

PERSPECTIVES

PROVIDING INSIGHT INTO TODAY'S EMPLOYEE BENEFITS ISSUES

Increasing Healthcare Costs and Your Employee Health Plan

Fifth Edition

HEALTHCARE costs, and consequently health insurance premiums, have been increasing at an alarming rate for nearly a decade. While the upward trend seems to be slowing, cost increases that are outpacing the rate of inflation are still the norm. Avoiding rising healthcare costs is nearly impossible, but you can learn about why they continue to rise, and what you can do to minimize the fallout for your organization and your employees.

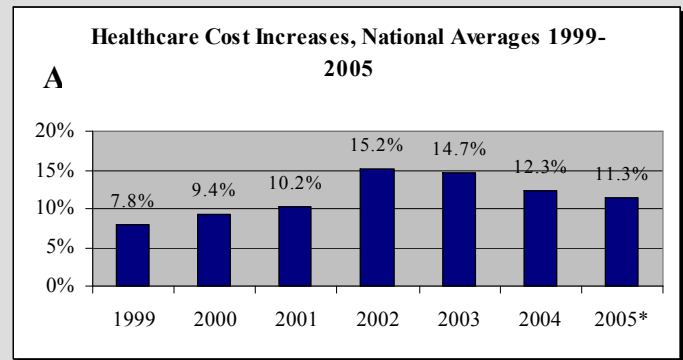
The next few pages will discuss the latest healthcare cost figures, the factors leading to nearly a decade of unprecedented rate hikes, and some solutions that firms around the U.S. are undertaking to help soften the blow.

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 percent. From 1999 to 2000, however, costs leapt 9.4 percent, 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 2005.

As the overall cost of healthcare has risen, there has been a subsequent rise in the rates employers are paying for employee health plans. These rate hikes have varied across the country



*Projected

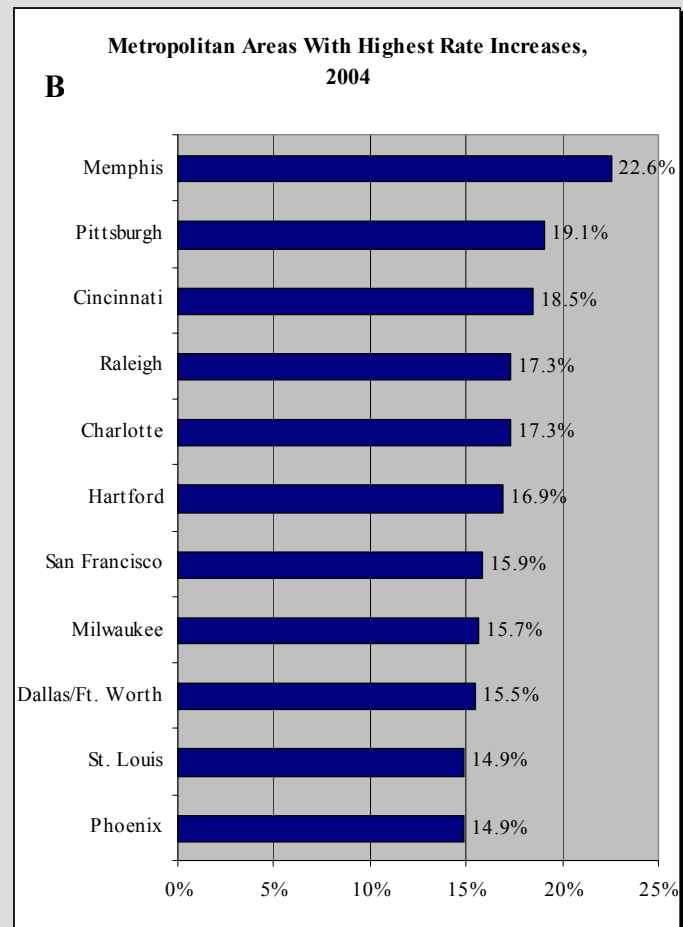


Exhibit 1

Source: Hewitt Associates, news release, "Health Care Costs Show Signs of Moderating, but Still Outpace Inflation," October 11, 2004.

over the last several years, hitting some metropolitan areas much harder than others. **Exhibit 1B**, above, illustrates the cities that recorded the highest rate increases in 2004.

While the rate of increase has slowed in recent years, 2004 was the seventh year in a row that health benefit costs rose faster than the rate of inflation, and the trend is expected to continue indefinitely. According to the *Mercer National Survey of Employer-Sponsored Health Plans 2004*, the average cost of healthcare benefits for active employees rose 7.5 percent in 2004 — from \$6,215 per employee in 2003 to \$6,679 per employee in 2004. This represents the lowest increase since 1999, and is well below the 10.1 percent increase seen in 2003. **Exhibit 2A**, below, shows the average total health benefit cost for active employees for the years 1994 to 2004. **Exhibit 2B** depicts the annual percent change in health benefit costs from 1987 through 2004. Note especially the dramatic upward trend since 1998, and the positive trend that is now emerging — a drop in the annual percent increase since 2002.

