



In The Matter Of:

**Before the Insurance Commissioner of the
State of Delaware**

Proposed Affiliation of BCBSD, Inc with Highmark, Inc

Docket No. 1509-10

October 5, 2011

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1 BEFORE THE INSURANCE COMMISSIONER
2 FOR THE STATE OF DELAWARE
3 IN RE: THE PROPOSED) VOLUME ONE
4 AFFILIATION OF BCBSD,)
5 INC., DOING BUSINESS) Docket No. 1509-10
6 AS BLUE CROSS BLUE)
7 SHIELD OF DELAWARE,)
8 WITH HIGHMARK INC.)

 Delaware Department of Insurance
 841 Silver Lake Boulevard
 Dover, Delaware

 Wednesday, October 5, 2011
 9:00 a.m.

BEFORE: THE HONORABLE BATTLE R. ROBINSON,
 Hearing Officer

APPEARANCES:

 DAVID S. SWAYZE, ESQUIRE
 MICHAEL W. TEICHMAN, ESQUIRE
 PARKOWSKI GUERKE & SWAYZE, P.A.

 800 King Street - Suite 203
 Wilmington, Delaware 19801
 for BCBSD

 FREDERICK K. CAMPBELL, ESQUIRE
 S. DOAK FOSTER, ESQUIRE
 MITCHELL WILLIAMS SELIG
 GATES & WOODYARD, PLLC

 425 West Capitol Avenue - Suite 1800
 Little Rock, Arkansas 72201
 for Highmark Inc.

Cont'd...

TRANSCRIPT OF PROCEEDINGS

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1 privileged. I note that information which the
 2 parties have agreed is or I have determined is
 3 privileged has been redacted or withheld from the
 4 public record.
 5 The confidential information is,
 6 nevertheless, part of the official record of the
 7 case and may be reviewed by parties, the Hearing
 8 Officer, and the Commissioner.
 9 In order to make these proceedings
 10 more meaningful for the public, counsel have made
 11 an admirable effort to keep the privileged
 12 information at a minimum, and I thank them for
 13 this effort.
 14 The Hearing Officer may also limit
 15 testimony that is outside the scope of the
 16 hearing, and in that respect I remind you that
 17 this is not a hearing on insurance rates. I
 18 understand that the cost of health insurance is a
 19 matter of concern to Delawareans and it certainly
 20 may be peripherally addressed in the proceedings
 21 today, but the focus of the hearing is to be on
 22 the structure of the proposed affiliation, not on
 23 rates.
 24 In her order, the Commissioner

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1 instructed me to apply the specific criteria set
 2 out in 18 Delaware Code, Section 5003(b)(2) and
 3 the parties consented to these criteria being
 4 employed in this matter.
 5 In addition, since the filing of the
 6 proposed affiliation, the Delaware General
 7 Assembly has enacted a new law which directs by
 8 statute that the Commissioner apply these
 9 criteria.
 10 It also contains directives as to
 11 conditions which must be placed on any approval
 12 of a change of control of a Health Service
 13 Corporation such as Blue Cross.
 14 According to the statute, these
 15 conditions are without limitation which indicates
 16 that additional conditions may be appropriate.
 17 As Hearing Officer, I must make
 18 certain that the proposed affiliation meets the
 19 criteria set out in Section 5003(d)(2) and
 20 applies with the statutory conditions of the new
 21 Section 6311.
 22 I must also consider whether
 23 additional conditions are called for, and it is
 24 my understanding that we will be hearing about

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1 additional conditions which are being proposed or
 2 have been agreed to by the parties.
 3 The applicable statutes, once again,
 4 are available online or in any public library
 5 which has a copy of the Delaware Code.
 6 Finally, in reviewing the documents,
 7 I noticed a number of acronyms, terms, and
 8 abbreviations which are no doubt familiar to the
 9 parties in the insurance business, but may not be
 10 known to the general public or, for that matter,
 11 to the Hearing Officer. I would, therefore, ask
 12 counsel to try to make certain that these terms
 13 are explained at least the first time they are
 14 used.
 15 As to the proceedings today, we will
 16 hear what I hope will be a very brief opening
 17 statement, then we will hear testimony from
 18 witnesses, and the other parties may
 19 cross-examine them.
 20 The Departments of Insurance and
 21 Justice will then present their witnesses who
 22 will also be subject to questioning by the
 23 applicants. At the close of the parties' cases,
 24 I will hear comments from the general public.

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1 I thank you for your attention. I
 2 remind you that since one of the purposes of this
 3 hearing is to create a record for the
 4 Commissioner, some of the testimony may be
 5 detailed, and I ask for your patience.
 6 Now I'm going to ask counsel to
 7 introduce themselves and their associates for the
 8 record and specify the party you are
 9 representing.
 10 Let's start over with Highmark and
 11 Blue Cross Blue Shield.
 12 If you would just state for the
 13 record your name and if you have a
 14 party-in-interest present in the courtroom, who
 15 you are represent.
 16 MR. CAMPBELL: My name is Rick
 17 Campbell. I'm with Mitchell Williams and I
 18 represent Highmark. Along with me is Mona Parikh
 19 who's with Buchanan Ingersoll. And then my
 20 partner, Doak Foster, also with Mitchell
 21 Williams.
 22 We have several representatives of
 23 Highmark here who will be testifying, and I can
 24 introduce them either at this time or at a later

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1 time.

2 THE HEARING OFFICER: You can

3 introduce them later when they testify.

4 MR. CAMPBELL: Thank you, ma'am.

5 THE HEARING OFFICER: Mr. Swayze?

6 MR. SWAYZE: Thank you, Your Honor.

7 My name is David Swayze and I'm a director of the

8 firm of Parkowski, Guerke & Swayze representing

9 Blue Cross Blue Shield of Delaware today.

10 With me is my fellow director, Mike

11 Teichman. To my left is the vice president and

12 general counsel of BCBSD, Bill Kirk.

13 MR. HOUGHTON: Your Honor, Michael

14 Houghton of the firm of Morris Nichols

15 Arsht & Tunnell. We're special counsel to the

16 Department of Insurance in this matter. My

17 partner Leslie Polizoti is here with me.

18 We have three associates from the

19 firm who have been working diligently on this

20 matter. Ryan Stottman, Brenda Mayrack, and Bryan

21 Townsend.

22 THE HEARING OFFICER: You're Ryan,

23 Brenda -- okay. I have seen your names, so I'm

24 glad to see you. Many times.

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1 MR. McCONNELL: Ian McConnell on

2 behalf of the Delaware Department of Justice. To

3 my right is Meredith Tweedie, Deputy Attorney

4 General, and the Attorney General of the State of

5 Delaware, Beau Biden.

6 In addition, we have Cynthia Shoss

7 with the law firm Dewey LeBoeuf representing

8 special counsel.

9 THE HEARING OFFICER: Thank you very

10 much.

11 And Mr. McConnell, it's my

12 understanding that the Attorney General would

13 like to make a statement today, and this seems to

14 me to be an appropriate time for him to do that.

15 Welcome, Mr. Attorney General, and we

16 will hear from you.

17 MR. BIDEN: Good morning, Your Honor.

18 I appreciate the opportunity.

19 Am I here?

20 THE HEARING OFFICER: Whichever you

21 feel more comfortable.

22 MR. BIDEN: I'll do it probably the

23 way it should be done before Your Honor.

24 THE HEARING OFFICER: I guess that's

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1 the witness seat.

2 MR. BIDEN: Good morning. Good

3 morning, gentlemen. Thank you, Your Honor.

4 Blue Cross Blue Shield of Delaware

5 was founded as a not-for-profit, as you know, in

6 Delaware as a Delaware corporation in 1935. The

7 State has historically granted a significant tax

8 break to the corporations that work to serve,

9 benefit, and promote the public good. For more

10 than 75 years, Blue Cross Blue Shield has and

11 continued to enjoy this favorable tax treatment,

12 as well as the goodwill and positive public

13 perception generated by its not-for-profit

14 status.

15 Each of these factors has played in a

16 part of Blue Cross Blue Shield's current market

17 dominance in Delaware and its strong financial

18 position, including the build up of substantial

19 capital and surplus that is higher than the

20 average for a plan of its size.

21 As of today, Blue Cross Blue Shield's

22 reserves are now approximately \$181 million.

23 This significant surplus of capital is, in part,

24 the direct result of Delaware's decades-long

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1 public subsidy of Blue Cross Blue Shield. It

2 must be protected, from my position, and our

3 position, it must be protected and retained for

4 the benefit of Delawareans.

5 The Department of Justice for the

6 State of Delaware has a significant and vested

7 interest in the outcome of this proceeding due to

8 our role in enforcing state consumer protection

9 laws, protecting not-for-profit or charitable

10 interests, and investigating matters involving

11 the public welfare.

12 The Attorney General, by common law,

13 acts, as you know, Judge, to protect the public's

14 interest in matters such as this, especially

15 where impact may be felt now or in the future on

16 the assets of a not-for-profit corporation.

17 Consideration of the public's

18 interest must include, and any approval decision

19 must address the disposition, present and

20 potential, of the assets of Blue Cross Blue

21 Shield of Delaware that were subsidized by

22 Delawareans for so many years, as well as the

23 assignment of responsibility for the future

24 management in business decisions that may affect

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1 the use of those public subsidized assets.
2 This past spring my office, assisted
3 by consultants, some of whom you were introduced
4 to this morning, specifically engaged for this
5 purpose, carefully reviewed the proposed
6 transaction. The intent of the Department of
7 Justice in reviewing the transaction is not to
8 duplicate, not to duplicate the work of the
9 Department of Insurance, but rather to meet our
10 own statutory and common law responsibilities.
11 The Department of Justice's statutory
12 responsibilities include a review of the proposed
13 transaction under the Not-For-Profit Healthcare
14 Conversion Act. Based upon the plain reading of
15 this statute, we determined that the proposed
16 affiliation was a, quote/unquote, healthcare
17 conversion under the act as it then existed. As
18 a result, the act required that a foundation be
19 created and funded, and funded to retain and
20 protect the public benefit asset or, quote, that
21 part of the fair market value of the converting
22 entity impressed with the public trust for the
23 public benefit, unquote.
24 The foundation's purpose would have

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1 been to serve the unmet healthcare needs of
2 Delawareans. A board of directors was to be
3 appointed by the governor, confirmed by the
4 Delaware State senate, and tasked with overseeing
5 the administration of the foundation. The
6 directors were to have been people with a wide
7 range of experience and skills to include
8 healthcare and business professionals.
9 As envisioned by the legislature, the
10 foundation requirement of the conversion act was
11 and still is the best way to protect Delaware's
12 public subsidy of Blue Cross Blue Shield of
13 Delaware.
14 After the Department of Justice's
15 announcement of our determination, which was
16 about three weeks to go of the General Assembly
17 seating, Blue Cross Blue Shield of Delaware
18 successfully lobbied the Delaware General
19 Assembly to change this important law, protecting
20 the charitable interests of a Delaware
21 not-for-profit corporation so that the proposed
22 transaction would no longer be a conversion under
23 the act, and a foundation would no longer be
24 required by law. The legislation was signed into

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1 law by the governor on July 12th, as you know,
2 2011.
3 Despite this change in the law, the
4 Department of Justice retains its common-law
5 authority as still expressly affirmed in the
6 conversion act to protect the charitable trust
7 and assets held by the public benefit in this
8 state for the public benefit in this state and
9 has continued its review of the transaction under
10 this standard.
11 The proposed affiliation as
12 contemplated has the practical effect of allowing
13 Highmark, a Pennsylvania-based entity controlled
14 and operated in Pittsburgh, to make decisions
15 about Blue Cross Blue Shield of Delaware and
16 about assets representing Delaware's public
17 subsidy of Blue Cross Blue Shield of Delaware
18 over seven decades.
19 The affiliation will, quite simply,
20 constitute a change in control of Blue Cross Blue
21 Shield where Highmark will become the sole member
22 of the Blue Cross Blue Shield board and the
23 licensee of the Blue Cross Blue Shield marks in
24 Delaware.

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1 Blue Cross Blue Shield of Delaware
2 will become a controlled affiliate of Highmark
3 under Delaware law, and within the meaning of the
4 rules of Blue Cross Blue Shield Association.
5 While this transaction, like any
6 merger, acquisition, or affiliation, will result
7 in some economies of scale, at the end of the
8 day, this is still a change of control of an
9 important Delaware institution, and that change
10 of control undoubtedly will have significant
11 impact on Delawareans.
12 Under the proposed transaction, the
13 board of directors of the combined Blue Cross
14 Blue Shield Delaware/Highmark entity will consist
15 of four Class A independent directors, four
16 Class B directors, who will be elected by
17 Highmark and the current president of Blue Cross
18 Blue Shield of Delaware.
19 The Highmark Class B directors will
20 have the power to dismiss the president/director
21 for any reason or for no reason at all.
22 The additional conditions sought by
23 the Insurance Commissioner relating to corporate
24 governance, there is no doubt that the board of

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1 directors of the combined Blue Cross Blue Shield
2 of Delaware/Highmark entity will be controlled by
3 Highmark.
4 Highmark's powerful and influential
5 relationship unquestionably will impact how Blue
6 Cross Blue Shield of Delaware operates its
7 business and what its corporate and charitable
8 priorities will be going forward.
9 Blue Cross Blue Shield of Delaware
10 will become part of Highmark's larger regional
11 corporate effort. This will affect efforts
12 ranging from decisions about Delaware jobs and
13 the treatment of Blue Cross Blue Shield of
14 Delaware policyholders, and possible use or other
15 disposition of Blue Cross Blue Shield public
16 benefit asset.
17 Given this controlled affiliate
18 relationship, there is a present risk, there is a
19 present risk that Delawareans investment in Blue
20 Cross Blue Shield over the past 76 years may be
21 diverted to other purposes. No amount of
22 conditions or papering, quote/unquote, this deal
23 will remove the potential for misuse or even
24 abuse.

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1 It does not take a lot of imagination
2 to conceive of scenarios where Blue Cross Blue
3 Shield of Delaware's significant reserves are
4 quietly or gradually diverted to purposes other
5 than serving Delawareans.
6 For example, as a controlled
7 affiliate and pursuant to the administrative
8 services agreement, Blue Cross Blue Shield of
9 Delaware will pay Highmark for the provision of
10 back-office administrative services. Highmark's
11 administrative costs and overhead are a portion
12 of the fee for those services. This includes
13 paying a portion of Highmark's CEO's salary and
14 other administrative expenses resulting from the
15 operating of Highmark's Pennsylvania-based
16 business.
17 At this time there is not even a
18 formal agreement between the applicant and
19 Highmark that would memorialize what is a
20 reasonable cost allocation of these types of
21 expenses. And it does not stretch the bounds of
22 credulity to imagine a scenario where costs are
23 not allocated equitably or reasonably from the
24 perspective of Delawareans.

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1 As the Attorney General of this
2 state, I'm charged with the responsibility of
3 protecting Delaware's considerable public subsidy
4 of Blue Cross Blue Shield of Delaware.
5 As such, I respectfully request that
6 Your Honor impose the following conditions on the
7 proposed transaction: Blue Cross Blue Shield of
8 Delaware and Highmark must establish a mechanism,
9 a mechanism to guarantee that the public's
10 investment in Blue Cross Blue Shield over
11 76 years remains in Delaware to be held and
12 protected for the benefit of Delawareans.
13 While I would contend that the best
14 method could be found in 29 Delaware Code 2533,
15 there may be other ways or methods to accomplish
16 this important goal.
17 The public's decade-long
18 subsidization of Blue Cross Blue Shield of
19 Delaware should be valued prior to the closing of
20 the transaction taking into account the effect of
21 the affiliation by a valuation expert approved by
22 the Department of Justice, but the asset that
23 shall be contributed to the foundation should be
24 in no event less than \$45 million.

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1 This minimum contribution amount is
2 both conservative and reasonable from our
3 perspective. Right now Blue Cross Blue Shield of
4 Delaware has reserves of approximately
5 \$181 million, or more than five times the level
6 the National Association of Insurance
7 Commissioners require, and more than three times
8 the level that Blue Cross Blue Shield Association
9 requires.
10 Furthermore, Blue Cross Blue Shield
11 of Delaware's current risk-based capital levels
12 are well above the national average for Blue
13 plans. Significantly, so when considering only
14 other Blue plans of similar size, even the
15 minimum amount of \$45 million would leave Blue
16 Cross Blue Shield of Delaware with over
17 \$135 million in remaining reserves.
18 That is, if I may repeat, even the
19 minimum of \$45 million would leave Blue Cross
20 Blue Shield with over \$135 million in remaining
21 reserves. It would not jeopardize the amount of
22 risk-based capital that Blue Cross Blue Shield of
23 Delaware would need to maintain the well above
24 the Blue Cross Blue Shield Association's

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1 recommended minimum; that is, 375 percent of the
2 risk-based capital, and the National Association
3 of Insurance Commissioners mandatory minimum of
4 200 percent of risk-based capital.
5 \$135 million in remaining reserves
6 would leave Blue Cross Blue Shield with
7 approximately 800 percent of risk-based capital.
8 That is, again, \$135 million of remaining
9 reserves would leave Blue Cross Blue Shield with
10 approximately 800 percent of risk-based capital.
11 A foundation based on the parameters
12 set forth in 29 Delaware Code, Chapter 2531 with
13 Section 2531 would obviously be one way to
14 accomplish the goal of protecting Delaware's
15 public investment in Blue Cross Blue Shield, and
16 I would offer that as the best way, Your Honor,
17 respectfully.
18 The Conversion Act requirements for
19 how a foundation must be created, funded, and
20 governed were designed to do an optimal job of
21 protecting the public benefit asset, or assets
22 attributable to the historic public subsidy for a
23 not-for-profit healthcare service corporation
24 entity. They provide an excellent blueprint that

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1 has been approved by the Delaware legislature.
2 The foundation's purpose would be
3 serving the state's unmet health needs and it
4 would be managed by a group of experienced and
5 independent directors. Such a foundation would
6 protect and ensure that the assets accumulated
7 through Delaware's public subsidy of Blue Cross
8 Blue Shield will be properly supervised, managed,
9 and ultimately -- and ultimately -- returned to
10 the citizens of this state.
11 That a foundation is not statutorily
12 mandated as it would be in a conversion does not
13 limit -- does not limit -- the ability that the
14 Department of Justice to find one to be necessary
15 to protect the public interest where control of a
16 not-for-profit in its assets are changing as is
17 the case here, nor would the finding that a
18 foundation is necessary in the transaction in any
19 way limit the Department of Justice's calculation
20 of the public benefit asset at the time of a
21 future conversion of Blue Cross Blue Shield of
22 Delaware to a for-profit entity.
23 On May 19th, 2011, Mr. Constantine,
24 who I highly respect, as I do his entire

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1 organization, assured the public at a public
2 hearing in New Castle County that the possibility
3 of an inappropriate transfer of Blue Cross
4 reserves to Highmark, quote, cannot happen, end
5 quote.
6 Based on that blanket statement and
7 assurance, Mr. Constantine should have no problem
8 creating a foundation that will guarantee his and
9 that promise will be kept. A foundation will
10 guarantee that the assets representing the public
11 subsidy to Blue Cross Blue Shield of Delaware
12 will remain in Delaware as is his promise.
13 Thank you for the opportunity to be
14 heard, Your Honor. And I look forward to the
15 rest of this hearing and my deputies will be ably
16 representing me and my office over the next two
17 days.
18 THE HEARING OFFICER: Good. Thank
19 you very much, Mr. Attorney General. We
20 appreciate your making yourself available and
21 coming here and making your statement, which I
22 will certainly take under advisement, and I will
23 be listening with interest of what your cocounsel
24 have to say.

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1 MR. BIDEN: Thank you very much.
2 THE HEARING OFFICER: Before I have
3 brief opening statements, I just wanted to place
4 on the record two matters that I have signed off
5 on in the past week.
6 First, I signed the motion that
7 Ms. Shoss be admitted pro hac vice to appear in
8 these proceedings, and that was signed on Monday.
9 So welcome to Delaware, Ms. Shoss.
10 MS. SHOSS: Thank you.
11 THE HEARING OFFICER: Second, when
12 the briefs came in from the parties, the Attorney
13 General's Office submitted with their brief a
14 report from Grace Capital Management, and there
15 was a motion by Blue Cross and Highmark that that
16 not be admitted as part of the proceeding today.
17 And after a teleconference at which I
18 heard from all counsel, I directed that that
19 would not be part of the proceedings today. I
20 reviewed the report and found that it went to a
21 mechanism for establishing an amount that might
22 be put into any foundation should the
23 Commissioner decide that that was an appropriate
24 condition.

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1 It seemed to me that the purpose of
2 the hearing today was not to get into mechanisms,
3 but to get into the rationale of what conditions
4 would be appropriate, and so I directed that I
5 would not have that as part of the record today.
6 I did state that I would recommend to
7 the Commissioner that, in the event I recommended
8 or she ordered apart from any recommendation I
9 make that a foundation be established, that it
10 would be appropriate at that point to have a
11 further hearing to establish a mechanism.
12 So that will be part of my
13 recommendations that go to the Commissioner. So
14 I wanted to put that on the record because I had
15 not formally done that.
16 Okay. We will start with some
17 hopefully brief opening statements.
18 Mr. Campbell, are you going to start?
19 MR. CAMPBELL: Yes, I am, if that's
20 how you would like me to proceed.
21 I do have one preliminary matter, if
22 it would be appropriate to bring this up.
23 THE HEARING OFFICER: Yes.
24 MR. CAMPBELL: That is, that we have

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1 a number of joint exhibits which the parties have
2 agreed to that we would like to move into
3 evidence to make it a part of the record. Those
4 joint exhibits have been provided to all the
5 parties and to the Hearing Officer, and I see
6 that you are surrounded by them.
7 We have three new additional joint
8 exhibits if I may just mention them. I have
9 given this information to the court reporter and
10 to the Hearing Officer's counsel.
11 First is Joint Exhibit No. 114, which
12 is an e-mail from Mr. John Still that was
13 received by the Department of Insurance on
14 October the 4th, 2011.
15 The next is Joint Exhibit No. 115,
16 which were assorted public comments received by
17 the Department of Insurance relating to this
18 transaction.
19 And the third exhibit, Your Honor, is
20 Joint Exhibit No. 116, which is a letter from the
21 Delaware State Chamber of Commerce that was
22 received today.
23 THE HEARING OFFICER: Thank you.
24 MR. CAMPBELL: In addition to the

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1 joint exhibits, Your Honor, we do have and would
2 like to affirm, to confirm with the Hearing
3 Officer that the docket entries which are on the
4 Department of Insurance website, which actually
5 is being updated even today as we speak, that all
6 those docket entries on the website will, of
7 course, be part of the record.
8 THE HEARING OFFICER: Is there
9 anything additional or any objections any of the
10 other parties would like to make to the admission
11 of these documents as part of the record?
12 MR. HOUGHTON: No objection here,
13 Your Honor.
14 MR. McCONNELL: No objection.
15 THE HEARING OFFICER: Then they will
16 be part of the record.
17 You may proceed.
18 MR. CAMPBELL: Thank you, ma'am.
19 As I mentioned, my name is Rick
20 Campbell and I'm counsel to Highmark, and
21 Highmark will have three witnesses today.
22 The first will be Ms. Karen Hanlon,
23 who's in the room, and Karen is the senior vice
24 president for financial planning and analysis.

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1 The second witness will be Ken
2 Gebhard, who's the vice president, cost
3 management and analysis.
4 And the third witness is Fred Earley,
5 who's the president of Highmark West Virginia.
6 At the outset I would like to make a
7 few comments about Highmark.
8 It's one of the ten largest health
9 insurance companies in the United States in terms
10 of membership with a total health membership of
11 about 4.8 million members.
12 It also is the largest in terms of
13 total revenue of the Blue Cross and Blue Shield
14 plans in the country that remain not for profit.
15 It's very proud of its status in that position.
16 Highmark is, as the Hearing Officer
17 stated, a Pennsylvania nonstock, nonprofit
18 corporation organized under the Pennsylvania
19 nonprofit corporation law of 1988, and its
20 origins go back to the early 1930s. It is
21 constituted to, or as it is constituted today,
22 it's actually a result of a consolidation between
23 Blue Cross Western Pennsylvania and Pennsylvania
24 Blue Shield.

