Goldman Sachs

Americas: Managed Care

The highest pricing trend in years

A national perspective on the small group and middle market

We have published a transcript of our industry expert conference call with Mike Turpin of USI Holdings, a leading employee benefits consulting firm with 77 regional offices, to provide visibility on health insurance pricing and product trends in the small-group and middle-market segments that represent the majority of profits for core managed care.

Aetna now leading the charge for higher pricing trend

Mike Turpin and his firm are seeing the highest pricing trend in years as carriers seek to recover from the industry underwriting cycle and respond to upward pressure on underlying medical cost trend. Aetna is leading the charge, with the strongest pricing discipline among the major carriers, as it looks to recover from underwriting shortfalls experienced this year. Turpin believes the higher pricing may also reflect anticipation of future pressure on margins – and new cost burdens for the carriers – under health reform.

Price acceleration observed in 3Q ECI release (10/30/2009)

The trend towards industry price acceleration is also consistent with the recent trend in the quarterly Employment Cost Index for Health Insurance (ECI), compiled by the US Bureau of Labor Statistics. The 3Q ECI of 4.7% (published Friday 10/30) showed a yield of 4.7%, up 120 bp from the six-year trough of 3.5% at 4Q08 (see our companion note, "3Q ECI: more confirmation for the upward inflection in pricing", 11/1/2009).

We remain Neutral on managed care but with a positive bias at this point given valuations and our view of industry trends as well as the likely outcomes for health reform legislation. CIGNA (CL-Buy) remains our favorite with the least downside exposure to health reform (and the underwriting cycle) among the core managed care names. We also recommend UnitedHealth (Buy) and Health Net (Buy).

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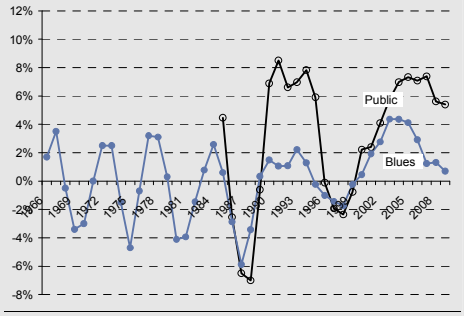

Source: State insurance reports, BCBSA, company data, Goldman Sachs Research estimates.

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Pricing trends observed by USI directionally consistent with other measures of trend

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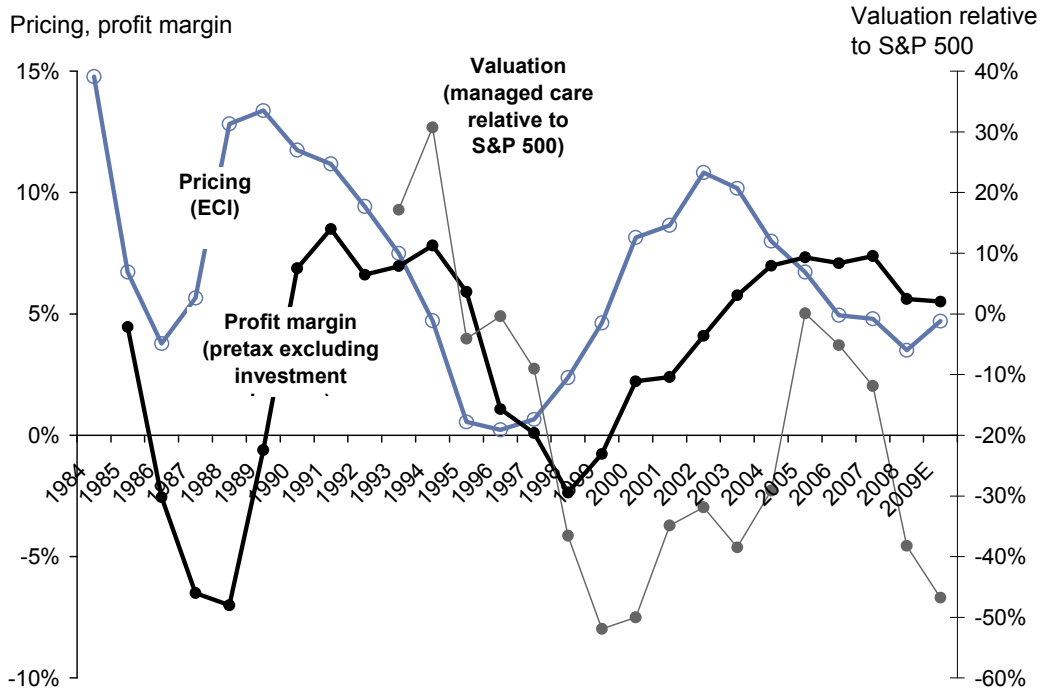
The 3Q2009 ECI of 4.7% (published Friday 10/30/2009) showed a yield of 4.7%, up 120 bp from the six-year trough of 3.5% at 4Q08 (see our companion note, "3Q ECI: more confirmation for the upward inflection in pricing", 11/1/2009).