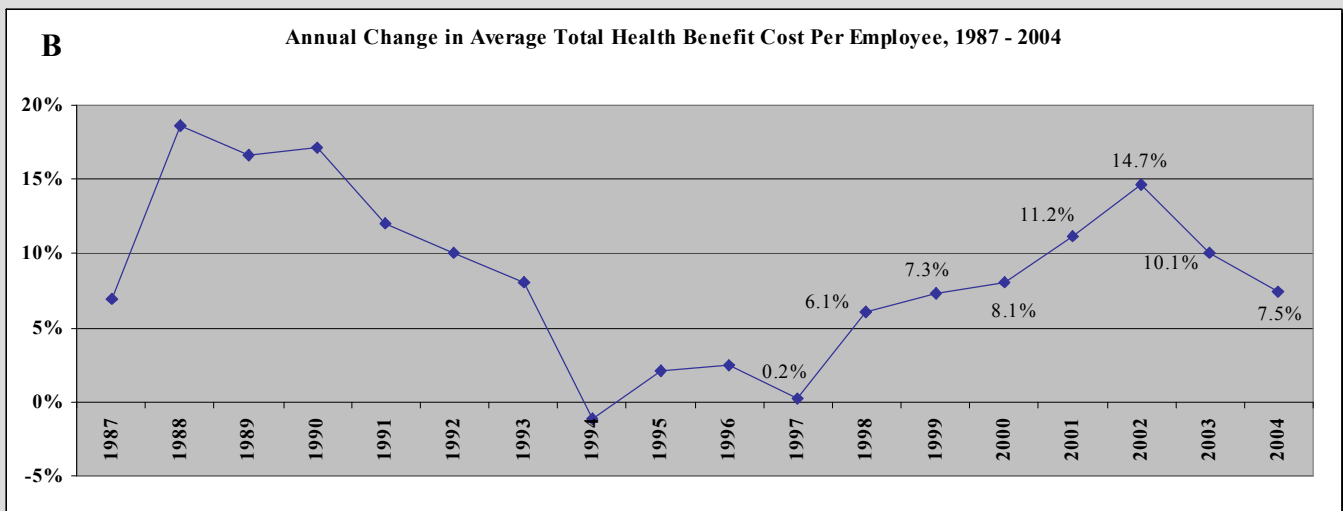
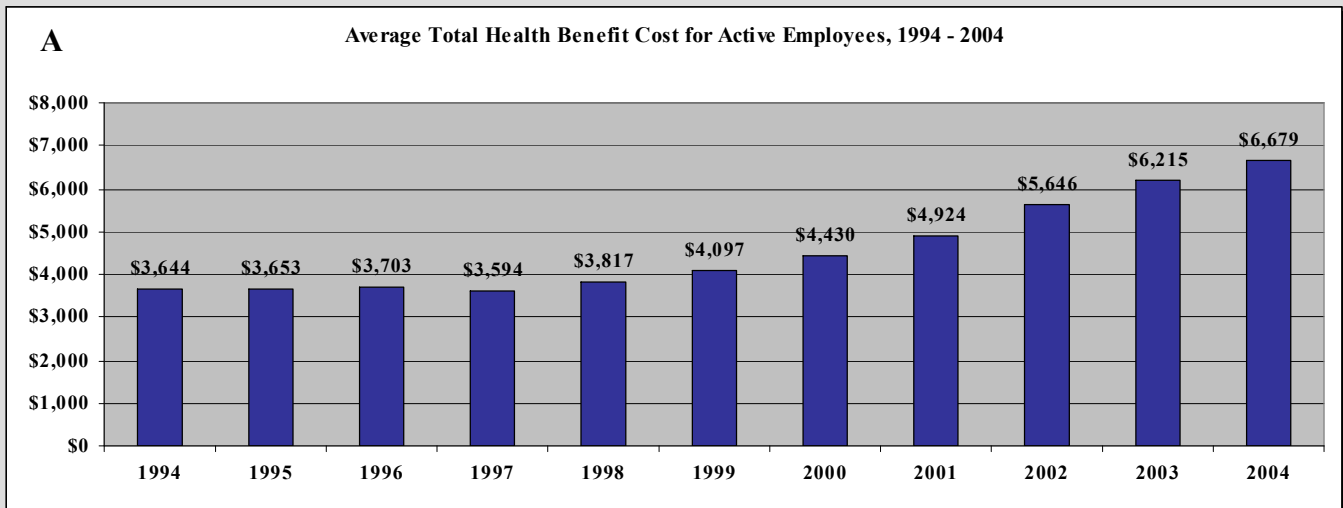
Healthcare cost increases varied significantly between small and large employers. Small employers (10 – 499 employees) fared much better than large employers, with an average increase of just 5.5 percent. **Exhibit 2C** compares the average total health benefit costs for active employees by employer size for 2003 and 2004.

