ASCENDE®

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NOT YOUR FATHER'S CADILLAC:

THE IMPACT OF THE CADILLAC TAX ON THE ENERGY INDUSTRY

The CEO of a major oil and gas producer said it best: *"It's raining, and it's going to rain for a long time. We are all going to get wet. A few people are going to drown. And I think that probably sums it up."*

The energy industry is at a crossroads, facing a challenging future. Energy companies that can rethink or reset how they operate will survive the downturn and position their company for future success.

The energy industry is also exposed to the harsh reality of the Affordable Care Act (ACA). A key provision in the law, the excise tax on high-cost employer-sponsored health coverage, known as the Cadillac tax, takes effect in 2018. The Cadillac tax seeks to penalize or tax companies that sponsor so-called "Cadillac" health plans that provide participants generous levels of benefits. When employers understand the implications of the Cadillac tax and the changing needs and preference in the energy workforce, they quickly begin to rationalize the strategic role of medical plans within the context of the reward program.

You may agree that a Cadillac automobile today is not the height of luxury as it may have been in the past. General Motors has improved the product line, but the brand does not reign supreme like it once did. The same logic applies to medical plans. What the Department of Health and Human Services has identified as a Cadillac plan looks more like a Ford or Chevy.

CADILLAC TAX

Quick Facts

- A provision of the Affordable Care Act (ACA) starting in 2018
- A 40% non-deductible excise tax on medical plans with annual premiums exceeding:
  - Individual............ $10,200
  - Family $27,500
- Threshold values adjust annually

ASCENDE ENERGY ACUMEN

2016 Benefit Plan Surveys

For more information about our sector surveys, please contact us at (713) 629-9666 or marketing@ascende.com.

Registration ends December 31st. The surveys launch in early January and will be open for data collection through early February.

Ascende's Energy Acumen Survey, conducted in the first quarter of each year and published in May, is open to all energy companies. In 2015, 96 companies representing exploration and production (E&P), drilling, midstream, energy services and engineering and construction (E&C) participated in the survey. These companies offer benefits to over 200,000 employees and an estimated 450,000 total family members. In 2015, the total projected health care premium for this group is in excess of $2.5 billion.

OUR OBSERVATION/YOUR TAKEAWAYS

THE IMPACT OF THE CADILLAC TAX

Ascende has analyzed the implications of the Cadillac tax on the energy industry, and the results have yielded some staggering findings. The 2015 premiums indicate that health plans sponsored by as many as 44% of the companies in this sample will hit the Cadillac tax thresholds by 2018. Further, without significant changes to medical plans in the coming years, this number increases to 89% by 2022. Cadillac taxes in 2018 are estimated to be $18 million, and they increase to $180 million by 2022.

CALCULATING THE CADILLAC TAX

The Cadillac tax imposes a 40% employer excise tax, beginning in 2018, on the premium cost of coverage for health plans that exceed a defined annual threshold of $10,200 for employee coverage and $27,500 for employee and spouse or family coverage. This premium cost calculation includes both employer and employee contributions, and may also include employer and employee pretax contributions to health savings accounts, flexible spending accounts and certain pretax voluntary benefits such as critical illness plans. Health insurance companies and sponsors of self-funded group health plans must pay the tax on the total dollar amount that exceeds the thresholds set by the government.

While this provision takes effect in 2018, it has more severe implications beginning in 2019 and beyond due to the method prescribed for indexing the thresholds. Beginning in 2019, the thresholds will be indexed by the consumer price index (CPI) and in years 2020 and beyond by CPI plus 1%. The implications of this adjustment method are significant. Given that U.S. health care inflation always far surpasses CPI (for example, CPI was 1.5% in 2013 and 1.6% in 2014), plans that do not exceed the threshold in 2018 will have a much greater probability of hitting the thresholds in 2019 and beyond because of health care inflation.

IMPLICATIONS FOR THE ENERGY SECTOR

Ascende's survey reveals specific sectors of the energy industry that have major cause for concern. Exploration and production and midstream have rich medical plan designs and coverage levels in their plans, a high average age and gender mix in their employee populations. These factors contribute to higher plan costs that will reach the Cadillac tax thresholds sooner than later.

