

Industry Outlook

January 20, 2010

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Medicare (Dis)Advantage -- 2011 Could Be Another Tough Year

Conclusion: Our conference call with Medicare Advantage experts John Gorman and Bill MacBain of the Gorman Health Group solidified our view that Medicare Advantage payment rates are vulnerable to falling shy of medical cost trends under the current Administration and Democrat-controlled (at least for a bit longer) Congress. The politics have turned "toxic" towards the plans in DC and our Medicare experts predict continued payment challenges as well as heightened regulation. Consolidation of market share and a decline in overall membership over the next 4 years (muted impact in 2010) is projected.

- **Payments To Plans Estimated To Rise 0-2% If A Multiyear Dr Payment Fix Is Enacted, Fall 2-3%+ If Only A 1 Year Fix Is Passed.** In addition to the physician payment fix, the assumed growth rate of Medicare costs, enactment of reform (assumed 3% cut in Senate enacted) and CMS's coding intensity adjustments are all key to final rates.
- **HUM, And To A Lesser Extent UNH And CVH Are Exposed To Medicare Advantage. Most Plans Have Grown Medicare Advantage Profitably Over The Past Few Years.** While CMS has indicated that it expects to collect up to 6% of premiums back from plans owing to coding audits, there have not yet been requests for refunds to the government -- remains a risk.
- **What's Next: 45-Day Notice On February 19 With Preliminary Sense For Methodology And Some Key Assumptions, Final Rates Due The First Week Of April.** Playback: Domestic toll-free callers: 888-203-1112, Replay Passcode: 6148310; International callers: 719-457-0820, Replay Passcode: 6148310. The replay call will be available until 11:59 p.m. ET on January 26, 2010.

**Please see addendum
of this report for
important disclosures.**

We continue to view Medicare Advantage as vulnerable to payment rates that do not keep up with cost trends under the current Administration and the Democratic-controlled congress. Our conference call with John Gorman and Bill MacBain further solidified our view that Medicare Advantage is not viewed favorably by Leadership in DC. While there are many moving parts in the calculation of Medicare Advantage payments (and our past efforts to forecast them have failed, as have attempts to determine a payment formula prior to the final rate release in April), **our Medicare Advantage experts anticipate 2011 Medicare Advantage payments to health plans from the government are likely to rise 0-2% in 2011 if a multi-year doctor fee fix is enacted, while a 1-year fix will likely result in rates down 2-3% or more.** Medical cost trends are generally running in the mid single digits.

A draft notice offering an indication of CMS's methodology and quantification of some of the factors used to calculate 2011 payments (the 45 Day Notice) is expected to be released on February 19th. Final rates are due out on April 4-5 with bids due (and therefore plan designs and premium levels for seniors set) on the first Monday in June.

The first key assumption in projecting Medicare Advantage payments is the growth rate of costs in the fee-for-service program. Our Medicare Advantage experts assume an underlying medical trend in the Medicare program of 3-4% (excluding the impact of the physician fee reduction). CMS had estimated a 2010 Medicare growth rate of 3.8% excluding the physician fee cut.

Reversing a 21% physician fee cut in 2010 would add 4% to payments if enacted before final Medicare Advantage payments are set and if the reversal applies to a minimum of 2 years (both 2010 and 2011). Currently, the 2010 cut is reversed for 60 days (until early March 2010). Our Washington experts indicate that the AMA is pushing hard for a permanent fix (costing \$200-250 billion over 10 years). Reversing the statutory physician fee cuts has been removed from the health care reform debate and there has been some discussion on the Hill about suspending statutory pay-go requirements and placing the SGR (sustainable growth rate which results in the cut to physician payments) fix in a non-healthcare vehicle (such as a bill to expand the long term debt levels). **The timing and magnitude of a physician fee fix is critical to Medicare Advantage payments.**

The Senate bill has proposed a 3% haircut to 2011 payments. According to our Washington experts, the House provision is calling for a 5% payment cut in 2011 followed by fixed payment cuts thereafter, bringing payments down to fee-for-service levels by 2014 (currently at 114% of fee for service on average). The House Medicare Advantage provisions are favored in Washington over the competitive bidding structure in the Senate (phased in over three years beginning in 2012) given the greater scorable savings and greater predictive ability by plans. However, the House-Senate merging process remains highly secretive and the Massachusetts Senate elections could impact the reform strategy pursued by Leadership. **Should reform fail to be enacted, payments would be helped by 3% relative our calculations, all else equal.**

