HEALTH STRATEGY ASSOCIATES *Smart Moves. Winning Strategies.*

Part 4 in the 2001 Series on Issues in the Health Care Industry

Workers' Comp Medical and Indemnity Cost Management

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We hope this letter finds you and yours safe and sound. The recent terrorist attack has affected all of us both personally and professionally. The losses have been horrific. At the same time we have gained a renewed sense of community and understanding that seemed missing in recent years. Never again will we take for granted our freedom and the wonderful country in which we live.

In the past, these letters have covered a variety of topics, from cost-shifting's impact on workers' compensation to the critical issue of provider data quality. This fall and winter, we will focus our attention on a single topic: workers' compensation medical and indemnity cost management.

The reason for this shift is three fold. First, there are a number of indicators, both macro and micro, that predict a rapid, and significant, increase in workers' compensation costs. Second, recent research by several entities, notably the Workers' Compensation Research Institute, along with the results of two market research studies conducted by Health Strategy Associates, provide a much deeper and broader understanding of the cost drivers of workers' compensation. Finally, the combination of escalating costs and a better understanding of the factors driving those costs will force the industry to look for better answers. We will conclude this series by highlighting several programs that promise to deliver better results.

This letter summarizes the indicators that we believe predict an increase in workers' compensation premiums and expenses. Costs had begun to increase with January 2001 renewals, but we haven't seen anything yet. While some of these indicators have been discussed at great length elsewhere, others are only now beginning to emerge. Combined, these indicators predict a future that is as bleak as the recent past was promising.

The last several years have seen little attention paid to workers' compensation. Premiums plummeted along with the frequency, and severity, of claims. The excess dollars in the industry enabled new entrants, as well as established names, to aggressively pursue new workers' compensation risks. And the equity and debt markets rewarded this aggressive behavior with returns on investment income that far outweighed claims and administrative expenses.

Those days are over. But before we bury them, let's use the sharpened vision of hindsight to see how we got to where we are. Much attention has been paid to this issue lately, but we believe the factors that have ended the recent halcyon days of workers' compensation are revealing.

High investment income returns covered up for poor basic execution of risk selection, pricing, and cost management. Those high investment returns, both in the equity and debt markets, are a distant memory.

The reinsurance market for workers' compensation in specific, property and casualty in general, and, overall, all insured lines have been devastated. Reinsurance premiums will explode as underwriters seek new funds to pay off old liabilities. Reinsurance capacity has evaporated as program managers refuse to even look at most submissions. Without reinsurance capacity at a "reasonable" price, comp carriers will be faced with a stark choice. They can take on more risk themselves, pay the increased reinsurance premiums, or refuse to write any but the best risks. Regardless, insureds will see their costs drastically rise.

As we predicted in an article in "National Underwriter" two years ago, cost shifting from governmental and group health programs to workers' compensation patients is increasing. Hospitals, physicians, ancillary providers, and pharmacies are looking to maintain their incomes in the face of strong pressure on their prices. Despite several years of "managed care", workers' compensation remains one of the easiest targets.

Pharmaceutical expenses are increasing at double-digit rates. Our research indicates costs at several large carriers have increased to more than 5% of medical expenses. Some carriers are seeing drug costs rise at a 20% annual rate.

Providers are rebelling against outrageously low workers' compensation fee schedules. This trend is nowhere more apparent than in Florida. Several provider groups, notably orthopods around Jacksonville and in central Florida have successfully forced carriers to pay significantly more than the fee schedule. This is but the first shot in a battle that will spread rapidly to other states, including Massachusetts and Pennsylvania.

Workers' compensation networks have been rewarded for contracting with high cost providers and delivering high "discounts" from those providers. While this "managed care technique" has resulted in large "savings" on a per-bill basis, it has done little to manage total medical costs. Providers have gamed the system, resulting in increased utilization and therefore higher total medical costs.

Employers have either paid little attention to existing workers' compensation return-to-work programs, or forgotten about them altogether. With premiums dropping to less than predicted claims, who could blame them. Now, they will be forced to dust off the binders, revisit their policies, and renew their commitment to return to work programs.

The booming economy of the late nineties and early last year is a sharp contrast to the layoffs experienced in 2001. Layoffs and reduced hiring always result in higher workers' compensation claims, and this time will be no exception.

Managed care firms have garnered high fees for little apparent results. In so doing, they may have drank the well dry. Workers' compensation executives are becoming increasingly skeptical of claims that managed care reduces expenses. As one senior executive put it, “all of them claim to save 20% or more, and my costs are going up at least that fast”.

These factors, and others highlighted elsewhere, far outweigh any positive signs in the workers' compensation market. The direction for the industry is clear. We are faced with rapidly rising premiums and much tougher underwriting driven by macro factors including a poor economy, reinsurance capacity, and pricing problems. Rising medical expenses, provider rebellion, cost shifting, and employer inattention lead the micro factors.

We have been coasting for several years. It's time to get back to work.

If you would like to discuss workers' comp medical and indemnity costs in more detail, please let us know by clicking on the link above left, or giving us a call. You can also visit our website at www.HealthStrategyAssoc.com.

Sincerely,

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Joseph Paduda, Principal of Health Strategy Associates, is an independent consultant focused in the Workers' Compensation and managed care markets. His clients include large Workers' Compensation insurers, managed care organizations, self-insured employers, and software and systems companies. Prior to his present position, Mr. Paduda was vice president of

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