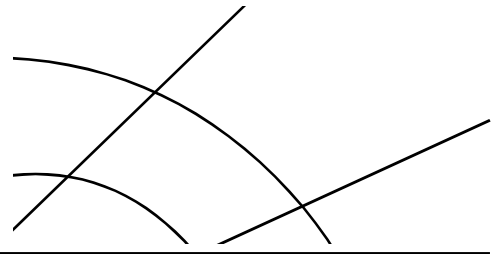




Plan Management Navigator



Analytics For Health Plan Administration

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LESSONS FOR HEALTH PLANS FROM THE INVESTMENTS INDUSTRY: PART 1 – FROM DISILLUSION TO UNBUNDLING

The health plan industry, as in the investments industry, has recently been subject to deep consumer skepticism concerning the value of the products that it sells. In both industries, consumers have reacted by demanding that services be unbundled, measured and priced separately. In the securities industry, consumers scrutinize both returns and management fees or commissions, while health care consumers can increasingly analyze health care separately from health plan administration. In the near and intermediate term, we think that administrative costs will be subject to the greatest pressures because they are the more easily measured and managed expense.

There are similarities between the components of the respective products: The securities production chain has the underlying performance of the portfolio plus a relatively small amount of various fees to purchase or manage the investments. The health care chain is comprised of the direct expenditures on health care, plus a relatively small amount of infrastructure to fund it.

The securities industry and the health plan industry seem to share industry dynamics. In both industries, customers are deeply conscious of the high cost of failure of the product and both have products whose performance is hard to reliably predict in advance. Historically, the presence of professionals in the production chain has served as the indicator of quality.

More recently, however, consumers have expressed skepticism about their experiences with these industries. As historically configured, they wonder whether they have gotten their money's worth from their vendors. As shown below, while their manifestations are different, these two industries face similar gulfs between consumer expectations and performance.

<i>Investments Industry</i>	<i>Health Plan Industry</i>
<ul style="list-style-type: none"> ▪ It is difficult to outperform the market as a whole and many managers fail to do so consistently. ▪ While active managers are paid to outperform the market, Modern Portfolio Theory is that managers, in general, can't do so. ▪ Consumers have been concerned whether sell-side analysts active in underwriting have conflicts of interest. 	<ul style="list-style-type: none"> ▪ Managed care has not, in the eyes of many consumers, met expectations for costs or quality. ▪ Consumers have expressed skepticism over the efficacy and appropriateness of utilization management procedures. ▪ Conflicts of interest are alleged. "Profits versus patients" is a misleading but resonating implication of conflicts of interest.

Dashboard Summary for August

For the trailing three months ended August 31, 2005, the twelve health plans in our Health Plan Dashboard reported revenue growth of 3.2%, with ASO/ ASC growth of 31.9% and managed care revenue decreased by 0.8%. Membership declined by 10.2% for managed care but increased by 41.2% in the indemnity business. Managed care and ASO had price increases of 11.6% and 24.0%, respectively, while indemnity posted an increase of 4.3%.

Health benefits ratios overall increased by 0.9 percentage points, but increased by 2.3 percentage points for managed care lines and decreased by 0.8 percentage points in indemnity lines. The number of scripts per person increased by 0.2 to 8.9 on an annualized basis. E/R visits decreased by 9.8 to an annual rate of 260.4 per thousand and hospital days per thousand decreased by 3.1 days to 302.6 days per thousand.

Administrative expense to premium decreased by 0.3 percentage points to 9.2% - per capita claims volumes increased while inquiries per member decreased. Staffing ratios increased by 0.50 FTEs to 17.4.

Information in our health plan dashboard is segmented by product. It is intended to complement the Sherlock Expense Evaluation Report in its brevity and timeliness. Please contact us regarding ordering information.

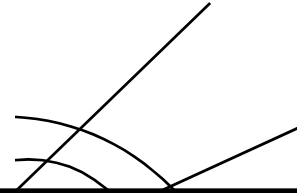
Consumers naturally react to such dissatisfaction by changing the way they do business. Their preferences, expressed in their respective markets, has been to unbundle services to facilitate measurement and pricing of each of the separate components. This of course means that discretion is withdrawn from the managements of these formerly bundled services.

For the securities firms, over many years there has been a shift away from the assumption that a favored brokerage firm was the best way to have both best execution as well as best investment advice. Mutual funds have shifted in favor of much more narrowly targeted investment objectives, and consumers increasingly favor index funds.

