L.E.K.

EXECUTIVE INSIGHTS

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Whatever Doesn't Kill You Will Make You Stronger – Perspective on the State of Medicare Advantage

As recently as a year ago, pending reimbursement cuts, a narrowing selling period, and a more onerous business environment all contributed to the conventional wisdom of a pullback in Medicare Advantage (MA). The Congressional Budget Office, owing to a tendency of seniors to leave their plan when their premiums rise, projected that the number of MA members by the end of this decade would fall to nine million from 11 million today. This absolute decline would happen even in light of the wave of Baby Boomers reaching eligibility.

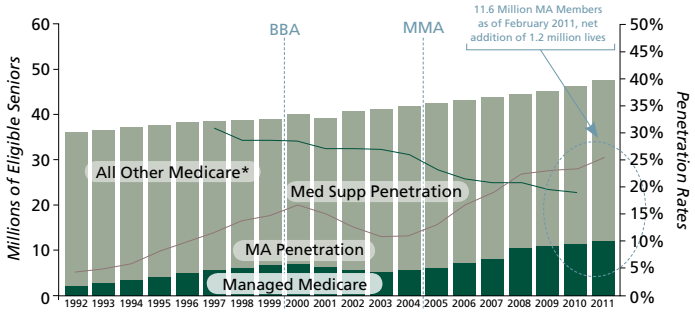
Last year, based on extensive research and analysis conducted independently and in conjunction with clients, L.E.K. Consulting published a forecast of MA membership, along with our rationale for optimism. Among the reasons for optimism:

- **There will be more seniors.** The annual growth rate will be 3% per year over the next decade, versus about 1% in the last decade.
- **It's still a good deal.** Seniors find the fee-for-service benefits and capped out-of-pocket spend appealing.
- **Once seniors become educated, they become fans of managed care plans.** While they may leave one plan if the premium goes up or benefits change, they remain within managed care, but just switch to another plan in the market.
- **Smaller markets have further room for growth in penetration.** Historically, while mature large markets (such as New York, Los Angeles, Miami) appeared to reach a natural ceiling, and rural/small markets languished, the mid-sized markets were "catching up" to the mature markets e.g., going from 20% of eligibles in MA to 30%).
- **Dual eligibles represent further upside.**

The 2010 selling season proved the resilience and continued value proposition of MA to seniors. MA penetration went above 25%, while Medicare Supplement (where seniors can buy insurance to pre-pay the 20% co-insurance on Original Medicare) continued its slow decline (see Figure 1).

Figure 1

As of the End of 2010, MA Penetration has Broken the 25% Barrier



Note: *Includes enrollment in Original Medicare and Medicare Supplement.
Source: CMS, KFF, NAIC, L.E.K. Analysis

Whatever Doesn't Kill You Will Make You Stronger – Perspective on the State of Medicare Advantage was written by **Tip Kim**, Vice President in L.E.K.'s Healthcare Services Practice. Please contact us at healthcare@lek.com for more information.

In a surprising turn of events, the large markets showed the most robust growth – the "ceiling" appeared to have been raised (see Figure 2).

There are many possible reasons for the rebound in MA. Among them are:

- The disruption of the transition away from private fee-for-service was largely played out in the marketplace by 2009
- Medicare Advantage payers were aggressive in their bids
- The 2008 economic downturn has created a long-term drag on both the actual wealth of seniors, as well as their perceptions of the future

As we look into the next few years, L.E.K. remains bullish on MA for a number of reasons:

- The current economic downturn has made seniors look harder at their health coverage options
- Healthcare reform and the ensuing political dialogue have made seniors look for safe havens
- The consumer view of "managed care" is evolving
- Health plans – driven by Star Quality Ratings, desire for retention and competitive dynamics – have made strides in provider and member relations and service
- Given the turmoil, uncertainty and profit trajectories of the commercial lines of business, Medicare appears more appealing for many broadline payers looking for growth
- There are a lot of seniors

Mark Twain on Wagner's Music: "It's Not as Bad as it Sounds"

The cloud hanging over MA is that the widely publicized cuts to Medicare and MA will make MA uneconomical for health insurers. The thinking goes that despite the fact that seniors love the product, there will be no plans available to them.

L.E.K. believes that, similar to when the Balanced Budget Act (BBA) in the late 1990's set all managed care rates at 95% of fee-for-service, there will be clear winners and losers. As was the case with the BBA, the number of players will fall materially.

However, we also believe that the overall membership will not fall; markets will not be abandoned as in the previous period. Risk-adjusted reimbursement (members who are sicker accrue more reimbursement from CMS); star quality ratings bonuses (out of five stars, each star is worth approximately $50 per member per month, a significant amount); changes to benefits will all enable plans to remain economically viable.