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1 One of the most noteworthy of
2 Highmark's affiliates is Highmark West Virginia.
3 Highmark West Virginia is a West Virginia
4 nonprofit health services corporation which
5 offers a variety of health insurance products and
6 services to customers in West Virginia, and it
7 began its relationship with Highmark in 1999.
8 In 2004 Highmark became the sole
9 member of Highmark West Virginia pursuant to a
10 business affiliation agreement similar to the
11 affiliation agreement between Highmark and Blue
12 Cross Blue Shield Delaware which is the subject
13 of today's proceeding.
14 Mr. Fred Earley, who, as I indicated,
15 he's the president of Highmark West Virginia and
16 will testify today, will say that since the
17 affiliation with Highmark, the West Virginia plan
18 has experienced exceptional growth in enrollment,
19 gains in efficiency, and enhanced financial
20 stability.
21 By all measures, and for all
22 stakeholders, the West Virginia affiliation has
23 been a huge success.
24 As I prepared for today's session, I

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1 asked myself: What would I want to know if our
2 roles were reversed and I were the Hearing
3 Officer and you were appearing before me? And I
4 came up with three questions which I would want
5 answered.
6 The first is: What is in it for Blue
7 Cross Blue Shield Delaware?
8 The second is: What is it in it for
9 Highmark.
10 And the third is: How can I best
11 protect the policyholders of Blue Cross Blue
12 Shield Delaware?
13 I will quickly answer these questions
14 and the testimony which you will hear today will
15 expand on my answers.
16 First, what is in the transaction for
17 Blue Cross Blue Shield Delaware? No. 1, Blue
18 Cross Blue Shield Delaware will continue to be a
19 Delaware nonstock, not-for-profit corporation
20 with the same corporate mission and the same
21 purpose that exists today. Nothing has changed.
22 No. 2, Blue Cross Blue Shield
23 Delaware will continue to maintain a prominent
24 local Delaware presence. Nothing has changed.

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1 No. 3, Blue Cross Blue Shield
2 Delaware will save approximately \$80 million in
3 technology costs.
4 And No. 4, Blue Cross Blue Shield
5 stakeholders, that is, its Delaware customers,
6 Delaware employers, Delaware providers, and
7 Delaware producers will receive enhanced service
8 and access to information that have never before
9 been offered in the state of Delaware.
10 The next question is: What is in it
11 for Highmark? What's in this transaction for
12 Highmark? There are three primary reasons, three
13 primary benefits for Highmark.
14 The first is this: Highmark will
15 have the opportunity to, once again, publicly
16 demonstrate its commitment to nonprofit
17 healthcare.
18 No. 2, Highmark can utilize its
19 excess infrastructure capacity to lower its costs
20 on a per-member basis, and this savings is worth
21 about \$18 million to Highmark on an annual basis.
22 And the third benefit to Highmark is
23 that Highmark gets a new market for its ancillary
24 products, primarily those in the dental and

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1 vision areas.
2 And the final question that I would
3 want answered if I were the Hearing Officer is
4 this one: How can I best protect the
5 policyholders of Blue Cross Blue Shield Delaware?
6 And I think there are three primary ways.
7 The first is you will ensure by
8 recommending the approval of this transaction
9 that the policyholders of Blue Cross Blue Shield
10 Delaware receive a claims guarantee from
11 Highmark. That is, a guarantee to the full
12 extent of Highmark's assets of all the
13 contractual and financial obligations of Blue
14 Cross Blue Shield Delaware. That's a significant
15 benefit.
16 No. 2, the policyholders of Blue
17 Cross Blue Shield Delaware will gain access to
18 Highmark healthcare coaches. These are
19 individuals whose jobs are to provide individuals
20 with information related to health issues.
21 That's something that has never been available
22 before to Delaware citizens.
23 And No. 3, the policyholders of Blue
24 Cross Blue Shield Delaware will continue to deal

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1 with a company headquartered in Delaware whose
 2 assets are protected by 37 conditions which were
 3 heavily talked about, discussed, and required by
 4 the Delaware Department of Insurance to ensure
 5 that Blue Cross Blue Shield Delaware remains a
 6 viable health insurer in this state.

7 The testimony that you will hear
 8 today and tomorrow will expand on these benefits
 9 and identify others that the Hearing Officer will
 10 readily note.

11 The standards for approving the
 12 transaction are those as identified by the
 13 Hearing Officer. And Highmark and Blue Cross
 14 Blue Shield Delaware have worked cooperatively
 15 with the Department of Insurance and the
 16 Department of Justice to ensure that the record,
 17 the exhibits, and the testimony satisfies those
 18 standards.

19 I want to personally commend the
 20 staff and counsel for the Department of Insurance
 21 for their diligence and hard work in keeping the
 22 parties on track and moving forward in an orderly
 23 matter. I have told them that many times and
 24 echo that and want to put on the record today

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1 that statement.

2 They are a competent and a
 3 hard-working group, and I can ensure the Hearing
 4 Officer and the citizens of Delaware that the
 5 Department of Insurance left no stone unturned,
 6 no matter uninvestigated in its review of the
 7 proposed --

8 THE HEARING OFFICER: No document in
 9 the file.

10 MR. CAMPBELL: There is not a piece
 11 of paper in Delaware that has not been put in
 12 this record. They have done a great job.

13 At the conclusion of the hearing and
 14 after any required posthearing filings, and with
 15 the conditions agreed to by Highmark and Blue
 16 Cross Blue Shield Delaware and by the Hearing
 17 Officer, we would ask the Hearing Officer for a
 18 favorable recommendation of the proposed
 19 affiliation to the Insurance Commissioner.

20 And we are asking that the
 21 Commissioner approve the transaction.

22 THE HEARING OFFICER: Thank you.

23 MR. CAMPBELL: Thank you.

24 Mr. Swayze?

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1 MR. SWAYZE: Thank you, Your Honor.
 2 Again, I'm, for the record, David Swayze. My
 3 colleague, Mike Teichman, is to my right. Mike
 4 will be handling direct examination of today.
 5 And also to my left is the general counsel of
 6 Blue Cross Delaware, and that's Bill Kirk, who,
 7 by the way, I think is the longest tenured
 8 general counsel of any Blue plan in the United
 9 States. We have the benefit of someone long of
 10 tooth in these matters.

11 I also want to join Rick in
 12 commending the Department of Insurance for its
 13 diligence and hard work and expertise. It has
 14 been a pleasure most of the time to work our way
 15 through a very, very complex process. And I
 16 think the final product has been well honed, well
 17 fashioned, and well polished. I'm very, very
 18 happy and proud to have been a part of that
 19 process.

20 Blue Cross Blue Shield of Delaware,
 21 and I'm going to refer to them throughout the
 22 proceeding generally as either BCBSD or the
 23 Delaware plan for ease of reference, will call
 24 three witnesses today.

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1 They are Tim Constantine, who's the
 2 president and chief executive officer of BCBSD;
 3 Scott Fad, BCBSD senior vice president of
 4 operations; and Jim Hynek, who is vice president,
 5 chief financial officer, and treasurer of the
 6 Delaware plan.

7 Your Honor, for the last 75 years,
 8 the nonprofit Blue Cross and Blue Shield of
 9 Delaware, BCBSD, has provided the gold standard
 10 for health insurance in this state.

11 What this hearing is really about is
 12 making certain that the Delaware plan has the
 13 resources that are necessary to sustain that gold
 14 standard for the indefinite future. It is
 15 BCBSD's earnest belief that the proposed
 16 affiliation with Highmark will best achieve this
 17 critical goal.

18 The Delaware plan will continue its
 19 quest for affiliation with Highmark today by
 20 presenting, as I noted, the testimony of
 21 knowledgeable witnesses who have had and now have
 22 much of the line responsibility for assuring the
 23 viability of BCBSD at a time of great economic
 24 market and political uncertainty.

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1 Collectively, they will address in
 2 detail why an affiliation is fundamental to the
 3 future of the Delaware plan, why Highmark is the
 4 ideal partner with whom to affiliate, and what
 5 benefits various Delaware constituencies might
 6 expect as the by-product of that affiliation.
 7 The first witness, Mr. Constantine,
 8 as president and CEO, will testify that, first,
 9 by chronicling the realization and management in
 10 the '90s that the long-term survival of BCBSD
 11 hinged on its ability to partner with a health
 12 insurer with much greater market and financial
 13 resources than its own.
 14 He will discuss the search process
 15 which ultimately resulted in the successful
 16 affiliation with CareFirst, an affiliation that
 17 lasted until CareFirst independence was
 18 circumscribed by the Maryland General Assembly.
 19 He will document the growing perils
 20 portended by remaining as a stand-alone company
 21 or adopting some alternative configuration.
 22 He will also document the exhaustive
 23 process initiated and implemented by the BCBSD
 24 board and management that resulted in the

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1 selection of Highmark as its successor partner,
 2 and he will make the case that Highmark is, in
 3 fact, the ideal partner.
 4 He will outline the structure of the
 5 affiliation with emphasis on the continued
 6 viability and local autonomy of BCBSD
 7 postaffiliation. He will affirm BCBSD's
 8 continuing and strong commitment to community
 9 philanthropy and service.
 10 The next witness, Scott Fad, who will
 11 follow Mr. Constantine, will address with
 12 particularity the highly sophisticated and
 13 multifaceted process that BCBSD and Highmark have
 14 initiated to assure a successful integration of
 15 the two companies and BCBSD's entry into
 16 Highmark's platforms, and the guiding principles
 17 that underlie this process.
 18 He will speak to numerous and various
 19 instructive similarities between the integration
 20 model utilized by the parties here and the model
 21 utilized by Highmark to successfully integrate
 22 the West Virginia plan.
 23 And finally, he will speak to the
 24 components of the end state operating model that

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1 will govern BCBSD's operations postaffiliation.
 2 He will also, importantly, address
 3 the impact of the affiliation on BCBSD's
 4 employment levels and the opportunities for the
 5 employees postaffiliation.
 6 The final witness, Your Honor, is
 7 Mr. John Hynek, the chief financial officer.
 8 Mr. Hynek will use as his text Schedule 9 to the
 9 Statement of Affiliation which he and his
 10 counterparts from Highmark prepared and which in
 11 pro forma format compares the economic impact of
 12 the proposed affiliation on BCBSD with the
 13 economic impact if BCBSD were to remain a
 14 stand-alone entity.
 15 His analysis, which will resonate in
 16 the testimony of other witnesses called by both
 17 the Department of Insurance and Highmark, paints
 18 a vivid portrait of the economic benefit of the
 19 proposed affiliation that the Delaware plan and
 20 the significant economic detriment to BCBSD
 21 should it not affiliate with Highmark.
 22 With the conclusion of the testimony
 23 from these witnesses and the corroborating
 24 testimony of witnesses from Highmark and DOI and

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1 its experts, Your Honor will have a comprehensive
 2 and expert perspective as to why the affiliation
 3 to BCBSD with Highmark is in the very best
 4 interest of BCBSD and its subscribers and poses
 5 no hazard to the Delaware insurance-buying
 6 public, all consonant with the standards
 7 articulated at Section 5003(d) of Title 18.
 8 Finally, Your Honor, I request the
 9 right and hopefully reserve the right to respond
 10 in detail to the condition formally propounded
 11 just yesterday by the DOI mandating the creation
 12 of a mechanism to be funded out of BCBSD reserves
 13 which DOJ characterizes as a means of holding and
 14 protecting certain of BCBSD's assets for the
 15 benefit of Delawareans with unmet healthcare
 16 needs.
 17 With that, Your Honor, let me thank
 18 you for the opportunity to address you today.
 19 And Mr. Teichman, as I indicated, will address
 20 the witnesses.
 21 THE HEARING OFFICER: Thank you,
 22 Mr. Swayze.
 23 Mr. Houghton?
 24 MR. HOUGHTON: Thank you, Your Honor.

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1 Good morning. My name is Mike Houghton. I'm a
2 partner with the Delaware law firm with Morris
3 Nichols Arsht & Tunnell. We are acting as
4 special counsel to the Department of Insurance in
5 this matter.
6 In this proceeding, the Department of
7 Insurance will provide detailed testimony that
8 explains, as Your Honor noted, the department's
9 nearly 12-month examination review of the
10 proposed affiliation, as well as the conclusions
11 and recommendations the department has developed
12 as a result of its examination.
13 As the applicants have described,
14 Blue Cross Blue Shield of Delaware, which I'll
15 try to refer to as Blue Cross, proposes to
16 affiliate with Highmark. The decision of the
17 Blue Cross board to enter into a strategic
18 partnership with Highmark, and of Highmark to
19 file an Affiliation Statement with the
20 department, requires the Delaware Insurance
21 Commissioner to evaluate the proposed affiliation
22 pursuant to Title 18, Chapter 3 of the Delaware
23 Code.
24 The Commissioner's prehearing order

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1 provides that the relevant criteria, as
2 Your Honor noted, for Your Honor's determination
3 are those found in Section 5003(d)(1) of Title 18
4 of the Code which we will describe in detail
5 later in these proceedings.
6 The application of these criteria to
7 the proposed affiliation has caused the
8 department to focus on whether the affiliation
9 protects Blue Cross's significant reserves,
10 keeping meaningful local control of Blue Cross in
11 Delaware, and allows Blue Cross to stand on its
12 own if the Commissioner approves the proposed
13 affiliation, and there is a later disaffiliation.
14 With the assistance of legal
15 financial and technology advisors, the department
16 has conducted an extensive analysis of the
17 affiliation.
18 Linda Sizemore, director of company
19 regulation for the department, will testify about
20 the department's analysis.
21 After the testimony the financial
22 advisor, Blackstone, through the testimony of
23 Mr. Martin Alderson-Smith, the senior managing
24 director, as well as the technology advisor

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1 retained by the department to assist in this
2 matter, KPMG, through the testimony of Mr. Ken
3 Jackson, the senior director, together this
4 testimony will support the department's
5 recommendation that the Commissioner approve the
6 proposed affiliation subject to -- subject to --
7 the 37 conditions that we propose.
8 Since the proposed affiliation is not
9 a merger, Highmark will become the sole member of
10 Blue Cross and will have the sole license to use
11 the Blue names and service marks in Delaware.
12 Blue Cross, however, will continue to
13 exist as a separate not-for-profit Delaware
14 nonstock corporation subject to the Insurance
15 Commissioner's general regulatory authority as
16 noted.
17 Highmark will guarantee, to the full
18 extent of its assets, all of Blue Cross's claims,
19 obligations to Blue Cross customers, and under
20 the rules of the Blue Cross Blue Shield
21 Association, this licensing status means Blue
22 Cross must become a controlled affiliate of
23 Highmark. Becoming a controlled affiliate
24 requires Blue Cross to give certain corporate

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1 control to Highmark.
2 The department has concluded,
3 however, that many aspects of the proposed
4 affiliation attempt to preserve Blue Cross's
5 autonomy and local presence.
6 Nonetheless, the proposed affiliation
7 does not give Highmark the right to use or
8 control Blue Cross's reserves, and the department
9 seeks to impose conditions that will prevent
10 Highmark from doing so.
11 Your Honor, the department has had
12 experience reviewing and approving and
13 dismantling a Blue's affiliation in the past, the
14 affiliation with CareFirst initially approved in
15 2000. Your Honor members that, I believe.
16 THE HEARING OFFICER: I remember it
17 well.
18 MR. HOUGHTON: As a result, the
19 department has closely examined the service and
20 support costs that Highmark will charge Blue
21 Cross, the compensation agreements of Blue Cross
22 executives, and the means of unwinding the
23 affiliation, if necessary, and of returning the
24 Blue's mark to Blue Cross.

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1 We understand and we agree with the
2 concern about whether Blue Cross's significant
3 reserves will be at risk and subject to Highmark
4 using those reserves for its own benefit.
5 Particularly in light of the General
6 Assembly's enactment of new Section 6311 of Title
7 18 of the Delaware Code, and conditions that are
8 required by legislation, the department has paid
9 particular attention to the way in which Highmark
10 could access Blue Cross's reserves.
11 In the department's view, this
12 combination of existing regulatory authority,
13 along with the conditions the department
14 advocates, and which the applicants have agreed
15 to, protect the Blue Cross reserves from
16 Highmark's misuse.
17 Pursuant to certain agreed-upon
18 conditions, Highmark may receive funds from Blue
19 Cross primarily in two ways.
20 First, Highmark may receive payment
21 from Blue Cross for Blue Cross's migration on to
22 Highmark's systems. This cost, at the
23 department's request, has been capped and the
24 department, based on advice of its advisors,

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1 believes the cap is reasonable.
2 Second, Highmark may receive payment
3 from Blue Cross for the ongoing services Highmark
4 will provide pursuant to the Administrative
5 Services Agreement. That has been alluded to and
6 referred to in prior comments.
7 Pursuant to agreed-upon conditions
8 requested by the department, the department will
9 have authority to review the annual budget for
10 such costs and any overages, and Highmark has
11 agreed to submit to the department's jurisdiction
12 to provide information, including access to
13 employees so that the department may meaningfully
14 analyze the budget and any cost overages.
15 The department will apply a fair and
16 reasonable criteria as set forth in Chapter 50 of
17 the Delaware Insurance Code in assessing any cost
18 allocation and any administrative charges.
19 Employing these tools, the department is
20 convinced that the Blue Cross reserves will
21 remain protected from use by Highmark and will,
22 instead, be used for the benefit of Blue Cross
23 and its subscribers.
24 On the basis of the department's

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1 capabilities, experience, and expertise as an
2 insurance regulator, its nearly year-long review
3 and analysis, its experience with the CareFirst
4 affiliation and disaffiliation, the department
5 concludes that the proposed affiliation between
6 Blue Cross and Highmark will not violate the
7 statutory criteria of Section 5003 if, and only
8 if, the Commissioner imposes certain conditions
9 on the affiliation.
10 As noted, if the department
11 recommends that the Commissioner and Your Honor
12 impose the 37 conditions that are critical to
13 assuring the department's ability to oversee the
14 assumption and control of one of Delaware's
15 largest not for profits, Delaware's largest
16 noninvestor-owned health insurer by an
17 out-of-state company, not itself subject to the
18 direct oversight of Delaware regulators charged
19 with protecting Delaware interests, without
20 conditions relating to, among other things,
21 requiring department review and approval of cost
22 allocations, unwinding the affiliation of key
23 commitments are not satisfied, assuring levels of
24 service to Delaware consumers, and requiring best

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1 efforts undertaken by Highmark to return the
2 marks to Blue Cross upon a disaffiliation,
3 without these, the department will not support
4 the proposed affiliation.
5 With these conditions, however, the
6 department believes that the proposed affiliation
7 satisfies the statutory criteria. The department
8 looks forward to presenting the details of our
9 analysis, conclusions, and conditions during the
10 course of the proceeding.
11 Thank you, Your Honor.
12 THE HEARING OFFICER: Thank you.
13 Mr. McConnell, do you want to add to
14 what the Attorney General had to say?
15 MR. McCONNELL: Your Honor, just
16 briefly, Ian McConnell, director of consumer
17 protection of the Fraud Division.
18 I don't have much to add to Attorney
19 General Biden's comments. I would say just to be
20 clear that the DOJ cannot recommend approval of
21 this transaction without a DOJ proposed condition
22 being a requirement of the deal.
23 We won't be offering direct testimony
24 at the proceedings, Your Honor, but we will

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1 respectfully reserve the right to cross-examine
2 any witnesses, if that's amenable, Your Honor.
3 THE HEARING OFFICER: Thank you. I
4 do have a question for you. It may not be
5 appropriate at this time, but I think so.
6 Are you supporting the conditions
7 that the other parties have agreed to and asking
8 that an additional condition be placed on it?
9 MR. McCONNELL: Your Honor, we're
10 remaining silent as to the 37 conditions proposed
11 by DOI. Our sole focus is the preservation of
12 the benefit asset.
13 Thank you, Your Honor.
14 THE HEARING OFFICER: Thank you. I
15 guess we will start with our testimony.
16 MR. BIDEN: Your Honor?
17 THE HEARING OFFICER: Yes, Mr. Biden.
18 MR. BIDEN: Perhaps a housekeeping
19 matter in terms of the prehearing motions.
20 So I understand your ruling as to
21 Mr. Swayze's motion that you heard late last
22 week, my understanding is that the motion was
23 twofold. One is he objected to the submission of
24 our report as to the valuation of the public

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1 benefit asset which you ruled in his favor that
2 it should not be part of the record at this
3 point.
4 THE HEARING OFFICER: At this point.
5 MR. BIDEN: And that Mr. Swayze also
6 asserted that Your Honor did not have authority
7 to hear a condition that we were proposing and
8 that you overruled that objection.
9 THE HEARING OFFICER: Yes. I ruled
10 that the Attorney General, as a party, seemed to
11 me the statute was clear that additional
12 conditions could be offered.
13 MR. BIDEN: Thank you, Your Honor.
14 THE HEARING OFFICER: And then the
15 third part just had to do with the recommendation
16 I would make about the appropriateness of
17 testimony about a mechanism somewhere down the
18 road.
19 MR. BIDEN: Thank you, Your Honor.
20 MR. CAMPBELL: Your Honor, if it
21 please the Hearing Officer, the parties have
22 agreed to a certain order of presentation of
23 witnesses, and I apologize that we did not inform
24 you of that.

