BEFORE THE INSURANCE COMMISSIONER

FOR THE STATE OF DELAWARE

In Re: The proposed affiliation of BCBSD, INC., doing business as Blue Cross Blue Shield of Delaware, with HIGHMARK INC.	))))	Docket No.1509-10

JOINT
PREHEARING MEMORANDUM
OF
HIGHMARK INC. AND BCBSD, INC.

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Dated: September 22, 2011

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I. **Nature and Stage of the Proceedings**

On October 7, 2010, Highmark Inc. ("Highmark") filed a *Statement Regarding the Affiliation of BCBSD, Inc. with Highmark Inc.* (the "Statement") with the Delaware Department of Insurance (the "Department"). Pursuant to the Statement, Highmark sought the Department's approval for an affiliation between Highmark and BCBSD, in which Highmark would acquire control of BCBSD.

On October 20, 2010, Commissioner Stewart issued a Pre-Hearing Order (the "Pre-Hearing Order") in which the Department, BCBSD, Highmark and the Delaware Department of Justice ("DOJ") were admitted as parties, and the standards set forth in 18 *Del. C.* § 5003(d)(1) governing the Department's approval of changes in control of domiciled insurers were made applicable to the Department's review process.

Retired Family Court Judge Battle R. Robinson was appointed Hearing Officer on November 4, 2010.

Also set forth in the Pre-Hearing Order were standards applicable to other persons wishing to become parties. A hearing on one such application, made by Dr. Jo Ann Fields, M.D. was held on January 18, 2011. An order denying her application was issued by the Hearing Officer on January 25, 2011. The Department and DOJ thereafter requested and received a large volume of documents and information from BCBSD and Highmark between January 2011 and the present.

On May 31, 2011, Attorney General Joseph R. Biden, III, issued a letter setting forth his determination that the transaction constituted a "not-for-profit healthcare conversion" under the provisions of 29 *Del. C.* § 2531, *et seq.* On July 12, 2011, Governor Jack Markell signed into law Senate Amendment No. 1 to Senate Bill 146 ("SB 146") which, among other things, provided that affiliations between not for profit entities would not be conversions – thereby negating the Attorney General's conversion determination. SB 146 also mandates the imposition of a number of conditions to any approval order issued by the Commissioner.

On August 5, 2011, the Hearing Officer set October 5, 6 and 7, 2011 as the dates for the public hearing in this matter. Subsequently, the parties reached agreement on dates on which expert reports would be due, stipulated facts would be filed, and pre-hearing memoranda would be filed. This is the joint pre-hearing memorandum of Highmark and BCBSD.

II. Background of Highmark

A. Nature of Highmark's Business Operations

With origins similar to those of BCBSD, Highmark's predecessors were created in the 1930s and did business as Blue Cross of Western Pennsylvania and Pennsylvania Blue Shield. Highmark was created through the 1996 consolidation of those two companies and today does business as Highmark Blue Cross Blue Shield in western Pennsylvania and Highmark Blue Shield in the remainder of the Commonwealth. Highmark is a Pennsylvania non-stock, non-profit corporation organized under the Pennsylvania Non-profit Corporation Law of 1988, 15 Pa.C.S. § 5101 *et seq.* It is authorized by the Pennsylvania Insurance Department (the "Pennsylvania Department") to operate a hospital plan and a professional health services plan in Pennsylvania pursuant to Pennsylvania's Health Plan Corporations Act, 40 Pa. C.S. §§ 6101-6127 and §§ 6301-6335. Under this authority, Highmark provides traditional indemnity, or "fee for service," health care insurance coverage to groups and individuals in Pennsylvania. Highmark also functions as an administrative services only (ASO) provider for certain self-insured groups.

Highmark is one of the 10 largest health insurance companies in the United States in terms of membership, with a total health membership of 4.8 million and total membership across all product lines of 30 million. It is a recognized leader in information technology and has been consistently ranked on *Information Week* magazine's annual listing of the nation's top 500 innovators of information technology, ranking 2nd among health insurers in 2009. Highmark is one of four "Blue" plans in Pennsylvania and one of 39 "Blue" plans (including BCBSD) in the nation. As an independent licensee of BCBSA, Highmark operates as Highmark Blue Cross

Blue Shield in the 29 western-most counties of Pennsylvania and as Highmark Blue Shield in the remaining counties of the Commonwealth.[1]

Highmark serves the 29 western-most counties of Pennsylvania and 21 counties of central Pennsylvania and the Lehigh Valley as a full-service health plan, offering health care coverage, on both an insured and self-insured basis, to groups and individuals. As a party to joint operating agreements, Highmark also provides professional health services coverage in conjunction with hospital coverage provided by Blue Cross of Northeastern Pennsylvania ("BCNEPA") in northeastern Pennsylvania and by Independence Blue Cross ("IBC") in southeastern Pennsylvania. Highmark does not provide indemnity coverage for hospital services in northeastern or southeastern Pennsylvania. In addition to its indemnity coverage, Highmark also offers health insurance coverage in 49 of Pennsylvania's 67 counties (excluding the five counties in the IBC service area and other counties in northeastern Pennsylvania), through a non-Medicare preferred-provider organization (PPO) program.

Highmark's wholly owned subsidiary, Keystone Health Plan West, Inc., offers health maintenance organization (HMO) coverage in western Pennsylvania to both the over-65 and under-65 group and individual insurance markets. Highmark has two other insurance subsidiaries which provide group and individual Medicare products: Highmark Senior Resources Inc., which offers Medicare Part D prescription drug coverage in Pennsylvania and West Virginia, and HM Health Insurance Company d/b/a Highmark Health Insurance Company ("HHIC"), which offers Medicare Advantage plans in West Virginia. HHIC also recently began offering small group coverage (for employers with 50 or fewer employees) in certain counties of

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1 Highmark's license agreements with BCBSA permit Highmark to operate as Highmark Blue Cross Blue Shield in the western portion of Centre County and as Highmark Blue Shield in the eastern portion of Centre County.

Pennsylvania. Highmark also offers Medicare Advantage products, as well as Medicare supplemental products, to the individual and group markets in western Pennsylvania, central Pennsylvania and parts of northeastern Pennsylvania. In northeastern Pennsylvania, the supplemental products are jointly underwritten with BCNEPA and the Medicare Advantage products are provided by Highmark.

In addition to its health insurance operations in Pennsylvania, Highmark has a number of affiliated insurers and dental and vision care affiliates doing business in that state and in other jurisdictions, including:

- HM Insurance Group, Inc. ("HMIG") which, through its subsidiaries, HM Life Insurance Company and HM Life Insurance Company of New York, is a recognized leader in stop loss and reinsurance. HMIG's subsidiaries, which also include Highmark Casualty Insurance Company and HM Casualty Insurance Company, hold insurance licenses in 50 states and the District of Columbia and maintain 25 regional sales offices across the country.

- United Concordia Companies, Inc. ("UCCI") and its subsidiaries, which offer a broad range of dental insurance products and services to members nationwide, employing more than 1,300 people in 30 offices located throughout the United States.

