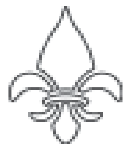

Plan Management
Navigator

Analytics for Health Plan Administration **Late July 2011**

Independent/Provider-Sponsored Plans' Administrative Costs Were 8.4% of Premiums in 2010

Summary

Independent/Provider-Sponsored plans' administrative expense growth declined once again in 2010. Administrative expenses were 8.4% of premiums in 2010. While raw per-member administrative cost trends decreased from 4.8% in 2009 to 3.9% in 2010, after eliminating the effect of product mix changes the rate of cost growth decreased from 3.0% to 2.3%.

The median administrative expenses of comprehensive products of Independent/Provider-Sponsored plans (IPS plans) participating in our performance benchmarking study in 2010 was $31.99 per member per month (PMPM), but varied greatly by product. In 2010, Medicaid products sold by these plans had administrative expenses of $17.11 PMPM. Medicare SNP was the highest administrative cost product, at $128.08 PMPM.

All values exclude investment and non-operating income and expense, income taxes and miscellaneous business taxes. Pharmacy and Mental Health costs are included in total administrative cost calculations and are allocated to the Account and Membership Administration cluster.

These results are excerpted from the Independent/Provider-Sponsored edition of the 2011 *Sherlock Expense Evaluation Report (SEER)*. The results are based on our detailed surveys of 2010 operating parameters of 15 Independent/Provider-Sponsored plans serving 5.8 million members.

Administrative Costs and Trends

For convenience of analysis, we group functional areas into clusters, and standardize for the size of the health plans by expressing expenses on a per member basis. Cost values and rates of change are shown in Figures 1 and 2. Appendix A provides values for plans participating in the 2010 survey, and comprises 2009 data.

Sales and Marketing expenses were $10.09 PMPM and grew at a sharply increasing rate, 6.4% in 2010 versus 1.6% growth in 2009. (All rates of change hold constant the universe of participants.) Eliminating the effect of product mix changes, the acceleration was similarly evident as PMPM Sales and Marketing costs increased by 4.0% compared with 1.0% in 2009.

Broker Commissions was the fastest growing function on a constant-mix basis and the second fastest as-reported. Using either calculation, it was the single most important factor in the increase in 2010. This continues a trend among IPS plans to increasingly emphasize an external distribution system. The small Product Development area was the fastest growing function as-reported and the second fastest on a constant-mix basis. Growth rates in the internal Sales and Marketing *function* declined.

Advertising and Promotion reversed its decline in 2010, as-reported, but declined further on a constant-mix basis. The increase had only a modest impact on the overall growth, however. The small Rating and Underwriting function grew moderately on a constant-mix basis and on an as-reported basis. Staffing ratios generally increased in this cluster of functions.

The 75th percentile value for this cluster was $11.29 and the 25th percentile value was $8.69 PMPM.

Independent/Provider-Sponsored plans in 2010 continued to reflect the economic turmoil of 2009. Year-over-year, for the 12 continuous plans, total commercial membership increased at a median rate of 0.9%, or 1.7% on average. By contrast, Medicare Advantage increased at a median rate of 19.3%, and the median growth in Medicaid HMO was

Figure 1. Benchmark Summary
Independent/Provider-Sponsored Costs by Functional Area Cluster, 2010 Data
Per Member Per Month

	25th PCTL	75th PCTL	Median	σ/ Mean
Sales & Marketing	$8.69	$11.29	$10.09	29.9%
Provider & Medical Management	4.20	6.26	5.40	38.4%
Account & Mem. Administration	7.88	12.67	11.05	36.1%
Corporate Services	3.65	7.04	4.76	49.1%
Total	$24.62	$38.83	$31.99	27.3%

**Account & Membership Administration Includes Pharmacy and Mental Health*

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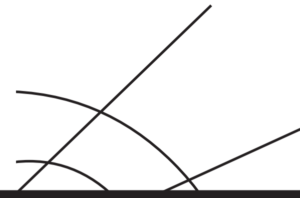


13.7%. Accordingly, while the product mix of commercial decreased by approximately 2 percentage points, the two governmental programs each increased by 1 percentage point each.

