

Retiree Drug Coverage under the MMA: Issues for Public Comment to Maximize Enhancement in Drug Coverage and Reductions in Drug Costs for Retirees

Discussion Paper: CMS Employer Open Door Forum

I. Summary:

The prescription drug benefit created by the Medicare Modernization Act (MMA) will provide increased resources to make prescription drugs more affordable to retirees. That is, we expect total support for retiree drug coverage will increase as existing employer and union contributions are augmented by new financial support from the Medicare retiree drug subsidy and the Medicare prescription drug benefit. On average, retirees will spend less – and many will spend significantly less – on prescription drug cost sharing and premiums than they otherwise would without the new law. CMS seeks a better understanding of how to achieve the maximum increase in support for retiree coverage, given the broad range of retiree benefit arrangements, employer contributions, and other factors that may affect how employers and unions will respond to the new drug assistance. CMS is presenting multiple options for employers and unions to offer enhanced drug coverage to retirees at a lower cost, consistent with the following policy goals:

- Maximize the number of retirees with employer-provided retiree drug coverage, and maximize the generosity of their coverage;
- Preclude “windfalls” (by assuring that plan sponsors contribute to retiree drug coverage at least as much as Medicare pays them as a subsidy);
- Minimize administrative burden while maximizing flexibility for employers and unions; and,
- Limit overall budgetary costs.

To best achieve these goals, we seek comments on our proposed regulations. In particular, we are interested in hearing what employers are likely to do under the various proposed options.

Employer-sponsored insurance has been an important source of drug coverage for many Medicare beneficiaries. However, for well over a decade, the availability and generosity of employer-sponsored retiree health coverage has been eroding, particularly for future retirees. We believe that Medicare Part D, including the retiree drug subsidy and the other options it gives employers for providing enhanced drug coverage, will help to counteract this trend by increasing the financial support available to employers for retiree drug coverage.

The CMS Office of the Actuary (OACT) reports there is considerable uncertainty associated with how employers and unions will react to the new Medicare drug benefit. This uncertainty has been compounded by the lack of information available before the release of our proposed rules. The additional information we are seeking from employers and their advisors should help reduce the uncertainty and facilitate the preparation of specific estimates of the extent to which employers and unions will take each of the available options.

As part of this effort, CMS also seeks comments on whether some retirees would have reduced drug costs if their employer ceases to provide retiree drug coverage. This appears possible in some retiree plans because, although offered by an employer, the retirees pay most or all of the plan premium themselves. From the standpoint of their estimated drug payments, such retirees may be better off purchasing a basic or an enhanced Medicare drug plan on their own, instead of continuing to receive drug coverage through their employer plan.

II. Choices Available to Employers and Unions

Employers and unions can choose between two broad options in offering additional retiree drug coverage: offering coverage that qualifies for the retiree drug subsidy, or enhancing the basic Medicare drug benefit.

1. Retiree Drug Subsidy

For retiree plans that offer coverage at least as generous as the standard Medicare prescription drug benefit, Medicare will make a tax-free payment to the plan sponsor. In 2006, this payment will equal to 28 percent of each retiree's allowable costs that fall between \$250 and \$5,000. (Employers with tax liabilities can continue to deduct the expenses for their retiree drug coverage, but the Medicare retiree drug subsidy payment is not subject to taxation.) Retirees subsidized in this way remain enrolled in their employer or union plan and would *not* join a Medicare Part D plan.¹ By remaining the primary insurer, each qualified employer or union plan retains complete flexibility in structuring its retiree benefits.

The CMS Office of the Actuary (OACT) estimates that Medicare payments for the retiree drug subsidy will average \$611 per beneficiary in 2006. In addition, employers with corporate tax liability will also benefit from the exclusion of this payment from taxable income. For employers with a marginal tax rate of 35%, the tax exclusion makes the Medicare payment equivalent to a taxable payment of \$940.

