



Transcript

Blue Cross Blue Shield Administrative Costs: A Review of 2009 Results

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Welcome to our summary of the benchmarking study for Blue Cross Blue Shield Plans. This is an unusually timely discussion because the health insurance industry is in a period of stress and its managers are focused on reducing the costs under their own roofs.

In 2008, the period of our last report on Blue administrative costs, unemployment averaged 5.8%. In 2009, it averaged 9.3%. Notwithstanding the muting effects of COBRA on the decline in health plan enrollment, this trend has necessitated more aggressive cost management. Health care reform has provided a further impetus, most notably through so-called “medical loss ratios” that indirectly limit administrative expenses. Coincidentally, the lead editorial in this morning’s *Wall Street Journal* is largely focused on the complex issues surrounding health plan administrative expenses as they interact with the new MLR requirements.

Indiscriminately slashing costs, however, can harm a plan’s competitive position. For instance, reducing customer service costs can harm customer satisfaction and hence member retention. Cutting medical management costs may lead to greater health benefit costs. Health plan managers, and I think that is who most of you are, must balance the need to drive down costs in the light of the long term competitive objectives of your organizations. We hope that this presentation assists you in some way.



The theme that the Blue Cross Blue Shield data suggests that, when compared to last year, plans are adapting to these changes by increasing spending on information systems and in corporate governance, where strategic changes are made.

Before I proceed, I do want to thank all of you who are participants in our various benchmarking studies. While participating plans realize a return on their investment in the benchmarking process, it is nevertheless the case that the summary benchmarks that we'll discuss today benefit consumers and the health plan industry as a whole.

As you may know, we have been performing these benchmarking studies for a number of years. They are widely accepted among health plan managers and other users. Plans participating in our benchmarking studies agree to complete our survey form in exchange for the resulting report. Costs must be segmented by product as well as by functional area: that segmentation is shown in the appendix slides. We also request numerous other metrics such as staffing, compensation and so forth. Our quality assurance procedures are also summarized in the appendices.

This is the second of a series of presentations on health plan performance metrics. A few weeks ago we summarized the Independent / Provider-Sponsored plan universe results, and we expect to host similar web conferences for Medicare and Medicaid plans this fall. All these presentations, including this one, will be posted on our web site.

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Today, I would like to provide a little bit of background on Sherlock Company, the levels of costs that the Blue Cross Blue Shield plans report and the sources of cost increase in 2009. Then I would like to speak to the costs by product reported by these plans. For the sake of brevity, I have included some supporting information only in appendix form.

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Sherlock Company is now completing its 13th consecutive annual survey of health plan operations and, at the end of this round, our benchmarks will reflect approximately 450 health plan years of experience. In all of our universes this year, we estimate the plans collectively serve 42.3 million members. Our benchmarks' focus is administrative



expenses and related operational drivers, but they also include many metrics of health care utilization.

Sherlock Company benchmarks are in widespread use by health plans, and health plans serving most insured Americans are users of our 2009 metrics. Most Blues and a plurality of other health plan association members are users of, or participants in, our benchmarks. Since the benchmarks are designed for plans' internal use, we have designed it to provide a high ratio of insight to effort, though I gratefully acknowledge that the efforts are considerable. Because we have multiple peer groups, and each of them has their strong suits from a reporting perspective, our benchmarks benefit from cross-fertilization across these peer groups.

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Today I would like to discuss the administrative cost results for the Blue Cross Blue Shield plans. Serving approximately 100 million members, collectively, the 39 Blue Cross Blue Shield Plans are the largest factor in the United States health insurance market. Our universe is comprised of 24 of those plans, 59% of the total, and one-third of all Blue Cross Blue Shield membership.

These plans are substantial organizations and, I believe, are fairly representative of Blue Cross Blue Shield Plans as a whole. They usually exceed \$3 billion in annual revenues and average 1.4 million in membership. In Blue "branded" business, they serve 26 states. For the most part, they are the sole Blue plan in that state, though in a few cases there is more than one plan per state. Typically, they provide insurance services to one-third of their entire population and are in markets "from sea to shining sea."

