Plan Management
Navigator
Analytics for Health Plan Administration Early December 2010

Summary of Decisions of Low Cost Independent / Provider-Sponsored Health Plans

Background and Methodology

The decisions of low cost plans differ from those made by higher cost ones. This analysis examines the differences for the Independent / Provider-Sponsored plans that participated in the *Sherlock Expense Evaluation Report (SEER)* in 2010.

For this analysis, the term "low cost" refers to the performance of health plans for the functional areas which make up approximately 75% of total administrative costs. These costs exclude the functional area of Medical Management and the functional area cluster of Sales and Marketing. The purpose of excluding Medical Management is that when effective, it drives down health benefit costs. Health benefits are identifiably discrete from administration and medical management may have benefits spanning years. Similarly, effective Sales and Marketing expenses often affect growth in subsequent years due, for example, to seasonal patterns. Therefore, it is of more value to focus on the remaining expenses that have an immediate impact on the operations of a health plan because their effect is largely confined to current period activities and each function's performance principally affecting only those other remaining activities.

To simplify, the expenses of the remaining activities incurred during a health plan year can be thought of as more or less self-contained, and reflect their complementary roles during that period. We call these "tactical" administrative expenses for the purposes of this analysis. We acknowledge that, for Information Systems in particular, this segmentation is subject to criticism. We also recognize that the architecture of expenses is established over multiple years. These tactical expenses are incurred, however, in ways that largely reflect, in that period, completely and

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Latest Health Plan Dashboard Results

For the trailing three months ended October 31st, 2010, the thirteen health plans in our *Health Plan Dashboard* reported health revenue growth of 6.6%. Indemnity grew by 1.0%, ASO / ASC grew by 1.8%, while Managed Care revenue increased by 7.5%. Medicare Advantage grew by 6.4% and Medicaid had revenue growth of 7.6%.

Overall, membership increased by 4.1% in health lines. Membership declined by 2.0% for Managed Care and 1.5% in the Indemnity business. Membership in Medicare Advantage products jumped by 9.8%, while Medicaid increased by 7.2%. The gains in Medicare Advantage and Medicaid were especially large among Provider-Sponsored Plans. ASO / ASC products experienced a membership increase of 4.3%.

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New *SEER* Universes Being Formed

The challenging operating environment for health plans has convinced many managers that effective management of operating costs is central to their plans' long-term success. The weak economy is placing great pressure on commercial enrollment, creating the risk that administrative expenses could be a source of negative operating leverage.

An additional challenge health plans face is that of the health care reform. Under this reform, the administrative expenses of health plans serving the commercial market are subject to the indirect limitations of the minimum medical loss ratios. The health care reform also will have some members using "exchanges" which are expected to create additional cost pressures in the affected portions of the commercial market. For plans offering Medicare Advantage, administrative costs will be subject to

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exhaustively those management decisions affecting a health plan's business processes.

To identify the decisions that lead to low costs, we divided the universe of Independent / Provider-Sponsored ("IPS") plans into a low cost group, comprised of approximately 25% of the universe, and all other plans in that universe. The low cost group was determined based on relative performance, after our comparisons eliminated the effect of product mix differences. We did not adjust for any cost of living differences since health insurance operating functions are not geographically confined.

Overall Cost Savings

Overall, low cost plans have tactical administrative expenses that are $6.39 PMPM or 36% lower than their higher cost counterparts. In the low cost plans, the Staffing Ratio was significantly lower than the high cost plans and accounted for the vast majority of the cost savings. Non-Labor Costs (supplies, depreciation and other operating expenses) had the second greatest influence on the low costs, while low Staffing Costs contributed the least to the overall cost savings for these plans.

When examining the results from a cluster standpoint, the functional area cluster called Account and Membership Administration explained nearly one-half of the favorable variance of the low cost plans. The expenses that make up this cluster are responsible for the majority of reported overall tactical costs. The component of costs that was most responsible for this favorable variance was overwhelmingly a low Staffing Ratio, followed by low Non-Labor Costs. Staffing Costs had a relatively minor effect.