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1 But let me say that we would like to
2 first present witnesses from Blue Cross Blue
3 Shield Delaware who will lay the foundation,
4 actually, for the transaction, followed by
5 witnesses for Highmark, and then witnesses for
6 the Department of Insurance.
7 THE HEARING OFFICER: Okay. Then,
8 Mr. Teichman, you will present your witnesses
9 now?
10 MR. TEICHMAN: Yes, Your Honor.
11 THE HEARING OFFICER: You may
12 proceed.
13 MR. TEICHMAN: Blue Cross Blue Shield
14 of Delaware, BCBSD, calls its first witness,
15 Timothy J. Constantine.
16 THE HEARING OFFICER: If you would
17 step forward. And I have asked the reporter here
18 to swear all the witnesses today.
19 TIMOTHY J. CONSTANTINE,
20 the witness herein, having first been
21 duly sworn on oath, was examined and
22 testified as follows:
23 - - - - -
24

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1 DIRECT EXAMINATION
2 - - - - -
3 BY MR. TEICHMAN:
4 Q. Mr. Constantine, before we begin your
5 direct testimony, can I just ask that you keep
6 your voice up so that the court reporter can
7 catch all of your comments? And if the court
8 reporter asks that you slow down or you stop,
9 please do so. Thank you.
10 Mr. Constantine, please state your
11 full name and position for the record.
12 A. Sure. I am Timothy J. Constantine,
13 president and chief executive officer of BCBSD.
14 Q. Can you briefly describe for us your
15 experience?
16 A. I joined BCBSD in August 1998 as vice
17 president of network and medical management. I
18 have held the position of president since
19 September 2001, chief executive officer since
20 November 2006.
21 Prior to joining BCBSD, I served as
22 chief financial officer for Union Hospital of
23 Cecil County Health System from June 1995 to
24 August 1998, and vice president of Community

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1 Health Services for St. Francis Hospital in
 2 Wilmington from January 1993 to June 1995.
 3 I was the manager for Arthur
 4 Andersen & Company in its audit business advisory
 5 division from June 1986 to December 1992. I
 6 graduated from Loyola College in Baltimore,
 7 Maryland, in May 1986, and received a Bachelor in
 8 Business Administration degree in accounting.
 9 I currently serve as a director on
 10 the following boards: The Blue Cross Blue Shield
 11 Association and its federal employee program
 12 board of managers, the United Way of Delaware,
 13 the Delaware State Chamber of Commerce, the
 14 Delaware Business Round Table, and the University
 15 of Delaware College of Health Sciences Advisory
 16 Board.
 17 Q. Mr. Constantine, please describe Blue
 18 Cross Blue Shield of Delaware for us.
 19 A. Blue Cross Blue Shield of Delaware, or
 20 BCBSD, is the largest health insurer in Delaware.
 21 BCBSD currently provides health insurance or
 22 administers health benefits for approximately
 23 394,000 people. Health insurance, whether fully
 24 insured, or administrative services only is the

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1 primary line of business for BCBSD. BCBSD is the
 2 primary licensee of the national Blue Cross Blue
 3 Shield Association, or BCBSDA in Delaware, and
 4 has the exclusive rights to market health
 5 insurance and issues policies and contracts using
 6 the Blue names and service marks throughout
 7 Delaware.
 8 BCBSD has no right to issue
 9 Blue-branded policies or contracts outside of
 10 Delaware.
 11 Q. How is BCBSD organized and regulated?
 12 A. BCBSD is organized as a Delaware
 13 nonstock, not-for-profit corporation that is
 14 regulated by the Delaware Insurance Commissioner
 15 under the provisions of Chapter 63 of the
 16 Insurance Code. Because BCBSD was in existence
 17 prior to the adoption of Chapter 63, BCBSD is not
 18 required to hold a certificate of authority the
 19 way other health insurers are.
 20 Q. Thank you.
 21 Can you give us a brief history of
 22 BCBSD?
 23 A. BCBSD was founded in 1935 at Group
 24 Hospital Service Inc., a not-for-profit

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1 corporation offering a prepaid hospital plan. At
 2 the time BCBSD was organized under the Delaware
 3 General Corporation Law as any other nonstock,
 4 not-for-profit corporation. The entity was
 5 financed with a \$1,626 loan from the four
 6 Wilmington hospitals that were its members.
 7 The original governing body was a
 8 board of trustees and each of the member
 9 hospitals was entitled to name three trustees to
 10 this board.
 11 The new company's three stated
 12 corporate purposes were to operate a hospital
 13 plan to furnish hospitalization to individual
 14 subscribers, to collect statistics and
 15 information, and otherwise promote activities
 16 that were in the best interests of the community
 17 with respect to its hospitals.
 18 In 1939 the "purpose" article was
 19 amended to add an additional clause providing for
 20 coverage at hospitals that were not members of
 21 the plan, and amendments in 1943 expanded
 22 coverage to include physicians' services.
 23 Additional amendments to the BCBSD
 24 certificate of incorporation were made in the

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1 mid-1960s and again in 1980. The 1980 purpose
 2 statement has appeared in all versions of the
 3 BCBSD Certificate of Incorporation filed since
 4 1980, and appears in the proposed Certificate of
 5 Incorporation that would be filed with the
 6 Division of Corporations to consummate the
 7 proposed affiliation.
 8 Q. Mr. Constantine, at one point BCBSD was
 9 affiliated with CareFirst. Can you give us a
 10 little background on that?
 11 A. CareFirst, Inc., is a not-for-profit
 12 licensee providing services in Maryland, northern
 13 Virginia, and Washington, D.C. In March 2000,
 14 the Delaware Insurance Commissioner approved an
 15 affiliation between BCBSD and CareFirst that was
 16 similar in many respects to the affiliation we
 17 are planning with Highmark.
 18 During that affiliation, CareFirst
 19 held the primary BCBSA licenses for Delaware and
 20 BCBSD's controlled affiliate license.
 21 In 2003 the Maryland General Assembly
 22 passed legislation that caused the existing
 23 CareFirst board to be removed and, among other
 24 things, gave the State of Maryland a material

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1 level of control over the future composition of
2 the CareFirst board of directors.
3 As a result, in 2004 the Delaware
4 Insurance Commissioner ordered the disaffiliation
5 of CareFirst and BCBSD. Thereafter, we attempted
6 to restructure the affiliation with CareFirst on
7 a contractual basis. Unfortunately, there was
8 litigation in both Maryland and Delaware and we
9 were not able to restructure the affiliation.
10 Ultimately the companies were
11 disaffiliated in September 2006, and BCBSD has
12 been operating as the primary licensee of the
13 BCBSA in Delaware since that time.
14 Q. Mr. Constantine, why doesn't BCBSD simply
15 remain a stand-alone plan?
16 A. As I mentioned earlier, BCBSD can only
17 operate as the BCBSA licensee for the State of
18 Delaware, and our ability to grow is, therefore,
19 very limited geographically.
20 By the early 1990s, the BCBSD board
21 of directors had determined that as a small,
22 single-state Blue plan, BCBSD's long-term success
23 required that it affiliate with a larger Blue
24 organization. Through affiliation, BCBSD could

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1 benefit from economies of scale, as well as
2 access to the enhanced resources that only a
3 larger plan could provide.
4 BCBSD then began a search for
5 potential affiliation partners. The search began
6 with an attempted transaction with Blue Cross
7 Blue Shield of New Jersey and ultimately resulted
8 in 2000 affiliation with CareFirst.
9 The CareFirst affiliation was largely
10 successful, resulting in reduced per-member,
11 per-month administrative expenses and increases
12 in membership, reserves, and employees.
13 However, the disaffiliation from
14 CareFirst just six years after it commenced
15 placed BCBSD back in the same position it was in
16 prior to the CareFirst affiliation.
17 Q. So what process did BCBSD go through to
18 plan for its future after the CareFirst
19 disaffiliation?
20 A. In late 2006, BCBSD's board of directors
21 and management began an extensive strategic
22 planning process designed to address the
23 challenge of maintaining BCBSD's strength and
24 stability over the long term. In preparation,

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1 the BCBSD board of directors met in February
2 2007 to discuss the implications of the recent
3 disaffiliation and the strategy for going
4 forward. Participants included the board, senior
5 management, and industry experts.
6 After presentations by the experts
7 and extensive discussion, the board directed
8 management to conduct a formal strategic planning
9 process to determine the future course for BCBSD.
10 Q. And what was the result of that strategic
11 planning process?
12 A. The board, working with management and
13 its advisors, ultimately determined that given
14 the competitive environment in which BCBSD must
15 operate, and the need for systems and
16 capabilities upgrades, the best option for BCBSD
17 was to, again, collaborate with a strong partner.
18 Over the next several months, the
19 team detailed BCBSD's market and organizational
20 requirements and analyzed its potential strategic
21 value as a partner.
22 Out of this process, over 30
23 potential partners were identified and studied.
24 Six, including adjacent regional and multi-state

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1 Blue Cross Blue Shield plans, were determined to
2 be best suited to meet the requirements of BCBSD.
3 Detailed evaluation criteria were
4 established and further due diligence of these
5 six was conducted with oversight by the board.
6 Q. How did BCBSD decide among the six
7 candidates?
8 A. In July 2007, each of the six partners
9 received a Partnership Memorandum requesting a
10 confidential proposal for establishing a
11 long-term strategic partnership. During the
12 remainder of 2007 and the first quarter of 2008,
13 these proposals were analyzed, additional
14 information was requested and evaluated, and the
15 executives of each of the six companies were
16 invited to make a presentation to the BCBSD
17 management team to discuss their proposals in
18 more detail.
19 After a thorough analysis and
20 evaluation, the potential partner list was
21 narrowed to three organizations for further
22 consideration and evaluation. Although Highmark
23 had made a strong presentation to BCBSD's
24 management team, it was not one of the three

<p style="text-align: right;">Page 62</p> <p>1 organizations invited to present to the BCBSD 2 board at this time, largely due to our concern 3 that Highmark's then-pending proposed merger with 4 independence Blue Cross would affect its ability 5 to focus on an affiliation with BCBSD. 6 The leadership of the three finalist 7 organizations each made a presentation to the 8 BCBSD board describing the proposed business 9 relationship, the rationale for partnering with 10 BCBSD, and the benefits of the relationship to 11 BCBSD, its members, accounts, providers, 12 employees, and the residents of the state of 13 Delaware. 14 Ultimately, however, BCBSD was unable 15 to reach agreement with any of these candidates. 16 Q. Then what did you do? 17 A. During the summer of 2009, management 18 updated its evaluation of the six previously 19 identified potential partners and, based on the 20 findings of this analysis, reissued an updated 21 Partnership Memorandum to two of these potential 22 partners, including Highmark, which by this time 23 had terminated plans to partner with Independence 24 Blue Cross.</p>	<p style="text-align: right;">Page 64</p> <p>1 access to the resources necessary to develop new 2 products and services demanded by the insurance 3 marketplace, access to information technology 4 systems, software, and infrastructure necessary 5 to administer health insurance products, and pay 6 claims in today's rapidly changing environment, 7 and access to resources, technology, and other 8 capabilities required to effectively implement 9 far-reaching federal and state mandates, 10 including the provisions of the Patient 11 Protection and Affordable Care Act, or PPACA. 12 Our primary competitors are Aetna, 13 Coventry, and United Healthcare. These 14 competitors dwarf BCBSD in size and each has a 15 national preference with very strong business and 16 technology capabilities. These large insurers 17 have the capital to invest in the leading-edge 18 technologies that consumers and providers demand, 19 and they have the size and leverage to secure 20 economies of scale and favorable national medical 21 cost agreements; for example, deeper rebates with 22 pharmaceutical manufacturers due to higher 23 volumes, etcetera. 24 Access to this size and leverage</p>
<p style="text-align: right;">Page 63</p> <p>1 Discussions were held with both 2 candidates and further due diligence was 3 performed. By year end 2009, our board decided 4 to engage in exclusive negotiations with Highmark 5 based on the potential fit of the two 6 organizations. 7 Q. Mr. Constantine, please walk us through 8 BCBSD's rationale to the affiliations. 9 A. Although BCBSD has successfully existed 10 as a stand-alone company since 2006, the 11 fundamental need for BCBSD to be affiliated with 12 a larger plan has not evaded. Significant 13 consolidation has occurred in the health 14 insurance industry over the last 20 years. This 15 is illustrated by the fact that in 1983 -- I'm 16 sorry -- 1993, 80 percent of the U.S. health 17 insurance market share was held by 47 insurers, 18 whereas today, just nine insurers held this 19 80 percent market share. 20 These large consolidated insurers 21 enjoy a size and scale that provides them with 22 many advantages over a smaller plan such as 23 BCBSD. These advantages include economies of 24 scale resulting in lower administrative overhead,</p>	<p style="text-align: right;">Page 65</p> <p>1 leads not only to enhanced capabilities, but 2 lower costs to consumers. BCBSD retained 3 Deloitte, an international consulting firm, to 4 consult an assessment of BCBSD's business 5 capabilities in 2004. This assessment was 6 updated in 2008 and again in 2010 and compared 7 BCBSD capabilities against market requirements 8 and industry competitors to project future 9 capital requirements and priorities. 10 In its assessment of BCBSD, Deloitte 11 determined that on a stand-alone basis, BCBSD 12 would need to make near-term investments and 13 capability improvements in the range of 14 \$88 million to \$140 million over the next several 15 years to maintain its strong position in the 16 marketplace. 17 Given that BCBSD currently delivers 18 its business on a core operating system installed 19 in the mid-1980s, BCBSD's future is dependent on 20 timely access to leading-edge technology and 21 business solutions; however, the expenditure 22 associated with these investments would amount to 23 between 49 percent and 77 percent of BCBSD's 24 current reserves.</p>

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1 While the Deloitte study focuses on
 2 technology enhancements remain competitive, BCBSD
 3 also needs access to enhanced product offerings
 4 and expanded capabilities. Specifically, BCBSD
 5 needs this access for the senior segment,
 6 government programs, compliance capabilities,
 7 consumer services, research and development
 8 resources, and the overall strategic platform
 9 that a large affiliate with greater resources can
 10 provide.

11 The healthcare industry has
 12 transformed considerably over the last decade
 13 with intense demand for cost control and
 14 significant expansion of regulatory oversight.
 15 The most direct evidence of this is the 2000
 16 passage of PPACA.

17 From a very practical view, a small
 18 independent plan such as BCBSD is not likely to
 19 have the human or technological resources to
 20 effectively evolve to meet these increased
 21 demands on its own.

22 Also important is the financial
 23 security an affiliation with a larger, very
 24 well-capitalized entity brings to BCBSD's

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1 stakeholders. As a small company, BCBSD's
 2 reserves, or surplus, are more limited and
 3 subject to greater volatility than the surplus of
 4 a larger company. This consequence has led
 5 industry analysts to determine that smaller
 6 companies need to maintain higher relative
 7 surplus levels than large companies.

8 This volatility was dramatically
 9 illustrated by the 30 percent drop in BCBSD's
 10 reserves that occurred in 2008 due largely to the
 11 economic downturn.

12 Q. Mr. Constantine, why did BCBSD select
 13 Highmark?

14 A. As noted earlier, we are pursuing the
 15 affiliation with Highmark after completing a
 16 thorough assessment of our strategic options
 17 during the four-year period subsequent to the
 18 company's disaffiliation from CareFirst.

19 The company believes that the
 20 agreement with Highmark offers the most
 21 practical, efficient, and cost-effective means of
 22 ensuring that BCBSD can meet the near-future and
 23 long-term needs of its Delaware stakeholders
 24 while remaining a viable and robust local

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1 presence in the Delaware employer marketplace.
 2 As you will hear from Ms. Hanlon,
 3 although Highmark is a not-for-profit like BCBSD,
 4 it is much larger. In fact, it is one of the ten
 5 largest health insurance companies in the United
 6 States with membership of almost 5 million and
 7 reserves in excess of \$3.7 billion.

8 It also has a state-of-the-art and
 9 highly capable information technology platform
 10 that has proven itself in service and support
 11 arrangements with several other Blue Cross Blue
 12 Shield plans.

13 With the Highmark affiliation, BCBSD
 14 would expect to invest approximately \$37 million
 15 over 18 to 24 months to migrate onto Highmark's
 16 technology and business platforms. This
 17 represents a substantial savings to BCBSD and its
 18 stakeholders from the \$88,000,000 to \$140 million
 19 that the company would need to expend as an
 20 independent health insurer.

21 Coinciding with BCBSD's plan to
 22 affiliate with Highmark is the impact of two
 23 significant federal mandates required of
 24 healthcare payors. The first of these is

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1 conversion to the International Classification of
 2 Diseases, 10th Revision, or ICD-10, which will
 3 result in a ten-fold increase in the number of
 4 diagnostic codes that must be utilized by health
 5 insurers and providers. The federal compliance
 6 deadline for ICD-10 is October 2013.

7 As mentioned earlier, the second
 8 federal mandate is the 2014 market reform
 9 provisions of PPACA. For PPACA, significant new
 10 provisions will become effective January 1, 2014,
 11 including: Integration with the new health
 12 insurance exchanges, elimination of medical
 13 underwriting, new product design mandates,
 14 Accountable Care Organization payment reform
 15 administrative capabilities, and medical loss
 16 ratio pool management and rebate administration
 17 capabilities.

18 For practical purposes, BCBSD would
 19 need to have systems, products, and services
 20 ready to go to market in early 2013 in order to
 21 meet the January 1, 2014, effective date of these
 22 new PPACA plans and regulations.

23 Q. Was affiliation the only alternative that
 24 you considered?

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1 A. There are two plausible alternatives to
2 affiliation.

3 First, make the capital investment
4 necessary to bring BCBSD's capabilities
5 up-to-date entirely on its own, or, second,
6 outsource BCBSD's information technology needs to
7 a third-party vendor.

8 Both of these alternatives were
9 rejected because they would result in less
10 desirable outcomes for BCBSD and its Delaware
11 stakeholders. If BCBSD were to attempt to make
12 the necessary capabilities enhancements on its
13 own, this would require enormous capital
14 expenditures without any increase in revenue or
15 access to the resources and products, services,
16 enhancements only available through an
17 affiliation.

18 Additionally, BCBSD would not have
19 the financial support of a larger company.
20 Similarly, outsourcing to another party, even
21 Highmark, to administer BCBSD business on outside
22 operations platforms also has a number of
23 disadvantages relative to an affiliation,
24 including: The cost to BCBSD would be higher

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1 under such an arrangement; BCBSD would not enjoy
2 the expanded financial security of being part of
3 a larger, more diversified organization, with
4 much greater financial resources; BCBSD would not
5 gain the advantage of access to the larger
6 company's nontechnology resources; and Delaware
7 employment would be adversely impacted by
8 outsourced back-room operations.

9 These were important considerations
10 in BCBSD's decision to seek an affiliation
11 generally and to enter into an affiliation
12 agreement specifically with Highmark under the
13 terms negotiated in the August 13, 2010, business
14 affiliation agreement, or the affiliation
15 agreement.

16 Q. Mr. Constantine, would you briefly
17 describe the affiliation structure?

18 A. It is critical to note at the outset that
19 following closing of the transaction, BCBSD will
20 remain a Delaware nonstock, not-for-profit
21 corporation with a corporate purpose set forth in
22 its postclosing Certificate of Incorporation that
23 is identical to its current not-for-profit
24 purpose.

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1 No assets are being transferred from
2 BCBSD as a result of the transaction and no
3 consideration is to be paid to or received by any
4 entity as a result of the transaction.

5 Under the affiliation agreement,
6 Highmark will become the sole member of BCBSD.
7 Although Highmark will be the sole member of
8 BCBSD, it has no membership interest as that term
9 is defined in the Delaware General Corporation
10 Law and, therefore, no right to receive dividends
11 or other distributions of profits or retained
12 earnings from BCBSD.

13 As the sole member of BCBSD, Highmark
14 will become the primary licensee of the Blue
15 Cross and Blue Shield service marks for Delaware,
16 but will exercise these rights only through
17 BCBSD.

18 Postclosing, BCBSD will become a
19 controlled affiliate of Highmark and will receive
20 BCBSD's controlled affiliate license. BCBSD
21 status as a controlled affiliate carries with it
22 a critical advantage in order for Highmark to
23 retain its primary licensee status in Delaware.
24 It must guarantee the obligations of BCBSD.

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1 At closing, BCBSD will file a new
2 Certificate of Incorporation and will adopt new
3 bylaws which together will reconfigure the board
4 of directors of BCBSD.

5 Q. How will the board of directors change
6 after the affiliation closes?

7 A. The postclosing board will be composed of
8 nine members, four of which are identified as
9 Class A directors. The membership of the initial
10 slate of Class A directors is at the discretion
11 of BCBSD, prior to closing, and will be comprised
12 of four members of BCBSD's present board of
13 directors.

14 Thereafter, Highmark, as the sole
15 member, will elect the Class A directors from
16 persons nominated by a nominating committee of
17 the board of directors. However, this nominating
18 committee will be comprised solely of Class A
19 directors.

20 Moreover, even after a Class A
21 director's term expires, he or she will continue
22 to serve as a Class A director until Highmark
23 elects the replacement nominated by the
24 nominating committee.

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1 Practically speaking, this means that
 2 the Class A directors will be self-perpetuating.
 3 We understand that the Department has proposed
 4 conditions requiring Highmark to not unreasonably
 5 withhold its election of a Class A nominee and to
 6 provide a reason in writing should Highmark
 7 decline to elect a Class A nominee. BCBSD does
 8 not oppose these conditions.
 9 Another board of directors, the
 10 Class B directors, are to be selected by Highmark
 11 at its discretion provided, however, in the
 12 initial years the Highmark chief executive
 13 officer and two of his direct reports will serve
 14 as members of this class to ensure a smooth
 15 transition process. Dr. Kenneth Melani is the
 16 Highmark chief executive officer and he will,
 17 therefore, serve as the first of the Class B
 18 directors.
 19 The direct reports chosen by Highmark
 20 to fill the second and third Class B seats are
 21 Highmark treasurer and CFO, Nanette DeTurk, and
 22 Highmark executive vice president of health
 23 services, Deborah Rice.
 24 Senate Bill 146 signed into law on

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1 July 12, 2011, adds a new section, Section 6311,
 2 to the Insurance Code. Among other things, this
 3 new section will require that the postclosing
 4 BCBSD board be comprised of a majority of
 5 Delawareans who are not employees of the company
 6 or any Highmark affiliate. All of the current
 7 BCBSD directors -- from whom the Class A
 8 directors will come -- meet this description;
 9 however, the fourth and final Class B director
 10 must also pass this test to qualify.
 11 Accordingly, Highmark will select the
 12 fourth Class B director in compliance with
 13 Section 6311 and has asked BCBSD to recommend
 14 suitable candidates.
 15 The ninth and final member of the
 16 postclosing BCBSD board will be the BCBSD
 17 president. The parties intend for me to serve in
 18 this role postclosing.
 19 Q. Does the Affiliation Agreement
 20 contemplate agreements between the parties
 21 postclosing?
 22 A. One of the many advantages of the
 23 transaction is the economies of scale that arise
 24 out of partnering with a larger entity.

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1 Accordingly, the agreement contemplates that
 2 BCBSD will enter into a Administrative Services
 3 Agreement with Highmark under which a broad range
 4 of services will be made available to BCBSD at
 5 cost, including an allocation of administrative
 6 overhead but with no provision for a profit
 7 margin for Highmark.
 8 Also, since BCBSD will be migrating
 9 to Highmark's information technology platforms
 10 and systems and there are significant costs
 11 associated with this migration, Highmark has
 12 agreed to make available to BCBSD an unsecured
 13 line of credit in the principal amount of
 14 \$45 million to help defray these costs if and to
 15 the extent that BCBSD determines that it needs
 16 this assistance.
 17 At this time BCBSD does not intend to
 18 draw upon this line of credit. As noted, the
 19 cost of this migration would be a fraction of the
 20 costs of BCBSD upgrading as a stand-alone entity.
 21 Q. Do the affiliation documents address a
 22 disaffiliation or an unwinding of the
 23 transaction?
 24 A. Yes. BCBSD's prior experience and

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1 disaffiliating from CareFirst is reflected in the
 2 terms of this transaction. Under the agreement,
 3 the Class A directors are given the right to
 4 cause the unwinding of the affiliation and
 5 Highmark's surrender of its primary licensee
 6 status in the event of certain occurrences.
 7 These are: The conversion of
 8 Highmark to for-profit status under Pennsylvania
 9 law, the insolvency of Highmark, the loss of
 10 Highmark's right to use the Blue service marks,
 11 and the enactment or adoption of certain changes
 12 in Pennsylvania law which affect the manner of
 13 selection or powers of the Highmark board of
 14 directors.
 15 Q. Mr. Constantine, are you concerned that
 16 Highmark might improperly access BCBSD's surplus
 17 following closing?
 18 A. No. As I mentioned, the transaction is
 19 structured such that Highmark has no right to
 20 receive dividends or other distributions of
 21 profits or retained earnings from BCBSD. Indeed,
 22 other than payments at cost for services fairly
 23 and reasonably allocated to BCBSD, and any
 24 repayments of interest or principal under the

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1 line of credit, we do not anticipate any funds
 2 flowing from BCBSD to Highmark.

3 In our due diligence of Highmark, we
 4 ran across nothing to give us concern that
 5 Highmark would be inclined to misuse assets held
 6 by its affiliates and nothing in the integration
 7 process currently underway causes me to change my
 8 mind.

9 Also the parties have agreed to a
 10 number of conditions that give the insurance
 11 department significant oversight of the budgeting
 12 process and material or unusual payments to
 13 Highmark.

14 Accordingly, I'm confident that our
 15 surplus will not be depleted as a result of any
 16 malfeasance by Highmark.

17 Q. Mr. Constantine, are BCBSD executives
 18 getting any special bonuses as a result of this
 19 transaction?

20 A. No BCBSD executive will be paid any bonus
 21 or incentive compensation as a result of
 22 negotiating or closing this transaction. The
 23 senior executive team -- the president, CEO, and
 24 six vice presidents -- at BCBSD is responsible

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1 for managing a complex business organization and
 2 an unsettled, highly excessive, and rapidly
 3 changing healthcare environment. Compensation
 4 for these senior executives is overseen by
 5 BCBSD's board of directors. The board's goal is
 6 to ensure that BCBSD is competitive in its
 7 efforts to retract, retain, and motivate the
 8 highest caliber of leadership.

9 On an annual basis, the board reviews
 10 and approves all senior executive base salary and
 11 incentive amounts, utilizing external benchmark
 12 data and recommendations by external --
 13 independent external experts.

14 The current targeted total
 15 compensation amount, base salary and potential
 16 incentive, for each of the executives are far
 17 below the average for nonpublicly traded Blue
 18 Cross Blue Shield plan officers, as well as the
 19 health insurance and managed care industry sector
 20 averages.

