



## MEDICARE PLANS' ADMINISTRATIVE COSTS INCREASE ON MARKETING GROWTH IN 2008

### Summary

Raw per member administrative cost trends increased from 3.3% in 2007 to 8.3% in 2008. Adjusting to eliminate the effects of changes in product mix, the rate of cost increase grew faster, a 10.2% increase versus 1.9% last year. Marketing costs sharply increased and comprised the majority of the increase, offsetting flat to down Corporate Services costs. For the universe of Medicare submitting 2008 data, administrative expenses comprised 10.2% of premium equivalents compared with 9.4% for plans submitting data in 2007.

The administrative expenses of Medicare plans participating in our performance benchmarking study was \$46.46 per member per month (PMPM), but varied greatly by product. Medicare SNP cost \$175.67 PMPM while the commercial ASO costs were \$17.73 PMPM.

In 2008, the commercial ASO administrative expenses were 6.6% of premium equivalents, the lowest ratio for comprehensive products in this universe. Medicare Advantage's administrative expenses were 9.7% of premiums, Medicare SNP was at 13.5% of premiums and Medicare PFFS was at 9.5% of premiums.

All values in this article exclude investment and non-operating income and expense, income taxes and miscellaneous business taxes. Pharmacy and Mental Health administrative costs are included in total administrative cost calculations but not in individual functional area clusters. These results are excerpted from the Medicare edition of the 2009 *Sherlock Expense Evaluation Report*, comprising 2008 data.

### Background on Medicare

Medicare Advantage (MA) and its administrative expenses are central to discussions of health care reform. Medicare Advantage administrative expenses are of interest for comparison purposes with the regular Medicare program, and the Medicare Advantage program may itself be subject to budget cuts.

According to Kaiser Family Foundation, Medicare Advantage membership increased by 14.2% to 10.3 million members in 2008. Medicare Advantage comprised 22.8% of total Medicare beneficiaries at that time. In 2008, total MA contracts increased by 21.5%, or by 130, to 735. In July of 2009, membership in MA

plans increased by 10.1% year over year to 11.1 million seniors, and now comprises 24.7% of total beneficiaries. There are were 751 contracts in July.

Some advocates for certain forms of health care reform compare Medicare administrative expenses with those of private plans. The independent congressional agency advising Congress on issues affecting the Medicare program advises against this noting that, "Because the administrative operations of Medicare and the private sector differ significantly, it is difficult to determine which program administrators health care benefits more efficiently." Moreover it is helpful to recall that administrative costs have substantial value. For instance, according to MedPAC, "CMS estimates that about \$9.8 billion in erroneous payments were made in the fee-for-service program in 2007."

**Figure 2. Medicare Advantage Benchmark Summary**

Medicare-Oriented Percent Change in Costs by Functional Area Cluster

	2007 Data		2008 Data	
	Percent Chg.	Percent Chg. Mix-Adjusted	Percent Chg.	Percent Chg., Mix-Adjusted
Marketing	22.3%	14.3%	18.0%	29.1%
Medical & Provider Mgmt.	-12.1%	-16.7%	13.6%	11.2%
Account & Mem. Admin.	1.8%	5.6%	6.0%	13.6%
Corporate Services	5.1%	0.0%	1.8%	-10.1%
Total	3.3%	1.9%	8.3%	10.2%

President Obama has targeted Medicare Advantage for cuts, specifying in his address of September 9, 2009, that he intends to eliminate "unwarranted subsidies in Medicare that go to insurance companies" though, according to MedPAC, HMOs, which serve 62.0% of MA members, cover the same services as traditional Medicare Part A and Part B at 98% of their cost.

### Membership Trends and Mix Changes

The eleven plans participating in our benchmarking study had growth well in excess of the growth for the universe with median growth of 27.7% and mean growth of 33.5%. Collectively, they served on average 1.1 million MA beneficiaries. Supplemental schedules of plans offering but not focused on MA served an additional 986,000 members for a total of 2.1 million members on average during 2008. Medicare Advantage members represented in all our benchmarks comprised approximately 22% of the total during 2008.

