PERSPECTIVES

PROVIDING INSIGHT INTO TODAY'S EMPLOYEE BENEFITS ISSUES

Increasing Healthcare Costs and Your Employee Health Plan

Fourth Edition

HEALTHCARE costs, and consequently health insurance premiums, have been increasing at an alarming rate for the past five years. Can you avoid it? Probably not. But, you can learn about why it is happening, and what you can do to decrease its impact on your organization and your employees.

The next few pages will discuss factors leading to the greatest increases in healthcare costs since the early 1990s, and some solutions that firms around the U.S. are undertaking to help soften the blow.

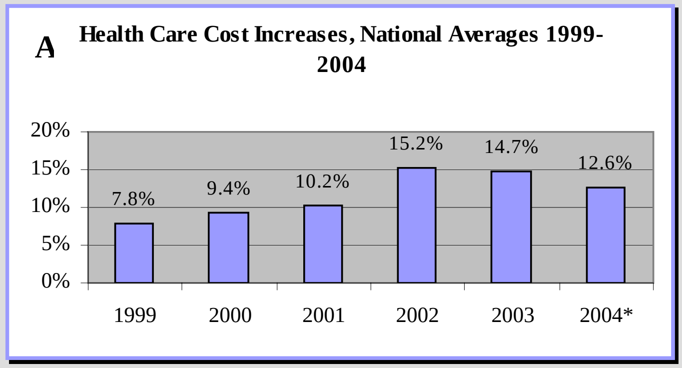
National Healthcare Cost and Renewal Rate Projections

Health benefits remain one of the most valuable components of any employee compensation package. Nonetheless, unpredictable and uncontrollable rate increases every year make it difficult for employers to balance employee needs with their own capabilities and bottom lines.

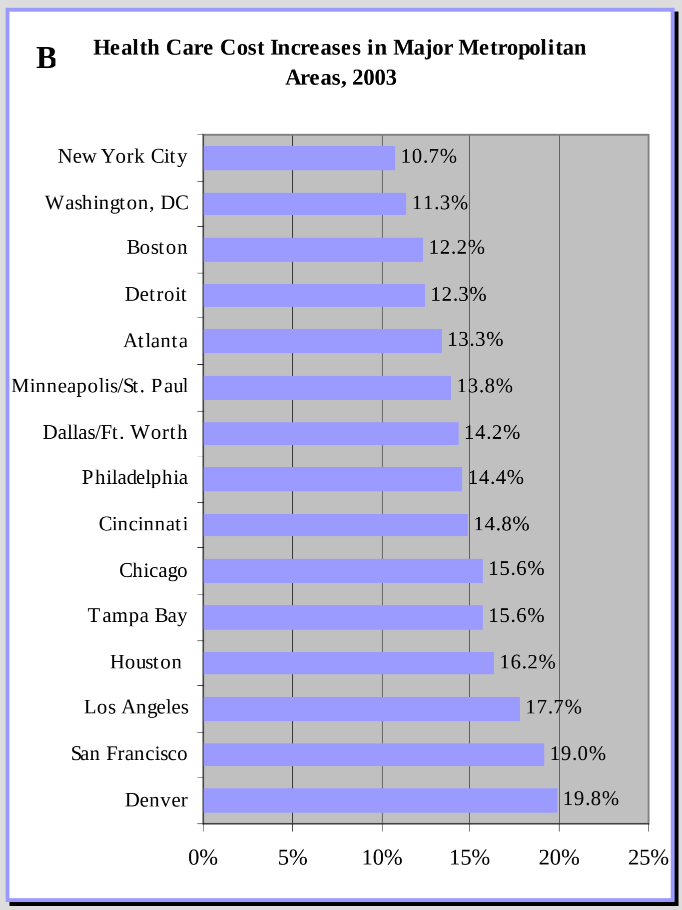
To understand why rates are rising so dramatically, one must understand that overall national healthcare costs are skyrocketing — reflecting the biggest surge in medical inflation since the early 1990s. From 1994 to 1998, average annual healthcare cost increases hovered around 2%. From 1999 to 2000, however, costs leapt 9.4%, and the annual percent change has entered and stayed in the double digits since. **Exhibit 1A**, right, depicts the percent change in average annual healthcare cost increases from 1999 to 2004.

