



ECONOMIC CLIMATE AND HEALTH PLAN COST REDUCTIONS?

The *Wall Street Journal* recently quoted noted Goldman Sachs analyst Matthew Borsch, "Now that investment income is significantly less, we could see less concern about an embarrassment of riches and more about battering down the hatches." As UnitedHealth Group CEO Stephen Hemsley told analysts, "The negative economic climate and outlook severely limits our visibility into 2009."

That "negative economic climate" has a number of implications for health plans in 2009. Regarding Mr. Borsch's observation on the investment climate, the volatility of certain investment vehicles and Federal Reserve activities has reduced the potential returns through non-operating earnings, on an already diminished base of investable assets. From an operating perspective, while health plan administrative costs are overwhelmingly variable in the longer term, there may be significant operating leverage implications in the short term. Also, the recent election of President-elect Obama raises concerns about potentially negative trends in Medicare Advantage rates.

Accordingly, many plans are "battering down the hatches," focusing on optimizing administrative expenses. Sherlock Company performance benchmarks can be a valuable tool to determine whether your health plan is operating at best practice and, if not, which functional areas and products represent the highest returns on investments in cost management initiatives.

REVIEW OF BLUE CROSS BLUE SHIELD OPERATIONAL TRENDS

The following is intended to provide a qualitative discussion of the operational metrics reported by the Blue Cross Blue Shield Plans in our most recent edition of performance benchmarking study. These operational metrics are drivers of financial metrics that we have previously discussed in the July 2008 *Plan Management Navigator*.

For the sake of brevity, we have not developed this in great detail. This summary should also be considered

anecdotal and impressionistic as compared with the precision of *SEER* Volume II.A on which it is based. Moreover, there is the possibility that changes in the sample could have affected each metric comparison. On the other hand, more than 90% of health plans participating in the 2008 edition of *SEER* also participated in 2007.

This discussion largely excludes medical management, health care utilization as well as other functions that do not lend themselves to operational metrics like claims or customer service.

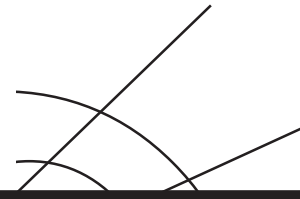
The text is written in order of observation within each functional area, as opposed to thematically. Because this is written for a general audience, a theme specific to your plan is impractical. Accordingly, we encourage you to have a look at Volume II.A of the *Sherlock Expense Evaluation Report*.

REVIEW OF FINANCIAL METRICS

In *Plan Management Navigator* for July 2008, we touched on trends in administrative expenses for Blue Plans as a whole. This section reviews those conclusions to place the operational metrics discussed in later sections in context.

For Blue Cross Blue Shield Plans, administrative expenses increased by 2.8% PMPM versus 5.7% last year. Marketing increased by 4.2%, the lowest increase since 2000. Corporate services costs increased by only 1.5% PMPM. Account and Membership Administration increased by 5.0%, the highest since 2001, as Medical and Provider Management costs increased by 10.0%, the highest since 2001.

Some of the changes are attributable to changes in the product mix. Medicare Advantage is now more important to surveyed Blue Cross Blue Shield Plans as a whole than is Medicare Supplemental. Despite the fact that only 12 Plans had Medicare Advantage of any significance, the total revenues, and profit potential, was in aggregate higher than for the 23 plans offering Medicare Supplemental. There was evidence of migration to Medicare Advantage from Medicare Supplemental, as Medicare Supplemental declined in membership.



In addition, membership generally migrated from POS and HMO to Indemnity and from insured lines to ASO lines. On average, membership increased by 2.7%.

The change in product mix has had an important affect on the rate of cost increase. Adjusted to hold constant the product mix, PMPM costs increased by only 2.8%. So adjusted Medical and Provider Management costs increased by only 2.2%, as Corporate Services costs decreased by 1.4%. Account and Membership Administration increased by 3.9%. On this basis, Marketing costs increased by 4.9%, PMPM.

