



BLUE CROSS BLUE SHIELD PLANS POST DECLINE IN GROWTH OF ADMINISTRATIVE COSTS IN 2008

Summary

Raw per member administrative cost trends decreased from 4.3% in 2007 to 2.7% in 2008. Adjusting to eliminate the effects of changes in product mix, the rate of cost increase grew faster, a 4.0% increase versus 2.5% last year. Together, increases in Information Systems and Medical Management expenses comprised at least 40% of the total increase in 2008. For the universe of Blue Cross Blue Shield plans submitting 2008 data, administrative expenses comprised 9.9% of premium equivalents compared with 10.4% for plans submitting 2007 data.

Managing administrative costs is a high priority for health plans. Weak membership trends due to a difficult employment environment lead to negative operating leverage unless administrative costs are successfully managed. Also, the current political environment creates particularly high degree of scrutiny of health plan administrative costs.

The administrative expenses of Blue Cross Blue Shield plans participating in our performance benchmarking study was \$25.95 per member per month (PMPM), but varied greatly by product. Medicare Advantage cost \$78.05 PMPM while the Indemnity / PPO ASO/ASC costs were \$20.02 PMPM.

In 2008, the Commercial POS ASO/ASC administrative expenses were 6.7% of premium equivalents, the lowest ratio for products comparable to those in other universes. Medicare Advantage's administrative expenses were 7.8% of premiums and Medicare Supplemental had the highest ratio, at 16.8% of premiums. The Federal Employee Program (FEP), unique to Blue Cross Blue Shield, had administrative costs of 5.4% of premiums.

All values in this article exclude investment and non-operating income and expense, income taxes and miscellaneous business taxes. Pharmacy and Mental Health administrative costs are included in total administrative cost calculations but not in individual functional area clusters. These results are excerpted from the Blue Cross Blue Shield edition of the 2009 *Sherlock Expense Evaluation Report*, comprising 2008 data.

Figure 1. Benchmark Summary
Blue Cross Blue Shield Costs by Functional Area Cluster, 2008 Data
Per Member Per Month

| | 25th PCTL | 75th PCTL | Median | σ/ Mean |
|----------------------------|-----------|-----------|---------|---------|
| Marketing | \$5.23 | \$9.78 | \$7.40 | 44.9% |
| Provider & Med. Management | 2.23 | 4.45 | 3.34 | 40.5% |
| Account & Mem. Admin. | 8.89 | 12.10 | 10.78 | 19.3% |
| Corporate Services | 3.83 | 5.18 | 4.46 | 27.5% |
| Total | \$23.15 | \$29.84 | \$25.95 | 22.9% |

Membership Trends and Mix Changes

In 2008, membership in Blue Cross Blue Shield Plans participating in our benchmarking study increased by 1.0%. However the mix of the business changed. Of the nine plans that had continuously offered Medicare Advantage, membership increased by 30.9% on average, as Medicare Supplemental membership declined by 3.0%. Medicare Advantage is nevertheless relatively small, comprising less than 3% of comprehensive members.

Of greater significance is the growth of ASO/ASC products and FEP as a proportion of total membership. While total commercial membership increased at a median rate of 1.0%, ASO/ASC increased at a median rate of 5.4%. In fact, except for FEP, considered by the Blue peer group to be a form of commercial insured, commercial insured products had a decline in membership.

Figure 2. Benchmark Summary
Blue Cross Blue Shield Percent Change in Costs by Functional Area Cluster

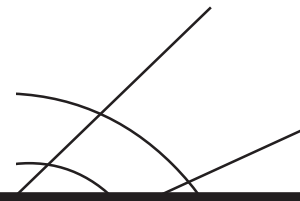
| | 2007 Data | | 2008 Data | |
|----------------------------|-----------|--------------|-----------|--------------|
| | % Change | Mix-Adjusted | % Change | Mix-Adjusted |
| Marketing | 4.2% | 4.9% | 3.5% | 2.8% |
| Provider & Med. Management | 10.0% | 2.2% | 11.3% | 9.1% |
| Account & Mem. Admin. | 5.0% | 3.9% | 2.2% | 4.1% |
| Corporate Services | 0.2% | -6.2% | -0.1% | 1.6% |
| Total | 4.3% | 2.5% | 2.7% | 4.0% |

FEP typically comprised approximately 8-10% of Blue Cross Blue Shield members in 2008, up approximately one-half percentage point from 2007. FEP increased by 2.3% among continuing respondents. This is a relatively high premium product among commercial products but its expenses PMPM costs are 13% lower than ASO products whose marketing costs FEP closely resembles.