Healthcare cost increases have varied across the country over the last several years, with some metropolitan areas hit much harder than others. **Exhibit 1B**, right, illustrates healthcare cost increases in some major metropolitan areas in the U.S.

Exhibit 1



*Projected
Source: Hewitt Health Value Initiative™ 2003.



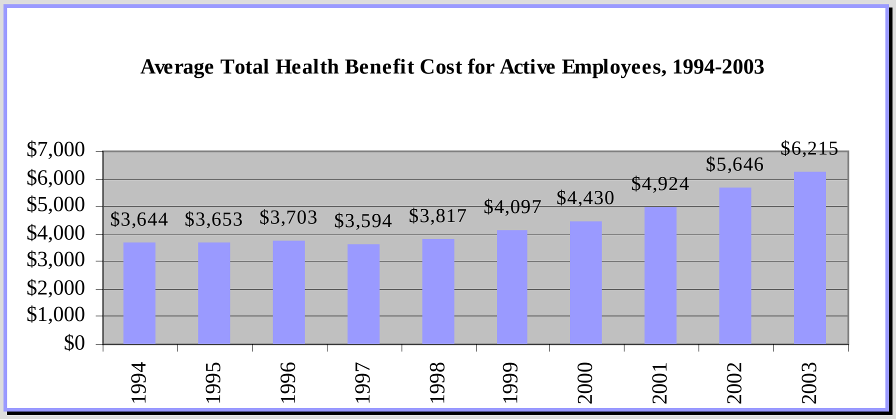
Source: Hewitt Health Value Initiative™ 2003.

Many employers have been faced with double-digit rate hikes over the last several years, reflecting the upward trend in overall healthcare costs across the nation. Despite a smaller than expected increase, 2003 was the sixth year in a row that health benefits costs rose faster than the rate of inflation, and the trend is expected to continue indefinitely. According to the *Mercer/Foster Higgins National Survey of Employer-Sponsored Health Plans*, the average cost of healthcare benefits for active employees rose 10.1% in 2003 — from $5,646 per employee in 2002, to $6,215 per employee in 2003. **Exhibit 2A**, below, shows the average total health benefit cost for active employees for the years 1994 to 2003. **Exhibit 2B** depicts how health benefit costs have changed from 1987 through 2003. Note especially, the upward trend since 1998, and the one positive sign that is now emerging — a drop in the percent increase from 2002 to 2003.

Exhibit 2C, below, illustrates the average increases by plan type for large and small employers combined.

Exhibit 2

A



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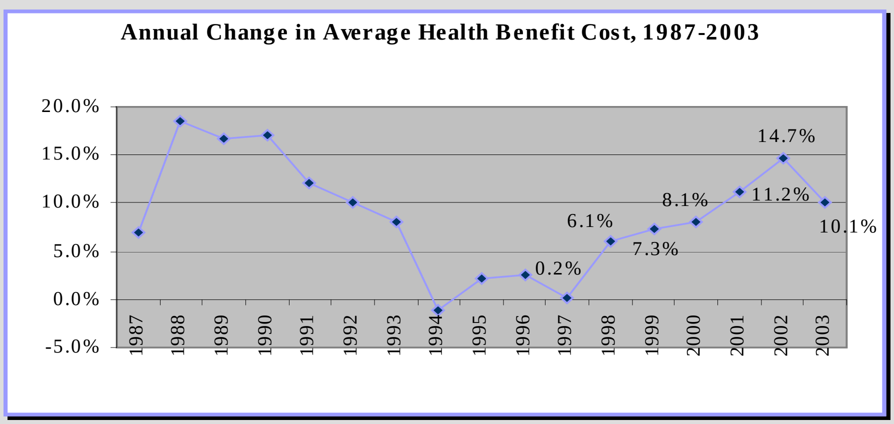

