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Request of:

EMPIRE BLUE CROSS AND BLUE SHIELD

To:

**THE DEPARTMENT OF FINANCIAL
SERVICES of the STATE OF NEW
YORK**

FOR APPROVAL OF SMALL GROUP COMMUNITY RATE INCREASES

Filed October 31, 2011



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NARRATIVE SUMMARY
[DOI and policyholder – for public posting]

I. OVERVIEW

Empire Blue Cross and Blue Shield (Empire) has made an application to the Superintendent of Financial Services to adjust premium rates for health insurance available to small groups of 2 to 50 eligible employees.

These small groups, employees, and their covered dependents are combined, by long standing New York law, in what is known as a community rated pool. All members enrolled in the pool plans are guaranteed issuance of coverage and are charged the same premium rate as any other member for the health insurance product they select regardless of health status, age, sex, or other demographic factors other than the region of the State where they reside.

All medical, hospital, pharmacy, and other covered care and necessary administrative costs are also combined, by law, for this pool in order to determine appropriate premium rates. These premium rates must support sufficient, sustainable revenue and reserves for both current and future coverage costs related to community pool products on a stand alone basis. Current approved rates for Empire's community pool products for small groups are inadequate for the rising costs incurred as provider charges continue to rise, and utilization of services increases. The change in utilization is driven increasingly by fewer small group employees being offered or selecting coverage through their employer. Those that continue to purchase coverage are disproportionately in need of covered care causing sharp increases in the overall cost incurred by Empire's and other insurers' community pool products even while general medical cost trends have abated slightly this year due to economic conditions in the overall New York market.

In the aggregate, Empire's overall proportion of small group premium revenue paid out in care benefits has historically been well above the State required minimum of 82 percent, and this historical performance is unsustainable. The more recent rising costs and utilization noted above have produced results that far exceeded the expected claim cost for these products and have driven a significant proportion of the increase needed in premium. Empire pays for care to levels that jeopardize the sustainability of coverage. Moreover, the unexpected state reductions to the subsidy for Healthy New York have led to significant losses in that product as well. Critical changes in the short term include appropriate premium rate adjustments reflecting the actual cost of care of community pool members, and changes in the number of small group plans Empire offers. With these changes, Empire remains committed in the longer term to finding new solutions for the small group market in New York. This will require working with all stakeholders in the

development of more affordable plan options for future years, and collaboration on efforts to improve both State and Federal reform initiatives.

The products specifically impacted by rate increases at this time are the Essential EPO product sold by Empire HealthChoice Assurance, Inc, (Empire's insurance company; NAIC code number 55093) and BlueChoice HMO, DirectConnection HMO, and Healthy New York products sold by Empire HealthChoice HMO, Inc (Empire's HMO company; NAIC code number 95433). The actual rate increases requested are provided below. Empire's proposed rates are subject to review and approval by the New York Department of Financial Services, with the determination by the Department supported by sound actuarial assumptions and methods. The rate application was filed with the Department on October 31, 2011 (SERFF numbers: AWLP-127621857 for Empire HealthChoice Assurance, Inc and AWLP-127621762 for Empire HealthChoice HMO, Inc). The actual rate increases approved will be communicated to the impacted parties upon completion of the Department's review and are scheduled to be effective beginning on April 1, 2012.

In addition, the Empire PPO sold by Empire HealthChoice Assurance, Inc will experience a small rate change. The rate change was filed with the Department on October 31, 2011 (SERFF#AWLP-127781790).

For Essential EPO, Empire PPO, BlueChoice HMO, and Direct Connection HMO, the proposed rates are expected to be implemented for small groups effective between April 1, 2012 and March 31, 2013. The rate for any individual small group will vary based on geographic area, renewal date, family tier, and benefit plan selected.

For Healthy New York, the proposed rates are expected to be implemented effective April 1, 2012. The rate for any specific small group or direct payment customer will vary based on geographic area, family tier, and the benefit plan selected.

In conjunction with this rate application, Empire intends to discontinue several other small group products from the New York market including the Prism, Value and Stepped EPO products and the PPO Plus and Total Blue products. The discontinuances are generally in response to the above noted disparity between premium revenues and the actual claim costs for the products being discontinued. We anticipate that many, if not most, of the members in the discontinued products who continue with Empire coverage will select one of the products subject to this rate application. We also anticipate that the migration of these members will trigger adverse selection and have potential further adverse rate impact of the remaining products.