Factors Impacting Medicare Advantage Payments In 2011 – Rough Math

| | 1-Year Dr Fee Fix | 2-Year Dr Fee Fix |
|-----------------------|--------------------------|--------------------------|
| Medicare Growth Rate | 3-4% | 3-4% |
| Dr Fee Fix | -0.5% | 4.0% |
| Senate (House @ 5%) | -3.0% | -3.0% |
| Code Creep Adjustment | -3.0% | -3.0% |
| | _____ | _____ |
| | -3.5-2.5% | 1-2% |

Source: Cowen and Company estimates

Our Medicare Advantage experts anticipate administrative code-creep adjustments to 2011 rates (accounting for the fact that Medicare Advantage plans code a higher intensity of illness versus the fee-for-service program for the same profile of enrollee) **in excess of the 3.4% cuts that impacted 2010 rates.** However, some Medicare Advantage predictors suggest that CMS may choose not to code-creep adjust in 2011 if explicit cuts have been enacted through reform. CMS could choose to extract code-creep adjustments for 2008 and 2009 (or just 2008 or choose not to make any adjustment) when calculating 2011 payment levels. The Administration indicated last April when it announced final 2010 rates that coding intensity had risen in 2008 versus prior years. **The magnitude of CMS's coding intensity extraction from the 2011 rates will also help to determine next year's payment levels.**

We have the following additional observations from our call with John Gorman and Bill MacBain:

- **The politics have turned “toxic” towards Medicare Advantage in DC, with a long term risk to plans that are not able to better demonstrate value and bend the cost curve.** The Gorman Group anticipates re-regulation (including expanding reporting of clinical measures to CMS) of Medicare Advantage plans. Special needs plans may be the “canary in the coal mine” as increasing regulation of these plans could portend increased regulation in the rest of the segment.
- **Gorman Group anticipates a more consolidated Medicare Advantage marketplace.** There are currently 750 health plans serving seniors. The market is expected to shrink by 1/3 over the next 4 years. Enrollment declines will be modest in 2010 but build over time given rate pressures in the segment.
- Because all plans are subject to the same coding intensity adjustment to final Medicare Advantage payments from CMS, **plans that lag the average in increasing coding intensity scores risk falling behind in payments relative to peers.** Of course, all plans attempting to maximize coding intensity will likely raise future adjustments by CMS (as its retrospective assessments suggest greater payment extractions are warranted owing to accelerating coding intensity in the prior year). Moreover, new Medicare Advantage plans (or new entry into a region) will likely lag the overall average in coding intensity in the early years - making it difficult to be profitable in a new market and likely minimizing new entrants.
- The House bill makes permanent coding-intensity adjustments while the Senate only includes coding adjustments through 2013.

- It is unclear which plans in which regions would benefit from a Senate provision grandfathering those plans hurt the most through competitive bidding and subsidizing beneficiary incremental benefits.
- With the Senate bill proposing a phase in from 2012-2014 of competitive bidding based on weighted average bids, the largest plans would wield the greatest weight and would likely push smaller plans out of the market. **In many markets, the Gorman Group anticipates that competitive bidding would result in weighted-average bids below local fee for service rates.**
- The Gorman Group does not believe a House provision calling for an 85% MLR floor would be problematic for most companies.
- Performance bonuses for managed care companies could add as much as 6% to premiums when fully implemented. The House bill proposes bonus payments beginning in 2011 for the lowest 1/3 of FFS cost counties with 20%+ Medicare Advantage penetration. The Senate, on the other hand would begin bonus payments in 2014. Both require 4-5 stars in order for plans to qualify. The average plan rating is 2.7 stars with only 2 (nonpublic) Medicare Advantage organizations achieving 5 star status.
- CMS began conducting audits in the fall of 2007 of Medicare Advantage risk scores. According to our experts, CMS is choosing 200 enrollees within set cohorts and using the results of those audits to extrapolate across all membership. CMS is examining medical records in order to determine if there is adequate documentation for specific risk scores. **While CMS has indicated that it expects to collect up to 6% of premiums back from plans, there have been no repayment requests yet among Gorman Group clients. Over time, our Medicare Advantage experts anticipate that CMS may seek repayments if a pattern of coding more aggressively than the medical records justifies continues.**
- While in the past, Medicare Advantage has been a product bought by lower-income seniors attracted to \$0 premium products in the HMO marketplace, **the Gorman group anticipates the Medicare Advantage marketplace will migrate into the more affluent segment of the market** - potentially cannibalizing the 9.5-10 million seniors with supplemental coverage. Payments falling shy of cost trends will likely force plans to raise premiums (likely pricing lower-income seniors out of the market) and as the number of PPO plans continues to grow.