In general, notwithstanding the growth of Medicare Advantage, it was the growth in the lower cost products that dominated the trends. Thus, administrative expenses grew faster on a constant mix basis than on an as-reported basis.

Administrative Costs and Trends

For convenience of analysis, we group various functional areas into clusters, and standardize for size by expressing expenses on a per member basis. Values and rates of change for these clusters and overall are shown in Figures 1 and 2. Appendix A provides values for all plans participating in 2008, and comprises 2007 data.



Marketing expenses were \$7.40 and grew by 3.5% PMPM, down from 4.2% growth in 2007. (All rates of change hold constant the universe of participants.) Advertising and Promotion was the fastest growing functional area and responsible for a significant share of the total increase. However, external broker Commissions comprised more than one-quarter of the total increase in the cluster's growth, though its rate of growth was the second lowest in the past nine years. While internal Sales and Marketing costs both grew and were responsible for a significant share of the increase, Product Development / Market Research declined in 2008 on a PMPM basis. The 75th percentile value for this cluster was \$9.78 and the 25th percentile value was \$5.23 PMPM.

Marketing expense trends, like those of other clusters, were affected by the changes in product mix. Holding the product mix constant, Marketing expense growth declined far more sharply, to 2.8% from 4.9% in 2007. Per member marketing costs are quite high for Medicare Advantage which may be a source of this difference between the as-reported and constant-mix analyses. On a constant mix basis, Advertising and Promotion was the fastest growing expense, followed by internal Sales and Marketing, which was also responsible for the most of the increase. On a constant mix basis, there was no increase in external Commission cost growth.

Medical and Provider Management grew by 11.3% (compared with 10.0% last year) to \$3.34 PMPM. While Provider Network Management and Services grew very modestly, the Medical Management / Quality Assurance / Wellness functional area grew very rapidly. The latter functional area was the fastest growing function and responsible for much of the total increase in 2008.

Provider Network Management and Services grew more rapidly, holding the mix constant versus 2007. The Medical Management / Quality Assurance / Wellness functional area narrowly followed the growth rate in Advertising and Promotion on a constant mix basis. It only followed the increase in Information Systems costs in its contribution to the total 2008 cost increase.

That medical management costs increased so dramatically after holding constant the product mix suggests that Blue Cross Blue Shield Plans participating in our benchmarking studies significantly increased their commitment to this activity in 2008. The costs of Medical and Provider Management at the 25th percentile was \$2.23 PMPM and \$4.45 PMPM at the 75th percentile.

Account and Membership Administration cost increased to \$10.78, up 2.2% from last year. In 2007, the rate of growth, on an as-reported basis, was 5.0%, an indicator that the rates of growth of costs in this cluster decelerated. The value at the 25th percentile was \$8.89 PMPM, while the costs at the 75th percentile were \$12.10 PMPM.

The fastest growing area was Information Systems, which was responsible for essentially all of the increase in this cluster. Costs increased in each of the Claim and Encounter Capture and Adjudication and Customer Services by roughly 1%. Enrollment / Membership / Billing cost growth was high relative to the cluster.

On a constant mix basis, the Account and Membership Adjudication cluster increased by 4.1%, approximately the same as 3.9% for 2007. The implied lower growth of the 2007 constant mix

assumption may relate to the increased proportion of FEP and ASO/ASC business in 2008. With the exception of Information Systems, the costs of no functional area grew by as much as 1%, and two declined. Again, the overwhelming reason for the increase on a constant mix basis was Information Systems, evidently a major commitment of the participating Blue Cross Blue Shield Plans. The modest growth of the other functions is consistent with the possibility of technical substitution in favor of more automated systems of customer service and claims adjudication.

Corporate Services costs declined by 0.1%, compared with growth of 0.2% in 2007. Most of these costs are in such support areas as Facilities, Legal, Printing and Mailroom and OPEB. The costs of these functions collectively declined by nearly one-half a percentage point. Also, Finance and Accounting declined, for the fourth time in five years. Corporate Executive / Governance costs increased at a high rate, as Actuarial increased at a faster than average pace.