DURING THE RECOVERY PERIOD

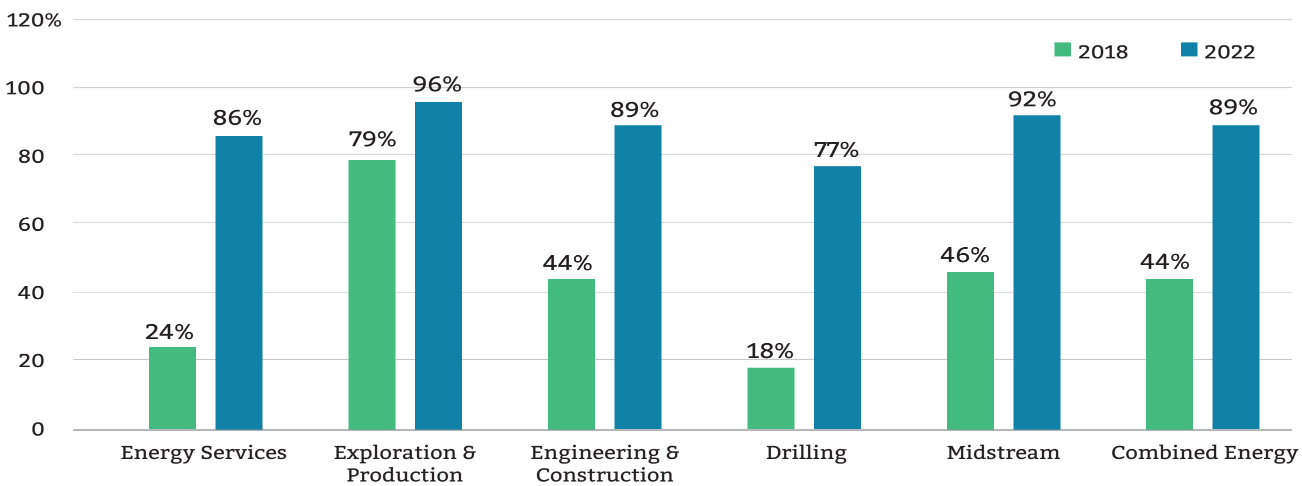
The recovery period is the perfect time to reset the culture, avoid the Cadillac tax and prepare for the future. Incremental changes should begin today to avoid paying a tax in 2018. With the composition of the energy workforce changing rapidly, paternalistic and overly rich benefit plans (particularly medical) may not be required to support the needs of the next generation of energy workers.

2015 ENERGY ACUMEN SURVEY RESULTS

Ascende's 2015 Energy Acumen Survey measured over 100 companies. Our analysis of the impact of the Cadillac tax includes 96 companies operating in the upstream and midstream sectors that offer PPO medical plans.

Using the 2015 reported premium equivalent medical plan rates and a standard medical inflation rate of 10%, Ascende projected the medical plan cost from 2015 to 2018 and beyond. Figure 1 illustrates the significant rise in the number of companies that hit the Cadillac tax in 2018 versus 2022.

Figure 1, Percentage of Companies with Medical Plans Exceeding the Limit in 2018 vs. 2022



SECTORS AND NUMBERS REPRESENTED IN FIG. 1

- **Exploration and production**: N=28 companies
- **Midstream**: N=13 companies
- **Services and equipment**: N=29 companies
- **Drilling** (onshore and offshore): N=17 companies
- **Engineering and construction**: N=9 companies
- **Combined energy**: N=96 companies

FIG. 1 OBSERVATIONS

- By 2022, almost all companies will hit the Cadillac tax threshold and pay a penalty due to the large difference in health care inflation and the indexing of the thresholds.
- The energy sectors with the greatest exposure in 2018 are exploration and production, engineering and construction and midstream.

The Cadillac tax paid by companies represents a cash non-deductible business expense of $17.9 million in 2018 and escalates quickly to $178 million in 2022. Figure 2 illustrates the breakdown by industry sector.

