Transcript

Blue Cross Blue Shield Administrative Costs Accelerate in 2017

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<Title Page>

Thank you for participating in this year's review of the Sherlock Benchmarks for Blue Cross Blue Shield Plans. I am Doug Sherlock, President of Sherlock Company.

Health plan managers endeavor to achieve administrative optimal costs. By that I mean the spectrum of costs ranging from Sales to Claims to Corporate Service and, importantly, Medical Management. If that is achieved, favorable health care trends amplify operating profits and mute operating losses. Managing what you measure facilitates your achievement of that goal. In a competitive environment, measurement implies comparison with the leaders of your industry. We offer what many call "the Gold Standard" for health plan benchmarks.

The 14 Blue Cross Blue Shield plans that are the subject of this presentation serve 37.1 million people with comprehensive insurance. These plans collectively serve about 52% of the membership of Blue plans that are not publicly traded.

Before I begin though, I want to express some appropriate thanks. This year marks the 21st year of the Sherlock Benchmarks. Cumulatively, it reflects the experience of approximately 815 health plan years, and includes Independent / Provider – Sponsored Plans, Medicaid Plans and Medicare Plans. This achievement has been possible through the efforts of my talented colleagues, one very visionary Blue Cross Blue Shield CFO and the professionalism of the participating plans especially our primary contacts within those plans. Since the subject matter of this web conference is free of charge and beneficial even to more casual analysts, I hope you share my appreciation. If gratitude is the new black, it is also a habit and a coat worn.

<Slide 2>

I'm going to breeze through this slide. It shows the topics that I will address, and lists the appendices. Note that the appendices contain last year's value and a list of all of the functions in each of the products offered by these Blue Plans. That means that administrative expenses are segmented into nearly 800 expense/product cells, each of which are separately analyzed. We only summarize broad trends here. We have also included some Market Segment cost information in the Appendix. Finally, we touch on protocols.

For those who have participated in past web conferences, you may notice a difference in that we'll give greater emphasis on trends in Compensation, Staffing ratios and Outsourcing. The continuity of participation makes that possible.

I will be posting the slides and the transcript of this within the next 24 hours. I very much welcome your questions at the end of this presentation and the audience will be muted during the presentation itself.

<Slide 3>

This slide summarizes long term administrative cost trends for Blue Cross Blue Shield Plans. When I speak of growth in costs in this presentation, it will generally be in *per member* terms.

In 2017, excluding the effect of Miscellaneous Business Taxes, Blue Cross Blue Shield Plans reported administrative cost increases of 5.9%, far higher than the previous three years, and the highest since 2013. By contrast, the 2017 trend in Account and Membership Administration was not extraordinary compared with the past eight years, with three other years equal to or greater than 2017. We have not shown this but, after the effect of the Miscellaneous Business Taxes, PMPM total administrative expense actually declined by 2.3%.

As we will develop, Customer Services and Claims functions declined while Rating and Underwriting, Corporate Executive, Association Dues, Provider Network Management and Services, Medical Management, Actuarial and increased, sometimes sharply. Staffing ratios were slightly higher, and compensation increased. Outsourcing was stable.

Different functions are prominent when trends are weighted by the dollar value of their costs. The most important sources of increase were Information Systems, Medical Management, Corporate Executive and Governance and Provider Network Management and Services. Broker Commissions was also a key contributor but we are cautious about the importance of this for both methodological and operational reasons.

To review, you can see that costs sharply increased as the Affordable Care Act came into implementation in 2012 and 2013. Information Systems expenditure increases were central to this. Not only were all existing insured products replaced but their Information Systems had to be reworked as well. The rate of growth in per member costs has declined since then and Total and Account and Membership Administration costs actually fell in 2015.

<Slide 4>

The comparisons on the prior slide are detailed in this one, in the second and fourth columns. These columns reflect the thirteen continuous plans, whose cost values have been reweighted to eliminate differences due to product mix. The first and third columns reflect the as reported values, that is, before the effect of our adjustments to eliminate year-over-year product mix differences. The arced arrows are to draw your attention to the comparison with prior year's values.

The increase in per member costs are across the board and are higher in the constant mix comparisons. All comparisons are higher, typically dramatically so. Account and Membership Administration remains low but Corporate Services is still relatively high. Sales and Marketing had the greatest jump in trend but Medical and Provider grew even faster.