21 The goal of attracting and retaining
 22 quality executive management assumes special
 23 importance following BCBSD's disaffiliation from
 24 CareFirst when there was an immediate need for

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1 stability as well as expert ease.

2 In 2007, the board directed
 3 management to retain the law firm of Young
 4 Conaway Stargatt & Taylor to conduct an executive
 5 compensation review. This law firm and
 6 management, in turn, became consultants to
 7 provide guidance on appropriate compensation
 8 packages for executive management.

9 As a result of this process, BCBSD's
 10 seven executives have entered into employment
 11 agreements, all of which predate the affiliation
 12 agreement.

13 I would note that in connection with
 14 the affiliation, some agreements were amended
 15 primarily to address the tax impacts of the
 16 agreements on BCBSD. My contract was amended to
 17 reduce the benefits I would receive in the event
 18 that severance benefits became payable in
 19 connection with the change of control.

20 All of these employment agreements
 21 include severance benefits, the principal
 22 elements of which take into account executive's
 23 base salary, incentive compensation, and medical
 24 benefits. If payable, such severance benefits

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1 would be paid for the remainder of the contract
 2 term or as specified period not to exceed two
 3 years. Severance benefits become payable if the
 4 executive's employment is terminated without
 5 cause, regardless of whether a change in control
 6 has occurred, or two, the executive submits his
 7 or her resignation following a specified material
 8 negative change in employment constituting good
 9 reason after a change in control has occurred and
 10 the good reason event is not corrected after
 11 notice of such event is provided by the
 12 executive.

13 Examples of good reason are a
 14 substantial reduction of the executive's duties
 15 or a substantial reduction in compensation.
 16 Thus, although the affiliation would constitute a
 17 change in control, the affiliation alone would
 18 not trigger benefits under the employment
 19 agreements. Such benefits would be payable only
 20 if one of the executives was thereafter
 21 involuntarily terminated or suffered an uncured
 22 material negative change in employment following
 23 the affiliation.

24 If the executive becomes entitled to

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1 severance benefits, the amount of the benefits is
2 generally the same with or without a change in
3 control, except that base salary continuation
4 payments and incentive payments are paid in a
5 lump sum reduced to present value within 60 days
6 of the termination if the termination occurs
7 within two years following a change in control.
8 BCBSD and Highmark have no plans to
9 terminate any of the BCBSD executives following
10 the affiliation. At some point the synergies and
11 economies of scale that are principal benefits of
12 the affiliation may cause employment changes or
13 reductions in force that impact one or more of
14 the seven executives with employment agreements.
15 So in preparing documents as part of
16 the review of the proposed affiliation, BCBSD
17 obtained estimates of a worst-case scenario. In
18 the highly unlikely event that all seven
19 executives were terminated immediately after
20 closing, thus being entitled to their maximum
21 possible 12 to 24 months' severance benefit, the
22 potential total lump-sum severance payments owed
23 to the seven executives would be approximately
24 \$5,960,000. A payment of this size relative to

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1 our assets and reserves would have no material
2 impact on the financial condition of the company
3 or its ability to pay claims or service
4 policyholders.
5 In 2009, BCBSD utilized Mercer to
6 assist it in evaluating a retention bonus program
7 to help ensure that BCBSD retains employees who
8 have special skills or knowledge that is vital to
9 maintaining certain business-critical functions
10 during the affiliation's transitional period.
11 Accordingly, eight BCBSD nonexecutive
12 management employees are eligible for retention
13 bonuses under this program. In the aggregate,
14 these retention bonuses amount to approximately
15 \$300,000, which is consistent with the findings
16 provided by Mercer regarding a program of this
17 type.
18 Q. Mr. Constantine, can you briefly describe
19 BCBSD's current level of charitable giving, and
20 can you tell us whether there's anything about
21 the proposed affiliation that would cause any
22 changes to your community support programs?
23 A. As the state's premiere health benefits
24 program, BCBSD has a strong commitment to the

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1 health and well-being of our members, and the
2 communities in which they live. Our company
3 proudly provides financial support to more than
4 100 Delaware organizations annually.
5 In late 2007, BCBSD expanded our
6 community support activities by establishing a
7 donor-advised fund at the Delaware Community
8 Foundation, a nonprofit organization that manages
9 and administers charitable funds throughout
10 Delaware.
11 This fund, known as Blue Prints For
12 the Community, was created to help address issues
13 faced by Delaware's uninsured and underserved
14 populations, as well as healthcare disparities
15 throughout the state.
16 To support the grant program, BCBSD
17 made an initial \$2 million contribution. The
18 company recently added over \$1.6 million to the
19 fund. Ongoing, BCBSD has committed to making
20 annual contributions equal to what the company
21 would owe in state corporate income taxes were it
22 subject to such taxes.
23 Our other community-focus program,
24 Working Well Together, reflects our ongoing

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1 dedication to making a difference in the health
2 and lives of Delawareans by making healthcare
3 more affordable and accessible, improving the
4 quality and safety of patient care, responding to
5 the increasing diversity of our members, and
6 supporting organizations that address
7 health-related issues within the community.
8 Our average aggregate annual
9 contributions under this program are in the range
10 of \$750,000.
11 We are committed to maintaining each
12 of these programs in connection with the Highmark
13 affiliation.
14 Q. Mr. Constantine, is there anything else
15 you would like to add?
16 A. In closing, we are very excited about our
17 potential partnership with Highmark. This
18 affiliation will allow us to retain our
19 not-for-profit status, enhance operations,
20 maintain financial stability, and continue to
21 provide the high level of local service that our
22 customers and providers expect.
23 Through the partnership with
24 Highmark, BCBSD will have access to expanded

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1 product offerings and enhanced capabilities and
2 resources for our customers, providers and
3 brokers.
4 The affiliation will also allow BCBSD
5 to become more cost-effective through shared
6 investment in systems and capabilities, and
7 continue as a significant local employer, a good
8 corporate citizen, and a strong contributor to
9 Delaware's economy.
10 MR. TEICHMAN: Thank you,
11 Mr. Constantine.
12 THE WITNESS: Thank you.
13 THE HEARING OFFICER: Mr. Campbell,
14 did you have any questions you wanted to ask him?
15 MR. CAMPBELL: No, ma'am.
16 THE HEARING OFFICER: Then
17 Mr. Houghton?
18 MR. HOUGHTON: Your Honor, I think
19 the Department of Justice was going to go next.
20 MR. McCONNELL: If I may, Your Honor.
21 I do have a few questions.
22 THE HEARING OFFICER: That's fine.
23 - - - -
24

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1 CROSS-EXAMINATION
2 - - - -
3 BY MR. McCONNELL:
4 Q. Good morning.
5 A. Good morning.
6 Q. Is it Constantine or Constantine? I have
7 heard it both ways.
8 A. It's Constantine. My wife tells our kids
9 that it rhymes with valentine.
10 Q. Thank you.
11 Blue Cross Blue Shield of Delaware is
12 and continues to be a not-for-profit, correct?
13 A. Correct.
14 Q. How long has it been a not-for-profit?
15 A. It has been a not-for-profit since 1935,
16 since our founding.
17 Q. Over 75 years?
18 A. Correct.
19 Q. Please explain what it means to you as
20 the CEO of Blue Cross Blue Shield of Delaware to
21 be a not-for-profit, a Delaware not-for-profit?
22 A. We exist for the benefit of our
23 customers, our members. Our role is to provide
24 them services and access to high-quality,

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1 cost-effective health services.
2 Q. I'm sorry.
3 A. That's it.
4 Q. Has being a not-for-profit contributed to
5 a positive public perception of Blue Cross Blue
6 Shield of Delaware, in your opinion?
7 A. We believe it has.
8 Q. Has this positive public perception
9 contributed to Blue Cross Blue Shield of Delaware
10 being the dominant -- market dominance in
11 Delaware?
12 A. I wouldn't go that far. First, I
13 wouldn't say we have a market dominance. But I
14 think our success in the marketplace is the
15 function of our employees and the level of
16 service and support they have provided over the
17 last 75 years.
18 Q. Before I move on, you said you wouldn't
19 say market dominance. Why wouldn't you say that?
20 A. We have the largest market share, but we
21 have several other large national competitors
22 that we compete with every day in the
23 marketplace.
24 Q. Of the insured public in Delaware, what

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1 percentage of the insured does your company
2 cover?
3 A. I don't know that specific market share
4 estimate. It's over 30 percent I do know.
5 Q. Is there another company that has over
6 30 percent of the market?
7 A. No. We're the largest.
8 Q. Thank you.
9 Is it fair to say that special tax
10 status that's granted to Blue Cross Blue Shield
11 of Delaware as a not-for-profit is a form of
12 subsidy by the Delaware public?
13 A. I would not characterize it as a subsidy.
14 We have not built any impact of paying taxes into
15 our rates or premiums. So I would say that our
16 members have benefited by not having premium
17 rates that reflect the need to collect or pay
18 taxes.
19 Q. I guess my question is more oriented
20 towards the Delaware citizen, not your
21 policyholder. If you weren't a not-for-profit,
22 you would be a for-profit, correct?
23 A. Or a mutual. But either structure.
24 Q. Would you have to pay taxes if you

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1 weren't a not-for-profit, you were a mutual or
2 for profit?
3 A. Certainly we would pay taxes if we were
4 for-profit. I'm not sure how mutual is
5 organized.
6 Q. By being a not-for-profit and allowing
7 you to be not-for-profit, Delawareans have
8 foregone taxes; is that correct?
9 A. That's correct, in that we have not paid
10 state corporate income taxes.
11 Q. So my question is: Is the Delaware
12 public foregoing taxes an investment in Blue
13 Cross Blue Shield of Delaware?
14 A. Again, I would not look at it as an
15 investment. I would say that our members have
16 benefited from it because we have not charged
17 them premiums that reflect the need to pay taxes.
18 Indirectly, perhaps, the Delaware
19 community is provided -- or indirectly, perhaps,
20 the Delaware community -- I'll just stop there.
21 Q. Is it indirectly or -- I'm sorry. I
22 don't want to belabor the point.
23 A. Sure.
24 Q. If you are a for-profit entity, you would

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1 pay taxes and those taxes would have gone to
2 Delawareans?
3 A. Correct.
4 Q. But you're not. You're a not-for-profit?
5 A. Correct.
6 Q. And you don't pay those taxes?
7 A. Correct.
8 Q. I guess my question is: Is the foregoing
9 of taxes a way of supporting, investing in,
10 subsidizing Blue Cross Blue Shield of Delaware?
11 A. That is a way to characterize it. It
12 could be characterized that way.
13 Q. What benefit, and I think you have
14 alluded to this already, what benefit inures to
15 the people of Delaware by affording your company
16 a not-for-profit tax status?
17 A. We currently provide administrative
18 services or insure over 300,000 Delawareans.
19 Those members, those customers of ours, we
20 believe, have the benefit of having reduced
21 premiums because we are able to offer them more
22 cost-competitive products that don't reflect the
23 state income taxes or the need to pay taxes.
24 Q. Okay. So I understand, you're saying

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1 that by not being required to pay taxes, you're
2 able to pass along that tax savings to your
3 customer or the policyholder and lower premium
4 rates?
5 A. Correct.
6 Q. What is the difference between Blue Cross
7 Blue Shield of Delaware premium rate today as
8 opposed to its largest for-profit competitor?
9 A. I don't know the answer to that. We have
10 hundreds of products, as presumably our
11 competitors do, and I just...
12 Q. Is it your understanding that there's a
13 significant difference between a for-profit
14 premium and a not-for-profit premium?
15 A. No, I would say they're pretty close.
16 It's a competitive marketplace, but I can't even
17 speculate.
18 Q. Historically, looking back, can you
19 inform the Hearing Officer, Judge Robinson, what
20 the difference has been between not-for-profits
21 and for-profit premium, Blue Cross Blue Shield of
22 Delaware's not-for-profit premium rate versus
23 your competitor's, which I assume you're familiar
24 with?

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1 A. Again, I couldn't even guess. I don't
2 know the answer to that.
3 Q. Is the only benefit of granting of Blue
4 Cross Blue Shield of Delaware a not-for-profit
5 status, is the only benefit that the policyholder
6 has a lower premium, ostensibly? Is that your
7 testimony?
8 A. I would say -- I think there's a benefit
9 from an image, public perception. I think
10 not-for-profit health plans are viewed more
11 positively than for-profit health plans.
12 Q. Let me be more specific.
13 Is a community reinvestment,
14 community investment of a part of the
15 bargained-for bargain when a not-for-profit is
16 granted favorable tax status, there will be some
17 sort of general community benefit?
18 A. In Delaware I'm not sure what the
19 requirements are.
20 Q. I'm not a healthcare lawyer or expert.
21 If you wouldn't mind, can you help educate me?
22 What does risk-based capital mean?
23 A. Risk-based capital is a very technical
24 term in the insurance industry and its used to

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1 measure reserve levels that an insurer must have
2 in place.
3 Q. It's a measure regulators use to measure
4 the health of an insurer?
5 A. The insolvency of an insurance company?
6 Q. If you have a low RBC, that's bad, and a
7 high RBC is good?
8 A. Correct. Correct.
9 Q. As of December 31st, 2010, Blue Cross
10 Blue Shield's RBC was 1,056 percent?
11 A. Correct.
12 Q. That's what I understand. What is it
13 right now?
14 A. Right now it's -- actually, I'll have to
15 defer. I don't know.
16 Q. Generally.
17 A. It's around that area now. Slightly
18 higher. It's somewhere in that neighborhood.
19 Q. That reflects the surplus level?
20 A. It reflects surplus or reserves.
21 Sometimes it's characterized as reserves.
22 Q. What's the surplus and reserves today?
23 A. Today -- again, I'll have to defer. Our
24 chief financial officer is testifying later.

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1 Q. Not an exact number. Do you have a
2 sense of --
3 A. From a statutory standpoint, it's
4 probably around \$180 million.
5 Q. How does that compare to similar-sized
6 not-for-profit Blue plans in the country?
7 MR. TEICHMAN: Madam Hearing Officer,
8 at this point I'm going to raise an objection,
9 and the reason is that I think where this line of
10 questioning is going is it's starting to talk
11 more about value, how much surplus there is, is
12 it too much, is it enough. And I think those
13 issues go really to the amount that fund the
14 foundation if and when Your Honor gets there.
15 And I think to the extent we're going
16 in that direction how much capital there is, how
17 much surplus is too much, not enough, etcetera, I
18 think those issues really go towards what you
19 characterized as a follow-on hearing to deal with
20 how much might go into a foundation once you have
21 decided, or actually the Commissioner has decided
22 that that mechanism is appropriate.
23 So I think the questioning that
24 Mr. McConnell is going towards really is starting

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1 to run up against Your Honor's order from last
2 week.
3 THE HEARING OFFICER: Mr. Teichman,
4 I'm going to let him proceed at this time with
5 this line of questioning, but I caution him that
6 he may soon get up against that --
7 MR. McCONNELL: I understand. I
8 appreciate that, Your Honor. And I understand
9 the objection and I appreciate it.
10 MR. TEICHMAN: Thank you, Your Honor.
11 BY MR. McCONNELL:
12 Q. I guess my question is: What is it in
13 relationship to other Blue companies?
14 A. Our reserves on a raw dollar basis are
15 significantly lower than the average of the Blue
16 Cross Blue Shield plans overall when you look at
17 the 170 million as of December 31st, 2010.
18 On our risk-based capital basis, the
19 1,056, it's higher than the Blue Cross Blue
20 Shield system average.
21 Q. Would you continue to describe Blue Cross
22 Blue Shield Delaware as being well-capitalized?
23 A. I'd say that's a fair characterization,
24 yes.

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1 Q. You described in your testimony that you
2 would continue to contribute the same level of
3 charitable contribution that you have in the past
4 going forward?
5 A. That's our commitment, yes, that we would
6 continue both with the payment in lieu of state
7 corporate income taxes, as well as the community
8 giving that we do each year.
9 Q. So to be clear, today you're making a
10 commitment in this proceeding that you will
11 maintain these programs at the same level or
12 higher and that the beneficiaries will be
13 Delawareans?
14 A. We have made a commitment that it will
15 continue at the same level and, correct, that the
16 beneficiaries would be Delawareans.
17 Q. Would you be willing to memorialize that
18 commitment?
19 A. That's something we would need to discuss
20 with Highmark, but something we could certainly
21 get back to you on.
22 Q. I'm trying to understand how you can
23 commit to something without being willing to
24 memorialize it.

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1 A. The commitment is we have, over the five
2 years of the pro forma financial projection that
3 we put together, we built into those financial
4 projections the continuation of the
5 community-giving program. We haven't looked
6 beyond 2015.

7 Q. I'm sorry, I'm confused. What is your
8 commitment?

9 A. Our commitment is twofold: Is to
10 continue the payment to the Delaware Community
11 Foundation's donor-advised fund in lieu of state
12 income taxes.

13 Secondly, it's to continue the
14 community contributions of \$750,000 a year
15 through the five-year period beginning with 2011
16 through 2015.

17 Q. So you will continue this for how long?

18 A. We have not had discussions beyond 2015.
19 That's something that we could caucus with
20 Highmark around and discuss. I've not had
21 discussions about any commitment beyond 2015.

22 Q. Does Highmark need to approve further
23 commitments along the lines you have done?

24 A. Highmark is -- my understanding, and

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1 actually I'll let Highmark speak for themselves,
2 but once we're part of Highmark, as part of our
3 budget process, the community contributions and
4 commitments will be built into that budget which
5 becomes -- which is subject to Highmark's
6 approval.

7 Q. But today there's no -- it's my
8 understanding from your testimony is that today
9 there is no written agreement memorializing the
10 arrangement you're talking about right now. Is
11 that correct?

12 A. Correct. That's my understanding.

13 Q. You described in your testimony the
14 amounts contributed annually to the BluePrints
15 fund as an expansion of Blue Cross Blue Shield
16 Delaware community support activities.

17 Were and are those payments
18 voluntary?

19 A. The commitment we made to the BluePrints
20 for the Community was an outgrowth of a Health
21 Service Corporation task force that was
22 established by the legislature in 2006, met
23 throughout 2006 into 2007. As part of that task
24 force, we made the commitment to begin making

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1 effective, I believe, January 1, 2008, to begin
2 making payments to the Delaware Community
3 Foundation to set up a donor-advised fund and
4 make payments in lieu of state income taxes.

5 So I would say it is a formal
6 commitment.

7 Q. The question was: Was it voluntary?
8 Your answer was --

9 A. Yes. It was an agreement that we reached
10 with the Health Service Corporation task force
11 members. It was something that we agreed to and
12 reached -- and, yes, it was voluntary. I don't
13 believe it's embedded in legislation or anything
14 anywhere.

15 Q. Were you aware that the Insurance
16 Commissioner of Pennsylvania has mandate that had
17 Highmark's RBC be maintained at the level of
18 550 percent to 750 percent?

19 A. Yes, I'm aware of that.

20 Q. Were you aware that any capital in excess
21 of this level must be contributed to various
22 charitable projects in the Pennsylvania
23 community?

24 A. Yes, I'm aware of that.

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1 Q. If Blue Cross Blue Shield of Delaware
2 affiliates with and has the support of the
3 guarantee of Highmark, is Blue Cross Blue Shield
4 of Delaware planning or willing to adopt a
5 similar policy regarding its excess capital?

6 A. We are not -- we have not planned to do
7 that. That is a commitment that we would need
8 to -- that would actually need to be determined
9 at our board level if the board was willing to
10 agree to that.

11 Q. Would Highmark have to approve that kind
12 of decision?

13 A. I would assume that Highmark would have
14 to approve that decision.

15 Q. Page 64 of the Blackstone report states
16 that one preliminary financial term of the
17 affiliation of West Penn Allegheny Health System,
18 West Penn, Your Honor, if I may, is that Highmark
19 will give a \$75 million grant upon the
20 affiliation to fund scholarships for students at
21 schools affiliated with West Penn and support and
22 help other educational programs.

23 Were you aware of that?

24 A. I am aware of that.

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1 Q. Have you discussed with Highmark the
2 possibility that Highmark might make a similar
3 community investment in Delaware in connection
4 with this affiliation?
5 A. I have not had a discussion with Highmark
6 around that, no.
7 Q. Why not?
8 A. I looked at that as an issue that was
9 exclusive to Pennsylvania and their arrangement
10 between Highmark and West Penn.
11 Q. Can you discuss what differentiates this
12 affiliation from that affiliation?
13 A. I really don't know specifics around the
14 arrangement between Highmark and West Penn.
15 MR. McCONNELL: May I have a moment,
16 Your Honor?
17 THE HEARING OFFICER: Sure.
18 BY MR. McCONNELL:
19 Q. A moment ago we were talking about the
20 BluePrints plan where in lieu of corporate taxes
21 you were contributing on an annual basis into a
22 foundation that helps meet unmet health needs in
23 Delaware.
24 A. Correct. A donor-advised fund.

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1 Q. You started that when?
2 A. We started it in 2007.
3 Q. Are you committed to donating those funds
4 retroactively? You started in 2007. Would you
5 be willing to look at 2006, '5, and on and back
6 and do a similar investment?
7 A. Again, this was an outgrowth of the
8 Health Service Corporation task force and it was
9 determined to be a prospective commitment. We
10 did not discuss the possibility of going back
11 retrospectively and doing that.
12 Q. Why not?
13 A. I don't recall the reason. It was
14 really -- it was part of the task force
15 deliberations and one of the agreements that was
16 reached with the task force. I don't recall why
17 we didn't -- or why it wasn't focused on anything
18 retrospectively. Or retroactively.
19 Q. Thank you. You stated that a broad range
20 of services will be made available to Blue Cross
21 Blue Shield of Delaware, costs, and that Blue
22 Cross Blue Shield will be allocated with
23 administrative overhead. Is that correct?
24 A. Correct.

