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EVALUATION OF BENEFIT PROGRAMS

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A consideration of how employers view their employee benefit programs:

- What are their costs?
- How are these costs measured and controlled?
- How are target cost levels established?
- What are the cost/benefit perceptions of employers?

MR. STUART F. RUBINSTEIN: Our panelists are Rick Dreyfuss, Manager of Executive Compensation and Benefit Analysis at Hershey Foods Corporation, and Andrew Wang, a consultant with Milliman and Robertson in Seattle.

Let's begin by asking the question, Which areas of benefit programs should employers be evaluating?

1. The level of benefits provided is certainly the most visible aspect of a benefit program and the primary determinant of the program's cost.

2. We are seeing a trend toward much closer examination of claim administration by employers. We are also seeing large differences in cost quoted to administer benefit programs between insurance companies and third-party administrators. The importance of administrative expertise for benefits where subjective judgment is required, such as long term disability (LTD), is critical.

3. In the area of funding, employers are beginning to realize that there is cost associated with transferring risk to an insurance company, and these employers are saving money by retaining all but catastrophic risks.

4. The best benefit program will be unappreciated and under utilized if it is not properly communicated to employees. Many of our clients are implementing medical care cost containment programs which require employees to obtain pre-certification of non-emergency hospital admissions or suffer financial penalties. These employers are developing an appreciation for the importance of benefit communication.

A process of benefit evaluation typically involves establishing objectives and relating the existing benefit programs to the objectives. General objectives for benefits which we have seen include:

1. Meeting the specific needs of the work force. For example, a dependent care benefit would be of a lot more interest to employees of a hospital who are 85% female and have an average age of 34 than to a union of electrical workers who are 98% male and have an average age of 48. The electrical workers would be much more interested in an AD&D benefit.

2. Protecting employees against catastrophic risks, including large medical expenses and interruption of income due to the inability to work.

3. Minimizing gaps and overlaps to the extent possible. We have seen employers who provided death benefits from as many as 6 or 7 different sources, including group term life insurance, AD&D, survivor income, the pension plan, the LTD plan, payroll deduction whole life insurance, and Social Security survivor's benefits.

4. We are certainly noticing a trend toward more benefit flexibility through offering employees choices with respect to their benefits.

5. The design of benefit programs is to some extent driven by tax laws. We generally recommend employers consider requiring employee contributions

for LTD plans, because the contributions will reduce the extent to which benefits received are taxed.

6. We have already mentioned the cost associated with transferring risk to an insurance company. In financing its benefit program the employer should retain a level of risk commensurate with the organization's overall risk philosophy.

7. Benefit objectives cannot be set in a vacuum. They are generally established with some regard to the level of benefits of organizations with which the employer must compete in the labor market.

Objectives which employers have considered for specific employee benefits are:

1. Death benefits, as a minimum, should provide for final expenses and replace income for a reasonable period of time. Because the need for death benefits varies so greatly among employees, employers will generally want to offer some flexibility to employees, such as voluntary employee-pay-all group term life insurance in multiples of annual earnings through payroll deduction.

2. In addition to the basic objective for medical benefits of protecting employees against the financial consequences of large medical bills, employers are modifying medical plans to encourage efficient utilization of the health care system. Most of the cost containment features with which we are familiar, such as managed health care, mandatory second surgical opinions, preadmission testing benefits, and financial penalties for inappropriate use of hospital emergency rooms, are an attempt to do this.

3. Disability benefits must satisfy the conflicting objectives of providing an adequate level of replacement income while maintaining sufficient financial incentive for the employee to go back to work. Efficient administration is especially important for long term disability. An administrator who is willing to deny a suspicious claim or help a claimant secure a Social Security disability award may be saving the plan hundreds of thousands of dollars.

4. For pension and capital accumulation plans, objectives might relate to the ratio of plan benefits plus Social Security to pre-retirement income adjusted to an after-tax basis. Most organizations sponsoring these plans will have objectives relating to rate of return on plan assets, perhaps benchmarked to some financial index.

Finally, many employers consider cost objectives to be the most important objectives for the benefit program. Appropriate cost objectives for employee benefits might be:

1. To maintain the annual increase in cost at a fixed rate, perhaps for medical benefits related to the increase in the medical care component of the Consumer Price Index (CPI).

2. To keep costs constant as a percentage of payroll. Certainly the funding method for a defined benefit pension plan is often selected with this objective in mind.

3. To maximize the cost effectiveness of the benefit program, where cost effectiveness is defined as the ratio of the perceived value of the benefit to the employee to the actual cost of the benefit to the employer. An example of a very cost-effective benefit is the voluntary employee-pay-all group term life insurance benefit, which we have already mentioned. This benefit costs the employer virtually nothing and yet is perceived to be of great value to those employees who need more insurance than the typical one or two times earnings provided by many employers. The least cost-effective benefit which comes to mind is post-retirement medical insurance. This benefit is very expensive to provide and and is totally unappreciated by most employees until a week or two before they retire. Considerations of cost effectiveness generally lead employers in the direction of flexible benefits. The perceived value of benefits to employees will be much higher if the employee has had input in determining the benefits which he receives.

MR. RICHARD C. DREYFUSS: Our marketing group at Hershey indicates that per capita consumption of chocolate currently stands at 12 pounds per individual

per year. This is up from 8.6 pounds in 1980 and 10 pounds in 1984 and is expected to increase significantly in the future. One almost wonders if this has actuarial implications.