- HVHC Inc. which, as the owner of New York-based Davis Vision, Inc. ("Davis Vision"), New Jersey-based Viva Optique, Inc. ("VIVA") and Texas-based Eye Care Centers of America, Inc. ("ECCA"), comprises one of the nation's largest vision companies. Davis Vision provides comprehensive vision benefits to more than 55 million members nationwide. Viva is a worldwide leader in ophthalmic frames and sunglass distribution and manufacturing. ECCA, with more than 400 retail stores in 36 states, is the third largest retail optical chain in the U.S.

Non-insurance subsidiaries of Highmark include its wholly owned subsidiary, Highmark Medicare Services Inc. ("HMS"). With offices in Pennsylvania and Maryland, HMS acts as a

Medicare Administrative Contractor under a contract with the Centers for Medicare & Medicaid Services, performing Medicare Part A and Part B fee-for-service claims adjudication and other administrative services for hospitals, other institutional providers, physicians and other health care practitioners in Delaware, Maryland, New Jersey and Pennsylvania, as well as the District of Columbia.

Highmark also has a controlled affiliate, Highmark West Virginia Inc. d/b/a Highmark BlueCross BlueShield of West Virginia, a West Virginia non-profit health services corporation ("Highmark WV"), which is particularly noteworthy in this proceeding. Highmark WV, which offers a variety of health insurance products and services to customers in West Virginia, began its relationship with Highmark in 1999. In 2004, Highmark became the sole member of Highmark WV pursuant to a business affiliation agreement similar to the Affiliation Agreement with BCBSD which is the subject of this proceeding. Highmark WV's articles of incorporation and bylaws provide Highmark with the power to elect all of the members of the Highmark WV Board of Directors (subject to certain restrictions), and Highmark is the primary BCBSA licensee for West Virginia, with Highmark WV its "controlled affiliate" in that state.

Highmark has an "A" rating from A.M. Best and Standard & Poors. As of December 31, 2010, Highmark had over $3.7 billion in surplus. Highmark's net income for 2010 was over $281 million. As of December 31, 2010, Highmark's Risk Based Capital ("RBC") was at the higher end of the range (550% to 750%) defined as "sufficient" by the Pennsylvania Insurance Department. At June 30, 2011, Highmark's statutory quarterly financial statement reflected assets of $6.9 billion, surplus of over $4 billion and net income of $289 million.

B. Highmark's Corporate Purposes

According to Article III of its Articles of Incorporation, Highmark's corporate purposes are the following:

> (a) To establish, maintain and operate one or more non-profit hospital plans, professional health service plans, health maintenance organizations, preferred provider organizations or other health care or employee benefits services, plans or organizations and to provide subscribers and customers of such services, plans or organizations with hospitalization, medical, health care and other benefits and services;
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> (b) To enter into agreements with subscribers to said plans and to enter into group and other contracts in accordance with the aforementioned purposes;
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> (c) To make and enter into contracts with duly licensed hospitals, extended care facilities, nursing homes, convalescent homes, other organizations and facilities and individuals to provide such benefits and services or otherwise facilitate these purposes;
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> (d) To act as a contracting agency, organization or carrier under Sections 1816 and 1842, or successor provisions, of Title XVIII of the Federal Social Security Act, with the power to perform all the services which may be required of a contracting agency, organization or carrier thereunder; to perform services similar or relating to those which may be required of a contract agency, organization or carrier thereunder in connection with any federal, state or local governmental health care program; and to perform services similar or related to those which may be required of such an agency, organization or carrier in connection with or associated with non-governmental organizations, individuals, groups and agencies in the health care field;
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> (e) To engage in, and to do any lawful act concerning, any or all lawful activities for which corporations may be incorporated under the Non-profit Corporation Law of 1988, as amended, or any subsequent law; and
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> (f) To do everything and anything necessary, suitable, proper, convenient or incidental to the aforesaid purposes, or which may be done by a non-profit corporation organized for such purposes under the laws of Pennsylvania.

III. Background of BCBSD

BCBSD is the largest health insurer in Delaware. BCBSD is organized as a Delaware non-stock, not-for-profit corporation that is regulated by the Commissioner under the provisions of 18 *Del. C.* § 6301, *et seq.* As a health service corporation regulated under Chapter 63 of the Insurance Code and in existence prior to the adoption of Chapter 63 in 1968, BCBSD is not required, and nor does it hold, a Certificate of Authority to write health insurance. BCBSD is governed by an eight member board, six of whom have served for many years. BCBSD's President is Timothy J. Constantine, who has held that position since 2001 (he was also appointed Chief Executive Officer in 2006).

BCBSD currently provides health insurance or administers health benefits to approximately 394,000 people. Health insurance, whether fully insured or administrative services only, is the primary line of business for BCBSD. In Delaware, BCBSD is the primary licensee of the national Blue Cross and Blue Shield Association ("BCBSA"), which owns the "Blue Cross"® and "Blue Shield"® names and service marks, and thereby has the exclusive rights to market health insurance and issue policies and contracts using the "Blue" names and marks throughout Delaware. BCBSD has no right to issue "Blue" branded policies or contracts outside of Delaware.

BCBSD was founded in 1935 as Group Hospital Service, Inc., a non-profit corporation offering a prepaid hospital plan. At the time, BCBSD was organized under the Delaware General Corporation Law as any other non-stock, non-profit corporation. The entity was financed with a $1,626 loan from the four Wilmington hospitals that were its members. The original governing body was a "board of trustees," and each of the member hospitals was entitled to name three trustees to the board. The new company's three stated corporate purposes were:

> to inaugurate, operate and maintain…a hospital service plan by which hospitals subscribing to the plan shall furnish hospitalization to individuals, who are also subscribers and contributors to the plan, when they may be in need of hospital care; to collect in connection with the operation of the plan, statistics and data to compile reports which may be deemed of value to the community, other hospitals and to the furtherance of the plan; to be of assistance in the promotion of such activities as are considered to be for the best interests of the community in relation to its hospitals.

(BCBSD's 1935 Certificate of Incorporation is attached hereto as Ex. A). In 1939, the "purpose" article was amended to add an additional clause providing for coverage at hospitals that were not members of the plan, and amendments in 1943 expanded coverage to include physicians' services. Additional amendments to the BCBSD Certificate of Incorporation were made in the mid 1960s, and again in 1980. The 1980 change revised the purposes section to read as follows:

> The purposes of this Corporation shall be: to develop, market and underwrite all types of health insurance and other employee benefit programs at reasonable costs; to promote policies and programs which foster effective health care cost containment; to act as underwriter or administrator for the administration of governmental health care programs; to provide all types of health services; to assist individuals in defraying the costs of all types of health services; to do all things in any way related to or connected with these purposes and to engage in any lawful act for which corporations may be organized under the General Corporation Law of the State of Delaware.

(Minutes of the meeting of the BCBSD Board of Directors on June 25, 1980 is attached hereto as Ex. B). This purpose statement has appeared in all versions of the BCBSD Certificate of Incorporation filed since 1980, and appears in the proposed Certificate of Incorporation that would be filed with the Division of Corporations in order to consummate the proposed affiliation.

