



SCALE SOMEWHAT AFFECTS BLUE ADMINISTRATIVE COSTS

Conventional wisdom holds that health plans administrative costs can be reduced through economies of scale. Analysts ranging from Peter Kongstvedt, to Ken Thorpe and to Himmelstein and Woolhander have suggested this probability. In the analysis we examine the performance of Larger Health Plans, often considered to exemplify best practices.

Over the years Sherlock Company has frequently studied scalability in administrative costs. With 230 health plans years of data, we are well equipped to do so. However, the overall scale effects are modest as most functional areas do not seem to display economies of scale.

To further examine the effects that size has on administrative costs, we compared universes Blue Cross Blue Shield Plans with Larger Plans. Larger Plans' total expenses were \$20.49 per member per month (PMPM), 22.5% lower than Blue Plans'.

However, Larger Plans' costs by product line varied across the board compared to Blue Cross Blue Shield Plans' costs. So we also performed an analysis that adjusted the Blue Cross Blue Shield universe's product mix, to resemble that of the Larger Plan universe. After we adjusted Blue Cross Blue Shield Plans' product mix to match Larger Plans' product mix, Larger Plans were only 2.3% or \$0.55 PMPM lower.

Before product mix adjustments Larger Plans' marketing costs were 22.5% lower than Blue Cross Blue Shield Plans. Account and Membership Administration and Corporate Service costs were also lower by 5.1% and 1.7%, respectively. Medical and Provider Management costs, however, were 15.7% higher.

Five Blue Cross Blue Shield Plans, with a mean membership of 3.1 million members, were selected for the Larger Plans Edition. The plans were relatively uniform and possessed the ability to compile high-quality, segmented financial and operational data. The mean membership of Blue Cross Blue Shield, with which the Larger Plans are compared, is 1.5 million members.

Larger Plans' Expenses by Functional Area Cluster

Marketing expenses included Rating and Underwriting, Product Development / Market Research, Sales and Marketing, Commissions and Advertising and Promotion. These expenses represented \$5.23 PMPM of the total administrative costs. At the 75th percentile, these costs were \$6.46 but only \$5.13 at the 25th percentile.

Medical & Provider Management was composed of Provider Network Management and Services and Medical Management. These expenses had a median value of \$3.32 PMPM. At the 75th percentile, these costs were \$3.47, but were as low as \$3.18 at the 25th percentile. Expenses for Medical & Provider Management are highly sensitive to the mix of products offered: Managed care products such as HMOs tend to require a higher commitment to this cluster of functions.

Account & Membership Administration had a median value of \$9.21 PMPM of administrative expenses in 2005, the largest share of administrative costs. This category of expenses includes many of the core functions such as Enrollment (including Membership and Billing), Customer Services, Information Systems and Claims (including Encounter Capture and Adjudication). Plans reported \$11.24 at the 75th percentile and \$7.73 at the 25th percentile. These expenses were more clustered than the other breakouts.

Corporate Services was the last category. It included investments in HIPAA compliance as well as Finance and Accounting, Actuarial, Corporate Services (including Human Resources, Facilities, Legal and Regulatory) Corporate / Executive and Association Dues and Miscellaneous Business Taxes). These expenses had a median value of \$5.69 PMPM in administrative expenses. Plans reported \$3.98 at the 25th percentile and \$5.93 at the 75th percentile.

Total Administrative Expenses were \$20.49 median expenses per member per month. This includes all administrative costs such as Marketing, Medical and Provider Management, Account and Membership Administration, and

Figure 1. Benchmarks for Larger Plans' Administrative Expenses: 2005
Cost Per Member Per Month - By Function, Comprehensive Products

	25th Percentile	75th Percentile	Median	¢/Mean	Median Blue Universe	Large Pct. Blue
Marketing	\$5.13	\$6.46	\$5.23	38.10%	\$6.74	77.55%
Medical / Provider Mgmt.	\$3.18	\$3.47	\$3.32	27.93%	\$2.87	115.69%
Account / Membership Admin.	\$7.73	\$11.24	\$9.21	25.09%	\$9.70	94.98%
Corporate Services	\$3.98	\$5.93	\$5.69	27.29%	\$5.79	98.27%
Total Expenses	\$20.28	\$27.10	\$20.49	26.46%	\$26.43	77.52%