For health plans, the bundled relationship was less long-lived because managed care made its most significant impact in the brief period between the mid-1980's to the mid-1990's. (Many would argue that, in the Alain Enthoven's *Health Plan* sense, it was never really adopted since for the most part consumers did not have the opportunity to choose between integrated delivery systems.) The role of professionals were briefly bundled with the managed care product as gatekeepers, a task



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for which they had mixed degrees of enthusiasm and expertise, and as medical directors and leaders of the health plans themselves.

The unbundling has taken the forms below, though consumer embrace of this is not universal. For instance, we know of numerous successful provider-sponsored health plans and Kaiser Permanente remains highly regarded by consumers, while many investors are well served by investment professionals assisting them in very traditional ways.

benefit plan models make them increasingly financially responsible. However, like the securities industry, we think that pressures will continue on administrative expenses. We note with interest that growth in administrative expenses among fifteen Blue Cross Blue Shield Plans we tracked were 0.2%, excluding medical management and broker commissions, down from 10.0% last year.

By the same token consumers are gaining access to new tools to measure performance. The following table outlines some of the interesting new means of understanding the value of the health care and investments that are available to consumers.

Like all analogies, the comparison between the investments industry and the health plan industry is necessarily simplified. For instance, whether medical management is a part of health care or administration is not discussed, and in truth its status will finally await the unit of delivery that consumers finally choose to receive care. But the point here is, as in the investment industry, consumers are adapting to their dissatisfaction by segmenting the health care production chain into ways in which it can be priced and measured more efficiently.

That both health care and investment services can be segmented has similar implications for both industries. Since both health care performance and investment returns are similarly difficult to predict in advance, administrative costs in each industry is the focal point of cost containment efforts. In the second part in this series, we will discuss the very specific implications of this on the operations of the specific businesses.

<i>Investments Industry</i>	<i>Health Plan Industry</i>
<ul style="list-style-type: none"> ▪ Split of execution from research from brokerage relationships. Hard-dollar research becomes available for purchase, outside the commission structure. ▪ Commissions and management fees become an element differentiating brokers and mutual funds, respectively. ▪ Use of auctions for pricing IPOs to eliminate brokerage firm allocation and pricing discretion. ▪ Greater use of Index Funds, virtually eliminating manager discretion. ▪ Rule FD disintermediates the analyst from the issuer - investor relationship. ▪ Greater use of highly targeted mutual funds 	<ul style="list-style-type: none"> ▪ Units of delivery of care shift from prepaid group practice, tight networks and integrated delivery systems, or Primary Care Gatekeepers to third party payments to providers in open networks. ▪ Consumer-Directed Health Care provides strong incentives to buy <i>each</i> aspect of health care delivery with efficiency. ▪ Consumers migrate to health plans offering a reduction or elimination of referral requirements. ▪ Utilization review efforts under closer internal scrutiny for cost-effectiveness by health plans. ▪ Health plan divestiture of health care delivery assets. ▪ Sale of provider-sponsored health plans by their sponsors.

Having broken the links in the production chain, consumers can endeavor to measure and price components separately. The larger components, the portfolio and health care performance, are recognized as hard to predict, while the much smaller commissions, fees and administrative expenses are priced as highly predictable services.

Depending on their view of their own and others' abilities to manage investments, the most demanding consumers often either minimize the risk in the portfolio by indexing, or perform their own research on investments. Using either strategy, they pay less to purchase or manage investments. For instance, institutional investors paid \$0.056 per share in late 1998 versus \$0.046 as of January 2004, while the expense ratio charged by Vanguard fell from 0.62% in 1978 to 0.26% in 2002.

Health care is subject to similar pressures. Like indexing¹, current health plan models take away discretion from management and consumers are increasingly encouraged to do their own research and certain

Footnotes:

¹ Ad drawback to this analogy is that while consumers may find market average performance to be attractive for investments, a patient might find it intolerable to receive average care.

<i>Investments Industry</i>	<i>Health Plan Industry</i>
<ul style="list-style-type: none"> ▪ Use of index funds increases, to assure the quality of investment performance achieves minimal standards of acceptability. ▪ <i>Wall Street Journal</i> approach to analyst measurement (versus <i>Institutional Investor</i>) ▪ Morningstar and other services come into their own to rate fund performance. ▪ Greater information provided to mutual fund investors about the management fees that they pay. 	<ul style="list-style-type: none"> ▪ WebMD, Aetna, BCBSA, etc. establish capacity to "rate" providers. ▪ Increased prominence of HEDIS and other rating services. ▪ Growing attractiveness of ASO/ASC arrangements, and growing awareness of their costs. ▪ Brokers and advisors increase their capacity to evaluate health plans.