One important factor in determining employer use of the retiree drug subsidy is the actuarial equivalence test. Our proposed regulation described several alternatives for

¹ Retirees always retain the option of opting out of employer or union-sponsored coverage and joining Medicare Part D. Employers would not be eligible to receive the retiree drug subsidy for any beneficiary that chose to enroll in Part D.

defining actuarial equivalence. A key goal is that any acceptable option must meet the requirement of avoiding employer windfalls (i.e., all Medicare payments to plans providing retiree drug coverage are passed on to retirees). For example, we note in the proposed regulation that we have concerns about the option of using a gross value test. This so-called “one-prong” test would assess only the total value of the benefit package offered by the employer, which would need to be at least equal to that of the standard Part D benefit. Because the test would be without regard to financing, it appears possible for the employer/union plan to qualify for the retiree drug subsidy. We are concerned that this option does not preclude windfalls, and thus should be rejected, unless public comments indicate how assessing only the gross value of benefits in conjunction with other regulatory oversight would prevent windfalls. Another option is to use a so-called “two-prong” test, where an employer/union plan would qualify for the retiree drug subsidy if it met two criteria: (1) a gross value test and (2) a net value test where the value of plan benefits financed by the employer/union would have to equal or exceed a relevant threshold for government subsidies under Medicare Part D. Options described in our proposed regulation for the net value test include comparing the net value of the employer drug coverage to: (1) the average value of the retiree drug subsidy (estimated to be \$611 in 2006), (2) an amount more closely related to the net value of the standard Medicare drug benefit, or (3) the average value of the standard Part D benefit for a beneficiary with generous wraparound drug coverage. These alternatives may have different implications for employer choices about using the retiree drug subsidy or providing access to enhanced drug coverage that supplements the basic Medicare benefit through mechanisms described below. For example, the “one prong test” may create burdens in administrative verification and oversight, and the “two prong test” may have different participation by employers and unions depending on the level of employer contribution required in the second “prong.”

We have already noted in and before our proposed regulation that we are not considering one preliminary option, which would set the second prong equal to the full value of the Medicare subsidy for an individual with any other drug coverage. This requirement is stricter than necessary to avoid a windfall and is likely to reduce the number of retirees who continue to receive their drug coverage primarily from their former employers or unions. Due to the uncertainty about the behavior of employers and unions relative to the choices detailed in our new proposed regulations, we have not estimated the extent to which retirees whose employers or unions would no longer offer primary drug coverage would instead receive secondary drug coverage from their former employer or union, as outlined below.

Impact Estimates

According to OACT, the “gross benefit” test would be the easiest for employers and unions to meet. Under this option for implementing actuarial equivalency, OACT estimates that 8.6 million Medicare beneficiaries would continue to receive primary drug insurance in 2006 through their former employers’ retiree health plans. Another 2.8 million would no longer have employer-sponsored primary coverage and are assumed to

become covered under the standard Part D Medicare drug benefit. A significant share of these beneficiaries would likely continue to receive comprehensive, employer-subsidized benefits under the additional options described below, and others are likely to have significantly lower drug expenditures because they will begin to receive more subsidized Medicare coverage. As noted previously, we have not at this time estimated the share of the 2.8 million beneficiaries who would continue to receive employer/union sponsored retiree drug benefits because their employer or union plan chooses to offer secondary coverage. And some retirees will be better off financially by participating in Part D plans, compared to staying in retiree drug plans where employers pay little, if any, of the costs.

For the option of setting the actuarial equivalency standard's net value test threshold at the level of the expected value of the Medicare retiree drug subsidy payment (currently estimated at \$611 for 2006, which is the level necessary to avoid windfalls), OACT estimates that 8.2 million Medicare beneficiaries would continue to receive primary drug insurance in 2006 through their former employers' or union's retiree health plans. Another 3.2 million would no longer have employer or union-sponsored primary coverage and are assumed to become covered under the Part D Medicare drug benefit. As noted previously, we have not at this time estimated the share of the 3.2 million beneficiaries who would continue to receive employer/union sponsored retiree drug benefits where their employer or union plan chooses to offer generous secondary (or supplemental) coverage. And as we discuss below, there are retirees who will be better off financially by participating in Part D plans (rather than staying in retiree drug plans where employers pay little, if any, of the costs).

2. Enhanced Benefits Through Medicare Part D Plans

Retirees can enroll in a Medicare Part D plan *and* still receive enhanced retiree drug coverage with assistance from their employer or union. Under these approaches – where the Medicare benefit is “primary” and the retiree coverage is “secondary” – employer or union costs are reduced *dollar-for-dollar* by the amount Medicare subsidizes Part D plans. Employers and unions can use these savings to:

- a) “Wrap around” Medicare (by offering supplemental benefits or coordinating coverage, as they commonly do for physician and hospital insurance);
- b) Contract with a Medicare Part D plan to offer enhanced benefits *only* to that employer or union's retirees (this is equivalent to offering a “fully insured” benefit); or
- c) Become a Medicare Part D plan offering enhanced benefits only to that employer or union's retirees (this is the equivalent to offering a “self-insured” benefit).

