

ANNEXURE 5: 4 ECONOMIES OF SCALE ON ADMINISTRATION FEES

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1. Introduction

1. Regardless of being self or third party administered, medical schemes incur administration expenses which count towards their non-healthcare expenditure. Where medical schemes contract with third party administrators, they pay the administrator a fee based on the number of medical scheme members. Medical schemes also pay a managed care fee where the administrator provides these services. Administration fees make up around 10% of members' monthly premiums, with the remaining 90% going towards healthcare expenditure. The managed care component is reported separately and counts towards healthcare expenditure.
2. Given the nature of the administration business, stakeholders told the HMI that there should be substantial economies of scale in the administrator market. This is because an administrator's business requires significant investment in large scale IT systems, in knowhow and in human capital. Economies of scale exist where, as a firm increases in size, its unit costs decrease. This, in essence, results in larger firms having lower per unit costs than smaller firms. In a competitive market, firms operate in an efficient manner and larger firms with lower per unit costs, charge less for their product, to the benefit of the customers. In a non-competing market, the firm and its shareholders, rather than the customer, benefit from the scale economies.
3. Within the administrator market, a competitive environment implies that efficient administrators pass cost savings, including savings obtained through economies of scale, on to medical schemes through lower monthly fees. Efficient administrators can also reward their shareholders with sufficient returns to stay in the market and incentives to invest in innovations that will lead to future growth. Administrators could, for example, invest in innovative systems that lead to operational efficiencies to the benefit of the medical scheme member. Other innovations could result in more effective contracting with providers, again to the benefit of the medical scheme member.
4. With economies of scale, larger medical schemes should benefit from paying lower administration fees as the administrator can spread the total cost of administering the large medical scheme across more beneficiaries. Similarly larger administrators (with large medical schemes or many medical schemes as clients) have more beneficiaries to spread their fixed administration costs over. Smaller medical schemes contracting with these large administrators should be able to benefit from economies of scale as the administrators can spread their total costs over all the medical schemes' beneficiaries under their administration. There may also be benefits from the overlap

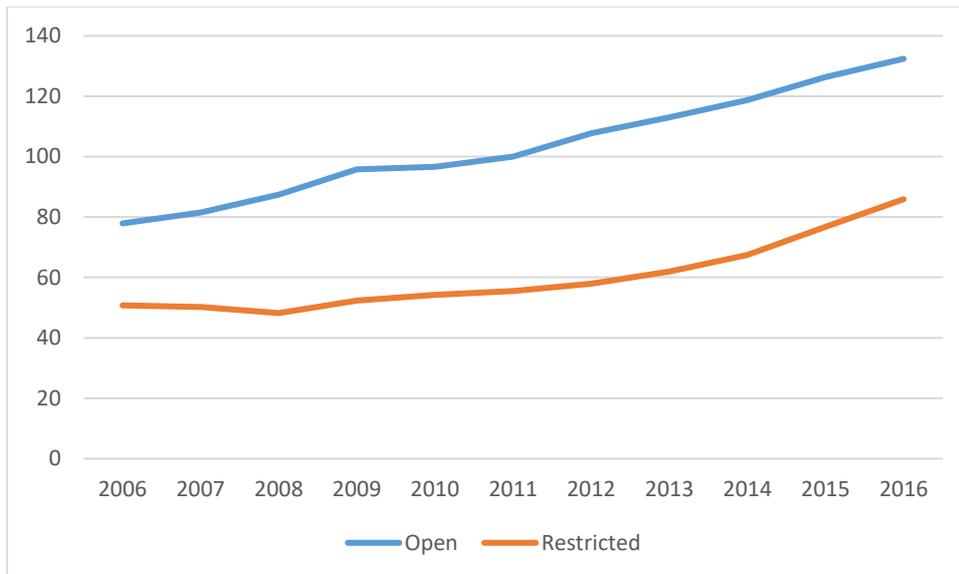
between the administration and managed care business as both can utilise the same IT systems and other administration functions.