We would note that the ECI reflects an "all-in" blend of yoy change in employer payments for health coverage per person, including product mix shift, and therefore is considerably lower than the gross pricing trends seen by industry brokers and consultants.

Pricing trends are highly correlated with industry profit margins and stock valuations, as can be clearly seen in historical trends (see Exhibit 1).

Exhibit 1: Pricing, profit margins, and valuation over 25 years
Pricing (ECI) vs. industry operating profit margin (core companies) vs. managed care relative PE



Source: US Bureau of Labor Statistics, FactSet, company data, Goldman Sachs Research estimates.

Transcript of conference call (October 21, 2009)

Matthew Borsch, Goldman Sachs: Good morning. Thank you for joining us today for the Goldman Sachs Managed Care Industry Expert Conference Call.

What I will today is introduce Mike Turpin, for comments on industry trends and I will walk him through some topical questions, and then we'll open it up for open Q&A.

Mike Turpin is Executive Vice President with USI Holdings, a leading employee benefits consulting firm with a focus on both the small-group and middle-market employer segments, and they have 77 offices in 21 states. From that breadth, Mike and his firm have a pretty fulsome view of industry trends.

Mike comes with 27 years of industry experience, and in the not very distant past, he was a regional plan CEO with UnitedHealth Group.

With that as background, I will turn it over to Mike to give us his view of trends in the midst of the 2010 pricing renewal season.

Mike Turpin, US Holdings: Thanks, Matt. Good morning. You know when I give these presentations, sometimes I have to refer to myself as a recovering insurance executive after spending 3 years as a CEO of the largest region of UnitedHealth Group, but that tenure gave me a fantastic view through a different lens as to how the "bread is baked" and delivered to the small, mid-size and large employer markets.

Despite higher price sensitivity, employers are making fewer carrier changes.

And with that perspective, I came back to go to into consulting and brokerage focusing on smaller and mid-sized firms and helping them understand and interpret the tea leaves and do the best to try to drive purchasing leverage working with a carrier market that is essentially an oligopoly of four carriers even as we see continued consolidation on the hospital side, which is creating more upward pressure on medical trends.

So what I thought I'd do today is review the macro trends we're seeing among the managed care companies.

I will frame this with my observation is that the national carriers make the majority of their money in a handful of markets, and so I will focus on those geographies, namely New York, California, Florida and Texas, but I'm happy to go beyond those markets and/or into greater detail if there are questions.

Another point is the increasingly 'sticky' nature of healthcare administration and the aversions employers have to switching carriers as healthcare becomes more complex. So there is less and less movement of employers from one insurer to another and a much greater predisposition to want to negotiate and remain with the existing carrier.

The increasing complexity of healthcare administration drives higher carrier switching costs.

So a few years ago at UnitedHealth, when I was looking at the numbers, I would often see that out of 100 accounts that were out to bid, as many as 70 of them might stay with the incumbent, and only 30 of them would move. This year, we're seeing a very similar pattern and it's actually increasing a bit, where fewer and fewer cases are moving because the incumbent carriers are doing their best to try to hold onto the business.

But what's favoring the carriers right now is they are all pricing with very aggressive and high-trend factors that they're using to build into their rating.

Borsch: Mike, if I could interrupt, just to clarify? When you say "aggressive", that is from purchaser perspective, correct? From a managed care investor perspective, we usually think of "aggressive" as lower priced…

Turpin: Yes. Higher priced. "Aggressive" from the purchaser perspective.

We are seeing trend factors in the 13-15% range. So if I'm looking at it from your investor perspective, the carriers are pricing "conservatively" as they try to deal with the very real

threat of hospital consolidation as hospitals gain an upper hand in contract negotiations and are passing on a larger and larger percentage of the cost of the carriers.

The highest pricing trends seen in years, despite the negative focus on health insurers in Congress.

