Financial Review of Prescription Drug Component of Medicare Prescription Drug, Improvement and Modernization Act of 2003

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Introduction The "Medicare Prescription Drug, Improvement and Modernization Act of 2003" (Act) proposes the broadest and most significant changes to the Medicare program since its enactment in 1965. One of the most publicized and expensive features of the legislation is the addition of a prescription drug benefit with voluntary enrollment beginning in 2006. Older Americans with drug coverage will incur an average cost of $2,500 to $3,000 in 2006 on prescription medications; their understanding of this new benefit will help them to make the right decision about enrollment. Although the Act also addresses many other issues related to Medicare, from a federal budget standpoint, none are as significant as the introduction of a new prescription drug benefit.

This document focuses on a description of the design and an analysis of the costs associated with the proposed new prescription drug benefit as it relates to Medicare beneficiaries who are not dually eligible for Medicaid benefits. The estimates provided here are based on information known about the program at the time of this writing which is subject to change.

How Does The Medicare Prescription Drug Plan Work? Beginning in 2006, Medicare will allow private health plans to provide coverage for prescription drugs and will guarantee the presence of at least two private health plans from which Medicare beneficiaries can choose to purchase drug coverage. These plans are separate from other private Medicare supplement or Medicare Advantage programs that may be available to beneficiaries. For geographical areas in which two private health plans are not available, the government will provide coverage to Medicare beneficiaries in that area. Each Medicare beneficiary will have an opportunity to enroll in one of the available plans by paying an initially estimated $35 monthly premium for coverage. Anyone who does not enroll in a plan when first eligible to do so will be charged an increasingly higher premium should they choose to enroll at a later date.

Figure 1 illustrates graphically the sharing of the prescription drug costs among the beneficiary, the private health plan and Medicare. The dollar amounts shown represent discounted charges that an insured person may experience, measured in 2006 dollars. (For every $100 spent in 2003, the equivalent cost in 2006 would be just over $150.) Each Medicare beneficiary has an annual deductible of $250 of expenses before the program provides any benefits. For the next $2,000 of prescription drug expenses, the private plan and Medicare pay 75% of the cost and the beneficiary pays 25%. The beneficiary must pay

100% of prescription drug expenses between $2,250 and $5,100 without any Medicare plan reimbursements. Once total expenses exceed $5,100 per year, the beneficiary is responsible for 5% of the cost. The private plan covers 15% of the balance, with Medicare reinsuring the remaining 80%.

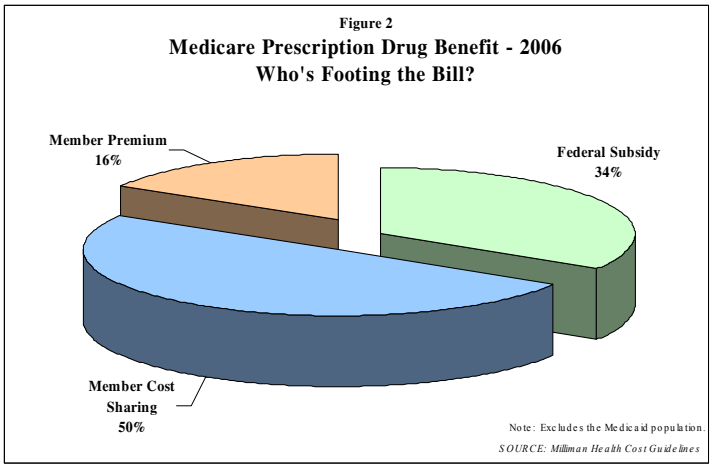
Figure 1
Medicare Prescription Drug Benefit
Cost Allocation

Annual Drug Cost	Beneficiary Share	Private Health Plan Share	Medicare Share
	5%	15%	80%
$5,100			
	100%	0%	0%
$2,250			
	25%	22%	53%
$250			
	100%	0%	0%

In Figure 1, the allocation of private health plan and Medicare share between $250 and $2,250 requires a calculation using information from the federal subsidy payment section of the act. The total federal subsidy to the private plans is equal to 74.5% of the benefit coverage (net of beneficiary share). Calculating the actuarial cost of coverage and taking into consideration the direct subsidy of 80% above $5,100, produces an indirect Medicare subsidy of 53% between $250 and $2,250.