5. The HMI has looked at the administration expenses and found that firstly open medical schemes pay more than restricted medical schemes. Secondly we found that administrators charge different fees to different medical schemes. Some administrators even charge different fees for different benefit options within a medical scheme. For example, the administrator may charge lower administration fees for the cheaper benefit options that target lower income earners and a standard fee for all other benefit options. The fact that administrators charge medical schemes within their stable different fees, in its self, is not a competition concern, however, it may illustrate the extent to which competition occurred during the tender process.
6. This annexure will first look at the different types of administration fees and the difference between open and restricted medical schemes. The inquiry considers whether large medical schemes benefit from economies of scale through lower administration fees. Next, the inquiry looks at the different administration fees medical schemes within the two large administrators pay. Finally we look at whether small medical schemes benefit from lower administration fees through contracting with large administrators.

2. Administration expenditure

7. The Gross Administration Expenditure (Risk + PMSA) is the total expense medical schemes incur both internally and what they pay to third party administrators. Figure 1 illustrates the Gross Administration Expenditure for open and restricted medical schemes per average beneficiary per month (PABPM).

Figure 1 Gross Administration Expenditure for Open and Restricted Medical Schemes (pabpm)



CMS Annual Reports from 2006 to 2016/2017

8. This graph illustrates that open medical schemes have substantially higher administration expenditure compared to restricted schemes. Stakeholders explained that the higher expenditure on administration for open medical schemes is because they require additional services, such as marketing and contracting with brokers, that restricted medical schemes do not need. Open medical schemes tend to have a greater number and more complex benefit options, which require additional actuarial input, and more sophisticated administration services. In addition there is a greater prevalence of fraud within the open medical scheme market, which requires additional administration attention.
9. Another explanation might be that administration fees in the restricted medical scheme market are determined through a competitive tender process. Some of the larger open medical schemes ability to switch administrators is limited, and they therefore lack negotiation or buyer power vis-à-vis their administrator.
10. The inquiry also looked at gross administration expenditure as a percentage of gross contribution income¹. The difference between open and restricted medical schemes is less pronounced in this measure. This could be because restricted medical schemes, on average, have cheaper benefit options. Amongst the restricted medical schemes, self-administered Food Workers Medical Benefit Fund, was the highest at

¹ Discovery Health explained to the HMI that administration expenses as a percentage of gross contribution income is the most appropriate measure of administration fees. This, they argue, is because medical schemes with simple and/ or relatively low premiums per member will require less intensive and sophisticated administration than those with more and richer benefit options (Discovery Health Letter to the HMI re confidentiality 11 June 2018 p 3). The HMI reports the various figures throughout our analysis.

39%. Golden Arrow Employees' Medical Benefit Fund was second highest at 15,5%. Impala Medical Plan was the lowest at 2,9%. The open medical schemes varied from 13,4% for Thebemed to 6,6% for Bestmed Medical Scheme.

3. Economies of scale for large medical schemes

11. The inquiry considered whether large medical schemes benefit through economies of scale in their administration expenditure. We also consider whether large medical schemes have the ability, through some degree of buyer power, to negotiate lower administration fees with their administrators.
12. For this analysis we look at the 10 largest restricted and open medical schemes pay in gross administration expenditure per average beneficiary per month (pabpm) and as a percentage of gross contribution income in Table 1. The table includes the "Total administration and co-administration fees pabpm" which is the administration fees that the medical scheme pays to a third party administrator. The table also includes the total fees paid to administrator, including managed care, administration and other- in other words all fees paid to a third party administrator. Finally, the table includes the number of benefit options as stakeholders stated that the more benefit options the medical scheme has, the more actuarial and other services the scheme requires.
13. It is important to note that the inquiry's assessment focuses on the various types of administration fees. It does not take into account the different services the administrator might provide or the quality of the service the medical scheme receives. The analysis also does not take into account the extent of investment administrators may undertake to improve efficiency and, with that, the service offering to their medical schemes. Rather, medical scheme trustees are best to assess the value of the service their medical scheme receives.