From year to year, the carriers have historically been ambivalent about "do we go for profit, or do we go for membership?" This year, it is clear that the carriers are going 'for profit' and that they are really showing strong pricing discipline.

The pricing trends we are seeing are the highest we've seen in years. We are seeing 25%-30% percent increases for a lot of mid-sized companies. The trends are across virtually every single market.

In small group, where the carriers typically make a large portion of their operating profit, renewals are as high as 30% or more in some cases.

This may seem counterintuitive given the negative focus on the health insurance industry from Congress and given the historical perspective that during the last major push for health reform in the early 1990s during the Clinton Administration there was an effort to "be on one's best behavior".

This time around, it almost seems that the opposite is occurring; i.e., that as public companies, the insurers don't believe the goodwill that they might create by pricing below their cost trends is going to translate into more moderate reforms.

It may be that the carriers believe reforms are going to be what they are going to be, that the political influence they have is limited, and the gloves are off and the race is on to make as much money as one can while the sun is still shining.

What's interesting is there does not seem to be a single carrier out there pricing lower than underlying medical cost trend. They all seem to be in a kind of "synchronized swimming event", where they are seeing to expand their margins, or at least compensate for the economic headwinds that they're experiencing.

Upward pressure on medical cost trends is a key factor driving higher pricing

However, there are obviously other factors driving the higher pricing. If you look at the economy, the carriers would argue that many of the workers being let go are younger employees and therefore that the age mix of the insured groups is rising as layoffs have driven a disproportionate percentage of younger employees out of the workforce.

You also have the H1N1 flu. It may have run its course in New York, but Florida and Texas seem to be heating up a bit.

[Higher profit is one motive, but the carriers are also responding to pressure on underlying medical cost trend from hospital and other providers, from deteriorating demographics, from the H1N1 flu, and from COBRA.]

COBRA is another factor. In many instances, COBRA members appear to be a two-for-one cost to premium given individuals want to get as many services performed as they can while they are on COBRA with an uncertain employment future.

Another factor impacting underlying cost trend is the increase in catastrophic claims, claims that are exceeding the stop loss points, reflecting the higher intensity of services on the inpatient hospital side.

So these underlying cost trend factors, particularly in the small-group market, may be driving the higher underlying medical cost trend and driving, in turn, higher pricing trend.

Aetna now taking the lead on pricing

Let's talk about the "Big 3" carriers, starting with Aetna.

Aetna more than the other carriers has taken the lead with the strongest pricing discipline and the highest pricing trends as they have recently suffered increased loss ratios. Other carriers are following suit.

Aetna is pushing very high renewals and they seem to be willing to lose market share for the sake of restoring their loss ratios. For that reason, Aetna is appearing inflexible to many of our clients, as United appeared to be a few years ago, a victim of their own success in some ways. Aetna seems solely focused on what they need to do for themselves and indifferent to what the clients are looking for. And when you're delivering increases of this size, people start to question whether the carrier has the ability to actually achieve the affordability it has been touting.

CIGNA is being opportunistic

CIGNA is a somewhat different situation. They have the least amount of market share in the small-group and mid-sized market, and they are trying to drive higher share in certain markets. CIGNA is doing that through some unique products. In New York, CIGNA is using its "minimum premium" arrangements to gain market share.

CIGNA is taking advantage of the purchaser frustration with pricing trend to offer an alternative, and we're finding that in some cases employers are interested and eager to move, but in other cases, purchasers are still a bit wary of CIGNA because they still don't view them as relevant in the small group market as compared to UnitedHealth or Aetna or even Anthem (WellPoint).

In New York, CIGNA is using its "minimum premium" product to gain market share.

The small-group and lower-end of the middle-market is where CIGNA doesn't have much market share. So the company appears to be pricing a little bit lower than the market to see if they can pick off some of the lower-loss-ratio (i.e., higher profit margin) accounts that are being caught up in what we call the block underwriting process from the insurers.

That is, the insurers basically take all of their insured business and they say this entire block of customers needs a 12%-15% increase in order to price to trend. When the first renewals go out, the underwriter might only get, for example, 12% for the first 50% of renewals, and so the remaining 50% get socked with renewals higher than 15% in order to price the overall block to trend.

What CIGNA is trying to do is pick off those cases in the second round that might have low loss ratios.

The broker and consultant view of UnitedHealth has improved

United is disciplined in most markets. But more aggressive in selected areas. For example in Illinois where they face a "fat and lazy" Blue competitor.