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Here is a summary of the results for the 2010 benchmarking study, reflecting 2009 calendar year results. (All of the costs are expressed in PMPM values.) Median costs were \$28.02 PMPM. Last year's results, in Appendix A, were \$25.95, with the difference reflecting all three factors of cost increases, product mix changes and some turnover in the universe.



To analyze the results, each participating plan segments its costs into more than 50 functions, which we have summarized into the clusters shown on this page. Appendix C broadly describes how we summarize these functions into the clusters reported here.

Account and Membership Administration is the dominant source of costs for health plans at \$12.21. This is followed by Marketing expenses at \$7.49. Provider and Medical Management, at \$3.41, and Corporate Services, at \$4.96, are relatively small clusters of expenses. By the way, the figure numbers refer to our free research publication, *Plan Management Navigator*, which is available on our web site, along with this presentation.

By the way, the median costs, expressed PMPM or as a percent of revenues, will be the way that we'll refer to cost metrics. Because medians are the 50th percentile value, the clusters won't necessarily sum to the median for total expenses. That is even more the case for the 25th and 75th percentiles.

Another calculation note is that when we make comparisons we try to be as careful as possible make them "apples-to-apples." So, where this slide pertains to all 24 Blue Cross Blue Shield plans that participated in the benchmarking study, the slides showing cost *changes* will reflect only those plans that participated in the comparison years. For instance, rates of change for 2009 are for the 21 plans that participated in both 2009 and 2010 surveys.

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This slide shows those rates of change. As recently as 2006, costs increased at low double digit rates on a constant mix basis, and early in the decade likely grew more than twice as rapidly as at present. This slide shows continued moderation in expense growth, especially in certain clusters of expenses.

On an as-reported basis, Blue plans had per member expense growth that declined from 2.7% in 2008 to 2.5% in 2009. (All of the percent comparisons are *changes* in per member per month.) Reweighting each plans' costs to eliminate the effect of changes in their product mix change, total expense growth is 3.8%, up from 1.6% in 2008.

Marketing cost declines were especially steep. As-reported, growth declined from 3.5% to 0.5%. They were less steep on a constant-mix basis, but still very notable, declining from 3.8% in 2008 to 2.0% in 2009.



Provider and Medical Management costs also grew less than last year but its growth rates exceeded that of the other clusters as a whole. Growth declined from 11.3% to 3.3% on an as-reported basis and from 12.0% to 5.4% on a constant-mix basis. The fact that Provider & Medical Management growth is higher than overall trend, even after backing out the effect of the mix differences and on top of impressive growth in the prior year, suggests that this activity remains a priority among Blue Cross Blue Shield plans. Industry lore is that a weak economy may lead to a surge in health care utilization so perhaps this growth is in response to the then current market conditions.

Account and Membership Administration costs increased in 2009, faster than in 2008. Growth increased from 3.1% in 2008 to 4.1%, as-reported, and from 0.7% to 4.2% on a constant-mix basis.

The much smaller Corporate Services cluster grew fastest and had the greatest reversal in cost trends. On an as-reported basis, cost growth shifted from a decline of 0.1% in 2008 to an increase of 5.5% in 2009. On a constant-mix basis, costs trend changed from a decline of 0.6% to growth of 5.7%.

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This slide highlights the functional areas within each cluster that contributed to the changes in costs, on an as-reported basis. Recall that overall costs increased by 2.5% PMPM. In this slide, the arrows and comments are referring to changes in costs not changes in growth. So a down arrow means that PMPM costs actually fell in 2009. The column "Greatest Change" refers to the percent change in PMPM costs. The "Highest Weight" column refers to the proportion of the dollar difference in administrative expenses explained by the dollar change in this function.

Growth in most marketing functions actually accelerated in 2009. Rating and Underwriting, for instance, grew rapidly, though this may be related to risk-adjustment expenses in the growing Medicare Advantage product. However, both Product Development / Market Research and Advertising and Promotion had declines. Because Advertising and Promotion is larger than most of the other functions, and it declined at low double digit rates, it dramatically reduced trend. Broker Commissions grew modestly but its relatively large size has made it, not Advertising and Promotion, the



most important factor in trend for this cluster. Marketing cost growth is sharply below each of the previous four years.

