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Time to A.C.T.

Administrative Cost Transformation for Health Plans

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Over the past five years, health plans have performed surprisingly well despite rising medical costs. Net margins increased, pulled up by a hike in premiums. Capital reserves rose, thanks to better investment returns. And the growth of administrative costs slowed relative to the increases in medical costs.

But today, this formula seems played out. Although enrollment in fully insured managed care plans grew by 4.9 percent in the U.S. between January and July 2007 alone,[1] plan members and employers are pushing back against premium hikes. The investment environment is suddenly deeply uncertain. And administrative costs are forecast to grow over the next few years.

Seeking to raise margins, many health plans are investing in capabilities that will bring new value to their member base in the form of new services. At the same time, on the cost side, plans continue to extend and build competency in medical cost-control and cost-management programs. Finally, a number of plans are renewing efforts to take control of their administrative and operating costs.

We believe this last move is particularly significant, because over the past few years many plans have experienced the same major problems—an ironic byproduct of the industry's general success:

- Business complexity in both the front office and the back office has grown. Health plans now need to support a larger number of product and service offerings and face increasing regulatory demands.
- The bar keeps rising in the effort to develop new capabilities. Informatics, disease programs, and electronic records all demand attention, and they all need to be funded somehow.
- Budget cuts have not delivered sustained results. Costs keep creeping back, and plans appear to be caught in an endless cycle.

Many plan executives say that these problems are now at the top of their agenda. But many are unsure about the right way to rectify these problems. Although the specifics of the solution will vary by company, most demand some variation of what Booz Allen Hamilton calls an administrative cost transformation (ACT).

Get It Off and Keep It Off

Making cuts that improve productivity numbers for a quarter or two is easy. The challenge is to make reductions that keep those costs off permanently. Too often, corporate savings programs are more like crash diets—sporadic, frustrating, and finally counterproductive. Rather than address the root causes that led to the rise in costs in the first place, such programs generally result in wholesale, indiscriminate cuts that leave the company with fewer employees and resources even as it tries to manage a growing workload. ACT overcomes the fundamental challenge of cost cutting: getting it off and keeping it off.

[1] *Health Insurance Law Weekly*, Jan. 2008, in an article on the latest Managed Care Market Surveyor market research report.