Before I speak on the Hershey perspective of benefit programs, I'd like to spend a minute to give you an idea of what Hershey Foods Corporation is.

First, we are a major diversified international food company employing approximately 15,000 full-time employees with sales of approximately $2 billion. I suspect that puts us pretty much in the middle of the Fortune 500. By some standards we are relatively large. However, in comparison to the top 50 companies in categories such as pension assets, sales, and numbers of employees, we are a mere fraction of these larger giants.

Our largest division is the Hershey Chocolate Company, which is a significant force in the confectionary business. We are also in the pasta business, being the largest manufacturer of branded pasta in the U.S. We also own Friendly Ice Cream and some 750 restaurants in the Northeast and Midwest. In addition, we have some ventures in confectionary and food products in Europe, South America, and the Far East.

To begin the discussion of the issues at hand, Hershey is unique. This fact, while not necessarily profound, is certainly critical in our compensation and benefit planning. We have our own "culture," which admittedly is an overused word these days. The company was founded by Milton Hershey in the early 1900s after two business failures and the successful sale of his Lancaster Pennsylvania caramel factory for $1 million. He decided to locate in the middle of Pennsylvania close to the milk -- as in milk chocolate.

In discussing a perspective on benefits, it's appropriate to consider why we have a benefit program. We have a written benefit philosophy and a benefit policy, as most large corporations do. Like many policies, the language is often general and basically intended as a guide.

To quote directly: "As the company has grown and expanded into several different industries, benefit programs have become more diverse as to content and

cost, reflecting the differing competitive practices among our several Divisions. While recognizing the need to preserve Divisional flexibility to meet business goals, the Corporation nevertheless believes that all employees are entitled to certain basic benefit coverage, that some consistency in approach should exist throughout the Corporation, and that differences in benefit plans should exist for logical business reasons and should not impede employee transfers among Divisions."

I'd like to paraphrase this passage. Our benefits exist to enhance the compensation and overall remuneration program for our employees. Benefits exist to enhance the security of our programs such that in a simplistic sense, employees can devote more time to concentrating on their jobs. Finally, benefits exist in response to the corporation's obligations to improve the quality of life for each of us.

Benefit programs provide a tax-effective way of providing employees with the needed protection for themselves and their families, both now and in the future.

In considering plan design, if you were to thumb through our benefit booklets you'd find a typical mix of group insurance, pension, and capital accumulation programs. Our working definition of "benefits" equates to those programs falling into the three major categories of group insurance, pension, and capital accumulation plans. Clearly, the intent of these programs is to supplement the direct cash compensation portion of the total program.

From the employer's perspective, we attempt to position ourselves among a universe of approximately 16 food companies, and our specific philosophy is basically threefold:

1. The value derived from our benefit coverage in the aggregate will be at or above that of the average food industry.

2. Our benefit cost as a percentage of pay and per capita benefit costs should not exceed Chamber of Commerce survey statistics covering the food and beverage industry.

3. Since we view benefits as an extension of the compensation program, our long range goal is to have benefit costs increase at the same rate as compensation costs. Stated differently, we would like benefit costs as a percentage of compensation to be constant.

These are long-term measures and are meant as a guide, not as an absolute in measuring the cost effectiveness of our benefit program.

We are unionized at certain facilities, and this also has a bearing on a benefit program. Not to be overlooked is the corporation's ability to pay, as this is certainly the reality when it comes to benefit financing.

Obviously, all of these factors consider prudent plan design which addresses the long-term implications of our benefit programs. Like other companies, we are having difficulty in doing our planning because when one considers the vicissitudes of tax reform legislation and the potential impact that this could have on your benefit program in total.

Let me now briefly discuss our philosophies and views within specific segments of our benefit coverages. Many of the views expressed here are either personal or related to our "culture," so it is certainly not a matter of the Hershey way versus the wrong way. Stated differently, we do things because they work for us.

Generally, we feel employees should pay a reasonable portion of the cost of the benefit program in order that they may be better aware of the cost implications and the nature of their benefit programs.

In the Group Life area we provide all employees, all salaried employees, I should say, with one times pay with the option of purchasing additional life insurance at company-subsidized group rates. These rates vary by quinquennial age categories. There is also a selection of contributory dependent life insurance coverages.

The main purpose of life insurance is to help preserve the standard of living in the event of death during the employee's working lifetime. After

retirement, this amount is graduated down to 25% of the preretirement income level subject to a maximum of $25,000.

We have taken this somewhat conservative approach because we feel we would rather put these benefit dollars in the pension plan providing a living benefit. Excess life insurance merely fosters estate building, which is not consistent with the intent of our benefit program.

In the health insurance area we have experienced significant increases in annual costs in recent years. Our costs over the last 5 years have increased at a compounded rate of approximately 10%.

This rate of increase has clearly exceeded the Corporation's benefit cost strategies. Our preference, as referenced earlier, is for benefit costs to be a constant percentage of pay. In the health insurance area we are looking at various options to control costs by employing five strategies, involving plan design, alternate delivery systems, funding techniques, wellness, and finally communications.