On a constant mix basis, costs increased by 1.6%, compared with a decline of 6.2% in 2007. The group of support functions including Facilities, Legal, Printing and Mailroom and OPEB declined as did Finance and Accounting, the latter for the third year in a row. Only Corporate Executive and Governance and Actuarial increased, holding constant the product mix of the plans. Total costs for this cluster were \$4.46 PMPM in 2008, while the 25th percentile value was \$3.83 PMPM and the value at the 75th percentile was \$5.18 PMPM.

Calculation of Mix-Adjusted Rates of Expense Growth

To make the most useful comparisons of administrative expenses, it is illuminating to eliminate the effects of product mix differences. This is beneficial both between organizations with different product mixes and also between periods. Accordingly, in comparing expenses between periods, we hold constant the product mix between the two years.

To do this, since Blue Cross Blue Shield plans report to us by product, we reweight their expenses so that the product mix existing in the prior period is the same as in the current one. We then recalculate the rates of change based on these reweighted estimates.

Costs as a Percent of Premium Equivalents

Notwithstanding its important drawbacks, health plans and others often express administrative costs as a percent of premiums. As shown in Figure 3, administrative expenses were 9.9% of premium equivalents for comprehensive products sold by Blue Cross Blue Shield plans. The 25th percentile value was 7.8% and the value at the 75th percentile was 10.5%. Comparing these results to those in Appendix B, administrative expenses were 50 basis points lower as a percent of premium equivalents. This decline is in part attributable to the heavier mix of Medicare, ASO and FEP each of which each have lower costs relative to premium. Some reporting differences also affected these comparisons but those differences appear to be minor.

Marketing costs comprised 2.4% of premium equivalents, with the 25th percentile value was 1.7% and the value at the 75th

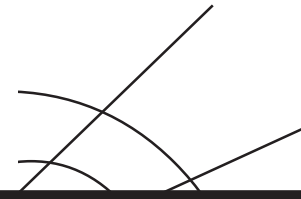


Figure 3. Benchmark Summary
Blue Cross Blue Shield Costs by Functional Area Cluster,
as a Percent Premiums or Equivalents, 2008 Data
Percent of Premium Equivalents

| | 25th PCTL | 75th PCTL | Median | σ/ Mean |
|----------------------------|-----------|-----------|--------|---------|
| Marketing | 1.7% | 3.5% | 2.4% | 45.2% |
| Provider & Med. Management | 0.9% | 1.5% | 1.2% | 38.5% |
| Account & Mem. Admin. | 3.2% | 4.5% | 3.9% | 23.1% |
| Corporate Services | 1.3% | 1.9% | 1.6% | 29.6% |
| Total | 7.8% | 10.5% | 9.9% | 23.7% |

percentile was 3.5%. The comparable median percent in 2007 was 3.0% or 60 basis points higher than for 2008.

The value at the 25th percentile for Provider and Medical Management was 0.9% of premium, while the 1.5% of premium equivalents represented the 75th percentile. The median value, at 1.2% was 10 basis points higher than the 1.1% posted last year.

The costs of Account and Membership Administration were 3.9% of premium equivalents, substantially identical to 3.8% reported last year. The value at the 25th percentile was 3.2% of premium equivalents and 4.5% of premium equivalents at the 75th percentile.

The median proportion of premium equivalents due to Corporate Services was 1.6%, 30 basis points lower than last year's value of 1.9%. Twenty-five percent of plans had values below 1.3% of premium equivalents or above 1.9% of premium equivalents in 2008.

Administrative Expenses by Product

All participants in our benchmarking studies segment their costs by product as well as by over fifty functional areas. Overall, the resources consumed in these products are reflected in administrative expenses that differ quite sharply between the various products. Our participants normally have quite robust activity-based costing systems to facilitate this. For example, among Blue Cross Blue Shield Plans, members in Medicare Advantage products submit 2.5 times as many claims as