Figure 2, Increasing Cadillac Tax Penalties by Sector from 2018 to 2022 (in millions)

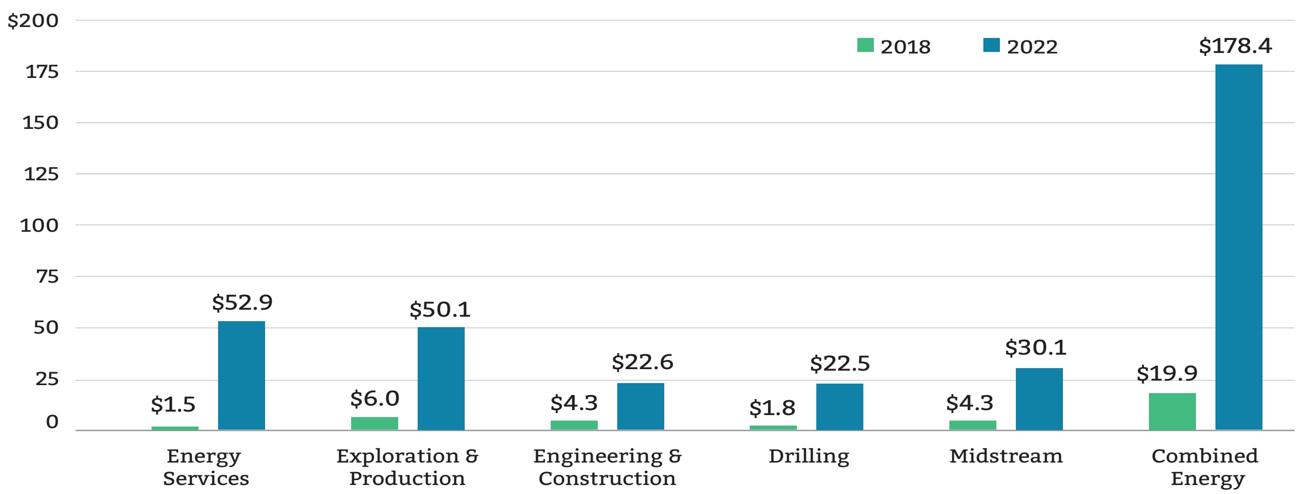


FIG. 2 OBSERVATIONS

- In 2018, 42 of the 96 energy companies will pay $17.9 million in penalties; by 2022, 85 of the 96 companies will pay $178.4 million.
- The most penalized sectors are companies operating in the following:
  - **Exploration and production** – 22 companies will pay $6 million in 2018
  - **Engineering and construction** – 4 companies will pay $4.3 million in 2018
  - **Midstream** – 6 companies will pay $4.3 million in 2018

