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Behind the numbers: Healthcare cost trends for 2008

Increases in health spending are continuing sources of pressure on business profitability. Businesses are faced with the annual challenge of analyzing, estimating, and managing their employee benefit plans' cost. The keys to the process are analysis of cost drivers and prediction of the medical cost trend for the upcoming year. This article summarizes a recent whitepaper produced by PricewaterhouseCoopers' Health Research Institute. To view a full copy of this article, please click [here](#).

What is medical cost trend?

For private payers, medical cost trend is the direction in which medical costs are heading. The trend is used by insurance companies to estimate benefit plan annual cost increases. It is influenced by several factors that go into future cost increases, including:

- **Medical cost inflation**—the change in the unit price of medical products and services
- **Utilization increases**—changes in the volume of services used because of health status, demographic changes, advertising and the use of new technology
- **Deterioration in the value of co-pays and deductibles**—co-pays that remain at a flat rate despite a rise in inflation and medical costs
- **Government cost**—shifting away from entitlement programs (such as Medicare and Medicaid) and toward the private sector

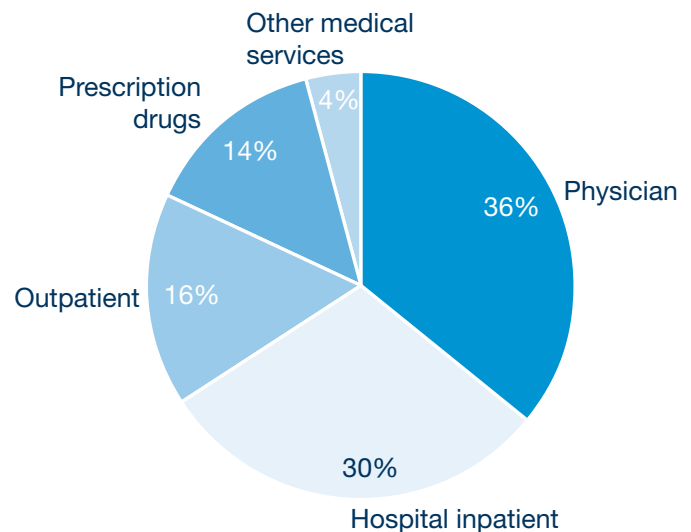
What is included in medical cost trend?

In evaluating medical cost trend, specific focus is placed on the key components driving healthcare costs – the largest single component of which is physician services, accounting for 36% of costs (see Chart 1). Hospital inpatient is the second largest at 30%, and outpatient services, including ambulatory surgical centers and diagnostic centers, were third at 16%.

What have increases in medical cost premiums been?

While medical costs are increasing, they do not necessarily correlate with higher premiums. In general, employers tend to be cutting back the benefits levels of their plans, so health insurance premium increases tend to be lower than medical cost trends. To mitigate the increase in medical cost trends, employers can either increase premiums or co-pays or change benefit plan design to a lower cost plan.

Chart 1: Share of benefit premiums, 2007



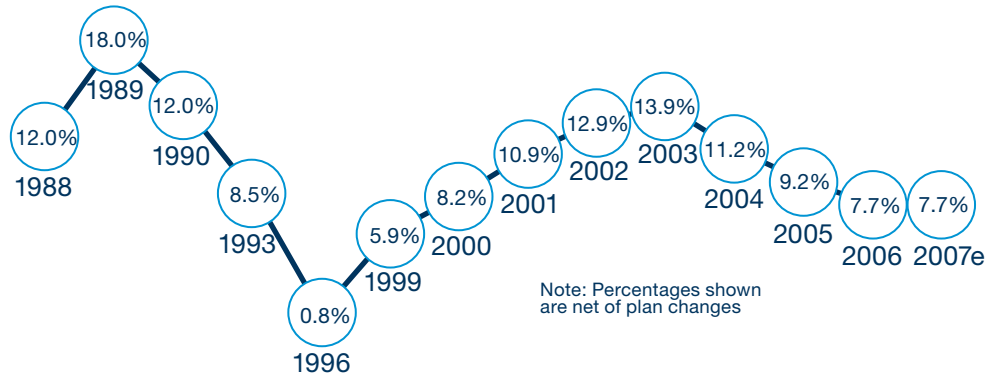
Source: Milliman Medical Index, 2007

As noted in Chart 2 below, the cost of private health insurance premiums has risen for the past 20+ years, but in contrast to the trend during the late 1990s and early 2000s, the size of the increases has been in decline since 2003. In addition, national health spending typically races ahead of the overall economy, which is measured by gross domestic product (GDP). However, in recent years, the gap between the two measures has narrowed significantly.