Figure 2

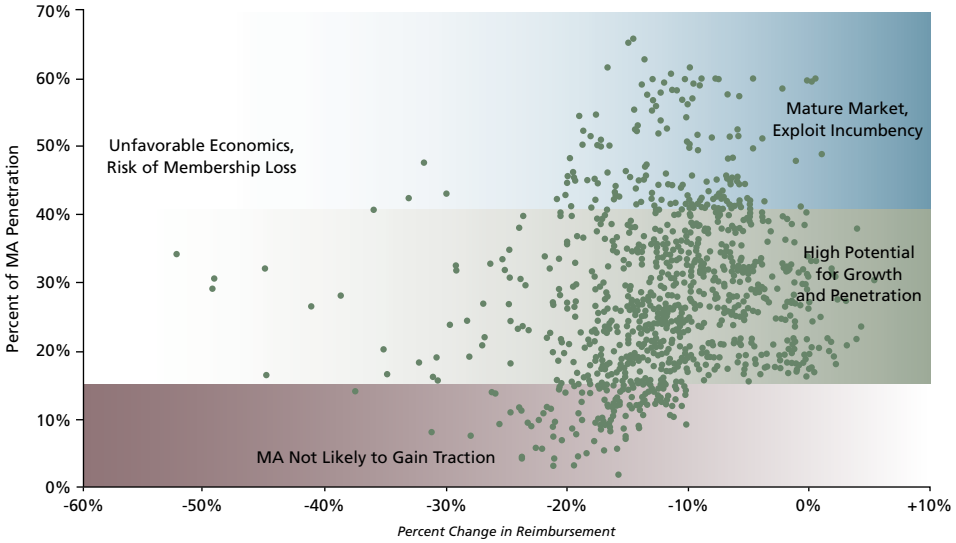
Penetration Change of MA Enrollment by 2010 Penetration Level (YE 2008 – 2010)

Medicare Eligibles				MA Enrollees			Enrolled % of Eligibles			Penetration PPT	
Penetration in 2010	MY 2008	MY 2009	MY 2010	YE 2008	YE 2009	YE 2010	YE 2008	YE 2009	YE 2010	YE08-YE09	YE09-YE10
0%-10%	7,654,834	7,823,669	7,983,551	458,467	470,611	519,381	6.0%	6.0%	6.5%	0.0%	0.5%
10%-15%	5,597,813	5,743,245	5,875,943	612,912	642,755	742,516	10.9%	11.2%	12.6%	0.2%	1.4%
15%-20%	5,438,522	5,577,937	5,720,263	823,478	859,255	1,001,755	15.1%	15.4%	17.5%	0.3%	2.1%
20%-25%	5,265,368	5,402,973	5,527,407	1,011,826	1,031,400	1,228,821	19.2%	19.1%	22.2%	(0.1%)	3.1%
25%-30%	4,233,852	4,346,695	4,454,862	1,019,027	1,092,868	1,235,161	24.1%	25.1%	27.7%	1.1%	2.6%
30%-35%	3,320,062	3,392,719	3,459,751	953,950	1,025,724	1,131,007	28.7%	30.2%	32.7%	1.5%	2.5%
35%-40%	4,753,771	4,868,277	4,964,717	1,625,980	1,727,022	1,876,706	34.2%	35.5%	37.8%	1.3%	2.3%
40%+	7,772,333	7,977,146	8,100,046	3,402,767	3,565,186	3,860,082	43.8%	44.7%	47.7%	0.9%	3.0%
Total	**44,036,555**	**45,132,661**	**46,086,540**	**9,908,407**	**10,414,821**	**11,595,429**	**22.5%**	**23.1%**	**25.2%**	**0.6%**	**2.1%**

Source: CMS Release January '09, January '10, February '11 for Enrollment; July '08, '09, '10 for Eligibles

Figure 3

County-Level MA Penetration by Percentage Change in Reimbursement (2017 Estimated)



Note: Above scatterplot is representative of 964 counties with quality data
Source: CMS, Woods and Poole, L.E.K. Analysis

In many markets, the rate cuts – while significant – are not as dire as they first appear. Our county-by-county analysis of pending rate cuts has shown that in many markets (including most of the major markets), payers are already operating at levels below the current "benchmark" set by CMS and Congress. As such, these markets will experience rate cuts that are substantively lower than the pro forma projections. In essence, the rate cuts are painful enough to spur payers into taking material strategic initiatives to manage costs, retain members (so that they get returns on their investments) and to become more efficient.

The combination of continued innovation, consolidation and benefit changes will yield a marketplace with a much healthier potential for growth than projected by the CBO (see Figure 3).

What Are These "Innovations"?

The principal change we observe in the marketplace is one that promises a closer relationship between physician providers and payers. We observe that even among payers that have traditionally had an "indemnity" view of the marketplace, there is broad recognition that the only way to succeed in this new regulatory and competitive regime is to "choose the right dance partners" among the provider network, develop truly collaborative care and member outreach protocols to effectively manage utilization, steer members into the right programs, and achieve sustainable margins and retention of members.

Figure 4 outlines the value proposition for payers to providers, and vice-versa, in the new regime.

Figure 4

Medicare Advantage Changes are Driving the Requirement for True Partnerships Between Payers and Providers

Value Created by Payers for Providers	Value Created by Providers for Payers
• Expertise in regulatory compliance and "coverage" • Alternative to remain independent versus joining hospital staff • Opportunity to get off the fee-for-service "gerbil wheel" • Specific, non-redundant care management programs consistent with "manufacturing" process • Extension of care via member outreach • Conduit to extract higher reimbursement (via coding, via bonuses, via retention)	• Effective retention tool and process • A product pathway (via concentric/overlapping networks, benefit levels, centers of excellence, etc.) • In a world of commoditization, the ability to truly differentiate vis-à-vis competitors • Thought leadership and incubator for care models that are sustainable within the constraints of reimbursement trajectories • A real bulwark against hospital monopoly power

Source: L.E.K. Analysis

Key Takeaways

In summary, we believe that the fundamentals for MA are sound. Payers and providers are taking proactive steps (often out of the limelight) that will ensure a sustainable business model, despite substantial rate cuts from CMS. L.E.K. believes that MA, as it has proven to date, is a robust business model with real consumer traction. MA well may prove itself to be a harbinger of the real, albeit unintentional, benefits of health-care reform.