In March 2000, the Delaware Insurance Commissioner approved BCBSD's affiliation with CareFirst, a non-profit health service corporation providing services in Maryland, Northern Virginia, and Washington, D.C. During that affiliation, CareFirst held the primary BCBSA licenses for Delaware, and BCBSD held BCBSA's "Controlled Affiliate" licenses. In 2003, the Maryland General Assembly passed legislation which caused the existing CareFirst board to be removed and, *inter alia*, gave the state of Maryland a material level of control over the future composition of the CareFirst board of directors. As a result, in 2004, the Delaware Insurance Commissioner ordered the disaffiliation of CareFirst and BCBSD, which, following litigation and failed attempts to restructure the affiliation on a contractual basis, was accomplished in September 2006. BCBSD has again been operating as the primary licensee of the BCBSA in Delaware since that time.

By the early 1990s, the BCBSD Board of Directors had determined that the long term success of BCBSD, as a small single state Blue plan, required that it consolidate with a larger Blue organization in order to benefit from economies of scale as well as the enhanced resources that only a larger plan could provide. BCBSD then began a search for potential affiliation partners that began with an attempted transaction with Blue Cross Blue Shield of New Jersey, and ultimately resulted in the 2000 affiliation with CareFirst. The CareFirst affiliation was largely successful, resulting in reduced per member per month administrative expenses and an increase in both membership and reserves. However, the disaffiliation from CareFirst, just six years after it commenced, placed BCBSD in the same position it was in prior to the CareFirst affiliation. Accordingly, in late 2006, BCBSD's Board of Directors and management engaged in an extensive planning process designed to address the challenge of maintaining BCBSD's strength and stability over the long term. The BCBSD Board of Directors held a retreat in February 2007 to discuss the implications of the recent disaffiliation and the strategy for going forward. Participants included the Board, senior management and industry experts. After presentations by the experts and extensive discussion, the Board directed management to conduct a strategic planning process to determine the future course for BCBSD.

BCBSD retained Louis Pavia, President of CareCompanion, who has provided strategic consulting services to BCBSD at various times for over 15 years, and Robert C. Cole, Jr., BCBSD's former President and CEO, to provide advice and guidance. Over the course of the next year, the management team, with the advice of additional experts, conducted research and held a series of strategy sessions where they:

- Analyzed trends and issues facing health insurers;
- Assessed the Delaware market;
- Identified critical challenges and opportunities for BCBSD;
- Undertook a Scenario Planning exercise;
- Established key requirements for success; and
- Defined a number of strategic alternatives.

The Board, working with management and their advisors, determined that given the competitive environment in which BCBSD must operate, and the need for systems and capabilities upgrades, the best option for BCBSD was to collaborate with a strong partner. Over the next several months, the team detailed BCBSD's market and organizational requirements and analyzed its potential strategic value to a partner. Out of this process, over 30 potential partners were identified and assessed. Six, including adjacent regional and multi-state Blue Cross Blue Shield plans, were determined best suited to meet the requirements of BCBSD. Detailed evaluation criteria were established and further due diligence of these six was conducted with oversight by the Board.

In July 2007, each of the six target partners received a Partnership Memorandum requesting a confidential proposal for establishing a long-term strategic partnership. During the remainder of 2007 and the first quarter of 2008, these proposals were analyzed, additional information was requested and evaluated and the executives of each of the six were invited to make a presentation to the BCBSD management team to discuss their proposal in more detail.

After thorough analysis and evaluation, the potential partner target list was narrowed to three organizations for further consideration and evaluation. Although Highmark had made a strong presentation to BCBSD's management team, it was not one of the three organizations invited to present to the BCBSD Board at that time, largely due to BCBSD's concern that Highmark's then-pending proposed merger with Independence Blue Cross would impede its ability to focus on affiliating with BCBSD.

The leadership of the three finalist organizations each made a presentation to the BCBSD Board describing their proposed business relationship, their rationale for partnering with BCBSD and the benefits of the relationship to BCBSD, its members, accounts, providers, employees and the residents of the state of Delaware. Ultimately, however, BCBSD was unable to reach agreement with these candidates. Accordingly, during the summer of 2009, management updated its evaluation of the six previously identified potential partners and, based on the findings of this analysis, reissued an updated Partnership Memorandum to two of these potential partners, including Highmark, which by this time had terminated negotiations with Independence Blue Cross. Discussions were held with both candidates and further due diligence was performed. By year end 2009, the Board decided to engage in exclusive negotiations with Highmark.

Since early 2010, BCBSD has been working exclusively with Highmark to establish a mutually rewarding partnership. This has included extensive due diligence by both parties, a presentation by Highmark's leadership to the BCBSD Board, a site visit to Highmark's headquarters in Pittsburgh and its affiliate in West Virginia, an independent assessment of Highmark's technology and infrastructure, numerous meetings and discussions with Highmark's senior leadership, and careful and considered contract negotiations. In July 2010, both the BCBSD and Highmark boards approved the Affiliation Agreement, and the Agreement was finalized and executed on August 19, 2010.

IV. BCBSD's Rationale for the Affiliation

Although BCBSD has existed on a stand-alone basis since 2006, the fundamental need for BCBSD to be affiliated with a larger plan has not abated. Significant consolidation has occurred in the health insurance industry over the last twenty years, illustrated by the fact that in 1993, 80% of the U.S. health insurance market share was held by 47 insurers, whereas today just 9 insurers hold this 80% market share. These large consolidated insurers enjoy a size and scale that provides them with many advantages over a smaller plan such as BCBSD. These advantages include:

- Economies of scale resulting in lower administrative overhead;
- Access to the resources necessary to develop new products and services demanded by the insurance marketplace;
- Access to information technology systems, software and infrastructure necessary to administer health insurance products and pay claims in today's technology intensive environment; and
- Access to resources, technology and other capabilities required to effectively implement far-reaching federal and state

> mandates, including the provisions of the Patient Protection and Affordable Care Act ("PPACA").

BCBSD's primary competitors are Aetna, Coventry and United Healthcare. These competitors dwarf BCBSD in size, and each has a national presence with business and technology capabilities that far exceed BCBSD's as a small, independent and not-for-profit company. These large insurers have the capital to invest in the leading edge technologies that consumers and providers demand, and they have the size and leverage to secure greater economies of scale and favorable national medical cost agreements (for example, deeper rebates with pharmaceutical manufacturers due to higher volumes, etc.). This leads to not just better capabilities but lower costs to consumers.

BCBSD is pursuing the affiliation with Highmark following a thorough assessment of its strategic options during the four-year period subsequent to the company's disaffiliation from CareFirst. The company believes that the agreement with Highmark offers the most practical, efficient and cost-effective means for assuring that BCBSD can meet the near-future and long-term needs of its Delaware stakeholders, while remaining a viable and robust presence in the Delaware employer community. With a Highmark affiliation, BCBSD will obtain access to these advantages as the means for offering the best and most affordable options for its stakeholders in Delaware.

BCBSD retained Deloitte LLP ("Deloitte"), an international consulting firm, to conduct an assessment of BCBSD's business capabilities assessment in 2004. This assessment was updated in 2008 and again in 2010, and compared BCBSD capabilities against market requirements and industry competitors to project future capital requirements and priorities (the 2008 Deloitte report with the 2010 update is attached hereto as Confidential Ex. C). In its assessment of BCBSD, Deloitte has determined that on a stand-alone basis, BCBSD would need to make near-term investments in capability improvements in the range of $88 million to $140 million over the next few years to maintain its position in the marketplace. Given that BCBSD currently delivers its business on a core operating system installed in the mid 1980's, BCBSD's future is dependent on near-term access to leading edge technology and business solutions, yet the expenditure associated with these investments would amount to between 49% and 77% of BCBSD's current surplus.

