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Zero-based budgeting for health plans: Dealing with uncertainty ahead

Zero-based budgeting may be the right recipe to deal with the cost control and flexibility needed in next year's budgets.

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COVID-19 has been linked to dramatic shifts in demand and extreme uncertainty within payer functions, which in turn could lead to bloated administrative spending in 2021. Executives seeking to right size and create variability in their budgets may want to consider a tried-and-true formula that has not gained traction in the healthcare world: zero-based budgeting.

The upcoming budget cycle, due to start or in the works with many payers this month, is likely to be particularly challenging. Chief financial officers potentially have less information on which to base their budgets due to shifts in "drivers of work," which are the units of demand on payer functions. This shift is a problem created by the COVID-19 crisis. For example, ambulatory claims have dropped (and since risen) significantly, and the volatility in claims and call volumes may continue through 2021.[1]

Similarly, demand on risk adjustment functions has changed as member and provider engagement adapt to the next normal. As we discussed in "Telehealth: A quarter-trillion-dollar post-COVID-19 reality," the use of telehealth has accelerated, with providers seeing between 50 and 175 times the number of patients via telehealth as before the pandemic.

At the same time, more members may lose their Commercial health insurance offered through their employer due to the recent economic downturn[2] and instead search for an Individual plan, or seek Medicaid eligibility.[3] If the economy rebounds in specific geographies, membership shift may end up being bidirectional, which could further add to swings and unpredictability in drivers of work volumes. These potential extreme shifts could be accompanied by significant complications in completing necessary work. Like many employers, payers are trying to optimize working-from-home models, while load-balancing a workforce that needs to respond to a geographically staggered crisis.[4]

As top executives know, all this uncertainty may result in budget "buffering": increasing budgets to be able to respond to any potential scenario (Exhibit 1). Claims shops, member enrollment or service centers, call centers, and corporate functions may add significant padding to budgets to deal with the possibility of further membership shifts and utilization swings.

Buffering may lead to oversized 2021 budgets. Customers may face budgetary pressures as the economy recovers, potentially adding to health plan pricing pressure. Furthermore, potentially oversized administrative budgets could build on an already substantial base built up in years of economic expansion. Over the last five years, administrative costs have outpaced revenue growth by, on average, 1.5 percentage points across Medicare, Medicaid, and Commercial Small and Large groups (Exhibit 2). Across payers in the United States, this has introduced more than $300 million in additional administrative costs every single year.[5]

To prepare for the potentially challenging year ahead, and to deal with potential unpredictable shifts in drivers of work, payers may consider starting with a clean sheet and creating variability in their budgets. This balance may be achieved with a methodology that is less familiar to the healthcare industry: zero-based budgeting.

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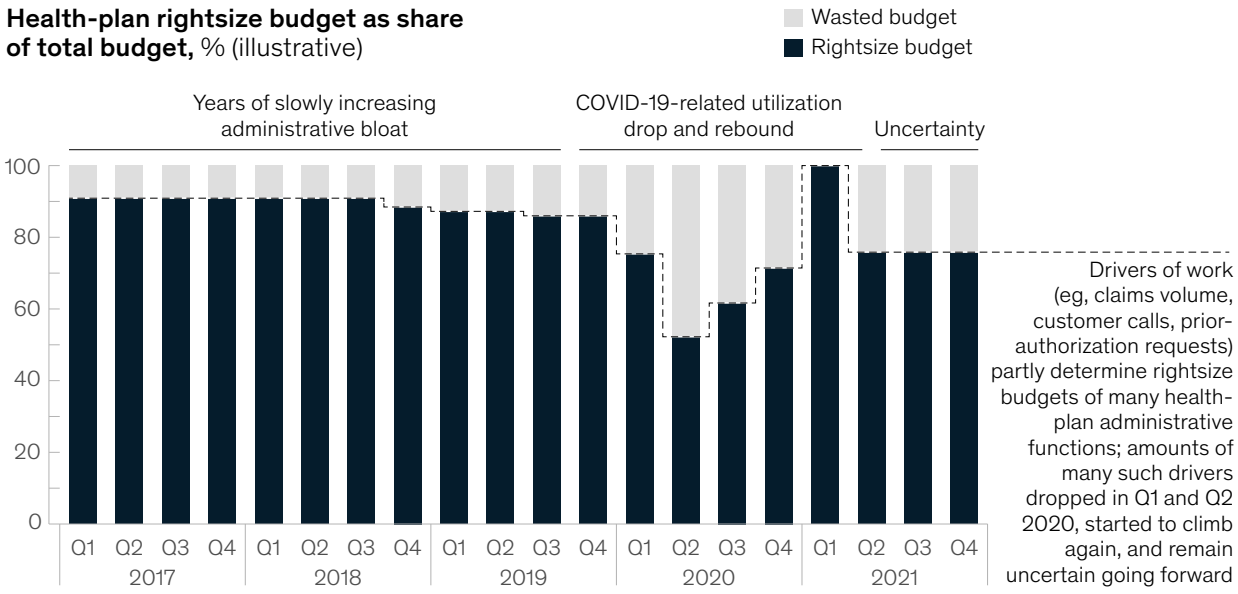
[1] Mehrotra A et al., "The impact of the COVID-19 pandemic on outpatient visits: A rebound emerges," The Commonwealth Fund, May 19, 2020, commonwealthfund.org.
[2] Banthin J et al., "Changes in health insurance coverage due to the COVID-19 recession: Preliminary estimates using microsimulation," Robert Wood Johnson Foundation, July 13, 2020, rwjf.org.
[3] Kaiser Health News, "Number Of Medicaid enrollees jumps; help may be on way for 'dual-eligibles,'" KHN Morning Briefing, June 16, 2020, khn.org.
[4] Livingston S, "Highmark Health sends 8,000 employees to work from home amid COVID-19 pandemic," *Modern Healthcare*, March 16, 2020, modernhealthcare.com.
[5] McKinsey Payor Financial Database analysis.