Table 1: Administration fees

Medical Scheme	Administrator (market share GCI)	Options (incl. EDOs)	Average Beneficiaries ²	Gross Admin Expenditure ³		Total other fees including admin and co-admin fees (pabpm)	Total Fees paid to Administrator ⁴ (pabpm)
				pabpm	% of GCI		
Restricted Medical Schemes							
GEMS	Medscheme (36,7%)/ Metropolitan (1,7%)	5	1 801 999	R78,1	5,4	R17,1	R32,7
						R32,0	R33,8
Polmed	Medscheme (36,7%)	2	497 129	R66,0	4,8	R39,7	R61,0
Bankmed	Discovery Health (39,4%)	6	214 305	R98,1	5,9	R79,3	R114,4
LA Health	Discovery Health (39,4%)	5	147 778	R114,6	7,6	R105,9	R133,8
Platinum Health	Self-Administered	3	96 409	R64,8	6,6	R0	R0
SAMWUMED	Self-Administered	2	83 523	R65,0	5,5	R0	R0
Sasolmed	Medscheme (36,7)	1	76 332	R76,9	4,4	R65,8	R103,1
Profmed	Professional Provident Society (2%)	5	68 637	R197,5	11,9	R117,1	R136,9
Transmed Medical Fund	Metropolitan (1,7%)	4	57 137	R113,9	8,1	R87,5	R87,5
Umvuzo Health Medical Scheme	Self-Administered	4	54 821	R101,5	9,7	R0	R0
Open Medical Schemes							

² The inquiry used average beneficiaries in this instance as the Council for Medical Scheme reports fees per average beneficiary

³ Gross Administration Expenditure (risk +PMSA), pabpm. This is the amount medical schemes set aside for administration fees including what they pay third party administrators.

⁴ Total fees paid to Administrator include accredited managed healthcare, administration fees and other pabpm. This figure is the total amount that medical schemes pay to third party administrators

DHMS	Discovery Health (39,4%)	22	2 707 913	R132,7	8,0	R127,7	R171,0
Bonitas	Medscheme (36,7%)	12 ⁵	676 785	R121,2	7,7	R82,2	R125,1
Momentum Health	MMI Health (3,0%)	23	257 371	R105,4	8,8	R99,7	R123,6
Bestmed	Self-Administered	13	200 400	R127,6	6,6	R0	R20,1
Medihelp	Self-Administered	10	195 858	R144,9	8,6	R0	R68,3
Medshield Medical Scheme	Self- Administered	8	153 415	R122,8	8,1	R0	R0
Fedhealth Medical Scheme	Medscheme (36,7%)	12	144 167	R168,2	9,3	R123,8	R164,4
Sizwe Medical Fund	Sechaba Medical Solutions (1,4%)	5	121 692	R168,1	10,7	R105,9	R133,7
LMS Medical Fund ⁶	V-Med Administrators	12	110 019	R135,8	7,7	R77,3	R132,0
	Medscheme Holdings (36,7%)					R97,4	R105,9
Keyhealth	Professional Provident Society Healthcare Administrators (2%)	6	75 506	R161,2	7,3	R96,2	R118,6

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⁵ Bonitas has 12 benefit options excluding LMS- including LMS there are 24 benefit options