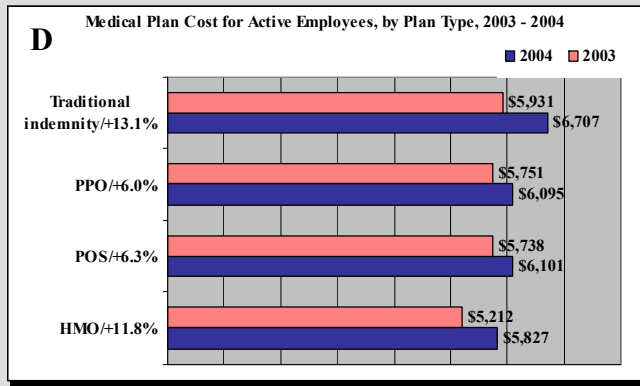
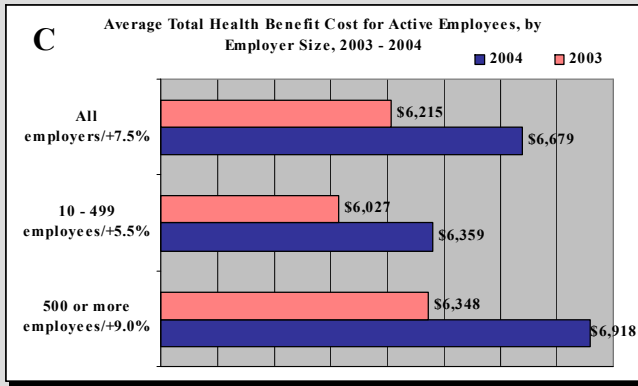
The Mercer report attributes the improved performance of small employers to a variety of factors:

- ✓ More small employers than large employers tend to be fully insured, and increased price competition among insurers made fully insured medical plans more competitive in 2004.
- ✓ In response to sky-high rate increases in previous years, small firms employed unprecedented cost shifting in 2003. For example, about one-third of small PPO sponsors required an individual in-network deductible of \$1,000 or more, resulting in an even larger than expected drop in utilization in 2004.
- ✓ Many not-for-profit insurers held excess surpluses in late 2003. State regulations require these surpluses to be returned to customers, and accordingly many small employers benefited.

Health benefit costs did slow for larger employers in 2004, but not as significantly as for small employers. Employers with 500 or more employees absorbed a 9.0 percent increase. Large employers also shifted more costs to employees in 2003 and 2004, but not to the same extent and consequently without realizing the same results as smaller employers. Nonetheless, reduced utilization may have led to the modest slowdown in costs for large employers.

The strategies employed in 2003 and 2004 may have some residual impact into 2005, but most likely not enough to keep the downward trend in tact for 2006 and beyond. Employers will need to execute additional tactics to keep costs down over time.





Source: Mercer National Survey of Employer-Sponsored Health Plans 2004.

Factors Leading to Increased Healthcare Costs

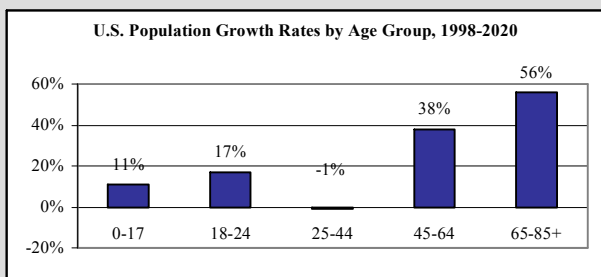
Why are U.S. healthcare costs skyrocketing? Several market conditions working in tandem have led to a decade of unrelenting increases. Understanding why your annual health plan renewal rates may be significantly higher than the previous year is the key to formulating alternatives and solutions to your 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.

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.

As this population shift occurs, 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.

Exhibit 3, below, shows projected U.S. population growth rates by age group from 1998 through 2020.



Source: Kiplinger Washington Letter, December 23, 1998.

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.

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.

Consolidation of Managed Care Companies

As managed care boomed throughout the 1990s, competition among industry giants — 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 led to serious dips in profitability and stock prices for a large number of carriers. 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.

Political Environment and Government Regulation

Healthcare issues, particularly those surrounding health plans and medical liability, have become one of the most hotly debated topics in the political arena, while health insurance is one of the most regulated insurance sectors on both the state and federal levels.

State and federal mandates have increased 25-fold over the last three decades. Often these mandates duplicate or conflict with each other, and they almost always come with increased

costs for the healthcare system. For example, the Health Insurance Portability and Accountability Act of 1996 (HIPAA) continues to impact the 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.

On the political front, concerns about timely access to quality healthcare services and calls for federal laws to protect consumers led to a variety of legislative initiatives, including the now defunct Patients' Bill of Rights. Homeland security interests, a slowing economy, the war in Iraq, and other domestic issues have since forced most of the political debate to the backburner. However, if the Patients' Bill of Rights were resurrected or other legislation regarding medical liability were initiated, the negative impact on healthcare costs is expected to be significant.

Issues such as prescription drugs for seniors, Medicare reform, and coverage for the uninsured will also continue to 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.

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.

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 percent). Without the surge in managed care plans the total amount spent on healthcare nationally — about 15 percent of 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, employers have backed away from offering rich benefits, and instead have employed 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 Services¹ (CMS) annually releases national health expenditures projections. Some of their most recent findings for the period 2004 - 2014 include:

- ✓ National health expenditures are projected to reach \$3.6 trillion in 2014, growing at an average annual rate of 7.1 percent during the period 2003 – 2014.
- ✓ Health spending is expected to reach 18.7 percent of gross domestic product (GDP)² by 2014, up from its 2003 level of 15.3 percent.

Old techniques are being replaced with new, often expensive treatments using new medical devices, diagnostic products, drugs, and surgical procedures.