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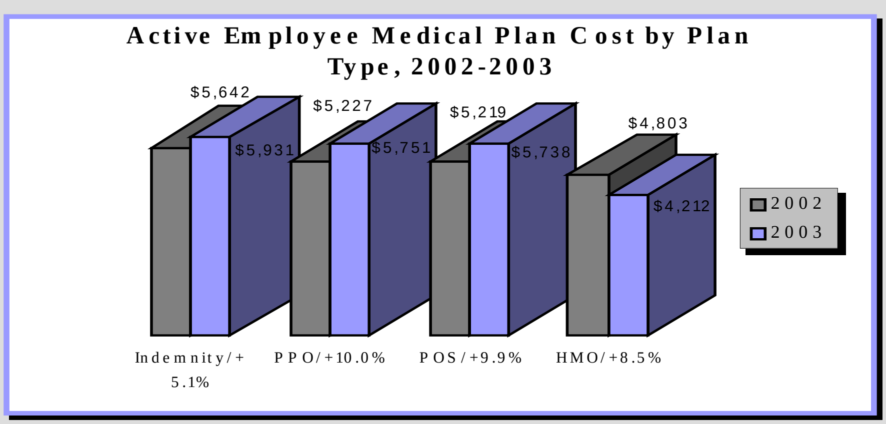


Source: Mercer/Foster Higgins National Survey of Employer-Sponsored Health Plans 2003.

Factors Leading to Increased Healthcare Costs

Why are U.S. healthcare costs skyrocketing? Several market conditions working in tandem have led to the current onslaught of steep increases. Understanding why your annual health plan renewal rates may be significantly higher than the previous year is the key to formulating alternatives and solutions to your particular plan's challenges. It is also the key to educating your employees about the reasons behind any plan or contribution changes you may decide to introduce.

A discussion of the key factors leading to recent hikes in medical costs and health insurance premiums follows.

Demographics: The Aging of America

It is an inescapable fact: the U.S. population is aging. While the population of older Americans is increasing, the number of children and younger people is remaining stable and even decreasing for some age groups.

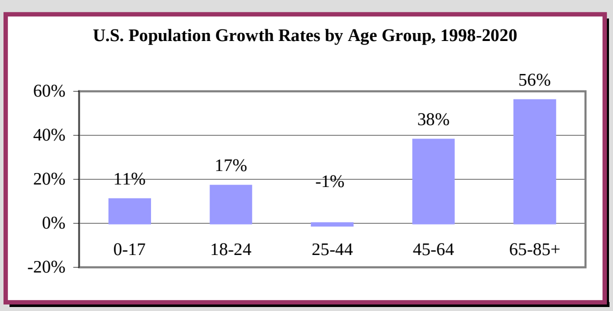
- ✓ According to the U.S. Census Bureau, from 1900 to 1994 the elderly population increased 9-fold. During the same period, the number of people under the age of 65 rose only 3-fold. The growth rate of elderly persons is expected to be modest from 1990 to 2010, and is then expected to ascend dramatically from 2010 to 2030 as the Baby Boom generation enters the 65 and older category. About 1 in 5 U.S. citizens will be elderly by the year 2030.

- ✓ **Exhibit 3**, below, shows the growth rate of persons aged 45 to 64 reaching 38% between 1998 and 2020, and the growth rate of those aged 65 to 85+ reaching 56% by 2020.

As the American population ages, there is a subsequent rise in the occurrence of chronic diseases like asthma, heart disease, and cancer, and a resultant need for more resources to fight these diseases. This leads to elevated utilization of prescription drugs and other medical services, and an overall rise in dollar expenditures on healthcare. Essentially, the cost of caring for an elderly person is dramatically higher than for a person under the age of 65 years old. Because of this, the growth of the number of people over age 65 is beginning to and will continue to have a drastic impact on many levels, from employers funding these employees until they become eligible for Medicare, to cost shifting from Medicare to the private sector — one of the biggest factors in medical inflationary trend.