While the Deloitte study focuses on technology enhancements, to remain competitive, BCBSD also needs access to enhanced product offerings and expanded capabilities in the senior segment, government programs, compliance capabilities, consumer services, research and development resources, and the overall strategic platform that a large affiliate with greater resources can provide. The health care industry has transformed considerably over the last decade, with intense demand for cost control and significant expansion in regulatory oversight, the most direct evidence of which is the 2010 passage of PPACA. From a very practical view, a small, independent plan is not likely to have the human technical resources necessary to effectively evolve to meet these demands on its own. Also important is the financial security an affiliation with a larger, very well capitalized entity such as Highmark brings to BCBSD's stakeholders. As a small company, BCBSD's reserves (*i.e.,* surplus) are more limited and subject to greater volatility than the surplus of a large company, a consequence that has led industry analysts to determine that smaller companies need to maintain higher relative surplus levels than large companies. This is dramatically illustrated by the 30% drop in BCBSD's reserves in 2008 due largely to the economic downturn.

With the Highmark affiliation, BCBSD would expect to invest approximately $37 million over 18 to 24 months to migrate onto Highmark technology and business platforms. This represents a substantial savings to BCBSD and its stakeholders from the $93 million to $150 million estimated by KPMG in the KPMG "Project Delaware" Report prepared for the Department of Insurance, dated September 6, 2011, that the company would need to expend as an independent health insurer. This effort would migrate BCBSD business from its current legacy systems to Highmark's platforms.

Coinciding with BCBSD's plan to affiliate with Highmark is the impact of two significant federal mandates on health care payors. The first of these is conversion to the International Classification of Diseases, 10^{th} Revision ("ICD-10") which will result in a ten-fold increase in the number of diagnostic codes that must be utilized by health insurers and providers. The federal compliance deadline for ICD-10 is October 2013.

As mentioned earlier, the second federal mandate is the 2014 market reform provisions of PPACA. For PPACA, significant new provisions become effective January 1, 2014, including:

- Integration with the new Health Insurance Exchange;
- Elimination of medical underwriting;
- New product design mandates;
- Accountable Care Organization payment reform administrative capabilities; and
- Medical loss ratio pool management/rebate administration capabilities.

For practical purposes, BCBSD would need to have systems, products and services prepared three to six months prior to January 1, 2014, in preparation for the January 1, 2014 effective date of these new PPACA plans and regulations.

There are two plausible alternatives to affiliation: (i) make the capital investment necessary to bring BCBSD's IT systems up to date, or (ii) outsource BCBSD's IT needs to a third party vendor. Both of these alternatives were rejected because they would result in less desirable outcomes for BCBSD and its Delaware stakeholders. If BCBSD were to attempt to make the necessary capabilities enhancements on its own, this would require enormous capital expenditure without any increase in revenue or access to the resources and product/service enhancements only available through an affiliation. Additionally, BCBSD would not have the financial support of a larger parent entity. Similarly, outsourcing to another party to administer BCBSD business on their operations platforms also has a number of disadvantages relative to an affiliation, including:

- The costs to BCBSD would be higher under such an arrangement;
- BCBSD would not enjoy the expanded financial security of being part of a larger, more diversified organization with much greater financial resources;
- BCBSD would not gain the advantage of access to the larger company's non-technology resources; and
- Delaware employment would be adversely impacted by outsourced back-room operations.

These were important considerations in BCBSD's decision to seek an affiliation generally, and to enter into an affiliation agreement specifically with Highmark under the terms negotiated in the August 19, 2010 Business Affiliation Agreement (the "Affiliation Agreement").

V. Highmark's Rationale for the Affiliation

Highmark continually seeks ways to lower its cost structure and expand its geographic reach, as it competes against larger, national competitors that have grown in size and scale through the acquisition of health plans and other businesses. The affiliation with BCBSD helps Highmark to reach both of these goals. By migrating BCBSD onto Highmark's technology platform and integrating business processes, Highmark is able to achieve scale. The affiliation also allows Highmark to increase the scale in our ancillary products, primarily, dental, vision and stop loss, by marketing the products with a partner with which we have a cohesive relationship to promote sales of these products. Lastly, the affiliation allows Highmark to expand its geographic reach by providing a "consolidation" model that promotes relationships between not-for-profit companies. This is in stark contrast to the typical methods of consolidation in the insurance industry, which involve the takeover of smaller insurance companies through for-profit conversions.

VI. Affiliation Structure and Post-Closing Governance

It is critical to note, at the outset, that following closing of the Transaction, BCBSD will remain a Delaware non-stock, not-for-profit corporation with a corporate purpose set forth in its post-Closing Certificate of Incorporation that is *identical* to its current not-for-profit purpose.[2] No assets are being transferred from BCBSD as a result of the Transaction, and no consideration is to be paid to or received by any individual or entity as a result of the Transaction.

Under the Affiliation Agreement, BCBSD has agreed to cause Highmark to become the sole member of BCBSD. Although Highmark will be the sole member of BCBSD, it has no

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[2] Article THIRD to the proposed Amended and Restated Certificate of Incorporation of BCBSD, Inc. appended to the Agreement at Exhibit B.

"membership interest" as that term is defined in the Delaware General Corporation Law, and therefore no right to receive dividends or other distributions of profits or retained earnings from BCBSD.[3]

As sole member of BCBSD, Highmark will become the primary licensee of the Blue Cross and Blue Shield service marks for Delaware but will exercise these rights only through BCBSD.[4] Post-closing, BCBSD will become a "controlled affiliate" of Highmark and will receive BCBSA's "Controlled Affiliate License." BCBSD's status as controlled affiliate carries with it a critical advantage in that in order for Highmark to retain its primary licensee status in Delaware, it must guarantee the obligations of BCBSD to its customers.

At closing, BCBSD will file a new Certificate of Incorporation and will adopt new Bylaws, which together will reconfigure the board of directors of BCBSD.[5] The post-closing board will be comprised of nine members, four of which are identified as "Class A" directors.[6] The membership of the initial slate of Class A directors is at the discretion of BCBSD (pre-closing) and will be comprised of four members of BCBSD's present board.[7] Thereafter, Highmark as sole member will elect the Class A directors from persons nominated by a nominating committee of the board of directors, however, this nominating committee will be comprised solely of Class A directors.[8] Moreover, even after a Class A director's term expires, he or she will continue to serve as a Class A director until Highmark elects the replacement

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3 8 *Del. C.* § 114(d)(2).

4 Affiliation Agreement at § 2.1.

5 Affiliation Agreement at § 3.1.

6 Article EIGHTH to the proposed Amended and Restated Certificate of Incorporation of BCBSD, Inc. appended to the Affiliation Agreement at Exhibit B.