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1 Q. When you use the term "administrative
2 overhead," what do you mean specifically?
3 A. Highmark's -- if you look at the cost
4 allocation model, there are home office expenses,
5 central expenses, and then more direct expenses.
6 Part of the overhead allocation would include
7 some of the home office expenses, the support of
8 the Highmark CEO and CFO, some of the other
9 executive leaders.
10 Q. When you state "home office," the office
11 is in Pittsburgh, Pennsylvania?
12 A. Correct.
13 Q. You said the support of the CEO, you mean
14 paying the CEO his salary?
15 A. The Delaware plan, BCBSD, would be
16 allocated a portion of the salary of the
17 executive management team. Highmark.
18 Q. Do you know what the salary is?
19 A. No.
20 Q. Do you know how much is being allocated
21 to Blue Cross Blue Shield of Delaware?
22 A. No.
23 Q. One possible way assets could be syphoned
24 from Blue Cross Blue Shield of Delaware is the

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1 overcharging for administrative services?
2 A. That's a possible way. I don't view that
3 as a risk, but correct, that's a possible way.
4 Q. We're just asking a question. The
5 question is is it possible that assets could be
6 syphoned from Blue Cross Blue Shield of Delaware
7 by overcharging for administrative costs?
8 A. That's certainly a risk that could occur.
9 Q. Another way assets could be diverted or
10 pulled out of Blue Cross Blue Shield of Delaware
11 could be the provision of inadequate services
12 charged at full cost. Isn't that correct?
13 A. Correct. That's correct.
14 Q. I'm trying to understand how costs would
15 be allocated to Blue Cross Blue Shield of
16 Delaware post-affiliation. Did you or your staff
17 create any modeling or forward projections of
18 what the costs would be?
19 A. We have looked -- and actually I probably
20 should defer to our chief financial officer who
21 was involved in the preparation of the financial
22 performance. So I probably should defer to him.
23 Q. You don't know?
24 A. In my role I reviewed the Highmark cost

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1 allocation methodology. I reviewed the pro
2 formas which included the costs -- the projected
3 costs that were to be allocated over the five
4 years.
5 Q. I guess my question is: Do you know if
6 there are modeling or projections created in
7 trying to anticipate what those costs would be
8 over time?
9 A. There were projections that were
10 developed in connection with the preparation of
11 the pro forma financial statements. I am not
12 sure how those projections were derived, but
13 there are experts here that will be testifying
14 later that could provide much more insight on
15 those.
16 Q. That's helpful, thank you.
17 What is your understanding of the
18 expected costs going forward?
19 A. The expected costs varies, and it really
20 is based upon when the Highmark support and
21 services come online. So, for example, 2012 the
22 projected costs that will be allocated are
23 minimal. And then as Highmark -- as we migrate
24 to the Highmark technology platform and services,

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1 then the cost allocation will become effective.
2 Q. You said you reviewed the cost allocation
3 methodologies, correct?
4 A. I reviewed a high-level summary of
5 Highmark's cost allocation methodology.
6 Q. Can you briefly explain what those
7 methodologies are.
8 A. Essentially it looks at Highmark's costs
9 broken out by home office, central office, at the
10 departmental level and then uses various measures
11 to determine how to allocate those costs. In
12 some cases it may be membership. Some cases it
13 may be claims. Some cases salary dollars. It's
14 a complicated, certainly very complex model,
15 detailed model.
16 Q. In the affiliation agreement there is a
17 time set specifically in the agreement where it
18 says that Highmark will stop providing
19 administrative services?
20 A. There is an Administrative Services
21 Agreement that's part of the overall proposed
22 affiliation. I don't recall if the agreement
23 specifies an end date. I just don't know.
24 Q. So it's possible that they could be

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1 providing services to Blue Cross Blue Shield of
2 Delaware indefinitely, from your knowledge?
3 A. Yes. I think either party must provide
4 the other party with notice to terminate.
5 Actually I think Highmark's ability to terminate
6 is very limited.
7 Q. Has a cost allocation formula methodology
8 been negotiated and/or memorialized between the
9 parties?
10 A. It's been memorialized in the affiliation
11 agreement that it will be at cost, including an
12 administrative overhead component and no
13 provision for profit.
14 Q. But as far as how, what is a cost, what
15 cost is allocated, has that been memorialized in
16 a way that binds the parties to a set of
17 standards that could be understood and
18 anticipated to be out into the future?
19 A. I'm not aware that it has been
20 memorialized in a formal agreement at this point.
21 Q. I guess, just for clarity sake, who
22 creates the methodology?
23 A. The methodology is created by Highmark
24 subject to our review and evaluation and testing.

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1 Q. Let's talk about that. What is the
2 review that you're going to have over the
3 methodology?
4 A. I would suggest that that be directed to
5 our chief financial officer. He will be very
6 involved in that process.
7 Q. Let me ask you this question: Let's say
8 you get a cost that's allocated to you by
9 Highmark and you think it's unreasonable, you
10 think it's an overcharge. What's the procedure
11 that you will use to advocate for the fact that
12 it's an overcharge?
13 A. We had this experience and we worked as
14 part of the CareFirst arrangement for six years,
15 so we do have some track record. What I would
16 envision would be that I would raise concerns to
17 my -- in my Highmark level, the individual to
18 whom I report to at Highmark.
19 We also have a mechanism in place in
20 the agreement that allows for dispute resolution
21 approach in the event that we're unsuccessful in
22 getting that resolved.
23 And one of the conditions that the
24 insurance department has proposed, also, I think,

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1 relates to potential disputes around intercompany
2 cost allocations.
3 Q. What I hear you saying is if you felt a
4 cost was unreasonable, you would go to your
5 Highmark chain of command and say I think this is
6 unreasonable and then you would have a
7 conversation about it; is that correct?
8 A. That, or we would work it through our
9 finance, the Delaware finance representative and
10 his or her contact at Highmark.
11 Q. If you couldn't come to an agreement,
12 there would be a dispute resolution process that
13 you would go through or you would go to an
14 arbitrator?
15 A. I believe there's a dispute resolution
16 agreement included in the agreements.
17 Q. Who ultimately will decide whether it's a
18 reasonable cost or not?
19 A. Ultimately I would view that as a
20 decision that both parties, Highmark and BCBSD,
21 would both decide.
22 Q. We will get back to that a second.
23 Will the cost allocation methodology
24 be subject to change a year from now?

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1 A. I would assume, yes, that it's a
2 constantly evolving process. So I would assume
3 that it could be subject to change.
4 Q. Who has the right to change it?
5 A. Highmark would have the right to change
6 it. We would have the right to review, audit,
7 and evaluate it.
8 Q. Will the cost allocation methodology, I
9 see there's a new condition in the DOI's proposal
10 saying they have, prior to closing, there needs
11 to be an approval in the cost allocation
12 methodology?
13 A. That's my understanding.
14 Q. Is DOI going to have ongoing approval of
15 cost changes in cost methodology?
16 A. I'm not aware of whether that's the case
17 or not. I don't know.
18 Q. So the provision of services could go on
19 indefinitely into the foreseeable future?
20 A. We hope so, yes.
21 Q. And Highmark are the folks that get the
22 allocated costs?
23 A. Highmark -- we will be allocating costs
24 for Highmark. However, our management team will

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1 be very involved in the process. Our board of
2 directors will be very involved in the process as
3 well.
4 Q. If there's no formal agreement
5 memorializing what the cost allocation
6 methodology is, how can you be sure that it's
7 going to be fair and reasonable five years from
8 now, ten years from now, or 20 years from now?
9 A. I would envision that assuming we get
10 approval and move forward with the affiliation,
11 we anticipate that we will spend -- immediately
12 start to work and review the cost allocation
13 methodology, reaching an agreement with Highmark
14 and prospectively, then, we will be able to look
15 at that every year and make sure that both
16 parties are comfortable with that approach.
17 Q. Mr. Constantine, you said that if there
18 was a dispute, you would raise that to your chain
19 of command?
20 A. I said that. I think there's also an
21 avenue where it could be from our finance officer
22 to his contact at Highmark as well.
23 Q. Postaffiliation, can you be removed for
24 cause or any cause or no cause?

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1 A. Yeah, I can be removed for cause or
2 without cause like I could today.
3 Q. Who would remove you postaffiliation?
4 Who would be the entity that says, thanks for
5 your services, Mr. Constantine?
6 A. Highmark would be the entity.
7 MR. McCONNELL: No further questions,
8 Your Honor.
9 THE HEARING OFFICER: Thank you.
10 Mr. Houghton?
11 MR. HOUGHTON: Just a second,
12 Your Honor.
13 Your Honor, I'd like to pass to the
14 witness, although I'm not quite sure how I'm
15 going to get to him. Usually I approach the
16 witness as opposed to the witness approaching me.
17 Thank you.
18 I handed the witness what is marked
19 and filed as Joint Exhibit 113. 113. And I'd
20 like to ask Mr. Constantine a few questions about
21 this exhibit.
22 - - - -
23
24

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1 CROSS-EXAMINATION
 2 - - - - -
 3 BY MR. HOUGHTON:
 4 Q. Mr. Constantine, this exhibit is
 5 captioned, "The Proposed Affiliation of BCBSD and
 6 Highmark, Department of Insurance Conditions."
 7 Is that correct?
 8 A. Correct.
 9 Q. Have you seen these conditions, this
 10 document previously?
 11 A. Yes, I have.
 12 Q. Can you generally describe, perhaps not
 13 in detail, but overall, what your understanding
 14 is as to what this document reflects?
 15 A. Sure. My understanding is that it
 16 reflects commitments, conditions to approval of
 17 the affiliation that Highmark and BCBSD have
 18 agreed to along with the Department of Insurance
 19 governing a number of items on a postaffiliation
 20 basis. There's conditions around governance,
 21 intercompany charges and allocations, community
 22 support.
 23 Q. So these reflect the -- this number keeps
 24 coming up -- the 37, which I like to say the 37

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1 conditions that have been advocated by the
 2 department and agreed to by Blue Cross and
 3 Highmark. Is that your understanding?
 4 A. That is my understanding.
 5 Q. Let me quickly just direct you to a few
 6 conditions.
 7 With respect to condition No. 10,
 8 condition No. 10 relates to the cost allocation
 9 methodology and formula. Is that correct?
 10 A. Correct.
 11 Q. What is your understanding as to what
 12 this particular condition provides and is
 13 intended to achieve?
 14 A. I think it's a couple of -- twofold, at
 15 least. One is to just ensure that the department
 16 is aware of the cost allocation methodology that
 17 will be used by the parties. But also to protect
 18 and ensure that Blue Cross's reserves are being
 19 used appropriately. And to ensure that the cost
 20 allocated to Blue Cross Blue Shield of Delaware
 21 by Highmark are consistent with what is
 22 characterized in the agreement so that it would
 23 be at cost.
 24 Q. Condition No. 11, what is your

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1 understanding as to what No. 11 is intended to
 2 achieve?
 3 A. Similar to ten, just to ensure that the
 4 costs being allocated to Blue Cross Blue Shield
 5 of Delaware by Highmark are appropriate.
 6 Q. Does it address the time frame and
 7 frequency of department review?
 8 A. Yes. Condition 11 describes the review
 9 will be annually.
 10 Q. With respect to condition 19, there has
 11 been some testimony and discussion about the
 12 resolution of disputes regarding two cost and
 13 administrative expenses, correct?
 14 A. Correct.
 15 Q. Can you please describe for me what your
 16 understanding of condition 19 is and how it
 17 works?
 18 A. Essentially this is intended to resolve
 19 disputes between the two parties that the parties
 20 are unable to resolve on their own, and it really
 21 ensures that the Department of Insurance has the
 22 authority to resolve the disputes as it
 23 particularly relates to cost allocation.
 24 Q. Could you read the text of the last three

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1 lines -- actually, beginning with line 4 which
 2 refers to the department -- the Delaware
 3 Department of Insurance, please?
 4 A. It ensures that the Department of
 5 Insurance has the authority to resolve any such
 6 disputes and to determine whether any such cost
 7 allocations are fair and reasonable.
 8 MR. HOUGHTON: I have no further
 9 questions.
 10 THE HEARING OFFICER: Mr. Teichman?
 11 MR. TEICHMAN: Your Honor, we do have
 12 some limited redirect.
 13 - - - - -
 14 REDIRECT EXAMINATION
 15 - - - - -
 16 BY MR. TEICHMAN:
 17 Q. Mr. Constantine, are you familiar with
 18 HMOs licensed in Delaware, organized in Delaware?
 19 A. Yes, I am.
 20 Q. Does Aetna and Coventry have an HMO in
 21 Delaware?
 22 A. I believe they both have operated an HMO.
 23 Q. Do you know if those HMOs pay premium
 24 tax?

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1 A. I don't know. I don't think they're
2 required to pay premium taxes, but I don't know
3 for sure.
4 Q. Mr. Constantine, can you elaborate just a
5 little bit on what happened to your reserves in
6 2008, your surplus?
7 A. Sure. Our surplus dropped about
8 25 percent between year-end 2007 and year-end
9 2008. It went from, I think, about \$160 million
10 to \$120 million, primarily a result of the
11 economic downturn that we experienced during late
12 2007 into 2008.
13 As a result, our risk-based capital
14 ratio percentage dropped from over a thousand to
15 about 730 percent at the end of 2008.
16 Q. Possible something like that could happen
17 in the future?
18 A. It is. We certainly hope not, but it is.
19 I think our reserves have continued to drop in
20 September or October with the market's
21 performance.
22 Q. So with that in mind, let me take you to
23 Mr. McConnell's question about whether you would
24 be willing to memorialize the commitment with

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1 respect to future contributions to either Working
2 Well Together or DCF out into the indefinite
3 future? Would you be comfortable doing that?
4 A. In this environment I think it would be
5 difficult for any plan to memorialize into
6 perpetuity a commitment.
7 Q. Just to be clear, it is the intention of
8 BCBSD to continue to make those kinds of
9 contributions; fair to say?
10 A. It is, clearly.
11 Q. Mr. Constantine, does BCBSD pay federal
12 income taxes?
13 A. Yes, we do. We pay and have since, I
14 believe, 1986 or 1987.
15 Q. If you know, Mr. Constantine, can you
16 tell me whether or not your premiums, your rates
17 could be competitive with Aetna, Coventry, United
18 if you had to pay and pass through a premium tax,
19 if you know?
20 A. Generally my experience in the insurance
21 industry is that the premium tax is essentially
22 an escrow, almost like a sales tax that it gets
23 added onto the cost of the premium and recouped
24 by the insurer. So ultimately it would be -- a

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1 premium tax would result in an additional premium
2 charge.
3 Q. Mr. Constantine, I'm going to ask you to
4 keep your voice up as you answer so everybody can
5 hear you.
6 That being said, if you know, having
7 to pass through that charge on to your consumers,
8 could you still be competitive with these larger
9 companies, Aetna, CIGNA, United, if you know?
10 A. I don't know.
11 Q. Fair enough.
12 Mr. Constantine, there was some
13 questioning with respect to commitments that
14 Highmark has had to make with respect to its
15 surplus levels and funding of trusts or whatever
16 in Pennsylvania. Are you aware that there is
17 specific statutory authority for that in
18 Pennsylvania?
19 A. I am aware of that, yes.
20 Q. Do you know of any similar authority in
21 Delaware?
22 A. I'm not aware of any similar authority.
23 MR. TEICHMAN: One moment,
24 Your Honor.

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1 I have nothing further.
2 MR. McCONNELL: One follow-up
3 question.
4 - - - - -
5 RECROSS-EXAMINATION
6 - - - - -
7 BY MR. McCONNELL:
8 Q. Just a point of clarification.
9 When you said. When the parties have
10 said that a guarantee is going to be part of this
11 transaction, what does that mean?
12 A. It is a commitment that Highmark is
13 making as the primary licensee for Blue Cross
14 Blue Shield -- or for Delaware that it will
15 guarantee our claims' obligations in the event
16 we, as a subsidiary, are unable to make payments
17 on.
18 Q. So if there's a substantial drop in your
19 surplus where you can't pay out your claims, who
20 pays them?
21 A. Highmark would be responsible.
22 Q. So you're in a fundamentally different
23 spot than you were when your surplus dropped
24 after -- postaffiliation. Before affiliation you

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1 didn't have that guarantee, so you had to rely on
 2 your surplus to pay out pending claims, and in
 3 this postaffiliation world we're talking about,
 4 having really a lot of capital on hand to pay out
 5 claims isn't necessarily -- is important?
 6 A. Well, I guess it's really two parts to
 7 the answer.
 8 One is we did not have an underlying
 9 claims guarantee in 2007 or 2008. I still
 10 believe it's important to have a healthy level of
 11 capital in this environment. Even with the
 12 Highmark affiliation, we have 40 to \$45 million
 13 in -- actually, \$50 million in projected capital
 14 investments over the next five years.
 15 We're also anticipating healthcare
 16 reform. When all the provisions become effective
 17 in 2014, there will actually be a larger pool of
 18 fully insured members for us to hopefully compete
 19 and ultimately sell coverage to. As we add more
 20 risk coverage, fully insured members, we have to
 21 increase our reserves. We have to make sure we
 22 have appropriate reserves.
 23 MR. McCONNELL: Nothing further,
 24 Your Honor.

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1 THE HEARING OFFICER: Mr. Houghton?
 2 -----
 3 RE-CROSS-EXAMINATION
 4 -----
 5 BY MR. HOUGHTON:
 6 Q. A follow-up question on my end.
 7 Mr. Constantine, there has been a
 8 prior disaffiliation of Blue Cross Blue Shield
 9 from an affiliate partner, correct?
 10 A. There has, yes.
 11 Q. It's conceivable, none of us are hoping
 12 for it, but it's conceivable there could be a
 13 disaffiliation here, correct?
 14 A. It's conceivable, yes.
 15 Q. What happens to the claims guarantee of
 16 Highmark in the event of a disaffiliation of Blue
 17 Cross Blue Shield from Highmark?
 18 A. If we're separate from Highmark, we do
 19 not have the guarantee.
 20 Q. So at that point in time what would be
 21 the basis for a review and examination by BCBSDA,
 22 the national association, as to whether or not
 23 you would be entitled to your mark?
 24 A. BCBSDA would review us and look at a lot

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1 of assets including our risk-based capital
 2 levels.
 3 Q. In order to get the mark back in the
 4 context of a disaffiliation, one of the key
 5 criteria for the national association is your
 6 capital level?
 7 A. It's certainly one of the criteria they
 8 use and used as part of the CareFirst
 9 affiliation.
 10 MR. HOUGHTON: No further questions.
 11 THE HEARING OFFICER: Thank you. I
 12 had a couple of questions I wanted to ask you.
 13 -----
 14 EXAMINATION
 15 -----
 16 BY THE HEARING OFFICER:
 17 Q. Having nothing else to read lately, last
 18 night I was reading the charter and the bylaws of
 19 Blue Cross Blue Shield.
 20 Does Blue Cross Blue Shield have
 21 subsidiaries?
 22 A. We do have subsidiaries. We have an
 23 agency that markets ancillary products, and we
 24 have another subsidiary that is essentially lying

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1 dormant. It really doesn't have any activity
 2 going through it.
 3 Q. Are they not-for-profit or are they
 4 for-profit?
 5 A. I do not know the answer, Your Honor.
 6 Q. I was curious because I read that and I
 7 just hadn't come across that.
 8 The other question I had: I see you
 9 do not have a finance committee on your board,
 10 and are your investments handled through an
 11 outside expert or --
 12 A. Sure.
 13 Q. Are you under contract with that
 14 individual? Will that individual or institution
 15 continue to handle your investments?
 16 A. Sure. We do have a finance and
 17 investment committee of the board today
 18 currently. And we use outside investment
 19 managers to manage our investment portfolio. We
 20 review our investments quarterly with the board
 21 committee that oversees those investments.
 22 Q. Do you anticipate that arrangement
 23 continuing or do you know at this point?
 24 A. I am not aware of how that will work

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1 going forward. I know Highmark has also its own
 2 finance committee. We will have a board along
 3 with a number of board committees. I'm not
 4 specifically certain as to how the review of
 5 investments will work.

6 THE HEARING OFFICER: Thank you.
 7 Thank you very much for your testimony,
 8 Mr. Constantine.

9 Let's take a brief break at this
 10 point.

11 (A recess was taken.)

12 THE HEARING OFFICER: Mr. Teichman,
 13 do you have your next witness?

14 MR. TEICHMAN: Thank you, Your Honor.
 15 BCBSD calls Scott Fad.

16 THE HEARING OFFICER: Scott Fad,
 17 would you step forward and be seated and be sworn
 18 in?

19 SCOTT FAD,
 20 the witness herein, having first been
 21 duly sworn on oath, was examined and
 22 testified as follows:

23 THE HEARING OFFICER: You may
 24 proceed.

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1 DIRECT EXAMINATION
 2 - - - - -

3 BY MR. TEICHMAN:

4 Q. Good morning, Mr. Fad. Can you please
 5 state your full name and your title for the
 6 record?

7 A. My name is Scott Fad, and I serve as
 8 senior vice president of operations at BCBSD.
 9 One of my roles with the company is to coordinate
 10 the Highmark affiliation business integration
 11 effort on behalf of BCBSD.

12 Q. Can you briefly describe your background
 13 and your education, or your experience, rather?

14 A. I'm a native of Newark, Delaware, and a
 15 graduate of the University of Delaware with a
 16 degree in English. I have 28 years of health
 17 benefit experience, serving in a variety of
 18 leadership roles inside and outside of BCBSD.

19 At BCBSD I have served as the
 20 director of customer and provider services,
 21 director of marketing administration, assistant
 22 vice president of the business development, vice
 23 president of operations. And I now serve as
 24 senior vice president of Health Plan Operations.

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1 In addition to my experience with
 2 BCBSD, I have managed a sole proprietary
 3 management consulting firm and I spent five years
 4 with the local Coventry Health Care plan where I
 5 served as regional vice president with
 6 responsibility for sales and marketing,
 7 regulatory affairs, quality assurance and
 8 communication.

9 As senior vice president of Health
 10 Plan Operations at BCBSD, I oversee several BCBSD
 11 divisions, including sales and marketing,
 12 underwriting, claims, customer and provider
 13 services, national account administration,
 14 information systems, project management and
 15 research.

16 I'm also responsible for coordinating
 17 the Highmark affiliation planning effort on
 18 behalf of BCBSD.

19 Q. When did BCBSD and Highmark commence
 20 affiliation planning and what is the objective of
 21 the planning effort?

22 A. BCBSD and Highmark began discussions
 23 about the affiliation planning effort in
 24 September 2010, shortly after the companies

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1 entered into the definitive affiliation
 2 agreement. The objective of the planning effort
 3 has been to develop a detailed roadmap for
 4 bringing the operations of the two companies
 5 together in the most effective manner possible.
 6 We expect to complete the planning phase in 2011.
 7 The planning effort was initiated before
 8 receiving final approval of the affiliation for
 9 two reasons.

10 First, we wanted to conduct a
 11 thorough analysis of every phase of BCBSD's
 12 business to confirm the overall business
 13 assumptions regarding the affiliation.

14 Second, we wanted to position the
 15 companies to swiftly implement the plan should
 16 affiliation be approved. This affiliation
 17 planning effort has been guided by the
 18 organizational and operational structure first
 19 outlined by Highmark in its response to our
 20 request for proposal. The advantages of the
 21 successful structure were confirmed during the
 22 subsequent due diligence effort.

23 Under the proposed approach, BCBSD
 24 will become Highmark's fourth core regional

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1 health market. The other three regional health
2 markets are Western Pennsylvania, Central
3 Pennsylvania and West Virginia.
4 Q. Mr. Fad, do you anticipate that BCBSD
5 will fit into the Highmark corporate structure in
6 a manner similar to that of Highmark Blue Cross
7 Blue Shield's West Virginia?
8 A. Yes. In fact, the proposed BCBSD
9 structure is generally based on Highmark's
10 affiliation with the West Virginia plan. In our
11 search for an affiliation partner, it was
12 important for us to work with a company that had
13 demonstrated success with implementing an
14 affiliation with a smaller plan.
15 During a due diligence process, BCBSD
16 reviewed the West Virginia model in-depth,
17 visited the West Virginia plan, and met with
18 West Virginia employees and leadership to gain a
19 firsthand understanding of how Highmark's
20 structure and approach works and how the business
21 integration effort was conducted in
22 West Virginia.
23 Based on these discussions, BCBSD and
24 Highmark were able to leverage the benefits and

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1 lessons learned from the West Virginia
2 affiliation when planning a timely and efficient
3 integration for Delaware.
4 After conducting this extensive
5 research, we were greatly impressed with
6 Highmark's ability to fully integrate the
7 West Virginia plan onto Highmark's
8 industry-leading technology platforms in business
9 solutions.
10 At the same time, West Virginia was
11 able to preserve its local presence as a robust
12 and growing West Virginia employer under local
13 leadership and offering local services.
14 This approach assures the
15 West Virginia plan remains dedicated to serving
16 West Virginia customers, accounts, healthcare
17 providers and other local stakeholders, while
18 also providing improved services and products as
19 a part of the Highmark platform.
20 Some of the key lessons that Highmark
21 and BCBSD have learned from the West Virginia
22 affiliation include the importance of maintaining
23 strong local presence, the appropriate
24 organizational structure for managing the

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1 business needs and opportunities of a regional
2 affiliate in the most effective manner, the need
3 to focus on driving efficiencies that will help
4 create lower premiums for customers, and the best
5 approach for managing a core systems migration
6 and other technology integration.
7 Q. Describe the affiliation planning team.
8 A. Prior to convening the first group
9 meeting, Highmark and BCBSD issued a request for
10 proposal to three leading consulting experts to
11 assist with our integration planning efforts.
12 After a detailed review of our options, we
13 engaged Deloitte, an international consulting
14 firm to support our planning efforts.
15 Deloitte has brought a comprehensive
16 knowledge of the healthcare industry and of
17 information technology, and has extensive
18 experience with helping companies navigate the
19 path towards successful business integrations.
20 In addition, Deloitte was able to
21 offer a well-tested electronic data room and a
22 program management methodology that has provided
23 us with a template and platform upon which
24 Highmark and BCBSD have been able to construct

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1 and begin to execute our detailed integration
2 plan.
3 For Highmark and BCBSD, the detailed
4 planning effort began in December of 2010. A
5 meeting was held in Delaware with representatives
6 from all core health business areas of both
7 companies. Also present were representative from
8 Deloitte.
9 Q. How was the planning process organized?
10 A. To facilitate the planning process, we
11 created 11 distinct project teams that represent
12 different disciplines within the company, such as
13 operations, information technology
14 infrastructure, medical management, and provider
15 relations.
16 We also created three additional
17 cross-functional teams to manage issues that span
18 across departments. These include a
19 communications team, an employee experience team,
20 and the financial analysis team.
21 Each of these 14 teams was led by one
22 leader from BCBSD and one leader from Highmark
23 who are supported by a project manager and
24 subject matter experts from both companies.