Let me now share with you some of our experiences in this particular area. Hershey, Pennsylvania (which comprises approximately half of our work force, or roughly 7,000 employees), could be categorized as being somewhat rural. Our employees don't leave, and as expected, there exist many established doctor/patient relationships. As most of you know, health maintenance organizations (HMOs) are typically most effective in large urban areas. Consequently, we have not seen a profusion of HMOs in our area, although we have identified a couple that appear viable. We have attempted to identify viable HMOs using five established criteria:

1. Quality of management
2. Depth of service
3. Cost to the company
4. Geographic proximity
5. Intangibles, such as rapport with the employer

Our position is that we wish to have the employees pay the differential in cost between the HMO and the cost of the basic health care plan. It's been debated by many whether HMOs save money. My own belief is that, with HMOs as with any other businesses, some are effective while others fail. It really depends upon many factors, including the pricing of this product for your own employees. HMOs all probably cost about the same in the long run, and I am not aware of any conclusive evidence that indicates that HMOs do in fact save money. In regard to those who say HMOs do save money, I look at some of the HMOs that have gone out of business and wonder if the actual dollars saved companies have literally drained the surpluses from these former HMOs. Is that really a savings or merely a complex transfer program?

In addition, we try to set up preferred provider arrangements (PPOs). In the central Pennsylvania area, with the Blue Cross and Blue Shield plans enjoying tremendous differentials relative to commercial carriers, we view this as the largest and perhaps the most viable PPO in town. In fact, hoping to extend our savings beyond these contractual arrangements, we have with great difficulty obtained hospital-specific data for each of our major hospitals and adjusted the total cost by the average length of stay -- and further by the degree of intensity as identified by the Medicare index -- to come up with a severity adjusted average rate per day in five major categories, including maternity and psychiatric.

Armed with this information, we were successful in identifying the high cost providers and receiving an offer from each hospital to lower its cost $40 per day for Hershey Foods employees. We are very pleased with this, because we feel competition among and between providers is the only effective way of lowering the total cost of medical care. However, this strategy must be supplemented by reducing the incidence of claims through wellness, cost incentives, or plan design. We feel the issue of quality of care will then fall into place. In the area of plan design, personally I do not like dual option plans, that is, a high and low option, or comprehensive major medical plans. While they are certainly most effective in transferring the cost to employees, I really question whether they have a significant overall impact on the overall incidence of services; in fact, with some employee plan designs with very low stop losses, there appears to be the potential for overutilization. Perhaps

those of you in the audience who have particular expertise in this area could shed some light on this.

In the second category, retirement, our philosophy is that we attempt to replace between 50% and 70% of an employee's pre-retirement gross take-home pay after thirty years of service, including consideration for primary Social Security. The 70% applies to lower income levels and 50% to upper income levels.

We also have a 401(k) plan which is matched in Hershey common stock, as we intend to use this company-provided cost in this defined contribution plan to develop ultimately a three-legged stool composed of defined benefit, defined contribution, and Social Security in providing total retirement income. At this point, however, we have not worked out the precise details as to how we will consider the savings plan component.

Interestingly, our initial findings have indicated that most of our company's competitors employ final pay plans augmented by savings plans with approximately a 3% match. We have a career average plan with periodic past service updates and a 2.5% match in our savings plan, so we are competitive on a current basis. In talking with human resource individuals at other food companies, I think in many ways they wish they had the added degree of flexibility inherent in our career average program. I often wonder whether the costs of their total retirement program will finally grow to an unacceptable level. Although, if the stock market continues at its explosive rate, it is very unlikely this problem will occur in the near future.

Here again, I would be most interested in your perspectives on how your various clients view this particular issue.

Next, I would like to discuss briefly some of the challenges that we are facing in doing our planning. I would categorize these challenges in basically two major areas. First is the external area, in which we are facing myriad cumbersome regulations. It seems clear in looking at pension plans that they are literally cluttered with amendments. It used to be we could remember the first amendment to a plan being, for example, an increase in benefit level, and

the second being a merger of one plan into the other. However, now the tally is so long it reminds me of something out of Trivial Pursuit.

The end result of this is that the administration and communication of pension programs are severely hampered. And while all of us have learned on a theoretical basis that the administration of a plan should never dominate plan design, I think the textbooks may be rewritten after we have finished the upcoming round of legislation that has emerged and shows no signs of curtailing. I'll talk a little bit more about communications shortly.

A further challenge is to be competitive, and competitive means selling our candy bars to you at a fair price. This translates into being competitive in procurement, competitive in our production and transportation costs, and ultimately competitive in our people costs, including the cost of benefits and compensation.

Next, there is the challenge in the medical care area, which I referenced earlier. I see the next hurdle being significant changes in Medicare and the issue of retiree medical insurance, which, in addition to creating some large entries on the balance sheets of employers, will also create difficulties with respect to plan design. My own belief is that Medicare supplemental plans will soon be outlawed, and companies will be forced to provide their program as primary coverage.

Finally, there is the area of commitment. It seems with some of the recent legal rulings that a benefit program is becoming a contractual promise, and the commitment to employees is now solidifying morally, if not legally. Unfortunately, the outcome of this is that we may be forced to become very conservative in the design of our benefit programs. A benefit which was once considered safe and flexible is now by fiat permanent and unpredictable.

The second area, the internal challenges which we face, are those challenges unique to Hershey Foods. I mentioned our concern in the medical care area being that we would like our long-term increases to hover at approximately the 6% level without transferring excessive costs to our employees.