The aging of the American population will continue to be a driving factor behind increases in the costs of healthcare for many years to come.

Exhibit 3



Source: Kiplinger Washington Letter, December 23, 1998.

About 1 in 5 U.S. citizens will be elderly by the year 2030.

Dramatic Rise of Prescription Drug Costs

Please turn to the attached *Special Report: Prescription Drug Costs and Your Employee Health Plan* for a discussion of why prescription drug costs are on the rise.

Consolidation of Managed Care Companies

As managed care boomed throughout the 1990s, competition among managed care giants like Aetna and Cigna — and among smaller regional players — became fierce. A desire to leverage economies of scale into bigger discounts from providers, and to gain enrollees and market share, induced many of the large organizations to consolidate and acquire smaller, weaker firms. They also kept premiums low and often did not keep them in line with the rate of medical inflation in order to gain business from rival companies and maintain their current customers.

Now, the landscape of the industry has changed. Years of under-pricing, weak underwriting, and the costly process of assimilating acquisitions has lead to serious dips in profitability and stock prices for a large number of U.S. managed care companies. Those who couldn't make the cut have either sold off their managed care operations to a bigger fish, or have completely gone out of business. Companies that haven't exited the market altogether are now faced with much less competition, and a renewed commitment to achieving healthy returns. This has ultimately resulted in increased rates.

Expansion of Providers

One of the major factors driving up the cost of healthcare is the growth of healthcare providers. Expansive healthcare systems that offer acute care hospitals, specialty facilities, clinics, labs, physician practice groups, and other services are becoming prevalent. Much of this expansion took place during the mid- to late-1990s and continues today. While these systems provide many benefits to the communities they serve, they also require a great deal of capital to fuel their growth. These capital expenditures by hospital systems and other providers place upward pressure on the costs of many medical services.

Political Environment and Government Regulation

Health insurance, and more specifically managed care, is one of the most regulated insurance sectors on both the state and federal levels, and has also become one of the most highly debated topics in the political arena.

State and federal mandates have increased 25-fold over the last three decades. Often these mandates duplicate or conflict with each other, and almost always come with increased costs for the healthcare system. For example, the Health Insurance Portability and Accountability Act of 1996 (HIPAA) continues to operations of many health plans seeking compliance. According to an April 2002 study by PricewaterhouseCoopers, HIPAA alone is responsible for adding billions of dollars of new compliance costs to the healthcare system.

Aside from HIPAA, there are over 1,500 mandated benefits at the state and federal level. Each of these has a cost associated with it, and together they have had a significant impact on healthcare costs.

PATIENTS' BILL OF RIGHTS

On the political front, concerns about timely access to quality healthcare services and calls for federal laws to protect consumers led to the passing of the Patients' Bill of Rights legislation in both the U.S. House of Representatives and the U.S. Senate. Prior to the terrorist attacks on September 11, 2001, the Congress was working to resolve differences between the two versions, and sign the bill into law. National security interests, a slowing economy, and the war in Iraq in early 2003 have since forced the debate to the backburner, but a resolution is still on the horizon.

Some of the contested provisions include:

- ✓ Requiring health plans to expand emergency services, access to specialists, and prescription drug coverage.
- ✓ Expanding the patient's right to sue health plans and employers if those entities *directly* participate in claim determinations.
- ✓ Prohibiting health plans from any involvement in medical necessity determinations.
- ✓ Direct access for women and children to OB/GYNs and pediatricians, respectively.
- ✓ Mandating that federal laws should override existing state laws.
- ✓ Extending proposed protections to all of the insured population, versus just to those who are covered by self-insured plans (those that are exempt from state law and regulated only by ERISA).

Both the House and Senate bills add a number of process mandates that could increase healthcare costs. One analysis, for example, found that health plans would need to follow over 700 new legal requirements if a Patients' Bill of Rights were passed. The scope of their potential impact on costs is widely debated.