Provider and Medical Management, in contrast with Sales and Marketing, posted a decline in growth, to 1.8% (compared with 9.6% last year) to $5.40 PMPM. On a constant-mix basis, per member cost growth fell from 9.0% to 0.5%. Both Provider Network Management and Services and Medical Management grew at approximately the same pace, and both were slower than last year. This pattern was evident on both an as-reported and on a constant-mix basis.

That Medical Management continues to grow faster than most functions, either on a constant-mix or on an as-reported basis suggests that this function remains a relatively high priority for the IPS plans. Staffing ratios for both functions appeared to have slightly declined between the two measurement years.

The costs of Provider and Medical Management at the 25th percentile was $4.20 PMPM and was $6.26 PMPM at the 75th percentile.

Account and Membership Administration costs increased to $11.05 PMPM, up 4.3% from last year. At the 25th percentile the cost of Account and Membership Administration was $7.88 PMPM, while the costs at the 75th percentile were $12.67 PMPM. In 2009, the rate of growth, on an as-reported basis, was 2.7% so cost growth increased in 2010. On a constant-mix basis, the increase in cost growth was even sharper, 5.0% as against 1.3% in 2009.

Information systems was far and away the most important reason for the increase, either as-reported or constant-mix. It was the fastest growing function in this cluster and, because of its size, had 5-7 times the impact of the next most important contributor to growth.

By contrast, Customer Services costs actually declined, as it also did in 2009, on both an as-reported and constant-mix basis. Claim and Encounter Capture and Adjudication costs also declined on a constant-mix basis.

Staffing ratios fell in Customer Services and were slightly lower in Claim and Encounter Capture and Adjudication. The results are consistent with the possibility of increased Independent/Provider-Sponsored plan automation of their activities.

Outsourcing decreased for Claim and Encounter Capture and Adjudication but increased for Enrollment, Customer Services and Information Systems. Over all functions, outsourcing is relatively unusual among Independent/Provider-Sponsored plans, equating to 10% of total FTEs, slightly higher than last year.

Corporate Services costs declined by 1.0% on an as-reported basis and 3.9% on a constant-mix basis. These declines generally continue the trend from last year when costs in this cluster grew by 2.0%, as-reported and declined by 4.1%, constant-mix.

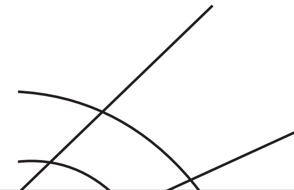
Central to this trend were declines in costs in a group of sub-functions containing Human Resources, Legal , Facilities, Audit, Purchasing, Printing and Mailroom. Actuarial also declined. By contrast Finance and Accounting and Corporate Executive and Governance costs increased. Compensation costs per FTE declined and diminished as a percent of total costs in this later function. Corporate Executive and Governance also contains all of the strategic consulting costs that may be incurred in connection with adaptation to the current environment.

Total costs for this cluster were $4.76 PMPM in 2010, while the 25th percentile value was $3.65 PMPM and the value at the 75th percentile was $7.04 PMPM.

Figure 2. Benchmark Summary
Independent/Provider-Sponsored Percent Change in Costs by Functional Area Cluster

	2009 Percent Change		2010 Percent Change	
	As Reported	Constant Mix	As Reported	Constant Mix
Sales & Marketing	1.6%	1.0%	6.4%	4.0%
Provider & Medical Management	9.6%	9.0%	1.8%	0.5%
Account & Mem. Administration	2.7%	1.3%	4.3%	5.0%
Corporate Services	2.0%	-4.1%	-1.0%	-3.9%
Total	4.8%	3.0%	3.9%	2.3%

Account & Membership Administration Includes Pharmacy and Mental Health



Accounting for Costs as a Percent of Premium Equivalents

Notwithstanding its important drawbacks, health plans and others often express administrative costs as a percent of premiums. Indeed, the insights thought to be available through the use of this metric is an underlying premise of the medical loss ratio provisions of the Patient Protection and Affordable Care Act.

As shown in Figure 3, administrative expenses were 8.4% of premium equivalents for comprehensive products sold by Independent/Provider-Sponsored plans. The 25th percentile value was 7.7% and the value at the 75th percentile was 10.1%.

Comparing these results to those in Appendix B, 2010 administrative expenses were 41 basis points higher relative to premium equivalents. But here the effects of mix differences are evident. Of the seven products continuously reported, only two had higher ratios, Insured POS and Medicare Supplemental. All other commercial products had lower ratios, as did Medicare Advantage and Medicaid. Please see the Mid-July 2010 edition of *Plan Management Navigator* for comparative information from 2009.