A situation which many companies have faced at one point or another is being in so many different businesses that you tend to focus on the various competitive segments -- i.e., the restaurant chains, the candy business, the pasta business -- and what the competitors provide in terms of benefits. Integrated within all this is an overall benefit policy which attempts to achieve a degree of coordination and continuity. Very often it's very difficult to determine which of the two factors is predominant. As a company, we would like to have enough flexibility in our plans to allow divisions to adjust their plans to the marketplace. However, this may impede internal transfers and the overall coordination of our benefit programs.

I mentioned communications earlier. This in one area in which Hershey, like many other companies, needs to devote more attention. It is always amazing how companies can spend millions of dollars on beautifully designed benefit programs, yet spend so little on communications. It's almost like not advertising the value of your product. Clearly, companies need to develop and devote themselves to strategies related to this particular area. I've heard many consultants come out with a figure of $25 per employee per year as not being an unreasonable amount to spend on communications. Quite often, the trouble is that corporations measure this cost relative to the returns to the bottom line. I certainly haven't encountered anyone who has come up with a mathematical model to determine the overall rate of return in this particular area. This, like many other intangibles such as training costs, is just very difficult to calculate.

Finally, a talk on benefits wouldn't be appropriate if we didn't talk a little bit about flexible benefits. We are currently reviewing flexible benefits, spending accounts, and all the nitty-gritty that goes along with those particular programs. Our belief is if a company is to adopt "flexible," "cafeteria," or "choice" -- whatever is your particular fancy for categorizing flexible benefits -- this concept has to be embodied in a company philosophy.

I have also heard of many major corporations (TRW, Honeywell, and American Can) that have put in premier flexible benefit programs. However, I often question whether flexible benefits are nothing more than a shell game to employees and

effectively disguise the fact that companies are attempting to shift benefit costs onto the shoulders of their employees.

This may not be a fair statement. However, this fact, compounded by some of the significant costs of maintaining a full flexible benefit program, seems insufficient to justify a complete overhaul, considering most companies' benefit programs inherently contain a significant degree of flexibility. Additional concerns involve anti-selection, and I need not go into that with this group any more than just to say that it is a factor to be considered. All this may explain why the large majority of companies do not have full-fledged cafeteria benefit programs. Nonetheless, we are analyzing whether flexible benefits fit and whether they are in the best interest of all in the long run. To provide maximum flexibility -- that is, to provide employees with a high degree of flexibility -- is not always consistent with a company philosophy, which in our particular case is somewhat paternalistic and exhibits a high degree of centralized control. This issue is further complicated by the competitive issues and the legal uncertainties faced by all companies.

Finally, my remarks would not be complete unless I said a few words about the consulting world. My thought here is to advise many of you that it appears that companies are becoming more and more Scrooge-like with their consulting budgets and certainly are scrutinizing the bottom line more and more. The need to have greater specialization and technical support in all areas is more acute now than ever with the growing complexity of issues that we are facing in the benefit area.

Like many other organizations, your product is service, and the ability to service your clients is ultimately your true test. Hershey uses many consulting firms based upon their degree of expertise contained within specific individuals who have good interpersonal skills in dealing with our senior management.

MR. ANDREW B. WANG: We know that the topic of our open forum is "Evaluation of Benefit Programs." Employee benefit programs include pension, group life, medical, dental, disability, employee assistance, etc. Although the evaluation of these benefit programs should be considered from a total benefit

program standpoint, the nature of these benefits often differs from one program to another. I would like to confine my remarks to the evaluation of employee benefit programs related to the health care area.

The evaluation of benefit programs should begin with an examination of the objectives of providing these benefits. Medical inflation has, over the past decade, outpaced the inflation rate as measured by the CPI, and there appears to be no end in sight to the increasing health care cost spiral. Although the general CPI has been lowered in the past year or so, the medical CPI still continues to be higher than the general CPI. This has led employers to really examine their objectives and therefore to redesign their employee medical benefit plans.

Talking about objectives, one of the primary objectives often stated in providing medical benefits to a larger extent is to protect employees against financial losses from large medical expenses at a reasonable cost. Traditionally, medical benefits have been provided through base plus supplemental major medical plans and comprehensive major medical plans. These benefits often include some deductible and coinsurance, and they are provided through insurance carriers or some form of self-insured programs. The deductible and coinsurance levels have often been left unchanged for many years.

As a measure to reduce the cost, at least from the employer's standpoint, we have observed a significant shift away from full first-dollar coverage. For example, more employers have been shifting from providing base benefits to comprehensive major medical benefits. Comprehensive major medical plans began to incorporate higher deductibles and coinsurance as employers finally recognized that the popular $100 deductible no longer makes economic sense. In determining the "appropriate" deductible and coinsurance levels, the employee's total out-of-pocket expense is also often evaluated. The questions arising are whether these expense levels are still reasonably in line with the objectives of providing medical benefit plans.

One question often asked by employers is how much cost reduction can really be achieved by increasing the deductible and coinsurance to a certain level. Of course, this is the employer's portion of the cost. Many employers often are

surprised by the limited cost reduction that can be achieved by increasing the deductible and coinsurance.

How do you actually evaluate the cost reductions that may result from the increased deductible and coinsurance? The typical approach is to use the claims probability distribution. This involves the incidence of claims and the average cost of claims. We have also seen employers using their own claims data to run through a claims processing process which shows how the cost is affected by paying at different deductible and coinsurance levels.