- ✓ CMS projected healthcare spending in the U.S. to grow 7.5 percent in 2004 — slightly less than the 7.7 percent growth in 2003. This stabilization of growth from 2003 to 2004 followed a steep deceleration from 2002 to 2003, after six years of acceleration from 1996 to 2002. CMS predicts steady growth in healthcare spending through 2006, at a rate of about 7.3 percent.
- ✓ Per-enrollee private health insurance premium growth was expected to fall from 9.9 percent in 2003 to 7.7 percent in 2004.
- ✓ CMS projected hospital spending to grow 7.0 percent in 2004, after a slowdown in 2003 when hospital spending grew 6.5 percent. Private sector hospital spending was expected to decelerate from 8.4 percent growth in 2003 to 6.5 percent growth in 2004, due to price stabilization and a deceleration in the growth of utilization. The slowdown in utilization is due to the quiet re-introduction of utilization management tools and the incorporation of some inpatient cost sharing.

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 Index³ (CPI). The U.S. Department of Labor Bureau of Labor Statistics recently released CPI figures for the period ending April 30, 2005.

Exhibit 4, below, shows the percent change in the CPI for various consumer expenditure categories since 1997. *Medical Care* is one of the categories.

Overall consumer prices rose 3.3 percent during 2004, down from a high of 3.4 percent in 2000. So far in 2005, overall consumer prices have risen 3.7 percent.

Costs for goods and services in the Medical Care category rose 4.2 percent in 2004, and 4.4 percent as of April 2005 — 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. The continued acceleration of medical care expenditures and inflation places additional upward pressure on health plan rates.

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. After years of trying to absorb most of the costs because of attraction and retention issues, many firms are now trying to attack the root causes of rising costs with sustained, systemic changes. Small businesses in particular continue to face the critical decision to raise employee contributions or to discontinue offering the coverage altogether.

In previous years, the majority of employers were using tactical, short-term approaches that shifted costs to employees. A 2005 Hewitt survey, *Health Care Expectations: Future Strategy and Direction*, found that employers now plan to control costs with long-term strategies that go further in addressing the actual causes of rising costs. The primary strategies involve introducing more consumer-driven plans, improving employee education, influencing positive employee behavior changes through condition management and wellness programs, and improving the amount and quality of data available on healthcare costs and quality.

Introducing or Expanding Consumerism

While basic cost shifting remains a prevalent means for managing costs, there is evidence of a movement toward more consumer-oriented solutions. Those companies that want to balance costs and employee relations are incorporating more of a consumerist focus into their plans for 2005 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 employees. Then, by providing appropriate tools and education, employers can help employees assume this responsibility.

According to the Hewitt survey, companies' interest in offering consumer-driven health plans as a means for controlling costs and providing more choices for employees continues to grow. The report offers the following results regarding the most

Annual Percent Change in CPI⁴, 1996-2004

	1997	1998	1999	2000	2001	2002	2003	2004	2005 ⁵
All Items	1.7%	1.6%	2.7%	3.4%	1.6%	2.4%	1.9%	3.3%	3.7%
Food & Beverages	1.6%	2.3%	2.0%	2.8%	2.8%	1.5%	3.5%	2.6%	3.0%
Housing	2.4%	2.3%	2.2%	4.3%	2.9%	2.4%	2.2%	3.0%	3.2%
Apparel	1.0%	-0.7%	-0.5%	-1.8%	-3.2%	-1.8%	-2.1%	-0.2%	-0.5%
Transportation	-1.4%	-1.7%	5.4%	4.1%	-3.8%	3.8%	0.3%	6.5%	7.7%
Medical Care	2.8%	3.4%	3.7%	4.2%	4.7%	5.0%	3.7%	4.2%	4.4%
Recreation	1.5%	1.2%	0.8%	1.7%	1.5%	1.1%	1.1%	0.7%	0.1%
Education and Communication	3.0%	0.7%	1.6%	1.3%	3.2%	2.2%	1.6%	1.5%	1.1%
Other Goods & Services	5.2%	8.8%	5.1%	4.2%	4.5%	3.3%	1.5%	2.5%	2.8%

Source: United States Department of Labor Bureau of Labor Statistics, news release, Consumer Price Index, April 2005.

prevalent models of consumer-driven health plans:

- ✓ 17 percent of surveyed employers use a health account plus high-deductible coverage model;
- ✓ 6 percent use multi-tier networks;
- ✓ 5 percent use a defined contribution approach; and
- ✓ 4 percent of employers use a customized design.

As the use of these consumer-driven models grows, they are expected to have lower rates of increase than traditional PPO, POS, and HMO models.

Hewitt's survey also addressed the use of Health Savings Accounts (HSAs). It found that employers are very interested in the HSA option, but few are offering them. Fifty-seven percent of employers surveyed are considering using HSAs in the future, but only three percent planned to provide access and contributions for active employees in 2005.

Improving Employee Education and Communication

The Hewitt survey and other recent studies agree that the only way for consumer-driven strategies to have their desired impact (to drive smarter consumer behavior among employees) is for companies to also invest heavily in the communication, education, and decision support tools that will result in better decision-making by employees and their dependents.