About that product mix, the average Plan participating in the Sherlock Benchmarks this year served 2.6 million people and the median membership was 1.6 million. The geographic reach extended from coast to coast and the size was evenly disbursed in tiers defined in million-member increments.

Thirteen of this year's participants participated in the prior year. Medicare Advantage grew especially rapidly. It composed 3.0% of the combined comprehensive membership and 11.0% of revenues for comprehensive products. But Medicare Supplemental grew also. Medicare Supplement, offered by all 14 Plans, was 6.2% of members and 4.9% of revenues for comprehensive products. Within the Comprehensive products, 82.6%was commercial, or 30.6 million. Approximately 18.3 million of the commercial members were served under some form of self-insurance arrangement, representing approximately 59.7% of the total commercial members. Commercial membership was flat to down and increasing in ASO/ASC to approximately 59.7% of the total commercial members. Within the Comprehensive products, 82.6%was commercial. Medicaid HMO, offered by three Plans, comprised 3.2% of membership. FEP included 5.0% of total comprehensive members.

<Slide 5>

Slide 5 shows the rates of change and the most important reasons for the changes, after eliminating the effect of product mix differences. These are the "real" rates of increase so I will spend a lot of time on this and discuss trends in order of their importance.

The Sales and Marketing cluster increased by 8.7%, the fastest rate in the past five years. For the third year in a row, the fastest growing functional area within this cluster was Rating and Underwriting. Rating and Underwriting is not a large function so that its growth impact is modest on the overall trends. But it had the most rapid overall growth and was rapid across nearly all products. Compensation was higher and staffing ratios were lower.

Blue Plans report three sub-functions in this function. Employer Group Reporting and Risk Adjustment grew quite rapidly while Other Rating and Underwriting (classic Rating and Underwriting) grew modestly. Outsourcing greatly increased in Risk Adjustment, and staffing (including outsourced) was sharply lower.

Broker Commissions is a large function, and had the greatest effect on the cost trend in this cluster. As we discuss later, we don't think that it is so much an increase in commitment to this distribution system but a continuity of relationships between customers and insurance brokers as product selection changed.

The cluster of Corporate Services costs increased by 9.3%, its fastest rate over the past five years and sharply accelerated in 2017. The function of Corporate Executive and Governance was among the fastest growing functional areas in cost growth. In addition to the CEO and COO, this function includes their staff, including enterprise process improvement and enterprise consulting. While this is among the smallest of the functional areas, it was also the fourth largest contributor to cost increases among the 16.

Staffing ratios for the Corporate Executive function sharply increased as did outsourced activities. In nearly all cases, the Plans with the strongest trends in operating earnings showed the sharpest increases in the compensation portion of this function's costs. For the Blue Cross Blue Shield Plans as a whole, median operating earnings increased from $1.43 to $8.13, and from 0.5% to 4.0% of revenues. Compensation has been volatile in this function and is up by 4% since 2014. A second possible contribution to costs, as opposed to just compensation, is the modest but commonplace decline in membership: this function is among those that are slower to adapt to volume changes.

Possibly related to improved profitability, certain charitable contributions also increased. Actuarial sharply increased, perhaps in synch with Rating and Underwriting. Association Dues and License / Filing Fees grew quite rapidly.

The cluster of Medical and Provider Management grew by 10.7%, like Sales and Marketing. This was the highest rate in the past five years. The acceleration and comparisons extended to both Provider Network Management and Services and Medical Management / Quality Assurance / Wellness functions.

Medical Management staffing was flat but was less likely to be outsourced. Staffing costs per FTE were higher. Cost growth was centered on sub-functions of Precertification, Quality Components and Other Medical Management. Staffing ratios and staffing costs per FTE were higher in each of these sub-functions. Outsourcing was mixed in these sub-functions.

Provider Network Management and Services grew even more rapidly. Outsourcing declined, compensation increased, and staffing ratios increased. While Provider

Services was flat to down, the Provider Audit / Billing Validation area grew especially rapidly.

Provider Contracting also grew rapidly. Other Provider Network Management Services, principally of the provider educational activities, grew rapidly.