7 Affiliation Agreement at 3.2(a)(xi).

8 Section 5.2(b) to the proposed Bylaws of BCBSD, Inc. appended to the Affiliation Agreement at Exhibit C.

nominated by the Nominating Committee. Another four directors, the "Class B" directors, are to be selected by Highmark at its discretion; provided however in the initial years the Highmark Chief Executive Officer and certain of his direct reports will serve as members of this class in order to assure a smooth transition process.[9] Dr. Kenneth Melani is the Highmark Chief Executive Officer, and he will therefore serve as the first of the Class B directors. The direct reports chosen by Highmark to fill the second and third Class B seats are Highmark Treasurer and CFO, Nanette DeTurk, and Highmark Executive Vice President of Health Services, Deborah Rice.

SB 146 adds a new section 6310 to Title 18. Among other things, this section will require that the post closing BCBSD board be comprised of a majority of Delawareans who are not employees of the company or any Highmark affiliate. All four Class A directors meet this description; however, the fourth and final Class B director must also meet this test in order to qualify. Accordingly, Highmark will select the fourth Class B director in compliance with section 6310, and has asked BCBSD to recommend suitable candidates. The ninth and final member of the post-closing BCBSD Board will be the BCBSD President.[10] Initially, this will be the current President, Timothy Constantine.

BCBSD's CareFirst experience is reflected in this Transaction. Under the Agreement, the Class A directors are given the right to cause the unwinding of the affiliation and Highmark's surrender of its primary licensee status in the event of certain occurrences. These are: (i) the conversion of Highmark to for profit status under Pennsylvania law; (ii) the insolvency of

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9 Section 5.2(c) to the proposed Bylaws of BCBSD, Inc. appended to the Affiliation Agreement at Exhibit C.

10 Section 5.2(a) to the proposed Bylaws of BCBSD, Inc. appended to the Affiliation Agreement at Exhibit C.

Highmark; (iii) loss of Highmark's right to use the "Blue" marks; and (iv) the enactment or adoption of certain changes in Pennsylvania law which affect the manner of selection or powers of the Highmark Board of Directors.[11]

One of the many advantages to the Transaction is the economies of scale that arise out of partnering with a larger entity. Accordingly, the Agreement contemplates that BCBSD will enter into an Administrative Services Agreement with Highmark, under which a broad range of services will be made available to BCBSD at cost, including an allocation of administrative overhead but with no provision for a profit margin.[12] Also, since BCBSD will be migrating to Highmark's information technology platforms and systems, and there is a significant cost associated with this migration (although, as noted this would be a fraction of the cost of upgrading as a standalone entity), Highmark has agreed to make available to BCBSD an unsecured line of credit to help defray these costs, if and to the extent that BCBSD determines that it needs this assistance.[13]

Given that the Affiliation Agreement, if consummated, would constitute a change of control of BCBSD, some discussion of BCBSD executive employment agreements is in order. The senior executive team (the President/CEO and six Vice Presidents) at BCBSD is responsible for managing a complex business organization in an unsettled, highly competitive and rapidly changing health care environment. Compensation for these senior executives is overseen by BCBSD's Board of Directors. The Board's goal is to ensure that BCBSD is competitive in its efforts to attract, retain and motivate the highest caliber of leadership. On an annual basis, the

[11] Affiliation Agreement at § 7.8; Article XIII to the proposed Bylaws of BCBSD, Inc. appended to the Affiliation Agreement at Exhibit C.

[12] Affiliation Agreement at Exhibit F.

[13] Affiliation Agreement at Exhibit G.

Board reviews and approves all senior executive base salary and incentive amounts, utilizing external benchmark data and recommendations by independent external experts. The current targeted total compensation amounts (base salary and potential incentive) for each of the executives are far below the average for non-publicly traded Blue Cross and Blue Shield Plan officers and the Health Insurance and Managed Care industry sector averages.

The goal of attracting and retaining quality executive management took on special importance following BCBSD's disaffiliation from CareFirst. In 2007, the Board directed management to retain the law firm of Young Conaway Stargatt & Taylor ("YCST") to conduct an executive compensation review. YCST, in turn, retained ORC Worldwide to provide guidance on appropriate compensation packages for executive management. As a result of this process, BCBSD's seven executives have entered into employment agreements all of which predate the Affiliation Agreement . These employment agreements include severance benefits, the principal elements of which take into account the executive's base salary, incentive compensation, and medical benefits, which would be paid for the remainder of the contract term or a specified period, not to exceed two years. Severance benefits become payable if: (1) the executive's employment is terminated without "Cause" (which would be the case regardless of whether a "Change in Control" has occurred), or (2) the executive submits his or her resignation following a specified material negative change in employment constituting "Good Reason" after a "Change in Control" has occurred and the Good Reason event is not corrected after notice of such event is provided by the executive. Examples of "Good Reason" are a substantial reduction of the executive's duties or a substantial reduction in compensation. Thus, although the Affiliation would constitute a Change in Control, the Affiliation alone would not trigger benefits under the employment agreements. Such benefits would be payable only if one of the executives was thereafter involuntarily terminated, or suffered an uncured material negative change in employment following the Affiliation.

If the executive becomes entitled to severance benefits, the amount of the benefits is generally the same with or without a Change in Control, except that base salary continuation payments and incentive payments are paid in a lump sum, reduced to present value, within sixty days of the termination if the termination occurs within two years following a Change in Control. BCBSD and Highmark have no plans to terminate any of the BCBSD executives following the Affiliation. Of course, the synergies and economies of scale that are principal benefits of the Affiliation may, at some point, cause employment changes or reductions in force that impact one or more of the seven executives with employment agreements. In preparing documents as part of the review of the proposed affiliation, BCBSD obtained estimates of a "worst case scenario," in the highly unlikely event that all seven executives were terminated immediately after closing, thus being entitled to their maximum possible 12 to 24 months' severance benefits. In that hypothetical scenario, the potential total lump sum severance payments owed to the seven executives would be $5,960,000[14].

Importantly, there are no arrangements currently in place, or contemplated, that would result in a bonus or incentive payment to BCBSD senior executives as a consequence of the proposed affiliation being approved and implemented. While other well-publicized corporate transactions have included such payments or potential payments, that is not the case with the proposed affiliation of BCBSD and Highmark.

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14 Medical benefits are excluded from the lump sum severance payment.

VII. Application of Chapter 50 Standards

Under the Pre-Hearing Order, the Hearing Officer is directed to apply the specific criteria for approving or disapproving a change of control of a Delaware domestic insurer found at 18 *Del. C.* § 5003(d)(1). These statutory criteria are preceded by the following paragraph:

> "The Commissioner shall approve any merger or other acquisition of control referred to in subsection (a) of the section unless, after a public hearing thereon, the Commissioner finds that:"...(Emphasis added).

Accordingly, assuming the Applicants, through their Affiliation Statement filing, have submitted full and complete information required by the statute sufficient to support approval of the filing, it must be approved unless the Commissioner finds that one of the six bases to disapprove the filing exists.[15]

A. After the change of control, the domestic insurer referred to in subsection (a) of this section would not be able to satisfy the requirements for the issuance of a license to write the line or lines of insurance for which it is presently licensed.