Exhibit 1

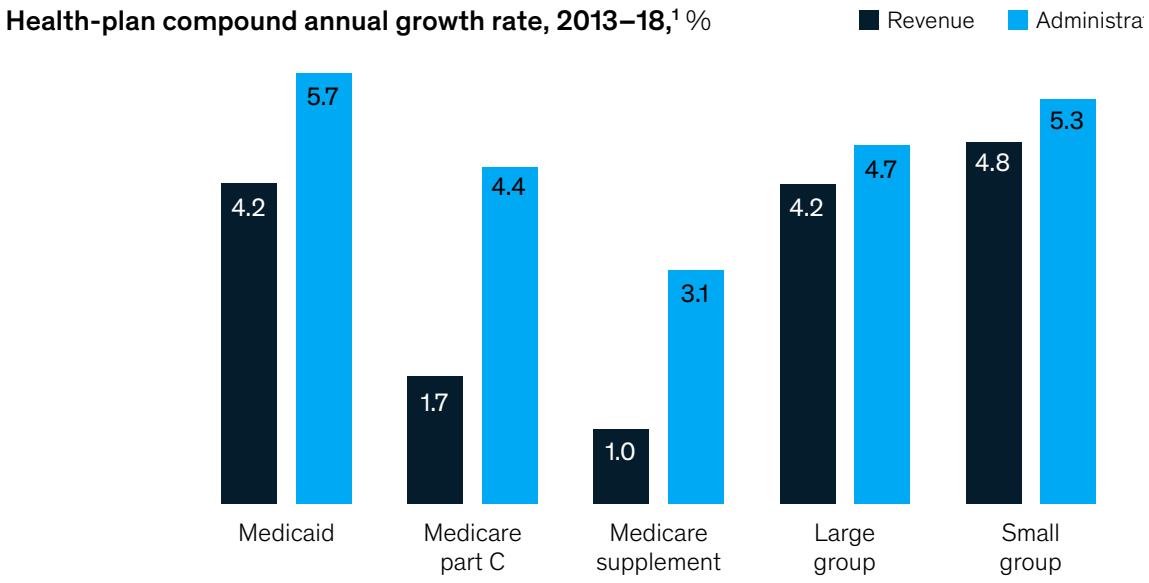
Administrative bloat, pandemic-related shifts, and uncertainty mean that 2021 budets for health plans may include a substantial amount of buffering.



Source: Centers for Medicare & Medicaid Services; SNL Financial; US state websites

Exhibit 2

Health-plan administrative costs have outpaced revenue growth.



[1]Based on per-member, per-month financial data.
[2]Because of reporting standards, administrative costs include taxes, licenses, and fees, excluding federal taxes.
Source: Centers for Medicare & Medicaid Services; SNL Financial; US state websites

Zero-based budgeting has gained traction in consumer goods

Zero-based budgeting, originating in the consumer goods industry, incorporates the simple notion that next year's budget should not just be "this year's budget plus two percent." Instead, the approach is to start with a blank page. Starting from scratch, stakeholders address how much work needs to be done in the next year, and what is required to do that work.[6] Although healthcare is different from the consumer goods industry, the zero-based budgeting process may still offer merit.