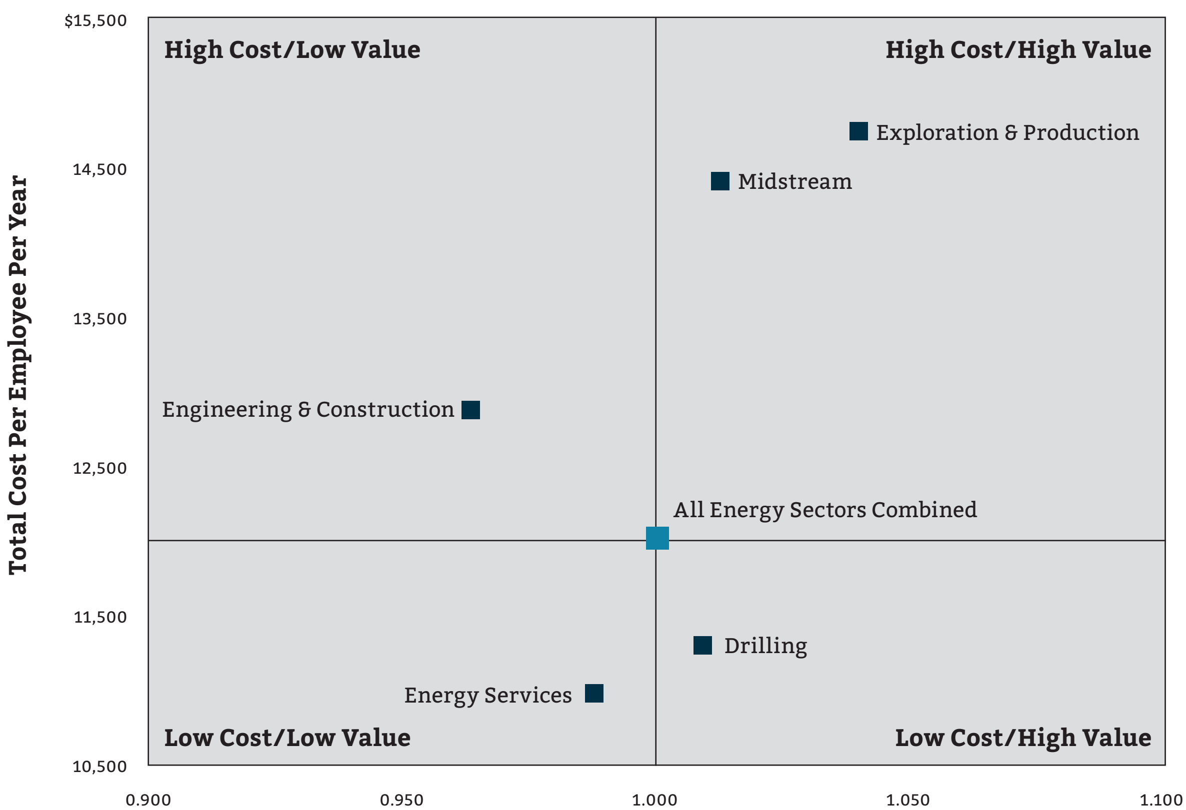
ENERGY INDUSTRY COST-VALUE MATRIX

Figure 3 provides a scatter gram that illustrates a comparison of the relative value of PPO medical plan designs (i.e., richness of the benefits) and their associated costs.

The value of the medical plans is defined by the employees' out-of-pocket costs at the time medical services are rendered such as office visit and prescription drug copayments, deductibles and coinsurance.

The cost of the medical plan is defined by the average per-employee, per-year premium costs (for companies that fund their plan through an insurance contract) or premium equivalent budget rates for companies that fund the obligation under a self-insured arrangement.

Figure 3, Relative Value and Cost Comparison



There is significant variance in the benefit plan design and cost across sectors. For example, during 2015, employers in the exploration and production sector offer an average medical plan design that exceeds the combined energy industry norm by 4.0%. Medical plan costs on a per-employee, per-year basis for the E&P group is $15,174 compared to the combined average across the energy industry, which is $12,189. This means an E&P company with 500 employees is spending almost $1.5 million more per year for a generous medical plan that is also subject to the Cadillac tax in 2018. The same is true for midstream companies. As a whole, a midstream employer with 500 employees is spending $1.3 million more per year for medical coverage compared to the energy group as a whole. In contrast, the E&C sector offers the least generous medical plan, but due to a high average employee age, the average cost is $13,131, which is 7.7% above the energy industry combined.

DO THE MATH

- Compared to the combined average cost across the energy industry,
  - An E&P company with 500 employees spends $1.5 million more per year
  - A Midstream company with 500 employees spends $1.3 million more per year