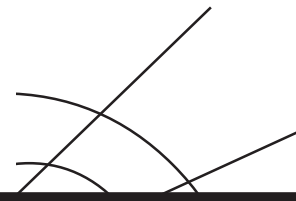
For plans included in the core benchmarks, which we used for the trend analysis, the mix of the business changed somewhat. Overall, Medicare Advantage was 49.8% of premium equivalents compared with 49.7% for 2008. However the mean proportion of Medicare SNP premiums increased by 0.6 percentage points to 15.5% of the total. The median share for commercial premium equivalents declined by 1.4 percentage points to 41.7%.

**Figure 1. Medicare Advantage Benchmark Summary**

Medicare-Oriented Costs by Functional Area Cluster, 2008 Data

Per Member Per Month

	25th PCTL	75th PCTL	Median	σ/ Mean
Marketing	\$10.64	\$38.64	\$17.77	77.7%
Medical & Provider Mgmt.	5.44	13.08	7.25	83.0%
Account & Mem. Admin.	9.28	23.90	13.43	59.9%
Corporate Services	7.15	17.83	10.96	75.1%
Total	\$34.97	\$90.38	\$46.46	70.5%



Medicare SNP is much more expensive to offer than other products. We think this likely contributed to the fact that the constant-mix growth exceeds that of the reported increase as shown in Figure 2.

## Administrative Costs and Trends

For convenience of analysis, we group various functional areas into clusters, and standardize for size by expressing expenses on a per member basis. Values for 2008 and rates of change for these clusters and overall are shown in Figures 1 and 2. Appendix A provides values for all plans participating in 2008, and comprises 2007 data.

**Marketing** expenses were \$17.77 and grew by 18.0% PMPM, down from 22.3% growth in 2007. (All rates of change hold constant the universe of participants.) As noted previously, Medicare plans had rapid growth and accordingly marketing expenses were the fastest growing expense cluster. External broker Commissions comprised most of the total increase in the cluster's growth, and its rate of growth exceeded that of last year. Internal Sales and Marketing costs and Advertising and Promotion also increased rapidly. The 75<sup>th</sup> percentile value for this cluster was \$38.64 and the 25<sup>th</sup> percentile value was \$10.64 PMPM.

Marketing expense trends, like those of other clusters, were affected by the changes in product mix. Holding the product mix constant, Marketing expense growth accelerated, to 29.1% from 14.3% last year. On a constant mix basis, internal Sales and Marketing growth comprised a plurality of the growth of this cluster, while there was a roughly 25% increase in external broker Commissions cost. Advertising and Promotion also grew rapidly.

Rating and Underwriting grew very rapidly on an as-reported basis and faster than any other functional area on a constant mix basis. This may be the result of greater emphasis on Hierarchical Condition Coding in 2008.

**Medical and Provider Management** grew by 13.6% (compared with -12.1% last year) to \$7.25 PMPM. While Provider Network Management and Services grew very modestly, the Medical Management / Quality Assurance / Wellness functional area grew rapidly and was responsible for over 20% of the total cost increase in 2008.

On a constant mix basis Medical Management / Quality Assurance / Wellness growth was even more impressive. It comprised nearly one-half of the increase in total administrative expenses, and was second only to Rating and Underwriting in its growth rate. By contrast, Provider Network Management and Services actually declined, holding the mix constant versus 2007. The Medical Management / Quality Assurance / Wellness functional area had the second fastest growth among functions. On a constant-mix basis, Medical and Provider Management increased by 11.2%. The costs of Medical and Provider Management at the 25<sup>th</sup> percentile was \$5.44 PMPM and \$13.08 PMPM at the 75<sup>th</sup> percentile.

**Account and Membership Administration** cost increased to \$13.43, up 6.0% from last year. In 2007, the rate of growth, on an as-reported basis, was 1.8%, an indicator that the rates of growth of costs in this cluster accelerated

### Calculation of Mix-Adjusted Rates of Expense Growth

To make the most useful comparisons administrative expenses between years, it is illuminating to eliminate the effects of product mix differences. This is beneficial both between organizations with different product mixes and also between periods. Accordingly, in comparing expenses between periods, we hold constant the product mix between the two years.

To do this, since Medicare plans report to us by product, we reweight their expenses so that the product mix existing in the prior period is the same as in the current one. We then recalculate the rates of change based on these reweighted estimates.

in 2008. The value at the 25<sup>th</sup> percentile was \$9.28 PMPM, while the costs at the 75<sup>th</sup> percentile were \$23.90 PMPM.