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1 The overall effort is being directed
2 by a shared program management office. This
3 office is cochaired by me for BCBSD and by my
4 counterpart at Highmark, Kathy Colwell, who is
5 the vice president of the office of corporate
6 strategic programming.

7 In addition, a team of senior
8 executives with Highmark in Delaware has provided
9 the guiding principles of the planning effort and
10 continues to serve in an advisory and guidance
11 capacity over each step of our progress. At last
12 count, over 400 employees from Highmark and BCBSD
13 have participated in some fashion in this
14 comprehensive planning effort.

15 Q. Mr. Fad, you mentioned guiding
16 principles. What are these?

17 A. The guiding principles of the planning
18 effort have been to preserve market-facing
19 functions in the Delaware market, leverage
20 policies and procedures across both
21 organizations, achieve future efficiencies from
22 enhanced productivity and reduce duplicative
23 functions across both organizations, and to
24 retain robust employment levels in Delaware.

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1 Q. Have BCBSD and Highmark arrived at a
2 model for their combined operations?

3 A. Yes. There are three phases to the
4 integration plan.

5 The initial phase of the planning
6 effort lasted from December 2010 through May
7 2011, during which the teams met frequently in
8 person, and by video and phone conference. The
9 teams began the planning process by reviewing the
10 proposed BCBSD End State Operating Model, as
11 defined in the original Highmark response to our
12 request for proposal.

13 This model is consistent with the
14 West Virginia affiliation model and provides
15 guidance on how BCBSD would be internally
16 organized upon completion of the integration.

17 The End State Operating Model offers
18 three organizational structures: Locally
19 managed, shared services, and centralized support
20 services. Different BCBSD functional areas will
21 operate under the structure most appropriate for
22 that area.

23 The Locally Managed Model includes
24 the functions that we believe are best managed

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1 and delivered locally, thus preserving BCBSD's
2 ability to be responsive to the Delaware
3 marketplace and our local stakeholders. These
4 functions will be located in Delaware reporting
5 directly to the BCBSD president, with best
6 practices shared among all Highmark affiliates.

7 The functions organized under this
8 model include sales and account management,
9 provider contracting, government affairs, and
10 community affairs.

11 The second structure is the Shared
12 Services Model. These functions are supported
13 and delivered in Delaware reporting to local
14 BCBSD management who will report to Highmark
15 senior management, but will also maintain close
16 coordination with the local BCBSD president.

17 These services will be predominantly
18 delivered locally here in Delaware by local BCBSD
19 employees, but will be moved onto Highmark
20 technology platforms to assure our stakeholders
21 have access to Highmark's exceptional products
22 and services.

23 Reporting directly to Highmark's
24 senior leaders provides us the opportunity for

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1 the application of best practices across all
2 Highmark locations, as well as giving Delaware
3 access to Highmark's considerable backup staffing
4 support from other locations. This backup
5 support will be extremely valuable for balancing
6 workloads in times of peak claim or phone call
7 volumes.

8 The functions organized under this
9 model include customer and provider services,
10 claims processing, billing and enrollment,
11 actuarial and underwriting, corporate
12 communications, product development, human
13 resources, legal, medical management, risk
14 management, audit, national account
15 administration, and information technology
16 applications, although some significant IT
17 application work will be centralized at other
18 Highmark locations.

19 The third model is the Centralized
20 Support Services Model. These functions are
21 directly managed by Highmark's experienced
22 business leaders and will be predominantly
23 delivered by staff at central locations that
24 support the entire Highmark enterprise. This

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1 includes computer operations and the
 2 administration of the Federal Employee Program.
 3 This model will also serve certain
 4 programs that do not currently exist within
 5 BCBSD, but which represent expanded product
 6 opportunity for Delawareans such as ancillary
 7 products including Highmark's United Concordia
 8 dental subsidiary, and senior products, including
 9 Highmark's Medicare Advantage and Medicare Part D
 10 plans.
 11 Q. Mr. Fad, how do you plan to transition to
 12 this end-state model?
 13 A. With the end-state model as our guide,
 14 the project teams looked at BCBSD's current
 15 business processes and technology and compared
 16 these to Highmark's business and technology.
 17 From this, the teams determined the best means
 18 for migrating the existing BCBSD business onto
 19 Highmark business processes and technology. The
 20 product of these efforts is a series of detailed
 21 blueprint documents that include an analysis of
 22 the work required for the business and systems
 23 migrations, the number of people required to do
 24 this work, the cost required to do this work, the

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1 synergies and other cost efficiencies gained, and
 2 the initial project plans that outline the
 3 various steps and timelines required to achieve
 4 completion of these projects.
 5 A total of 70 distinct projects were
 6 identified by the teams. A few examples are
 7 migrating BCBSD business onto Highmark's core
 8 claims processing platforms, upgrading BCBSD
 9 web-based services to Highmark capabilities,
 10 implementing a comprehensive data warehouse and
 11 leading edge medical cost analytics for Delaware
 12 business, financial systems integration, human
 13 resource system integration, pharmacy program
 14 migration, product management and product
 15 development integration, implementation of a
 16 digital strategy in Delaware, and best practice
 17 policy and procedure integration, anything from
 18 regulatory compliance oversight to human resource
 19 policies and investment management strategy
 20 oversight and processes, etcetera.
 21 A separate group worked with the
 22 teams to view all the projects together, looking
 23 for dependencies and prerequisites between the
 24 various work streams to assure the projects would

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1 be deployed in their proper sequence and in the
 2 required timelines.
 3 All of the projects and their
 4 timelines and major deliverables were then
 5 plotted accordingly onto a master project plan?
 6 Q. Mr. Fad, the affiliation planning process
 7 seems to be quite an undertaking. Can you give
 8 us an idea of its scope?
 9 A. The final eleven project team blueprint
 10 documents combined to well over a thousand pages
 11 long. The electronic data room in which the
 12 overall planning effort is taking place currently
 13 includes well over 10,000 pages of draft plans,
 14 meeting notes, summaries, executive reviews,
 15 analyses, and worksheets.
 16 This is an indication of the
 17 considerable effort the companies have put into
 18 assuring the plan has been sufficiently
 19 researched and vetted for accuracy and
 20 appropriateness.
 21 Q. Sir, exactly where are you in the
 22 process?
 23 A. The initial phase of the planning effort
 24 was concluded in May 2011. Since then, the

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1 project teams have been engaged in the second
 2 phase of project planning. In this phase the
 3 teams are examining the data fields on our
 4 respective systems and creating the mapping
 5 strategies that will support the integration of
 6 these systems.
 7 The teams are also building out the
 8 core systems migration plan in greater detail,
 9 and they are researching and refining our costs
 10 and human resource requirements.
 11 Full and final business integration
 12 between BCBSD and Highmark is expected to be
 13 completed 18 to 24 months after an approval of
 14 the affiliation. A number of key deliverables
 15 will be completed well before the end of this
 16 period, including a full turnkey core systems
 17 migration now targeted to take place 15 months
 18 after approval.
 19 Highmark originally applied their
 20 experience with the West Virginia affiliation to
 21 arrive at a top-down investment of \$35 million
 22 for the cost of the BCBSD integration. Since
 23 then, the eleven functional planning teams have
 24 been working on the detailed plans and a

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1 bottom-up analysis to confirm the cost estimate.
2 Based on our current analysis, we
3 estimate the cost to BCBSD for migrating onto
4 Highmark's industry leading capabilities will be
5 \$37.4 million. We are continuing our work to
6 refine this estimate in our ongoing planning
7 effort.
8 As has been discussed earlier and has
9 been confirmed in the KPMG review of the proposed
10 affiliation, this represents a considerable
11 savings from the estimated \$100 million to
12 \$140 million that BCBSD would otherwise need to
13 spend to obtain such capabilities as an
14 independent company.
15 It is important to note that at the
16 conclusion of the integration effort, BCBSD will
17 be able to operate at a much leaner and more
18 efficient manner. This will reduce our overall
19 operating costs which has a beneficial impact on
20 healthcare premiums. It will also have an impact
21 on the number of employees required to run the
22 BCBSD business.
23 Q. So what will the impact be on employment
24 levels in Delaware following the affiliation?

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1 A. In order to achieve the administrative
2 efficiencies, economies of scale and synergies
3 that are so important to the affiliation, the
4 BCBSD end-state employment levels appear to place
5 BCBSD at approximately 435 FTEs. Obviously this
6 is a significant reduction from the current
7 employment level of 617 FTEs; however, this is
8 not the end of the employment story.
9 In negotiating the affiliation
10 transaction, and in the subsequent affiliation
11 planning process, we stressed the importance of
12 preserving robust employment in Delaware. This
13 is reflected in the affiliation documents,
14 including the business affiliation agreement
15 where Highmark and BCBSD agreed to use
16 commercially reasonable efforts to maintain
17 employment levels in Delaware that are
18 proportionate to the employment levels that
19 Highmark maintains in other geographic areas to
20 directly service it health insurance holders.
21 Highmark has also agreed to maintain BCBSD's
22 corporate headquarters in Delaware.
23 In addition, Highmark and BCBSD have
24 made three voluntary commitments regarding

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1 employment stability if the affiliation is
2 approved.
3 First, Highmark and BCBSD will assure
4 the total number of employees in Delaware will be
5 the same after the implementation of the
6 affiliation is complete, approximately 18 months,
7 as it was at the start of the affiliation
8 integration activities.
9 As I mentioned a moment ago, this
10 number is currently 617 and we do not expect it
11 to change significantly before we close the
12 transaction.
13 The positions will be either BCBSD
14 positions or Highmark positions located in
15 Delaware. It should be noted that this
16 commitment presumes continuity and enrollment in
17 market share. Should there be a significant
18 decrease in BCBSD's enrollment or market share
19 during the implementation period, for example,
20 from the loss of a large customer that results in
21 any lost BCBSD positions, Highmark would not be
22 responsible for replacing those lost positions.
23 Second, any BCBSD employee whose
24 positions are eliminated due to the

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1 implementation will be given first opportunity to
2 fill any new BCBSD or Highmark positions that are
3 created in Delaware.
4 And third, Highmark will make
5 good-faith efforts to locate additional positions
6 in Delaware as Highmark's business opportunities
7 arise.
8 Finally, I would like to note that
9 Highmark and BCBSD have agreed that for a period
10 of four years, the companies will maintain
11 account management, customer service and provider
12 service to Delaware customers by Delaware-based
13 staff under the immediate supervision of
14 Delaware-based staff.
15 Although BCBSD expects to maintain a
16 high level of quality for these services at all
17 times, the purpose of this agreement is to ensure
18 the present quality of these services is not
19 diminished in the early years of the affiliation.
20 Beyond these immediate commitments,
21 in our due diligence effort process, we placed
22 considerable importance on the results of the
23 Highmark West Virginia experience. There,
24 although the plan experienced the same

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1 significant integration between Highmark and West
 2 Virginia that Highmark and BCBSD anticipate,
 3 employment has actually grown meaningfully in
 4 West Virginia since the affiliation as the plan
 5 has grown stronger both financially and in
 6 enrollment as the beneficiary of Highmark's
 7 business capabilities.

8 BCBSD experienced similar growth in
 9 employment following the CareFirst affiliation
 10 and we expect to see it with Highmark as well.

11 Q. Mr. Fad, one quick follow-up question.
 12 Her Honor asked that when we use an
 13 acronym that we explain it. You used the term
 14 FTE?

15 A. Full-time equivalent, which is a
 16 position. We have 617 FTEs today. That means we
 17 have 617 employees filling 617 positions at Blue
 18 Cross Blue Shield of Delaware today.

19 MR. TEICHMAN: Thank you, Mr. Fad.
 20 THE HEARING OFFICER: Mr. McConnell?
 21 - - - - -
 22
 23
 24

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1 CROSS-EXAMINATION
 2 - - - - -
 3 BY MR. McCONNELL:
 4 Q. Good morning, Mr. Fad. Just about good
 5 morning. Almost good afternoon.
 6 You stated at the beginning of your
 7 testimony today that Blue Cross Blue Shield's
 8 proposed affiliation to Highmark that we're
 9 considering today is based on or similar to the
 10 West Virginia plan affiliation; is that correct?

11 A. That's correct.

12 Q. What was the state of the West Virginia
 13 Blue Cross Blue Shield plan at the time that
 14 West Virginia affiliation occurred?

15 A. I don't know all the details. Certainly
 16 they were financially distressed when Highmark
 17 originally began to work with the West Virginia
 18 plan.

19 Q. So is it safe to say that the financial
 20 condition of the West Virginia Blue Shield plan
 21 and Blue Cross Blue Shield of Delaware are
 22 sort -- are in different or were in different
 23 financial positions --
 24 A. It's my understanding that that's

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1 accurate. You probably want to defer to the
 2 folks at Highmark who would have worked with the
 3 West Virginia plan at that time.

4 Q. Are there differences in the proposed
 5 affiliation we're thinking about today or
 6 considering today from the proposed affiliation
 7 in West Virginia based on the distinction between
 8 the financial conditions of the Blue Shield
 9 plans?

10 A. I'm sorry. Can you repeat that?

11 Q. Were there differences negotiated based
 12 on the fact that in West Virginia the Blue plan
 13 is not doing as well and in our case we have got
 14 a well-capitalized, well-funded Blue Cross Blue
 15 Shield plan, are there differences in the
 16 agreement? Is it similar -- your testimony is
 17 that this agreement is similar to the agreement
 18 in West Virginia?

19 A. I guess what I'm testifying to is the
 20 similarity in the ultimate organizational
 21 structure between where Highmark in West Virginia
 22 or how they're organized today and the
 23 organizational structure and the advantages that
 24 that brings and would bring to Delaware.

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1 Q. But you're not aware of, and this is your
 2 testimony, you're not aware of any substantive
 3 differences between the two plans that are
 4 predicated on the fact that Blue Cross Blue
 5 Shield Delaware was in a much stronger financial
 6 position than the West Virginia plan?

7 A. Sorry, but I'm not -- I would have to
 8 defer the nature and condition Highmark of
 9 West Virginia might have been in to the folks at
 10 Highmark who would have been involved with the
 11 Highmark organization.

12 Q. Fair enough. Just a couple other
 13 questions on a different vein.
 14 Were you a part of the BluePrints
 15 discussion in 2007?

16 A. No, I wasn't.

17 Q. Are you familiar with it at all?

18 A. I have some familiarity with it, but I
 19 was not part of those discussions.

20 Q. When Blue Cross Blue Shield of Delaware
 21 reached agreement with the task force about the
 22 payments to BluePrints in lieu of taxes, are you
 23 aware of any modeling or estimates that might
 24 have been done to estimate what the costs would

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1 be if that agreement were extended retroactively?
2 A. I was not.
3 Q. So the community reinvestment that Blue
4 Cross Blue Shield of Delaware does each year that
5 is discretionary, in other words, not required
6 pursuant to an agreement in lieu of taxes, what I
7 understand is approximately \$750,000 a year. Is
8 that correct?
9 A. I believe that's what's reflected in our
10 pro formas, but I'm not directly responsible for
11 those functions. That would be more with our CFO
12 and CEO.
13 MR. McCONNELL: No further questions.
14 MR. HOUGHTON: No questions,
15 Your Honor.
16 THE HEARING OFFICER: Anything
17 further, Mr. Teichman?
18 MR. TEICHMAN: No redirect,
19 Your Honor.
20 THE HEARING OFFICER: Mr. Fad, thank
21 you for your testimony. We appreciate it. You
22 may resume your seat.
23 Ready to call your next witness?
24 MR. TEICHMAN: We are. BCBSD calls

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1 James Hynek.
2 THE HEARING OFFICER: Mr. Hynek, do
3 you want to step forward and be sworn in?
4 JAMES HYNEK,
5 the witness herein, having first been
6 duly sworn on oath, was examined and
7 testified as follows:
8 - - - -
9 DIRECT EXAMINATION
10 - - - -
11 BY MR. TEICHMAN:
12 Q. Good morning, Mr. Hynek. I think it's
13 still morning.
14 A. Yes, for a few minutes.
15 Q. Can you state your full name and title
16 for the record, please?
17 A. Yes. My name is James Hynek. I am the
18 vice president, chief financial officer, and
19 treasurer of Blue Cross Blue Shield of Delaware.
20 Q. What are your professional credentials?
21 A. I obtained my certified public accounting
22 certificate in Illinois. I am also currently a
23 registered certified public accountant in
24 Illinois.

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1 Q. Can you describe your professional
2 experience for us?
3 A. Yes. I have public accounting experience
4 with Deloitte Haskins & Sells. I have internal
5 audit experience with PepsiCo, Inc., and United
6 Technologies Corporation, and I have health
7 insurance experience of approximately 20 years,
8 including Aetna Health Plans in a variety of
9 financial roles with preferred care as
10 controller, Unity Health Plans as chief financial
11 officer, Coventry Health Care of Delaware as
12 chief financial officer.
13 I joined Blue Cross Blue Shield of
14 Delaware as director of financial planning and
15 analysis in March 2009, and became their chief
16 financial officer on March 2010.
17 Q. Mr. Hynek, did you assist in the
18 preparation of Exhibit 9 of the Affiliation
19 Statement that's presently on file with the
20 department, and if you did can you describe the
21 purpose for us?
22 A. I developed the format and methodology
23 used to prepare the financial statements for the
24 preparation of Exhibit 9. Input used to develop

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1 these statements was obtained from both BCBSD and
2 Highmark personnel. The exhibit consists of two
3 pro forma financial statements for BCBSD with
4 projections through 2015.
5 One projection reflects an
6 affiliation with Highmark and it's referred to as
7 the affiliation version. The other projection
8 assumes BCBSD will remain an independent entity,
9 and is referred to as the stand-alone version.
10 The objective of Exhibit 9 is to give
11 the Department of Insurance comparative financial
12 statements in order to assess the financial
13 impact of BCBSD's proposal affiliation with
14 Highmark.
15 Q. Mr. Hynek, can you explain for us why
16 Exhibit 9 to the Affiliation Statement was
17 recently revised?
18 A. Yes. Exhibit 9 was first prepared in
19 late 2010 and originally filed with the
20 department in January of this year. The
21 department advised that it would be most helpful
22 to their review if BCBSD management would, one,
23 update pro formas to reflect the actual financial
24 results for 2010; two, provide an updated

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1 forecast for 2011 that reflected management's
 2 best financial assessment of what would actually
 3 happen in the stand-alone versus the affiliation
 4 scenarios; and three, develop separate enrollment
 5 projections for each version.
 6 Q. Can you walk us through some of the key
 7 assumption in the exhibit?
 8 A. Certainly. The financial statements are
 9 based on the actual financial results for 2010.
 10 The financial statement projections for 2011
 11 through 2015 were developed based on GAAP basis
 12 and converted to a statutory basis in the same
 13 basis that BCBSD reports financial results to the
 14 department on a quarterly basis.
 15 If I might just divert to identify
 16 what those acronyms refer to.
 17 Q. Please do.
 18 A. GAAP refers to generally accepted
 19 accounting principles, which is what is commonly
 20 used throughout the United States. That's what
 21 we prepare our financial statements based on
 22 through our general ledger. Then we revert them
 23 to a statutory basis. That's the prescribed
 24 accounting practices for the Delaware Department

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1 of Insurance.
 2 The more significant assumptions are
 3 related to enrollment, minimum loss ratio
 4 requirements, capital expenditures, and community
 5 contributions.
 6 Enrollment is expected to increase
 7 during the forecast period in the affiliation
 8 version based on Highmark's product development,
 9 data analysis, and employer reporting
 10 capabilities. The latter is essential to
 11 providing information to both fully insured and
 12 self-funded large employer groups. Conversely,
 13 the continued enhancement of aforementioned
 14 capabilities by our competitors will adversely
 15 impact BCBSD's competitive position resulting in
 16 a projected decline in enrollment in the
 17 stand-alone version.
 18 Under either version of the pro forma
 19 financial statements, it is assumed that BCBSD
 20 will comply with the minimum loss ratio
 21 requirements of the new healthcare reform law, as
 22 well as the minimum loss ratio requirements
 23 mandated by Internal Revenue Code Section 833.
 24 The cost of capability enhancements

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1 needed by BCBSD for the affiliation version and
 2 standalone version were obtained from Highmark
 3 and Deloitte, respectively. Routine capital
 4 expenditures were assumed to approximate
 5 \$2 million per year. Total capital expenditures
 6 for the affiliation version were \$51 million
 7 through 2015 and are summarized as follows:
 8 \$35 million related to the Highmark integration
 9 project capital expenditures, \$5.8 million in
 10 2011 capability enhancement capital expenditures,
 11 \$2.2 million in 2011 routine capital
 12 expenditures, and \$8 million for 2012 through
 13 2015 in routine capital expenditures.
 14 Total capital expenditures for the
 15 stand-alone version were \$130 million through
 16 2015. As such, the stand-alone version requires
 17 \$79 million more in capital expenditures than the
 18 affiliation version through 2015 summarized as
 19 follows: \$114 million related to
 20 Deloitte-recommended capability enhancements,
 21 \$5.8 million in 2011 capability enhance capital
 22 expenditures, \$2.2 million in 2011 routine
 23 capital expenditures, and \$8 million for 2012
 24 through 2015 related to routine capital

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1 expenditures.
 2 With respect to community
 3 contributions, BCBSD will continue to accrue and
 4 make payments to Delaware Community Foundation in
 5 lieu of state income tax, as well as additional
 6 community contributions.
 7 Q. So describe for us the comparative
 8 results.
 9 A. Overall projections indicate that it is
 10 more favorable for BCBSD to affiliate with
 11 Highmark than to remain a stand-alone company.
 12 The primary financial impact of the proposed
 13 affiliation on Blue Cross's financial condition,
 14 at least in the period projected by the pro
 15 formas, will be the difference between the costs
 16 incurred by Blue Cross to upgrade it IT systems
 17 as an affiliate of Highmark versus those same
 18 costs if Blue Cross were to remain a stand-alone
 19 entity.
 20 Specifically, Blue Cross is currently
 21 estimated to spend \$35 million in IT upgrades if
 22 it affiliates with Highmark. If Blue Cross
 23 remains a stand-alone entity, estimates range
 24 from \$88 million to \$140 million.

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1 Q. Please walk us through the results of the
 2 affiliation case pro formas as compared to the
 3 stand-alone case pro formas.
 4 A. Let me start by giving you a few 2010
 5 numbers as a baseline.
 6 The amounts we will discuss are on a
 7 statutory basis. As of December 31, 2010, BCBSD
 8 reported earned premium of \$499 million with
 9 total combined claims costs and general
 10 administrative expenses of \$491 million, which
 11 resulted in an underwriting gain of approximately
 12 \$8 million and net income of \$15 million.
 13 We also reported capital and surplus,
 14 sometimes referred to as reserves, of
 15 \$171 million and the risk-based capital ratio of
 16 1,056 percent.
 17 The affiliation version of pro formas
 18 reflects increases in enrollment, premium and
 19 claims through 2015. Such growth may be expected
 20 to increase the underwriting gain and resulting
 21 net income. However, the impact of additional
 22 depreciation expense resulting from capability
 23 enhancements reduces that income to between nine
 24 and \$11 million for 2011 through 2014.