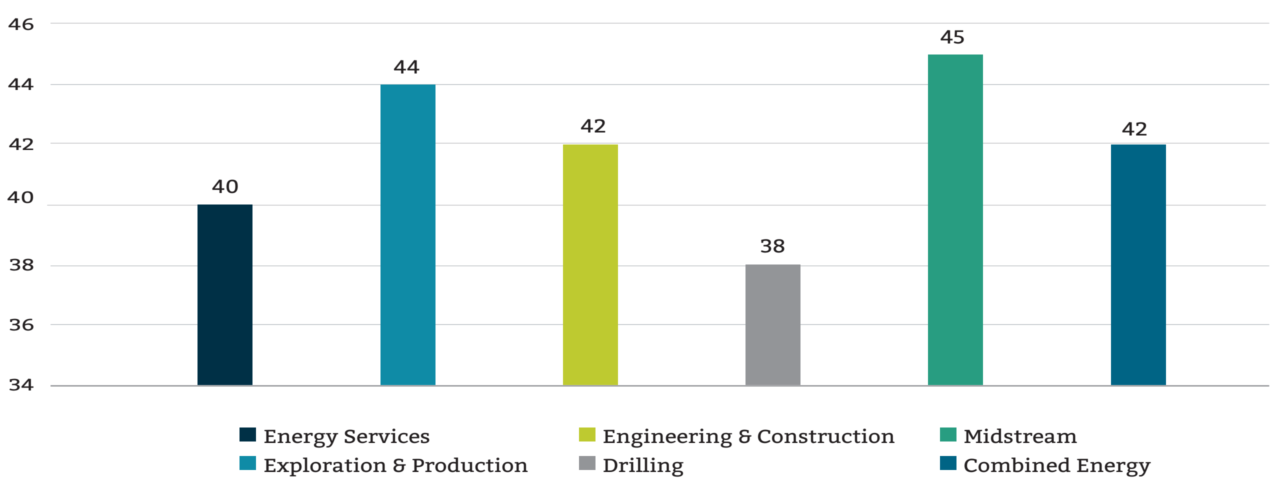
FACTORS CONTRIBUTING TO HIGH COST

There are several factors that contribute to the energy industry's high medical plan costs.

AVERAGE AGE

Age has a significant influence on the utilization and cost of health care services. The higher the age of the covered population, the higher incidence of chronic conditions and the need for more acute and medical care and pharmacy services.

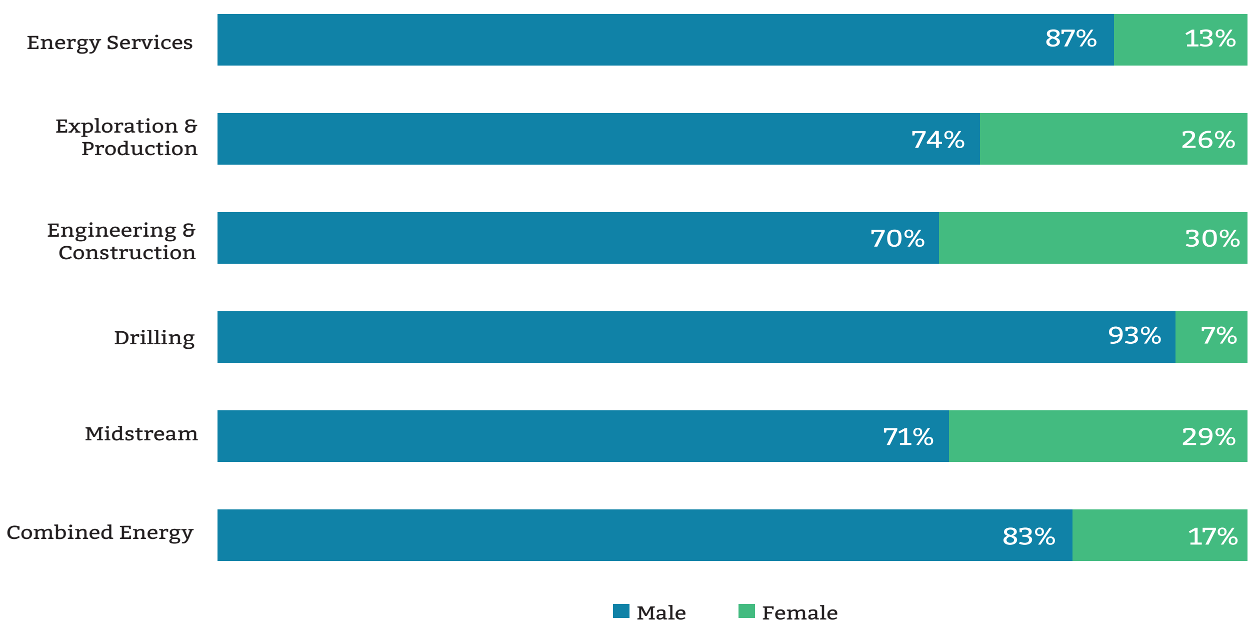
Figure 4, Average Age



GENDER MIX

The gender mix of a population has an influence on health care utilization and costs. For example, females of childbearing age use more health care services when compared to men of a similar age. As men approach age 50, the cost of care becomes even greater due to multiple diagnoses such as diabetes, heart disease and cancer. Figure 5 shows an overview comparing the gender mix across the energy industry.