The zero-based budgeting process encourages budget owners to ground their projection in "drivers" of work. An example of a driver might be the number of claims likely to be processed next year—itself driven by membership and utilization shifts.[7] One of the potential benefits of a budget that links its funding needs to membership-shift assumptions or claims-volume assumptions is that those assumptions can be challenged, or refined, as the year progresses. That refinement may be particularly helpful in the volatile COVID-19 era.

A zero-based budgeting effort would start with a detailed view of drivers of work (Exhibits 3a and 3b). Although many components of payer operations are primarily driver based, some are less so—such as the product strategy function.

6 Böhm W, "Zero-based budgeting gets a second look," January 3, 2019, McKinsey.com.
7 Ibid.

Exhibit 3a

A zero-based budget approach may be suitable for driver-based components of payer operations.

Payer-operation value chain

● Primarily driver based ◉ Partially driver based ○ Primarily not driver based

Business strategy	Product strategy	Sales and marketing	Enrollment and billing	Network and contracting	Claims
○ Business strategy and planning	○ Actuarial work and pricing	● Sales and marketing analytics	● Enrollment	○ Provider strategy	● Claims intake
	● Rating and underwriting	● Sales-account management	● ID card	● Provider contracting	● Claims processing
	● Risk adjustment	● Broker management	● Billing	● Provider credentialing	● Claims payment
	○ Product development	● Broker communications	● After enrollment	○ Provider relations	● Claims audit and reporting
		○ Advertising, media, and PR	● Payment processing	○ Provider portal	● Payment integrity
		○ Charitable contributions	● Specialty enrollment and billing	○ Specialty contracting	○ Specialty operations
		○ Other sales and marketing		○ Other network activities	○ Third-party operations
					○ Cost sharing and provider-to-payer fees

Exhibit 3b

A zero-based budget approach may be suitable for driver-based components of payer operations.

Payer-operation value chain

● Primarily driver based ◉ Partially driver based ○ Primarily not driver based

Medical management

- ○ Medical-management policies
- ● Precertification
- ● Utilization management
- ● Medical review
- ● Case and care management
- ● Disease management
- ● Behavioral health
- ○ Quality management and accreditation
- ○ Pharmacy and ancillary

Customer service

- ● Correspondence
- ● Appeals and grievances
- ● Contact center (member)
- ● Contact center (provider)
- ○ Specialty operations
- ○ Member experience
- ○ General support and other customer service

Insights and analytics

- ○ Medical-management analytics
- ○ Specialty and other analytics
- ○ Reporting and other data functions

Corporate functions

- ◉ Finance
- ◉ Procurement and vendor management
- ◉ Project management
- ○ Compliance and audit
- ◉ HR
- ○ Legal
- ○ Facilities and real-estate management
- ○ Government affairs
- ○ Executive spending

IT

- ○ Enterprise architecture
- ○ Infrastructure operations
- ◉ Application acquisition and development
- ○ Amortization of applications
- ◉ Application maintenance
- ○ IT security
- ◉ IT management and other IT spending

A potential three-phased approach to a zero-based budget

Payers might consider a three-phased approach to zero-based budgeting (Exhibit 4), starting with an initial diagnostic and preparation phase to understand which functions and sub-functions are sufficiently driver based to be included in the zero-based budgeting effort, followed by a detailed mapping of general ledger data to the driver-based taxonomy.

The first phase would include building up a detailed understanding of how drivers of work, such as Medicaid inpatient (IP) claims volumes, link to resource and budget requirements in sub-functions, such as Claims intake. The next step would be to understand how different scenarios may affect those drivers. Using the same Medicaid IP claims example, this step involves understanding how the macroeconomic, epidemiological, and supply and demand scenarios (taken from the Strategy Department group) may affect membership shifts toward Medicaid. This step involves seeking to understand how IP claims may progress over time in different geographies. In this stage, stakeholders might also consider how other recent cost initiatives, such as digitization efforts, may have impacted the drivers for the sub-function.

Exhibit 4

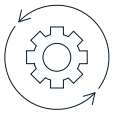
Health plans could use a three-phase approach to zero-based, 'variabilized' 2021 budgeting.

