

Will health fund rationalisation lead to significant premium reductions?

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Abstract

It has been suggested that rationalisation of health funds will generate significant albeit unquantified cost savings and thus hold or reduce health fund premiums. 2001-2 Private Health Industry Administration Council (PHIAC) data has been used to analyse these suggestions. Payments by funds for clinical services will not vary after fund rationalisation. The savings after rationalisation will arise from reductions in management expenses, which form 10.9% of total fund expenditure. A number of rationalisation scenarios are considered. The highest theoretical industry wide saving found in any plausible scenario is 2.5%, and it is uncertain whether this level of saving could be achieved in practice. If a one off saving of this order were achieved, it would have no medium and long term impact on fund premiums increases given funds are facing cost increases of 4% to 5% per annum due to demographic changes and age standardised utilization increases. It is suggested discussions on fund amalgamation divert attention from the major factors increasing fund costs, which are substantially beyond fund control.

Background

It has been suggested in the media that fund rationalisation will generate significant savings and consequently reduce the cost of Private Health insurance (PHI) (Durie, 2002), (Probyn, 2002). No quantification of the size of anticipated savings was made. This paper considers the financial benefits that can be expected as a result of fund rationalisation and the likely impact on health fund premiums.

Health fund income and expenditure 2001-02

In 2001-02 health funds as a group incurred a loss of \$60 million. Major sources of income and items of expenditure are outlined in Table 1. These are rounded to the nearest million dollars.

It is anticipated that fund rationalisation will make no significant difference to benefit or ambulance levy payments. The only significant expenditure item likely to be significantly reduced by fund rationalisation is management expenses, which accounts for 10.9% of total fund expenditure. The relative importance of the various components of management expense is outlined in Table 2.

Table 1: Major Components Health Fund Income and Expenditure 2001–02

Income	\$ millions	Percentage of Income
Contribution income	\$7,266	99.1%
Investment and Other Income	\$66	0.9%
Total Income	\$7,332	
Expenditure	\$ millions	Percentage of Expenditure
Benefits	\$6,459	87.4%
State Ambulance Levies	\$99	1.3%
Management expenses	\$804	10.9%
Other including Tax and Extraordinary	\$29	0.4%
Total Expenditure	\$7,391	
Nett Loss after Tax	\$60	

Source: www.phiac.gov.au Operations of the Registered Health Benefit Organisations (RHBOs) Annual Report 2001-02 – Part C Report on Organisation's Financial operations - Table 2 - Statement of Financial Performance 2001-02 pp 54-57

Table 2: Health Fund Management Expense (ME) Components - 2001–02 Industry Average

Component	Percentage
Commission	6%
Computer Costs	8%
Depreciation and Amortisation	3%
Finance Charges	3%
Labour Costs	43%
Management Fees/ Share Corporate Overheads	5%
Postage Telephone	4%
Printing Stationery	4%
Rent and Property Expenses	6%
Research, Advertising and Publicity	9%
Other	9%

Source: www.phiac.gov.au Operations of the Registered Health Benefit Organisations (RHBOs) Annual Report 2001-02 – Part B Operations Review - Figure 32 - Management expenses by Category 2001-02 pp29

Anticipated reduction in management expenses post fund rationalisation

How large would the reduction in management expenses be following fund rationalisation? It is assumed that when two or more funds amalgamate, the management expenses previously incurred by the largest fund will remain unchanged. These are unlikely to reduce given increased membership, the need to continue to rent buildings, run computer systems, advertise etc. Savings will arise from reducing the management expenses that previously were incurred by the smaller fund(s) participating in the amalgamation.

Some components of management expense that relate directly to the number of people covered will be unchanged after rationalisation. These include Commission, Postage and Telephone, and Printing and Stationery, 14% of fund management expenses. In addition, a significant portion of labour costs are related to member services and claims processing and will not be totally eliminated after fund amalgamation. It is assumed that 60% of Labour Costs and all other costs of the smaller fund(s) are saved e.g. Computer Costs, Rent, Research/ Publicity. The nett effect is to save two thirds of the total management expenses previously incurred by the smaller fund(s).

This estimate of management expenses reduction might be too high as will be discussed later. This level of saving in management expenses, that is, two-thirds of management expenses for all but the largest fund involved in any amalgamation, is assumed in the modelling that follows.