The effect of mix is also evident when one looks at the components of the administrative expense ratios. Except for Sales and Marketing's increase, all other clusters of functions declined relative to premium equivalents. While we prefer medians because they mute the effects of outliers, as the 50th percentile values, medians don't sum and mix differences exacerbate this counterintuitive result.

Corporate Services costs declined as a percent of premiums by 24 basis points, to 1.2%. Twenty-five percent of plans had values below 1.1% of premium equivalents or above 2.0% of premium equivalents in 2010.

This decline was followed by Account and Membership Administration, which declined by 10 basis points to 2.7% of premium equivalents. (Both 2010 and 2009 figures report the direct costs of Pharmacy and Mental

Calculation of Premium Equivalents

Administrative services relationships, comprising approximately 24% of all Independent/Provider-Sponsored 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 health plans provide rather than for the cost of care, which is borne by the self-insured groups. In other words, under GAAP accounting, if expressed as a percent of revenues, administrative expenses under ASO arrangements will have a denominator that is a small fraction of the premium dollar, dashing the intuitive appeal of the administrative expense ratio. This is a recurring problem that became increasingly visible during health care reform debates.

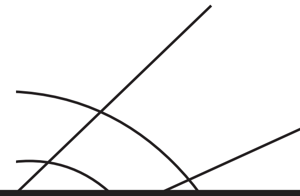
Our solution to mitigating this potential for misinterpretation is to express expenses as a percent of premium equivalents. Since each of the plans submits the health care expenses for the self-insured groups (which they know since they process their groups' self-insured claims), by adding this amount to the administrative service fees actually billed, we are able to estimate what the premiums would have been if the groups has been insured. These are called premium equivalents.

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

Figure 3. Benchmark Summary
Independent/Provider-Sponsored Costs by Functional Area Cluster, 2010 Data
Percent of Premium Equivalents

	25th PCTL	75th PCTL	Median	σ/ Mean
Sales & Marketing	2.3%	3.3%	2.6%	22.4%
Provider & Medical Management	1.1%	1.9%	1.3%	31.2%
Account & Mem. Administration	2.5%	3.5%	2.7%	27.9%
Corporate Services	1.1%	2.0%	1.2%	43.4%
Total	7.7%	10.1%	8.4%	17.0%

**Account & Membership Administration Includes Pharmacy and Mental Health*



Health administration within these clusters.) The value at the 25th percentile was 2.5% of premium equivalents and 3.5% of premium equivalents at the 75th percentile.

Provider and Medical Management also declined but by a rounding difference, leading to the same ratio of 1.3%. The value at the 25th percentile for Provider and Medical Management was 1.1% of premium, while 1.9% of premium equivalents represented the 75th percentile.

Only Sales and Marketing increased, by 31 basis points to 2.6% of premiums. We earlier noted that Sales and Marketing costs grew faster than most clusters and broker Commission growth was the largest single source of increase for IPS plans in 2010. Sales and Marketing costs, at the 25th percentile, were 2.3% and the value at the 75th percentile was 3.3%. The comparable median percent in 2009 was 2.3%.

Calculation of Constant Mix Rates of Expense Growth

To make the most useful comparisons of administrative expenses, it is helpful to eliminate the effects of product mix differences. This improves comparability both between organizations with different product mixes and between periods.

Accordingly, in comparing expenses between periods, we hold constant the product mix between the two years. This is especially important since Medicare Advantage and Medicaid products have increased in the product portfolios of Independent/Provider-Sponsored plans. Medicare Advantage consumes far more resources per member than comparable products for people under 65 years of age, and marketing costs are sharply lower for Medicaid products.

Thus, excluding the effect of mix changes can provide additional valuable insights to trends in health administrative expenses as they are reported. To calculate cost trends while excluding mix changes, we take advantage of the fact that Independent/Provider-Sponsored plans report to us by product. We can then reweight their prior year expenses to match the product mix in the current period. We then calculate the rates of change in costs based on these reweighted estimates.

Administrative Expenses by Product

All participants in our benchmarking studies segment their costs by product, as well as by over forty functional areas. Our participants have the ability to segment these costs either through quite robust activity-based costing systems, or through commonsense activity-based allocation methodologies readily available to all plan financial people. For example, members in Medicare Advantage products submit far more claims than commercial members so total claims processing costs may be allocated by claims as opposed to members. Because of lower Sales and Marketing costs, such ASO/ASC PMPM costs are usually much less than for comparable insured products.