Stocks mentioned: prices and ratings

| Stock | Ticker | Price (\$, 19/1/2010) | Cowen and Company rating |
|----------------------|--------|-----------------------|--------------------------|
| Coventry Health Care | CVH | 26.71 | Neutral |
| Humana Inc | HUM | 51.94 | Underperform |
| UnitedHealth Group | UNH | 35.13 | Outperform |

Source: Cowen and Company

Addendum

STOCKS MENTIONED IN IMPORTANT DISCLOSURES

| Ticker | Company Name |
|--------|----------------------|
| CVH | Coventry Health Care |
| HUM | Humana |
| UNH | UnitedHealth Group |

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(a) Assumptions: Time horizon is 12 months; S&P 500 is flat over forecast period.

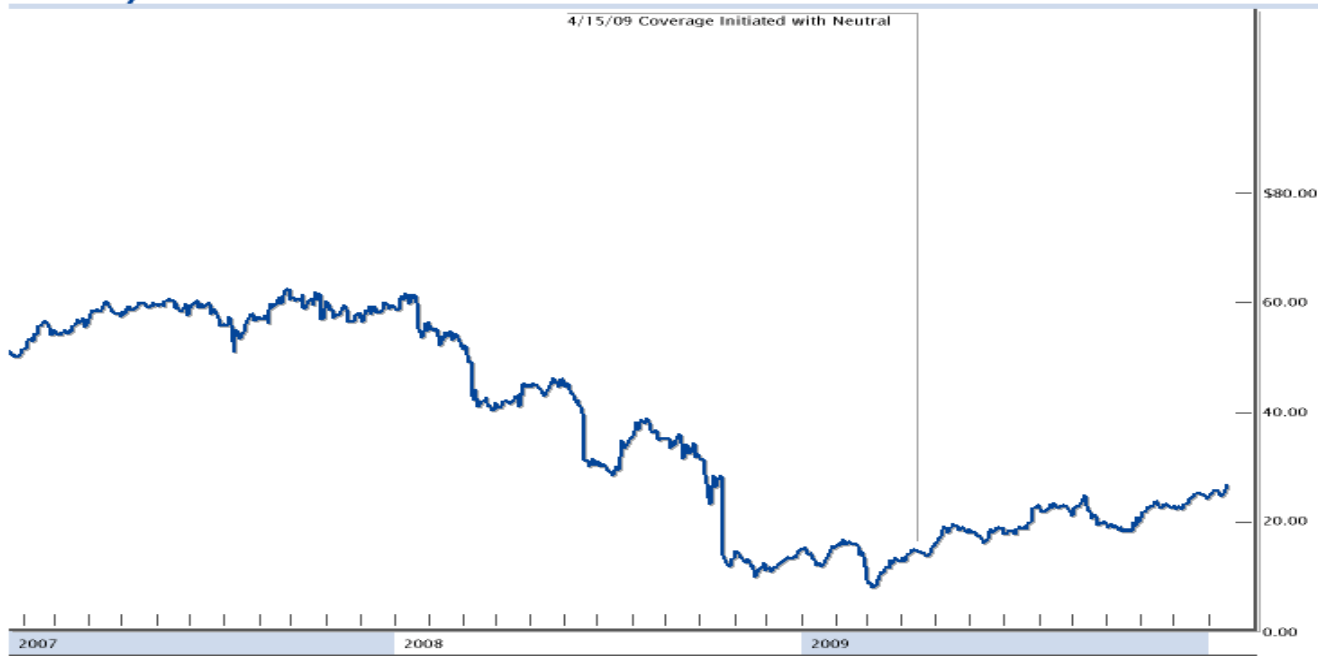
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|---------------|---|---|
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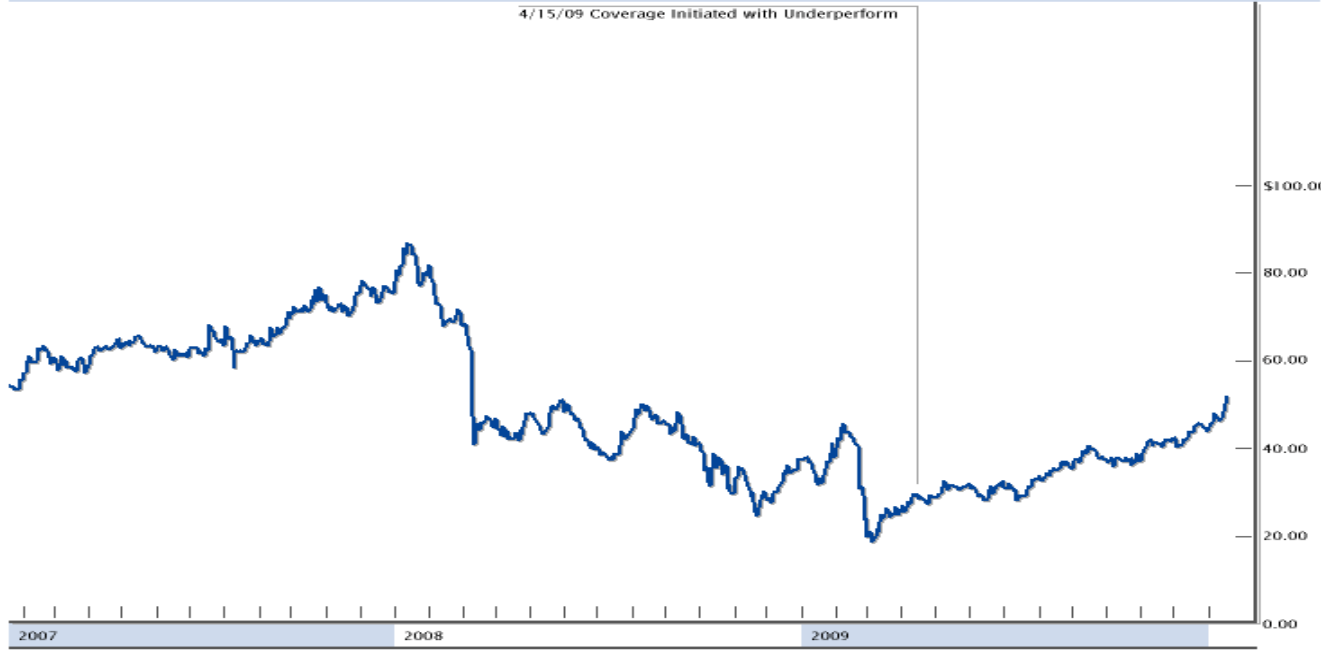
Coventry Health Care - CVH