REQUIRING ACTIVE ENROLLMENT

2005 marked a turning point in which many employers are requiring their employees to take part in active enrollment. This means that employees are required to take action with their enrollment or risk being enrolled into a default plan that may not meet their needs. Employees who don't comply may even lose their coverage. Active enrollment ensures that employees are aware of their options and that they review them to ensure they are making the best possible choices.

IMPROVING DECISION SUPPORT TOOLS

Realizing that the new choices available to employees can be overwhelming, employers are offering an unprecedented number of decision support tools to help employees evaluate their options. These new tools include medical expense estimators, health plan comparison charts, provider quality data, patient education and condition management information, health risk assessments, and expense account explanations and estimators.

The most outstanding trend in this regard is the increasingly popular move toward using the Internet to help employees become more educated healthcare consumers. One recent 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.

Increasing Disease Management and Wellness Programs

Hewitt's *Health Care Expectations: Future Strategy and Direction* found that the number of companies using disease management programs has grown significantly, from 73 percent in 2004 to 83 percent in 2005. In addition,

- ✓ 49 percent of companies profile prevalent chronic conditions in their workforce (up from 42 percent in 2004);
- ✓ 30 percent offer incentives to encourage employee participation in wellness programs (up from 21 percent the previous year); and
- ✓ 27 percent of respondents measure the impact of disease management programs on health and productivity (up from 22%).

Also noteworthy, employers appear to be taking great strides to address obesity, with 64 percent providing coverage for bariatric surgery and 56 percent offering weight management programs.

Improving Data

Hewitt's survey suggests that employers are attempting to control costs by creating greater market transparency with more and better data. These measures include encouraging the use of accredited plans, reviewing HEDIS and other available data, and using narrower networks based on provider quality data.

Other Strategies for Reducing Costs

The following are some additional tactics that employers are using to reduce healthcare costs.

CONTRIBUTION STRATEGIES

Employers are looking for ways to control costs by evaluating how they differentiate contributions for employers and their dependents. Pay-based contribution models are also commonly used.

DEPENDENT COVERAGE CHANGES

Changing the rules for dependent coverage may be one way to influence employee behavior. The most common practices include:

- ✓ implementing higher cost sharing for dependents (31 percent);
- ✓ providing flexible credits for opting out of coverage (24 percent);
- ✓ requiring additional contribution if an employee's working spouse does not accept coverage from his or her own employer; and
- ✓ requiring an employee's working spouse to accept coverage from his or her own employer.

Employers are offering an unprecedented number of decision support tools to help employees evaluate their options.

CHANGE PRESCRIPTION DRUG COVERAGE

Efforts to control overall healthcare costs by making changes to prescription drug benefits include:

- ✓ using a three-tier design,
- ✓ increasing coinsurance,
- ✓ requiring step therapy,
- ✓ requiring the use of generics,
- ✓ requiring mail order of certain drugs, and
- ✓ using a therapeutic MAC/reverse copay design.

GOVERNMENT INTERVENTION

According to Hewitt's research, three-fourths of employers are looking to the government to restrict malpractice awards, restrict patent extensions for brand name drugs, and allow employees to access their Flexible Spending Accounts (FSAs) before HSAs to enable savings for retirement coverage. More than half of the employers surveyed feel that the government should make Medicare available to early retirees at their own cost, and that U.S. consumers should be allowed to purchase prescription drugs from foreign countries.

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 in this report. 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.

Notes:

¹Formerly the Health Care Financing Administration (HCFA).

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

³The 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.

⁴Reference base: 1982-1984.

⁵Unadjusted annual rate twelve months ended in April 2005.

Perspectives is provided to Jerry Gregory & Associates clients for informational purposes. Please seek qualified and appropriate counsel for advice on how to apply the topics discussed herein to your employee benefits plan.

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SPECIAL REPORT: Prescription Drug Costs and Your Employee Health Plan

Fifth Edition

Prescription Drug Spending Trends

Rising prescription drug costs are a primary cause of escalating overall spending on healthcare, and also represent an increasingly large portion of healthcare expenditures. Pharmaceutical research is continually providing treatment breakthroughs that should not be impeded, but the costs associated with this progress are beginning to and will continue to have a major impact on healthcare financing and delivery systems.

According to the Centers for Medicare & Medicaid Services (CMS), overall national spending on healthcare has been rising steadily for over a decade, and will continue to rise sharply well into the next decade. Overall healthcare expenditures were 8.8 percent of gross domestic product (GDP) in 1980, and are projected to reach 18.7 percent of GDP by 2014.

Prescription drugs are making up an increasingly large portion of those expenditures. Overall healthcare spending rose

7.5 percent from 2003 to 2004, while spending on prescription drugs rose 12.9 percent — more than any other personal health category.

Not all the news is bad, however. CMS predicts that while prescription drug spending hit an all-time high in recent years, the upward trend may be slowing. Despite remaining the fastest-growing health expenditure category, drug spending has slowed over the last several years, from 19.7 percent in 1999 down to 12.9 percent in 2004. The deceleration is expected to continue throughout the 2004 – 2014 projection period due to slower growth in drug prices, the expiration in patent protection for several top-selling drugs, and increased use of multi-tiered copays that have slowed demand.

Exhibit 1, below, depicts overall drug spending from 2001 to 2013 (projected), as well as the percent change from year to year.