1. License Not Required. At the present time, BCBSD does not have a license (*i.e.,* a Certificate of Authority) as an ordinary health insurer. Rather, BCBSD is authorized to write health insurance business as a health service corporation under Chapter 63 of Title 18. The licensing provisions of Chapter 5 of Title 18, that are applicable to ordinary insurers, are not applicable to BCBSD. Moreover, because it was in existence prior to November 1, 1968 (the date on which Chapter 63 of Title 18 became effective), BCBSD is not required to

15 *See In the Matter of: Proposed Affiliation of BCBSD, Inc., doing business as Blue Cross Blue Shield of Delaware, with CareFirst, Inc.,* 2004 WL 2419161 (Del. Super., Oct. 5 2004) ("the Commissioner must approve the proposed transaction unless she determines that the transaction would implicate any of the concerns identified in the statute.")

obtain a Certificate of Authority. *See* 1§ 6304. BCBSD's licensing status will not change as a result of the closing of the transaction.

2. ***BCBSD Remains a Not-For-Profit Health Service Corporation.*** Nothing about the transaction changes BCBSD's status under Chapter 63. Indeed, following consummation of the transaction, BCBSD will remain a not-for-profit Delaware non-stock corporation that will continue to meet the definition of "health service corporation" under 18 *Del. C.* § 6302, which reads as follows:

> § 6302. Health service corporation defined.
>
> "Health service corporation" means a non-profit corporation, without capital stock, organized under the laws of this State for the purpose of establishing, maintaining and operating plans to provide hospital, physicians' or related health services, or indemnity therefor, for such persons as become members or subscribers of any plan of such corporation.

3. ***No Change in BCBSD Financial Condition.*** BCBSD's financial condition will not change as a result of the closing of the transaction. As of June 30, 2011, BCBSD's statutory surplus was $181 million.

B. The effect of the merger or other acquisition of control would be substantially to lessen competition in insurance in this State or tend to create a monopoly therein.

1. ***Dental Issue Only.*** None of the lines of business written by BCBSD and Highmark exceed the competitive threshold prima facie standards set forth in 18 Del. C. § 5003A(d) except for dental.[16] As to the Delaware dental business, the key market shares break down as follows:

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[16] See pages 50-56 of the Report on the Proposed Affiliation between Blue Cross Blue Shield of Delaware and Highmark Inc. – September 13, 2011, prepared by Blackstone Advisory Partners

• Delta Dental Inc. and Delta Dental of DE, Inc.	77.70%
• Highmark	6.87%
• BCBSD	13.04%

2. ***Presumption Rebutted.*** By exceeding the *prima facie* threshold, the combination of BCBSD's and Highmark's market shares in the dental line of business creates a rebuttable presumption that the competitive standard as to the dental line of business would be violated by the Affiliation. However, the presumption is fully rebutted as follows:

- The dental market in Delaware is minimally competitive at the present time. Delta Dental has a market share of 77%. By comparison, BCBSD currently has only 13.04% of the market share, and Highmark, through its affiliate United Concordia Life and Health Insurance Company ("United Concordia"), has just 6.87% of the market share. Together, these result in a combined market share of only 19.91%. With an almost 80% market share, Delta Dental has a virtual monopoly on the Delaware dental insurance marketplace. Accordingly, a combination of BCBSD and United Concordia will actually help make the market more competitive, not less, by introducing a stronger combined entity into the market.

- Competition to be Increased. The United Concordia business is predominantly composed of Delaware-resident employees of Pennsylvania employers and is not the result of active marketing by United Concordia in Delaware. If the affiliation is approved, it is contemplated that United Concordia would indeed become an active competitor in the Delaware dental insurance marketplace. It would have a much better chance of succeeding in penetrating the Delaware market than has BCBSD to date. This is largely due to the fact that BCBSD's dental plan is a standard reimbursement plan that does not utilize a provider network. On the contrary, United Concordia provides a more robust dental plan that utilizes a provider network (as does, by the way, the dominant player in the market, Delta Dental). United Concordia will be able to offer an employer group plan as well as an individual product. Again, given the overwhelming dominance of Delta in the market, these factors will foster rather than stifle competition.

L.P.

- No Significant Barriers to Entry. We are aware of no significant barriers to entry into the Delaware dental insurance marketplace, other than the routine licensing and compliance requirements applicable to all insurers.

3. ***No Bundling.*** Neither BCBSD nor United Concordia would impose any "bundling" requirement after the Affiliation. In other words, BCBSD would not require a customer to purchase United Concordia dental coverage in order to purchase BCBSD health coverage. Nor would United Concordia require a customer to purchase BCBSD health coverage in order to purchase United Concordia dental coverage. Each will be offered on a standalone basis by two different entities.

4. ***Predominate Public Benefit.*** Finally, Section 5003(d)(1)b.2. provides that the acquisition of control *shall not* be disapproved if any of the criteria provided by Section 5003A(d)(3) exist. This section prevents disapproval (on the basis of competition) if the acquisition of control will yield substantial economies of scale or economies in resource utilization that cannot feasibly be achieved in any other way, as well as whether the public benefits that would result from those economies exceed the public benefits that would arise from not lessening competition. As demonstrated herein, the benefits of the affiliation, specifically including economies of scale and economies in resource utilization, far outweigh any concerns that may arise concerning the dental coverage. Finally, we note that dental insurance is an insignificant aspect of the overall transaction.

For all of the foregoing reasons, substantial evidence exists that the resulting affiliation of Highmark and BCBSD will have no anticompetitive effect whatsoever, and in fact could serve to increase competition in the Delaware dental insurance market.

C. The financial condition of any acquiring party is such as might jeopardize the financial stability of the insurer, or prejudice the interest of its policyholders.

1. ***Relative Size.*** Highmark is one of the 10 largest health insurance companies in the United States in terms of membership, with more than 4.8 million members, and is the largest not-for-profit Blue Plan by total revenue.

2. ***Financial Strength.*** Highmark is a very well capitalized health insurer, as demonstrated by the following:

- Highmark had over $3.7 billion in reserves (surplus) as of December 31, 2010, as reflected in its statutory Annual Statement filed with its domestic regulator, the Pennsylvania Insurance Department.
- Highmark's net income for 2010 was over $281 million.
- As of year-end 2010, Highmark's Risk Based Capital ("RBC") was at the higher-end of the range defined as "sufficient" by the Pennsylvania Insurance Department that is 550% to 750% of authorized control level.

3. ***High Ratings.*** Highmark is "A" rated by A.M. Best and Standard and Poors.

4. ***Support for BCBSD.*** Highmark's strong financial position would enable it to provide a measure of financial assistance to BCBSD, if needed, pursuant to the guarantee mandated by the BCBSA. Highmark also stands ready to extend the $45 million line of credit pursuant to the Line of Credit Agreement attached as an exhibit to the Business Affiliation Agreement.

5. ***No Access to BCBSD Assets.*** Highmark has no need or plans to access any of BCBSD's assets or surplus funds, and, in fact, could not legally do so without the prior review and approval of the Department, pursuant to a Form D filing under the Delaware Insurance Holding Company Act. *See* 18 Del. Admin C. § 1801.

6. No Profit for Administrative Services. As contemplated by the Business Affiliation Agreement, Highmark and BCBSD will enter into an Administrative Services Agreement whereby Highmark will provide administrative services to BCBSD; however, Highmark will provide these at cost and will forego any profit from these services.

7. No Impact on Highmark's Financial Condition. Highmark does not project that the Affiliation will have any detrimental impact on its financial condition.

D. The plans or proposals which the acquiring party has to liquidate the insurer, sell its assets or consolidate or merge it with any person, or to make any other material change in its business or corporate structure or management, are unfair and unreasonable to policyholders of the insurer and not in the public interest.