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Cowen and Company Price and Ratings History

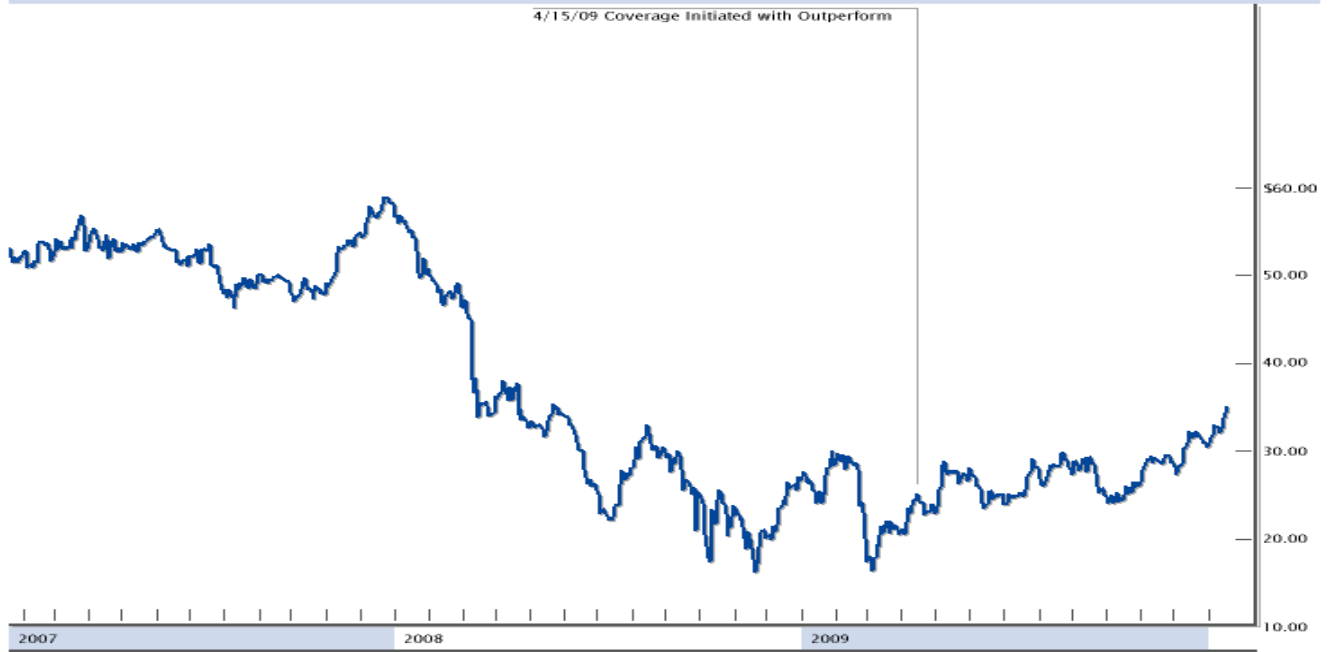
Humana - HUM



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Cowen and Company Price and Ratings History

UnitedHealth Group - UNH



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