

- 30 **Q. What positions have you held during your career at Highmark?**
- 31 A. My entire career at Highmark has been in Corporate Finance with an emphasis on cost
32 and budget activities. I began as a Financial Analyst and have held positions as a
33 Manager, Director and Vice President.
- 34 **Q. How long have you held your present position as Vice President, Cost Management
35 and Analysis?**
- 36 A. I have held my present position since May 2009.
- 37 **Q. Please describe the scope of your duties as Vice President, Cost Management and
38 Analysis at Highmark?**
- 39 A. As Vice President, Cost Management and Analysis, my accountabilities include
40 administering the company's budgeting, cost accounting and administrative cost
41 forecasting activities. In addition, my duties include accounts payable, 1099 reporting
42 and Federal Employee Program ("FEP") cost compliance.
- 43 **Q. To whom do you report at Highmark and to whom does that person report?**
- 44 A. I report to Karen L. Hanlon, Highmark's Senior Vice President, Financial Planning and
45 Analysis. Karen reports directly to Nanette P. DeTurk, Highmark's Executive Vice
46 President, Chief Administrative and Financial Officer.
- 47 **Q. Have you been a part of the Highmark team that has worked on the proposed
48 affiliation between Highmark and BCBSD that is the subject of this hearing?**
- 49 A. Yes.
- 50 **Q. What role have you played, on behalf of Highmark, in the development and analysis
51 of the proposed transaction?**
- 52 A. Early on, I supported the due diligence process by reviewing BCBSD's administrative
53 cost information, and based on this information, performing high-level analysis to
54 determine the potential impact of the affiliation on Highmark's administrative costs.
- 55 Once the definitive agreements were signed in August 2010, I supported Karen Hanlon,
56 Highmark's Senior Vice President, Financial Planning and Analysis, and Jim Hynek,
57 BCBSD's Chief Financial Officer, in the development of input to use in preparing the
58 Affiliation-version of the financial pro formas. This input included developing estimates
59 of the potential post-affiliation cost synergies, the service charges that would be
60 applicable to BCBSD for administrative services to be provided by Highmark to BCBSD,
61 and the cost to BCBSD of integrating BCBSD onto Highmark's IT systems and operating
62 platform. Subsequent to this work, I worked with Karen and Jim to update this input
63 based on information coming out of the integration planning process for inclusion in the
64 updated financial pro formas. I was also on the financial analysis team which validated
65 output coming from the integration planning process. I have also participated in

66 discussions with the Department of Insurance advisors relative to Highmark’s cost
67 allocation methodologies and the cost information included in the financial pro formas as
68 described above.

69 **Q. Are you familiar with the proposed Administrative Services Agreement between**
70 **Highmark and BCBSD?**

71 **A.** Yes.

72 **Q. Can you describe the nature and purpose of the Administrative Services**
73 **Agreement?**

74 **A.** The purpose of the Administrative Services Agreement (“ASA”) is to establish a
75 contractual relationship between BCBSD and Highmark relative to services that
76 Highmark may provide to BCBSD following the affiliation. The ASA describes the
77 scope of services that Highmark may provide to BCBSD, the manner in which Highmark
78 will be compensated for providing these services, the term of the ASA, events that trigger
79 a termination, requirements related to maintenance of records and access to data, and
80 other matters, including but not limited to, a resolution process in the event of a dispute
81 arising out of the ASA.

82 **Q. With regard to the manner in which Highmark will be compensated by BCBSD for**
83 **services under the ASA, are you familiar, Mr. Gebhard, with Article II.A. of the**
84 **ASA which provides in part “BCBSD shall compensate Highmark for Highmark’s**
85 **provision of the Services in an amount equal to BCBSD’s fair and reasonable**
86 **allocable share of the total actual cost without provision for profit to Highmark of**
87 **providing the Services. Such costs shall include, without limitation, employee**
88 **salaries, employee benefits and other direct and indirect administrative costs,**
89 **including reasonable charges for corporate overhead. BCBSD’s allocable share of**
90 **the cost of the Services shall be determined in accordance with Highmark’s**
91 **established cost accounting practices as in effect from time to time. . . .”?**

92 **A.** Yes. In simpler terms, that provision means that Highmark will provide services to
93 BCBSD “at cost” – without provision for profit to Highmark.

