Overall, CDHC appears to be a fairly high-risk option for employers, and one that doesn’t guarantee control of health care inflation. Simpler strategies are available for managing costs although they aren’t painless for employers or their employees. Most consumers are entirely in the dark about CDHC, and although they are strongly in favor of having more choice and control over their health care, especially when care is needed, it’s not clear that they feel equipped to design benefits and/or provider networks in advance.

There is no question that the Web is a powerful tool for health care administration, information and decision support, but the electronic pipelines and systems needed to connect employers, brokers, providers, consumers and health plans with accurate, secure, real-time data and transactions are still under construction and not accessible to many. So it looks like various elements of CDHC – defined contributions, Personal Health Accounts, high-deductible and tiered options, Web-enabled decision-making – will be implemented during the coming year, but that “full-blown” CDHC is likely to be an experiment among selected employers rather than a major market force.

For more information please contact your account executive.

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You've probably seen the headlines: "Defined Contribution Picking Up Steam." "DC is Inevitable." "DC Plans Face Uncertain Future." "DC Health: The Ice Cream of the Future." Confused? Who wouldn't be?

At Harvard Pilgrim, we want to help you sort out your options and make it easier to find affordable, high-quality health benefit plans. Since there are so many different approaches to "defined contribution" - most of them largely untested - we thought this brief overview and a few hypothetical examples would be useful. You can also visit our Employers and Brokers Website at www.harvardpilgrim.org for some excellent Online links.

What is Defined Contribution?
The potential confusion begins with what to call this class of products. "Defined Contribution" refers primarily to a funding strategy in which employers make a fixed dollar contribution to their employees' health care. In this overview, we'll use a broader definition - "Consumer Directed Health Care" (CDHC).

With CDHC an employer makes a defined contribution toward one or more health coverage options (HMO, PPO, etc.) or to an employee's Personal Health Account, or both, and gives their employees choices as to how the money may be spent. The degree to which an employer steps back from designing plans or earmarking funds can vary among CDHC models, as can the degree to which an employee can design his or her personal health care approach. In addition to greater choice, employees generally shoulder more financial risk and responsibility. Conceptually, it's similar to a 401(k) retirement plan. The Internet is usually a key component of CDHC plans, supporting administration, benefit or network design, consumer decision-making and health information.

In general, CDHC plans promise administrative simplification, predictability of employers' health care expenses, increased consumer choice, and the possibility of employee cost savings using pre-tax dollars.

What do the current models look like?
There are multiple business models for CDHC plans and more than a dozen companies selling them. Although most are still evolving, they look something like this:

**Self-directed health plans** can be set up by an insurer or by an "e-health" company. They offer online tools to help employees choose from multiple health plans...
that are priced by varying deductible levels. Employers fund a Personal Health Account and employees use the account to pay for their medical expenses, including services that aren’t usually covered, and to pay their deductibles. Any money left in the account at the end of the year can be rolled over to the next.

**Self-directed provider network plans** allow consumers to use the Web to design their own network of doctors and hospitals and to choose varying levels of copayments within a managed care product. The plans contract with providers and allow consumers to calculate the cost of their network and copayment options using an online “shopping cart” approach.

**Benefit design plans** offer employers tools for custom configuration of benefits packages along with online enrollment and employee self-service functions. Employees are given a broad variety of coverage options with differing copayments and premiums.

**Health plan catalog plans** offer a variety of online, health-benefits design and administration services that support defined contribution, Personal Health Accounts, benefit design, health plan selection and enrollment.

**Time-of-need network plans** offer negotiated discounts on dental and vision care, alternative therapies, Rx, etc., often in conjunction with Personal Health Accounts.

**Why the buzz?**

As with many trends in health benefits, the principal reason for increased interest in CDHC is the sharp rise in health care costs and health insurance premiums – up 50 percent in the past five years, with no end in sight. When asked how they plan to manage health care costs in the next year, 20% of employers said they would seriously consider CDHC. (This compares with 71% that would reduce benefits or increase employee cost sharing.) Other, related, drivers behind CDHC include:

- Employers want employees to have a greater stake in managing costs.
- Employers would like to distance themselves from benefit decision-making to avoid managed care backlash and potential liability.
- Employers hope to reduce employees’ resentment about greater cost sharing by involving them more in decision-making.
- Employees are accustomed to the defined contribution concept because of 401(k) plans.

**Example A**

- Employer makes a fixed annual contribution of $5000 to a Personal Health Account for an employee’s family health care.
- Employee uses $4000 to buy family health coverage online, with a $1000 medical deductible and a $1000 prescription drug deductible. Preventive care is covered in full.
- $1000 remains in the employee’s Personal Health Account. (Annual rollover allowed.)
- Employee puts $500 pre-tax in a flexible spending account. (Use or lose.)