SUMMARY OF FUNCTIONAL AREAS' OPERATIONAL METRICS

There were changes in each of the functional areas. A few anecdotal highlights follow on those functional areas that lend themselves to a definable output. This is expanded in sections that follow. Capitalized titles for functions (e.g., "Rating and Underwriting") refer to specific functions that are identified and analyzed in our benchmarking studies. Only the function is capitalized as opposed to any clarifying adjective.

- Rating and Underwriting costs increased, mainly due to increased total costs per FTE.
- There appears to have been a large increase in broker Commissions per broker member.
- Higher Enrollment costs were affected by more transaction activity per member, greater staffing and lower costs per FTE.
- Customer Services costs were essentially stable. There was upward pressure due to higher staffing ratios, lower productivity and higher costs per FTE. Lower numbers of manual inquiries per member were cost drivers that helped offset this.
- While Provider Relations Services manual inquiries per member increased, and costs per FTE increased, improving productivity and lower staffing ratios mitigated cost growth.
- Claim and Encounter Capture and Adjudication costs increased, PMPM. While

the staffing ratio declined, per FTE costs increased. Productivity also increased although cost per claim processed increased.

- IS costs were essentially the same as last year. Information Systems, however, has fewer employees and each is supporting more total Plan employees. IS costs per total FTE increased, as have IS costs per IS FTE. In all, it appears that Blues are becoming more automated.
- Corporate Services had steady or lower costs, mainly attributable to lower staffing ratios.
- Human Resources had higher PMPM costs, mainly due to higher HR costs per FTE. Staffing ratios were lower, and the number of total FTEs was higher relative to the HR FTEs. Total HR costs per employee increased.

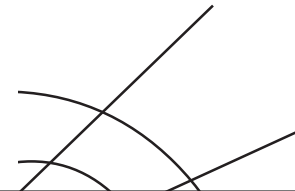
Overall, staffing ratios were lower than last year, especially when membership is adjusted to convert Medicare Advantage members to commercial equivalents. Staffing costs per FTE were somewhat higher.

MARKETING

The Marketing cluster includes the functions of Rating and Underwriting, Product Development and Market Research, Advertising and Promotion, internal Sales and Marketing and external broker Commissions.

- There seems to be a slight decline in group persistency, especially in Medicare Supplemental products.
- Broker share of total members seems to have increased on a constant universe basis.
- Broker commissions per broker member appeared to have increased.
- While product mix changed in 2007, it changed at a slower rate than in 2006.





- A higher proportion of reporting plans outsourced their FSA/HSA administration.
- Plans reported a decline in the number of groups but an increase in average group size.
- Staffing costs per total FTE were slightly higher.
- Rating and Underwriting costs increased, largely due to increased total costs per FTE.

- Average speed of answer appeared to have declined, as did abandonment rate.
- The proportion of inquiries resolved in seven days was essentially unchanged.
- Customer Services costs were essentially stable. There was upward pressure due to higher staffing ratios and costs per FTE were slightly higher. Lower productivity and lower numbers of manual inquiries per member were other cost drivers.

ENROLLMENT, MEMBERSHIP AND BILLING

Only the function of Enrollment, Membership and Billing is discussed in this section.

- The length of time that it takes to process enrollment transactions, measured in average processing days, appears to have increased.
- Number of cards issued per member has decreased.
- Individuals comprised a higher proportion of total enrollment transactions.
- The average age of membership declined.
- Higher Enrollment costs were affected by more transaction activity per member, greater staffing and lower costs per FTE.

CUSTOMER SERVICE

Only the function of Customer Service is discussed in this section.

- While staffing costs increased, non-staffing costs decreased in this functional area.
- The number of total manual inquiries per member declined in 2007. This appeared especially to be the case for individual members.
- The number of total inquiries per member appeared to decline, especially for individuals.

PROVIDER NETWORK MANAGEMENT AND SERVICES

The Provider Network Management and Services function is comprised of sub-functions including Provider Relations Services, Provider Contracting, Provider Audit / Billing Validation and Other Provider Network Management and Services. In the following analysis, we discuss only the Provider Relations Services and the Provider Contracting sub-functions.