⁶ LMS has since merged with Bonitas Medical Fund

14. Table 1 illustrates that there is a difference between what restricted and open medical schemes pay both in gross administration expenditure and fees paid to administrators. When looking at gross administration expenditure for the 10 largest restricted medical schemes, the inquiry did not find any significant benefits for economies of scale. Government Employees Medical Scheme (GEMS) is by far the largest but has higher administration expenditure than South African Police Service Medical Scheme (Polmed) and Sasolmed, as well as the self-administered medical schemes, SAMWUMED and Platinum Health. However, when looking at the gross administration expenditure as a percentage of gross contribution income, then GEMS's 5.4% is amongst the lowest.
15. When looking at the other administration and total fees restricted medical schemes pay to administrators, we again note that there does not appear to be any clear benefits of economies of scale for the larger medical schemes. The third and fourth largest restricted medical schemes, Bankmed and LA Health Medical Scheme (LA Health) receive administration services from the largest administrator, Discovery Health, and their fees are the second and third highest amongst the ten largest restricted medical schemes⁷. Only Profmed (the 8th largest) pays more in other administration fees than Bankmed and LA Health (in the 10 largest restricted medical schemes). Polmed, the second largest restricted medical scheme pays third party administrators the lowest of the ten largest medical schemes on a pabpm basis. Polmed recently changed administrators to the second largest administrator and the medical scheme may have used the tender process as an opportunity to negotiate low administration fees.
16. The inquiry also did not find clear signs of benefits from economies of scale in the gross administration expenditure pabpm of the ten largest open medical schemes. Of the ten largest open medical schemes, Momentum Health, the third largest, has the lowest gross administration expenditure of R105,4. Fedhealth Medical Scheme (Fedhealth) and Sizwe Medical Fund, the seventh and eighth largest have the highest total administration expenditure at R168 pabpm. DHMS, which is by far the largest open medical scheme has higher gross administration expenditure (at R132,7) than the next three largest open medical schemes. DHMS, is 4 times larger than Bonitas, 10.5 times larger than Momentum and 13,5 times larger than Bestmed⁸.

⁷ When looking at administration fees as a percentage of GCI, Bankmed is the 24th and LA Health the 43rd lowest of the restricted medical schemes.

⁸ Based on Council for Medical Scheme Annual Report 2016/2017 average beneficiaries

17. When looking at the other administration fees and total fees paid to an administration, on a pabpm basis, DHMS pays the second highest of all open and restricted medical schemes. Only the Chartered Accountants (SA) Medical Aid Fund (CAMAF) pays more. We have not assessed what these fees cover and if the higher fees are justifiable based on the services and innovations that Discovery Health provides. Discovery Health justifies the administration fees through the value metric study Deloitte undertakes on an annual basis⁹.
18. When looking at administration as a percentage of gross contribution income for the four largest open medical schemes relative to the rest of the 22 open medical schemes, Bestmed is the lowest at 6,6%, Bonitas is 4th lowest at 7,7%, DHMS is 6th lowest at 8% and Momentum Health is 11th lowest at 8,8%¹⁰.

4. Administration fees within an administrator

19. Given that the HMI has not been able to draw sound conclusions based on the quality and value for money medical schemes get from their respective administrators, the HMI looked at the difference in administration fees within the two largest administrators. This is based on the assumption that an administrator will offer similar quality service to all its medical schemes under administration. The HMI did not find any significant correlation between size of the medical scheme and the administration fees they pay within the two large administrators.

Discovery Health

20. Discovery Health is the largest administrator with 39,4% of the market (based on GCI). Discovery Health administers one open (DHMS) and 16 restricted medical schemes. As explained in Chapter 5 titled “Fundlers”, Discovery Health has been very successful in winning tenders over the last decade and has also not lost a medical scheme client. Discovery Health has a strong vertical relationship with DHMS and it is very unlikely that DHMS will switch administrators.
21. Discovery Health provides an integrated service of administration and managed care to its medical scheme clients. The inquiry assumes that the services it provides, for the most part, are consistent to all medical schemes. The inquiry found that three of the medical schemes’ administration fees were the same as their total fees paid to the administrator. This may either indicate that the medical scheme bought a bundle of managed care and the administration services and reported one figure to the CMS or

⁹ DHMS Competition Commission Submission 17 November 2014

¹⁰ Council for Medical Schemes Annual Report 2016/2017

they did not use any managed care or other services from DHMS. We will only discuss the total other administration fees below.