Employee’s family incurs $3500 in non-preventive medical expenses and $700 in Rx.

- Employee pays $1000 in medical and $700 in Rx deductibles - $1000 from Personal Health Account, $500 from flexible spending account and $200 from personal funds.

**Example B**

- For an individual employee, the employer buys first-dollar preventive coverage and coverage with a $1000 deductible for non-preventive care, at a cost of $1200.
- Employer makes a fixed annual contribution of $1000 to the employee’s Personal Health Account. (Roll-over allowed.)

Employee incurs $750 in non-preventive medical expenses and $150 for non-covered medical services (massage therapy).

- Employee pays $750 in deductibles and $150 for massage therapy from the Personal Health Account. Employee rolls over $100 to next year’s Personal Health Account.

**Employer cost: $5000**

**Employee cost: $700 ($500 of which is in pre-tax dollars)**

- Employers and consumers are increasingly comfortable using the Web for administration, information gathering and purchasing.

The drive toward CDHC could accelerate if the unemployment rate and the rate of increase in health premiums continue to rise, if changes in tax and insurance law make it more financially attractive to employers, if court decisions or legislation significantly increase employers’ liability exposure and if leading employers successfully implement CDHC plans.

**Will it save employers money?**

While CDHC provides a new framework for employers and employees to manage health care costs, it does not necessarily mean employers will spend less. Employers already can increase, decrease
or terminate their contribution at will under current models, because funding is voluntary, but many factors constrain this ability, including the need to attract and retain employees, tax code incentives, union contracts and company tradition or culture. What CDHC can do is make employer contribution levels more predictable.

CDHC typically changes the roles of the employer and employee in determining the scope and level of health insurance benefit packages (what’s covered and for how much), the selection of health plans and providers, the amount of money spent on insurance vs. other health care expenses, and the time and resources needed for plan administration.

**What are the drawbacks of CDHC?**

Today’s health care market is based on risk pooling, group purchasing and leveraged pricing of medical services. The fragmentation and potential for selection bias inherent in some CDHC models could drive costs up, rather than down. In addition, CDHC raises serious selection issues if it is offered side-by-side with other types of coverage, since it’s likely that healthy, low-risk employees will choose the CDHC model. On the other hand, employers may not be ready to offer it as a total replacement solution.

In the opinion of many, the employer is vital to the system to protect employees – to negotiate with insurers, analyze contracts and networks, monitor quality and measure vendor performance. Employees still expect their employers to play a paternalistic role when it comes to health benefits. Other concerns include:

- CDHC causes consumers to base their benefit and network choices largely on cost.
- Employees with significant medical and/or Rx expenses may quickly spend through their Personal Health Accounts and forego needed care.
- Excellent education and communications will be required to help consumers make reasonable decisions.
- CDHC may have limited appeal to employees who are satisfied with their current plan.
- If employers don’t increase their defined contributions to keep pace with health care inflation, their employees will be forced to bear a growing share of the cost.
- Provider confusion and frustration may increase with complex new products.
- The “dot-coms” that offer CDHC could go through a major shakeout and the number of survivors is unknown.
- CDHC doesn’t address fundamental problems like the underlying causes of rising health care costs or the uninsured.

As one analyst puts it, “A new brand of backlash will strike when sick employees are denied treatment because they didn’t understand the fine print regarding the plan they purchased over the Internet.”

**What are employers’ options?**

In the face of rising health care costs, employers can pursue one or more of the following strategies:

- Use a prudent buyer approach by choosing health plans that provide the most value at the lowest possible cost.
- Raising their employees’ share of the premium.
- Increase employees’ copayments and/or deductibles.
- Place limits on covered services (within the limits of state and federal laws).
- Fix the employer contribution at a fixed dollar amount rather than a fixed percentage.
- Move to a CDHC model with a defined contribution and greater employee responsibility for benefit and/or network design.
- Employer makes a fixed annual contribution of $2000 to a Personal Health Account for an employee’s individual health care.
- Employee goes to an online “supermarket” and chooses a panel of providers, with a $15 copayment option, at a total cost of $1900. ($100 remains in the employee’s Personal Health Account.)
- Includes 3-tier Rx coverage and wrap-around coverage with a $1000 deductible for services not provided by the employee’s provider panel, including out-of-area.
- Employee puts $500 pre-tax in a flexible spending account.

Employee gets care from a subspecialist not in provider panel.

- Employee pays a $1,000 deductible with $500 from flexible spending account, $100 from Personal Health Account and $400 in personal funds.

**Employer cost:** $2000

**Employee cost:** $900 ($500 of which is in pre-tax dollars) plus copayments

or