Provider and Medical Management also grew slower than in any of the previous four years. Medical Management grew most rapidly and, because it is a larger function than Provider Management and Services also comprised the lion's share of the increase in this cluster.

The cluster of functions that constitute Account and Membership Administration grew faster this year than last. It was all about Information Systems. At low double-digit rates of increase, it was the second fastest growing among *all* functions. More importantly, its size meant that its growth largely explained overall expense growth for the Blue universe. Enrollment cost growth was also rapid but Customer Services costs actually declined.

The Corporate Services cluster of expenses also grew more rapidly this year by 5.5%. Corporate Executive / Governance was by far the fastest growing function. The Corporate Services function is much larger than Corporate Executive / Governance, so much so that while it grew slowest among the functions in this cluster of expenses, it was the main factor in its growth.

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I have mentioned that there were significant changes in the product mix of Blue Cross Blue Shield plans, and this slide details them. Membership grew modestly but less rapidly in commercial versus government products. Within the commercial sector, insured membership sharply declined, while ASO / ASC even more sharply increased. We hypothesize that this may be due to employers need to conserve cash in a difficult credit environment and the possibility that larger self-insured firms are faring better than their smaller counterparts in these difficult economic times.

By the same token, membership in Medicare Advantage and Medicaid are both way up. Medicare Advantage an affordable alternative to consumers so that the weak economy could be a factor in this as well. I believe these changes have had an effect upon the expense mixes of these reporting Blue Cross Blue Shield Plans.

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This slide reflects the contribution of various functions to cost growth after we hold constant the product mix between the comparison years. Expenses grew by 3.8% PMPM, faster than last year and faster than the 2.5% on as-reported basis.

Marketing costs grew by only 2.0% PMPM, probably reflecting overall economic weakness. In fact, Advertising and Promotion actually declined and Product Development / Market Research grew by four-tenths of a percent in 2009. Internal Sales and Marketing and external broker Commissions were the dominant sources of the increase in costs. That Commissions are often calculated as a percent of premiums contributes to its relatively rapid growth. While Rating and Underwriting costs are small, they grew at the second fastest rate.

On a constant-mix basis, Provider and Medical Management costs grew at the second fastest rate among the clusters of expenses for Blue Cross Blue Shield Plans. While less than last year's rate of 12.0%, this 5.4% growth suggests that this cluster of functions continues to be a priority for Blue plans. There are two functions in this cluster: Medical Management (including precert, disease management, case management, etc.) and Provider Network Management and Services (which fields provider inquiries and negotiates contracts). Medical Management grew fastest and, since it is the larger functional area, is also chiefly responsible for the growth in the costs of this cluster.

Just to anticipate a question, this trend was in no way affected by changes in medical loss ratio definitions under health care reform. Regardless of how health plans report to other audiences, and regardless of how they may actually offset the costs of care, we require that they report Medical Management as administrative expenses for our purposes.

Account and Membership Administration costs were the most important factor of cost increases for Blue Cross Blue Shield plans though, at 4.2%, not the fastest growing cost cluster. Information Systems, whose costs grew fastest in this cluster of functions (and second fastest among all functions) also had the greatest overall impact on this cluster's cost trend. While the small Enrollment area also grew quickly, Customer Services costs declined PMPM and Claims grew very modestly. It is interesting that Blue emphasis on Information Systems mirrors expectations of information systems investments under health care reform.



Corporate Services cost growth was the fastest growing cluster of expenses though it is a relatively small cluster. PMPM costs grew by 5.7%. Corporate Executive / Governance grew fastest. While not growing nearly as rapidly, the much larger Corporate Services function contributed nearly as much to growth in this cluster of expenses.

The Corporate Executive functional area is where the strategic direction of Blue Cross Blue Shield Plans is formulated. It contains the Six Sigma, corporate planning, enterprise business process improvement and other activities that you would expect to grow in the current volatile health plan business environment. There was also some staff turnover, greater “outsourcing” and staffing ratio increase, all of which may be associated with adaptation to a changing market. This parallels the trends that we have seen in information systems.

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We are not great fans of expressing administrative expenses as a percent of premium since (a) it isn't actionable, (b) it confounds cost performance with factors of revenue yield, (c) it varies quite a bit by product and (d) if one uses GAAP accounting for the revenue denominator, and that revenue is in part ASO/ASC fees, then the actual ratio conflicts with normal intuitions about it.