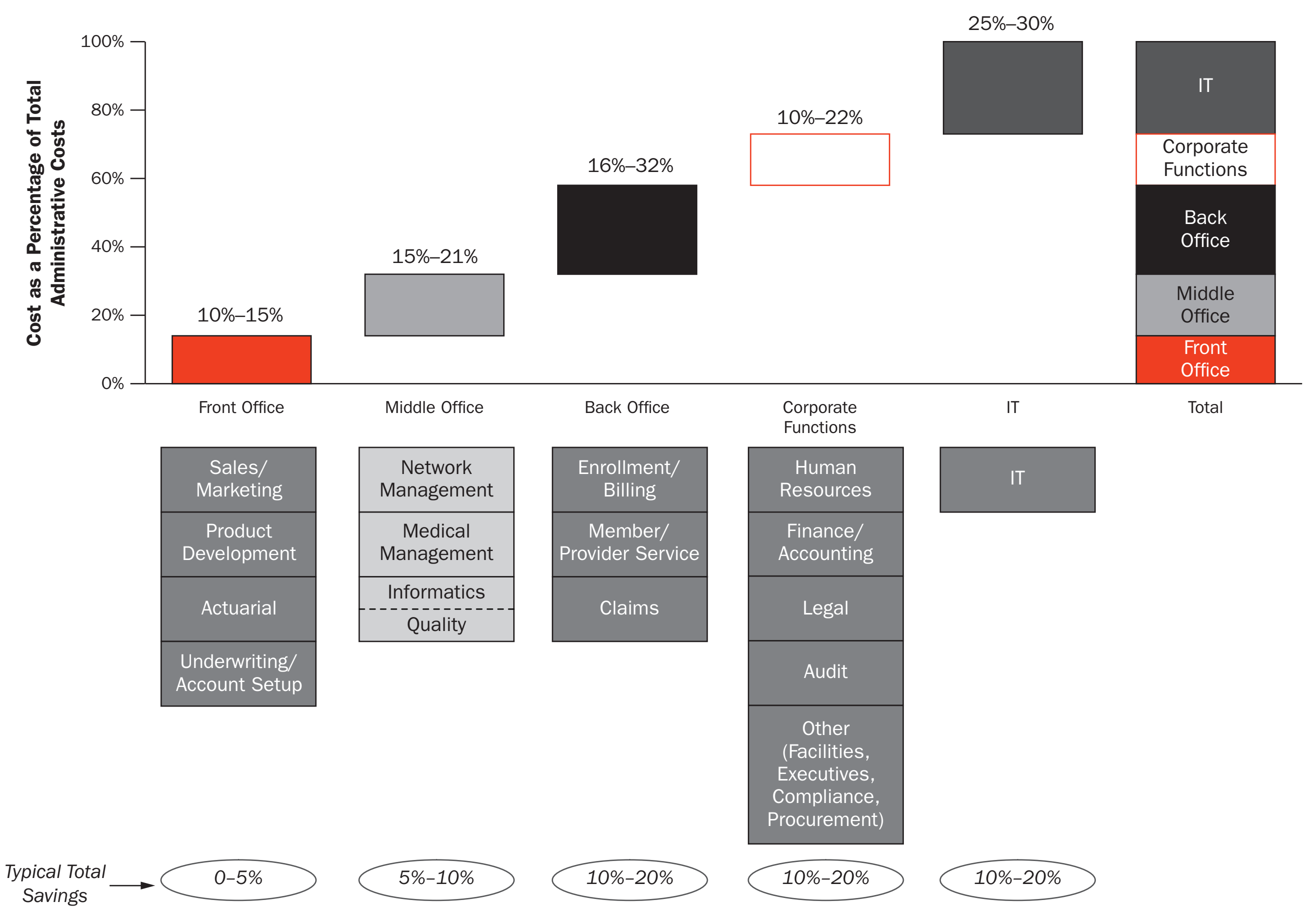
An administrative cost transformation begins with an analysis of the sources of expenditures across the value chain. In most healthcare administration systems, administrative expenditures are divided into three parts: the front, middle, and back offices.

The front and middle offices typically account for the smallest percentage of total administrative budget, 25 to 36 percent (see Exhibit 1). Because of the relatively small size of this area and the fact that it is perceived as a profit center, senior management tends to be reluctant to see it as a starting point for major cutbacks.

Back office, corporate functions, and IT make up most of the rest, constituting 51 to 84 percent of total administrative costs. Their relative sizes and perceived status as cost centers tend to make them more obvious candidates for reform. Unfortunately, however, back-office cuts are also typically the easiest to botch, because the internal relationships between these functions and front and middle office are often poorly understood, and total investment requirements for system rationalization and upgrades are often only apparent over the long term.

In our experience, costs are best framed by asking three simple questions (see “The What, Where, and How of Costs and How to Manage Them”). These questions are often asked and answered in a nearsighted, ad hoc way in other kinds of cost-cutting exercises. An administrative cost transformation, on the other hand, typically reviews all the cost levers at once—an important advantage because

Exhibit 1
Administrative Costs as a Percentage of Total Selling, General, and Administrative (SG&A) Costs by Value Chain



