

BLUE CROSS BLUE SHIELD PLANS VERSUS INDEPENDENT / PROVIDER-SPONSORED PLANS: WHO HAS LOWER COSTS?

All health plans endeavor to pare their costs to the lowest levels consistent with their growth and service objectives. Administrative expenses can be directly controlled by the management team and, in a price-sensitive competitive environment, administrative costs can be a central focus of competition. On the other hand, such cost control entails a complex tradeoff since it is hard to know in advance whether the targeted reductions will improve a plan's competitive position with a superior cost structure or harm it by inferior service.

Since health plans rarely have the ability to conduct controlled experiments to optimize their administrative costs, they often employ external benchmarks to see how others have modeled the optional solution in this tradeoff. This is analogous to inferring the value of a private company through P/E multiples in the public equity markets. As with the pricing of private stock shares, the optimal solution to the quality / cost trade-off assumes a degree of market efficiency regarding the firms' performance of their functional tasks. Accordingly, deviation from the benchmarks are operationally notable because they may require explanation for why the company has decided to pursue an "inefficient" solution.

Accordingly, the questions most commonly asked of managements are:

- How am I doing relative to my competition?
- Are there factors beyond my control that affect my standings?

- What areas are the sources of variance?

In this analysis we discuss the first two questions in the context of a comparison between our benchmarking universe of Independent / Provider-Sponsored Health Plans with our universe of Blue Cross Blue Shield Plans. In addition to organizational dissimilarities, these plans are differ in size and product mix so we explore the role of each in our analyses.

The Total Results

Overall, Blue Cross Blue Shield Plans (Blues) report lower costs than their Independent / Provider-Sponsored (IPS) competitors, when measured on a per member per month (PMPM) basis. Median total costs for IPS plans were \$4.13 higher, at \$29.49, than their Blue counterparts. (Please note that these are median values. Accordingly, the totals are not sums of the medians shown in the analysis.)

Provider and Medical Management costs for IPS plans were considerably higher as were Marketing costs. Notably, Account and Membership Administration and Corporate Services costs were lower for IPS than Blues.

Figure 1. Blues versus IPS
Median Costs by Functional Area Cluster
Per Member Per Month

	Blues	IPS	Difference
Marketing	\$7.46	\$8.23	(\$0.77)
Provider & Medical Management	3.12	4.39	(\$1.27)
Account & Mem. Administration	10.23	9.30	\$0.93
Corporate Services	4.40	4.36	\$0.04
Total	\$25.36	\$29.49	(\$4.13)

This Blue cost advantage is not as clear-cut as it appears, as shown in Figure 2. Measured as a percent of premiums equivalents, IPS's costs are lower with a median value of one percentage point less. Account and Membership Administration for

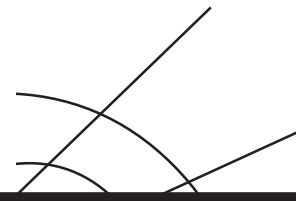


Figure 2. Blues versus IPS
Costs by Functional Area Cluster, as a Percent Premiums or Equivalents
Percent of Premium Equivalents

	Blues	IPS	Difference
Marketing	3.0%	2.6%	0.4%
Provider & Medical Management	1.1%	1.3%	-0.2%
Account & Mem. Administration	3.8%	2.8%	1.0%
Corporate Services	1.9%	1.7%	0.1%
Total	10.4%	9.4%	1.0%

IPS plans is lower by a full percentage point and, in contrast to the PMPM calculations, Marketing costs are less as a percent of premiums. As with the PMPM calculations, the Provider and Medical Management cluster of expenses for IPSs are higher and Corporate Services costs are lower than their Blue competitors.

Why do Figure 1 and Figure 2 seem to contradict one another? As we develop later, the universes' differing product mixes affects the comparisons. Both the differences in the revenue yields of the products offered and IPS's relatively heavy emphasis on managed care products contribute to the differences.

Differences by Product

A conclusion about the relative costs of these universes becomes heavily qualified when each of the products are considered individually. For some of the products, such as the POS and Medicare Advantage, IPS and Blue costs are fairly similar.

However, the biggest differences are in areas in which the respective universes have at least a reputation for concentrated focus. Blue costs

are lower in Indemnity & PPO and their Medicare Supplemental while IPSs are lower in their HMO product. Thus any aggregate comparison of costs between the two universes should to eliminate the effect of the differences in the products that they offer.

(Please note that the total for IPS plans used here and in subsequent comparisons is considerably lower than the total reported in Figure 1. Products not found in both universes were omitted in these comparisons. Medicare Cost was omitted, but more importantly Medicare Special Needs Plans, with very high per member costs was also omitted.)