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1 In 2015, it is projected that net
 2 income will return to approximate the results
 3 experienced in 2010 of between \$15 million and
 4 \$16 million. Capital and surplus for 2011
 5 through 2013 are projected to remain within
 6 \$5 million of \$171 million at the end of 2010,
 7 with increases in 2014 and 2015.
 8 The increases in 2014 and 2015 allow
 9 the risk-based capital ratio to return to a level
 10 that approximates BCBSD's RBC reported at
 11 December 31st, 2010. The stand-alone version
 12 reflects a decline in enrollment through 2015.
 13 Premium earned and related claims incurred remain
 14 relatively consistent for 2012 through 2015. As
 15 with the affiliation version, it should be noted
 16 that the medical loss ratio maintained during the
 17 period approximates 85 percent.
 18 Because the implementation period for
 19 placing capability enhancement assets in service
 20 is longer in the stand-alone version than in the
 21 affiliation version, the more significant impact
 22 of depreciation on the stand-alone version does
 23 not begin to materially degrade financial
 24 performance as noted on the pro forma income

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1 statements until 2014 and 2015, when losses are
 2 projected at \$3 million and \$20 million,
 3 respectively.
 4 On the pro forma balance sheet,
 5 capital and surplus steadily declined from 2012
 6 through 2015 because statutory accounting
 7 requirements limit the portion of computer
 8 hardware and software assets that can be
 9 reflected on the balance sheet. As such, the
 10 projected RBC ratio also reflects a decline
 11 beginning in 2012.
 12 Q. Mr. Hynek, the projections seem to
 13 indicate that total selling, general and
 14 administrative expenses is lower in the
 15 stand-alone scenario. What are the synergies?
 16 A. Projections do show total selling,
 17 general and administrative expenses, typically
 18 called SG&A, for the affiliation version are
 19 higher than on the stand-alone version. The
 20 reason for this, however, is that the total SG&A
 21 expenses in the affiliation version are
 22 supporting a larger enrollment.
 23 In order to put SG&A expenses between
 24 both versions on a comparable basis, the expense

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1 is divided by the number of months for each year.
 2 Just for the Hearing Officer's note,
 3 the term "member's months" is how we create an
 4 equivalency between different plans or different
 5 products.
 6 So if a member is with Blue Cross
 7 Blue Shield of Delaware at the very beginning of
 8 the year and finishes the year with Blue Cross,
 9 we count that each month they're with our plan as
 10 one member month.
 11 So in other words, if a member has
 12 been with Blue Cross Blue Shield of Delaware for
 13 the entire year, they are 12 member months. This
 14 allows us to -- because we will have groups
 15 coming on and groups leaving the organization,
 16 that allows us to create an equivalent or a
 17 denominator that we use to create
 18 per-member-per-month calculations.
 19 When this comparison is made, the
 20 stand-alone version SG&A PMPM exceeds the
 21 affiliation version in 2013, 2014 and 2015. This
 22 is what you would expect and it demonstrates some
 23 of the synergies that we expect to see in the
 24 affiliation.

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1 Q. Mr. Hynek, let's turn to the issue of
 2 cost allocations. Can you describe the plan for
 3 allocating costs from Highmark to BCBSD?
 4 A. Business Affiliation Agreement between
 5 Highmark, Inc., and BCBSD, Inc., dated
 6 August 19th, 2010, reflects the key elements with
 7 respect to payments made by BCBSD to Highmark for
 8 services provided by Highmark in under the
 9 Administrative Services Agreement. Article II of
 10 this agreement provides that BCBSD's payment to
 11 Highmark for services it provides will be "in an
 12 amount equal to BCBSD's fair and reasonable
 13 allocable share of the total actual costs without
 14 provision for profit."
 15 This section further provides that
 16 BCBSD has the "right at any time and from time to
 17 time to review and inspect the appropriate
 18 records of Highmark relating to Highmark's costs
 19 of providing the services and any other amounts
 20 due and owing to Highmark."
 21 Because the executive management team
 22 at BCBSD will be evaluated, in part, on the
 23 financial performance of the company, we will
 24 have an incentive to ensure that BCBSD is

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1 receiving only those allocations that are,
 2 indeed, fair and reasonable.
 3 To this effect, we will be embarking
 4 on a comprehensive evaluation of the Highmark
 5 cost allocation methodology in the first quarter
 6 following the closing in order to determine the
 7 substantive testing that will be necessary in
 8 order to monitor these allocations over time.
 9 We have not done so because, No. 1,
 10 the transaction has not been approved; No. 2, the
 11 evaluation will involve a substantial expenditure
 12 of time and energy; and 3, it may involve access
 13 to at least some information as proprietary and
 14 confidential to Highmark.
 15 We believe the postclosing period is
 16 adequate to develop our testing and monitoring
 17 protocols.
 18 I would also note that the parties
 19 have agreed to a number of conditions designed to
 20 ensure that the allocations under the
 21 Administrative Services Agreement are fair and
 22 reasonable, including a condition that will
 23 result in costs relating to BCBSD's migration on
 24 the Highmark's IT platform being capped at

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1 \$42 million.
 2 MR. TEICHMAN: Thank you, Mr. Hynek.
 3 - - - - -
 4 CROSS-EXAMINATION
 5 - - - - -
 6 BY MR. McCONNELL:
 7 Q. Mr. Hynek, good afternoon.
 8 A. Good afternoon.
 9 Q. Just a few questions.
 10 I'm sorry. How long have you been
 11 the CFO?
 12 A. About 18 months.
 13 Q. Are you familiar with the events of 2007
 14 in the drop of excess or surplus or capital?
 15 A. I have seen BCBSD's financial history,
 16 yes.
 17 Q. Are you aware that in 2008 the surplus
 18 was 730 percent of RBC?
 19 A. Yes, I believe that's accurate.
 20 Q. Isn't it true that this is still more
 21 than three times what is required by the
 22 Insurance Commissioner?
 23 A. That's the minimum level required by the
 24 Department of Insurance.

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1 And I believe, also, they also look
 2 at other conditions in addition to risk-based
 3 capital when they review the condition --
 4 financial condition of an organization. So it's
 5 a minimum requirement and they use other
 6 criteria. And that's based on my discussions
 7 with the prior chief examiner.
 8 Q. Thank you.
 9 Are you familiar with the charitable
 10 history of Blue Cross Blue Shield of Delaware as
 11 far as its donations and charitable donations in
 12 the state of Delaware?
 13 A. Somewhat, yes.
 14 Q. Are you familiar with the BluePrints
 15 plan?
 16 A. I'm aware of it, yes.
 17 Q. From reviewing the documents that were
 18 provided to the Department of Insurance and our
 19 office, it appears that around \$750,000 per year
 20 is the amount that Blue Cross Blue Shield of
 21 Delaware donates to charities outside of the
 22 amount of the \$1.6 million in lieu of taxes,
 23 BluePrints plan. Is that fair to say?
 24 A. Just to make a correction there, that

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1 \$1.6 million is related to what was accrued for
2 2010. That number will have changed based on the
3 income of the organization.
4 Q. The BluePrints plan essentially, as I
5 understand it, is that in lieu of taxes, Blue
6 Cross Blue Shield of Delaware donates the amount
7 they would have otherwise paid in state corporate
8 taxes to the fund?
9 A. To the foundation.
10 Q. That's required under an agreement you
11 have; is that correct?
12 A. That's a letter that was agreed to by
13 Blue Cross Blue Shield of Delaware.
14 Q. Outside of that, from our review of the
15 records, three-quarters of a million dollars,
16 \$750,000 is donated in an average year. Is that
17 correct?
18 A. I think that's the number we put into pro
19 formas for 2011 through 2015. And historically,
20 that would sound reasonable, at least for the
21 last few years I have been there.
22 Q. It's the position of Blue Cross Blue
23 Shield of Delaware, I think, and correct me if
24 I'm wrong, that you cannot commit even to

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1 continue that amount without having discussions
2 with Highmark or further getting permission from
3 Highmark; is that correct?
4 A. I think that contribution level would be
5 determined based on the available financial
6 resources of the company.
7 Q. Do you have any kind of comparison or
8 idea of how the \$750,000 that Blue Cross Blue
9 Shield of Delaware does on an annual basis to
10 charitable efforts is compared to other
11 companies?
12 A. I would suggest if you're looking in
13 Delaware, Aetna and Coventry, I believe, are also
14 operating health plans and, therefore, you could
15 look at their -- I'm assuming you could look at
16 their annual statements for the chief examiner
17 could request that same information from them.
18 Q. Do you know if it's high or low in
19 comparison to other similar Blue plans?
20 A. I don't have access to information to
21 answer that question.
22 Q. Let's just, if I may, just briefly touch
23 base on cost allocation.
24 You stated that postclosing period

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1 there's going to be a time, adequate time to
2 develop testing and monitoring protocols in
3 connection with the fairness of the cost
4 allocation?
5 A. Yes.
6 Q. As of today, is it true that there's no
7 written agreement relating what that cost
8 allocation formula will be?
9 A. I believe that's being developed.
10 Q. But is there an agreement today for what
11 that's going to be?
12 A. I'm not aware of one.
13 Q. Is it true that the applicants are
14 proposing to enter into the proposed affiliation
15 without any written agreement on the cost
16 allocation formula going forward?
17 A. My belief is that there is an agreement,
18 is that when the affiliation agreement as I cited
19 in my testimony, that there will be an allocation
20 based on cost and an allocation would be fair and
21 reasonable.
22 Q. That's the affiliation agreement.
23 Is there an agreement that's going to
24 lay out how that cost is going to get allocated,

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1 what's the methodology behind it, the specifics
2 that you can rely on as a member of Blue Cross
3 Blue Shield of Delaware going into the future
4 that you can project costs going forward?
5 A. The cost allocation process can be a
6 process that changes over time to meet new
7 business requirements, new types of costs,
8 etcetera. So it's not as if it's frozen in time
9 and written down for posterity.
10 Q. So what I hear you saying, there will not
11 be a written agreement relating to cost
12 allocation?
13 A. When we do our performance review, we
14 will have a written document that documents the
15 process that's used for cost allocations.
16 Q. Will that be an agreement that binds the
17 parties about what that process is going to be?
18 A. That's up to BCBSD and Highmark
19 governance structure. We would use that as the
20 basis for determining if the costs are fair and
21 reasonable.
22 Q. I'm sorry. I'm probably not asking my
23 questions properly.
24 I hear you saying, and correct me if

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1 I'm wrong, that there will be a document that
 2 lays out the cost methodology. Is that correct?
 3 A. There would be a document that we use
 4 internally to reevaluate the reasonableness and
 5 fairness of the cost allocations. There will
 6 also be an Administrative Services Agreement
 7 which may refer to that document or that process
 8 that we use to monitor the cost allocations.
 9 Q. Is that document an agreement between
 10 Highmark and Blue Cross Blue Shield of Delaware
 11 whereby you can be bound, either party can be
 12 bound by what cost allocation methodology going
 13 forward into the future?
 14 A. That would be the Administrative Services
 15 Agreement that would dictate that.
 16 MR. McCONNELL: I have no further
 17 questions, Your Honor.
 18 MS. MAYRACK: Your Honor, Brenda
 19 Mayrack representing the Department of Insurance.
 20 THE HEARING OFFICER: You may
 21 proceed.
 22 - - - - -
 23
 24

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1 CROSS-EXAMINATION
 2 - - - - -
 3 BY MS. MAYRACK:
 4 Q. Are you familiar with what is Joint
 5 Exhibit 113 which memorializes the conditions
 6 that the parties have agreed to?
 7 A. I would have to get a copy of that.
 8 Q. I can provide that. If I can direct your
 9 attention to page 3, specifically condition
 10 No. 10, are you familiar with that condition?
 11 A. Yes.
 12 Q. Do you mind just reading for the record
 13 the first sentence of condition 10?
 14 A. Yes. It says: "Prior to closing, BCBSD
 15 and Highmark shall file with the Department of
 16 Insurance the cost allocation methodology and
 17 formula."
 18 Q. So basically what this condition would
 19 accomplish is prior to the closing of the
 20 affiliation, that the Department of Insurance
 21 would see the cost allocation methodology that
 22 you referred to in your cross by the Department
 23 of Justice?
 24 A. That is correct.

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1 Q. Basically, if there's approval of the
 2 proposed affiliation, there would be a period of
 3 more intense and comprehensive review of the cost
 4 allocation methodology between Blue Cross and
 5 Highmark, and then whatever came out of that
 6 process would then be filed with the Department
 7 of Insurance for this condition for the
 8 department --
 9 A. That's what it says, yes.
 10 Q. Thank you.
 11 If I can refer you to condition
 12 No. 11. Are you familiar with that condition?
 13 A. Yes.
 14 Q. So this condition would then require
 15 going forward postclosing of the affiliation that
 16 the department would annually review the cost
 17 allocation methodology; is that correct? Is that
 18 your understanding?
 19 A. Yes.
 20 Q. Okay. And then if there were any
 21 changes, obviously there would be an annual
 22 review of any changes of that cost allocation
 23 methodology by the Department of Insurance?
 24 A. Yes.

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1 Q. Do you mind just reading that condition?
 2 A. Item 11?
 3 Q. Item 11, that's correct.
 4 A. "The Delaware Department of Insurance
 5 will annually review and approve the exam of
 6 Highmark charges which will be fair and
 7 reasonable in accordance with provisions of
 8 18 Delaware Chapter Section 5005."
 9 MS. MAYRACK: Just one moment,
 10 Your Honor.
 11 No further questions from the
 12 Department of Insurance.
 13 THE HEARING OFFICER: Thank you,
 14 Ms. Mayrack.
 15 MR. TEICHMAN: Just a very brief
 16 follow-up.
 17 - - - - -
 18 REDIRECT EXAMINATION
 19 - - - - -
 20 BY MR. TEICHMAN:
 21 Q. There was some discussion of risk-based
 22 capital requirements, and in your testimony, or
 23 certainly in earlier testimony today there was
 24 also discussion of PPACA the new healthcare

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1 reform legislation that's going to start kicking
2 in over the next couple years.

3 Do you have a sense or can you tell
4 us what those requirements are going to do for
5 your risk-based capital needs, requirements going
6 forward?

7 A. Under PPACA, the minimum loss ratio
8 requirements limit the amount of income a health
9 plan can earn by requiring a minimum amount that
10 can be spent by the health plan on medical
11 expenses and quality improvement expenses.

12 I'm trying to -- I apologize.

13 Q. If you can't answer my question --

14 A. I guess we're talking about the
15 risk-based capital, if we look at -- are you
16 asking me to how we look at risk-based capital
17 with respect to our current levels of RBC?

18 Q. I guess my question is: When PPACA is
19 fully implemented, what kind of impact will that
20 have on risk-based capital, if you can tell us?

21 A. I think we have reflected that in the
22 pro forma statements, yes.

23 Q. One other question on risk-based capital.
24 Mr. McConnell asked you, made mention

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1 of the NAIC or the Department of Insurance
2 minimum. I think there was a question that
3 aren't you three or five times higher than the
4 minimum.

5 Do you know what happens if the
6 company actually hits that minimum level?

7 A. There will be somewhat intensive
8 oversight by the Department of Insurance when we
9 get close to that level. If Blue Cross Blue
10 Shield Association at 375 percent, and once you
11 get close to that level, they will monitor
12 relatively closely.

13 And then the one thing to keep in
14 mind with risk-based capital levels, they really
15 need to be sized to size the plan, and I believe
16 Ms. Hanlon can comment on how Pennsylvania's
17 addressed that issue.

18 But if you look at our risk-based
19 capital level at the end of the year was 1,056,
20 our -- we had an independent consultant actuary
21 look at our risk-based capital levels and I
22 believe they indicated it was in the range of 950
23 to 1,200 would be appropriate during normal
24 circumstances. With all the economic conditions

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1 going on, that's between 950 and 1,200 I think is
2 Blue Cross Blue Shield of Delaware's targeted
3 area, and we're within that target area.

4 Q. Mr. Hynek, a very simple question: What
5 is the purpose of having surplus? Why do you
6 have it?

7 A. The purpose of surplus is if you're a
8 not-for-profit like we are, there's one
9 additional reason for surplus is we can't go out
10 to capital markets and raise capital. So,
11 therefore, capital and surplus would be used, A,
12 to fund capital enhancements; B, to fund a
13 catastrophic event.

14 For example, if there was a
15 catastrophic event or calamity or something of
16 that nature where there would be a significant
17 amount of claims or injured members that would
18 have to be addressed, as well as economic
19 downturns.

20 As we experienced during 2008, you
21 know, you'd see employers, not some would leave
22 coverage, others would downstaff their
23 organizations. And, therefore, you have a
24 certain level of fixed expenditures going on, but

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1 you have got less premium coming in.

2 And then the other important
3 component is our investment portfolio. You would
4 have declines in your investment income, and
5 especially in the principal of your investments
6 through downturn in the markets.

7 Q. Mr. Hynek, I think you testified about
8 the fair and reasonable standards that's set out
9 in the Administrative Services Agreement,
10 correct?

11 A. Yes.

12 Q. And that's an obligation of Highmark,
13 that the cost allocation shall be fair and
14 reasonable, correct?

15 A. Yes.

16 Q. Now, you mentioned an internal document.
17 Is that a document BCBSD would create
18 postclosing?

19 A. Yes.

20 Q. Is that a document that you will create
21 in this first quarter?

22 A. Yes. Actually, I think we would create
23 it consistent with the condition that's been
24 established within this document in front of --

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1 Q. Actually prior to that?

2 A. Yes.

3 Q. And the purpose of that document, again,

4 is to make sure that allocations, when they come

5 in, are fair and reasonable?

6 A. The purpose of the document is to

7 document -- I mean, there's two major steps

8 whenever you have any type of process from an

9 accounting perspective.

10 The first step is document the

11 process and develop a comprehensive understanding

12 of the process itself to understand what's

13 actually happening, and that's where you can

14 assess, overall, it appears fair and reasonable.

15 Then the second part of the process,

16 then, is to do substantive testing. Substantive

17 testing can be done in a number of ways. You can

18 do actually detailed testing to say I saw this

19 cost of \$8 million and it got allocated based on

20 these mechanics within the allocation

21 methodology.

22 You can also do analytical

23 procedures. Those analytical procedures would be

24 for us, for example, we compare what is our

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1 administrative expense PMPM as it is today versus

2 what it is in 2015.

3 You can also compare it to budget.

4 You'd say my expected expense PMPM payment is X

5 and coming out at Y, and you want to explain

6 those variances.

7 So that's part of the ongoing

8 substantive testing, both detailed calculations

9 as well as analytical testing.

10 And then that document that I

11 initially referred to that's also referred to in

12 the conditions then is updated over time based on

13 changes in the system. And systems will

14 consistently change over a period of time, as I

15 mentioned before, to address changes in business

16 conditions, new types of costs, new types of

17 technologies that occur over a period of time.

18 MR. TEICHMAN: Thank you.

19 MR. McCONNELL: Just a few more

20 questions, if I may.

21 THE HEARING OFFICER: Yes.

22 - - - - -

23

24

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1 RECROSS-EXAMINATION

2 - - - - -

3 BY MR. McCONNELL:

4 Q. Ms. Mayrack actually pointed to certain

5 directions. I directed to DOI conditions,

6 page 3, condition No. 10. That first sentence,

7 can you read that first sentence again, please?

8 A. "Prior to closing, BCBSD and Highmark

9 shall file with the Department of Insurance the

10 cost allocation methodology and formula."

11 Q. Does it say that DOI will approve it?

12 A. It does not say that in that section.

13 Q. Does it say that the cost allocation

14 methodology and formula will be an agreement

15 between the parties?

16 A. It does not, but I guess -- two issues

17 there.

18 No. 1 would be in my role as chief

19 financial officer, my obligation to the company

20 is to ensure that all transactions are

21 documented. In other words, if I'm dealing with

22 another party, that means that a contract is

23 required. So there would have to be an agreement

24 between the two entities from my perspective to

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1 maintain my obligation to the company.

2 The second issue, then, is would be

3 with BCBSD, my obligation is to make sure that

4 the allocations are fair and reasonable. So if

5 the DOI does not approve it, I certainly would

6 have to approve both the process documentation,

7 as well as any basis for making charges to BCBSD,

8 whether it's Highmark or any other entity.

9 Q. So, Mr. Hynek, just to be clear, I hear

10 you saying there will be an agreement relating to

11 cost methodology and allocation prior to closing?

12 A. There will be a contract or agreement

13 between BCBSD and Highmark to document the

14 transactions between the entities.

15 Q. Would you be willing to share that with

16 the DOJ?

17 A. We will provide that -- I think from a

18 regulatory perspective, we're required to share

19 that with the DOI. That would leave that with

20 the Department of Insurance how they disseminate

21 that document.

22 Q. You won't provide it to DOJ? I'm asking

23 you if you will provide a copy of an agreement

24 relating to cost allocation methodology to the

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1 Department of Justice.
2 A. I would provide it to the Department of
3 Insurance. That's my -- that's who's regulating
4 me, is the Department of Insurance.
5 Q. Okay. Five years from now, ten years
6 from now when no one in this room is here
7 anymore, who gets to change the cost allocation
8 methodology?
9 A. I would expect that Highmark is
10 maintaining the allocation methodology because
11 it's not just Blue Cross Blue Shield of Delaware.
12 It's Highmark West Virginia and it's the entities
13 within Highmark that are allocated expenses. So
14 they would have to maintain and update that cost
15 allocation methodology.
16 Q. And if there's a dispute again, who do
17 you go to to say I think this is unreasonable?
18 A. I would discuss the issue with currently
19 Ms. Hanlon who will be testifying later.
20 Q. Who's she?
21 A. She is the senior vice president of
22 financial planning at Highmark. And discuss the
23 issue with her. And then if there's not a
24 satisfactory resolution, then take it to

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1 Constantine, president and CEO of Blue Cross Blue
2 Shield of Delaware.
3 Q. And is it true that Blue Cross Blue
4 Shield Delaware postclosing will be an affiliate
5 of Highmark?
6 A. Yes.
7 MR. McCONNELL: Nothing further.
8 THE HEARING OFFICER: Anything
9 further?
10 MR. TEICHMAN: No follow-up.
11 MS. MAYRACK: Could we have a few
12 questions?
13 THE HEARING OFFICER: Yes.
14 - - - - -
15 RECROSS-EXAMINATION
16 - - - - -
17 BY MS. MAYRACK:
18 Q. Mr. Hynek, can I direct your attention,
19 please, to condition No. 10?
20 A. Yes.
21 Q. Actually, and condition 11.
22 Do you have an understanding of the
23 Department of Insurance's regulatory powers under
24 Chapter 50 of Title 18?

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1 A. I cannot cite what those specific powers
2 are, but I would assume, based on my experience
3 with the department with my current carrier and
4 prior carrier, that it's pretty open authority
5 that would give the department the authority to
6 both review and approve and request documentation
7 regarding any transaction with respect to the
8 company.
9 Q. And then can I just ask you to read
10 condition 11 again for the record?
11 A. Yes. "The Delaware Department of
12 Insurance will annually review and approve a
13 planned Highmark charges which shall be fair and
14 reasonable in accordance with the provision of
15 18 Delaware C, Section 5005.
16 MS. MAYRACK: Your Honor, the
17 Department has no more questions.
18 THE HEARING OFFICER: Thank you.
19 My counsel is going to ask you a
20 question.
21 MR. SWAYZE: I object, Your Honor.
22 MR. FINIZIO: I was going to object
23 to Mr. McConnell's statement about no one being
24 here five, ten years from now.

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1 MR. TEICHMAN: What do you know that
2 we don't?
3 MR. FINIZIO: Really, this is, in
4 large part, for my personal edification. If you
5 don't know at some point, I'd like someone to
6 educate me.
7 How does the Highmark guarantee
8 influence or impact the RBC calculations? Does
9 it have any impact or will it have any impact?
10 THE WITNESS: It does not affect the
11 RBC calculation by BCBS. D.
12 MR. FINIZIO: So that will not be
13 something that you will seek to count as part of
14 somehow part of the surplus?
15 THE WITNESS: It's a backstop, but
16 it's not recognized in the RBC calculation
17 itself.
18 MR. FINIZIO: And you have no plan to
19 try and have that recognized in some way?
20 THE WITNESS: RBC calculation is
21 indicated -- or monitored or the instructions
22 come from the National Association of Insurance
23 Commissioners. I would just leave it at that.
24 MR. FINIZIO: Thanks.