For each of these alternatives, employers or unions can choose between “stand alone” prescription drug plans (PDPs) or Medicare Advantage plans (including not just HMOs but also the new PPO option created by the law), including plans that offer special enhanced options exclusively for a particular employer or union.

OACT has not estimated the number of retirees retaining employer or union coverage where employer/union drug coverage is secondary (because the beneficiaries are enrolled in a Medicare Part D plan). Anecdotal evidence available to OACT before the release of the proposed regulations suggested that the majority of such beneficiaries would probably not receive drug benefit supplementation through their employer or union. One reason, as noted below, is that some retirees are in plans where employers or unions make no contribution to the costs of drug coverage. Such employers or unions are unlikely to make contributions to “wraparound” Medicare. These retirees could be better off financially by replacing their current, unsubsidized retiree coverage with the new subsidized Medicare drug coverage. As noted previously, however, one of the goals of this paper is to obtain more information on the intentions of retiree plan sponsors now that they have additional facts about the new Medicare drug benefit. OACT is continuing to investigate the likelihood of each possibility and hopes to be able to make more specific estimates in the future.

The uncertainty surrounding the OACT preliminary estimates of employer and union behavior is highlighted by another element of the OACT cost estimate. There are strong financial reasons to believe that the wraparound option will prove attractive to employer and unions, particularly public sector employers exempt from taxation. While the estimated value of the retiree drug subsidy is \$611 for sufficiently generous retiree drug coverage (before considering the tax implications), the savings to employers and unions in the wraparound option will average about \$900 per beneficiary in 2006. In other words, employers can offer comprehensive drug coverage by “wrapping around” (or supplementing) Medicare benefits for \$900 less than it would cost to do so without the new law. As noted in the proposed rule, CMS estimates that at least 60 percent of individuals receiving retiree drug coverage have plan sponsors that are exempt from Federal income tax (such as state or local governments or non-profit corporations). Thus for many plan sponsors, the Federal support associated with having Medicare become the primary insurer with employers offering wraparound benefits could be up to almost \$300 larger than the value of the retiree drug subsidy. Wrapping around the standard Medicare drug benefit may also be attractive in that it is more similar to how employers already augment Part A and Part B Medicare coverage. We seek comments to assist us in refining these estimates and thus in determining the most effective approaches to allowing all types of employers, unions and retirees to reduce their drug costs.

III. Factors Affecting Employer and Union Choices

CMS is committed to engaging retirees, employers, unions, state and local governments, insurance companies, pharmacy benefit managers, benefit consultants, and consulting actuaries in a constructive dialogue to maximize the value and flexibility of the multiple options for enhancing retiree drug coverage, while minimizing restrictions and burdens consistent with the MMA. One absolute policy requirement is that we will not permit windfalls.

Many factors will influence the responses of employers and unions to the new Medicare assistance for retiree drug coverage. As noted above, one critical decision is whether plan sponsors want to remain the primary insurer and receive the retiree drug subsidy, or become a secondary payor (by wrapping around Medicare coverage, with Medicare as the primary insurer). Either way, the actual benefits received by retirees can remain unchanged at a substantially lower cost to the employer. Because either approach can be implemented so that beneficiaries can't tell the difference, employers and unions can continue to offer comprehensive coverage using the most financially advantageous approach.

The attractiveness of available alternatives will determine which option is selected, the degree to which employers and unions continue to provide retiree drug coverage, and the extent to which retirees benefit from their employer/union's action. Relevant considerations include how much financial support each option would provide to plan sponsors and retirees, the current contributions of employers and unions to their retiree coverage, whether retirees can save money by switching to the Medicare drug benefit, the extent to which new restrictions or other burdens would be imposed under various options, and the timely availability of product offerings (whether on a fully-insured or self-insured basis).