Diagnosis and preparation

- Map general-ledger data to driver-based taxonomy
- Compile detailed view of drivers of work mapped to taxonomy, with zero-based-budget templates linking drivers to budget outcome
- Project scenario-based COVID-19 impact on each set of drivers of work (eg, Medicaid in-patient-claims volume)
- Conduct zero-based-budgeting training for budget owners

Bottom-up budgeting

- Work with budget owners to construct zero-based budget
- Conduct CFO-sponsored "challenge sessions" to sharpen zero-based budgets
- Decide on trigger points based on drivers of work to increase or decrease budget in 2021
- Sign off on budgets through existing budget processes



Implementation

- Implement zero-based budgets across the organization
- Conduct biweekly challenge sessions, led by central zero-based-budget office, to monitor progress, unlock budget-control efforts, and approve trigger points

The final step in this phase would involve rolling out zero-based budgeting training to budget owners included in the process. This step is likely less daunting than it seems. Our experience has found it typically takes roughly three people from each sub-function to understand the zero-based budgeting methodology for the process to be successful.

The second phase is the bottom-up budgeting itself. In this phase, the budget owners would construct their 2021 budget from the ground up. They would start with the projected driver volume for their sub-function, and link this to full-time employees and other budgetary inputs. In CFO-sponsored "challenge sessions," this highly transparent budgeting construct may allow leaders to see which drivers of work create the largest budgetary need. It may also lead to constructive prioritization discussions. Linking the drivers back to the scenarios as built out in the first phase, budget owners could suggest "trigger points," linked to scenario outcomes, in which their budget is expanded or decreased based on certain events or thresholds before or in 2021.

Once the new, zero-based budgets are approved, the third phase would involve continuing periodic challenge sessions. This phase may create transparency as the budget cycle progresses, allowing leaders to assess the need for interventions or budget changes based on predefined trigger points.

Zero-based budgeting may create opportunities to reinvest for multiple reasons:

— ***Transparency:*** Zero-based budgeting creates a transparent link between drivers of work and budgetary outcome, which in turn may allow leadership to suggest deprioritization of certain work. This transparency may expose the need to address the volume of certain drivers (through levers such as digitization, outsourcing, process redesign). One example is claims intake: an outsized impact of claims error rates may lead to a discussion about additional automation options.

— ***Mind-set:*** The process encourages budget owners to ask "Do I really need this?" This question may reveal the portion of each budget that is not directly linked to drivers of work. In our claims intake example, the workforce not directly attributable to drivers of work may be reallocated to higher-impact roles within the Claims Department.

— ***Conditionality:*** Zero-based budgeting allows for in-year, predefined trigger-based increases or decreases of the budget. This refinement may enable budget owners to build in less of a buffer to deal with uncertainty. To conclude our Claims Department example, if the budget owners know that they may receive 10 percent more money for every 10 percent (unexpected) increase in membership, they may not have to build in a large buffer to deal with uncertainties, potentially creating savings.

Business leaders find that the transparency created by the methodology helps put budget owners in the driver's seat; encouraging them to switch from a reactive budget negotiation to one in which the budget owner is empowered to start anew, challenge the status quo, and interrogate any opportunities for improvement in their organization. In one recent case, a leading European (non-healthcare) insurance company completed a zero-based budgeting process. The organization identified substantial cost savings in the process, to the point that executive leadership has now started to run new acquisitions through rounds of zero-based budgeting to facilitate rapid understanding of the assets.[8]

Role of the zero-based budgeting team

The zero-based budgeting team, sponsored by the CFO, plays a critical role in these efforts. The zero-based budgeting team would work directly with budget owners and train them to create scenarios, map drivers of work, and create the new budget from zero. The zero-based budgeting team would also conduct periodic challenge sessions, both to right size the budget and to track progress against that budget in-year.

It is important that the zero-based budgeting team consists of broadly respected leaders with a deep understanding across the value chain. Active CFO support and engagement may also empower the zero-based budgeting team to challenge budget decisions and set appropriate trigger points for scenario-based variables.

2021 will likely be a challenging year. Administrative costs have outpaced revenue growth in recent years for many payer organizations (Exhibit 2), and many suspected this imbalance would need to be addressed in the future. Considering strategies to control administrative costs, while allowing for variability to deal with uncertainty in the months ahead, is likely to be one of the key ways payers can prepare. The savings generated and labor capacity freed up through this process can be redeployed towards higher-value activities in the "new normal," including, for example, intensified member and provider engagement.

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8 Böhm W, "Zero-based budgeting gets a second look," January 3, 2019, McKinsey.com.

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