These differences are manifest in their overall cost differences. The most expensive product offered by Independent/Provider-Sponsored plans is their Medicare SNP product at $128.08 PMPM, followed by Medicare Advantage, at $68.81 PMPM. The low cost product is Medicaid, which has a PMPM cost of $17.11.

Commercial ASO has a median PMPM cost of $19.40, also low. The Commercial HMO Insured, Commercial POS Insured and Commercial Indemnity and PPO Insured, were $29.49, $36.65 and $39.95, respectively. The cost differences between the insured and ASO products is largely the marketing cost differences found between the large and smaller groups. Product cost shown in Figure 4.

As shown in Figure 5, on a percent of premium equivalent basis, the product ranking of administrative expenses is different. The lowest median percent of premium equivalents for comprehensive products was commercial ASO/ASC at 5.2%, while the high cost product is Commercial Insured Indemnity & PPO at 11.7%.

Note that while, Medicare SNP, the high cost plan on a PMPM basis, it is lower than average measured as a percent of the premium dollar, at 7.7%. Medicare Advantage is also relatively low cost at 7.8%. Medicare Supplemental and Medicare Cost are relatively high at 11.5% and 8.5%, respectively. The Commercial HMO Insured and Commercial POS Insured are, respectively, 9.1% and 9.4% of premiums.

As an aside, a comparison of Figures 4 and 5 with the comparable figures in the *Plan Management Navigator* earlier this month illustrates the complexity of making comparisons between sets of health plans, specifically Blue Cross Blue Shield (Blue) Plans. One important factor is product mix: because IPS plans are far more heavily committed to Medicare Advantage than are Blue Plans, IPS plans have higher PMPM costs and lower costs relative to premiums. Notwithstanding the limitations, one possible generalization may be made – the universes tend to have low costs in areas of historic product focus. IPS plans have lower costs for their Insured HMO business while Blue Plans have low costs in their Insured Indemnity business.

Figure 4. Benchmark Summary
Independent/Provider-Sponsored Costs by Product, 2010 Data
Per Member Per Month

	25th PCTL	75th PCTL	Median	σ/ Mean
Commercial Insured				
HMO	$25.41	$39.50	$29.49	28.2%
POS	$23.54	$41.96	$36.65	39.1%
Indemnity & PPO	$29.10	$44.45	$39.95	24.7%
Commercial ASO	$14.22	$24.20	$19.40	34.1%
Medicare Supplemental	$23.94	$31.91	$25.90	35.1%
Medicare				
Advantage	$61.02	$81.53	$68.81	27.5%
SNP	$121.27	$169.47	$128.08	34.5%
Cost	$27.08	$45.10	$29.53	51.1%
Medicaid	$15.51	$26.16	$17.11	34.4%
Comprehensive Total	$24.62	$38.83	$31.99	27.3%
Medicare Part D	$16.58	$20.83	$19.89	37.9%

Figure 5. Benchmark Summary
Independent/Provider-Sponsored Costs by Product, 2010 Data
Percent of Premium Equivalents

	25th PCTL	75th PCTL	Median	σ/ Mean
Commercial Insured				
HMO	8.3%	10.8%	9.1%	23.3%
POS	7.6%	13.0%	9.4%	49.0%
Indemnity & PPO	9.0%	14.7%	11.7%	37.8%
Commercial ASO	4.7%	7.5%	5.2%	35.8%
Medicare Supplemental	9.0%	15.5%	11.5%	37.1%
Medicare				
Advantage	7.1%	9.9%	7.8%	19.9%
SNP	6.5%	11.4%	7.7%	55.0%
Cost	7.8%	10.8%	8.5%	32.8%
Medicaid	6.5%	10.6%	7.3%	36.0%
Comprehensive Tot	7.7%	10.1%	8.4%	17.0%
Medicare Part D	7.1%	15.2%	12.9%	56.5%

Background on Sherlock Benchmarks

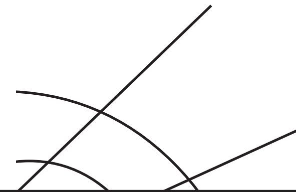
The universe in this analysis consisted of fifteen Independent/Provider-Sponsored plans, which collectively serve 5.8 million members. With an average size of 385,000 members, these are substantial organizations and represent a who's who of such plans. They are regionally-prominent organizations, in part because they often are associated with leading health systems. Twelve of this year's participants participated in the previous year and 67% of this year's participants have five or more years of experience participating in *SEER*.