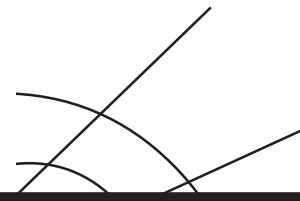


Figure 2. Benchmarks for Larger Plans' Administrative Expenses: 2005

Cost Per Member Per Month - By Product Line

	25th Percentile	75th Percentile	Median	σ /Mean	Median Blue Universe	Large Pct. Blue
Commercial HMO						
Insured	\$27.42	\$41.88	\$35.42	42.12%	\$34.59	102.40%
ASO / ASC	\$17.73	\$27.92	\$19.34	45.67%	\$19.34	100.00%
Commercial POS						
Insured	\$27.78	\$34.36	\$31.78	21.49%	\$29.95	106.11%
ASO / ASC	\$19.52	\$22.30	\$20.60	13.34%	\$18.53	111.17%
Indemnity & PPO						
Insured	\$27.83	\$41.50	\$29.99	29.44%	\$29.99	100.00%
ASO / ASC	\$16.18	\$18.96	\$17.89	14.46%	\$18.80	95.16%
Medicare Advantage	\$41.47	\$66.82	\$46.79	47.25%	\$54.21	86.31%
Medicaid HMO	\$21.39	\$22.34	\$21.87	6.13%	\$22.82	95.84%
Medicare Supplemental	\$21.83	\$25.72	\$24.30	19.25%	\$24.30	100.00%
Stand-alone Dental	\$3.92	\$4.29	\$4.11	12.81%	\$3.73	110.19%

Corporate Services. Plans reported \$27.10 at the 75th percentile and \$20.28 at the 25th percentile.

Larger Plans' Expenses by Product

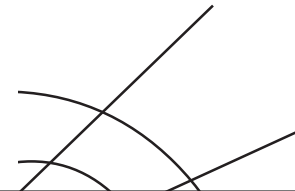
Due to varying resource requirements, total costs differed by product. For instance, HMO products tend to have a much greater commitment to medical management, and the various ASO products operate with lower marketing costs than their insured counterparts.

Among insured products, Medicare Advantage had the highest costs at \$46.79 PMPM. Commercial HMO Insured had median costs of \$35.42 PMPM. Commercial POS and Indemnity & PPO Insured costs were \$31.78 PMPM and \$29.99 PMPM, respectively. Medicaid HMO and Medicare Supplemental had costs of \$21.87 PMPM and \$24.30 PMPM, respectively. ASO/ASC products typically cost between \$10 to \$15 less PMPM to administer than their insured.

Figure 3. Benchmarks for Larger Plans' Administrative Expenses: 2005

Costs as a Percent of Premium or Equivalents - By Product Line

	25th Percentile	75th Percentile	Median	σ /Mean	Median Blue Universe	Large Pct. Blue
Commercial HMO						
Insured	11.67%	17.02%	13.99%	13.87%	14.46%	96.75%
ASO / ASC	7.96%	14.55%	9.56%	50.12%	9.56%	100.00%
Commercial POS						
Insured	11.34%	13.49%	13.25%	19.41%	13.49%	98.22%
ASO / ASC	9.11%	11.00%	9.45%	19.64%	9.11%	103.73%
Indemnity & PPO						
Insured	12.03%	13.88%	13.69%	27.09%	13.88%	98.63%
ASO / ASC	8.25%	9.08%	8.83%	24.65%	9.08%	97.25%
Medicare Advantage	5.51%	8.74%	6.59%	45.14%	7.89%	83.52%
Medicaid HMO	9.88%	11.99%	10.93%	7.95%	13.04%	83.82%
Medicare Supplemental	15.33%	20.35%	20.18%	20.11%	15.33%	131.64%
Stand-alone Dental	15.81%	16.10%	15.95%	2.50%	16.24%	98.21%