Figure 4. Benchmark Summary
Blue Cross Blue Shield Costs by Product, 2008 Data
Per Member Per Month

| | 25th PCTL | 75th PCTL | Median | σ/ Mean |
|----------------------------|-----------|-----------|---------|---------|
| Commercial HMO | | | | |
| Insured | \$25.76 | \$36.45 | \$30.81 | 26.3% |
| ASO / ASC | \$18.80 | \$26.56 | \$21.73 | 25.9% |
| Commercial POS | | | | |
| Insured | \$26.66 | \$35.89 | \$29.84 | 24.3% |
| ASO / ASC | \$14.34 | \$22.08 | \$20.13 | 32.0% |
| Indemnity & PPO | | | | |
| Insured | \$29.90 | \$38.86 | \$32.30 | 26.1% |
| ASO / ASC | \$16.64 | \$23.49 | \$20.02 | 27.5% |
| Medicare Advantage | \$58.72 | \$82.16 | \$78.05 | 19.5% |
| Medicaid | \$19.97 | \$23.12 | \$20.67 | 15.2% |
| FEP | \$13.78 | \$18.81 | \$17.49 | 30.4% |
| Medicare Supplement | \$23.09 | \$37.62 | \$30.04 | 36.9% |
| Comprehensive Total | \$23.15 | \$29.84 | \$25.95 | 22.9% |
| Stand Alone Dental | \$2.38 | \$3.60 | \$3.32 | 72.8% |
| Medicare Part D | \$13.02 | \$23.62 | \$17.52 | 50.4% |

Calculation of Premium Equivalents

Administrative services relationships, typically comprising more than one-third of all Blue Cross Blue Shield commercial members, play havoc with the intuition that administrative costs, when expressed as a percent, are a proportion of the premium dollar. That is because, under ASO relationships, employers are only billed for the administrative services that they provide rather than for the cost of care, which is borne by the self-insured groups.

Our solution to this is to express expenses as a percent of premium equivalents. Since each of the plans submits the health care expenses for the self-insured groups (which they know since they process their self-insured claims), by adding this amount to the administrative service fees actually billed, we are able to estimate the premium equivalents of the ASO arrangements.

Note that, as with premiums, fees charged to ASO clients reflect a profit assumption. Therefore to estimate premium equivalents it is appropriate to add the fees rather than the administrative expenses to directly compare costs with the insured business.

members in insured HMO products so their costs per member are accordingly higher. Similarly, ASO/ASC products have lower overall costs than their insured counterparts since ASO/ASC arrangements are normally provided only to larger groups that tend to be less costly to market to.

These differences are manifest in their overall cost differences. The most expensive product offered by Blue Cross Blue Shield plans is their Medicare Advantage product at \$78.05 PMPM. The least expensive comprehensive product offered by other health plans was the Indemnity / PPO product sold on an ASO basis at \$20.02 PMPM. This is shown in Figure 4. FEP was lower still, at \$17.49.

As shown in Figure 5, on a percent of premium basis, the ranking of administrative expenses is different. The lowest median percent of premium equivalents was POS sold on an ASO/ASC basis at 6.7%. The HMO product sold on an ASO basis is also low, at 7.3%. The unique FEP product was also low, at 5.4%. Medicare Advantage nearly reversed its metric ranking with administrative expenses of only 7.8% of premiums.

Background

The peer group universe in this analysis consisted of twenty-two Blue Cross Blue Shield plans, which together served 31.3 million

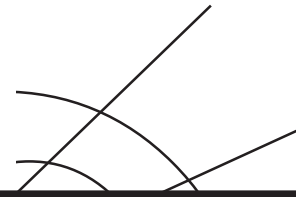


Figure 5. Benchmark Summary
Blue Cross Blue Shield Costs by Product, 2008 Data
Percent of Premium Equivalents

| | 25th PCTL | 75th PCTL | Median | σ / Mean |
|----------------------------|-----------|-----------|--------|-----------------|
| Commercial HMO | | | | |
| Insured | 10.3% | 11.6% | 10.5% | 15.8% |
| ASO / ASC | 5.6% | 9.9% | 7.3% | 29.9% |
| Commercial POS | | | | |
| Insured | 9.2% | 12.4% | 11.3% | 26.1% |
| ASO / ASC | 5.7% | 9.4% | 6.7% | 32.1% |
| Indemnity & PPO | | | | |
| Insured | 10.0% | 12.8% | 11.6% | 30.2% |
| ASO / ASC | 6.8% | 9.2% | 7.5% | 29.6% |
| Medicare Advantage | 6.8% | 10.2% | 7.8% | 30.9% |
| Medicaid | 7.6% | 9.9% | 8.6% | 25.9% |
| FEP | 4.3% | 5.9% | 5.4% | 27.3% |
| Medicare Supplement | 13.1% | 22.7% | 16.8% | 33.9% |
| Comprehensive Total | 7.8% | 10.5% | 9.9% | 23.7% |
| Stand Alone Dental | 13.8% | 27.7% | 15.9% | 66.3% |
| Medicare Part D | 13.6% | 19.9% | 16.1% | 55.1% |