As noted above, Empire is required by New York State law to develop rates that are actuarially sound, assume at least 82% of premium revenue will be spent on health care costs, cover all claim costs, and also contribute to claims reserves. The percent of premium attributable to claims is essentially how much of the premium dollar is used to pay claims and is referred to as the Medical Loss Ratio (MLR). The actual MLR may vary over time based on changes in the amounts charged by hospitals, physicians, and other providers, the increase in health care trend or inflation and health care utilization by our members. Overall, Empire's MLR for small groups is currently substantially higher than the 82% statutory minimum and its administrative costs are among the lowest of all

health insurers in New York. With the proposed rate adjustments, Empire's overall MLR is expected to continue to remain significantly above the 82% minimum allowable ratio. In the event Empire's MLR does not meet the required minimum, Empire will refund the difference to policyholders.

Empire has attempted to limit the rate increases to the lowest increases possible while preserving the financial integrity of the products. Based on the performance of these products, our current rates were set at an inadequate level and are unsustainable. This rate action is expected to move the rates toward an adequate level to compensate for both anticipated utilization and the annual increases in the cost of medical care (*See description of health care costs below*).

Periodic rate adjustments are necessary to secure the ability of Empire, or any insurer, to produce sufficient revenue and surplus for reserves to assure continued coverage and claim payments both for current healthcare needs and potential catastrophic cost situations. Empire's reserves vary from year to year based on actual healthcare costs incurred and typically vary from 3 to 6 months of claims costs above the minimum required by New York State law. Failing to meet the minimum statutory reserves will deem the insurer as "impaired" under the New York Insurance Law. These reserves are the "insurance" that ensures payment even when costs run higher than anticipated or emergencies or disasters occur, and should not be used as an alternative fund to temporarily reduce rate adjustments.

In filing this rate application we were sensitive to the fact that individuals and small businesses struggle to afford higher premiums and we are seeking the premium necessary, as determined by our actuaries, to maintain a viable health plan. In our sound actuarial judgment it is clear that an increase in premiums is critical to ensure the viability of these products. Failure to approve these rates will lead to even greater rate increases and fewer product offerings in the future as claim costs will eventually exceed premiums collected.

II. FACTORS CONTRIBUTING TO THE PROPOSED RATE INCREASE

Escalating Health Care Costs

The cost of health care services, equipment and products continues to be the primary reason for rate increases. Nationally, the growth in the cost of medical care continues to significantly outpace consumer inflation. Total medical cost for a typical American family of four increased 7.8% last year (2009/2010 data), up from 7.4% in 2008/2009. The raw number annual increase of \$1,303 is the largest recorded in the previous ten years. The country experienced a significant increase in the hospital inpatient annual rate of increase, which rose from 7.7% in 2009 to 9.8% in 2010. The hospital outpatient annual rate of increase rose from 10.2% to 11.6% over the same time period.¹

These trends reflect underlying changes in the demographics and health status of America's population. The aging population is driving some of the increase – as people

¹ See, 2010 Milliman Medical Index

age they use more health services. Between 2000 and 2050, the population aged 65 and older is expected to grow from 12% to 21%, as the “baby boomer” population ages and life expectancy continues to rise. As this population nears Medicare eligibility the proportion of the insured population at older ages increases, thus increasing average costs. Unfortunately, the country’s declining health and the increase in obesity and other health concerns, even at younger ages, forces average costs upward.

In addition, in New York, these increasing costs and the economic pressures on small employers and their workers have caused fewer groups to offer coverage to their employees. These same costs and conditions have caused smaller numbers of the employees to elect to participate in coverage if it is offered. As a result, the remaining community pool of members Empire covers is disproportionately in need of covered care compared to when a larger, more balanced proportion of small company workers were enrolled. This has increased cost substantially for the community pool for Empire, and for other New York insurers who participate in the small employer market.

Hospital

Hospitals (inpatient and outpatient care) account for the largest share (45% to 55%) of the health care premium dollar in New York and their share continues to grow. Factors driving this growth include increasing demand for care, rising costs to hospitals of the goods and services needed to provide care, growing intensity of care needs, and the shifting of costs of Medicaid and Medicare hospital payment cuts to insurers. As hospitals see higher and higher costs, and payments from Medicaid and Medicare do not keep pace, hospitals have demanded higher and higher reimbursement from private insurers.

Nationally, increasing costs to hospitals for the goods and services purchased to provide care accounted for 64% of overall growth in spending on hospital care from 2004 to 2008². The increase in labor costs is the most important single driver of spending growth for hospitals, accounting for about 35% of overall growth and more than half of the growth in the costs of purchased goods and services.

The increase in cost is also attributed to other factors including increased intensity of hospital care, i.e., hospitals are using more resources to care for each patient. Increased intensity can be attributed to a variety of factors, including sicker patients with more complex conditions.³

The increase in cost for hospital inpatient care in Empire's operating area surpasses the rate for the rest of the country. An approximate 8% rate of increase due solely to increases in the contracted hospital reimbursement level is currently projected for both 2011 and 2012.