Regardless of whether employers choose to remain the primary insurer or become a secondary insurer for prescription drugs, Medicare Part D provides financial support that makes retiree drug coverage much more affordable. The amount of financial support available under each option will vary depending in part on the characteristics of each employer and their retiree population. As mentioned previously, OACT has estimated that retiree drug subsidy payments will average about \$611 per retiree in 2006. For employers with tax liabilities, the tax-free nature of the retiree subsidy increases its value. For example, a tax free subsidy of \$611 would be equivalent to a taxable payment of \$815 for an employer with a 25 percent marginal tax rate and \$940 for an employer with a 35 percent marginal tax rate. In comparison, if an employer chooses to become a secondary insurer offering wraparound coverage, the indirect subsidy to employers is estimated to average about \$900 per retiree in 2006. Thus, for some plan sponsors, the Federal support associated with having Medicare become the primary insurer could be larger than the retiree drug subsidy. For others, the level of support under the two options may be more comparable.

Employers currently contribute widely varying amounts to their retiree drug coverage. This will also likely affect how they view the options to offer primary or secondary drug coverage. In particular, because of the windfall prohibition, employers will not qualify for the retiree drug subsidy unless they pass on the full amount of the subsidy to beneficiaries. As shown in the table below, many large employers pay a very large share of the premium for retiree health insurance and would have little difficulty qualifying for the retiree drug subsidy, while other employers make little or no contribution. Employers that make a relatively small contribution to retiree health insurance may not qualify for the retiree drug subsidy. Especially for these employers, it may be easier to provide secondary drug coverage that wraps around Medicare Part D. Finally, in certain cases,

the employer contribution may be so small that beneficiaries may be better off financially if employers cease providing coverage and the retirees purchase Medicare Part D on their own, since that coverage includes a 75 percent government subsidy. In particular, as the table below shows, about 20 percent of large employers offering retiree health coverage make no financial contribution to their retiree health plan at all. If retirees in these plans simply stopped receiving drug coverage through these plans and obtained Medicare Part D coverage instead, they would save at least \$900 in actuarial value compared to what they are paying now – that is, they would be substantially better off financially. We seek comments on how best to assist these beneficiaries with lowering their drug costs, recognizing that in some cases they may prefer to have drug coverage that can be integrated with their plans’ other supplemental medical benefits.

| Distribution of Employers (firms with 1,000 or more employees) by Share of Premium Paid by Employer | |
|--|-----|
| 0% of Premium | 21% |
| 1-39% of Premium | 5% |
| 40-59% of Premium | 18% |
| 60-79% of Premium | 22% |
| 80-99% of Premium | 23% |
| 100% of Premium | 11% |

Source: Kaiser/Hewitt 2003 Survey on Retiree Health Benefits, January 2004. Data for private sector firms with 1,000 or more employees offering health benefits to retirees age 65 and older

Finally, employer and union responses depend on the ability of Medicare to support the provision of enhanced coverage that reflects the particular circumstances of their existing coverage and their retirees. There are a number of steps that CMS might take to reduce administrative burden and promote flexibility for employers and unions to achieve our shared goals. For example, it is essential that CMS facilitates making reliable Medicare-approved products available in a timely manner, so employers have time to decide how best they can provide enhanced retiree drug benefits..

Using Waiver Authority to Maximize Retiree Drug Coverage

Flexibility in the design of high-quality coverage is also likely to influence employer decisions. As noted in the preamble of the proposed rule, CMS intends to use its broad waiver authority to facilitate employers and unions offering retirees their current high-quality drug benefits under these options. We specifically seek comments on waivers that would help support enhanced retiree drug coverage by reflecting the circumstances of particular existing retirement plans.

One example of a possible CMS waiver policy would allow insurers to offer retiree drug coverage (coordinated with Medicare) anywhere in the nation. This would involve:

- Participating as a Medicare PDP in at least one region of the country and having a nationwide pharmacy network;
- Having a nationwide pharmacy network; and
- Obtaining an enrollment waiver that allows the PDP to serve just the employer or union’s retiree group, and to serve them nationally.

Such customized retiree coverage options – with Medicare primary and the employer or union plan secondary – are typical for employers’ supplemental offerings that fill in beneficiary cost sharing for Part A (hospitals) and Part B (physicians). The relative attractiveness of this option will directly influence the extent to which plan sponsors that do not use the retiree drug subsidy are able to augment Medicare Part D coverage.² OACT has not estimated the impact of potential waiver policies on retiree coverage enhancements, and we seek comments on how to use them to maximize coverage enhancements. By using our regulatory and waiver authority to facilitate the widespread availability of attractive secondary insurance options, we believe that many plan sponsors that choose not to apply for the retiree drug subsidy will offer enhanced retiree drug coverage as secondary payers, integrating their enhanced benefits with Medicare in a manner that is seamless from the standpoint of their retirees.