What has been the long-term medical cost trend?

Medical costs have generally tended to increase over time, but in the past three to four decades their growth has continuously decelerated. While the increase in healthcare costs certainly deserves continued concern, it appears that tools and methods developed to control these costs have had an effect over time. Some of the deceleration in trend may stem from lower inflation rates in recent years. Specifically, the Consumer Price Index (CPI) grew at 7.1% annually from 1970 to 1979, but only 2.5% annually from 1996 to 2005. To remove this effect, PricewaterhouseCoopers estimated the trend using inflation-adjusted spending and premiums and still found a pronounced downward trend in the CPI-adjusted growth in both Medicare and private, third-party payer spending.

Chart 2: Percent increase in private health insurance premiums, 1998–2007e



Source: The Kaiser Family Foundation and Health Research and Educational Trust for 19989–2006, PricewaterhouseCoopers estimate for 2007.

Medical cost trend for 2008: Continued deceleration on the horizon

PricewaterhouseCoopers surveyed five of the largest healthcare carriers in the US, which together represent more than 30 million members and provide the full range of products on a national basis, to find out which trend factors they are using when determining premium rates. Based on this survey, medical costs are expected to rise over the previous year as shown in Chart 3.

While too early to evaluate the long-term impact of consumer-directed health plans (CDHPs), it appears that their cost trend is running about 2.5 percentage points below cost trends of HMOs and PPOs. However, enrollment in these plans is still fairly low, and it is probably too early to determine whether these plans can lower medical costs long-term. According to the Kaiser Family Foundation, of all large firms (firms with greater than 200 employees) only 3% of employees were enrolled in high-deductible health plans, whereas 22% were enrolled in HMOs, 62% in PPOs, and 9% in POSs, with the remaining percentage enrolled in conventional plans.

Chart 3: 2007 and 2008 expected medical cost trend

Payer	2007	2008
PPOs	11.9%	9.9%
HMOs/POS/EPOs	11.8%	9.9%
Consumer-directed health plans	10.7%	7.4%

Source: PricewaterhouseCoopers estimates.

Factors influencing the deceleration of medical cost trends

In looking at the year ahead, PricewaterhouseCoopers identified four influences that are affecting the cost trend in the short-term (one to two years) and the long-term (three to five years):

Short-term influences

- Slower spending growth for prescription drugs
- Increased transparency and cost sharing with employees

Long-term influences

- Total health management approach to benefits
- Broadening of the digital backbone in healthcare

Below is a description of each of these trends.

Slower spending growth for prescription drugs

The recent slower growth in spending on prescription drugs stems from a number of converging factors: introduction of fewer blockbuster drugs, some blockbusters going off patent, transition of some drugs to over-the-counter status, the acceptance of tiered formularies, and a lower rate of price growth. As one indicator of slower growth, the percentage growth in per capita spending on prescription drugs recently dropped below the percentage growth in national health expenditures for the first time in nearly 30 years - meaning that prescription drug costs are growing at a slower rate than national health care expenditures. In addition, a key factor in the lower growth rate is the increase in generic dispensing. In 2006, generics accounted for 60% of all prescriptions dispensed in the US – a 13% increase over the previous year.

Increased transparency and cost-sharing with employees

Increased transparency and broader cost-sharing is a cornerstone of the healthcare consumerism movement. Consumer-directed health plans have been the standard bearers of this movement. These plans are typically characterized by high deductibles and are often associated with certain side accounts such as health savings accounts (HSA) and health reimbursement arrangements (HRA). However, the healthcare consumerism movement is broad in spectrum and covers a number of different elements including increased price transparency, higher cost-sharing to discourage unnecessary utilization, and informational resources.

Employers continue to encourage more cost-sharing with their employees as an integral part of benefit design. Higher co-pays, higher deductibles, and an increase in cost-sharing tiers for health plans are all a part of this general trend. The intention of consumerism is to reduce costs by eliminating unnecessary care and encourage higher value in healthcare consumption. At the same time, many plans are including preventive care at a lower cost-sharing level to avoid barriers to early detection.

Total-health-management approach to benefits

Individuals who lead healthier lifestyles typically are more productive, file fewer medical claims, and have lower medical costs. More employers are investing in wellness and are developing incentives for employee adoption of healthier lifestyles. Research has shown that some employers have received a \$3 to \$1 return on investment for preventive services and health promotion.