94 **Q. Is the compensation for services described in this provision of the ASA reflected in**
95 **the “cost information” included in the financial pro formas you mentioned earlier?**

96 **A.** Yes.

97 **Q. Please describe in detail Highmark’s cost allocation practices and how they would**
98 **be applied in regard to BCBSD under the ASA.**

99 **A.** Highmark’s cost allocation framework (as provided in Exhibit 26 of the Pre-
100 Hearing Memorandum of the Delaware Department of Insurance) differentiates between
101 costs originating in Highmark’s Home Office and those originating in the various
102 Business Segments within Highmark’s holding company system. Home Office refers to
103 functions or activities responsible for managing or serving two or more Business

104 Segments. The Business Segments represent divisions of the overall Highmark enterprise
105 that are identified with producing a particular product or service. In Highmark's cost
106 allocation framework, BCBSD business will reside in the Commercial Health Business
107 Segment which also includes Highmark West Virginia, and the Central and Western
108 Pennsylvania Regional Business, Senior Markets and National Business of Highmark Inc.
109 Other Business Segments include the non-health business such as Vision, Dental, etc. as
110 well as Highmark Medicare Services.

111 Home Office expenses largely consist of either centralized service functions, such as
112 Information Technology or staff management of certain activities that benefit either the
113 entire enterprise or multiple, though not necessarily all, business segments, such as
114 Corporate Finance. The first step of the methodology for allocating Home Office
115 expenses is to allocate centralized service functions to segments on the basis of the
116 service furnished to or received by each segment. Allocation of centralized service
117 expenses is followed by the allocation of staff management functions which are first
118 allocated based on specific activities provided in support of an identifiable business
119 segment. When this isn't possible due to the nature of the activity, residual Home Office
120 expenses are allocated using a methodology reflective of the beneficial or causal
121 relationship between such expenses and the receiving segments. As noted previously, for
122 cost accounting purposes, BCBSD will reside in the Commercial Health business
123 segment. Costs that will be allocated within the Commercial Health segment include
124 costs originating in that segment itself as well as those allocated to that segment from the
125 Home Office as described above. Cost allocations within the Commercial Health
126 segment then follow an allocation sequence as follows:

- 127 • Expenses are directly assigned to a particular market, for example, West Virginia,
128 Western Pennsylvania, Central Pennsylvania, et al, to the maximum extent possible
129 (for example, Sales)
- 130 • Expenses that are not directly allocated to a particular market because they support
131 multiple markets are accumulated into logical and relatively homogenous pools to be
132 allocated on bases reflecting the relationship of the expenses to the markets concerned
133 (such as claims or customer service systems)
- 134 • Remaining expenses are allocated to each market in proportion to its share of the total
135 cost allocated either directly or through a homogenous pool as described above (for
136 example, Health governance)

137
138 As described above, these cost allocation methodologies will determine the inter-
139 company charges from Highmark to BCBSD. All inter-company charges will be at
140 actual cost, without provision for profit, consistent with the terms of the Administrative
141 Service Agreement. In addition, Highmark and Blue Cross have agreed to certain
142 conditions relating to cost allocation, including allowing Department approval of the
143 annual charges to be assessed against Blue Cross, as well as Department approval of any
144 payments for charges materially in excess of the approved charges.

145 **Q. Are Highmark’s cost accounting practices audited by any government entities? If**
146 **so, please explain.**

147 **A.** Yes, Highmark’s cost accounting practices are audited by several government entities.