The fastest growing area was Customer Services, at approximately 10%. The largest increase, with respect to the proportion of the total, was Information Systems. Enrollment costs grew faster than the cluster while Claim and Encounter Capture and Adjudication grew more slowly.

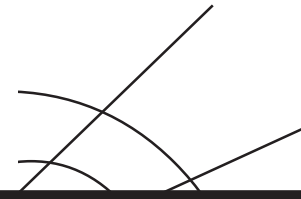
On a constant mix basis, the Account and Membership Adjudication cluster increased by 13.6%, faster than the 5.6% for 2007. Enrollment and Information Systems represented most of the increase while Claim and Encounter Capture and Adjudication had the greatest increase.

**Corporate Services costs** increased by only 1.8%, compared with 5.1% in 2007. These costs include such support areas as Finance and Accounting, Actuarial, Corporate Services (like Facilities, Legal, Printing and Mailroom and OPEB), Corporate Executive / Governance and Association Dues and License / Filing Fees. Three of the five functions within this cluster actually declined. These functional areas are among the few that exhibit economies of scale and it is possible that the participants' membership growth has led to per-member cost declines. Finance and Accounting and Association Dues and License/Filing Fees costs increased.

On a constant mix basis, costs decreased by 10.1%, compared with no change in 2007. Only Association Dues and License / Filing Fees increased on this basis. It is possible that the increase in this functional area's costs is related to the significant expansion of these enterprises. Two of the functional areas, Corporate Executive / Governance and Actuarial, declined at double digit rates. Total costs for this cluster were \$10.96 PMPM in 2008, while the 25<sup>th</sup> percentile value was \$7.15 PMPM and the value at the 75<sup>th</sup> percentile was \$17.83 PMPM.

**Figure 3. Medicare Advantage Benchmark Summary**  
Medicare-Oriented Costs by Functional Area Cluster,  
as a Percent Premiums or Equivalent, 2008 Data  
Percent of Premium Equivalents

	25th PCTL	75th PCTL	Median	σ / Mean
Marketing	2.8%	5.0%	3.5%	45.0%
Medical & Provider Mgmt.	1.3%	2.0%	1.7%	43.1%
Account & Mem. Admin.	2.4%	3.3%	2.6%	25.7%
Corporate Services	1.9%	2.8%	2.4%	45.7%
<b>Total</b>	<b>8.0%</b>	<b>13.0%</b>	<b>10.2%</b>	<b>33.3%</b>



## Calculation of Premium Equivalents

Administrative services relationships comprise a relatively small part of the business mix of Medicare Advantage plans. On average, they comprise 11.2% of members and most plans in our survey do not serve this market at all. Nevertheless, to the extent such relationships exist, they 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 they provide rather than for the cost of care, which is borne by the self-insured groups.

Our solution to this 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 self-insured claims), by adding this amount to the administrative service fees actually billed, we are able to estimate the premium equivalents of the ASO arrangements.

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

## Costs as a Percent of Premium Equivalents

Notwithstanding its important drawbacks, health plans and others often express administrative costs as a percent of premiums. As shown in Figure 3, administrative expenses were 10.2% of premium equivalents for comprehensive products sold by Medicare plans. The 25<sup>th</sup> percentile value was 8.0% and the value at the 75<sup>th</sup> percentile was 13.0%. Comparing these results to those in Appendix B, administrative expenses were 80 basis points higher as a percent of premium equivalents. The sharp increase in marketing costs is likely responsible for this and mix differences muted the ostensible changes.

Marketing costs comprised 3.5% of premium equivalents, with the 25<sup>th</sup> percentile value at 2.8% and the value at the 75<sup>th</sup> percentile at 5.0%. The comparable median percent in 2007 was 2.7% or 80 basis points lower than for 2008.

The value at the 25<sup>th</sup> percentile for Provider and Medical Management was 1.3% of premium equivalents, while the 2.0% of premium equivalents represented the 75<sup>th</sup> percentile. The median value, at 1.7% was 40 basis points higher than the 1.3% posted last year.

The costs of Account and Membership Administration were 2.6% of premium equivalents, slightly lower than the 2.8% reported last year. The value at the 25<sup>th</sup> percentile was 2.4% of premium equivalents and 3.3% of premium equivalents at the 75<sup>th</sup> percentile.

