



Transcript

Blue Cross Blue Shield Administrative Costs: A Review of 2010 Results

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Welcome to our 2011 summary of the benchmarking study of 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.

The impetus to closely look at administrative expenses arises from a weak economy and health care reform. According to the Bureau of Labor Statistics, 13.9 million people are unemployed and 6.2 million have been unemployed for six months or more. This can only affect health plan enrollments: A June 2011 report by the Kaiser Commission on Medicaid and the Uninsured found that 57% of adults who were unemployed and looking for work were uninsured. Negative operating leverage can result if costs are not managed effectively in an environment when revenues are under pressure.

Health care reform leads to additional pressures on health plan administrative expenses. Premium rate increases will be subject to more intense oversight and medical loss ratios (MLRs) will be subject to strict minimums. In short, health care reform limits managerial latitude in many strategic decisions leaving chiefly administrative cost management as the principal avenue of managerial discretion.

However, indiscriminately slashing costs 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

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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 in optimizing those costs.

The theme that the Blue Cross Blue Shield data suggests is that, when compared to last year, plans are adapting to these changes by slowing cost growth. The key exceptions to this is in the Marketing cluster and in information systems and finance functional areas.

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.

This is the first of a series of presentations on health plan performance metrics in 2011. A few weeks from now we will summarize the Independent / Provider-Sponsored plan universe results, and we expect to host similar web conferences for TPAs, Medicare and Medicaid plans later this summer. 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 2010. 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 14th consecutive annual survey of health plan operations and, at the end of this round, our benchmarks will reflect approximately 510 health plan years of experience. In all of our universes this year, we estimate the plans collectively serve 50.0 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 2010 metrics. 70% Blues participate in our benchmarking study, additional ones license it. 55% of all AHIP Board members work for plans that 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.

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 Appendix C. We also request numerous other metrics such as staffing, compensation and so forth. Our quality assurance procedures are summarized in Appendix D.

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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 27 of those Plans, 69.2% of the 39 primary licensees and collectively they serve 38.3 million members.

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 alone, they serve 29 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 2011 benchmarking study, reflecting 2010 calendar year results. (All of the costs are expressed in PMPM values.) Median costs



were \$27.33 PMPM. Last year's results, in Appendix A, were \$28.02, with the difference reflecting actual increases in costs, product mix changes and the addition of some new participants in the universe.

To analyze the results, we have summarized into clusters the more than 50 functions that the plans report. Appendix C tells what functions go into each cluster reported here.

Account and Membership Administration is the dominant source of costs for health plans at \$11.71. This is followed by Marketing expenses at \$7.15. Provider and Medical Management, at \$3.40, and Corporate Services, at \$4.61, are relatively small clusters of expenses. By the way, the figure numbers refer to our free publication, *Plan Management Navigator*, which is available on our web site, along with this presentation.

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.

While I'm discussing calculations, when we make comparisons we try to be as careful as possible make them "apples-to-apples." So, where this slide pertains to all 27 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 2010 are for the 24 plans that participated in both 2010 and 2011 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. 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 2.5% in 2009 to 1.0% in 2010. Reweighting each plans' costs to eliminate the effect of changes in their product mix, total expense growth is 1.8%, down from 3.8% in 2009.



Marketing was unique among the clusters in that its growth accelerated. *As-reported*, growth increased from 0.5% to 1.5%. Eliminating the effect of product mix changes, the acceleration was even more evident, increasing by 4.8% compared with 2.0% in 2009.

Provider and Medical Management costs posted a decline in growth. Growth declined from 3.3% to 1.6% on an as-reported basis and from 5.4% to 2.1% 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.

Account and Membership Administration costs increased in 2010, slower than in 2009. Growth decreased from 4.1% in 2009 to 1.9%, as-reported in 2010, and from 4.2% to 2.2% on a constant-mix basis.

The much smaller Corporate Services cluster actually declined compared with growth in the prior year. On an as-reported basis, cost growth shifted from an increase of 5.5% in 2009 to decline of 1.0% in 2010. On a constant-mix basis, costs trend changed from a growth of 5.7% to a decline of 1.0%.

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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 1.0% 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 2010. 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 2010. Product Development / Market Research, for instance, grew at double digit rates. However, both Rating and Underwriting and Commissions had declines. Advertising and Promotion is larger than most of the other functions, and it increased. Broker Commissions declined due to the mix shift in favor of ASO/ASC and FEP products which have relatively low marketing costs. Marketing cost growth was above last year's growth, unique among the clusters.



Provider and Medical Management 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.

Growth decreased in 2010 for the cluster of functions that constitute Account and Membership Administration. Information Systems was far and away the most important reason for the increase that did occur. It grew faster than most functional areas, particularly so among functional areas in its own cluster. Because of its size, Information Systems had the greatest upward effect on overall costs. Results are consistent with the possibility of increased Blue Cross Blue Shield Plan automation of their activities. For instance, Enrollment / Membership / Billing, Customer Services and Claim and Encounter Capture and Adjudication either had declines in PMPM costs or no increase.

The Corporate Services cluster of expenses declined by 1.0%, a reversal from last year. Central to this trend were declines in costs in a group of sub-functions containing Human Resources, Legal, Facilities, Audit, Purchasing, Printing and Mailroom. This is a large functional area and so affects overall trends. Other declining functions include Actuarial and Corporate Executive and Governance. Finance and Accounting actually experienced a sharp increase in cost 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 even more moderately in commercial. 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 Medicaid and Medicare Supplemental are both up, though Medicare Advantage membership declined this past year.