Source: Booz Allen Hamilton

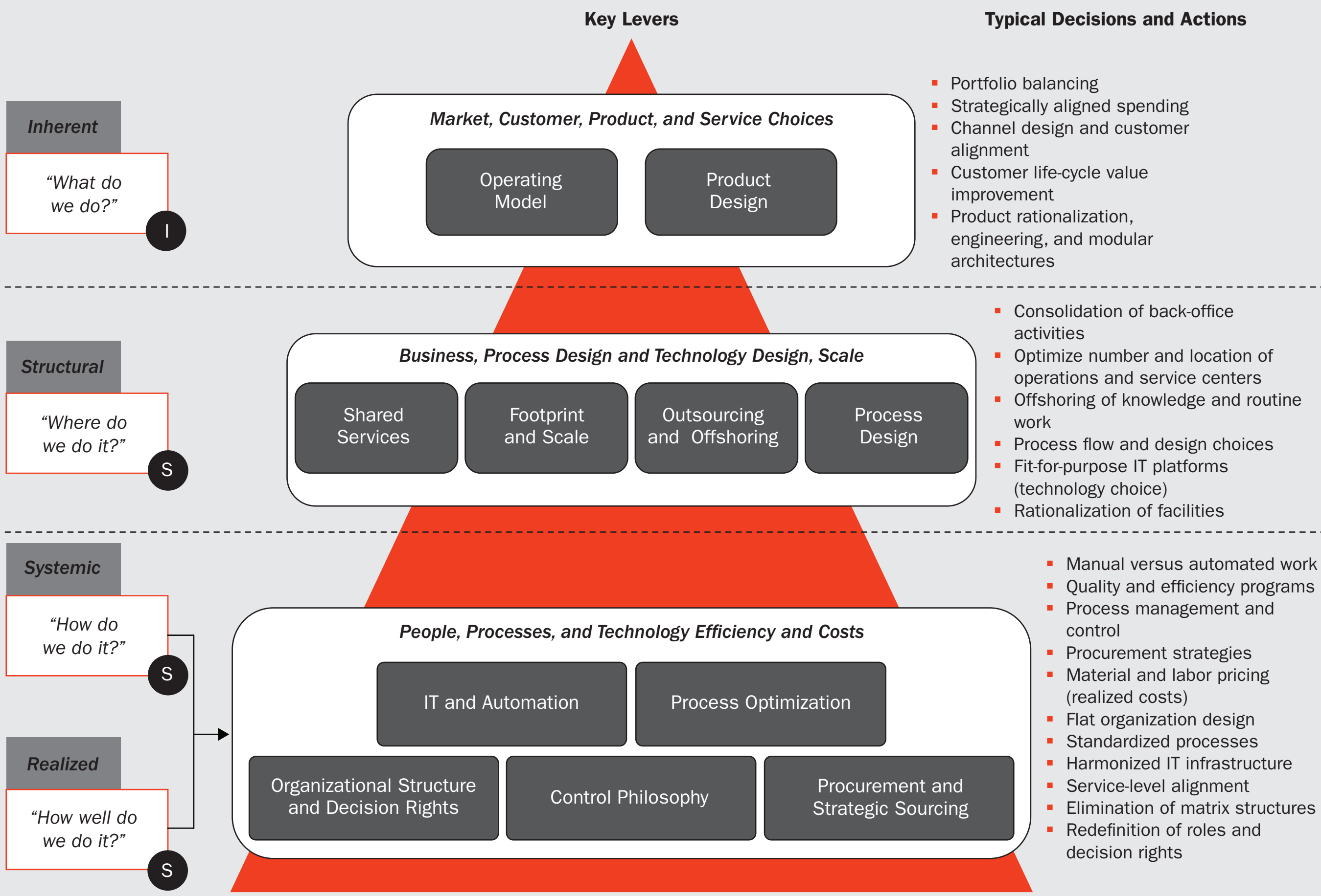
The What, Where, and How of Costs and How to Manage Them

Proven approaches to addressing costs begin with understanding what drives costs and what levers can be used to manage them.

- ***What do we do?*** (Inherent costs)—What are the inherent costs of the products and services offered and the operating model to deliver those products and services?
- ***Where do we do it?*** (Structural costs)—What are the choices that have the biggest impact on the fixed costs of a business, such as process footprint/scale, outsourcing/offshoring, and process design?
- ***How do we do it and how well do we do it?*** (Systemic and realized costs)—What are the systemic and realized costs of this business (the "how" and "how well" a business gets its work done)? How does the company optimize its processes, choose the degree of work it automates, and create an organizational structure, control philosophy, and procurement practices?

Exhibit 2 illustrates how these three questions are often answered.

Exhibit 2
Inherent, Structural, Systemic, and Realized Cost Levers



Source: Booz Allen Hamilton

in our experience, the most frequent mistake most organizations make in undertaking a cost containment campaign is not looking at the problem in a holistic way. Instead, executives scatter their efforts across the enterprise, cutting costs temporarily but failing to address the root drivers of those costs.