The median proportion of premium equivalents due to Corporate Services was 2.4%, 30 basis points lower than last year's value of 2.7%. Twenty-five percent of plans had values below 1.9% of premium equivalents or above 2.8% of premium equivalents in 2008.

## Administrative Expenses by Product

All participants in our benchmarking studies segment their costs by product as well as by over forty functional areas. Overall, the resources consumed in these products are reflected in varying administrative expenses that differ quite sharply between the various products. Our participants normally have quite robust activity-based costing systems to facilitate this. For example, suppose commercial HMO products have 40% of the claims volume as Medicare Advantage products. Commercial products administrative expenses will be accordingly lower. Similarly, ASO products have lower overall costs than their insured counterparts since ASO arrangements are normally provided only to larger groups that tend to be less costly to market to.

These differences are manifest in their overall cost differences. The most expensive product offered by Medicare plans is their Medicare SNP product at \$175.67 PMPM. Medicare Advantage and PFFS followed. The least expensive comprehensive product offered by these health plans was the ASO product at \$17.73 PMPM. This is shown in Figure 4. Medicare Part D was lower still, at \$16.34.

As shown in Figure 5, on a percent of premium basis, the ranking of administrative expenses by product is different. The ASO product remained among the low cost product on a percent basis but it was followed by Medicare PFFS and Medicare

**Figure 4. Medicare Advantage Benchmark Summary**

Medicare-Oriented Costs by Product, 2008 Data

Per Member Per Month

	25th PCTL	75th PCTL	Median	$\sigma$ / Mean
HMO	\$27.61	\$34.83	\$30.81	25.8%
POS	29.42	36.63	31.88	29.1%
Indemnity & PPO	34.24	45.51	41.36	25.6%
Total Comm. Ins.	\$27.21	\$36.31	\$32.43	18.4%
ASO	15.85	19.04	17.73	34.7%
Total Commercial	\$23.68	\$31.55	\$29.30	17.6%
Medicare Supplemental	\$25.66	\$25.66	\$25.66	NM
Medicare Advantage	69.08	155.08	101.29	44.1%
Medicare Advantage PFFS	63.39	79.96	68.14	23.4%
Medicare SNP	160.36	177.36	175.67	18.7%
Medicare Total	\$68.75	\$132.16	\$94.74	42.3%
Medicaid	18.95	29.78	23.98	27.6%
Comprehensive Total	\$34.97	\$90.38	\$46.46	70.5%
Medicare Part D	\$14.27	\$16.70	\$16.34	27.7%

**Figure 5. Medicare Advantage Benchmark Summary**

Medicare-Oriented Costs by Product, 2008 Data

Percent of Premium Equivalents

	25th PCTL	75th PCTL	Median	$\sigma$ / Mean
HMO	9.3%	12.3%	10.4%	17.7%
POS	9.2%	11.2%	10.0%	20.4%
Indemnity & PPP	12.7%	16.4%	14.9%	29.1%
Total Comm. Ins.	9.6%	12.5%	12.0%	18.9%
ASO	5.2%	7.0%	6.6%	56.1%
Total Commercial	8.3%	12.2%	10.5%	21.5%
Medicare Supplemental	7.2%	7.2%	7.2%	NM
Medicare Advantage	7.2%	17.1%	9.7%	47.2%
Medicare Advantage PFFS	7.9%	10.7%	9.5%	30.3%
Medicare SNP	11.9%	14.4%	13.5%	27.9%
Medicare Total	7.3%	14.2%	9.5%	42.4%
Medicaid	7.7%	10.4%	8.5%	31.9%
Comprehensive Total	8.0%	13.0%	10.2%	33.3%
Medicare Part D	9.5%	13.1%	11.6%	27.8%

Advantage. The high cost products, calculated based on a percent of premium equivalents, were all commercial, followed by Medicare SNP.

## Comparisons Across Universes

Health plans in other Sherlock Company benchmark universes also offer Medicare products. Figure 6 compares them. It is notable that while the Independent / Provider - Sponsored plans and the Blue Plans are fairly similar in their costs, the Medicare universe has costs that are much higher. Marketing expenses and Corporate Services costs are especially high in Medicare-focused plans.