148 Two of Highmark’s business segments (Highmark Medicare Services and United
149 Concordia Dental) have contracts with the Federal Government that are covered by the
150 Federal Government’s Cost Accounting Standards (CAS). Because a share of
151 Highmark’s Home Office costs flow to these contracts, Highmark’s Home Office cost
152 allocations must be compliant with the CAS. As a result, Highmark must disclose its
153 accounting practices to the Federal Government. This disclosure is then subject to audit
154 to verify that Highmark is allocating costs consistent with its disclosure statement and
155 that allocation practices are consistent with the CAS. These audits are performed by the
156 Defense Contract Audit Agency (DCAA) on behalf of the Centers for Medicare &
157 Medicaid Services (CMS) and the Department of Defense (DOD). The DCAA has found
158 Highmark’s Home Office cost accounting practices to be *Adequate and Compliant*, and
159 that Highmark’s methodology for allocating the Home Office Residual pools results in an
160 equitable allocation to business segments.

161 The Federal Employee Program (FEP), which sits in Highmark’s Commercial Health
162 business segment (the same segment in which BCBSD will reside), is audited by the
163 Office of Personnel Management’s Office of the Inspector General. The objectives of
164 this audit are to determine whether administrative costs charged to the Federal Employees
165 Health Benefits Program (FEHBP) were actual, allowable, necessary and reasonable in
166 accordance with the terms of the contract and applicable laws and regulations, such as the
167 Federal Acquisition Regulations (FAR). FEP administrative costs are also audited by the
168 Blue Cross Blue Shield Association.

169 Since Highmark does not have CAS-covered contracts in its Commercial Health business
170 segment, allocation methodologies within this segment are not disclosed to the Federal
171 Government. However, markets, including Delaware, benefitting from the activities
172 provided in any expense pool within the Commercial Health business segment will
173 receive consistent cost allocations based on common methodologies and statistics.

174 **Q. How long has this cost accounting system been in place at Highmark?**

175 **A.** Highmark’s cost allocation system has been in place since January 1998. Revisions to
176 the allocation methodologies within the overall framework have been made as necessary
177 to align with organizational and operational changes over time.

178 **Q. How was the cost accounting system developed?**

179 **A.** The cost accounting system was developed by first looking at what requirements exist as
180 to information coming out of the system and then determining the best approach for
181 addressing these requirements. Since Highmark has both commercial and government
182 business, each with a unique set of requirements, the system was designed to address the
183 needs of both. However, the overall objective of consistent, fair and equitable cost

184 allocations to businesses, based on the beneficial or causal relationship between such
185 costs and the receiving businesses, applies to both commercial and government business.

186 On the commercial side, information coming out of the cost accounting system is used to
187 assess financial performance and as input to the pricing of our products and services. On
188 the government side, cost information must be compliant with government regulations
189 and is often the source for determining reimbursements. With this in mind, the system
190 that was implemented in January 1998 was developed with the support of Arthur
191 Andersen & Co., who provided expertise pertaining to the development of a system and
192 associated methodologies that were structured to be fair and equitable while enabling
193 compliance with the Federal Government's Cost Accounting Standards (CAS). The
194 system was built using Highmark's PeopleSoft tool, which facilitated the efficient
195 integration of allocated cost information into the monthly financial closing process.

196 **Q. How often are allocation methodologies revised and what would be an example of**
197 **such a revision?**

198 **A.** Allocation methodologies are revised on an as-needed basis to meet the overall objective
199 of fair and equitable allocations to businesses, based on the beneficial or causal
200 relationship between such costs and the receiving businesses. There are a number of
201 factors that could trigger the need to review and possibly revise cost allocation
202 methodologies. At the Home Office level, examples of these factors include introduction
203 of a new technology or centralized service, reorganizations that impact the businesses
204 supported by an existing cost pool, organizational changes resulting from an acquisition
205 or divestiture, etc. Within the Commercial Health Segment, there are also factors that
206 could influence the need to analyze potential revisions to the allocation methodologies.
207 These include, but are not limited to, introduction of a new product line or organizational
208 changes that impact the manner in which segments and/or products are supported from
209 both governance and operational perspectives.