The increase in deductible and coinsurance would naturally result in reducing employee benefits and reducing the employer costs. The reduction in benefits may lead to dissatisfaction from the employees. Therefore, instead of increasing the deductible and coinsurance level, various cost containment features are incorporated into the existing benefit plan. There has also been an increased emphasis on the use of alternative delivery systems such as HMOs and PPOs. HMO enrollments have continued to increase rapidly.

A more recent development (actually not too recent) in the benefit design area is the offering of dual option programs. Typically the employee is offered a choice of a traditional form of medical benefit program with higher deductibles and coinsurance or the use of participating providers with lower deductibles and coinsurance. Negotiated reimbursement levels for the participating providers are lower than the community average charge levels. The design of the dual choice program stems from the fact that on one hand, the employer can reduce the premium cost by increasing the deductible and coinsurance on its traditional benefit program; on the other hand, original benefit levels can be maintained through the use of participating providers without increasing the cost of the benefit programs. The purpose of cost containment features in benefit programs and of participating in the HMOs or PPOs is to encourage a more efficient use of the health care system and therefore reduce the cost.

We already mentioned the cost. What are the costs, and how can you evaluate the cost associated with providing the medical benefit programs? We can visualize the total cost of the medical benefits as a box. Included in the box are the employer's portion and the employee's share. The evaluation of benefit

programs must consider not only the employer's cost, but also the employee's cost. The mere increase in plan deductible and coinsurance is really cost shifting, not cost reduction. Such a cost shifting may also be achieved by increasing the employee's portion of the premium without really changing the original benefit program. A real cost reduction to both employers and employees can only be achieved by reducing the total box.

This brings us back to the employer's philosophy and objectives in providing medical benefit programs. Due to the tax structure in our country and sometimes union bargaining agreements over the past decades, employers have been paying an increasing portion of the total cost. However, we have observed a shift away from employers' paying 100% of the cost. In other words, employees are picking up an increasing proportion of the cost, either through higher contribution to the premium or increases in deductible and coinsurance. A recent survey conducted by Equitable Life through Lou Harris seems to indicate acceptance by the majority of the public of sharing the costs of these medical benefit programs. The sharing of the cost would also make the employees more aware of the cost associated with these benefit programs and appears also to have the appeal of getting more appreciation from the employees of the value of the benefit programs.

How do you measure these costs? Medical plan costs are typically measured on a per employee basis. Often employers also like to look at the cost as a percentage of the total payroll. As I mentioned earlier, the medical inflation has, over the past decade, outpaced the general CPI. How do employers determine if the increase in cost from one year to another is really still reasonable?

The actual cost of the medical benefit can be determined as the sum of the products of the utilization and the average cost per service for different categories of services. Actual costs can also be analyzed based on some of the experience data. The experience can also be analyzed on a per certificate or per member basis. The experience data can then form a basis to evaluate the effectiveness and also the reasonableness in the use of the health care system, or be used to project the future costs.

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We have observed an increase in demand by employers for their own claims experience data, not in aggregate, but in detail. The availability of this detailed claims data would enable them to analyze the utilization and charge levels of their own experience. We have also seen employers requesting detailed claims tapes from administrators. The claims experience has been used to determine what areas of changes can be implemented in the benefits program to reduce the cost. We have been working with a large employer recently that requested detailed data. It has about 30,000 employees and runs a system to recalculate the benefit costs at various different deductible and coinsurance levels. It is considering various changes in the benefits program, and this is one way it can analyze how cost reductions can really be achieved. In such an evaluation the employer also looks at how much cost has been shifted to the employees.

What is still lacking is a yardstick that employers can use to measure their costs against -- in other words, to determine the reasonableness of the cost level. In the evaluation of the reasonableness of the cost level, employers have also been requesting the total experience of their administrator so they can compare their cost to other groups' costs. The one problem with this kind of comparison is that often one employer's geographic area may differ from another's, and the employer does not recognize the geographical difference in the cost. Also this comparison may not really take into account the utilization differences due to demographic differences.

The incorporation of cost containment features leads to the evaluation of the effectiveness of these programs. Does the implementation of these features reduce employer costs or merely reduce the benefits? I have seen employers gradually realizing that even though the cost containment feature can reduce part of the medical costs, often the implementation of these programs costs a great deal. So in evaluating the savings accomplished by cost containment features, one really should also look at how much cost is associated with implementing these programs.

In conclusion, the evaluation of benefit programs is a complex issue. Cost is very much on the employer's mind, but cost is not the only issue to be evaluated. The evaluation of benefit programs must balance between the cost

objectives to be achieved and the employer's philosophy in offering these benefit programs.

MR. J. MARTIN DICKLER: Mr. Dreyfuss, where would a group universal life insurance program fit in with Hershey's corporate philosophy?

MR. DREYFUSS: We're not too big on it, primarily because when we de-couple that arrangement and look at what makes it tick, we see a group term insurance plus a savings feature. We feel that our current benefit program has the best of both worlds. We currently have very favorable group rates, plus we do have a savings plan which enables an employee to set aside pre- or post-tax monies in order to accumulate for their specific objectives.

MS. DOROTHEA D. CARDAMONE: Mr. Dreyfuss, you said you negotiated savings with some of the hospitals in Pennsylvania. Could you elaborate on what you were doing and how you went about it?