The functional area most responsible for the superior performance of the Account and Membership Administration cluster is that of Information Systems, which explained the vast majority of this variance. Again, a low Staffing Ratio contributed the most to the low costs of Information Systems, followed by low Non-Labor Costs. Interestingly, these low cost plans had higher Staffing Costs than their counterparts, which offset some of the favorable variance of this function. Information Systems is more likely than most functions to be outsourced so we worried that this could create some softness in the distribution of expense variance drivers. However, this does not appear to be the case since Information Systems functions for high cost plans are just as likely to be outsourced as the low cost plans.

Another functional area that significantly contributed to the favorable variance of Account and Membership Administration was that of Claim and Encounter Capture and Adjudication. This area is more closely linked with Information Systems than any other functional area. More than one-third of Information Systems activity was in support of this function, among the IPS plans reporting this data. A low Staffing Ratio was the primary driver of low costs here, while Staffing Costs were also less than other plans. Non-Labor Costs were high for this function and offset some of the favorable variance

The cluster of Corporate Services comprises approximately one-third of the tactical expenses. The functions in this cluster include Finance and Accounting, Actuarial, Corporate Services function and Corporate Executive and Governance. Many of the scalable functions are found in this cluster. The average size of the low cost plans was 400,000 members, compared with 330,000 members among their higher cost peers, so scale may play a role here. But scale is not definitive: the three largest participants are in the high cost group. For this cluster, a low Staffing Ratio was responsible for nearly all of the favorable variance. Low Staffing and Non-Labor Costs contributed slightly to the low costs.

Low Corporate Services *functional* area costs greatly influence the overall difference with the higher cost plans. The primary driver of low costs in this area was a low Staffing Ratio, followed by low Non-

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Labor Costs. Staffing costs were also lower than the other plans and contributed to the favorable variance.

The functional area of Provider Network Management and Services had a moderately favorable impact on the overall tactical variance. Again, the majority of this cost savings came from the Staffing Ratio. Unlike most other functions, nearly all of the balance of the favorable variance is from low Staffing Costs.

The Choices Low Cost Plans Make in Tactical Expenses

Low cost plans make decisions that differ from their higher cost peers. Hallmarks of these decisions include levels and distributions of expenses between functions, the levels and distribution of staff between functions, the levels of compensation and the distribution between functions and levels of non-labor expenses.

Cost Variances. Among the low cost plans, Corporate Executive and Governance represented the greatest percent favorable variance enjoyed by the low cost plans, followed by Actuarial. One significant finding was that the low cost plans did not spend more on one function and reduce costs in others. Rather, they maintained low costs *across the board*, but some functions were lower than others.

Components of Cost Variance. The leading sources of the overall favorable variance were the functional areas of Information Systems and Corporate Services. This was followed by the functional areas of Claims and Corporate Executive and Governance.

Staffing Ratio Variances. Low Staffing Ratios were primarily responsible for the difference between the low cost and other plans. In terms of functional areas, the Corporate Executive and Governance area for low costs plans had the greatest variance from their peers, followed by Actuarial. By contrast, Finance and Accounting and Enrollment were the closest to the other plans, but still with favorable variances.

Components of Staffing Ratio Variances. As noted earlier, the Staffing Ratios of low cost plans are significantly lower than those for their high cost peers. The most important source of this difference is in the functional area of Claims, followed by Information Systems. The Staffing Ratios for all of the other functional areas were also low as well.

Staffing Cost Variance. As noted before, Staffing Costs represent a small portion of the favorable performance of low cost health plans. In some cases, the Staffing Costs are actually higher in the low cost plans, such as Corporate Executive and Governance and Information Systems. When compared to the other plans, Staffing Costs were notably lower in the functional areas of Provider Network Management and Services, Finance and Accounting and Enrollment.

Components of Per Employee Staffing Cost Variance. Total Staffing Costs represented only a modest source of the overall tactical variance. Of the total Staffing Costs variance, Provider Network Management and Services comprised a significant portion of it, followed by Finance and Accounting and Enrollment. Conversely, the functional areas of Corporate Executive and Governance and Corporate Services had higher Staffing Costs than the other plans and offset some of the favorable overall tactical variance.