210 We recognize that predictability and stability of cost allocations are important to our
211 business segments. Unless something of a material nature takes place during the course
212 of the year that would otherwise result in inequitable allocations, we generally limit
213 allocation methodology changes to the January allocation cycle of each calendar year.
214 This better enables us to incorporate anticipated allocation changes into the annual
215 financial planning process and significantly minimizes the impact of cost allocation
216 methodologies on financial results. This also facilitates satisfaction of our CAS
217 disclosure requirements.

218 **Q. What business is included in the Commercial Health business segment?**

219 **A.** The Commercial Health business segment includes business reporting to Highmark's
220 Executive Vice President, Health Services. This includes Western and Central
221 Pennsylvania Regional Markets, West Virginia Markets, National Markets and Senior
222 Markets. Within the cost allocation framework, Delaware Markets will be part of the
223 Commercial Health business segment post-closing.

224 **Q. Are cost allocation methodologies within the Commercial Health business segment**
225 **applied on a consistent basis?**

226 **A.** Allocation methodologies within the Commercial Health business segment are
227 applied consistently to all businesses within the segment. Each cost pool allocates to the
228 various markets and products based on a common methodology using consistent statistics
229 or other allocation basis. The allocations are driven entirely by the objective application
230 of these statistics to all markets and products benefiting from the services provided by the
231 respective cost pools. For example, in the Highmark Claims Adjudication Jobs cost pool,
232 which is allocated based on number of claims processed, if 10% of the claims processed
233 relate to West Virginia business, then 10% of the expenses in this cost pool will be
234 allocated to West Virginia business. This is true for each of the large operational cost
235 pools. For the General & Administrative cost pools, a Total Cost Input (TCI) basis of
236 allocation is generally used and is applied consistently to all businesses benefitting from
237 the pool's activities. For TCI pools, each business receives a share of the pool's allocated
238 cost proportionate to the costs already allocated to the business in earlier stages of the
239 cost allocation process.

240 **Q. Are Highmark's cost accounting practices unique or unusual, or are they**
241 **representative of customary or mainstream cost accounting practices for health**
242 **insurance companies?**

243 **A.** Highmark's cost accounting practices are in conformity with customary insurance
244 accounting practices. However, within the overall framework of customary insurance
245 accounting practices, companies have discretion to develop their cost accounting
246 practices to best suit unique requirements given their specific business model. As
247 mentioned previously, Highmark's cost accounting practices have been significantly
248 impacted by its government contracts and the compliance requirements therein. Also, the
249 existence of multiple markets within the Commercial Health business segment has
250 influenced Highmark's cost accounting practices.

251 **Q. Does Highmark have an Administrative Services Agreement in place with**
252 **Highmark WV and does that Administrative Services Agreement contain a similar**
253 **provision to that contained in the proposed Administrative Services Agreement**
254 **between Highmark and BCBSD as to compensation paid to Highmark for such**
255 **services being based on Highmark's cost accounting practices?**

256 **A.** Yes, Highmark has an Administrative Services Agreement in place with Highmark WV.
257 The ASA states that:

258 *"MSBCBS shall compensate Highmark for Highmark's provision of the Services in an*
259 *amount equal to MSBCBS's fair and reasonable allocable share of the total cost to*
260 *Highmark of providing the Services. Such costs shall include, without limitation,*
261 *employee salaries, employee benefits and other direct and indirect administrative costs,*
262 *including charges for corporate overhead. MSBCBS's allocable share of the cost of the*
263 *Services shall be determined in accordance with Highmark's established cost accounting*

264 *practices as in effect from time to time. MSBCBS also shall reimburse Highmark for any*
265 *and all direct third party costs incurred by Highmark for the benefit of MSBCBS.”*

266 This language is essentially identical to the language in the proposed ASA between
267 Highmark and BCBSD.

268 **Q. Does Highmark include any provision for profit in its cost accounting system for**
269 **charges to affiliates for services rendered?**

270 **A.** No. Highmark does not include any provision for profit in its cost allocation processes.
271 Therefore, charges to affiliates would not include a provision for profit.