Modelling financial savings due to fund amalgamation

The fund amalgamations in the following tables are purely hypothetical and have been chosen to illustrate the savings that arise following different patterns of fund rationalisation. Some of the modelled amalgamations might well raise the interest of the Australian Competition and Consumer Commission (ACCC).

Savings are calculated as follows. The contribution income of the amalgamated entity is assumed to equal the total Contribution income of the amalgamating funds. The management expenses of the amalgamated entity is assumed to equal the management expenses of the largest of the participating funds plus one third of the management expenses of the other fund(s). The saving in combined management expenses post amalgamation is expressed as a percentage of the amalgamated funds contribution income as a reflection of projected savings in costs and premium rates.

In the modelling that follows a large fund is defined as having 2001–02 contribution income of at least \$500 million, a medium sized fund having 2001–02 contribution income between \$100 million and \$500 million and a small fund as having 2001–02 contribution income under \$100 million .

Results

Scenario 1 – One of the four largest funds amalgamating with a small fund

In Table 3 Fund S refers to a hypothetical (non-existent) small fund that has the average management expenses and contribution income of small funds as defined in the preceding paragraph. Fund S is assumed to have management expense of \$3 million and contribution income of \$27 million.

Table 3: Management Expense (ME) Changes Post Amalgamation Large and Small fund

Fund 1	ME Fund 1	Fund 2	ME Fund 2	ME - Old	ME - New	Combined 2001-2 Contribution income	Saving – absolute and as percent of Combined Income
AXA	\$75m	Fund S	\$3m	\$78m	\$76m	\$849m	\$2m – 0.2%
HCF	\$53m	Fund S	\$3m	\$56m	\$54m	\$558m	\$2m – 0.4%
MBF	\$145m	Fund S	\$3m	\$148m	\$146m	\$1,337m	\$2m – 0.1%
MBP	\$213m	Fund S	\$3m	\$216m	\$214m	\$2,046m	\$2m – 0.1%

Abbreviations: AXA – AXA Health Fund (formerly National Mutual)
HCF- Hospital Contributions Fund of Australia
MBF- Medical Benefits Fund of Australia
MBP - Medibank Private
\$m – \$ million

Source: www.phiac.gov.au www.phiac.gov.au Operations of the Registered Health Benefit Organisations (RHBOs) Annual Report 2001-02 – Part C Report on Organisation's Financial operations - Table 2 Statement of Financial Performance 2001-02 pp 54-57

Scenario 2 – One of the four largest funds amalgamating with a medium sized fund

In Table 4 Fund M refers to a hypothetical (non-existent) medium sized fund that has the average management expenses and contribution income of over \$100 million but under \$500 million associated with medium sized funds. Fund M is assumed to have management expense of \$27 million and contribution income of \$194 million.

Table 4: Management Expense (ME) Changes Post Amalgamation Large and Medium fund

Fund 1	ME Fund 1	Fund 2	ME Fund 2	ME - Old	ME - New	Combined 2001-2 Contribution income	Saving – absolute and as percent of Combined Income
AXA	\$75m	Fund M	\$27m	\$92m	\$74m	\$1,016m	\$18m – 1.8%
HCF	\$53m	Fund M	\$27m	\$80m	\$62m	\$725m	\$18m – 2.5%
MBF	\$145m	Fund M	\$27m	\$172m	\$154m	\$1,504m	\$18m – 1.2%
MBP	\$213m	Fund M	\$27m	\$240m	\$222m	\$2,213m	\$18m – 0.8%

Abbreviations: AXA – AXA Health Fund (formerly National Mutual)
HCF- Hospital Contributions Fund
MBF- Medical Benefits Fund of Australia
MBP – Medibank Private
\$m – \$ million

Source: www.phiac.gov.au Operations of the Registered Health Benefit Organisations (RHBOS) Annual Report 2001-02 – Part C Report on Organisation's Financial operations - Table 2 Statement of Financial Performance 2001-02 pp 54-57

Scenario 3 – All small and medium funds amalgamating with Medibank Private

This is an improbable scenario used to illustrate the possible savings from fund amalgamations that reduce the number of funds to five – AXA, HCF, HBF, MBF and Medibank Private (MBP).