We cannot solve all of these problems but we address a few of them in this slide. Most importantly, we employ premium equivalents for ASO/ASC products. Essentially, this means that we incorporate sponsor health benefits into the ASO/ASC's top line. Our calculations of premium equivalents is discussed in detail in August's *Plan Management Navigator*.

This slide shows administrative expenses as a percent of premium equivalents. At 9.7%, it is below the 9.9% in 2008 and 10.4% in 2007. Account and Membership administration, at 4.0% of premium, comprises the single largest portion of administrative expenses, followed by Marketing at one-fourth at 2.4%. Provider and Medical Management costs and Corporate Services costs were 1.1% and 1.7%, respectively.



While a precise comparison is impossible since medians don't sum and the universes differ, on a percent basis, Provider & Medical Management declines seem to be the largest factor in the 20 basis point improvement from last year.

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Costs vary quite a bit by product which is why we and our participants segment costs in this way. Because of their low marketing costs, ASO/ASC products are generally the lowest cost comprehensive product offered by Blue Cross Blue Shield plans. The specialty product, FEP, sold to federal employees, is lower still. Medicare Advantage is the high cost plan: seniors have greater health needs, so submit more claims and have more customer service interactions as well.

At a per member per month cost for comprehensive products of \$28.02, these plans' relative emphasis on ASO/ASC products is evident. At costs ranging from \$21-24, they average about \$10 less than their insured counterparts. Blue plans are also often leaders in Medicare Supplemental products, at \$28.93.

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This slide shows the administrative expenses of each product offered by the Blue Cross Blue Shield universe of plans, expressed as a percent of the premium equivalent. Note that the various ASO/ASC products have very low costs measured as a percent of premium, ranging from 7.3% to 7.8%. FEP is even lower at 5.4%.

But note how, expressed as a percent of premium, Medicare Advantage is among the lower cost products as well, at 8.4% of premiums. Medicare has low administrative costs relative to premium in part because the administrative activities tend to be less per dollar of health benefits. Put a different way, health costs per claim is 20% higher in this product than for commercial lines. A hospital stay for a 75 year old is often a more intensive experience than for a 45 year old. Since health care costs are much larger than administrative expenses as a factor of premiums, the administrative expense ratio is lower.

Medicare Supplemental represents the converse case. Not all health care costs are included with Med Sup health care since it interacts with regular Medicare but many of



the administrative activities are. Thus, their administrative expenses are high relative to premium.

Insured commercial products have far higher administrative expenses relative to premiums than their ASO/ASC counterparts. This mainly stems from much smaller Marketing expenses though Medical Management tends to be lower in ASO/ASC as well.

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This is the end of my formal presentation. The headline conclusion is that, for Blue Cross Blue Shield Plans, administrative expenses are 9.7% of premium, a decline from 9.9% last year and 10.4% the year before. Administrative expense growth continued its moderate trend.

Health care reform and the weak economy likely did not directly affect cost trends. For instance, slow enrollment did not lead to negative operating leverage. But it appears that Blue Cross Blue Shield plans did spend money in accordance with what one expect under health care reform and in a difficult economic environment. Information Systems and Corporate Executive / Governance (including strategic planning) had the most notable growth. While the rate of cost increase from Provider and Medical Management is sharply down from last year, its relative growth this year implies that this continues to be a priority for the Blues.

I have attached to the end of this presentation some appendices in support of this presentation. They include 2008's costs, the functions found in the clusters we have been speaking of and some notes on our quality assurance procedures and our business model.

Now I would like to open this for questions about the results of the benchmarking study.

Questions

I want to again thank you for your participation in this web conference. More in depth and actionable information is available in the benchmarking study itself, which anyone can license. Please contact me directly if you are considering licensing these materials.



Late in September and in early October, we will have similar web conferences on the results of the Medicare and Medicaid plans. We hope that you will consider participating in those web conferences as well.

I want to close by once again thanking all of you who participated in this study for your efforts. Your participation not only enhances your own firm's performance but also raises the bar for all other plans.

This is Doug Sherlock of Sherlock Company.