But it's not just a matter of asking the right questions. Some companies in a number of industries have found that, over time, it is possible to achieve permanent step changes in administrative costs by applying seven key principles:

1) Ensure that senior leadership is aligned
2) Simplify the product portfolio
3) Think wisely about IT
4) Attack the sacred cows
5) Build in the right control philosophy
6) Clean up the physical footprint
7) Manage the effort as a program

1. Ensure that senior leadership is aligned. Cost reduction is a difficult subject for any organization to address. Typically, the most important sources of cost savings are invariably the hardest to cut. What is only a line item on paper may translate into a cherished part of the corporate self-image, an important part of someone's career, or the livelihood of hundreds of colleagues. Executing such changes is disruptive and uncomfortable at best.

This is even truer in an organization without an ingrained sense of cost-consciousness. When that's the case, the organization must feel some kind of deep conviction that its survival depends on making some hard choices.

Anything less than complete alignment and commitment of the executive team reduces the campaign's chance of success. Many organizations have launched cost-savings programs only to find that when the moment of truth arrives to execute the plan, leadership is conflicted. The organization senses confusion, and dissent against the plan gains strength. In the end, such an initiative can even be counterproductive, as internal turf battles to preserve jobs and favorite programs siphon energy from permanent plan changes.

How the leadership handles this expected resistance often determines the outcome of the initiative. In many ways, leaders' behavior in this situation is more important than the messages they disseminate. For example, routinely deferring cost projects, delaying tough employee decisions, allowing special authorizations for expenditures, and, most important, not holding the management team accountable for objectives will erode efforts at cost reduction. Leaders' actions need to consistently reinforce objectives, demonstrating conviction and resolve in decision making and priority setting that could otherwise undermine cost reduction efforts. This is best accomplished by developing a shared understanding of the baseline and ensuring a collective alignment on the target. Leaders need to complement these actions with frequent communication. But the timing and message must be carefully orchestrated, coordinated, and phased, always emphasizing that any costs cut must be in accord with the company's underlying values.

Maintaining this resolve is also essential. One integrated health plan and provider succeeded in cutting 7 percent of costs in the first year of a three-year plan to reduce costs by 15 percent, but reached only 2 percent the second year. The reason for the shortfall was that the company's leaders began to confuse the organization by pushing other priorities forward along with cost reduction. Although finance remained committed to cutting costs, every other function argued in favor of other priorities, such as developing new products and capabilities. Leaders still spoke about meeting their three-year target, but the effect of pushing forward competing priorities simultaneously was to ensure that little progress was made on any particular initiative—including the cost-savings plan.

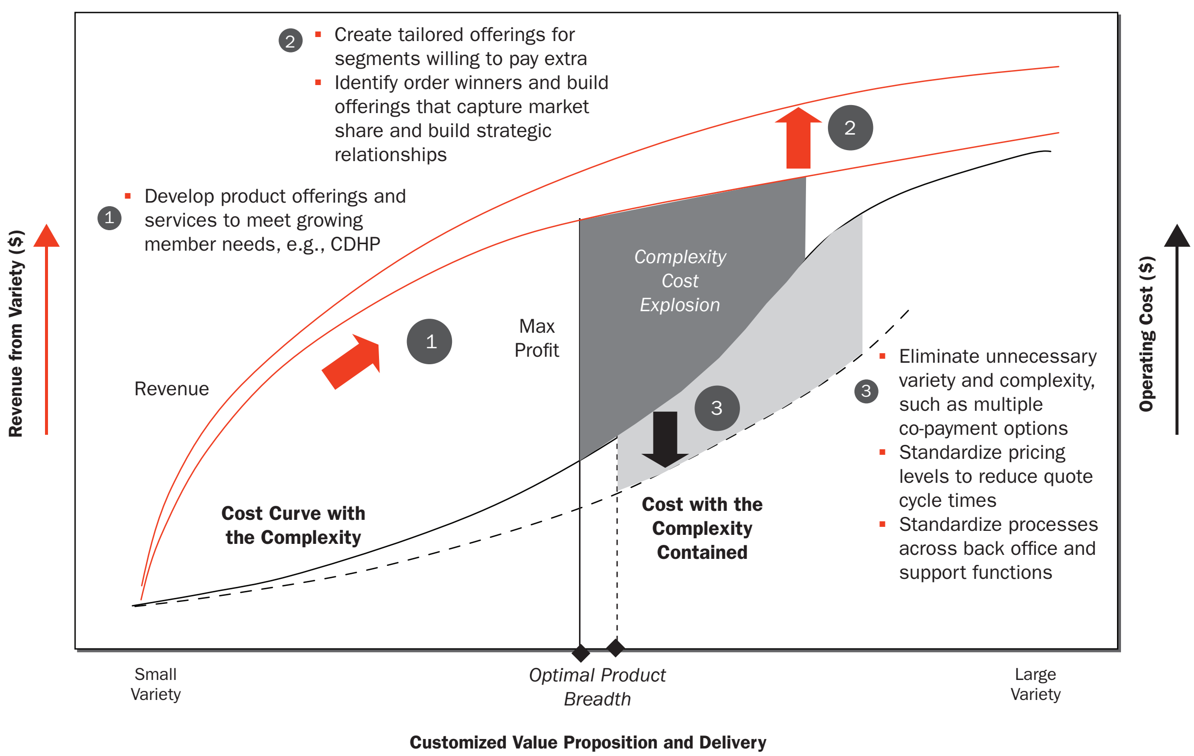
2. Simplify the product portfolio. At a time when the manufacturing industry was faced with growing product complexity, most companies responded by simplifying their portfolio. Today, we believe health plans face a similar challenge. In many health plans, offerings have evolved from simple contracts to broker-customized benefit plans that incorporate an increasing number of features designed to give employers and consumers more choice.