We also seek comments on the other considerations affecting the choices of employer and union plan sponsors that are not directly related to Medicare. Some of these potentially important influences include the existence of collectively bargained agreements, contribution strategies adopted by individual employer and union plan sponsors (including whether employer contributions are capped), plan sponsor preferences about remaining primary versus becoming secondary to Medicare, the profitability (and tax status) of companies, and labor market conditions.

Implications for Maximizing the Increase in Support of Drug Coverage for Retirees and Reductions in Retiree Drug Spending

The Medicare Part D coverage options outlined in the proposed regulation provide employers and unions with a variety of approaches for providing enhanced drug coverage for their retirees. One main goal of seeking public input involves how to use each of these options together to provide the greatest additional support possible for drug coverage for retirees.

Employers have the option of continuing to be the primary insurer for retiree drug coverage and receiving the Medicare retiree drug subsidy or providing enhanced or wraparound drug coverage that is secondary to the subsidized Medicare Part D benefit. We anticipate that most beneficiaries will continue to receive primary drug coverage from an employer that receives the Medicare retiree drug subsidy. In particular, OACT has estimated the number of retirees whose employer and union plans would choose to

² In a recent report, the Congressional Budget Office (CBO) commented that even for retirees whose employers dropped their retiree drug coverage, “CBO assumed that the affected retirees would enroll in a Medicare drug plan with their former employer potentially cashing them out or at least choosing to pay their Part D premium as a means of compensation.”

remain “primary” and take the retiree drug subsidy (instead of encouraging their retirees enroll in a Medicare Part D plan by providing “secondary” coverage) under preliminary versions of some of the options presented for defining actuarial equivalence to qualify for a retiree drug subsidy. This is not equivalent to estimating the number of beneficiaries who will continue to receive retiree drug coverage that is as good as or better than what they would receive without the new law. In particular, it does not take into account the various approaches for employers to “wrap around” Part D to provide generous retiree drug coverage at a lower cost. Moreover, evidence on the current generosity of employer coverage suggests that some retirees will be better off if their current retiree drug coverage (which may not be subsidized at all) is replaced by subsidized Medicare Part D coverage, regardless of whether or not they continued to receive additional employer drug coverage.

We also anticipate that many employers and unions will choose to enhance their retiree coverage by “wrapping around” Medicare Part D and taking advantage of the options available to employers for providing enhanced drug coverage. In all of these cases, financial support from Medicare Part D can augment contributions by employers, enabling them to provide a more generous and less costly drug benefit for retirees than is possible through employer support alone. Other beneficiaries may get new help from employer payments of their Part D premium, and other new employer payments made possible by the new Medicare subsidies. OACT has not estimated the number of retirees who will retain or enhance their drug coverage by having their employer-sponsored plans become secondary to Medicare, nor the number who will benefit financially from other employer responses, e.g., premium payments or other financial benefits offered by employers in conjunction with Part D coverage.

Finally, some employers that currently offer retiree group health insurance make little or no contribution to the cost of that coverage. Such employers will not qualify for the retiree drug subsidy, and their retirees could be better off financially if they enroll in Part D coverage rather than staying with their current, unsubsidized employer-sponsored drug coverage. It appears very likely that the Medicare subsidy for standard Part D coverage (about \$1,250 in 2006 for a beneficiary without supplemental coverage) will substantially reduce the total drug spending by this group of retirees if they stop receiving drug coverage through their employer and enroll in Medicare Part D. However, we have not yet developed precise estimates of how much these retirees would benefit from using the new alternatives to employer or union-sponsored retiree coverage, and we seek comments on how to best serve this group of retirees.

Taking all of these considerations together, we conclude that the implementation of Medicare Part D, including the retiree drug subsidy, will result in combined aggregate payments by employers and Medicare for drug coverage on behalf of retirees generally being greater—and frequently significantly greater—than they otherwise would have been without the enactment of the MMA. We are particularly interested in how we can maximize this enhanced support for retiree drug coverage, as this is a core objective for our implementation of the new drug benefit. While the overall support for retiree drug coverage will increase significantly under all of the approaches we are considering, we

are thus particularly interested in comments on how to achieve the biggest improvement in drug coverage and greatest reduction in drug costs for all beneficiaries with retiree drug coverage.