members. Twenty-one of this year's participants participated in the previous year and 77% of this year's participants have six or more years of experience participating in SEER. Selected information concerning last year's analysis is included in Appendix A and Appendix B, below.

Of the people under comprehensive health benefit plans, 12.9 million were served under commercial self-insurance arrangements, though the typical plan had only one-third of its members served this way. Medicare Advantage, offered by eleven plans, comprised less than 3% of the total membership of the plans that offered them. Medicare Supplemental, offered by universally by this peer group, comprised approximately 7% of membership.

Cost trends are based on the results for plans that participated in each of the comparison years. PMPM and percent values are for all plans that reported this year. We employed median values throughout this process as the best measure of central tendency.

Overall, our benchmarks in 2009 will comprise the experience of approximately 396 health plan years. We also have universes of Independent / Provider-Sponsored Plans, Larger Health Plans, Medicare Advantage Plans and Medicaid Plans. We will be reporting on the results for the latter two universes in the next two months.

Does Benchmarking Make a Difference?

Because of Sherlock Company's business model, we have limited in-depth knowledge of how most of our participants implement the results of their participation in our benchmarking studies. On the other hand, one possible gauge of the usefulness of our benchmarks is the relative cost performance of those plans participating in our benchmarks and those that do not.

To assess this, we compared the per member administrative expenses of Blue Cross Blue Shield plans who participated in our benchmarking studies with those that did not. The source of this information is publicly available data from the 39 primary licensees, as reflected in our June 2008 and 2009 editions of PULSE.

We found that participants in this year's benchmarking study had administrative expenses that were 2.4% lower than their non-participating counterparts and their 2008 growth in administrative expenses averaged 3.7%, 3.2 percentage points lower than the 6.9% reported by their non-participating peers.

While these are appealing conclusions, they come heavily qualified. The public information supplied by plans is not as robust as was supplied to us through our benchmarking studies so calculations based on them are less robust as well. In certain instances, we rejected data that seemed unrealistic for analytical purposes, and we have not adjusted for product mix. An example of the effects of these differences is that the 3.7% reported here differs from the 2.7% reported in Figure 2.

Accordingly, we do not consider this proof of the benefits of our benchmarks, so much as encouragingly consistent with what one would expect. After all, you manage what you measure.

Appendix A. Benchmark Summary
Blue Cross Blue Shield Costs by Functional Area Cluster, 2007 Data
Per Member Per Month

| | 25th PCTL | 75th PCTL | Median | σ / Mean |
|----------------------------|-----------|-----------|---------|-----------------|
| Marketing | \$5.36 | \$9.89 | \$7.46 | 43.6% |
| Provider & Med. Management | 2.08 | 3.87 | 3.12 | 38.6% |
| Account & Mem. Admin. | 8.90 | 12.16 | 10.23 | 20.6% |
| Corporate Services | 3.85 | 5.49 | 4.40 | 36.9% |
| Total | \$22.02 | \$30.54 | \$25.36 | 24.0% |

Appendix B. Benchmark Summary
Blue Cross Blue Shield Costs by Functional Area Cluster, as a Percent Premiums or Equivalents, 2007 Data
Percent of Premium Equivalents

| | 25th PCTL | 75th PCTL | Median | σ / Mean |
|----------------------------|-----------|-----------|--------|-----------------|
| Marketing | 1.9% | 4.0% | 3.0% | 44.3% |
| Provider & Med. Management | 0.8% | 1.4% | 1.1% | 44.1% |
| Account & Mem. Admin. | 3.5% | 5.2% | 3.8% | 24.5% |
| Corporate Services | 1.4% | 2.2% | 1.9% | 36.4% |
| Total | 8.3% | 12.4% | 10.4% | 25.9% |