The end result is generally increased downstream complexity. The broker thinks he has just made his client happy and made a sale, but he is likely unaware that he has also created more costs. Fulfilling such orders typically leads to ongoing retrofitting of back-office functions such as claims and billing to handle new processes. This drives up the per member per month cost. It also saddles the company with the task of serving up-front demand for these new capabilities and then managing the ongoing support costs for these products over time.

Some health plans have started to tackle this creeping complexity by discontinuing low-volume and low-value-add offerings. The most forward-thinking health plans are addressing product design too, by creating modular service plans. In much the same way as a buyer of a Dell computer can customize certain sets of features but not every feature, this approach lets members and benefits executives select certain groups of features, but only among modules where the service processes are clearly configured and the cost structures are clearly understood. What complexity remains is isolated and confined mostly to strategically important, high-value areas. These can be dealt with more carefully, while processes to take care of the fixed, ready-made modules can be optimized, boosting efficiency and quality, and lowering cost all across the value chain (see Exhibit 3).

But how do you decide what plans to discontinue? At one leading health plan, executives began by evaluating the volume and profitability of different products, then set about eliminating minor variations of product design, setting a path to reduce the overall number of products in the portfolio. Next, the plan sought to identify the bundles of repeatable features/components across products to integrate into a back-office redesign. This product simplification yielded savings of 10 percent of total administrative costs across all its functions. Within the back office, the organization continued the simplification process,

Exhibit 3
Optimization of Cost of Complexity versus Revenue from Variety



Source: Booz Allen Hamilton

streamlining work flows and simplifying IT automation and maintenance—a move that delivered up to 25 percent savings in certain areas of spend, such as claims processing.

3. Think wisely about IT. When health plans begin to look for cost savings and a means for controlling complexity, IT is often seen as the easiest lever to pull. Whether the need is for better decision making or higher productivity, turning to IT too quickly often leads to overly costly solutions. More important, leaning heavily on IT may serve only to optimize a bad situation rather than eliminate the root causes of process problems. Many health plans have found that in the course of drawing up the business case for an IT solution, the forecast cost savings are based largely on the process improvements the IT solution entailed, not the new application. Across many industries, we have seen that as much as 70 percent of the anticipated savings from a process optimization effort is independent of the technology. What tends to matter more are simple process changes, scale benefits, functional policy changes, and better demand management. Furthermore, organizations can get caught in the trap of waiting for the IT solution before undertaking any process changes, whether or not they depend on the technology.

When management seeks to address every problem with an IT solution, the backlog of high-priority initiatives grows too long, investment needs increase, and maintaining the organization's focus on its top priorities becomes a prolonged effort. At some point, demand overwhelms supply and there are no longer sufficient resources to support the new investment. When that appears to be happening, senior executives should step in and evaluate the long list of projects against current strategic priorities. Projects that are not high-return and aligned to the overall strategy should be cut to ensure that funds and the organization's capacity are focused on the most important issues.