Approximately 1.1 million of the commercial members were served under some form of self-insurance arrangement, comprising approximately 24% of their total commercial members. Medicare Advantage, offered by 12 plans, comprised 6.5% of their total comprehensive membership. In 8 of the plans, Medicare Advantage comprised more than 20% of their total revenues.

Rates of change in costs are calculated by including only plans that participated in both of the comparison years. By contrast, PMPM values are actual for all plans in the universe. We employed median values throughout this analysis as the measure of central tendency because it minimized the effects of any outlier responses.

Including all of our benchmarks, those published in 2011 will comprise the experience of more than 510 health plan years. We also have universes of Blue Cross Blue Shield Plans, TPAs, Larger Health Plans, Medicare Advantage Plans and Medicaid Plans. In August, we will publish on TPAs and expect to publish on Medicaid and Medicare plans in September.

Navigator



Why Administrative Costs Matter Now

The Patient Protection and Affordable Care Act and the weak economic environment has increased the impetus to manage health plan administrative costs. According to the Bureau of Labor Statistics, seasonally-adjusted employment declined from a peak of 146.6 million in November 2007 to 139.8 million in May 2011. 13.9 million people were unemployed and 6.2 million had been unemployed for six months or more. A June 2011 report by the Kaiser Commission on Medicaid and the Uninsured found that 57% of adults who were unemployed and looking for work were uninsured. For health plans, the weak economy contributes to a loss of membership and a commensurate need to reduce administrative costs.

Health care reform leads to additional pressures on health plan administrative expenses. The Affordable Care Act, signed into law in March 2010, does this in two notable ways: Premium rate increases will be subject to more intense oversight and medical loss ratios (MLRs) will be subject to strict minimums. In fact, the MLR rule is explicitly intended to encourage efficiency: "The rebate provisions of section 2718 are designed not just to provide value to policyholders, but also *to create incentives for issuers to become more efficient in their operations*." (Italics added.) In short, health care reform limits managerial latitude in many strategic decisions leaving chiefly administrative cost management as the principal avenue of managerial discretion.

Government-sponsored programs are similarly subject to administrative cost pressures. Under the Affordable Care Act, Medicare Advantage will be subject to medical loss ratio rules beginning in 2014. The pressures on Medicaid are important but more indirect. High unemployment has increased the number of people eligible for Medicaid. Also, under the Affordable Care Act, one-half of all newly insured people will be new enrollees in state Medicaid programs. So, while membership growth can be anticipated for Medicaid plans, state Medicaid programs are under financial stress as 44 states and the District of Columbia are projecting 2012 budget shortfalls. Thus, as with commercial plans, close attention to the management of administrative expenses is today will be central to maintaining viability for Medicaid and Medicare plans, now and in the future.

Appendix A. Benchmark Summary
Independent/Provider-Sponsored Costs by Functional Area Cluster, 2009 Data
Per Member Per Month

	25th PCTL	75th PCTL	Median	σ/ Mean
Sales & Marketing	$7.87	$9.81	$8.97	31.7%
Provider & Medical Management	3.73	6.54	4.86	46.1%
Account & Mem. Administration	8.41	11.69	10.64	31.4%
Corporate Services	3.82	7.16	5.51	48.3%
Total	$23.64	$37.76	$28.35	28.7%

**Account & Membership Administration Includes Pharmacy and Mental Health*

Appendix B. Benchmark Summary
Independent/Provider-Sponsored Costs by Functional Area Cluster, 2009 Data
Percent of Premium Equivalents

	25th PCTL	75th PCTL	Median	σ/ Mean
Sales & Marketing	2.0%	3.1%	2.3%	29.4%
Provider & Medical Management	1.0%	1.7%	1.3%	34.6%
Account & Mem. Administration	2.7%	3.1%	2.8%	22.5%
Corporate Services	1.2%	1.8%	1.4%	39.4%
Total	7.2%	9.0%	8.0%	17.9%

**Account & Membership Administration Includes Pharmacy and Mental Health*