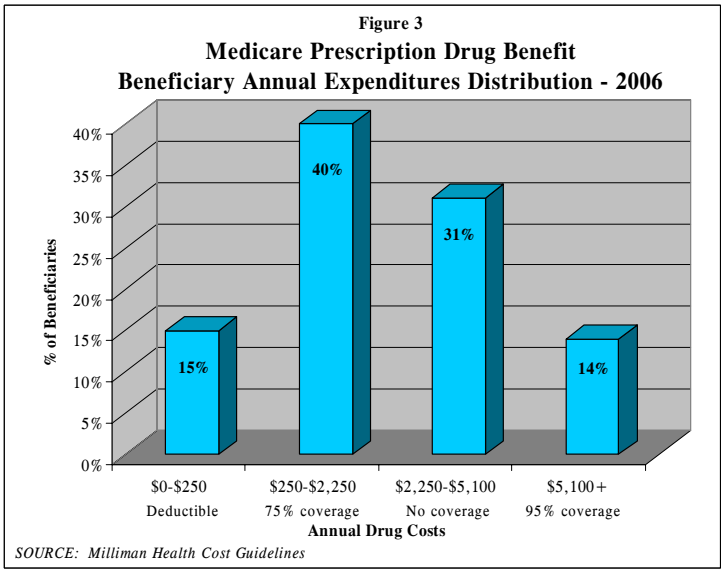
For years after 2006, each of the key elements of coverage (e.g., the initial monthly premium of $35, the deductible of $250, the maximum of $2,250 and the out-of-pocket threshold of $5,100) will increase at the rate of increase in the cost of prescription drugs per beneficiary. We estimate this increase to be about 15% per year based on current drug trends, which is slightly less than historical levels. At this rate, for example, the annual deductible would rise from $250 in 2006 to about $500 in 2011 and to $1,000 in 2016.

Who Pays For How Much Of The Drug Expenses? We project that in 2006, the program's first full year of operations, Medicare beneficiaries, on average, will be paying 66% of the total cost of pharmacy care, 50% in cost-sharing (i.e. deductible, coinsurance) and 16% in the form of a $420 ($35 monthly) annual premium. The remaining 34% of the cost of pharmacy care represents the benefits payable by the private health plan and the federal government. Figure 2 displays this distribution of total costs for pharmacy care among member cost sharing (50%), member premiums (16%) and federal subsidies (34%).



Our calculations indicate that the Medicare drug coverage has an expected cost between $1,320 and $1,500 per beneficiary per year in 2006.[1] Of this amount, $420 will be funded by the beneficiary premium and the remainder by the Federal subsidy.

How many dollars of drug expenses do Medicare beneficiaries incur? As shown in Figure 3, we estimate that about 15% of beneficiaries have costs less than the $250 annual deductible; 40% have drug expenses between the deductible and the initial coverage maximum limit of $2,250, where the new private plan and Medicare pay 75% of expenses; and 31% of beneficiaries will incur expenses between $2,250 and $5,100, where the beneficiary pays 100%. That leaves 14% of beneficiaries who will receive benefits at the 95% level for annual pharmacy expenses in excess of $5,100, which the federal government considers catastrophic.



[1] This estimate is based on the plan design proposed in the Medicare Prescription Drug, Improvement & Modernization Act of 2003, the Milliman *Health Cost Guidelines*, and actuarial judgment. We have assumed typical market level pricing discounts, dispensing fees and rebates in our analysis.

Which of these beneficiaries will benefit economically from the Medicare drug plan? Our calculations indicate that beneficiaries whose annual drug expense equals $810 will be in a "break even" financial position. In other words, their out of pocket expenses for the plan's cost-sharing features plus the plan's premium will equal their $810 in expenses. Beneficiaries with higher annual drug costs will benefit economically from the program while there will be a net cost for those beneficiaries with less than $810 in annual expenses. We further estimate that about 30% of Medicare beneficiaries will have annual expenses below this $810 break-even point, and that the remaining 70% will benefit economically from the program.