Table 5: Management Expense (ME) Changes Post Amalgamation MBP and all Small and Medium Funds

Fund 1	ME Fund 1	Fund 2	ME Fund 2	ME - Old	ME - New	Combined 2001-2 Contribution income	Saving – absolute and percent of combined income
MBP	\$213m	All others	\$270m	\$483m	\$303m	\$4,103m	\$180m – 4.4%

Abbreviations: All others – All health funds except AXA, HBF, HCF, MBF, MBP
MBP – Medibank Private
\$m – \$ million

Source: www.phiac.gov.au Operations of the Registered Health Benefit Organisations (RHBOS) Annual Report 2001-02 – Part C Report on Organisation's Financial operations - Table 2 Statement of Financial Performance 2001-02 pp 54-57

Scenario 4 – All other funds amalgamating with Medibank Private

This Scenario is extremely improbable in practice. It illustrates the maximum savings possible from fund amalgamation.

Table 6: ManagementExpense (ME) Changes Post Amalgamation All Funds

Fund 1	ME Fund 1	Fund 2	ME Fund 2	ME - Old	ME - New	Combined 2001–02 Contribution income	Saving – absolute and percent of combined income
MBP	\$213m	All others	\$591m	\$804m	\$412m	\$7,266m	\$389m – 5.4%

Abbreviations: All others – All health funds except MBP
MBP – Medibank Private
\$m – \$ million

Source: www.phiac.gov.au Operations of the Registered Health Benefit Organisations (RHBOs) Annual Report 2001-02 – Part C Report on Organisation's Financial operations - Table 2 Statement of Financial Performance 2001-02 pp 54-57

Discussion***Is the suggested generic saving in management expenses plausible?***

The modelling in this paper has been based on the generic assumption that savings will equal two thirds of the management expenses of all funds involved in an amalgamation except the largest. This may be too high for a number of reasons including:

- Lower savings in relation to costs such as rent, labour, and advertising when the amalgamation involves funds that have historically operated in different states.
- Costs involved in ensuring computer and other systems are compatible post amalgamation.
- Redundancy costs.
- Costs related to termination of leases and contracts.
- Consultant costs relating to the amalgamation process.

The relation between the percentage reduction in management expenses of the smaller funds and the savings projected is significant. If the savings in relation to the smaller funds were 50% of management expenses, the projected savings would be reduced by a quarter. If the savings were 33% of management expenses, the projected savings would be halved e.g. the savings illustrated in Table 5 would be 2.2% not 4.4% and those illustrated in Table 5 would be 2.7% not 5.4%. Against this in the unlikely event of the savings rising to 90% of the management expenses of the smaller fund savings would be increased by 35% e.g. the savings illustrated in Table 5 would be 5.9% not 4.4% and those illustrated in Table 5 would be 7.3% not 5.4%.

What is the maximum savings due to plausible fund Amalgamation?

Scenario 4 where all funds amalgamate produces the largest saving of the four scenarios modelled. This scenario is implausible except if it was part of a series of changes leading to a legislated government monopoly. If such an amalgamation did occur, savings of 5.4% are projected. Such a monopoly might generate new inefficiencies offsetting at least some of the modelled savings.

Scenario 3 projects the second largest saving – 4.4%. The savings of 4.4% modelled are not industry wide and affect only the funds involved in the modelled amalgamation. It is doubtful if such an arrangement would ever obtain ACCC approval as the market share of Medibank Private would become very large.

Other combinations of fund amalgamations that also have the effect of reducing the number of health funds to five might gain ACCC approval. A more appropriate basis for modelling the industry wide savings arising from reduction of total health funds to five is to assume that all five remaining funds are involved in a series of amalgamations that gains ACCC approval. The industry wide saving remains at \$180 million out of Contribution income of \$7,266 million (2.5%). This is the largest plausible saving modelled on an industry wide basis. This pattern of amalgamations is likely to involve some of the remaining five funds expanding their role in states where they currently have little activity; hence the level of saving modelled may not be achieved in practice.

Scenario 2 projects both some savings in fund management expenses and has realistic prospects of ACCC approval. The HCF/Fund M amalgamation modelled in this scenario shows the largest savings at 2.5%. This saving is achieved only for the funds involved in the amalgamation, not all funds.

It will be noted from Scenario 1 that there is little savings arising from amalgamation of small and large funds, and the minimal savings modelled affect only the funds involved not funds as a group.

Do small funds have high management expenses?