MR. DREYFUSS: As I mentioned before, we looked at our hospital data and tried to determine the utilization, where the employees were going, and what the average cost per day was. But the trouble with this is that we had to look at intensity, as we have some hospitals that deal mainly with very acute conditions. We couldn't just look at that blindly, so we did the best we could and we used Medicare severity indices, sort of like a degree of difficulty which enabled us to normalize all of the hospital costs on a truer basis. Now it's not the most precise science, although we felt it was a very reasonable approach. I guess the hospitals did, too, since when we met with them and presented our data they indicated some of the misgivings that they had about the interpretation, but nonetheless they agreed their costs were higher relative to the norm, by about $40. With that in mind, they offered us a $40 per day discount for the first 10 days of inpatient admission.

MS. CARDAMONE: So you looked at all the hospitals?

MR. DREYFUSS: We looked at about 25 hospitals. From a practical standpoint 6 hospitals composed 90% of our total utilization.

MS. CARDAMONE: Mr. Wang, do we have any idea how many larger companies have actually incorporated cost containment features into their plans and what percentage of all plans is now using that kind of feature? Does anyone have statistics on that?

MR. WANG: I have not seen firm statistics on that. It seems to me over the last couple of years more and more companies, particularly larger employers, have incorporated some features. The cost of implementing and communicating to the employees is a very high cost area. For the smaller employers the dual option program seems to be more popular because that continues to be offered through the term insurance arrangement, and the insurance companies would provide communication advice for them.

MS. CARDAMONE: Do you think smaller employers are welcoming cost containment features?

MR. WANG: They do want them, but the question is how to incorporate them into their programs and at the same time communicate them very clearly to the employees. That's the kind of question they have in mind. If it's misunderstood it can cause a lot of employee dissatisfaction, and that is one of the major concerns in hesitating to implement this kind of program.

MS. CARDAMONE: Yes. I think we got into the cost containment area with a product for small employers and then found that they were not as happy as we thought they would be with this feature, and it takes a lot of education. I think there is growing acceptance of it, but the small employers need to hear from a lot of different angles what it can do for them.

MR. JOHN M. BERTKO: Mr. Wang, what's your response to some of the service bureaus that provide normative data in terms of looking at claims, such as MedStat and others? How would you stand up with the data they sometimes present?

Several of these services will go through and do just what you're saying: repay claims or analyze claims from a variety of points of view. Say company X's claims are compared with normative data in this way, and it has too many

maternity or too many mental and nervous conditions compared with everybody else in the files.

MR. WANG: One problem with using these services is that their data do not recognize the possible changes in the utilization pattern due to changes in the benefit program. This is one of the shortcomings. The advantage in using their information is that it is straightforward, and you can use the data fairly quickly.

MR. BERTKO: I think what my questions really boils down to is do you attach any degree of credibility to the data that these companies are manipulating and what the entries turn out to be?

MR. WANG: It depends on the size of the company. For example, the one I mentioned with over 30,000 employees, I can say that its data are fully credible. The company has looked at not just one years' experience but 3 years' experience and is looking at not just the aggregate but also separating the hospital utilization from outpatient utilization. Through the implementation of some of the programs over the years we have observed a reduction in the hospital utilization and at the same time a shift to the outpatient utilization, as we expected.

MS. LINDA K. STONE: Mr. Dreyfuss, have you looked at making any changes to your defined benefit plan such as the cash balance approach, since you are already at a career average type plan? And secondly, how do you plan to integrate your 401(k) plan into the total replacement ratio? At what point in time do you feel that's going to be a feasible approach?

MR. DREYFUSS: As far as the cash balance plan, we're looking at it. There are certain aspects of it that we find particularly attractive, although I think it's a little early to say whether we are going to adopt that. With regard to the second question as to how we will incorporate the defined contribution plan, that's also a difficult issue for us to handle, because one of our objectives, as I indicated, is to remain competitive. If the majority of employers are using final pay plans and in addition have defined contribution plans, and if we view that goal as our objective, then we try to change paths

by sort of merging the best of both worlds in defined contribution and defined benefit. You can't have both. So I think it would be somewhere down the road. In terms of how we would do that, we may use an accumulation and then convert it to an annuity, although I'm not convinced that's the fairest way to do it, because the price of Hershey stock has been doing very well, as have most other companies. If you make an annuity out of that you're really short-changing the employees, as far as I'm concerned. So down the road we intend to do it, it's just that our updates may be less frequent, or they may not be as rich as they were in the past. It's just too early to tell. With some of the tax legislation we may not even have a 401(k) to worry about, so the issue may become moot.

MR. JOHN DRISCOLL*: AT&T just put in a pre-certification program, and communications was indeed very important. I spent a lot of time on the print material and had orientation sessions throughout the country, and it appears to be going over quite well. I had a question about wellness in your communications program. Is this formalized yet, and if so, could you elaborate.

MR. DREYFUSS: The answer very simply is no. But I'd be happy to elaborate. Wellness gets into one of these soft dollar games. You try to have a proposal that wellness is desirable and have a proposal to spend $100,000 on a certain aspect, whether it be subsidizing employees' activities or building a health center or whatever. Everyone is trying to look at the rate of return as if he were investing this, which he really is. Maybe some of you out there have some hard data that I could take back to Hershey. But I think it's our general sentiment that healthier employees live longer. As far as the true implementation of that, we have had great difficulty getting resources, although we have a physical fitness facility located right in the building in which I work. It's always amazing to me how little usage it gets; maybe it's too convenient. We do have the stop smoking programs and things of that nature, such as "buckleup." As far as communications, here again we are trying to improve the quality and quantity of our communications to our employees. We are trying to adopt a philosophy that our communications cost will be some fraction of our total benefit costs. You can sort of build that into your planning year after

* Mr. Driscoll, not a member of the Society, is Division Manager, Benefits Administration of AT&T.

year, but we keep going back to the fact that Hershey, not unlike other companies, does scrutinize the bottom line. We are trying to get the right rate of return on the particular dollar of communications. So it is indeed one of our challenges. However, on a more positive note, we are having employee meetings this year, and that is in conjunction with a completely new communications program that we are unveiling shortly.