Non-Labor Cost Variance. As stated before, Non-Labor Costs were the second most important driver of performance for the lowest costs plans. In terms of variance from the other plans, the functional area of Finance and Account had the greatest percent advantage in these costs, followed by Enrollment and Information Systems. The functional areas of Customer Services and Claims actually had higher Non-Labor expenses for the low cost plans.

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Components of Non-Labor Cost Variance. Superior performers, as a rule, have lower Non-Labor Costs per FTE. As a percent of the overall favorable variance of Non-Labor Costs, the functional area of Information Systems was the greatest contributor, followed by Corporate Services. Claim and Encounter Capture and Adjudication and Customer Services actually were higher for the low cost plans and offset some of the overall Non-Labor Costs variance.

The fact that Non-Labor Costs for Information Systems are higher and Non-Labor Costs for Claim and Encounter Capture and Adjudication are lower than the other plans raises the possibility that classification differences explain some of this. Notwithstanding our care of this process, we cannot rule this out. However, the results indicate that when the Non-Labor Costs differences for these two functional areas are summed together, the net effect is that Non-Labor Costs are still significantly low, suggesting that classification differences would be unlikely to be the most important effect, even if it had occurred.

Strategic Expenditures of Low Cost Plans

As noted above, certain expenses, especially Sales and Marketing and Medical Management, have returns that may be realized over a longer period of time. In addition, Medical Management expenses may yield lower health care costs. For this analysis, we call these strategic activities. So, we have considered these expenses separately and, in this analysis, assumed that health plans with low costs in the tactical functions are also likely to make insightful decisions regarding strategic functions as well. Interestingly, however, like the tactical expenses, the costs in strategic expenses are lower overall as well.

For the low cost plans, the Sales and Marketing functional area cluster had expenses somewhat lower than the other plans, but the drivers of these costs are much different than other clusters. The favorable variance is entirely due to a low Staffing Ratio. Non-Labor Costs offset much of the favorable variance while Staffing Costs were also high. (Non-Labor Costs for this cluster include broker Commissions and Advertising.)

The most important source of lower costs is in Sales, which represents a significant portion of the lower costs in the Sales and Marketing cluster. The Sales function's costs are lower primarily due to a low Staffing Ratio, followed by low Staffing Costs. Non-Labor Costs were higher in low cost plans, however.

Rating and Underwriting is another important source of favorable variance. Costs are lower due to a lower Staffing Ratio. While Non-Labor Costs are lower and contribute to the favorable variance, Staffing Costs are higher and offset that same variance

By contrast to the low costs of internal sales, external broker Commissions are relatively high compared to the other plans. The combination of low internal Marketing and Sales expenses combined with higher Commissions suggests that the low cost plans favor an external distribution system, rather than an internal one.

Advertising and Promotion costs are also higher. While Staffing Ratios are higher, the Staffing Costs are low.

It is notable that these low cost plans grew at a rate almost identical to their higher cost peers. While both groups grew at approximately the same rate overall, for the mix of products offered by the low cost group, the low cost plans had a median growth rate substantially higher than the high cost plans.

The average size of commercial groups served by the low cost plans is higher than that in the higher cost group. The greater the group size, the lower marketing expenses would be expected to be.

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However, this is due entirely to one plan with a very high average group size.

The firms with the lowest costs in the tactical areas also have low costs in Medical Management. This function, as opposed to Sales and Marketing, is central to the lower costs of the strategic functions. The costs in this functional area are lower and comprised the majority of the total favorable variance in strategic costs. Staffing ratios are low and are the primary driver of the total favorable variance in costs. Non-Labor Costs savings and low Staffing Costs comprised the balance of the favorable variance.

The median health benefit ratio for the low cost plans was slightly lower than that of the plans with higher administrative costs. Also, when adjusted to the product mix of the low cost plans, the high cost plans had a health benefit ratio greater than their unadjusted ratio. We do not know whether the higher health benefit ratio is the cause or the effect of the higher medical management costs that the high tactical cost plans face.

Conclusion

This analysis identifies the hallmarks of the choices that low cost health plans make. It is free of product mix bias, and the data has been thoroughly scrubbed.