Figure 4 explains what at first glance were the apparent contradictions between Figures 1 and 2. Note that in every instance of commercial products sold by IPSs and Blues, which ever peer group is lower in PMPM, Figure 3, then it is also lower when expressed as a percent of premiums, Figure 4. This is also true of Medicare Supplemental products as well. Accordingly, product mix is a

Figure 3. Blues versus IPS
Costs by Product
Per Member Per Month

	Blues	IPS	Difference
Insured Commercial			
HMO	\$30.12	\$28.61	\$1.51
POS	28.15	27.28	0.86
Indemnity & PPO	30.43	34.64	(4.21)
Commercial ASO/ASC	\$20.58	\$17.03	\$3.55
Medicare Supplemental	\$27.43	\$56.30	(\$28.87)
Medicare Advantage	69.00	69.22	(0.22)
Medicaid	19.94	24.65	(4.71)
Comprehensive Total	\$25.36	\$27.82	(\$2.46)

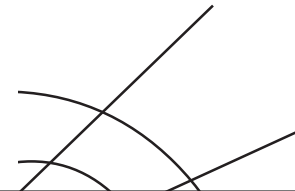


Figure 4. Blues versus IPS

Costs by Product

Percent of Premium Equivalents

	Blues	IPS	Difference
Insured Commercial			
HMO	12.0%	10.1%	1.9%
POS	10.4%	9.6%	0.9%
Indemnity & PPO	11.8%	14.2%	-2.4%
Commercial ASO/ASC	7.7%	6.4%	1.3%
Medicare Supplemental	16.4%	31.4%	-15.0%
Medicare Advantage	8.7%	7.8%	0.9%
Medicaid	9.3%	9.0%	0.3%
Comprehensive Total	10.4%	9.4%	1.0%

factor in the aggregate differences in Figures 1 and 2.

Figure 4, along with Figure 3, highlights that the relationship between costs calculated as a percent of premium equivalents and PMPM varies by product. For instance, Medicare Advantage, which has the highest administrative costs on a PMPM basis, also has among the lowest costs when expressed as a percent of premiums.

As with Figure 3, Figure 4 excludes Medicare Cost and SNP products. Because these products are only offered by Independent / Provider-Sponsored plans, we exclude the values for these products from our analysis in the balance of this report.

Effect of Product Mix

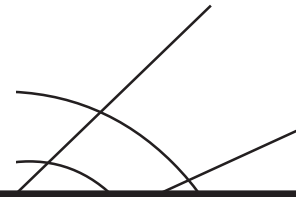
In fact, Blues and IPSs offer much different products to their customers. Independent / Provider-Sponsored Plans focus on true managed care products. HMO comprises 42.9% of their business. When added to the Medicare Advantage and Medicaid, managed care products comprises 64.1% of their product portfolio.

By contrast, Blue Cross Blue Shield Plans are heavily committed to products that entail the member or plan sponsor maintaining a high degree of discretion in their use of health benefits. Of their product mix, 83.6% are either in Indemnity & PPO, ASO/ASC or Medicare Supplemental.

Figure 5. Blues versus IPS

Median Universe Product Mix

	Blues	IPS	Difference
Insured Commercial			
HMO	6.5%	42.9%	-36.4%
POS	3.6%	2.1%	1.5%
Indemnity & PPO	40.6%	17.4%	23.2%
Commercial ASO/ASC	36.5%	16.2%	20.3%
Medicare Supplemental	6.5%	0.3%	6.2%
Medicare Advantage	2.2%	6.5%	-4.3%
Medicaid	4.2%	14.7%	-10.5%
Comprehensive Total	100.0%	100.0%	0.0%



Because the product mixes are so different, the most accurate comparisons between plans should hold constant their product mixes. Figure 6 shows the values of each universes weighted by the product mix of the opposite universe. Thus, when the product mix of IPS plans are reweighted to match the Blue product mix, IPS costs remain higher. However, when product mix of Blue plans are reweighted to match that of the IPS universe, costs are substantially identical.

Regardless of how they are adjusted, within the functional area clusters, IPS plans have higher Marketing and Provider and Medical Management costs. They also have lower Account and Membership Administration Costs. Reversing the comparisons in Figure 1, the Corporate Service cost cluster is higher for IPS plans than Blue plans. (Numbers differ from the Figure 1 presentation in that the values are the products of the median costs and their median product mixes, and also exclude the SNP and Medicare Cost expenses, as previously noted.)