Information Systems was the fastest growing function in the Account and Membership Administration cluster, which increased by 3%. Staffing ratios were mixed, though higher in Operations and Support Services. Outsourcing decreased slightly. The growth driver appeared to be Applications Acquisition and Development, which had a widespread tendency to "onboard" these services. Compensation trends were mixed in this function.

By contrast, Customer Services and Claims posted declines. Also, each had declines in staffing ratios. Customer Service had an increase in compensation and a decrease in outsourcing, Claims had flat compensation and an increase in outsourcing. To be clear, these functions retain the manual activities even as automation moves work to Information Systems. We haven't analyzed this yet, but I expect we will see an increase in Auto-adjudication and use of web portals when we look at Blues' reported operations.

Enrollment posted moderate growth and an increase in outsourcing. It appears that there was a decline in the percent of Blue Cross Blue Shield commercial insured members that were individual to a median of approximately 25% compared with 29% last year. In total, the commercial membership in these Plans decreased slightly as group membership increased as individual decreased. On the other hand, individual-focused Medicare Advantage was the fastest growing product.

<Slide 6>

This slide explains the *reported* rates of change, that is, the values with no adjustments for changes in product mix. These trends, again, are based on continuous plans. For the most part, there is an excellent correspondence between the constant mix and as reported renderings. So, I won't spend a lot of time on this slide.

The one exception to this is broker commissions. On a mix-adjusted basis, broker Commissions was a key source of growth while, on a constant mix basis it actually declined. The difference puzzled us. But we found that in several cases, Blue Plans are reporting sharp increases in ASO/ASC broker commissions. This was often associated with sharper than average shift in favor of ASO/ASC products and a sharp increase in ASO/ASC PMPM fees. Possibly supporting the above, and the sampler is sketchier on this point, broker overrides and bonuses appeared to be much more important, particularly in Commercial ASO/ASC. We suspect that some groups that were previously insured became ASO/ASC, but the higher commission structure of these accounts remained intact.

Let me close this section with a few summary observations. All my trend comments are based on continuously participating plans and includes the effect of staffing and costs performed on an outsourced basis. Overall, it appears that staffing is slightly higher than last year among continuing plans. Over all participating plans, Blue Cross Blue Shield Plans have approximately 18.8 FTEs per 10,000 members, though we believe that it differs between products and market segments. Of the 14 functional areas with staff, five had ratio increases and four had declines. Key areas of staffing growth included Provider Network and Corporate Services and Medical Management. Key declines included Claims and Customer Services. An indicator of increasing automation was that Information Systems also added staff.

Compensation was typically higher. Inflation is a factor, since 10 of the 14 primary functional areas increased. But there was also a significant difference in the mix of employees: the key areas of staffing growth employed higher cost FTEs, like Operations and Support Information Systems people, while the lower cost FTEs, like member services reps, declined.

Overall, outsourcing was about the same as last year. Five of the 14 functions increased in outsourcing while four decreased, notably the substantial Information Systems and Medical Management functional areas.

<Slide 7>

Up until now, I have focused solely on the administrative expenses that managers can control. For instance, we have excluded from the discussion capital costs such as interest and dividends because they are the result of financing decisions made at the board level or at least beyond the purview of the operating managers. For those of you with an interest in investment theory, this cost segmentation also comports with the observation that financial leverage is independent of operating performance and works the same way whether the organization or the portfolio manager employs the debt.

For that same management control reason, we have excluded Miscellaneous Business Taxes from this analysis. These taxes, which are primarily associated with the Affordable Care Act, layer in additional costs. Unless the plan restructures to consolidate government business in one non-profit, these taxes are unaffected by management, especially operational management. From an operating perspective, perhaps the central attribute of such taxes is to amplify the need to manage administrative costs.

This Miscellaneous Business Tax expense is not part of the expenses that give rise to the 5.9% total increase, but the costs sharply declined in 2017. According to the IRS, "The Consolidated Appropriations Act of 2016, Title II, § 201, Moratorium on Annual Fee on Health Insurance Providers, *suspended* collection of the health insurance provider fee *for the 2017 calendar year only.*" In 2016, among participating Plans' commercial insured business, the Annual Fee was a median of $7.72 and a mean of $7.49.