Highmark has no plans or proposals to liquidate BCBSD, sell its assets, or to consolidate or merge it with any other person. The proposed changes in its corporate structure and management will be in the public interest for a number of reasons:

1. Needed Business Changes to be Beneficial. Both BCBSD and Highmark do, of course, anticipate a number of changes in BCBSD's business. These changes will not only be fair and reasonable to BCBSD subscribers and in the public interest but are also intended to be highly beneficial to subscribers and the insurance buying public and to foster the public interest.

2. Best Solution to Needs of BCBSD. BCBSD is pursuing the affiliation with Highmark after a thorough assessment of its strategic options over a four-year period following BCBSD's disaffiliation with CareFirst. BCBSD believes that the agreement with Highmark offers the most practical, efficient and cost-effective means for assuring that BCBSD can meet the near-future and long-term needs of its Delaware stakeholders, while remaining a viable and robust presence in the larger Delaware employer community. As highlighted below, with a Highmark affiliation, BCBSD will achieve these objectives and be in a position to offer the best and most affordable options for its stakeholders in Delaware.

3. ***Claims Guarantee.*** Highmark's obligation to guarantee the contractual and financial obligations of BCBSD to its customers provides an extra layer of protection for BCBSD's customers.

4. ***Greatly Reduced IT Investment Requirement.*** With the Highmark affiliation, BCBSD expects to achieve a substantial savings in its critical IT investment as it migrates onto Highmark technology and business platforms –as much as $80 million less than would be required if BCBSD were to remain a stand-alone company.

5. ***Increased Products and Services.*** A number of Highmark products and services may become available through BCBSD as the Affiliation matures and market conditions dictate, including:

- Medicare Advantage;
- Medicare Part D;
- BlueEdge Dental;
- Highmark Vision;
- Medicaid Managed Care; and
- Retail Stores.

Also, BCBSD's affiliation with Highmark will enable BCBSD to provide a buy-in product to supplement Delaware's Children's Health Insurance Program ("CHIP"). This program will allow for subsidized insurance premiums for the approximately 22,000 children in Delaware who are uninsured but who do not meet the eligibility criteria for Medicaid or full cost, "free," CHIP.

6. Benefits to Delaware Stakeholders. Delaware stakeholders will greatly benefit from Highmark's state-of-the-art technology and systems.

- **Members**. BCBSD's members will have access to Highmark's member portals – *My Blue Link* a nd *Blues On Call*.
  - *My Blue Link* – web-based resource center
  - *Blues On Call* – "health coach" via registered nurse provides information about specific health-related topics
- **Employers**. BCBSD's employer groups will have access to Highmark's employer portal – *Highmark Online*.
  - View membership and group information
  - Update eligibility
  - View their claims bill online
  - E-mail customer service
  - Leverage online reporting functionality to track employee FSA (Flexible Spending Accounts) and HRA (Health Reimbursement Accounts)
- **Providers**. BCBSD's providers will have access to Highmark's provider portal – *NaviNet*, which enables providers to:
  - Obtain information regarding fee schedules
  - Check member eligibility of claim status
  - Submit changes resulting in direct updates into the appropriate system

Providers will also greatly benefit from Highmark's Real-Time solutions, which include:

- Real-Time Estimation
- Allows providers to determine accurate member liability
- Real-Time Claim Adjudication
- Allows providers to submit a claim that is processed in real-time at the point of service
- Accelerated Payment
- Increases speed of payment to providers if they participate in Real-Time and EFT/paperless programs.

- **Producers**. BCBSD's brokers and agents will have access to Highmark's producer portal.
  - Use the Small Group quoting tool for prospective Small Group business
  - Obtain online quotes and applications for individual products
  - Leverage online commission statements and agency related reporting

7. ***Maintenance of Delaware Presence.*** In order to achieve the economies of scale necessary to make the Affiliation a success, BCBSD anticipates that there will be reductions in BCBSD's present 617 full-time employee base. These reductions are expected to fall most heavily in the IT, finance and operations areas. These synergies of course are what will help BCBSD become more cost competitive; however, BCBSD and Highmark are extremely sensitive to the impact of job loss on individuals as well as the Delaware community. Accordingly, Highmark and BCBSD have committed to maintaining a significant Delaware presence and to maintain the BCBSD corporate headquarters in Delaware. Furthermore, the parties have agreed to use commercially reasonable efforts to maintain employment levels that are proportionate to those in other Highmark service areas. Confirming this, Highmark is

committed to the following regarding employment stability for BCBSD if the Affiliation is approved:

- Highmark will assure the total FTE positions in Delaware will be the same after implementation of the Affiliation is complete (approximately 18 months) as it was at the start of the Affiliation integration activities. The positions will be either BCBSD positions or Highmark positions located in Delaware.

- Any BCBSD employees whose positions are eliminated due to the implementation will be given the first opportunity to fill any new positions that are created in Delaware.

- If there is a significant decrease in BCBSD's enrollment or market share during the implementation period (*e.g.*, from the loss of a large customer) that results in any lost positions, Highmark will not be responsible to replace those lost positions.

- Highmark will also make good faith efforts to locate additional FTE positions in Delaware as Highmark's business opportunities arise.

8. Lower Premium Increases. Current projections anticipate that premiums will increase in the Delaware health insurance marketplace regardless of the affiliation status of BCBSD. However, BCBSD and Highmark have projected, in Exhibit 9 to the Affiliation Statement, that these rate increases will be lower (about 3%) under the Affiliation scenario than if BCBSD were to continue on a standalone basis. BCBSD and Highmark do not project any changes in the costs charged by providers to their patients or their patient's insurers as a result of the Affiliation.

9. Fortification of BCBSD Financial Condition Long-Term. The pro forma financial projections in Exhibit 9 also demonstrate the positive impact that the Affiliation is expected to have on BCBSD's financial position. These pro forma financials project that, on a standalone basis, BCBSD's RBC and reserves will deteriorate significantly as BCBSD makes capital expenditures on IT capabilities and thereafter begins to depreciate these items. In fact by 2015, on a standalone basis BCBSD projects that, largely as a result of these capital expenditures, BCBSD's reserves may shrink to just under $100 million (from over $181 million today) and its RBC may drop to as low as 550% of authorized control level (from approximately 1,000% presently). By contrast, under an affiliation scenario, BCBSD reserves are expected to grow to over $200 million by 2015, and its RBC levels will remain steady in the range of 1,000%.

10. No Access to BCBSD Assets. Although Highmark will become the sole corporate member of BCBSD following closing, this does not mean that Highmark has any right to dividends or distributions of profits or retained earnings from BCBSD. To the contrary, because Highmark will not have a "membership interest" as that term is defined in 8 *Del. C.* § 114(d)(2), Highmark will have no right to share in the profits and losses of BCBSD (i.e., BCBSD cannot pay any dividends to Highmark). Moreover, any transfer of assets from BCBSD to Highmark on an inter-company contractual basis will be subject to filing review and approval, as appropriate, by the Delaware Insurance Department under the Delaware Insurance Holding Company Act.