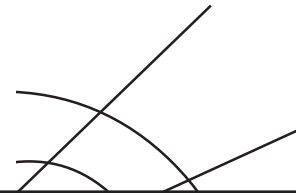
Provider Relations Services

- Manual provider inquiries per member are up, productivity seems up, per FTE costs are up and PMPM costs are up. While staffing costs are up, non-staffing costs are down.
- Total inquiries per member are down, and the manual proportion has increased. (Manual inquiries equals all manual calls, paper / written inquiries and manual electronic inquiries. The total is all manual inquiries plus automated inquiries.)
- The average speed of answer and abandonment rate were essentially unchanged.

Provider Contracting

- PMPM per month costs are down and the staffing ratio is also down. The total costs per FTE, however, are up and providers per contracting FTE is also up. Plans report somewhat fewer providers per 10,000 members.





- While staffing costs are up, non-staffing costs are down.
- There was also a slight change in the mix of providers. There were fewer primary care physicians, professional specialists and facilities and there were more ancillary providers.
- The cycle time to enroll has improved due to faster credentialing. The reenrollment cycle time, however, has worsened due to both slower recertification and slower time to place on system.

CLAIM AND ENCOUNTER CAPTURE AND ADJUDICATION

The Claim and Encounter Capture and Adjudication function is comprised of COB and Subrogation, Blue Card Home and Custom Par Fees, Medicare Crossover Fees and Other Claim and Encounter Capture and Adjudication. The lion's share of claims processing costs are found in Other Claim and Encounter Capture and Adjudication. Except for one reference to COB and Subrogation, expense data tends to refer to this "other" sub-function.

- The PMPM costs of claims processing are somewhat higher. Volumes of claims are down, staffing ratio is lower, the costs per FTE are up and productivity is up. Staffing costs increased.
- COB and subrogation costs are essentially the same as last year, as are components such as costs per FTE and staffing ratio.
- Auto adjudication rates were generally higher. They were somewhat so in commercial, but up to a greater degree for claims by members of groups. They were also up in Medicare Advantage and Medicaid HMO. Claims requiring manual intervention were down.
- Paper receipts are way down. There are fewer imaged claims which may be due in part to the fact that paper claims are less. The percent of paper claims that are imaged are less.

- Electronic receipts are up for commercial, though down for individuals. They are up for Medicare Advantage, Medicare Supplemental and Medicaid. The *proportion* of receipts that are electronic are up for every product area.
- The percent of claims medically reviewed increased slightly but the percent of those reviewed and are paid has decreased.
- Cost per claim processed increased overall and in many products as well.
- Compensation costs typically increased for claims people.
- Every metric of payment speed improved.

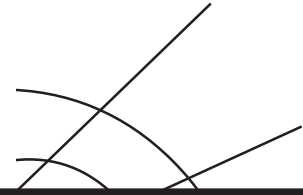
INFORMATION SYSTEMS

The Information Systems functions includes four sub-functions: Operations and Support Services, Application and Maintenance, Applications Acquisition and Development and Security Administration and Enforcement. We have segmented this section into a discussion of overall trends, cost within this functional area reflected in natural accounting categories, and some comments on the specific platforms. In this as well as other sections, remember that response rates limit the degree to which these conclusions may be generalized.

Overall

- The average life of most platforms declined, as the book values of each platform (hardware and software) declined.
- Information systems expenses, while up slightly, changed in emphasis. Information systems Application Acquisition and Development increased as Operations and Support and Application and Maintenance remained steady.
- Within Operations and Support and Application and Maintenance, Data Network, Engineering and Capacity Management increased while data center costs decreased.





Each of these costs are standardized for members.