So, relative to the roughly $45 PMPM for commercial insured products that $7-8 dollars is substantial. On a constant-mix basis, per member Miscellaneous Business Tax costs decreased by 54.9% down from decrease of 1.7% last year and a surge of 369.1% in the 2014. The median value of such taxes is $5.63, down from $12.57 in 2016, and remains approximately 12% versus 21% of all administrative costs last year.

<Slide 8>

To this point, we have focused on rates of change rather than the underlying values of the components of administrative costs. The next few slides speak to the values of these activities, though it is necessarily a summary.

A very rough gauge of trend is difference in the raw numbers between last year's values and this year's. The median PMPM value of $34.99, 9.4% greater than the median value of $32.00 last year. This compares to the as-reported increase of 5.1% among continuous participants.

The prior year values are shown in Appendix A and are also excerpted on this page. The total medians are higher, and the cost mixes vary. Note that the universes of Blue Plans vary as well.

There is some correspondence with the overall administrative cost trends on Slide 4 and increases that resulted in the values shown here. Overall, this comparison seems to resemble the as-reported comparison in Figure 2. This is not surprising since neither approach adjust for product mix and there was a great deal of continuity in participation. Medical and Provider Management grew by 9.9% in both approaches, and Sales and Marketing increased by 4% (rounded) in both approaches. Their values were $4.44 and $8.79, respectively.

Account and Membership Administration increased modestly in Slide 4 and the median value of $14.66 was 0.7% higher than last year. Corporate Services grew rapidly and here, with costs of $6.27, there is an increase by a dollar or 19.0% from last year. This sharply exaggerates the actual increase of 9.1%.

Interestingly, the cluster values are more disbursed. The differences between 25th and 75th percentile values are greater, and the coefficients of variation tend to be greater as well. This may be a factor in why the total increase of 9.4% to $34.99 greatly exceeds the increase of 5.1% in Figure 2.

<Slide 9>

I have noted the effect of product mix changes on trend and this slide shows what I mean. Note that the ASO/ASC products have costs that are about 60% of that of the insured commercial products. The overwhelming reason for the differences stem from Sales and Marketing cost differences.

Median ASO/ASC PMPM costs range from $24.14 in the Commercial POS product to $26.70 in the Indemnity and PPO. The latter is the single most important product offered by the Plans, comprising a median of 45% of the comprehensive membership, on average. (Last year it was 43%, before that it was 39%.) Insured product costs ranged from $43.85 for Indemnity and PPO to 48.87 for HMO.

Other low-cost products included FEP at $23.63, Medicare Supplemental at $33.29 and Medicaid (relative to other insured products) at $43.22. The highest cost in Blue

Comprehensive products is Medicare Advantage at $97.63. Drilling further, we would normally expect to see lower costs for group because of lower Sales and Marketing expenses but this is not year's result. One possible explanation for this that Group Medicare is still unusual for Blue Plans.

This panel has elected not to include Medicare SNP as a comprehensive product, but it costs $191.33. These are primarily dual-eligible members. The specialty insurance products, Medicare Part D and Stand Alone Dental, are low cost products at $15.65 and $4.20, respectively.

For continuously participating plans, membership declined overall at a median rate of 0.5% and an average rate of 0.7%. Eight of the 13 posted declines. Commercial membership declined at a median rate of 0.3% - the 4.6% decline in commercial insured was partially offset by the 2.7% increase in commercial ASO/ASC. Medicare Advantage was the fastest growing product at 7.0%, though Medicare Supplemental grew as well. Medicaid declined as did FEP.

<Slide 10>

This is similar to the previous slide, only expressed in percents. The median administrative expense relative to premiums was 8.9% while the equivalent value for last year was 8.3%. (By the way, we are using premium equivalents here.) Increases in copayments and deductibles can push those ratios higher. In many respects, the relationships between the costs of various products measured in percents parallel those measured in PMPM values. The ASO/ASC products range from 6.0% to 7.9% for HMO and Indemnity and PPO, respectively. These values are substantially lower than the ratios for insured products that go from 8.6% for HMO to 10.2% for POS. Another low ratio product is FEP, at 5.4%.

The highest percent ratio product, Medicare Supplemental at 16.9%, is also among the lowest values measured on a PMPM basis. That this product is secondary to Medicare while many of the claims paying activities of Medicare are borne by this product likely explains this paradox.