Certainly, IT solutions can lead to significant productivity gains and workplace improvements, such as automated claims processing and self-service member portals, but in the end their success depends largely on the degree of process optimization that took place before.

4. Attack the sacred cows. Cost reductions are tough. During a cost-cutting campaign, the role of leadership is often tested and tried not just by what leaders say but by what they do. Serious programs address the entire scope of the business, thereby sending the message that this is a new era. How often have we been in situations where everything is in play except "the corporate jet" or "the executive canteen"?

Attacking everyone's sacred cows requires company leaders to take an unflinching look at all kinds of expenditures. This tends not to be a politically popular activity. In one large health plan, for example, the CEO asked company analysts to reexamine similar efforts over the past five years through the lens of "what was excluded and why." He found that every exclusion had a valid reason—but every reason had an equally valid counterargument. Taking on such sacred cows often unlocks scale for savings far beyond what the organization thought possible.

Exposing sacred cows typically requires the kind of unbiased view and independent viewpoint that this CEO demonstrated. One tactic that one national payor used was to appoint its most senior executive to lead a cost reduction program. It was a savvy move, because the tenured executive knew where to look for fat—for instance, the places in the budget where the hidden HR or claims department costs were buried. And because this executive had six months until retirement and already had a contract in place to stay on post-retirement as a contractor, he had no skin in the game.

5. Build in the right control philosophy. In today's tough market, operating as efficiently and leanly as possible is essential. Health plans must incorporate cost savings as a cultural element in day-to-day operations, systematically questioning and examining sources of defects, waste, and variance.

Traditionally, plans addressed variances and optimized processes only to find that over time, processes become inefficient again due to newly added complexity, long refresh/upgrade cycles, unplanned growth, and lack of a control philosophy to drive continuous improvement and sustain gains. When plans undertake an administrative cost transformation, whether across the enterprise or in a specific process, the end result must include an embedded control philosophy to ensure sustainability and ongoing cost improvement. The difference between quality control and quality assurance is subtle yet profound.

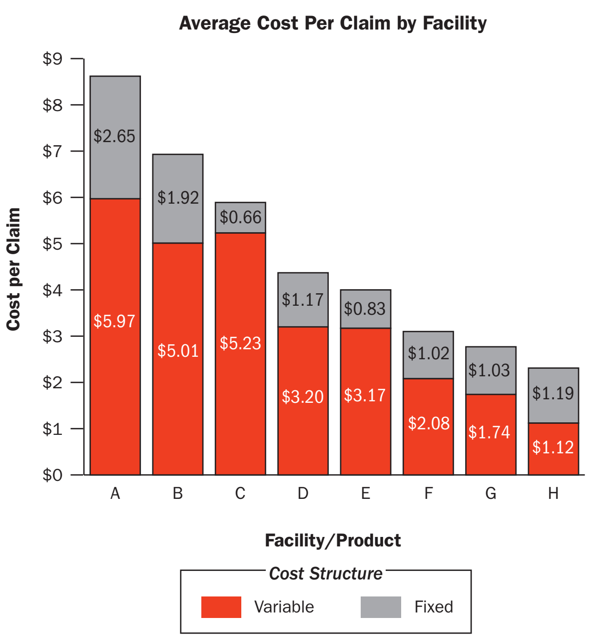
Cost reduction programs need to carefully examine processes to identify waste and unnecessary cost variances, utilizing tools such as Lean or Six Sigma to address their root causes. In the end, such optimization leads to improved quality, productivity, and efficiency, as well as lower costs. Initially, organizations set up centers of excellence with practice champions to make some early converts to these control philosophies. Then as competency grows, the capabilities and work flow into the mainstream of the organization, and over time the centers of excellence become virtual teams of individuals dispersed across the larger enterprise, with perhaps a small training staff to support capability growth.