- Respondents reported a decline in the share of production runs attributable to claim and encounter capture and adjudication in favor of other applications, enrollment, customer and provider service and other. (Because of data definition and other comparability issues, this conclusion is qualified.)
- While data is limited, it appears that IT resources were less devoted to infrastructure projects and more devoted to process improvement projects.
- Generally, IS people are supporting more Plan FTEs. There are typically fewer IS staff per member and the total costs per FTE have increased. Costs PMPM have remained stable.
- Data Center was characterized by a decline in accrual costs, and book value per member decreased. Notwithstanding, computing capacity increased while the cost of that capacity decreased. Utilization rates appeared to have increased.
- The costs of Desktop Services (those costs related to configuration and hands-on support) were the same as last year on a PMPM basis. Users supported increased.
- Desktop call center costs declined in 2007. The number of calls per user appears to have declined as productivity of call center personnel increased. The staffing ratios appeared lower. While most metrics of response speed, and resolution rates were the same, handle times declined.

Natural Accounting

- Overall, personnel costs are about the same PMPM. They seemed higher in Engineering, Capacity Management and Project Management Office and support, while lower in other areas.
- Consultant and Contractor costs were up, and focused on Application Acquisition and Development. They were down in activities of Operations and Support and Application and Maintenance.
- On a PMPM basis, software amortization and hardware depreciation appeared higher, certain other expenses, including outsourced costs and all other, appeared lower.

Trends in Platforms

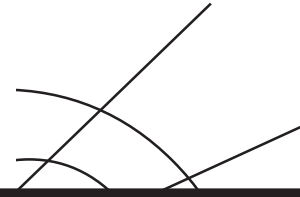
- Voice Network and Telephony had more users and cost per user was unchanged. Costs per member increased.
- Data center processing power and storage capacity appear to have increased.
- Data Network costs increased, PMPM. Cost per user and users supported increased.

FINANCE AND CORPORATE SERVICES

This section combines the analyses for functions of Finance and Accounting and Corporate Services. Corporate Services includes Human Resources (though we develop it separately below), Legal, Facilities, Audit, OPEB, Purchasing, Imaging, Printing and Mailroom and Other Corporate Services.

- Overall, costs PMPM were approximately the same as last year. While staffing levels were slightly lower, costs per FTE were higher.
- Days of accounts receivable inched downwards in 2007.
- Mail volume increased, per member, for both inbound and outbound mail.
- *Facilities* costs were lower, on a per member per month basis. There were fewer total staff, and the cost per usable square foot was less. The proportion of total square feet that was usable inched upwards. *Facilities* costs per total Plan FTE declined.
- *Facilities* were increasingly owned rather than leased. Staffing costs related to *facilities* were less..





- Most components of facilities costs (rent, depreciation, etc.) declined or stayed the same.
- Expenses relating to the *Legal* functional area increased. (These costs exclude any settlements.) Staffing is higher and internal legal compensation is higher. The proportion of legal expenses that are paid for external legal services has declined. There seems to be a tendency to have internal legal staffs take on a greater share of total legal needs.

HUMAN RESOURCES

This section discusses Human Resources as a function as well as the human resource activities of the Plans in our universe.

- Human Resources costs are higher, both per member per month and per FTE, while the staffing ratio is less. Growth in staffing costs seems to be the main reason for the increase.
- Both total turnover and retention have increased slightly.
- Separations have declined, relative to total FTEs. This was true for both voluntary separations and for involuntary separations. However, retirements increased.
- Rate of hiring and mix of internal versus external have remained relatively constant.
- Missed days increased in 2007. While FMLA, short term disability and workers comp days were relatively stable, other days missed increased.
- Almost every category of employee had a decline in training hours. Enrollment appeared to be an exception.
- Total compensation increased for Plan employees. About one third was attributable to salaries. Bonuses comprised much of the rest. Health benefits declined as a percent of total compensation.

- Estimated outsourced staffing costs have decreased as a percent of total staffing costs.
- Total staffing ratios appear to have declined slightly, especially if the increase mix in favor of Medicare Advantage is considered. Provider Network Management and Service, Claims, Information Systems seem to be central to this trend.
- A smaller proportion of total FTEs are outsourced in 2007 versus 2006. Medical management appears more likely to be outsourced, and Information Systems is less likely.
- The proportion of the workforce with ten or more years of tenure has increased. 