Blue Shield or Independent / Provider-Sponsored plans. The term scatter diagram seems especially appropriate here, and the regression line indicates that less than one percent of the difference in administrative expenses can be explained by scale.

Because it is important to consider the effect of product mix, we made a second scatter diagram taking that factor into account. To do so, we analyzed the relative performance of each plan individually. First, we reweighted the product mix of the combined universe so that it exactly matched that of the company to be analyzed. Then, we multiplied the resulting product mix times the median cost of each product for the universe. Thus, the product-mix weighted costs are exactly comparable to that of the company to be analyzed. Finally, we subtracted the actual values of each plan from the product-mix adjusted universe: A negative value means that a plan's costs are below that of the universe, considering the mix, while a positive value means that its costs are high on a mix adjusted basis.

Figure 6. Blues versus IPS
Product Mix Adjusted Costs by Functional Area Cluster
Per Member Per Month

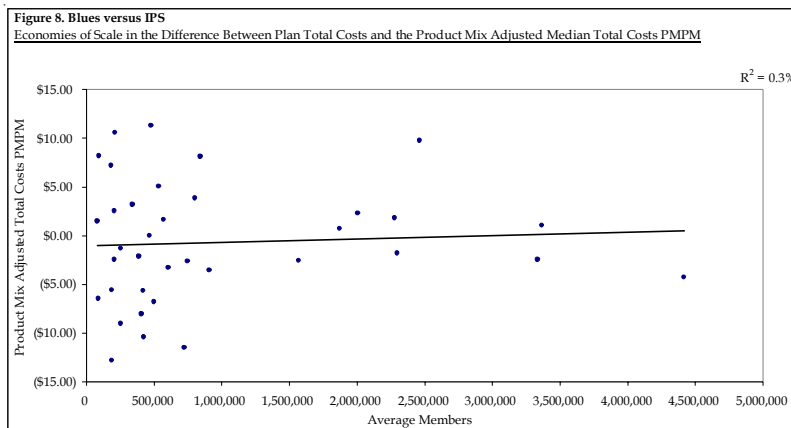
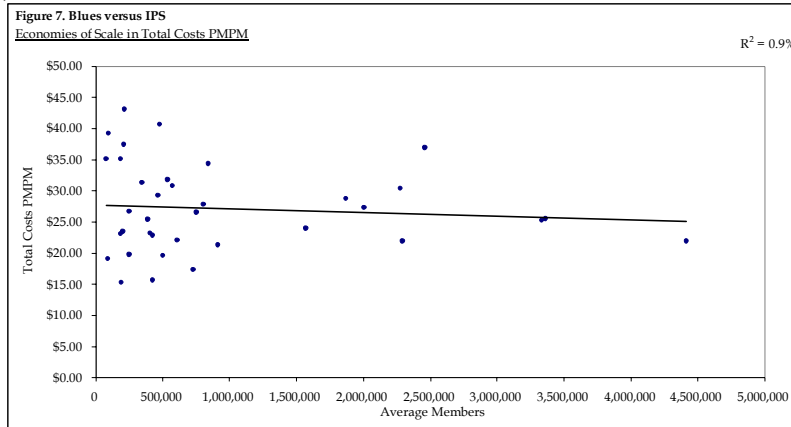
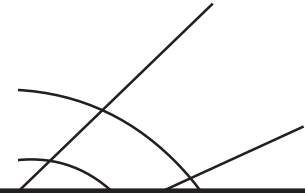
	Blues Product Mix			IPS Product Mix		
	Blues	IPS	Difference	Blues	IPS	Difference
Marketing	\$7.72	\$9.43	(\$1.70)	\$7.83	\$9.03	(\$1.19)
Provider & Medical Management	3.29	4.02	(0.72)	4.32	\$4.49	(0.17)
Account & Mem. Administration	10.44	8.29	2.15	10.84	\$8.69	2.15
Corporate Services	4.64	5.34	(0.70)	5.02	\$5.65	(0.64)
Total	\$26.95	\$29.30	(\$2.35)	\$29.62	\$29.90	(\$0.28)

Economies of Scale

In light of the fact that when IPS product mix was reweighted to match the Blue mix Blues had lower costs, then it is reasonable to wonder whether the Blues enjoy a scale advantage over IPS plans. Blue plans are in fact larger with an average membership of 1.3 million as against 308,000 for the IPS plans.

Figure 7 maps the PMPM costs against the size of the plans. The plotted plans include all of the plans regardless of whether they are Blue Cross

Figure 8 is similar to Figure 7 in that economies of scale, if present, explain little of the differences in costs between the plans. We interpret the slightly positive slope as indistinguishable from demonstrating no scalability at all.