Particularly in comparison with Blue Cross Blue Shield Plans, Marketing costs are high. Internal Sales and Marketing and Rating and Underwriting are the central elements of difference. Broker commissions play a smaller role in this difference.

Corporate Services costs are the other major source of variance. Since many of the scalable functions such as Actuarial, Corporate Executive / Governance are responsible for the variances, we assume that the smaller size of these rapidly growing firms is having an effect. Facilities costs are also high and may well act in a scalable way in relatively small, fast growing firms.

Medical and Provider Management and Account and Membership Administration were remarkably similar across universes.

## Background on This Universe and SEER

The peer group universe in this analysis consisted of eleven Medicare plans, which together served 3.0 million members. On average 67.1% of the premiums and fees of these plans came from Medicare Advantage products. The median membership in this universe was 241,000 members.

**Appendix A. Medicare Advantage Benchmark Summary**  
Medicare-Oriented Costs by Functional Area Cluster, 2007 Data  
Per Member Per Month

	25th PCTL	75th PCTL	Median	σ/ Mean
Marketing	\$9.36	\$13.50	\$10.49	94.9%
Medical & Provider Mgmt.	5.31	7.52	6.48	114.8%
Account & Mem. Admin.	9.44	13.33	10.84	73.9%
Corporate Services	7.25	10.45	9.94	96.3%
<b>Total</b>	<b>\$34.56</b>	<b>\$40.75</b>	<b>\$39.26</b>	<b>93.2%</b>

**Appendix B. Medicare Advantage Benchmark Summary**  
Medicare-Oriented Costs by Functional Area Cluster,  
as a Percent Premiums or Equivalents, 2007 Data  
Percent of Premium Equivalents

	25th PCTL	75th PCTL	Median	σ/ Mean
Marketing	2.3%	3.7%	2.7%	39.0%
Medical & Provider Mgmt.	1.2%	1.8%	1.3%	45.2%
Account & Mem. Admin.	2.1%	3.2%	2.8%	32.9%
Corporate Services	1.3%	2.9%	2.7%	42.7%
<b>Total</b>	<b>8.2%</b>	<b>10.8%</b>	<b>9.4%</b>	<b>30.5%</b>

Changes in costs are based on the results for plans that participated in both of the comparison years. PMPM and percent values are for all plans that reported this year. We employed median values throughout this process as the best measure of central tendency.

Overall, our benchmarks in 2009 (containing 2008 data) comprise the experience of approximately 396 health plan years. We also have universes of Independent / Provider-Sponsored Plans, Larger Health Plans, Blue Cross Blue Shield Plans and Medicaid Plans. We have completed our reporting on the results of the Independent / Provider-Sponsored Plans, and Blue Cross Blue Shield Plans and the results of these may be found on our web site. We will be reporting on the Medicaid results in the next three weeks.

**Figure 6. Medicare Advantage Benchmark Summary**  
Medicare-Oriented Characteristics by Universe, 2008 Data

	Medicare*	Indep. / Prov. Sponsored	BCBS	Combined Universes**
<b>Administrative Expenses PMPM</b>				
25th PCTL	\$66.37	\$64.60	\$58.72	\$65.48
Median	94.74	76.35	78.05	77.52
75th PCTL	\$130.09	\$96.06	\$82.16	\$93.17
σ/ Mean	42.7%	37.0%	19.5%	36.3%
<b>Administrative Expenses as a Percent of Premiums</b>				
25th PCTL	7.1%	6.9%	6.8%	7.1%
Median	9.5%	7.7%	7.8%	8.3%
75th PCTL	15.4%	10.8%	10.2%	10.9%
σ/ Mean	44.8%	36.2%	30.9%	38.6%
<b>Plans Offering Medicare Advantage</b>	11	13	11	30
Medicare Adv. and SNP Revenues	\$12,430,913,871	\$4,547,997,517	\$8,584,779,507	\$22,688,984,973
Comprehensive Total Revenues	\$18,464,615,487	\$24,946,077,289	\$112,236,617,639	\$147,454,021,960

\* For the Medicare universe, Medicare is the subtotal of the Medicare Advantage and Medicare Advantage PFFS product.

\*\* Five firms included in two universes, are excluded from combined figures.