The trend toward higher inpatient costs is tempered somewhat by a projected slowing of utilization growth compared to 2009.

For hospital outpatient benefits, utilization increases are expected to slow, but such

² See, 2010 American Hospital Association

³ See, 2010 American Hospital Association

increases have been high in recent years.

Medical

Costs per member for medical professionals have experienced only moderate increases over the past year and are projected to trend at a moderate rate of 4-5% per year over the coming years.

Prescription Drugs

Over the past year, drug cost increases have been tempered by the favorable financial arrangement between WellPoint, the parent company of Empire, and ExpressScripts. We expect a modest cost increase over the coming years.

III. ADMINISTRATIVE SAVINGS

Recognizing the impact the rate increases will have on our customers Empire has attempted to mitigate their impact by vigilantly reducing selected administrative costs to offset increases that are necessary or beyond our control. Some of these efforts included:

- From 2008 to 2010, we have optimized our distribution channels and methods. During this period we reduced those distribution costs by 25-30% and will continue to look for additional efficiencies;
- We implemented a cost-saving process improvement and automation of claims payment system;
- We reduced staffing and improved efficiencies; and,
- We reduced real estate expenses.

As a result of these efforts and other cost savings measures, Empire has among the lowest administrative costs in the industry, currently at approximately 10.8% of revenue. Excluding the amount paid to the State in premium taxes, our administrative costs have been reduced to 8.9% for the small group segment. While we continue to strive to reduce administrative costs further, we want to avoid sacrificing customer service, which we believe would be at risk by further cost reductions.

IV. HISTORICAL FACTORS

New York Health Care Cost

New York stands out as an especially costly state in which to purchase healthcare. New York City remains the second most expensive major metropolitan area in the country with respect to healthcare costs. A 2010 report by Milliman shows the cost of care to be 118.8% of the national average, up from 117.4% in 2009.⁴ New York's dubious distinction as a high cost state is also borne out in Dartmouth Atlas data which shows the State outpacing national average costs in a wide variety of indicators.⁵ As a ratio to national average cost, New York State registered 1.15 in overall Medicaid reimbursements; 1.31 in professional and laboratory reimbursements; and 1.37 in short

⁴ See, 2010 Milliman Medical Index and 2009 Milliman Medical Index

⁵ See, Dartmouth Atlas, last accessed 12/15/2010

stay inpatient reimbursements.

Nationally, the cost per inpatient discharge continues to increase. In New York, the cost per inpatient discharge has increased from \$5,910 in 2005 to \$9,833 in 2009. In 2009, New York's cost per inpatient discharge also exceeded the national median value of \$8,638.

New York's length of stay (days) is another contributing factor to cost. In 2009, New York's length of stay (days) averaged 4.3, exceeding the national median value of 4.15 days.⁶

New York Taxes

New York adds more insurance taxes and assessments than any other state in the country. These consist of both direct taxes and a number of indirect taxes amounting to a total of over \$4.1 billion in taxes passed on to New York healthcare customers in the form of higher premiums. These taxes include:

- NYS Premium Tax – this 1.75% tax is on all HMO and insurance contracts (and there is an additional amount for customers in the MTA service area). For 2010 Empire paid \$103.9 million to the State in premium taxes.
- Covered Lives Assessment – this indirect tax is a charge on all fully and self insured “covered lives” The purpose of the Covered Lives Assessment is to raise funds for a variety of state programs and for the state Budget. The Assessment is included in claims costs for purposes of calculating the MLR. This assessment is a charge of from \$2.67 to \$15.36 per individual contract per month and from \$8.80 to \$50.70 per family contract per month. For 2010, Empire will pay \$301.9 million in covered lives assessment.
- HCRA Surcharge – this is a 9.63% surcharge on all hospital discharges. The purpose of the HCRA Surcharge is to raise funds for a variety of state programs and for the state budget. The Assessment is included in claims costs for purposes of calculating the MLR. For 2010, Empire will pay approximately \$381.0 million in HCRA Surcharges.
- NYS Insurance Department “332” Assessment – while this assessment is appropriately intended to fund the cost of the Department's regulatory activities, there is an indirect tax whereby a large portion of the revenue generated by the assessment is used to fund other programs not directly related to insurance regulation. This assessment is charged to insurers based on the number of New York insured members they cover. Empire will pay \$54.8 million in 332 assessments for 2010.

While there were not any tax increases which have contributed to the rates being increased with this application, each of these taxes is increased regularly by the State and has in the past contributed significantly to the need for annual increases in rates.

