



CITY OF KIRKLAND
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MEMORANDUM

To: City Council
From: William R. Kenny, Human Resources Director
Date: September 20, 2006
Subject: Medical Benefits Strategies

The City's medical benefits strategy over the past couple of years has been to offer employees and their families equitable and competitive medical benefits programs, while increasing cost sharing with employees. The intent of this strategy is to enhance medical consumerism and educate employees on the true costs of healthcare. Given the options of our current provider, Association of Washington Cities Employee Benefit Trust (AWC), we have been moving our employee groups (both Union and non-represented) to Regence Plan B and Group Health Plan 2.

As part of the 2005 and 2006 Union negotiations strategy, we have continued to move City employees to Regence Plan B and Group Health Plan 2. IAFF Local 2545 is the one outstanding group that has not yet made this move as their negotiations will be pending next year. We have also proposed language in the recently negotiated contracts that would provide, during the term of the agreements, for a "due diligence" study of medical programs, costs and other options available to the City of Kirkland. Obviously, generally the Unions have been hesitant to "pre-agree" to potential unknown changes but have agreed to language that provides for exploring options toward "substantially equivalent benefits" and provides for future bargaining of any major changes.

Working with the Benefits Committee on a "due diligence" study also allows us a chance to keep an eye on what changes AWC will be making in 2007. We have been told by their staff that they will be introducing a High Deductible Health Plan with a Health Savings Account. (A separate discussion of HSAs is following) We will not know the exact design of this plan until the AWC Board holds their vote on October 5th. Shortly after this decision we are hoping to have a Benefits Committee meeting to update the members and set the frame work for next year's study.

As an overview, there are four options that are generally available to an employer and that we intend to take a look at as part of the "due diligence" study. Those four options are: 1) self-insuring, 2) contracting directly with insurance carriers, 3) moving to another multi-employer trust, or 4) staying with AWC.

Self-insuring

A self-insured plan is established with a dedication of City monies into a reserve pool to pay for employee's medical expenses. Thus, the employer becomes the provider of benefit rather than an insurance company. In some instances, "excess coverage" / stop loss insurance can be secured for unusually large occurrences but this is often expensive and follows the depletion of the City's monies. Typically, an employer contracts with a Third Party Administrator and pays a minimal fee for them to process employees' medical claims. There are potential cost savings in self-insuring, but the City will have a hard time assessing what these savings could be because we do not have access to our claims experience. The biggest risk factor in self-insuring is being unable to predict high claims. With such a small employee population, one high claim could wipe out reserves, so any potential savings on premiums would essentially be tied up in these reserves in order to protect the City. According to the analysis obtained in a 2004 benefits study, in order for the City to self-insure it was recommended that there be over a million dollars set in reserve to pay for medical claims.

With the increased cost of medical procedures, this amount has undoubtedly risen to a much higher amount. While worthy of some continued consideration, this option clearly carries great risk associated with any potential cost-savings.

Contracting Directly with Insurance Providers

The second option, contracting directly with an insurance carrier, poses risks as well. Because AWC does not provide to individual participating members access to our claims experience we would be unable to provide that to potential carriers. Rates are typically set through a combination of factors including employee population size, employee and family demographics and previous claim experience (actual costs). With our relatively small employee population and lack of specific claims experience information, any potential carriers would likely have to give us community rates, which tend to be higher than the market average. There is a potential that to attract our business they may offer a lower rate at first, but then we have the potential to see double digit increases in future years. In essence, the insurance carriers would gain substantial control over the City's medical programs, benefit levels, costs and available physician providers.

Move to Another Multi-Employer Trust

Another, perhaps more realistic and cost effective option is contracting with a different multi-employer trust. Of those available the Public Employees Benefit Board (PEBB) is a viable option because they have a larger pool of employees. This is basically the Washington state employees trust program but is currently still available to political sub-divisions and has a participating pool of approximately 500,000 employees in comparison to AWC's 15,000 employees. There would be both positive and negatives if a switch was made to PEBB. PEBB offers more coverage options, not restricting employees to just Regence and Group Health, and currently has a more cost effective retiree medical plan from the employee/retiree perspective, as they currently get the same rates as active employees rather than being rated as a separate group. (It is noted that both PEBB and AWC may have to make future retiree and employer rate adjustments regarding these OPEB and FASB accounting rules, affecting PEBB and AWC respectively, but this and the affects will not be determined until at least 2007.) One down side of PEBB is that employees would no longer be able to cover opposite sex domestic partners and would only be able to cover spouses, dependents, and same sex domestic partners. PEBB's rates are slightly higher than AWC's at this time, but because they have a larger population upon which to spread their experience, premium rates could potentially increase as a slower rate. It must also be noted that the State's board sets benefit levels and programs, reducing any local control but also assuring greater competitive awareness and cost containment among the participating insurance carriers. We will want to look at this option because we are not sure how long this trust will be open to municipalities as the original purpose of this trust was to cover state employees.