22. The HMI assumes that Discovery Health may provide additional services in the form of marketing and distribution for DHMS and LA Health. Furthermore, DHMS is likely to require additional actuarial and other services as it has significantly more benefit options at 22, compared to the next largest, Bankmed with 6. The rest of the medical schemes have four or less benefit options. The sizes of the medical schemes under administration vary significantly. DHMS, with 2 707 913 beneficiaries is 12.6 times larger than the next largest medical scheme, Bankmed and 18,3 times the size of the third largest, LA Health. The smallest medical scheme is University of the Witwatersrand, Johannesburg Staff Medical Aid (Wits Med) with 5 042 beneficiaries (Wits Med has since merged with DHMS).
23. The inquiry found that the largest medical scheme, DHMS paid the most at R171,0 in total fees paid to an administrator. This is significantly higher than the small medical scheme, Naspers Medical Fund that paid the second highest of R149,4 pabpm. BMW Employees Medical Aid Society is more or less the same size as Anglovaal Group Medical Scheme (Anglovaal) and they both have one benefit option, however, BMW Employees Medical Aid Society only paid R101,1 pabpm compared to Anglovaal's R142,5. Two small medical schemes, Tsogo Sun Group Medical Scheme and Glencore Medical Scheme pay the lowest fees to an administrator at R83,7 and R72,8 pabpm respectively. Glencore Medical Scheme moved to Discovery Health in July 2016. DHMS paid more than two times the amounts these small medical schemes paid.
24. LA Health who may require similar marketing and distribution services paid a total of R133,8 pabpm in total fees to Discovery Health. However, DHMS members pay substantially more administration fees than LA Health members even though DHMS is 18,3 times its size. This may underscore the point made earlier that DHMS lacks the buyer power that LA Health has.¹¹ Bankmed, which is the second largest and who recently moved to Discovery Health, paid R98,1 in administration fees pabpm. This lower administration fee may be a result of a competitive tender process.
25. When looking at the gross administration expenditure as a percent of contributions, the inquiry found that that three of the small restricted medical schemes within the

¹¹ LA Health's GAE as a % of GCI is 7,6% compared to DHMS's 8%

Discovery Health group were higher than DHMS and the rest lower. The lowest were Glencore Medical Scheme and BMW Employees Medical Aid Society at 4.7%.

26. Discovery Health states that the administration fees it charges its “open medical scheme client is well within the market range as DHMS is currently 17th lowest of the 23 open medical schemes when measured as a percentage of gross contribution income.”¹² Furthermore, Discovery Health has explained that its administration fees with DHMS has been constantly falling in real terms.¹³ It appears to the inquiry that Discovery Health is gradually, over a number of years, reducing its fees to more comparable levels. The fact that Discovery Health can afford to take several years to reduce its fees to more competitive levels underscores the observation that both DHMS and Discovery Health enjoy considerable market power in terms of the consumer, and in terms of the open medical scheme respectively in the Discovery stable.
27. The lower fees restricted medical schemes pay may, to some extent reveal the difference in administration fees determined in a competitive environment. Furthermore, the medical schemes switching to Discovery Health may benefit from the lower tariffs Discovery Health is able to get from the facilities. The lower amount that medical schemes pay in claims through Discovery Health negotiated tariffs may be more than sufficient to offset any higher administration fees they may pay.

Medscheme Holdings

28. Medscheme is the second largest administrator with 36,7% of the market share based on GCI. Medscheme had 15 medical schemes under administration during the reporting period, of which three are open and the remainder are restricted. ¹⁴The inquiry is of the view that the two remaining open medical schemes, Bonitas and Fedhealth are not as closely aligned to Medscheme as in the case of DHMS/ Discovery Health, however, it is still unlikely that either medical scheme can easily switch to another administrator. There has, however been movement of restricted medical schemes as Glencore Medical Scheme moved to Discovery Health and Polmed switched to Medscheme.