272 **Q. Is the Highmark cost accounting system one that is entirely a matter of mechanical**
273 **application of a prescribed formula or is there ever any subjectivity involved?**
274 **Secondly, if subjectivity is sometimes involved, please describe the circumstances**
275 **when subjectivity might come into play and who has the power to exercise such**
276 **subjectivity?**

277 **A.** Highmark makes every effort to make the cost allocation process as objective as possible.
278 Our goal as stated previously is for the process to result in cost allocations that are fair
279 and equitable and based on the beneficial or causal relationship between such costs and
280 the businesses receiving the allocations. That being said, there is always some level of
281 subjectivity in the allocation process, as some functions do not bring with them a logical
282 set of statistics upon which to base the allocations as do other functions.

283 Highmark takes a variety of steps to mitigate the inherent subjectivity in the allocation of
284 costs for certain functions. These include the establishment and execution of consistent
285 allocation methodologies to all businesses based on available input. This input includes
286 discussions at least annually with cost center managers to understand their activities and
287 get their perspectives on the businesses benefitting from these activities. On the back-
288 end, business owners (which would include BCBSD) have the ability to challenge cost
289 allocations, which would result in further review of the allocation methodology for a
290 particular cost element.

291 As related to the BCBSD transaction, the most significant allocations from Highmark to
292 BCBSD will be related to technology costs associated with the core applications.
293 Allocations of these costs tend to be the most objective by their very nature due to the
294 availability of common statistics that are used to logically allocate these cost pools, e.g.
295 claims processed for the Claims Adjudication Jobs pool, inquiries for the Customer
296 Service Jobs pool, etc.

297 **Q. Please describe the process for any affiliated entity to challenge the amount or**
298 **nature of costs allocated to them from time to time by Highmark?**

299 **A.** I will use Highmark WV as the basis for describing how the process would work as to a
300 cost allocation issue that might arise as to BCBSD or any other Highmark affiliate.

301 Each month, Highmark WV receives an invoice from Highmark with details supporting
302 the cost allocations from Highmark. This invoice is reviewed by the Highmark West
303 Virginia President's financial support staff. If this review results in questions regarding
304 the appropriateness of a particular cost allocation, the Highmark West Virginia
305 President's financial support staff would work directly with Highmark's Cost Accounting
306 and Reporting department, which reports to the Director, Cost Accounting and Reporting
307 who reports directly to me, to address the question. If the issue cannot be resolved at this
308 level, the Highmark West Virginia President would be made aware of the issue and likely
309 raise the issue at a monthly Executive Financial Review meeting attended by the
310 Highmark West Virginia President and senior Highmark financial staff. If still
311 unresolved, the next step in the resolution process would be for the Highmark West
312 Virginia President to raise the issue to the attention of Highmark's Executive Vice
313 President, Health Services who would work with Highmark's Chief Financial Officer to
314 resolve the issue. While issues of this nature have never reached this level in West
315 Virginia, if the issue was still unresolved, it would be raised to Highmark's CEO and
316 Highmark West Virginia's President for resolution and to the respective Boards if still
317 unresolved.

318 **Q. Is this the process that would be followed for BCBSD to challenge the amount or**
319 **nature of costs allocated to it by Highmark?**

320 A. Essentially. The primary difference between the process that West Virginia follows and
321 the process that Delaware would follow is that, if a dispute is unable to be resolved by
322 Highmark's CEO and BCBSD's President, and then is unable to be resolved by the
323 BCBSD Board of Directors, then the Delaware Department of Insurance would resolve
324 the dispute. This is due to a condition that the Delaware Department of Insurance has
325 proposed, and to which Highmark and BCBSD have agreed.