Larger Plans' Costs as Percent of Premiums or Equivalents by Product

Administrative expenses also varied by product when expressed as a percent of premiums or equivalents. Excluding the effects of services that are commonly capitated such as behavioral health and prescription drugs, Medicare Advantage had the lowest costs, at 6.6% of premiums. Medicare Supplemental had the highest costs as percent of premiums at 20.2%. Commercial Insured products tended to be slightly below the median of Blue Plans while Commercial ASO products tended to be in line with Blue Plans.

Among the Commercial Insured products, HMO had the highest costs at 14.0% of premiums, followed by Indemnity & PPO at 13.7% of premiums and Commercial POS at 13.3% of premiums. Again, the Commercial ASO/ASC products comprised a lower percent of premium equivalents than their insured counterparts. Indemnity and PPO was 8.8%, Commercial POS was 9.5% and Commercial HMO was 9.6%.

Larger Plans' Expenses Compared to Blue Plans

Scalability is a factor in health plan administration, as is readily apparent in start-ups of new plans and new products of old plans. This seems to be a factor when comparing Larger and Blue Plans. Overall, Larger Plans had lower expenses compared to Blue Plans. Marketing expenses for Larger Plans were 22.5% lower than the Blue Plans.

Within the functional area of Marketing, commissions were 14.6% lower than Blue Plans possibly due to their larger commitment to ASO products. Such products are normally sold to larger employers who rely on internal resources or consultants in the development of their benefit offerings. Medical and Provider Management was the only area Larger Plans' expenses were higher, by 15.7%. Account and Membership expenses were 5.1% lower than Blue Plans. IS Expenditures and Claim and Encounter Capture and Adjudication costs were 9.3% and 10.7% lower than Blue Plans, respectively. This helped to explain the lower Account and Membership expenses for Larger Plans. Corporate Services expenses were 1.7% lower than that of Blue Plans.

Results Adjusted for Product Mix

As previously noted, different products require different resource commitments. Thus, when considering the effects of scale, it is illuminating to adjust for any differences in product mix.

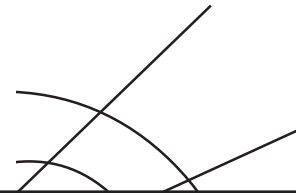
It is notable that mixes are somewhat different between the Larger Plans and Blue Plans as a whole. Larger Plans tended to concentrate more in Indemnity & PPO, ASO where 44.5% of the product mix was this product compared to the 39.3% share offered by the Blue Plans. Total Commercial Insured was 7.4 percentage points lower in the product mix for Larger Plans.

Figure 4. Benchmarks for Larger Plans' Administrative Expenses: 2005 Product Mix

Product Mix	Larger Plans	Blue Plans	Difference
	Universe	Universe	
Commercial HMO Insured	4.2%	5.7%	-1.5%
ASO/ASC	0.9%	1.3%	-0.5%
Commercial POS			
Insured	4.0%	3.6%	0.4%
ASO/ASC	4.5%	3.7%	0.8%
Indemnity & PPO			
Insured	27.5%	33.8%	-6.3%
ASO/ASC	44.5%	39.3%	5.2%
Tot. Comm. Ins.	35.7%	43.1%	-7.4%
Tot. Comm. ASO	49.9%	44.4%	5.5%
Medicare HMO	1.8%	1.4%	0.4%
Medicaid HMO	2.6%	1.8%	0.8%
Medicare Supplemental	10.1%	9.3%	0.7%
Total Comprehensive	100.0%	100.0%	0.0%

To understand how we adjust for product mixes, it is important to recall that each Plan reports expenses by functional area and by product. Therefore, we are able to segment costs into function / product expense cells, such as marketing costs for HMO products sold on an ASO basis. Accordingly, each Plan's total administrative costs effectively represents a membership-weighted total. So, in order to adjust for product mix differences, all we have to do is to reweight the product/function expense cells so that the two universes have identical product mixes. To eliminate the effect of product mix on costs, we adjusted the product mix of the Blue Cross Blue Shield universe, measured by members, to equal that of Larger Plan universe. The results are shown in Figure 5.