¹² Letter response to broker questions dated 27 February 2018.

¹³ Discovery Health Response to the Revised Statement of Issues: Competition Commission Market Inquiry into the Private Health Sector 22 March 2016 p 46

¹⁴ During this period, LMS (an open medical scheme) switched from V-Med Administrators to Medscheme and has since merged with Bonitas. Glencore Medical Scheme has also switched from Medscheme to Discovery Health

29. The HMI found that Fedhealth, the smaller of the two open medical scheme under Medscheme's administration, paid the third highest in total fees paid to an administrator of all medical schemes at R164,4 pabpm. Bonitas, which is 4.7 times the size of Fedhealth paid significantly less at R125,1pabpm. In this instance, while we do not make a finding on the actual rand amount, we would expect, if there were economies of scale, that the larger scheme should pay less than the smaller scheme. However, this does not hold true outside of Medscheme as Bonitas pays significantly lower than DHMS.
30. The inquiry found that four of Medscheme's restricted medical schemes pay more than the open medical scheme, Bonitas, even though Bonitas has significantly more benefit options and may require additional services as described above. Of the restricted medical schemes, Old Mutual Staff Medical Aid Fund pays the most at R35,4pabpm Polmed, who only recently changed administrators, pays the least at R61 pabpm. This low amount could reflect the outcome of a competitive tender process¹⁵.
31. When looking at gross administration expenditure as a percentage of gross contribution, the inquiry found that Horizon Medical Scheme, Old Mutual Staff Medilca Aid Fund and Fedhealth are higher than Bonitas.

5. Small medical schemes contracting with large administrators

32. Next the HMI considered whether small medical schemes benefit through lower administration fees by contracting with large administrators. When looking at the 20 smallest medical schemes, we found a wide range in total fees paid to administrators. The figures ranged from Fishing Industry Medical Scheme (Fishmed) (the sixth smallest) who paid R31,3 pabpm to Metropolitan Health to Anglovaal Group Medical Scheme (Anglovaal) the 17th smallest who paid the highest in this grouping of 111,8 pabpm to Discovery Health. We also found a number of smaller administrators within this grouping including Providence Healthcare Risk Managers (Pty) Ltd, Universal Healthcare Administrators (Pty) Ltd and Sweidan and Company (Pty) Ltd whose medical schemes administration fees fall within this range.

It is therefore not possible to conclude that smaller medical schemes that contract with larger administrators benefit from economies of scale of the larger administrator through lower administration fees. However, again this analysis does not take into account the full range of services the medical scheme receives from the administrator

¹⁵ The HMI does not include GEMS here as it only contracts for some of its services from Medscheme

6. Conclusion on administration fees

33. By merely assessing the size of the medical scheme and administrator, the HMI found that there do not appear to be any benefits of economies of scale passed onto the members in the form of lower administration fees. The HMI is not in the position to assess the difference of quality and extent of the service either between administrators or from a single administrator to its medical schemes. The trustees of the medical schemes must be of the view that they get value for money from their administrator. If they are of the view that they do not receive value for money, then they should go out to tender to compare administrators.
34. The restricted medical scheme market's administration fees appear to be determined on a competitive basis through the tender process. However, where the medical scheme is unable to go to tender, as is the case for many open medical schemes, then the administrator is under less pressure to pass on any benefits of economies of scale through lower administration fees.
35. The HMI has found that Discovery Health has been successful in winning tenders for restricted medical schemes. This may have less to do with the administration fees and all the services it provides, but more to do with the outcomes of the tariff negotiations. Given that healthcare costs make up around 90% of membership contributions, any savings a medical scheme can through the tariff process will outweigh the administration premium.