UnitedHealth is being very selective. Let me put that in historical context and a contrast with Aetna: Aetna had been for years the best at picking certain markets to take market share because the pricing was high enough that you could go in and grab membership without severely deteriorating the overall loss ratio.

By contrast, UnitedHealth in recent years would do that with first-year discounting, where they would discount their first-year rates and then second year increase the renewal to reclaim profit margin for cases that were written at a poor loss ratio. And in some cases they were successful and other cases they were not.

I don't see United doing that this time around. They are aggressively trying to gain market share, particularly with the larger, self-funded employers, but not necessarily doing it by "robbing Peter to pay Paul" or mortgaging their tomorrow for the sake of market share.

Poor integration seems to have been a theme with some of United's larger acquisitions.

UnitedHealth is getting "out of the penalty box" with brokers and consultants.

Oxford actually has been doing very well, but it isn't clear if United will continue to invest in the Oxford platform and keep it contemporary. There are some signs that the Oxford platform is aging and needs to get more contemporary with medical management, clinical programs, and better claims data.

United's acquisition of PacifiCare is another example of where United when though a lot of 'growing pains' in the integration. However, United has worked on that and we are hearing a lot less noise about service-based issues.

UnitedHealth is also showing traction is resolving their problems, and as a result they are getting "out of the penalty box" with a lot of brokers and consultants. Much of the progress appears attributable to Gail Boudreaux's leadership along with a return to fundamentals. They are pricing to trend and improving provider and customer service.

United is using the goodwill they are gaining as currency to insinuate their way back into brokers and to reassure them that if they move the business to United, they will have a smooth customer experience and they will also get the benefit of some of the clinical programs that many employers are beginning to realize are the only levers they have left to pull to try to moderate their medical costs.

The Blues are pricing lower than others

The Blue Cross companies are pricing with slightly lower trends than the others, with rate increases more in the 11-13% range. That would include Anthem (WellPoint). We are seeing not-for-profit Blue Cross plans price at even lower trend in certain markets.

The impact in the market is mixed. The larger employers are choosing Aetna and United that have better clinical programs. But many of the smaller and mid-size fully-insured employers are choosing carriers on price.

And that's where the Blues continue to maintain an advantage and where Anthem (WellPoint) isn't necessarily losing as much market share as a consultant or broker might think they "should" because there's a belief that over time employers would 'wise up' and say "look, I can get two percent better on a hospital contract with the Blues, but if clinically they can't manage the patient through the delivery system as well as Aetna or United, the cost overall will be greater."

But many of these middle-market buyers are still very much economic buyers who are focused on price, and at some level they don't always feel that their loss experience truly reflects their own population's experience, and therefore they're just chasing rate.

That said, we are seeing that it's becoming harder and harder to move from one insurer to the other because of the many different administrative programs linking the employer to the insurer. These include health savings accounts and a variety of clinical programs. To change carriers today, an employer has to disconnect and deconstruct a lot of different "tentacles" that the carrier has now embedded into their workplace.

In California, mid-teen renewals across the board

Consistently across the country, I'm seeing Aetna as leading the charge. For example, this is what we are seeing in California in terms of pricing trend in the 'under-300' market:

- Aetna 15%

- Anthem (WellPoint) 14%
- Blue Shield 16%
- Health Net 15%
- CIGNA 12%-14%
- Kaiser 17%-19%

Kaiser's high trend is an interesting case that seems to betray the presumption that staff model integrated delivery systems are not experiencing high cost increases.

If accounts have poor loss ratios, large claims or high COBRA loss ratios, we can expect to see 35-40% increases. If you were tracking the industry and asking "are they being disciplined?" the answer is yes. On the employer's side, it's bewildering and disconcerting.

In Florida, the Blues are pricing below other carriers

In Florida, The Blues are offering competitive renewals below market trend and trying to sell the unit cost advantage they have with many of providers. But again with the Blues, the question is, are they pricing to trend?

CIGNA is making a pretty big push and Humana is offering flexible solutions in the market that are appealing to employers.

The losers in Florida are UnitedHealth with its acquisition of Neighborhood Health Plan (NHP), an acquisition that doesn't appear to have been integrated very well.

In New York, CIGNA is a source of competitive pressure for United

In New York, Oxford represents a major profit driver for United and they are pricing to 15% trend. They are frustrated, I think, by CIGNA that is engaged in a strategy to pick-off some of the higher profit margin accounts and gain share in the middle market. CIGNA also appears to be the most flexible in product and plan design.