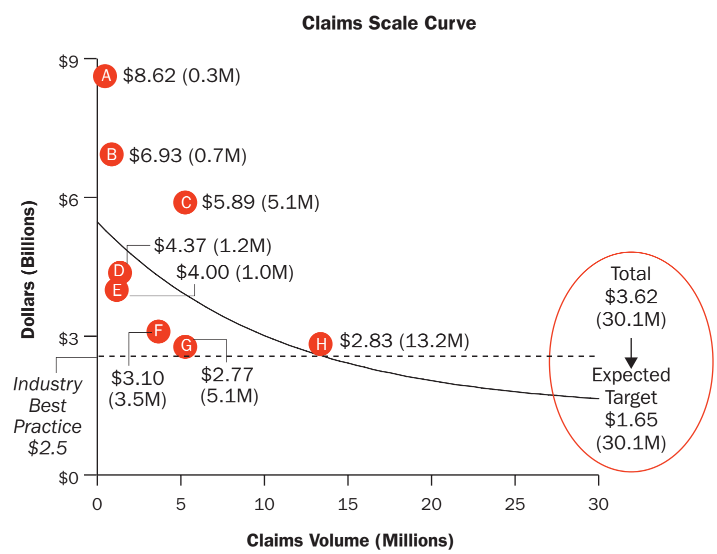
This approach has already worked in many industries. Although healthcare is a unique industry, we believe that health plans will have the same experience with ACT as companies in other industries that have used it for cost transformations: reduced waste and a more efficient company.

6. Clean up the physical footprint. As health plans continue to grow, either organically or through consolidation, the operational footprint typically expands as well. In a cost-conscious environment, plans need to regularly assess whether their current footprint is still efficient. Often, the natural course of business evolution encumbers companies with the equivalent of vestigial gills or the vermiform appendix—appendages that perhaps once served a clear function but are now there only because they have always been there. A thorough study of current footprint costs and opportunities for optimization can reveal previously overlooked chances for cost savings through geographic consolidation or relocation.

Bringing together processes such as contact centers or claims operations, either physically or virtually, tends to lead toward better utilization of fixed costs, and reduces the overall per unit marginal costs (see Exhibit 4). An appropriately scaled facility or process improves many aspects of the operation—including better-used

Exhibit 4
Variation in Claims Cost by Facility and Recognized Scale Impact





Source: Booz Allen Hamilton

resources, superior load balancing, improved isolation of complexity through the use of specialists, and faster transfer of best practices. A large national plan recently consolidated its contact centers to meet customer needs and realized that the technology had progressed to such an extent that consolidation hitherto thought infeasible was now considered fairly routine. As a result, the usual perception of cost as being somehow at odds with service turned out to be the opposite of the truth: Executives found they had reduced service cost by 25 percent while simultaneously raising overall quality and member satisfaction.

In another situation, a company that had grown considerably over the years found that it now maintained a large operating footprint with multiple claim centers running across the country, all performing the same operations. By consolidating the centers at a single location and creating some new scale economies, the company was able to lower error rates and reduce operating costs per claim by 20 to 30 percent to industry competitive rates, with opportunity for further improvement.

7. Manage the effort as a program. Cost reduction efforts demand the same level of energy and focus as launching a new product or pursuing a new group. This means dedicated teams, clear milestones, work plans, and a governance structure that focuses on outcomes. Reporting lines should cascade down through the organization clearly, in a way that creates a high degree of internal transparency. Campaign tracking needs to be set against a well-defined baseline, ensuring that companies do not see costs shuffled rather than cut, disappearing in one department only to reappear somewhere else.

But as important as it is to monitor metrics and accounts, a true cost transformation isn't achieved by bean-counting alone. Managers must also frequently play the role of coaches. In one health plan, managers also focused significant resources on educating the employees on subjects like Lean, Six Sigma, root cause analysis, and continuous improvement. The corporate headquarters' efforts helped provide individual programs with the tools to reduce costs and increase the acceptability and effectiveness of the program. This emphasis on educating the staff paid off, helping the company avoid the common trap of allowing the large program management offices to manage through templates and process tracking rather than on a more direct basis.

Conclusion

Most health plans follow one or more of these seven steps when they try to execute a cost-cutting strategy. And they succeed—but only partially, and only for a relatively short time. Ultimately, their goals are seldom achieved in full, and sooner or later all those costs creep back. Following all seven steps is the best way we know to ensure that a genuine administrative cost transformation takes root.

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Booz Allen Hamilton has been at the forefront of management consulting for businesses and governments for more than 90 years. Providing consulting services in strategy, operations, organization and change, and information technology, Booz Allen is the one firm that helps clients solve their toughest problems, working by their side to help them achieve their missions. Booz Allen is committed to delivering results that endure.

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