While much of the concern about the political environment surrounding the managed care industry is regarding pending legislation, there is no doubt that recent regulations have resulted in increased costs for health plans. Additional issues, such as prescription drugs for seniors, Medicare reform, and coverage for the uninsured will play a big role on political and legislative agendas in the coming years, and will undoubtedly continue to place upward pressure on costs.

Increased Utilization and Consumer Demand

Utilization of many healthcare services has risen over the decade. A number of factors such as improvements in medical procedures and technology, the influence of managed care, elevated consumer awareness and demand, and a boost in the number of practicing physicians, caused health services like the number of surgical procedures and the number of prescription drugs dispensed to rise significantly. Other services, such as breast cancer screenings, immunizations for children, and diagnostic procedures like CT and MRI have also experienced sharp utilization increases.

Clearly as utilization increases, there is upward pressure on medical loss ratios, which ultimately influences the rates charged by insurance carriers.

New Medical Technology

Life expectancy and disease-specific mortality rates in the U.S. are steadily improving. Developments in medical technology, including methods for early detection of disease and the introduction of new treatments and medications for acute illness, have played a major role in enhancing these statistics. Old techniques are being replaced with new, often expensive treatments using new medical devices, diagnostic products, drugs, and surgical procedures. These include everything from digital mammography to hip replacement to radioactive "seeds" used to treat prostate cancer.

It is not surprising that these new procedures come with hefty price tags, and therefore drive the overall cost of healthcare — and subsequently health plan rates — upward.

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Weakening of the Managed Care System

The booming economy of the late 1990s, consumer demand, and the regulatory environment discussed above have led to a general weakening of the managed care system.

In the early 1990s, managed care was seen as a temporary fix to high medical inflation. By cutting payments to doctors and hospitals and requiring strict oversight of expensive drugs and procedures, managed care reduced insurance rate increases for a few years (average premium increases per year from 1994 to 1998 were only 2%). Without the surge in managed care plans, the total amount spent on healthcare nationally — about 15% of the gross domestic product — would be higher.

During the economic boom of the late 1990s, patients and employers migrated away from the tightest forms of managed care, HMOs. Employers seeking to hire the best employees in the tight job market moved towards offering plans that allow patients to see doctors that are "out-of-network" or have much less strict referral processes, such as Point-of-Service (POS) plans. In addition, many employers making health plan purchase decisions focused on keeping employees happy by ensuring that most doctors in an area were in the chosen network, rather than choosing narrower networks with deeper discounts.

Provider contracting has also placed a strain on the managed care system. Many hospitals that have taken a beating due to the

Balanced Budget Act of 1997 — which cut billions of dollars from Medicare managed care payments — and by other financial difficulties are now willing to walk away from health plans that they view as offering insufficient reimbursement rates and prohibitive payment practices. In many cases, these threats have won hospitals and other providers significant increases in reimbursement for the first time in several years. These actions are having a domino effect as other providers become more courageous and attempt to exert power during negotiations with health plans.

With the level of premium increases seen over the last several years expected to continue, more employers are backing away from their attempts to offer richer benefits, and instead are trying a number of tactics to reduce costs.

Healthcare Spending and Medical Cost Inflation

Overall healthcare spending and medical cost inflation are ascending, often due to many of the factors discussed above. Below are summaries of each of these trends.

National Healthcare Spending

The Centers for Medicare & Medicaid Services[1] (CMS) annually releases national health expenditures projections. Some of their most recent findings for the period 2003 - 2013 include:

- ✓ National health expenditures are projected to reach $3.4 trillion in 2013, growing at an average annual rate of 7.3 percent during the period 2003 – 2013.
- ✓ Health spending is expected to reach 18.4 percent of gross domestic product (GDP) by 2013, up from its 2002 level of 14.9 percent.
- ✓ The recent CMS projections indicate a slowdown in the growth of national health expenditures beginning in 2003, after six years of accelerating growth. The slowdown is attributable to decreases in public healthcare spending, including Medicare and Medicaid, and in private health insurance spending per enrollee, as well as modest decelerations in medical price and utilization.
- ✓ CMS projects a deceleration in per-enrollee private health insurance premiums, from 11.4 percent in 2002 to 10.4 percent in 2003, to 7.1 percent by 2005. This slowdown is attributed both to the projected continued deceleration in underlying medical costs per-enrollee and an anticipated turn in the underwriting cycle in 2004.
- ✓ Out-of-pocket spending is expected to grow more rapidly over the projection period in comparison to the previous decade because of efforts by employers and insurers to share costs with employees. However, the growth rate of total health spending is still expected to outpace the growth rate of out-of-pocket spending, causing the out-of-pocket share of total health expenditures to fall from 13.6 percent in 2003 to 13.0 percent in 2013.
- ✓ CMS predicts that hospital spending growth will remain the most important driver of health spending growth. Hospital spending accounts for 26.2 percent of the projected increase in health spending in 2003, while prescription drug spending and physician spending account for 18.0 and 19.3 percent, respectively.

Medical Cost Inflation

Medical cost inflation figures tell a similar story. However, inflation differs from overall spending in that the GDP figures depict *actual dollars spent* on healthcare services in a year, while inflation reflects the *cost difference* for medical services relative to a base year.

One measure of inflation in the United States is the Consumer Price Index[3] (CPI). The U.S. Department of Labor Bureau of Labor Statistics recently released CPI figures for the period ending May 30, 2004.

Exhibit 4, below, shows the percent change in the CPI for various consumer expenditure categories since 1996. *Medical Care* is one of the categories.

Overall consumer prices rose 1.9% during 2003, down from a high of 3.4% in 2000. So far in 2004, overall consumer prices have risen 5.1%.

Costs for goods and services in the Medical Care category rose 3.7% in 2003, and 5.8% as of March 2004 — higher than the overall inflationary rate. One can see that medical costs are increasing at a higher rate than the overall inflation rate, and more than most of the other expenditure categories.

In general, with medical care expenditures and inflation accelerating at a higher rate than in the recent past, it is easy to see why there is also upward pressure on health plan rates.

Annual Percent Change in CPI[4], 1996-2004

	1996	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004[5]*
All Items	**3.3%**	**1.7%**	**1.6%**	**2.7%**	**3.4%**	**1.6%**	**2.4%**	**1.9%**	**5.1%**
Food & Beverages	4.2%	1.6%	2.3%	2.0%	2.8%	2.8%	1.5%	3.5%	1.5%
Housing	2.9%	2.4%	2.3%	2.2%	4.3%	2.9%	2.4%	2.2%	3.5%
Apparel	-.2%	1.0%	-.7%	-.5%	-1.8%	-3.2%	-1.8%	-2.1%	2.0%
Transportation	4.4%	-1.4%	-1.7%	5.4%	4.1%	-3.8%	3.8%	.3%	14.9%
Medical Care	***3.0%***	***2.8%***	***3.4%***	***3.7%***	***4.2%***	***4.7%***	***5.0%***	***3.7%***	***5.8%***
Recreation	3.0%	1.5%	1.2%	.8%	1.7%	1.5%	1.1%	1.1%	2.2%
Education and Communication	3.4%	3.0%	.7%	1.6%	1.3%	3.2%	2.2%	1.6%	1.8%
Other Goods & Services	3.6%	5.2%	8.8%	5.1%	4.2%	4.5%	3.3	1.5%	2.8%

Source: United States Department of Labor Bureau of Labor Statistics, news release, Consumer Price Index, May 2004.

Exhibit 4

Employers React — What Can You Do?

You and other employers are undoubtedly trying to determine how to keep accelerating health plan rates from having debilitating repercussions on your organization. Many firms have been trying to absorb most of the costs because of attraction and retention issues, but are now realizing that they will have to pass portions of the costs on to their employees in the form of increased contributions or out-of-pocket expenses. Small businesses in particular are facing the critical decision to raise employee contributions, or to discontinue offering the coverage altogether.