A belief that small funds have relatively high management expenses may be implicit in some of the suggestions concerning fund rationalisation. PHIAC data suggests the opposite. The fifteen Restricted Membership Organisations have an average contribution income of \$33 million and their management expenses average 7.7% of contribution income. In addition four of the nineteen open membership funds with 2001-2 contribution income below \$100 million in 2001-2 have management expenses below the Open Membership average of 11.1% of contribution income (PHIAC, 2002a). While there is fund to fund variation within both the Restricted and Open Membership groups, this data is inconsistent with the proposition that small funds necessarily have high management expenses and their amalgamation would invariably result in significant savings.

Can management expenses be reduced without fund amalgamation?

In 2000-1 fund management expenses were 11.8% of contribution income. In 2001-2 management expenses were 11.1% of contribution income (PHIAC 2002a) despite the over 20% increase in hospital and ancillary claims over these two years. This suggests a significant improvement in efficiency with regard to management expenses can and has occurred without fund amalgamations

Would fund rationalisation lead to lower hospital charges?

In theory health funds may negotiate relatively lower hospital charges as a result of an increased market share post rationalisation. Whether lower charges would result in practice is open to question.

There are only eight fund negotiation groups as the small and medium funds other than NIB negotiate as part of either the Australian Health Service Alliance or Australian Regional Health Group. While a medium fund by the definition used in this paper, NIB is nonetheless a substantial fund with 2001-2 contribution income of \$370 million. There are no small funds negotiating individually, a situation in which some relative reduction in hospital rates following rationalisation would be plausible.

The existing negotiating groups already have substantial market share in their main states of operation and amalgamation into e.g. five negotiating groups, is unlikely to result in any of these groups gaining dominant market share in a state. It is unlikely that the ACCC will allow future amalgamations that give one fund a dominant share of the market in a given state. As a result amalgamations are more likely to lead to increased market share of those funds that already have a significant market share but are not the currently the largest fund in a state. This will produce no benefits to the largest fund in a state and this will restrict any gains due to increased market share.

A large fund which gains a minor increase in market share following rationalisation with a small fund(s) is unlikely to gain a significant increase in market power.

It is unclear whether relatively small differences in market share (+/- 10% of market share) lead to significant differences in hospital negotiation outcome in practice. Statements made by many hospitals to AHSA suggest that major fund are charged much the same rate but there is no information available by which these statements can be confirmed.

For these reasons it is unclear what savings, if any, in hospital charge rates would arise from fund rationalisation. In this paper it has been assumed that this is zero. It is highly questionable whether significant reductions in hospital charge rates will arise from increased fund rationalisation based on scenarios acceptable to the ACCC.

What are the major factors underlying fund cost increases?

It is suggested that there are three significant factors underlying increased costs to health funds, assuming that membership remains relatively stable following the increases in mid 2000. These are:

- The steady increase in the average age of people covered by health funds that has occurred from mid 2000 onward and is projected to continue.
- Increased utilization of clinical services on an age standardised basis.
- Provider charge increases.

AHSA projections suggest the first two factors will drive hospital table costs up by 4% to 5% per annum, depending on the state being considered (Hanning 2001). Each percentage point of provider charge increase will add a further 1% to the annual increase. Ancillary table costs have increased more rapidly than hospital table costs in four of the last five years hence projections of increases in fund costs in regard to hospital tables are unlikely to underestimate cost increases over all clinical services (PHIAC 2002b).

In the context of the demographic and utilization factors that will increase costs by 4% to 5% per year, a one off industry wide saving of under 2.5% in fund costs will have minimal effect of health fund premiums and then only in the short term. A further significant factor increasing fund costs is increased provider charge rates. The increase in provider charges certainly will be above zero and may well exceed the Consumer Price Index (CPI) given factors such as the increased cost of public liability insurance and increased private sector Nursing Costs likely to flow from public sector increases such those recently been granted in New South Wales.

Conclusion

The anticipated savings due to fund amalgamation are small in the context of overall fund costs and the major factors leading to fund cost increases. Many small funds are already more efficient than industry averages and amalgamating these funds with larger funds is likely to produce very little saving. Health Funds have shown in 2001–02 they can improve efficiency and reduce management expenses without amalgamation. Discussions on fund amalgamation divert attention from the main factors leading to increased fund costs. Fund amalgamations will minimal relief from cost increases, and then only in the short term. They will not lead to significant premium reductions. The major reasons for fund cost increases are factors over which health funds have little if any influence.

References

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