Stay with AWC

The final option is to stay with AWC. We have established a good relationship with AWC and they are making some changes that help to keep them a viable option. Clearly, a participating city has more direct input into the AWC trust than with the other options. They are also more sensitive to participant plan design needs and cautious as to the impact of premium rate changes upon local budgets. It is necessary to continue to watch how introducing the high deductible plan with an HSA will play out and affect the other plans. This year's premium increases continue to be reasonable in consideration of medical and provider costs patterns and we are hoping that this trend will continue.

It is noted that some cities have developed a strategy of going toward AWC's current PPO but with the recent move of Kirkland employees toward Plan B and the pendency of the AWC HSA offering during 2007, this strategy as an interim step would not be recommended at this time.

Health Savings Accounts – an overview

A Health Savings Account (HSA) is a vehicle that changes the traditional view of medical insurance. Typically, the "insurance" is reserved for the more expensive medical costs and procedures and the employee is responsible for all expenses up to a high specified amount. Thus, it is referred to as a high deductible health plan (HDHP). The key to the HSA is that the employer provides some monies to the (employee-owned) account and the employee is responsible for the remainder, up to the deductible limit. If the account monies are not spent, they are 'owned' (subject to IRS

limitations) by the employee. This makes the employee more cost-aware than the traditional co-pay based health insurance plan.

The trend in benefits is moving towards consumer driven plans. These plans are said to increase awareness about health care savings and, in turn, can save the employer money in the long term. To qualify as a High Deductible Health Plan, based on IRS regulations, the plan design must include a deductible of at least \$1,000 for an individual and \$2,000 for a family. A PPO plan is in place above the deductible limit. We have not yet seen AWC's final plan design, but it has been recommended for passage to the AWC Board in October, 2006. It is noted that the HSA offering is intended to be in conjunction with other plans. In Kirkland's case, for example, individual employees could elect to stay on Plan B or go to the HSA.

If AWC does choose to introduce a HSA eligible plan than this is an option that the City may want to be able to offer employees. We have heard a lot of interest from employees in helping with retiree healthcare and an HSA is one way to offset some retiree costs. HSA deposits are tax-deductible, up to a maximum of \$2,600 for an individual and \$5,150 for a family, and the withdrawals that are used to pay approved out-of-pocket healthcare costs are tax-free. Unlike previous health-savings plans offered by employers, account balances not used in one year can be carried over to the next (essentially beginning to save for retirement), as well as from job to job. And like an individual retirement account, while the funds can be used for any purpose, when the account holder pays for qualified expenses (including retiree health care premiums) the withdrawals are considered taxable income at that time but no penalty for withdrawal is imposed.

To make the plan attractive to employees, a participating City would probably have to make a deposit into the HSA to cover some of the employee out of pocket costs they will face from the high deductible. Even if the City were to make a deposit into the HSA, they are still thought to save money as the deposit and PPO premium is less than current rates. Additionally, consumerism occurs because employees will think twice before spending their own money on pricey treatments and remedies. It must be noted, however, that since HSAs were first introduced in 2004 there has been some analysis that concludes that HSAs aren't likely to hold down healthcare spending as much as first hoped.

As identified above, if AWC does offer a HSA plan, they have said that it will be an individual choice plan, meaning that we will not have to move a whole bargaining unit into that option, but rather it would be third option along with Plan B or Group Health. While individual choice is attractive to employees, this could also pose some problems as well because the other plans could have adverse selection causing the premiums on those plans to increase. This is because the HSA is most attractive to the "healthier" employees and the per-employee cost in the other plans corresponding increases. Benefits consultants are estimating that HSA plans will need at least a 40% enrollment in order to see employer savings and still maintain the cost of the other medical plan offerings.

It will be beneficial for the City to see what AWC chooses to do in this area because it will give us a better comparison when we begin our "due diligence" study in 2007. As we are aware the Unions will only look at options that offer "substantially equivalent benefits" this could include the HSA option if there is enough interest.

Another area of consideration before implementing an HDHP/HSA is the employee communication. Consultants are suggesting a six month to one year communication and education plan before making an HDHP/HSA available due to the complexity of the plan design. This should continue after plan roll-out. Individuals are not used to thinking as consumers when it comes to healthcare. For all of the reasons noted above, choosing to offer a HDHP/HSA is not a panacea or quick fix, but it is an option that we will definitely want to consider.

Recommendation

The City of Kirkland's medical benefits strategy is well on-track given the options available and the current trends. Those alternatives that may offer additional cost-savings also carry marked increases in risk for the City of Kirkland. It is therefore recommended that the further review of options in 2007 will provide for the next phase of strategy discussion and information for Council's consideration.