Figure 4 shows the beneficiary out-of-pocket costs for various levels of annual drug expenditures. The first column shows undiscounted drug costs that would be borne by someone with no drug coverage. The middle column shows the benefits that may be achieved via the discounts that might arise from participating in the Medicare drug program. The last column shows the total annual out-of-pocket costs to the beneficiary, comprised of both the $420 annual premium and the cost-sharing amounts for beneficiaries with various annual drug expenses. All amounts are in 2006 dollars.

Figure 4
Medicare Prescription Drug Benefit
How Much Will It Cost Me in 2006?

Annual Drug Expenditures		
Uninsured Beneficiary[1]	**Insured Beneficiary[2]**	**Beneficiary Out-of-Pocket[3]**
$0	$0	$420
$650	$500	$733
$1,060	$810	$810
$1,960	$1,500	$983
$3,260	$2,500	$1,420
$6,530	$5,000	$3,920
$13,060	$10,000	$4,265

[1] The uninsured beneficiary will benefit from discounts at the pharmacy
[2] The insured beneficiary already receives discounts at the pharmacy
[3] Including required $35 monthly premium payment

As an example, a person who currently has no drug coverage and who has $1,930 in annual drug costs (about $160 per month) will have $1,500 of expenses after pharmacy discount which represents the basis for coverage in the insurance program. In addition to paying $420 in premiums ($35 per month for 12 months), that beneficiary will pay the $250 annual deductible plus 25% of the $1,250 (i.e., $1,500 -$250) in expenses beyond the deductible, or $312.50. Medicare's payment would be 75% of the expenses in excess of the $250 deductible, or $937.50.

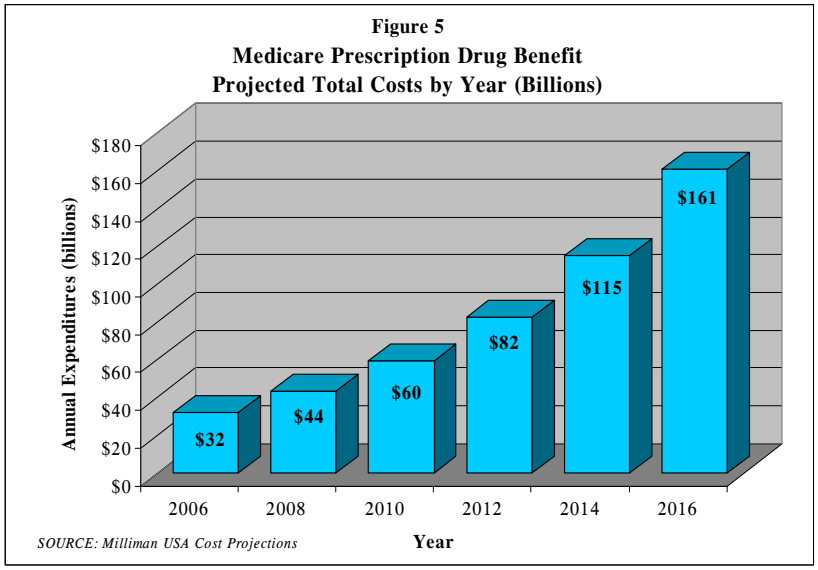
Similarly, a beneficiary with $810 of discounted drug expenditures will be required to pay the deductible ($250), plus 25% of the amount in excess of the deductible ($140), plus the

annual premium of $420, which results in the beneficiary paying for 100% ($810) of the total benefit cost.

How Much Will The Program Cost Taxpayers? We estimate that the federal subsidy for the Medicare drug program will cost approximately $448 billion between fiscal years 2004 and 2013. This estimate is higher than the $409 billion estimate developed by the Congressional Budget Office. The $448 billion represents approximately 34% of the total drug costs for the covered Medicare population, with the Medicare beneficiary paying the remaining 66%.