Despite success in the declining rate of tobacco usage, other risk factors that contribute to heart disease and cancer are increasing. They include rising levels of obesity and more sedentary lifestyles. As a response, employers are creating a more holistic approach to health benefits that considers lifestyle factors and prevention rather than just claims management. Employers are encouraging employees to “own” their health through a variety of incentives and programs such as nutrition counseling, weight-loss programs, and gym memberships.

Broadening of the digital backbone in healthcare

The digital backbone that connects health providers, payers, and vendors is expanding. Connecting the health system electronically will aid payers in better managing both performance and compliance throughout the continuum of care. Technologies such as personal computers, electronic health records, wireless systems, biometric devices, and imaging software are increasingly being used by clinicians and business offices to coordinate and improve care, decrease duplication, and reduce cost.

During the past few years, most hospital systems have been allocating an average of 25% of their capital spending on health IT, according to Fitch Ratings, a New

York ratings agency. While initial spending on IT has been shown to add to costs, the longer-term effect is one of reduction in costs.

Making the digital backbone a reality stems from progress on two issues that have long been cited as barriers to health IT adoption: lack of national standards and interoperability. Since the devastating hurricanes of 2005, which displaced patients and destroyed paper medical records, state and federal authorities began to recognize the importance of health information interoperability. In addition, the Department of Health and Human Services has published a framework of actions public and private sectors can take to meet the objective of interoperability.

While still in its early stages, the potential to improve quality and reduce variation in provider practice patterns will be strengthened as the digital backbone continues to strengthen. As this movement becomes more prevalent, the potential of a “quality dividend” can also help to support reductions in healthcare cost trend over time.

The medical cost trend is expected to be lower in 2008 compared with 2007. While many factors affect premium increases, it is likely that premium increases will be lower in 2008 as well. The causes for the current deceleration are complex, but it's clear that the movement into consumerism is real and is affecting medical costs. Rewards for maintaining healthy lifestyles, for use of nurse coaches, for transparency of cost of care, and for digitization of the medical industry will continue to affect medical costs. Enhancements to employee Internet tools and the use of employee data to educate, inform, and assist in behavior modification are critical factors in the eventual success of healthcare consumerism.

Making business decisions using analytics

Like most business professionals, HR practitioners face a constant stream of buzzwords. It seems that every so often, a particular word or phrase becomes the new hot topic and is repeated ad nauseam until the next one takes its place. The “war for talent,” talent management, diversity and inclusion, work/life balance, corporate social responsibility—the list is endless. One of the widespread focal points for HR today is analytics, which refers to technologies and practices that allow organizations to integrate and analyze business information, helping management predict future employee outcomes and improve its decision-making.



Recently, members of PricewaterhouseCoopers (PwC) Saratoga attended a conference focused on performance management analytics for the Finance community. CFO Magazine sponsored the conference, which featured the co-developer of the balanced scorecard, Robert S. Kaplan, along with Finance and Operations leaders from leading gaming, financial service, and software organizations. As the topic of analytics continues to gain interest in the HR community, PwC Saratoga hoped to learn more about how the financial community is working with analytics software. At the conference, speakers noted that analytics is most common in sales, operations, and budgeting, with growth in procurement and research & development. HR analytics was not mentioned.



We were surprised to hear results from a yet to be published CFO magazine study about the financial community’s adoption of analytics software. The results of this study revealed that 70% of respondents believed that the Finance function was expected to be the performance management and analytics expert within their organization. Additionally, while 14% of companies reported being highly automated, 54% percent reported only partial automation. This leaves nearly a third of respondents without any form of automation.

While HR has a long way to go in automating its reporting, it may actually be less behind the automation curve than functions such as Finance. According to the above noted CFO Magazine research, when asked about barriers to adopting performance management analytic tools, the top two reasons cited were complexity in IT systems (cited by 48% of respondents) and complexity in business processes (cited by 42% of respondents).

In the fall of 2007, PwC Saratoga participated in an HR analytics symposium with leading measurement gurus such as Saratoga founder, Dr. Jac Fitz-enz, and Dr. Jack Phillips, along with analytics practitioners from organizations such as Freddie Mac, Microsoft, Science Applications International Corporation (SAIC), Sysco, and Tyco. The goal of this event was to understand how HR professionals use analytics as well as to identify the challenges they face when attempting to implement analytics solutions. While an increasing number of organizations use HR analytics, few to date have been

able to create leading (as opposed to lagging) business indicators or predictive workforce models from them. However, symposium participants noted that HR analytics is in its infancy and feel that it has much untapped potential.