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Changes in product mix have an effect upon the expense mixes of these reporting Blue Cross Blue Shield Plans because the operational support varies so much between the various products. 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 1.8% PMPM, slower than last year's pace of 3.8%. It is faster than the 1.0% increase on as-reported basis.

Marketing costs grew by 4.8% PMPM. This could be due to greater optimism about the economy, a shift in distribution systems or both. Commissions were the single largest source of cost increase for the Sales and Marketing cluster, an effect that was not apparent on an as-reported basis because of the mix shift in favor of ASO/ASC and FEP products. Product Development /Market Research grew at double digit rates. Internal Sales and Marketing also grew. Advertising and Promotion growth was higher in 2010 but the increase only had a modest impact on the overall growth. The small Rating and Underwriting function grew moderately.

On a constant-mix basis, Provider and Medical Management cost growth fell from last year's rate of 5.4% to 2.1%. But the mix of expenses changed dramatically. 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). While Provider Network and Management and Service cost declined, Medical Management increased. Medical Management continues to grow faster and, since it is the larger functional area, is also chiefly responsible for the growth in the costs of this cluster. Medical Management evidently remains a relatively high priority for the plans.

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 an important factor of cost increases for Blue Cross Blue Shield plans though, at 2.2%, it is not the fastest growing cost cluster. Information Systems, whose costs grew fastest in this cluster of functions and had the greatest overall impact on this cluster's cost trend. The other functions in this cluster, Enrollment, Customer Services and Claims, either had declines in PMPM



costs or no increase at all. It is interesting that Blue emphasis on Information Systems mirrors expectations of information systems investments under health care reform.

Outsourcing increased for Information Systems but declined for all other functional areas in this cluster. Overall, outsourcing is relatively unusual among Blue Cross Blue Shield plans, equating to 10-11% of total FTEs, substantially unchanged from last year.

Corporate Services cost growth declined by 1.0%, compared with an increase of 5.7% last year. Central to the trend were declines in costs in a group of sub-functions comprised of Human Resources, Legal , Facilities, Audit, Purchasing, Printing and Mailroom. Corporate Executive / Governance costs also declined in 2010 and average compensation declined in 2010. Despite the overall decline in the cluster, the function of Finance and Accounting costs actually increased.

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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 addressed a few of them as we prepared this slide. Importantly, we employ premium equivalents for ASO/ASC products. Essentially, this means that we incorporate health benefits paid for by the benefit plan sponsor into the ASO/ASC top line. Our calculations of premium equivalents is discussed in detail in July's *Plan Management Navigator*.

This slide shows administrative expenses as a percent of premium equivalents. At 9.2%, it is below the 9.7% in 2009 and 9.9% in 2008. Account and Membership administration, at 3.9% of premium, comprises the single largest portion of administrative expenses, followed by Marketing at 2.3%. Provider and Medical Management costs and Corporate Services costs were 1.1% and 1.6%, respectively.

While a precise comparison is impossible since medians don't sum and the universes differ, on a percent basis we can see some rough indications of the source of the decline in percents. Sale & Marketing, Account and Membership Administration and Corporate



Services each declined as a percent of premiums while Provider & Medical Management remained unchanged from last year. Appendix B shows last year's values.

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Costs vary quite a bit by product which is why our participants segment costs in this way. After all, it not very informative to know that a health plan focused on commercial ASO/ ASC products has lower costs than one focused on Medicare Advantage.

As shown in this slide, because of their low marketing costs, ASO/ ASC products are generally the lowest cost comprehensive product offered by Blue Cross Blue Shield plans. At costs ranging from \$20-24, they average about \$10 less PMPM than their insured counterparts. At a per member per month cost for comprehensive products of \$27.33, these plans' relative emphasis on ASO/ ASC products is evident.

The specialty product, FEP, sold to federal employees, is even lower than the various ASO/ ASC products. Medicare Advantage is the high cost product: seniors have greater health needs, so submit more claims and have more customer service interactions as well. Blue plans are also often leaders in Medicare Supplemental products, which on average cost \$28.70.

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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 6.2% to 8.2%. FEP is even lower at 5.2%.

But also note that, expressed as a percent of premium, Medicare Advantage is also among the lower cost products, at 8.4% of premiums. Medicare has low administrative costs relative to premium in part because the administrative activities tend to be less relative to any health care episode. Health costs per claim submitted to a Blue plan is 20% higher for Medicare than for commercial lines. For instance, 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 since it interacts with regular Medicare but many of the administrative activities are. Thus, its administrative expenses are high relative to premium, at 16.0%.

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 9.2% of premium, a decline from 9.7% last year and 9.9% the year before. In 2007, administrative expenses were 10.2% of premium equivalents. Administrative expense growth continues to moderate, with a significant overall decline in growth from last year.

Health care reform and the weak economy has increased the need to optimize health plan administrative costs. It is interesting to us that, at least as far participating plans go, slow enrollment did not lead to negative operating leverage.

In fact, even some of the areas that Blue Cross Blue Shield plans had increases were in accordance with what one expect under health care reform and in a difficult economic environment. Information Systems and Finance and Accounting were notably higher. Product Development /Market Research also had notable growth. While the rate of cost increase from Provider and Medical Management is sharply down from last year, the shift in favor of Medical Management says that this continues to be a priority for the Blues.

Many thanks for your attention to this somewhat dry, but I hope informative presentation. I have attached to the end of this presentation some appendices in support of this presentation. They include 2009'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.



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.

In late July, we will have a similar web conference on the results of the Independent/Provider-Sponsored plans. Soon after this we will report on TPA trends. Finally, in late summer, 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 our various studies for your efforts. Your participation not only enhances your own firm's performance but also raises the bar for all other plans.

This is Douglas Sherlock of Sherlock Company.