⁶ See, 2010, Ingenix, Almanac of Hospital Financial and Operating Indicators

V. DETAILS OF THE PROPOSED RATE INCREASE

Empire provides health insurance protection to over 5 million persons in 28 counties in eastern and southeastern New York State. The proposed premium rates affect approximately:

- 2,000 Essential EPO members
- 51,000 Healthy New York members
- 32,000 small group Direct HMO / HMO members
- 10,000 small group PPO members

Small group community-rated customers are those who have coverage through an employer-sponsored group of between 2-50 eligible employees. Premium rates for small group contracts are regulated by the Superintendent of Financial Services pursuant to Section 4308 or 3231 of the Insurance Law. The following tables show proposed annual rate changes for the indicated community rated products:

Essential EPO Medical - ALL Regions	
Next policyholder anniversary between 4/1/2012 - 3/31/2013	
Individual, Parent/Child(ren), Family	+14.0% - 19.0%
Husband/Wife	+19.0% - 24.0%

Essential EPO Prescription Drug - ALL Regions	
Next policyholder anniversary between 4/1/2012 - 3/31/2013 #	
Individual, Parent/Child(ren), Family	+14.0% - 19.0%
Husband/Wife	+19.0% - 24.0%
Healthy New York Medical and Prescription Drug- ALL Regions	
Effective 4/1/2012	
Individual, Parent/Child(ren), Family	+16.0% - 21.0%
Husband/Wife	+21.0% - 26.0%

Direct HMO / HMO Medical - Standard			
Next policyholder anniversary between 4/1/2012 - 3/31/2013 *			
	Downstate 1 & 2 Regions	Mid-Hudson Region	Capital, Upstate 1 & 2 Regions
Individual	+14.0% - 19.0%	+14.0% - 19.0%	+14.0% - 19.0%
Husband/Wife	+19.0% - 24.0%	+19.0% - 24.0%	+19.0% - 24.0%
Parent/Child(ren)	+14.0% - 19.0%	+20.0% - 25.0%	+18.0% - 23.0%
Family	+15.0% - 20.0%	+19.0% - 24.0%	+22.0% - 27.0%

Direct HMO / HMO Medical - Carve-out			
Next policyholder anniversary between 4/1/2012 - 3/31/2013 *			
	Downstate 1 & 2 Regions	Mid-Hudson Region	Capital, Upstate 1 & 2 Regions
Individual	+24.0% - 29.0%	+24.0% - 29.0%	+24.0% - 29.0%
Husband/Wife	+25.0% - 29.9%	+25.0% - 29.9%	+25.0% - 29.9%
Parent/Child(ren)	+20.0% - 25.0%	+27.0% - 29.9%	+23.0% - 28.0%
Family	+19.0% - 24.0%	+23.0% - 28.0%	+25.0% - 29.9%

Direct HMO / HMO Prescription Drug - ALL Regions	
Next policyholder anniversary between 4/1/2012 - 3/31/2013 * #	
Individual, Parent/Child(ren), Family	+15.0% - 20.0%
Husband/Wife	+20.0% - 25.0%

PPO Medical - ALL Regions	
Next policyholder anniversary between 4/1/2012 - 3/31/2013	
Individual, Husband/Wife, Parent/Child(ren), Family	+0.0% - 5.5%

PPO Prescription Drug - ALL Regions	
Next policyholder anniversary between 4/1/2012 - 3/31/2013 #	
Individual, Husband/Wife, Parent/Child(ren), Family	+3.0% - 6.1%

The New York Department of Financial Services previously approved Empire's request to replace the current prescription drug riders with a new set of prescription drug riders effective November 1, 2011. Therefore, to avoid confusion, rate increases are only shown for policyholder anniversaries between 11/1/2012 – 3/31/2013, when the plan designs before and after the policyholder anniversary are the same.

*The total increase for April 2012 groups will reflect the requested 2012 increase in the rate grid plus the 2011 2nd Quarter increase of 6.3% approved by the Department but not implemented due to the timing of the Department's approval of the rate increase.

Note: For those small group HMO members who are eligible for Medicare and thus receive lower "carve-out rates" (approximately 5% of small group HMO members), their annual renewal increase will be higher than those small group HMO members who are not eligible for Medicare (members who receive standard rates).

The New York Department of Financial Services previously approved Empire's request to eliminate the discount in rates that we had granted those members who were eligible for Medicare. Effective January 2013 for small group HMO members, members who are eligible for Medicare and those that are not will pay the same rate.

VI. FINANCIAL DATA

Exhibit 1 contains the audited Statement of Financial Condition at December 31, 2010 for Empire HealthChoice Assurance, Inc.