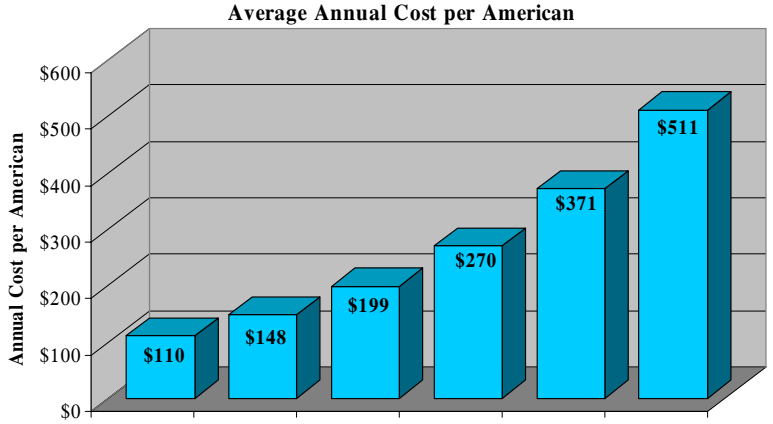
It is noteworthy that the "10-year" estimated cost of the program published by the federal government really only covers 7 years and 9 months during which the private drug plans will be in place. The first 27 months of the measurement period are virtually free of cost. Because of this, the average annual cost of the program over the years the plan is operational during the 10-year projection period (i.e. fiscal years 2004-2013) is almost $53 billion using CBO's estimates.

Figure 5 shows projected annual costs for illustrative years from 2006 to 2016. The costs start at approximately $32 billion in 2006 and grow steadily each year thereafter. Note that the annual cost in 2016 is approximately $161 billion, a five times growth in the government's expenditure for the program in a ten-year period.



What will this program cost the average American? Based on our cost projections, in 2006, the federal subsidy for the Medicare drug program will cost every man, woman, and child in America approximately $110. This cost will grow to approximately $511 by 2016. Figure 6 shows this progression of costs

Figure 6
Medicare Prescription Drug Benefit
Average Annual Cost per American



SOURCE: Milliman USA Cost Projections

If prescription drug expenditures continue to grow at the rate they have in the past few years, this burden will increase by a factor of more than 4.5 every 10 years. Based on this rate of growth, the burden on every American would grow as shown in Figure 7. It is clear that major modifications to the program will be needed in the future.

Figure 7
Medicare Prescription Drug Benefit
Cost Burden

Year	Approximate Burden per American
2006	$110
2016	$511
2026	$2,370
2036	$11,000

How Good Are These Projections? The forecasts of the cost for the Medicare drug program are driven by several critical assumptions. One important assumption is the rate at which drug costs will increase from year to year, commonly referred to as the trend rate. This trend rate is a function of many variables, including the unit cost for each prescription, the number of prescriptions used by each beneficiary, the advent of new expensive drugs, etc. If the annual trend rate is understated by three percentage points, the cost of the program through 2013 will increase by about 9%, or $38 billion. Conversely, if the actual trend turns out to be three points less than anticipated the program's cost will decrease by about 8% over this same period.

Another important assumption is which members will choose to enroll in the program. The forecasts presented above assume that virtually all eligible Medicare beneficiaries enroll in the program. A beneficiary who currently is uninsured for prescription drugs will have access to discounted pharmacy charges by participating in the program. Figure 3 shows that a sizeable portion of the Medicare population has annual expenses that are below the plan's

deductible. Compounding this further is the fact that about 30% of the eligible population has expenses that are below an economic break-even point for participation in the plan. If the beneficiaries with annual cost less than the $250 annual deductible (i.e., 15% of beneficiaries) decide not to participate in the Medicare drug plan, the loss of their premium revenue will be greater than the reduction in the benefits payable by the program. As a result, the federal subsidy will increase by about 8%.

Technical Appendix The cost estimates presented here are based on the Milliman *Health Cost Guidelines* and actuarial judgment. Because the numbers contained in this analysis are the product of assumptions about future events, including the rate of growth in the Medicare population, increases in the cost and utilization of prescription drug services, enrollment in the new program by Medicare beneficiaries, along with other assumptions, it is expected that actual results will vary from these estimates.