The Medicare products are much more similar to commercial products on a percent than on a PMPM basis. This is consistent with administrative requirements of insured people tending to track their health needs.

<Slide 11>

This slide shows the administrative expenses by cluster of functions. As in the previous page overall costs were at 8.9% of premium equivalents, higher than the 8.3% last year. Except for Sales and Marketing, the median values for all of the clusters grew in comparison to the 2016 values shown in Appendix B. I suspect that, because local cost differences are as not much reflected in percents, these ratios cluster more than are found in the PMPM values on Slide 8.

As noted earlier, these differences won't track with the values shown in Slide 4 because the universe and mix have changed.

<Slide 12>

The overall cost trends accelerated by 5.9%, far higher than the previous three years and the highest since 2013. Account and Membership Administration was not extraordinary compared with the past eight years, with three of the prior seven years equal to or greater than 2017.

However, the mix of expenses is sharply different. Sales and Marketing increased at the fastest rate in the past five years. For the third year in a row, the fastest growing functional area within the cluster was Rating and Underwriting. Perhaps aligned with this, Corporate Executive & Governance, Association Dues and License /Filing Fees and Provider Network Management and Services, Medical Management and Actuarial also grew much faster than the overall trends, sometimes sharply.

By contrast, Customer Services and Claims posted declines. Each of these had declines in staffing ratios, consistent with increasing automation.

This presentation, (transcript and slides) will be posted on our web site in the next few hours. In addition to these slides, we include last year's values, some descriptive materials and, perhaps most interesting, a slide analyzing costs by segment. By segment, I mean On-Exchange, Off-Exchange and Compliant, Grandfathered, and small, medium and large groups.

In about two weeks, we will summarize the Independent / Provider - Sponsored plan universe results, and we expect to host similar web conferences for Medicare and Medicaid plans later this summer. Additional information, including tables of contents on the benchmarks themselves are found on the website. Call me if we can elaborate.

Thank you for your attention to our presentation. Now I would like to open this for questions.

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Questions and Answers

Q: Did the decline in membership affect the cost trends?

A: That is a possibility. While we consider economies of scale to be less important than conventional wisdom, the two plans with the sharpest declines had much higher rates of admin growth. And it was where you would expect it, in the functions we identified as slower to adapt especially in the Corporate Services area.

Q: What do you mean by "percent outsourced", for instance in the context of your statement that medical management was less outsourced in 2017?

A: We use a metric of outsourced FTEs and calculate outsourcing as the sum of those outsourced FTEs and the ones that the Plans employ. Either the Plans supply the outsourced FTEs, or they use a schedule we supply them. The intent is to avoid distortions from the differences in labor and non-labor cost mix that may arise from outsourcing.

Q: You mentioned that the 18.8 FTE per thousand staffing ratio differs from product and market segment. Would you elaborate?

A: The participating plans tell us that their costs differ by product and by segment and divide their costs accordingly in their survey forms. So, when we estimate staffing for individual products and segments, we divide the PMPM costs by the total costs per FTE. In doing this, we assume that the labor/non-labor mix is similar across each plan's products and that the underlying costs are specific to each plan. We think both assumptions are reasonable.

Q: Do the members include Host services, that is, Plan services to other plans?

A: No. We do analyze those costs but neither the costs nor the members served under those relationships are included in this analysis. I believe that there are approximately 7.1 million such members.

Q: Do you know whether this is similar to other plans such as regional or national plans?

A: We think probably. First, from time-to-time, large national plans participate, and we also have a universe of Independent / Provider – Sponsored plans, so we know a bit about them. Second, we think that, in the case of national plans, the scale effects are few and limited in effect. For the most part, the organizations compete in the same labor markets and use similar processes so they will likely perform similarly. Differences don't result from systematic differences but from execution.

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

In late July, in two weeks actually, we will have a similar web conference on the results of the Independent / Provider - Sponsored plans. 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.

Let me thank you all for the hard work that goes into the 20th annual edition of the Blue benchmarks. We know, because we measure this, that participation pays off in lower costs. But the "by-product" is something that benefits the industry as a whole. Thank you!

This is Douglas Sherlock of Sherlock Company.