declined by 0.8%.

<Slide 10>

This is similar to the previous slide, only expressed in percents. The median administrative expense relative to premiums was 9.0% similar to the value for last year was 8.9%. (By the way, we are using premium equivalents here.) 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 6.9% to 7.4% for HMO and Indemnity and PPO, respectively. These values are substantially lower than the ratios for insured products that go from 9.4% for HMO to 10.8% for Indemnity and PPO. Another low ratio product is FEP, at 5.2%.

However, the highest percent ratio product, Medicare Supplemental at 15.5%, is also among the lowest values measured on a PMPM basis. That this product is secondary to Medicare while many of the claims paying and other activities of Medicare are still borne by the Plans likely explains this paradox.

The specialty products, with very low PMPM costs, also had high percents. Administrative costs for Stand-alone Part D was 17.9% of premiums and Stand-alone Dental was 17.2%.

The Medicare products are much more similar to commercial products on a percent than on a PMPM basis. This is consistent with administrative requirements of insured people tending to track their health needs. We touched on that tracking of health benefits and administrative costs when we were discussing group and individual Medicare Advantage in the previous slide.

<Slide 11>

This slide shows the administrative expenses by cluster of functions. Overall costs were at 9.0% of premium equivalents, roughly the same as the 8.9% last year.

Except for Sales and Marketing, the median values for all of the clusters either declined or remained the same in comparison to the 2017 values. But, as with the total, the ratios look very similar to those of last year.

These ratios cluster more than are found in the PMPM values on Slide 8. I suspect that this is because local cost of living differences are not as much reflected in percents as they are in PMPMs.

<Slide 12>

The Plans that participated in this year's study had costs that were $38.51 PMPM versus $34.99 last year. In this presentation, I've emphasized growth holding the universe constant but changes in participation plus changes in product mix also made a difference.

The overall cost trends increased by 5.5%, higher than last year's increase of 5.1%. Once we back out the effect of product mix differences that favored lower cost products such as ASO/ASC, the trend was 6.7%, up from 5.9% in the prior year.

While most clusters of expenses declined, Account and Membership Administration grew. This was driven by Information Systems but, a little unusually, the other functions in this cluster, Claims, Enrollment and Customer Services, also grew.

While Sales and Marketing grew less rapidly in 2018 than in 2017, Marketing expenses surged. I don't know whether they are linked to increases in Information Systems costs but there is a pattern that they occur together sometimes.

The restoration of the Health Insurance Tax has caused Miscellaneous Business Taxes to increase from 12% to 25% of commercial insured product costs. We haven't included the effect of this in any of our trend analyses since they are impractical to manage. Needless to say, cost growth would have been much higher had we included the effect of this.

This presentation, (transcript and slides) will be posted on our web site, hopefully later today. 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. There is also a description of our benchmarking process.

In early July, 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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Q. You had said that it is unusual for plans to report growth in areas like claims and enrollment when they also report increases in Information Systems. What do you mean?

A. Over the past decade or so, it has been common to see slower growth or even declines in claims and enrollment when Information Systems has grown. I assume that this is effectively automation. That did not occur in 2018.

Q. Why do you think that growth in Information Systems and Marketing have sometimes occurred together?

A. My educated guess is that this happens when the organizations decide that the market is interested in new products. Since a product involves payments on behalf of members to providers, innovation can be complex. So, Information Systems investments assure the Plan is able to honor the commitments of new products.

Q. Do you think that these cost trends are similar to what you find for other health plans?

A. I do think that they are similar across types of plans. All competitors in this industry operate within the same health benefits and labor markets, and also they operate within the same technical constraints. Moreover, when we have seen other plans, such as Independent / Provider – Sponsored Plans, they tend to operate similarly. There is far more difference between plans in a universe than between universes.

Q. You mentioned that Information Systems grew faster than other administrative expenses. Does this mean that they increased as a percent of premiums?

A. I believe so. *(Editor's note. We checked Commercial Insured and can verify that this is indeed the case. In fact, all of the key subfunctions, (a) Operations and Support Services, (b) Applications Maintenance, (c) Applications Acquisition and Development, and (d) Security Administration and Enforcement, increased as a percent of premiums.)*

Q. You mentioned that 45% of comprehensive products were ASO/ASC both in this and last year. But you also said that membership grew more in ASO/ASC while Insured declined. How does that happen?

A. Great question. There are several reasons. First, medians, as the 50^{th} percentile value, do not capture this effect. Second, the set of Plans differed. Third, while Insured declined, other products increased, notably MA.

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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 early July, 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.

I want to once again thank the participants for the hard work that has gone into the 21^{st} annual edition of the Blue benchmarks. 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.