Firms around the U.S. are undertaking a variety of measures to help minimize the effect of rate increases on their organizations. **Exhibit 5**, below, shows results from the Towers Perrin *TP Track* “The Changing Face of Health Care: Balancing Employer and Employee Needs” survey regarding actions employers anticipate taking to manage healthcare costs.

According to the survey, employers are focusing on interventions that they deem effective in managing costs — typically tactical, short-term approaches that shift costs to employees. The survey also found that employers tend to choose those tactics that they consider to be the most effective in controlling costs in the short-term. For example, three of the most prevalent tactics that are being used were also cited in the survey as having the most impact on cost savings.

- ✓ ***Selective changes in copayments or coinsurance for prescription drug plans.*** This approach is either in use currently or planned to be used in the future by 85% of the survey respondents, and is likewise reported as effective by 85% of respondents.

- ✓ ***Selective changes in copayments or coinsurance for health plans overall.*** This tactic, designed to encourage cost-effective use of healthcare, is in use or planned by 80% of respondents and is reported as effective by 72%.

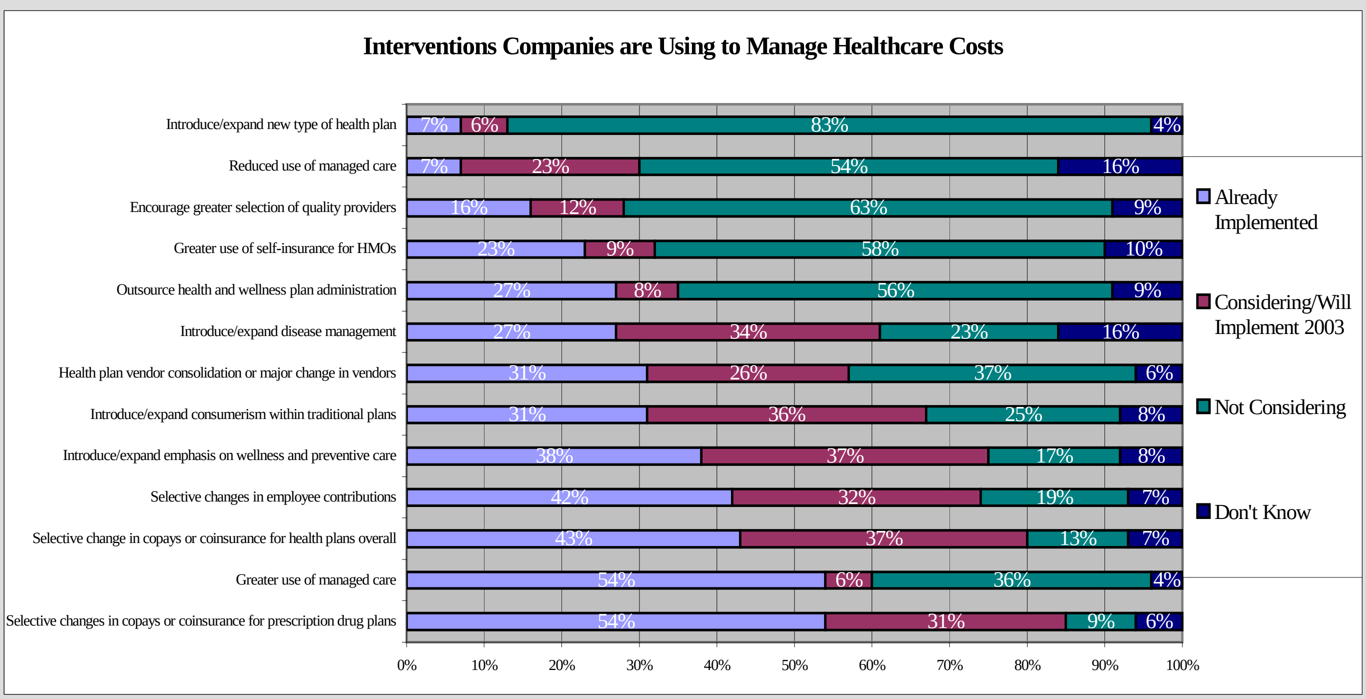
- ✓ ***Selective changes in employee contributions.*** Employers use this intervention to encourage cost-effective selection of plans. It is in use or planned by 74% of respondents, and is considered effective by 72%.