MR. PETER D. CRUTCHETT: Mr. Dreyfuss, if I heard you correctly I believe you said that most of your competitors have final pay pension plans, whereas yours is a career average plan, and yet you believe yours to be competitive. Unless my understanding of these plans is incorrect, for a career average plan to be competitive with a final pay plan from the employee's point of view, you're dependent on very low rates of inflation. Are you happy that this is a reasonable long-term assumption?

MR. DREYFUSS: Let me just say our career average plan is not a pure career average plan. It's one where we update past service at certain yearly intervals and assume that the employee earned that wage in the past. And we are comfortable with that. We feel it's the right think to help us manage our pension costs and very simply stated, we just think it's right for us.

MR. CRUTCHETT: Do your updates match inflation?

MR. DREYFUSS: I would say they do. They are pretty close to inflation. We're not terribly uncomfortable with that, because our compensation costs somewhat mirror inflation. If we can just make inflation our index, then that's not a bad objective to have, especially in days like this where inflation is very low.

MR. STANLEY H. TANNENBAUM: A thought occurs that maybe in approaching the topic of employee benefit programs we ought to look at this as a compensation issue, as opposed to a benefit issue. You cannot divorce the benefit issue from the compensation. What is the cost to the employer for compensation if it gives the employee all benefits and no salary? He has total health care and total retirement income and can't afford to live today. The employer could go the other way and give the employee nothing: give him the total check and

say it provides for all his needs. Is any study really being done to see what the compensation cost of the program is? And in particular we talk about cost containment. If an employer tells the employee it will pay 50% of his medical costs, clearly that costs the employer less than 100%, but if the employer made that promise to an employee, would the total cost of medical care go up or down? Would the employer in fact have a 50% cost if it only paid 50%? Would it have more than 50% of what it had before, or less? What happens to the intangibles, as you say, if you communicate a program? You can't put a price tag on communication, because how do you put a control group in? You tell half the employees of the program; you don't tell the other half, and see if their claims are different? What is the cost benefit? What is the value to the employer? How do you say what the value is to the employee who comes to work every day or one who doesn't come to work? Where is the price tag? How does it reflect the price of a bar of chocolate? Do you have to be competitive and say a bar of chocolate costs this much, therefore total compensation for an employee is this much? How do you go about it? Have any studies of that nature been done? Similarly, on health care, when you get statistics, are they based on the total cost of health care or total cost of health care benefit programs? The two are different. Has anybody done any study to see whether the cost of the program affects the cost of health care?

MR. DREYFUSS: As I mentioned, we try to look at compensation and benefits as a program, as a total package. We have extensive surveys in the compensation area to make sure that our wages and bonuses are competitive with the marketplace. Also, as I have mentioned, one of our objectives is to have our benefit coverage in the aggregate be at or near the average of the major food companies. But the question Stan raises is a good one and makes you think long and hard about what you are really spending these monies on and what you are getting in return for this. I really don't have the answer, Stan, to be honest with you. But I think it's a good question and one that certainly challenges us daily. I'm not aware, though of any conclusive evidence either way.

MR. GREGG L. SKALINDER: We're picking on Mr. Dreyfuss, but it's only because we're so fascinated by life in Hershey, Pennsylvania. If you do have a career average plan that you continue to update, there really is no long-term difference between that and the final average plan. I'm sure you know this,

and perhaps your financial people know that you are merely tinkering with the incidence of cost. The cost of the plan is the cost of the plan, and so on. How do you fit it in your 401(k) plan? We had a client in the food industry that converted a final average plan to a career average plan with the express intention of not updating the career average plan except as it will monitor the actual benefits that are being paid to recent retirees on a periodic basis and, if need be, take some action to meet retirement income goals for retirees.

My question relates to post-retirement benefits. You briefly covered the life benefit that reduces down to 25% of what it presumably was at retirement with a maximum of $25,000. I'd be very interested to hear what, if anything, Hershey has done in the medical area. Also, why do retirees need death benefit protection up to $25,000? A good number of our clients have taken the position that merely covering reasonable burial expenses is adequate. I'd be interested in what your thinking was in going into that level of benefit?

MR. DREYFUSS: Let me answer the life insurance question first. Based on certain statistics that we have seen in competition with the other food companies, we are at the lower end of the echelon. I see a lot of food companies that offer continuation of their active life insurance -- that is, one or two times earnings -- right into retirement. As we all know, you're just buying a death benefit; it's just a question of when. We like our formula. It is based on pay, 25% of pay, so we feel we have some control there. With regard to the medical plan, we have a Medicare supplemental plan. Medicare pays first and then we supplement. We don't supplement to the full extent of the Medicare deductibles. We pay $260, and I believe the Medicare deductible is $492. We update this periodically according to our ability to pay. Here again I am aware of a lot of companies that have a carve out plan. By that I mean they basically preserve the active life insurance or active medical insurance right into retirement. I think this is going to be a tough one for them when the costs and the accounting implications are really felt, because they won't be able to put the thing into reverse with regard to this contractual promise to retirees. So we have a plan which provides us a certain degree of control. The other point I made was, I'm not sure how long these Medicare supplemental arrangements are going to be allowed, because I think the government wants to get out of the Medicare business and transfer more of the costs on to the

employer. At that point I'm not sure what we're going to do; we'll have to regroup and think again.