While overall U.S. sales in retail prescriptions were up 8.3 percent in 2003, research has shown there was wide variation in

Drug Spending Continues to Increase, but Trend May Be Slowing

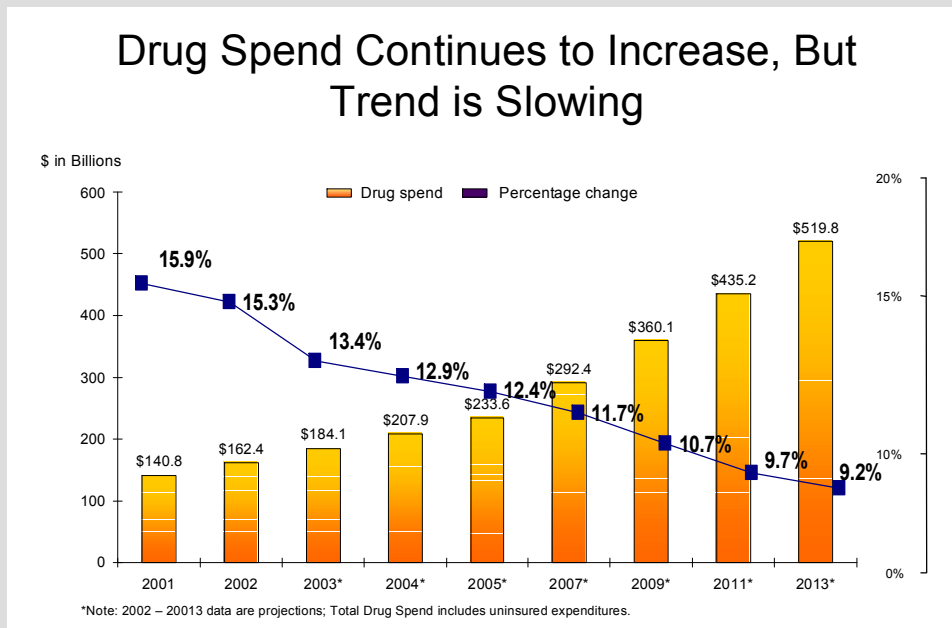


Exhibit 1

spending hikes on a state-by-state level. Oklahoma actually recorded a decrease in prescription sales, at -4.4 percent, while Delaware had the highest rate of growth at 23.6 percent. For most states, the increase in total spending was caused more by growth

in the average price per prescription, rather than by rising utilization.

Exhibit 2, below, depicts how the growth in prescription drug spending varied among states from 2002 to 2003.