On a product mix adjusted basis, Larger Plans operate \$0.55 PMPM lower or 97.7% of the adjusted median of \$24.00 PMPM for the Blue Plans. Much of this difference can be



attributed to \$0.95 PMPM difference in functional area of Account and Membership Administration, in which Larger Plans were less than Blues.

Marketing costs were \$0.26 PMPM lower, or 95.9% of the Blue Cross Blue Shield median. As stated previously, Larger Plans tended to have a higher concentration of ASO products than Blues. This would ultimately lead to a lower cost in marketing due to a lower expense of commissions, which is the lion's share of costs for the functional area.

Provider and Medical Management costs were \$0.48 PMPM higher and were 117.2% of the median. Corporate Services costs were \$0.18 PMPM higher than the Blue Cross Blue Shield universe or 103.4% of the median.

Account and Membership Administration costs were 90.2% PMPM of the median and \$0.95 PMPM lower than the median for the Blue Plans. It is interesting to note that IS Expenditures were 9.3% lower in Larger Plans than in Blue Plans, as stated earlier, which could explain some of the difference between universes. This difference between Larger Plans and Blues lends to the idea that there is a hint of possible scalability in the area of Account and Membership Administration and the managers of Larger Plans are getting more in return for the money they spend than those of Blue Plans.

The Larger Plans Edition of *SEER* is one of several Sherlock Company benchmarks for the management of health plan performance. Other universes include Medicaid Plans, Independent (mainly Provider Sponsored) plans, Blue Cross Blue Shield Plans, Medicaid-oriented plans, and Medicare Advantage plans.

In addition to the financial metrics, other performance metrics are included in companion volumes of operational metrics. These metrics include factors affecting costs such as member use of the function, employee productivity, unit cost and staffing ratios. These volumes also include various drivers of such metrics, the extent to which these functions are performed electronically, quality measures, employee compensation analyses, and other function-specific measures. Key functional areas include marketing, customer service, claims, enrollment, medical management, healthcare utilization, and provider relations. Examples of metrics are average cost per inquiry, average speed of answer and the average cost, speed and accuracy of processed claims.

Figure 5. Benchmarks for Larger Plans' Administrative Expenses: 2005
Product Mix Adjusted Total Costs

	Marketing	Provider and Med. Mgmt	Acct and Mem. Admin.	Corporate Services	Comprehensive Total
<i>Larger Plans</i>	\$6.03	\$3.28	\$8.79	\$5.36	\$23.45
Median Blue	\$6.28	\$2.80	\$9.74	\$5.18	\$24.00
Percent Median	95.9%	117.2%	90.2%	103.4%	97.7%
Difference	(\$0.26)	\$0.48	(\$0.95)	\$0.18	(\$0.55)
Pct. Total Diff.	47.1%	-87.5%	172.6%	-32.2%	100.0%

Background

Collectively, the various *SEER* reports are the definitive benchmarks for health plan administration. They are critical tools to enhance operational performance and support strategic initiatives ranging from management of the product portfolio, vendor negotiations, outsourcing and business combinations.

Volume I (Financial Metrics) of *SEER* Larger Plans contains ten principle product areas and fifty-five functional areas. Separate analyses include individual products, small group and national accounts, outsourced functions such as mental health, pharmacy and COB / Subrogation and function allocated information systems. Products include HMO, Point-of-Service, Indemnity and PPO, Medicare Advantage, Medicaid HMO and Medicare Supplemental.

Sherlock Company (www.sherlockco.com), based in Gwynedd, Pennsylvania, provides informed solutions for health plan financial management. Since its founding in 1987, Sherlock Company has been known for its impartiality and technical competence in service to its clients.

Additional information concerning the 2006 *Sherlock Expense Evaluation Reports* is available by contacting Sherlock Company.

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