Figure 5, Gender Mix



MEDICAL PLAN DESIGN

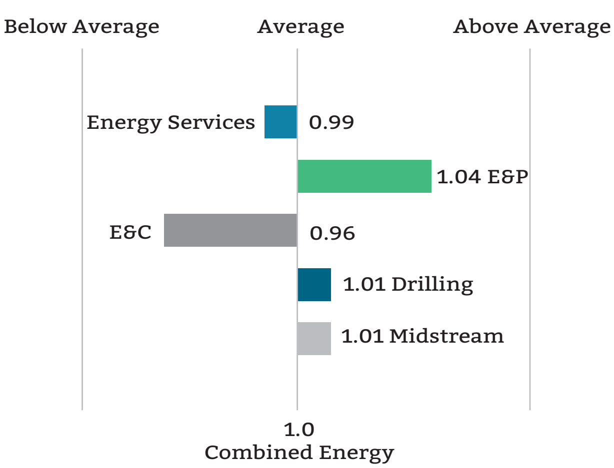
The plan design and coverage features directly impact medical plan costs. Coverage features dictate the amount of out-of-pocket expenses incurred by employees. Lower out-of-pocket expenses for the employee translate to a higher-cost plan for the employer. Conversely, a plan with higher out-of-pocket expenses is offered at a lower overall premium. It's worth noting that rich medical benefit plans are subject to a higher than average cost trend because of the leveraging effect of price and utilization of new technology such as imaging, medical devices, surgical procedures and prescription drugs, especially rapidly emerging biologics.

Figure 6 is a high-level comparison of the plan design and coverage disparity that contribute to medical plan costs across several energy sectors.

Figure 6, PPO Plan Design/Coverage Disparity

DESIGN FEATURE	COMBINED ENERGY	ENERGY SERVICES	E&P	E&C	DRILLING	MIDSTREAM
Network deductible						
• Individual	$500	$600	$500	$750	$500	$500
• Family	$1,500	$1,500	$1,000	$2,000	$1,250	$1,125
Coinsurance (in/out)	80%/60%	80%/60%	90%/70%	80%/60%	80%/60%	80%/60%
Office visit copay	$25	$25	$20	$30	$25	$25
Out-of-pocket maximum						
• Individual	$3,000	$3,500	$2,275	$4,750	$2,750	$2,575
• Family	$7,000	$9,000	$5,000	$10,000	$7,500	$5,800

Figure 7, Medical Plan Value Relative to Combined Industry



STOP AND THINK

- Ascende's research indicates that employee perception of medical plan value does not correlate to the actual value of the plan.
- Most employees can't distinguish the difference between "rich" plans that offer more value versus an average plan. Knowing this, employers should be less motivated to sponsor plans that are better than average.
- Understanding employee perception and the impact of the Cadillac tax should be enough to question the value and ROI of providing medical plans that exceed the average.

WHAT CAN ENERGY COMPANIES DO?

Despite the downturn in commodity prices and the length of time it may take global demand to catch up with supply, smart energy companies are in a great position to reset the role of medical benefits in the framework of total compensation. Our modeling shows that if employers are able to curtail their health trend by five percentage points between now and 2018, the number of companies expected to hit the Cadillac tax in 2018 drops from 42 down to 16, and the total tax is reduced by almost $16 million.

What can companies do now to begin to address health care trend?

- Avoid the costly Cadillac tax by resetting the strategy and developing a glide path to 2018. These changes should not occur in one year, but over several years to ease the impact on employees. Make a three- to five-year strategic benefit plan.
- Partner with a consultant who understands the energy industry, its business operations and employee needs and preferences.
- Understand how the energy workforce is changing. The downturn in the oil patch will usher in rapid change in the composition of the energy workforce. All benefit plans today were designed to meet the needs and preferences of the Baby Boomer generation. Generation X and Millennials don't value the same benefits as Baby Boomers. This creates an opportunity to shift strategy and investment.
- Don't create a value proposition for employees with programs that are inflationary and highly regulated, like medical benefits. There is limited return on investment (ROI) with these programs.
- Employ cost management strategies in health plans that focus on health improvement and management of preventable health conditions. Whether this is referred as a wellness program or is linked to your overall safety program, your focus should be on understanding the major drivers of health care costs and the appropriate programs to manage these costs.
- Have honest conversations with employees about the facts and circumstances of the energy industry, health care costs and responding to government regulations that impact the workplace.

To discuss the Cadillac tax in more detail or to participate in our survey, contact Ascende:

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