Growth in Prescription Spending Varies Significantly Among States

Percent Change in Total Sales of Retail Prescriptions, 2002 – 2003

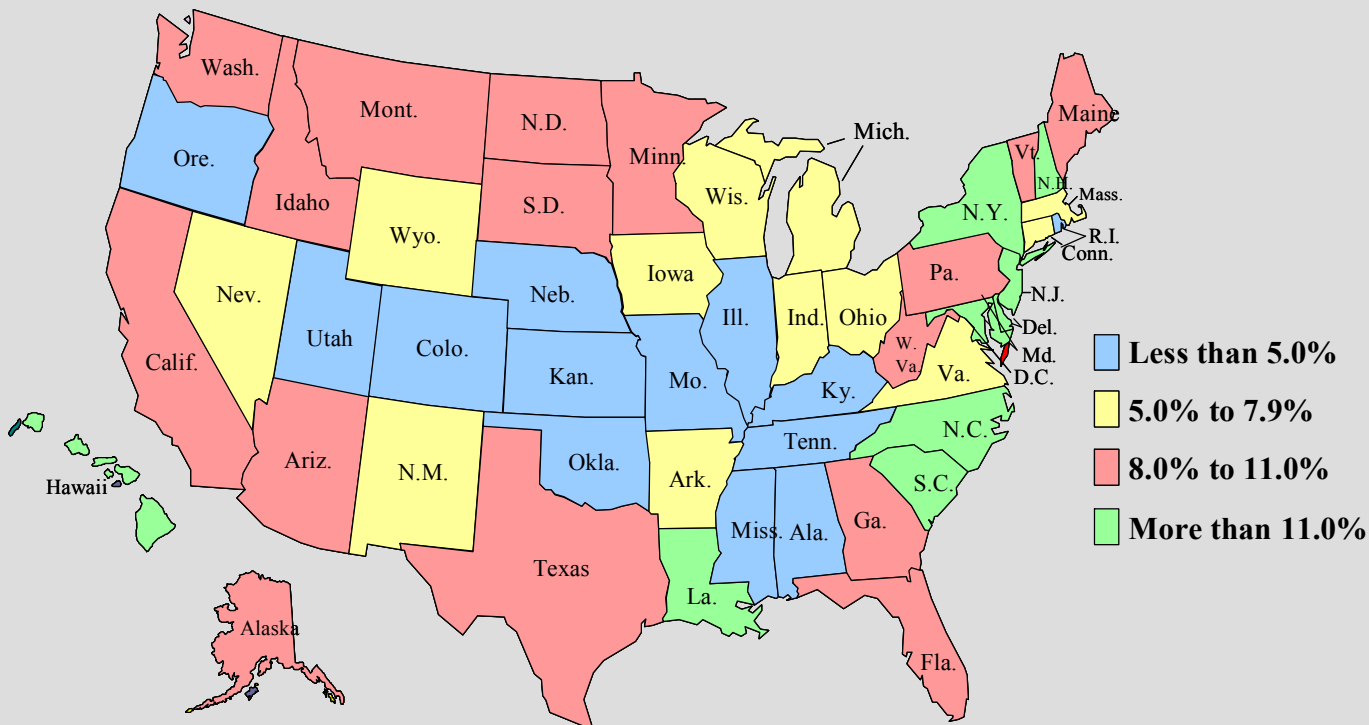


Exhibit 2

NOTES: These data are based on restated figures for 2002 from Verispan, LLC. To accurately calculate the changes in the number of retail prescriptions filled, total sales of retail prescriptions filled and average price of prescriptions filled, Verispan, LLC provided 2002 data from the Vector One™: National source to compare to the 2003 data from the same source. Vector One™: National collects data from a panel of retail pharmacies, third party payers, and data providers. Data shown here are for calendar year 2003. Retail pharmacies include independent pharmacies, chain pharmacies, food stores, and mass merchandisers found in 814 defined regional zones. These data describe the number of prescriptions filled by retail pharmacies only and exclude those filled by mail order.

DEFINITIONS: Rx drugs or Prescriptions: All products filled by retail pharmacies, including new prescriptions and refills of both brand name and generic drugs. These products exclude drugs purchased without a prescription.

SOURCE: The Kaiser Family Foundation, State Health Facts Online. Data Source: Calculations based on Vector One™: National from Verispan, LLC. Special Data Request, 2004.

Impact on Health Plans and Employers

The fast and steep ascent of the cost of prescription drugs is undoubtedly having an impact on insurance carriers and managed care organizations, and consequently on employers who sponsor employee health plans.

CMS reports that prescription drug expenditures make up approximately 11.6 percent of overall national health expenditures, and projects that figure to reach 15.5 percent by 2013. Recognizing this trend, payers and plan sponsors have moved toward more aggressive plan designs — like higher copayments or three-tier copayment plans — that shift more of the cost burden to members.

Driving Forces

Pharmaceutical costs are rising due to a variety of factors that can be linked to two major driving forces: the increased flow of new drugs to market, and increased utilization.

Flow of New Drugs to Market

A primary force behind the growth of overall prescription drug spending is the introduction of new branded drugs to the marketplace. New drugs are classified as those approved by the Food & Drug Administration (FDA) since 1992. Expedited by a rise in the number of FDA new drug approvals, federally funded research, and growth in private research and development spending, the number of new drugs being introduced to the marketplace is greatly accelerating. These new drugs are often more effective than old therapies that they replace, yet this innovation bears a hefty price tag.

- ✓ According to the *Medical Cost Reference Guide* developed by the BlueCross BlueShield Association in June 2003, new and pipeline drugs account for a majority of prescription drug spending growth. In 2002, existing drugs accounted for only 3.6 percent of drug spending growth, while new and pipeline drugs accounted for 10.6 percent of the growth in drug spending.
- ✓ AdvancePCS reports that the number of new drugs entering the market appears to be increasing, especially high-cost biotech drugs. In 2002, the U.S. Food and Drug Administration (FDA) approved 78 new drugs, nearly 20 percent more than in 2001. The year 2002 also saw the greatest number of approvals for biotech drugs and vaccines in a single year; the FDA approved 35 new biotech drugs and vaccines or new indications for biotech therapies — up from 24 in 2001.

Increased Utilization

It is a fairly simple concept: more people are using more prescription drugs, thereby driving overall spending upward. The number of prescriptions dispensed has been growing dramatically from 1992 to the present, and is projected to continue at a similar pace for years to come.

Exhibits 3A and 3B, right, illustrate the growth in the number of prescriptions per capita and total prescriptions dispensed from 1993 to 2002.

There are a number of reasons for the growth in utilization of prescription drugs. They include the following.

INSURANCE COVERAGE FOR PRESCRIPTION DRUGS

Individuals with insurance are more likely to use prescription drugs than those without. Only 10 percent of drug costs were funded by third party coverage in 1970; in 2003, private health insurance paid for 50 percent of drug costs. Likewise, consumers paid for 80 percent of drug costs out-of-pocket in 1970; currently out-of-pocket funding accounts for only 40 percent of drug costs.

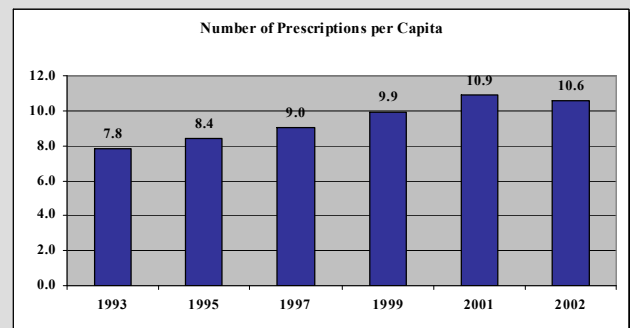
THE AGING OF AMERICA

As discussed earlier in this article, Americans are growing older and are expected to live longer than ever before. With this general aging of the population there is a higher incidence of chronic disease, and a resultant increase in the use of pharmaceuticals to treat those conditions. This demographic trend is the leading cause of increased utilization of prescription drugs.