Many brokers are obligated to be out in the market to look, but there's just not that much business moving, particularly in New York.

Q&A

Q: Let me ask a question about the $7 billion per year 'industry fee' that might be part of the health reform and would represent another cost on the fully-insured business. Under the Senate Finance Committee plan, that fee is slated to kick in next year.

Most of us have assumed that carriers will need to pass this through in the form of higher pricing, with estimates that it would add 200-300 basis points to the already very high trend. But given the timing, what is the contractual ability of the carriers to push that through for 2010?

Carriers seem to be including an "extra" 100 basis points in pricing.

Turpin: Well, let me first comment on the current pricing trend. As we look at underlying cost trends, we really don't see the justification for 15% pricing trend. Maybe 60% of the healthcare budget, facilities and specialty, is running in the double-digits, but the, but the 40%, primary care, prescription drugs, and other, is not.

So it would seem that provisions are already being made for something like this industry fee. My guess is that they have about 100 basis points baked in, if not more, with the 15% trend they are pricing to.

That said, I think it's going to be very difficult for the carriers if they try to price in something of the size of the proposed industry fee. They would need to go to 16%-17% trend or higher starting in January and that could create a lot of political and social backlash.

If the carriers start to jam that through it will be interesting to see if somebody breaks ranks or aggressively promotes some sort of self-insured solution as a way of avoiding the pass through.

CIGNA could be uniquely positioned with its Great West platform.

CIGNA with its Great West platform could be uniquely positioned to offer the self-funded product to middle-market and even small employers. But you could expect that someone would challenge the ERISA preemption of self-funded plans if reform sparks a massive flight to self-insured plans.

Q: What might that shift to self-insuring look like?

Turpin: You could see a movement towards self-funding down into the mid-sized market. The issue will be that the carriers will move these products from the 125% liability that you see today to maybe 105% liability so that they can collect essentially a conventional equivalent premium but have enough risk transfers so there is a self-funded component to it that allows them to avoid premium taxes.

Q: That sounds in some ways like it could be the worst of both worlds for the carriers? They get essentially an ASO fee per member, which is a lot lower than the risk profit, but they take the risk?

Turpin: Except this wouldn't be a traditional large employer ASO fee, because most small employers don't have the kind of that kind of statistically credible base of employees. Instead of a $35 ASO fee, we might be looking at a $60 ASO fee.

And so there's a bizarre scenario where the carriers could come out with hybrid self-funded plans that for all intents and purposes are almost fully insured and end up with a higher margin percentage on the block business.

But I think if they did that full-scale, someone would no doubt question the ERISA preemption that self-funded plans have or question whether or not there's enough risk being transferred to truly qualify as a self-funded plan.

A tough road for carriers leveraged to Medicare Advantage.

So those are scenarios. I would not count the carriers out. But I think on Medicare Advantage, anybody who's leveraged in that area, that's a tough spot for them to recover from. But I think in the traditional marketplace there are still levers they believe they can pull.

Q: What are you seeing on the cost trend side right now?

Turpin: You are seeing layoffs impact the demographics. Lay-offs are impacting the younger, less tenured population, which in turn is souring the demographics.

In terms of provider pricing on the hospital side, I think that for years the carriers had more of the upper hand in these contract negotiations. But several of these large systems have been whetting their knives to come back in and renegotiate, and they know that most employers right now do not have the courage to begin to narrow their networks, which is really the only lever they have left to regain what I call market force control over the hospital consolidation and leverage that they're achieving.

UnitedHealth has come out with their product called "Edge", which offers incentives to go to a narrower network. Other carriers are pushing similar products.

But interestingly enough, the employers are very tentative about the two main areas that they should be a lot more aggressive on, and one is wellness or what I call population health management, doing a much better job of managing the underlying health of the

employers. The other is that they are not really entertaining the idea of narrowing the networks.

Borsch: We're at the 45-minute mark, so I think this is a good place to conclude the call. Mike, I can't thank you enough. This has really been a fascinating real-time look at what's going on in the purchaser and carrier market. Thank you again to all the clients who dialed in.

-END-

Rating and pricing information

CIGNA Corp. (B/N, $27.84), Health Net, Inc. (B/N, $14.91) and UnitedHealth Group (B/N, $25.95)

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