A few conclusions may be drawn. While the expense savings are concentrated in Information Systems, Corporate Services and Claims, they are found in all tactical functions across the board. This is suggestive of an overall management commitment and a culture of conservative spending throughout the organization.

Also, low costs have little to do with Staffing Costs. Rather, they are generally mostly the result of lower Staffing Ratios and Non-Labor costs. It is suggestive of thoughtful attention to the processes of executing health plan transactions.

Factors such as propensity to outsource, membership growth and scale seem to have little to do with achieving low costs.

This analysis is not an operational blue print however. This analysis contains no recommendations on what information system to buy, what proportion of claims should be autoadjudicated or the appropriate mix of manual versus automated customer service inquiries to shoot for.

The premise of this and our other benchmarking efforts is that the heads of the various functional areas are experts on how to improve their operations and that they are committed to doing so. We also recognize that aggressive cost management requires that managers make difficult decisions. In short, our benchmarks are intended to serve as catalysts to the actions that managers may already see as necessary on an intuitive level and also provide a broad-brush description of what those operational targets must look like. Those managers are likely experts in executing the goals implied in this analysis.

Additional information is available to users of the Independent / Provider-Sponsored edition of the Sherlock Expense Evaluation Report.

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Indemnity and Managed Care had price increases of 5.8% and 4.5%, respectively, while ASO / ASC posted a 1.4% increase. Medicaid posted a decrease of 6.0% as Medicare Advantage premiums decreased by 0.9%.

Health benefits ratios overall fell by 1.9 percentage points, but decreased by 3.7 percentage points (as a percent of premium equivalents) for the Medicaid line and dropped by 3.5 percentage points for Indemnity. The number of scripts per person decreased by 0.2 to 9.7 on an annualized basis with the largest decrease in the Medicare Advantage product, by 1.6 to 33.4. E/R visits per thousand members decreased by 13.7, or 5.3%, to an annual rate of 243.6 per thousand and hospital days decreased by 12.8 days to 310.1 days per thousand. All products experienced declines in hospital utilization.

The administrative expense to premium ratio remained at 9.6%, while the administrative costs per member per month declined 1.3% to $26.20. Claims volumes increased by 0.09 to 14.9 per member per year while inquiries per member fell 0.12 to 1.6 per member per year. Staffing ratios decreased by 0.52 FTEsper 10,000 members to 19.8, primarily led by a 1.92 FTE decline from Blue Plans.

Health plans in our *Dashboard* universe are comprised of a mix of Blue Cross Blue Shield and Independent/Provider-Sponsored plans. Please let us know if additional information would be of interest to you and your organization.

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pressures of their own. This product will ultimately face MLR minimums, but rate increases will be especially meager in the intermediate term. For plans offering Medicaid, weak state budgets will place continuing pressure on plans' Medicaid operations.

Benchmarking helps firms determine whether they are operating at best practice for costs and, if not,

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what functional areas provide the highest return on management's efforts in improvement. If improving your plan's performance is on your company's agenda for 2011, we invite you to consider participation in Sherlock Company's benchmarking surveys.

We have a very strong network of plans. Fifty-eight plans serving more than 43 million insured Americans participated in our benchmarking studies in 2010. Our universes consist of Blue Cross Blue Shield Plans, Independent/Provider–Sponsored plans, Medicare plans, Medicaid plans and Third Party Administrator plans.

We have unparalleled experience. Now completed our thirteenth survey, we have 454 health benefit years of experience. Our data definitions, metrics, "scrubbing" procedures and analysis methods are well-developed. Our experience means our benchmarks achieve a high degree of insight for your efforts.

Our benchmarks are generally accepted. Including licensees, health plans serving more than one-half of all insured Americans are current users of our benchmarks. They are also relied upon for advocacy and health policy purposes.

We are structurally sound. Reliability is enhanced by its voluntary participation, freedom from conflicts of interest and incentives against the "tragedy of the commons."

If your plan would like to consider participation, we invite you to give us a call at 215-628-2289 or email us at sherlock@sherlockco.com. We will launch the surveys beginning in March 2011 to reflect 2010 calendar year results.