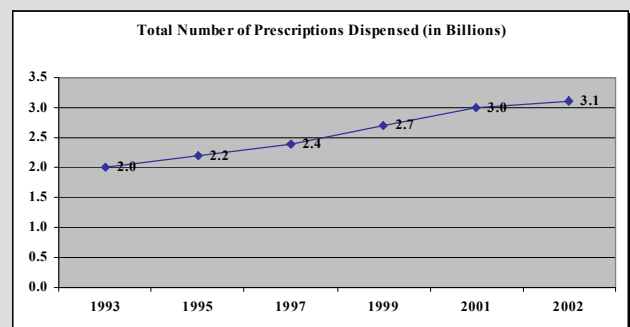
AGGRESSIVE DIAGNOSIS AND TREATMENT METHODS

New technology and clinical protocols have brought increasingly aggressive diagnosis and treatment methods and a greater emphasis on preventive measures. Pharmaceuticals often play a primary role in these more aggressive ways of diagnosing and treating diseases.

A



B



Source: Adapted from National Institute for Health Care Management, 2002; Verispan Scott-Levin 2003, as reported by Kaiser Family Foundation, 2004a, as reported in BlueCross BlueShield Association *Medical Cost Reference Guide*, Revised October 2004.

PHARMACEUTICAL MARKETING

In 1985, the FDA lifted its moratorium on direct-to-consumer (DTC) advertising of prescription drugs. Prior to this change, pharmaceuticals were marketed solely to physicians and other medical professionals. Now, prescription drugs have become one of the most highly marketed product categories, with spending on DTC advertising of prescription drugs growing from \$55 million in 1991 to \$2.6 billion in 2002. Many feel this promotional push is creating inappropriate consumer demand that is contributing to unnecessary utilization. In addition, critics of the drug companies charge that pharmaceutical prices could be lower if exorbitant amounts of money were not being spent on advertising.

What Can Employers Do?

Several opportunities exist to help you keep your employee health plan's prescription drug costs in control. Through careful analysis and consideration and with the advice of your benefits consultant, you may decide that one or several of the following cost saving tools is right for your particular needs.

- ✓ **Offer a plan with an open formulary.** The open formulary encourages the use of appropriate, cost-effective prescription drugs through physician education, voluntary therapeutic substitution, member communication, and by higher copayment requirements for non-formulary drugs.
- ✓ **Offer a plan with a closed formulary.** The closed formulary excludes coverage for certain drugs.
- ✓ **Increase coinsurance or copayments.** Sharing costs with employees encourages more responsible drug utilization by increasing patient sensitivity to drug costs.
- ✓ **Require generic substitution.** Requiring employees to substitute appropriate generic medications for more expensive brand-name drugs will have a substantial impact on your plan's prescription drug spending.
- ✓ **Offer a plan that utilizes therapeutic/pharmacy interventions.** This means that utilization of preferred drugs is encouraged over non-preferred drugs when clinically appropriate.
- ✓ **Make utilization management a part of your prescription drug plan.** This includes measures such as prior authorization, step therapy, and managed drug limitations such as restricting refills for certain medications depending upon clinical guidelines.
- ✓ **Use a narrower pharmacy network.** Greater discounts can often be achieved by using a narrower network.
- ✓ **Offer a mail order drug benefit.** Mail service pharmacies can generally negotiate deeper discounts from drug wholesalers and manufacturers than retail pharmacies can. These savings can be passed on to the payer.

Exhibit 4, right, depicts the most common changes

employers made to their pharmacy benefit plan for 2004, or were considering for 2005.

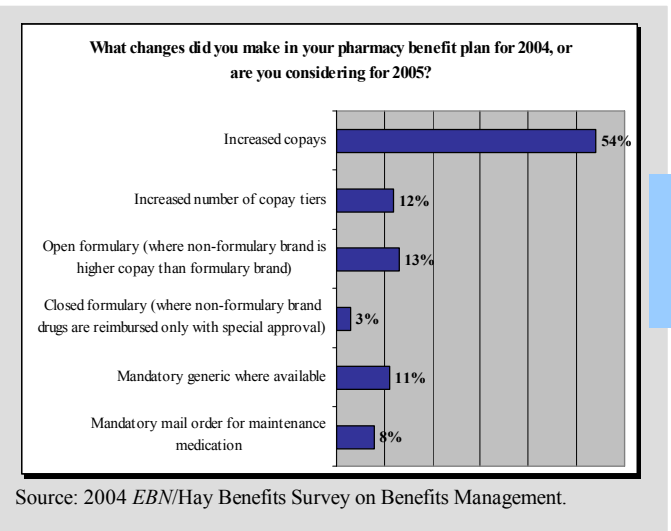


Exhibit 4

Clearly there are many options to explore if you are trying to better manage your health plan's prescription drug costs. Educating your employees about the reasons for rising drug costs and their impact on your health plan will be the key to successfully introducing changes to your plan or the out-of-pocket amounts required of your employees.

Perspectives is provided to Jerry Gregory & Associates clients for informational purposes. Please seek qualified and appropriate counsel for advice on how to apply the topics discussed herein to your employee benefits plan.