Below are some of the key points PwC Saratoga took from both the performance management analytics conference and the HR analytics symposium:

- **Organizations need to tie their workplace initiatives to their corporate strategies.** Robert S. Kaplan estimates that 30% of departmental initiatives are not tied to corporate strategies. Any initiative not directly tied to a business strategy needs to be removed. Attendees of the HR analytics symposium echoed this point, also noting the alignment of corporate initiatives to business strategies as a key driver of success when implementing HR analytics solutions. They also recommended the creation and adoption of standardized metrics, definitions, and models, which would provide organizations with more consistent data, metric results, and benchmarks - both internally and externally.
- **Successful analytics solutions require strategy, tools and people.** During the performance management conference, one sophisticated financial services firm noted that while they have a very powerful analytics tool, the tool alone is not enough. The speaker spent a fair amount of time discussing the importance of their people practices including recruiting, mentoring, performance management, and job rotation programs for analytics professionals. At the HR analytics symposium, participants noted that a successful implementation of an HR analytics solution requires a different skill set for HR - one with greater analytics capabilities and better business acumen.
- **There are drivers of success beyond finances.** A pioneer in the concept of the economic value added framework noted that unlike tangible assets such as computers, manufacturing equipment, buildings, etc., intangible assets such as human capital have the capacity to increase their value the more they are used. While the HR community and PwC Saratoga strongly agree with this observation, this is a key message yet to be embraced by Wall Street analysts and the financial community in general.
- **Finance has data challenges.** PwC Saratoga often hears from our HR clients about a desire to focus more on strategic data. Similarly, one software vendor estimates that Finance spends 60-80% of

its time pulling tactical data and generally faces challenges in pulling consistent data. While Finance has the advantage of Generally Accepted Accounting Principles (GAAP), which provide consistency in the definitions of financial terms, HR does not enjoy the same benefit. One of the key takeaways from the HR analytics symposium PwC Saratoga participated in was that HR and workforce analytics groups need standardized workforce metric definitions, instructions, and methodologies to ensure that their organizations are focusing on the “right” things.

- **Strategic placement of resources.** An executive from the gaming industry told a counterintuitive story. After using analytics software to analyze game floor traffic, the organization determined that by removing 20% of the games from one of their casinos, it could actually increase revenue. The results of this experiment proved successful as the 20% reduction in games resulted in a 20% increase in profits. This is a real world example of how analytics can directly impact the business.
- **Tying pay to performance.** Through analytics analysis, one organization determined that if it was able to improve an employee’s performance from a “B” rating to an “A” rating within its performance management system, there would be a corresponding increase in customer profitability of 15-20%. Uncovering this linkage, the organization modified its pay for performance plan to provide employees with weekly updates on their customer satisfaction scores. In 2007, it paid out more than \$100 million in bonuses. Yet another example of how analytics can positively impact the business.

While analytics tools offer great potential, they are not for the faint of heart. According to conference speakers, the average time to fully implement a financial analytics solution is 17 months. It takes 5 months just to deploy the first usable analytics application at an average cost of \$1.1 million. Additionally, International Data Corporation (IDC) estimates that less than a third of analytics solutions are successful, with a mere 16% of packaged financial analytics packages resulting in success.

PwC Saratoga practitioners have real world experience designing and implementing HR analytic solutions. If you are interested in learning more about how analytics, data warehousing and business intelligence can help your organization, please contact Michael Tindall at michael.tindall@us.pwc.com or (646) 471-1296.

Metric of the month: Internal management hiring source

An increasing number of Saratoga's clients are demonstrating interest in succession planning metrics. We hear from many who are looking to establish a formal program within their organization, but want a metric that will immediately begin to evaluate the quality of their leadership pipeline.

Saratoga's Internal Management Hiring Source metric provides one method for how to begin tracking an organization's leadership pipeline. The formula for calculating this metric is:

Internal Management Hires / Total Management Requisitions Filled

This metric allows organizations to assess the percentage of leadership positions being filled by internal candidates. Tracking this metric's progress over time is critical to ensuring results are trending in line with organizational strategy. For example, an organization looking to develop talent internally would hope to see increasing results over time, while an organization looking to bring in "new blood" would hope to see decreasing results over time.



Have an idea or topic that you would like Saratoga to write about? If so, we would love to hear from you! Please send your ideas and/or topics to saratoga@us.pwc.com.

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