Organizational Form

Finally, we thought it might be informative to rank the plans in their relative costs to illustrate their distribution, noting whether they are Blue or IPS. We have compared the costs between Blue and IPS plans in an informal way, ranking each plan by the relationship between its costs and that of the universe, after having reweighted the costs in the universe to exactly match the mix in each plan. This is the same relative cost data that was employed to develop the regression line used in Figure 8.

The intent here is to highlight how the organizational forms of the respective plans relate to their relative ranking. There may be advantages in either organizational form. Blue Cross Blue Shield plans have a well-known and highly regarded brand name and, collectively through their Association, endeavor to hold themselves to high performance standards. Independent / Provider-Sponsored plans have their own advantages in that they are often regionally prominent and are frequently linked to a locally well-regarded provider system. In the case of provider-sponsored plans, these organizations are able to conduct medical management in a more transparent and seamless environment.

The ranking illustrates that organizational form is not firmly linked to cost leadership. Both Blue and IPS plans are scattered throughout the ranking.

More quantitatively, as shown in Figure 10, the performance of the universes seems similar. While the median values for the Blues are less than that of the IPS plans, the mean values favor the IPS plans. Mirroring the distribution of responses in Figure 9, the coefficient of variation of the absolute value of each plans performance relative to that of the product mix adjusted universe is also very similar.

More quantitatively, as shown in Figure 10, the performance of the universes seems similar. While the median values for the Blues are less than that of the IPS plans, the mean values favor the IPS plans. Mirroring the distribution of responses in Figure 9, the coefficient of variation of the absolute value of each plans performance relative to that of the product mix adjusted universe is also very similar.

Some Conclusions

This analysis indirectly highlights the important role of the individual managerial strengths within each plan in achieving overall cost leadership.

Product mix is important to take into account. The administrative costs of ASO products are two thirds of their insured counterparts and Medicare Advantage is more than twice as costly to administer than similar products for commercial members. To not take product mix differences into account is misleading for comparison purposes.



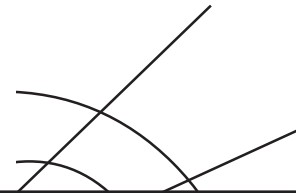


Figure 9. Blues versus IPS
Plan Ranking by Relative Adj. Costs

Plan
IPS
Blue
Blue
IPS
IPS
IPS
Blue
Blue
IPS
Blue
Blue
Blue
Blue
Blue
Blue
Blue
Blue
IPS
IPS
Blue
Blue
IPS
Blue
Blue
Blue
IPS
Blue
IPS
Blue

Figure 10. Blues versus IPS
Total Cost Product Mix Adjusted Difference
Per Member Per Month

	Blues	IPS
Median	(\$2.16)	(\$0.03)
Mean	(\$0.44)	(\$1.05)
σ / Mean	73.3%	69.9%

level of maturity in membership, scale is less important than execution.

Organizational form does not inevitably correspond with a competitive advantage. On a product mix adjusted basis, there appears to be no basis for believing that either Blue and IPS plans are structurally superior with respect to overall cost leadership.

A new look at the cost structures of health plans is appropriate. For Blues and IPS plans, this is an era of unprecedented change in product mix. The new Medicare Advantage products offered by these plans do not fit well within the existing frameworks of either of these organizations. For IPS plans, the costs are dramatically higher than found in commercial products. For Blues the differences are even more profound in that the resource requirements for plans serving the Medicare population are much higher, and systems of care management are far more applicable, than for the products in its traditional product portfolio.

The good news for health plan managers is that their ability to execute can in fact overcome what they perceive to be operational disadvantages, relative to other plans. Since they are competing against firms solely on the basis of the products they offer, aggregate costs are less important than those of each product. Scale and organization types, if they affect costs, apparently do not do so in any overwhelming way.

NOTE: SOURCE DATA

This analysis is drawn from data submitted in connection with our *Sherlock Expense Evaluation Reports*. Data is from the 2007 calendar year. Our peer groups of plans are comprised of 23 Blue Cross Blue Shield Plans and 13 Independent / Provider-Sponsored health plans.

Scale does not always lead to an overall competitive advantage. A great fear among smaller health plans is that they will be overwhelmed through the scalar advantages of their larger competitors. While we can never rule out this advantage entirely, apparently the effect of scale is small. This is not to say that there are not advantages of scale when comparing start-ups with mature organizations. Rather, once a plan achieves some threshold