MR. SKALINDER: As a detailed follow-up are you currently accounting for your post-retirement medical costs? Are you buying insurance for this certainty of post-retirement death benefit payment?

MR. DREYFUSS; No, we're not establishing any type of accrual. We are conforming to the disclosure requirement in the annual report to indicate what the total cost of life and medical is. But we have not done anything with respect to accruals or balance sheet entries. The death benefit is insured.

MR. SKALINDER: May I ask why, since it is a certainty of payment, and presumably the dollar amounts are not so large?

MR. DREYFUSS: I think we want to give the retiree a tax break because life insurance proceeds are not taxable.

MR. CHARLES CHITTENDEN: I wanted to respond to some of the questions that Stanley Tannenbaum raised. We have a sick pay plan: people who are sick (and you can be sick as many days as you like) don't get paid. It works the same for holidays and vacation. And since Gregg Skalinder had the flu a few years ago, we really have had a very low incidence of absence dues to health reasons. I think about .1% of the available days in the year have been taken as sick days. Also, I wanted to make a comment on wellness. If we have just one wellness program, I think we all realize that would be a stop smoking program. I think it's really useful for actuaries to try to point out the importance of that. People mention stop smoking clinics in the same breath as "buckle up for or safety," "go jogging," or whatever, but they're really not on the same order of magnitude. Smokers consume far more of the medical care costs than non-smokers. With the arrangements we have currently, we are encouraging smokers because we fund the plan the same for smokers as for non-smokers. Therefore, the non-smokers are paying the price. Also, disability and loss of productive time are much higher for smokers than for non-smokers. The only thing that's cheaper is the pension. I think we should begin to reflect these differences in our pricing and in our benefits.

MR. RUBINSTEIN: I certainly second Mr. Chittenden's comments about stop smoking programs. I know there's one insurance company that has separate group rates for smokers and non-smokers, and I've always wondered why there hasn't been a movement in this direction.

MR. CHRISTOPHER S. MOORE: Mr. Dreyfuss, you mentioned earlier that you had an objective of sharing the costs with the employees at Hershey and used the example of group life insurance -- one times earnings being paid by the employer and the optional coverage by the employees. Do you have any specific objectives for the sharing of costs between the company and the employees, and if so, how are they determined and communicated to the employees?

MR. DREYFUSS: Our specific objective is to subsidize 30%. Why 30%? It's just something we're comfortable with. We feel that's a reasonable price to pay. We communicate to employees the fact that the rates are subsidized. We don't get into a rigorous analysis with them, because in actuality we're paying the insurance company a single rate. So we made certain assumptions in order to insure that we were getting the proper subsidy. We charge employees rates based upon the five year age groups I mentioned earlier. We try to receive enough employee deductions such that the amount we receive from employees is subsidized 30% relative to the flat rate that we're paying the insurance company. We look at that every two years and adjust our rates accordingly if we see a wide variation in utilization of that particular benefit.

MR. DAVID LEVENE: An assumption was made that the total box, employer cost and employee cost, should be looked at. Cost shifting between one or the other may not be effective. Putting in higher deductibles may just be cost-shifting from the employer to the employee. Is there anyone on the panel who might feel a bit differently, that the total cost could be reduced since the employee may become a smarter shopper and may not overutilize certain benefits?

MR. WANG: I think I mentioned earlier that the introduction of the higher deductible and coinsurance would impact the utilization pattern to some extent. But, on the other hand, the increase in the deductible, if it does not really follow the pattern of the CPI, does not really have that significant an impact.

The impact may be that if you increase the deductible from $100 to $250 then after a couple of visits to the doctor's office plus some prescription drugs, your deductible has already been met. The $100 deductible may be just one visit plus some drugs. In that sense, it does not really impact the utilization pattern that much. But it does. The fact that you are reducing the benefit to the employee, whether it's really necessary for the employee to have the care or not, is what I'm talking about. And to reduce the loss, if you can negotiate with the provider and reduce the amount you have to pay, is the real reduction in the loss.

MR. GREGORY TODD SWIM: I'd like to point out to everybody something I think we're all aware of but may have forgotten. If you look back historically from 1950 to 1984, health care expenditures as a percentage of GNP went from about 4.5% to well in excess of 11%. I think that because of the government DRGs and cost containment programs becoming very popular in 1984 and employee deductibles increasing, etc., in 1985 for the first time health care expenditures as a percentage of GNP actually went down below 11%, to 10.8% or 10.9%. I don't want to be simplistic about it, but I think it's clear that when the ultimate consumer of health care, the employee, is asked to pay a little more and in conjunction asked to adhere to certain cost containment provisions, that certainly less health care is going to be utilized. Now whether that's good or bad in the long run, and whether in the year 2000 we'll be healthier for that, I don't know. But it's pretty clear to me that if you look back in history, it shows clearly that the box, at least in the short run, is going to be reduced.