The survey also indicates that while basic cost-shifting is still a prevalent means for managing costs, there is evidence of a movement toward a more strategic approach that includes longer-term consumer-oriented solutions. Those companies that want to balance cost and employee relations are incorporating more of a consumerist focus into their plans for 2003 and beyond.

Essentially, employers are finding ways to make healthcare a shared responsibility and commitment between employer and employee by putting more decision making power (and potentially cost-management power) into the hands of the employees. Then, by providing appropriate tools and education, employers can help employees assume this responsibility.

For example, more than one-third of the survey’s respondents indicated they planned to introduce and expand wellness and preventive care programs. In addition, 36% plan to introduce or expand consumer-oriented elements within their traditional plans, while almost the same percentage will introduce or expand their disease management initiatives.

Exhibit 5



Source: Towers Perrin *TP Track*: The Changing Face of Health Care: Balancing Employer and Employee Needs, October 2002.

One potential trend to note is the increasingly popular move toward using the Internet to help employees become more educated healthcare consumers. The *TP Track* survey found that most employers are using Web-based solutions to implement consumer-oriented elements into their traditional plan designs. For example, many companies are providing Web-based employee health portals — often as part of an overall human resources portal — to support preventive care and wellness initiatives.

Which solution is right for you? Should you pass costs on to employees, at the risk of losing some of them? Or, should you try to manage costs in some of the other ways discussed above. Ultimately, it is a decision that you need to come to through thoughtful and detailed analysis of your plans, and with the advice of your broker-consultant.

Below are some questions you can address in order to begin developing an effective strategy that is right for your organization.

- ✓ Is our program structure, plan design, and pricing appropriate?
- ✓ Do we have the right vendors, services, contracting, and funding in place?
- ✓ Are our employee communication efforts appropriate and effective?
- ✓ Do we have the right disease and case management programs for our employees?
- ✓ Do our pricing and plan design features encourage cost-conscious behavior on the part of our employees?
- ✓ Do our employee communication efforts and resources motivate our employees to become educated and effective healthcare consumers?

What Should I Tell My Employees?

It's a fact: healthcare costs and health plan rates are increasing at a higher rate than during most of the past decade. You want to continue to offer valuable health benefits to your current and future employees, and you want those benefits to help you attract and retain good employees. However, you also need to consider the cost-effectiveness of those benefits at a time when hefty rate hikes are the norm, rather than the exception.

The information contained in this report is designed to help you understand why your renewal rates may have increased, and to consequently help you educate your employees about the reasons for any plan or contribution changes you may have to make. If your employees understand current trends in the healthcare industry, they will be more supportive of any such changes, and will appreciate the resources required to provide them with their healthcare benefits.

Many companies are providing Web-based employee health portals to support preventive care and wellness initiatives.

Notes:

[1]Formerly the Health Care Financing Administration (HCFA).

[2]Gross Domestic Product (GDP) is the total market value of all final goods and services produced within a country in one year.

[3]The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. It is the most widely used measure of inflation. The CPI is generally expressed as an index relative to a reference base. Most CPI indices have a 1982-84 reference base, meaning that the Bureau of Labor Statistics (BLS) sets an average index level (representing the average price level) for the 36-month period from 1982 to 1984. The BLS then measures changes in relation to that figure. The figures here represent changes in consumer prices for each year shown, relative to the 1982-1984 base year.

[4]Reference base: 1982-1984.

[5]Seasonally adjusted annual rate three months ended in March 2004.