11. Continued Commitment to Community. The parties do not expect to make any substantial changes in BCBSD's day to day activities or policies. Thus, for example, there are no plans for any substantial changes in BCBSD's provider contracts or to contracting activities, which are expected to remain a local function. Similarly, there are no plans to change BCBSD's present practice of community support, highlighted by its funding of a donor advised fund, Blue Prints for the Community, most recently the recipient of a $1,630,000 donation from BCBSD in May, 2011.

E. The competence, experience and integrity of those persons who would control the operation of the insurer are such that it would not be in the interest of policyholders of the insurer and of the public to permit the merger or other acquisition of control.

1. Highmark's Directors and Officers. The qualifications of Highmark's board and executive management are described in the biographical affidavits filed with the Affiliation Statement. These affidavits demonstrate that the Highmark board and management is highly qualified to competently govern and manage Highmark and all of its affiliates

2. Highmark's Additions to BCBSD Board. In addition to being responsible for the day to day operations of Highmark, three of the four BCBSD Class B directors, Highmark CEO, Dr. Kenneth Melani, Highmark Treasurer and CFO, Nanette DeTurk, and Highmark Executive Vice President of Health Services, Deborah Rice, will come from the ranks of Highmark executive management. The final Class B director will be selected in accordance with the requirements of SB 146, and will thus be a Delaware resident. The Parties are in the process of identifying potential candidates for this position.

3. ***BCBSD Management Retained.*** While the companies anticipate eventual synergies through consolidation of some management functions, there are no current plans to make material changes to the management of BCBSD; indeed, Timothy Constantine, the present President of BCBSD, will continue to fill this role post closing. As for the Class A directors, each will be selected by BCBSD from the members of the present BCBSD board, all of whom are prominent Delawareans and who have successfully governed BCBSD for many years. If, and to the extent that some executives are released or undergo significant diminution of compensation or responsibilities, and as a result severance benefits become payable, the financial impact of these (worst case scenario – $5.6 million) would not have a significant impact on BCBBSD's financial condition.

4. ***Proven Affiliation Success in West Virginia.*** Perhaps the best evidence of the competence, experience and integrity of Highmark's management is the West Virginia success story. Highmark and the West Virginia Blue Cross Blue Shield plan [formerly Mountain State Blue Cross Blue Shield and now Highmark Blue Cross Blue Shield West Virginia ("Highmark WV")], entered into their first agreements in 1999 which evolved into an affiliation that is very similar to the proposed Affiliation between Highmark and BCBSD. Over the first ten years of Highmark WV's relationship with Highmark (1999-2010), Highmark WV's surplus increased from $19 million at December 31, 1999, to $242 million at December 31, 2010; its RBC rose from 276% at December 31, 1999 to 1013% at December 31, 2010; and its membership rose from 253,000 at December 31, 1999, to 544,000 at December 31, 2010. Fulltime employees in West Virginia increased from 670 in 1999 to 850 in 2010, as Highmark WV filled a jobs need for Highmark at that time.

F. The acquisition is likely to be hazardous or prejudicial to the insurance buying public.

1. Affiliation Will Benefit Public. Far from being hazardous or prejudicial, the Affiliation will have positive benefits to the insurance buying public, including:

- Improvement in the projected financial strength of BCBSD for years to come, backstopped by the guaranty of Highmark, a $6 billion company.

- The likely introduction of many products and services that BCBSD presently does not have the resources to offer. By increasing the array of products that might be offered to different segments of the public, including the individual market and senior market, and by reducing the amount of future rate increases for health insurance coverage in Delaware as provided by BCBSD, the Affiliation will have a positive impact on access to healthcare in Delaware. BCBSD subscribers will also have access to Highmark's integrated care management services, which are designed to deliver comprehensive health management services that promote better health and optimize health care investment. These programs help to prevent illness, lower risk, and slow disease progression, thus improving health outcomes and controlling costs. The programs combine health management, pharmacy benefit and productivity management programs.

  Services include:

  - A full range of wellness programs
  - Discounted access to national network of complementary and alternative health providers
  - 24x7 telephonic coaching for chronic diseases and targeted conditions
  - Decision support tools
  - Large case management services
  - Dedicated medical director consultative services
  - Reporting and clinician data analysis

- A commitment to an ongoing Delaware presence.

- Smaller projected rate increases.

- Real-time services designed to assist the provider community.

- By ensuring the financial stability and future competitiveness of BCBSD, Delaware's largest health insurer, and by making available more health insurance products and services to both insureds and providers, the Affiliation will ensure that BCBSD will remain a viable third party payer, thereby helping to enhance both the quality and availability of health care in Delaware.

- Please also note that the reasons cited for meeting standard D herein-above, are also applicable to this standard F.

Based upon the information set forth above, Highmark and BCBSD maintain that the proposed affiliation meets the criteria made applicable to this matter under the Pre-Hearing Order.

VIII. <u>Witnesses BCBSD Expects to Call at the Public Hearing</u>

A. Timothy J. Constantine, President, BCBSD

Mr. Constantine's testimony will summarize BCBSD's corporate history and structure, BCBSD's need for affiliation, its historical efforts to find an affiliation partner, the selection of Highmark, and the key facets of the Affiliation Agreement.

B. Louis Pavia, President, Care Companion

Mr. Pavia's testimony will address the due diligence process undertaken by BCBSD that led to the selection of Highmark.

C. Scott Fad, Senior Vice President, BCBSD

Mr. Fad will testify to the integration process currently underway between Highmark and BCBSD, and will describe the ultimate integration objectives that the companies intend to achieve

D. James Hynek, Chief Financial Officer, BCBSD

Mr. Hynek will testify to the projected financial condition of BCBSD on a standalone basis and on an affiliation basis and will also provide testimony on Highmark cost allocations from BCBSD's perspective.

IX. Witnesses Highmark Expect to Call at the Public Hearing

A. Karen L. Hanlon, Senior Vice President, Finance and Planning, Highmark

Ms. Hanlon's testimony will address all aspects of the proposed affiliation from Highmark's perspective, other than cost allocation issues. Ms. Hanlon will address Highmark's corporate structure, business and history, its management and its financial condition, as well as describing detailed aspects of the transaction and how the affiliation will meet the needs of BCBSD and will be in the best interests of BCBSD stakeholders.

B. Ken B. Gebhard, Vice President, Cost Management and Analysis, Highmark

Mr. Gebhard will testify concerning Highmark's cost-allocation methodology whereby costs are allocated to affiliates within the Highmark corporate structure and which will be the basis for charges to BCBSD under the proposed Administrative Services Agreement between Highmark and BCBSD.

C. J. Fred Earley, II, President, Highmark West Virginia Inc.

Mr. Earley will testify as to Highmark WV's past and present relationship and experience with Highmark over the past twelve years and which relationship is now an affiliation similar to that proposed between Highmark and BCBSD.

X. CONCLUSION

For the reasons set forth herein, BCBSD and Highmark respectfully submit that the proposed affiliation between them does not implicate any of the standards set forth in Section 5003 that govern the Commissioner's review of change-of-control transactions. Accordingly, BCBSD and Highmark respectfully request that the Hearing Officer recommend to the Commissioner that the proposed transaction, and specifically the Amended Certificate of Incorporation and Amended Bylaws of BCBSD as well as the Administrative Services and Line of Credit Agreements between Highmark and BCBSD, be approved.

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