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1 THE WITNESS: You're welcome.
2 THE HEARING OFFICER: Did that
3 question engender any further?
4 (No response.)
5 THE HEARING OFFICER: Thank you.
6 Thank you. You may resume your seat.
7 It's my understanding that's the
8 final witness for Blue Cross?
9 MR. SWAYZE: Yes.
10 THE HEARING OFFICER: I think this is
11 an appropriate time to break for lunch.
12 MR. SWAYZE: We would agree.
13 THE HEARING OFFICER: One hour, is
14 that sufficient? Okay. See you back here at
15 1:30. Thank you.
16 (Lunch recess taken at 12:30 p.m.)
17 (Proceedings resumed at 1:45 p.m.)
18 THE HEARING OFFICER: Okay, everyone.
19 The hearing will now resume.
20 And my understanding is that Highmark
21 will be calling its witnesses, and Mr. Foster is
22 going to examine the first two witnesses.
23 MR. FOSTER: Thank you, Your Honor.
24 I'd like to call Ms. Karen Hanlon.

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1 THE HEARING OFFICER: Ms. Hanlon?
2 - - - - -
3 KAREN HANLON,
4 the witness herein, having first been
5 duly sworn on oath, was examined and
6 testified as follows:
7 - - - - -
8 DIRECT EXAMINATION
9 - - - - -
10 BY MR. FOSTER:
11 Q. Ms. Hanlon, would you please state your
12 full name for the record, please?
13 A. Karen L. Hanlon.
14 Q. By whom are you employed and at what
15 location?
16 A. I'm employed by Highmark, Inc. -- which I
17 will refer to in the remainder of my testimony as
18 "Highmark" -- at the company's headquarters in
19 Pittsburgh, Pennsylvania.
20 Q. What is your job title with Highmark,
21 Inc.?
22 A. I'm the senior vice president for
23 financial planning and analysis.
24 Q. What's your educational background?

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1 A. I completed an undergraduate degree in
2 business at Grove City College in Grove City,
3 Pennsylvania, in 1992.
4 Q. Do you hold any professional
5 designations?
6 A. I'm a certified public accountant.
7 Q. How long have you been employed by
8 Highmark?
9 A. I have worked at Highmark for 14 years.
10 Q. Were you employed prior to your
11 employment with Highmark?
12 A. Prior to working at Highmark, I worked
13 for five years at KPMG Peat Marwick in
14 Pittsburgh, a national accounting firm.
15 Q. Could you tell us, please, what positions
16 you have held during your career at Highmark?
17 A. Since joining Highmark, I have served as
18 the manager, accounting procedures and reporting
19 at HM Insurance Group, which was formerly known
20 as Transgeneral Insurance Company, a wholly-owned
21 subsidiary of Highmark.
22 I then transferred to the Highmark
23 corporate finance department and since have
24 served as the manager, financial accounting and

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1 reporting, director, forecast and analysis,
2 assistant controller, forecast and analysis, vice
3 president, financial and analysis, and am
4 currently the senior vice president, financial
5 planning and analysis.
6 Q. In your present job as senior vice
7 president for financial planning and analysis,
8 what are the scope of your duties?
9 A. As senior vice president, financial
10 planning and analysis, I oversee the forecasting,
11 financial planning, financial analysis, and
12 administrative budget and cost areas for
13 Highmark. I also oversee the tax compliance and
14 planning activities.
15 Q. To whom do you report at Highmark and to
16 whom does that person report?
17 A. I report to Nanette P. DeTurk, Highmark's
18 treasurer and CFO. Nanette reports directly to
19 Dr. Kenneth Melani, Highmark's chief executive
20 officer.
21 Q. Ms. Hanlon, would you describe generally
22 the corporate nature and type of business in
23 which Highmark is engaged?
24 A. Highmark is a Pennsylvania nonstock,

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1 nonprofit corporation organized under the
2 Pennsylvania nonprofit corporation law of 1988
3 with origins dating back to the 1930s. Highmark
4 as it is constituted today, was created in 1996
5 consolidation of Blue Cross of Western
6 Pennsylvania and Pennsylvania Blue Shield.
7 It does business as Highmark Blue
8 Cross Blue Shield in Western Pennsylvania and as
9 Highmark Blue Shield in the remainder of
10 Pennsylvania.
11 Highmark is authorized by the
12 Pennsylvania Insurance Department to operation a
13 hospital plan and a professional health services
14 plan in Pennsylvania pursuant to Pennsylvania's
15 Health Plan Corporations Act. Under this
16 authority, Highmark provides traditional
17 indemnity or fee-for-service healthcare insurance
18 coverage to groups and individuals in
19 Pennsylvania.
20 In addition to its indemnity
21 coverage, Highmark also offers health insurance
22 coverage in 49 of Pennsylvania's 67 counties
23 through a preferred provider organization, or
24 PPO, program. Highmark is also an administrative

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1 services only, or ASO provider for certain
2 self-insured groups.
3 As a party to joint operating
4 agreements, Highmark also provides professional
5 health services coverage in conjunction with
6 hospital coverage provided by Blue Cross of
7 Northern Eastern Pennsylvania in northeastern
8 Pennsylvania, and in conjunction with hospital
9 coverage provided by Independence Blue Cross in
10 southeastern Pennsylvania.
11 Highmark also offers Medicare
12 Advantage products, as well as Medicare
13 supplemental products to the individual and group
14 markets in western Pennsylvania, central
15 Pennsylvania, and parts of northeastern
16 Pennsylvania.
17 In northeastern Pennsylvania, the
18 supplemental products are jointly underwritten
19 with Blue Cross of northeastern Pennsylvania.
20 Highmark is one of the ten largest
21 health insurance companies in the United States
22 in terms of membership with a total health
23 membership of over 4.8 million.
24 It is also the largest in terms of

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1 total revenue of those Blue Cross Blue Shield
2 plans in the U.S. that remain not-for-profit.
3 Q. Ms. Hanlon, Highmark also owns or is
4 affiliated with a number of other businesses that
5 were reflected in the corporate chart that
6 Highmark filed as Exhibit 6 to the Statement of
7 Affiliation filed with the Department seeking
8 approval. Is this correct?
9 A. Yes.
10 Q. Could you describe the scope of the
11 business activities in which these various
12 subsidiaries are affiliates of Highmark are
13 engaged?
14 A. Highmark's wholly subsidiary, Keystone
15 Health Plan West, Inc., offers health maintenance
16 organization, or HMO coverage in western
17 Pennsylvania to both the group and individual
18 insurance markets.
19 Highmark has two other insurance
20 subsidiaries which provide group and individual
21 Medicare products. Highmark Senior Resources,
22 Inc., which offers Medicare Part D prescription
23 drug coverage in Pennsylvania and West Virginia,
24 and HM Health Insurance Company, which does

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1 business as Highmark Health Insurance Company, or
2 HHIC, and offers Medicare Advantage plans in
3 West Virginia.
4 HHIC also recently began offering
5 small group coverage for employers with 50 or
6 fewer employees in certain counties of
7 Pennsylvania.
8 In addition to its health insurance
9 operations in Pennsylvania, Highmark has a number
10 of affiliated insurers and dental and vision care
11 affiliates doing business in that state and in
12 other jurisdictions, including HM Insurance
13 Group, Inc., or HMIG, which through its
14 subsidiaries, HM Life Insurance Company and HM
15 Life Insurance Company of New York, is a
16 recognized leader in stop loss and reinsurance.
17 HMIG's subsidiaries, which also include Highmark
18 Casualty Insurance Company and HM Casualty
19 Insurance Company, hold insurance licenses in 50
20 states and the District of Columbia, and maintain
21 25 regional sales offices across the country to
22 sell, primarily, limited-benefit medical plans,
23 stop loss, reinsurance and workers' compensation
24 coverage;

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1 United Concordia Company, Inc., and
 2 its subsidiaries, which offer a broad range of
 3 dental insurance products and services to members
 4 nationwide, employing more than 1,300 people in
 5 30 offices located throughout the United States;
 6 HVAC, Inc., which is the owner of
 7 Davis Vision, Inc., or Davis Vision, Viva
 8 Optique, Inc., or Viva, and Eye Care Centers of
 9 America, Inc., also known as ECCA, comprises one
 10 of the nation's largest vision companies. Davis
 11 Vision provides comprehensive vision benefits to
 12 more than 55 million members Nationwide. Viva is
 13 a worldwide leader in ophthalmic frames and
 14 sunglass distribution and manufacturing, ECCA,
 15 with more than 400 retail stores in 36 states, is
 16 the third largest retail optical chain in the
 17 United States.
 18 Noninsurance subsidiaries of Highmark
 19 includes wholly-owned subsidiary Highmark Medical
 20 Care Services, Inc., or HMS, with offices in
 21 Pennsylvania, Maryland, HMS acts as a Medicare
 22 Administer Contractor under a contract with the
 23 Centers For Medicare and Medicaid Services
 24 performing Part A and Part B fee-for-service

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1 claims adjudication and other administrative
 2 services for hospitals, other institutional
 3 providers, physicians, and other healthcare
 4 practitioners in Delaware, Maryland, New Jersey,
 5 and Pennsylvania, as well as the district of
 6 Columbia.
 7 Finally, perhaps the most noteworthy
 8 of Highmark's affiliates as regards to these
 9 proceedings is Highmark West Virginia, Inc.,
 10 which does business as Highmark Blue Cross Blue
 11 Shield West Virginia, which I will refer to in
 12 the remainder of my testimony as "Highmark
 13 West Virginia," a West Virginia nonprofit health
 14 services corporation.
 15 Highmark West Virginia, which offers
 16 a variety of health insurance products and
 17 services to customers in West Virginia, began its
 18 relationship with Highmark in 1999. In 2004,
 19 Highmark became the sole member of Highmark
 20 West Virginia pursuant to a Business Affiliation
 21 Agreement similar to the affiliation agreement
 22 between Highmark and BCBSD which is the subject
 23 of this proceeding.
 24 Highmark West Virginia's Articles of

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1 Incorporation and Bylaws provide Highmark with
 2 the power to elect all of the members of the
 3 Highmark West Virginia board of directors,
 4 subject to certain restrictions, and Highmark is
 5 the primary Blue Cross Blue Shield Association or
 6 BCBSDA licensee for West Virginia with Highmark
 7 West Virginia being a controlled affiliate of
 8 Highmark in that state.
 9 Q. Ms. Hanlon, does Highmark have any
 10 contractual relationships with any BCBS plans?
 11 A. Highmark has contractual plans with
 12 several BCBSD plans to serve as the administrator
 13 for portions of their health business. Some of
 14 these plans include Blue Cross Blue Shield of
 15 Louisiana, Blue Cross Blue Shield of Florida,
 16 Inc., Blue Cross Blue Shield of Nebraska, Blue
 17 Cross Blue Shield of Arizona, and Excellus Blue
 18 Cross Blue Shield.
 19 In each of these cases Highmark is
 20 providing services for a limited portion of each
 21 plan's business, primarily national account
 22 business. In other cases Highmark provides a
 23 much more limited offering of merely sharing a
 24 secured data center environment with a company

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1 not interested in making this type of capital
 2 investment or capital commitment on its own.
 3 Our subsidiaries also have
 4 contractual relationships with many BCBSD plans
 5 which can vary widely in their scope of services.
 6 Q. So in the course of your duties as senior
 7 vice president of financial planning and analysis
 8 at Highmark, did you become involved in the
 9 review and analysis by Highmark of the proposed
 10 affiliation between Highmark and Blue Cross Blue
 11 Shield of Delaware?
 12 A. Yes.
 13 Q. Can you describe the role you have
 14 employed with regard to the proposed affiliation?
 15 And in doing so, please also describe the overall
 16 process Highmark has followed in reaching the
 17 point we are at today in seeking the
 18 Commissioner's approval of the affiliation.
 19 A. I became involved in the affiliation
 20 process very early on as a member of the Highmark
 21 team that prepared the response to BCBSD's
 22 request for proposal.
 23 Highmark received the request for
 24 proposal from BCBSD in August 2009 and responded

<p style="text-align: right;">Page 198</p> <p>1 to it in October 2009, including a presentation 2 to BCBSD's management at that time.</p> <p>3 Over the next several months I 4 participated in the team that prepared the term 5 sheets and the subsequent definitive agreements 6 and oversaw the extensive due diligence process.</p> <p>7 Between October 2009 and the signing 8 of the definitive agreements in August 2010, 9 BCBSD and Highmark management had several 10 meetings, including a meeting with the executive 11 management and a board member of Highmark 12 West Virginia. Highmark's board of directors was 13 briefed on the status of the affiliation on a few 14 occasions as the discussions progressed. 15 Highmark's board of directors approved the 16 execution and delivery of the Business 17 Affiliation Agreement on July 28, 2010.</p> <p>18 I also worked with Jim Hynek, BCBSD's 19 chief financial officer, in preparing the 20 financial pro formas that would subsequently be 21 filed with the Delaware Department of Insurance. 22 I'll subsequently refer to the Delaware 23 Department of Insurance as "DOI." 24 These pro formas project the</p>	<p style="text-align: right;">Page 200</p> <p>1 Finance was one of the work groups within the 2 affiliation planning process and I provided 3 executive guidance for the finance team.</p> <p>4 The affiliation planning process also 5 included accumulating a refined estimate of the 6 integration costs and synergies associated with 7 the affiliation. Highmark's cost and budget 8 department, which reports to me, was integral in 9 analyzing the results of the work that the teams 10 completed in those areas.</p> <p>11 Ultimately, the results of this work 12 were incorporated into the final set of financial 13 pro formas that were completed in conjunction 14 with the affiliation and submitted to the DOI.</p> <p>15 Most recently the pro formas were 16 updated as of August 31st, 2011, and filed with 17 the DOI as revised Exhibit 9 to the Statement of 18 Affiliation.</p> <p>19 As the DOI's and the Department of 20 Justice's staff, Blackstone, and KPMG completed 21 their work, I also participated on the team that 22 supplied information to assist with the 23 consultants' review. That brings us to the 24 current time and my participation in today's</p>
<p style="text-align: right;">Page 199</p> <p>1 financial results of BCBSD on both a stand-alone 2 and an affiliation, with Highmark, basis through 3 the year 2015, and are identified as Exhibit 9 to 4 Highmark's Statement of Affiliation or Form A 5 filing with the Delaware DOI.</p> <p>6 From a Highmark perspective, 7 preparation of the pro formas involved review of 8 the assumptions utilized in the development of 9 the pro formas and the related outcomes. The 10 primary input that Highmark had in the 11 development of the pro formas were the 12 integration costs, ongoing costs to be allocated 13 from Highmark, and synergies associated with the 14 affiliation.</p> <p>15 Subsequent to the filing with the DOI 16 of the Statement of Affiliation seeking approval 17 of the affiliation, Highmark and BCBSD agreed to 18 embark on a planning process to identify the 19 scope, timing, and cost of the work that would 20 need to take place to execute the technology and 21 business process integration between BCBSD and 22 Highmark.</p> <p>23 A number of affiliation teams were 24 formed to ensure adequate focus on each area.</p>	<p style="text-align: right;">Page 201</p> <p>1 hearings.</p> <p>2 Q. So, Ms. Hanlon, why is Highmark 3 interested in this affiliation with BCBSD? What 4 is it that Highmark hopes to gain?</p> <p>5 A. The primary economic benefit of this 6 transaction for Highmark is that it allows us to 7 lower our cost structure per member as we will 8 have more members processing on our 9 infrastructure. Essentially it adds to our 10 scale.</p> <p>11 The full value of the benefit to 12 Highmark upon full integration is estimated to be 13 \$18.8 million annually which equates to 25 cents 14 per member per month.</p> <p>15 This is critical when you are 16 competing against much larger insurance companies 17 that operate nationally and capture membership 18 from throughout the country. The affiliation 19 also allows Highmark to market our ancillary 20 products, primarily dental, vision, and stop 21 loss, with a partner with which we have a very 22 cohesive relationship to promote sales of those 23 products, increasing availability of these 24 products for Delawareans, and making the</p>

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1 administration of the products simpler for our
2 customers.

3 Lastly, as demonstrated by our
4 successful affiliation with the West Virginia
5 Blue plan, affiliating with like-minded
6 not-for-profit Blue plans supports our
7 prospective submissions and allows us each to
8 continue to provide value to the communities we
9 serve.

10 Q. You were present for the testimony of
11 Mr. Constantine -- I'm sorry, yes, Constantine, I
12 got it right, regarding the proposed affiliation
13 transaction, and do you agree with
14 Mr. Constantine's description of the key elements
15 of the proposed affiliation transaction,
16 including the amendment of BCBSD's Certificate of
17 Incorporation and bylaws, the implementation of
18 Administrative Services Agreement, and the line
19 of credit agreement between BCBSD and Highmark?
20 A. Yes.
21 Q. And with that in mind, would you please
22 of describe the nature and purpose of the
23 Administrative Services Agreement?
24 A. Under the Administrative Services

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1 Agreement, or ASA, Highmark will provide a broad
2 range of services including infrastructure,
3 technology and software and hardware support to
4 BCBSD at cost, including a reasonable allocation
5 of administrative overhead but not including any
6 provision for profit to Highmark.

7 Q. Are you aware of any terms contained in
8 the Administrative Services Agreement that are
9 not fair and reasonable as to BCBSD?
10 A. No. The terms in the ASA are fair and
11 reasonable to BCBSD. The terms contained in the
12 ASA are essentially the same as those included in
13 the ASA with Highmark West Virginia. The ASA
14 calls for BCBSD to pay its allocable share of the
15 costs of services provided to it which includes
16 the cost for services such as executive
17 oversight, strategic planning, procurement, and
18 other corporate services which are sometimes
19 referred to as corporate overhead.

20 BCBSD's allocable share of the costs
21 will be based on Highmark's established cost
22 accounting practices which will be used
23 consistently across all the business lines for
24 which Highmark is providing services. This

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1 includes all of Highmark's health business, the
2 business with Highmark West Virginia, Highmark's
3 ancillary subsidiaries such as dental, vision,
4 and stop loss, and external parties that utilize
5 Highmark systems. The ASA does not include any
6 profit margin to be paid to Highmark. BCBSD will
7 receive the services and access to Highmark
8 business that I mentioned and simply must pay
9 Highmark for the allocated cost of those
10 services.

11 Q. Now, Ms. Hanlon, you mentioned the ASA
12 references to cost allocation and to Highmark's
13 cost allocation practices. Are you familiar with
14 that subject or would you defer to another
15 Highmark representative as to questions on
16 Highmark's cost allocation and cost accounting
17 methodology?
18 A. Yes, I'm generally familiar with that
19 subject, but I would defer to Highmark's next
20 witness, Mr. Ken Gebhard, on that issue as Ken is
21 the more knowledgeable person in that area.
22 Q. Ms. Hanlon, attached as Schedule 1 to the
23 Administrative Services Agreement is a document
24 entitled, "Plan of Systems Conversion and

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1 Integration." Can you explain the purpose and
2 content of that document?
3 A. This document is a by-product of an
4 extensive affiliation planning process. The
5 purpose of the schedule is to memorialize in the
6 ASA the plan's scope, approach, and timing of the
7 integration plan. As I mentioned earlier,
8 Highmark and BCBSD began integration planning
9 efforts in earnest as soon as the Business
10 Affiliation Agreement was signed. The process
11 was designed to identify the projects that must
12 be undertaken to integrate business areas and
13 systems and potential value to be realized
14 through the affiliation.

15 Planning efforts extended into
16 estimating the costs of each project and
17 capturing interdependencies across teams.
18 Projects were sequenced over the two-year
19 affiliation time frame based on estimated effort,
20 priority, and predecessor/successor
21 relationships. Project summaries were prepared
22 to include a description of each project,
23 identification of major milestones and
24 activities, key risks, assumptions, and issues,

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1 work estimates, planned delivery dates and
2 identified dependencies. These project summaries
3 are contained in Schedule 1.
4 As a result of this effort, both
5 Highmark and BCBSD are prepared to immediately
6 move forward with implementation of the migration
7 and integration as soon as the closing of the
8 affiliation occurs which is a critical factor as
9 far as BCBSD and Highmark are concerned.
10 Q. Would you please summarize, Ms. Hanlon,
11 how BCBSD's employees, subscribers, providers,
12 and the insurance-buying public in Delaware will
13 be affected as of the first day of the
14 affiliation and how and when those effects will
15 expand over time?
16 A. The first day of the affiliation becomes
17 effective, virtually nothing will change from the
18 way it exists at BCBSD today. Providers,
19 subscribers, group customers, and the
20 insurance-buying public in Delaware will continue
21 to receive services from BCBSD as they do today.
22 They will not interact with BCBSD any
23 differently.
24 The only impact to employees on the

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1 first day the affiliation becomes effective will
2 be that a very limited number of executives will
3 begin to report organizationally to an executive
4 at Highmark. For example, Tim Constantine will
5 report to Highmark's executive vice president of
6 health services day one after the affiliation is
7 effective. Likewise, Jim Hynek, the CFO at
8 BCBSD, will report organizationally to me at
9 Highmark.
10 All of the remaining finance
11 employees at BCBSD will continue to report to
12 Jim, though, on day one as they do today, so the
13 organizational changes across the employee base
14 will be very limited at first. Over time the
15 leader of each BCBSD market-facing function will
16 report to Tim Constantine, while the BCBSD
17 leaders of other functions will report to
18 supervisors at Highmark. Thus, even over time
19 the market-facing functions which involve the
20 most interaction with Delaware consumers and
21 policyholders will still report to the president
22 of BCBSD.
23 As business systems and processes are
24 integrated between Highmark and BCBSD, over a

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1 period of 18 to 24 months, most constituents will
2 see a change in our opinion for the better. The
3 affiliation planning documents provide a roadmap
4 for what changes will occur and an estimate of
5 when the changes will occur.
6 Upon completion of integration,
7 subscribers, group customers and the
8 insurance-buying public will continue to have the
9 same benefits and coverage that they have today,
10 but their business will be administered on a more
11 automated advanced technology platform.
12 They will have access to member and
13 group customer portals that were not previously
14 available to them, and in some cases will be able
15 to complete transactions electronically that
16 would have previously been manually processed.
17 They will also notice over time the
18 change of the BCBSD name in the market to
19 Highmark BCBSD, and most likely new products in
20 the market BCBSD will be able to offer because of
21 its affiliation with Highmark.
22 Employees will also have access to
23 better online tools to assist in completing their
24 functions. This includes things like all of the

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1 operational systems, claims processing, customer
2 service, sales automation tools, billing and
3 financial systems, along with Highmark's intranet
4 site for employees, management tools and more.
5 The technology and business process
6 changes will ultimately enable BCBSD to operate
7 more efficiently.
8 Q. Ms. Hanlon, would you please explain the
9 purpose of the line of credit agreement and why
10 you believe its terms are fair and reasonable to
11 BCBSD?
12 A. Highmark is providing to BCBSD liquidity
13 with which to pay the integration costs if needed
14 through the line of credit. Borrowing on the
15 line of credit is at the discretion of BCBSD and
16 the funds drawn from the line of credit may only
17 be used for integration costs. The line of
18 credit is for up to \$45 million and has an
19 interest rate at the lesser of one month Libor
20 plus 350 bases points or the U.S. prime rate.
21 The amount on the line of credit comes due on the
22 seventh anniversary of the agreement. There is
23 no prepayment penalty and there are no fees for
24 unused balances under the line of credit which

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1 would be a standard provision in a third-party
 2 credit agreement.

3 Q. Ms. Hanlon, what plans does Highmark have
 4 with regard to the branding of BCBSD after the
 5 affiliation?

6 A. Highmark and BCBSD are preparing a
 7 brand-recognition campaign in the event that the
 8 affiliation is approved. The brand-recognition
 9 campaign will introduce BCBSD stakeholders to the
 10 Highmark organization and the Delaware affiliates
 11 new brand, Highmark Blue Cross Blue Shield
 12 Delaware or Highmark BCBSD.

13 The rebranding of BCBS of Delaware to
 14 Highmark BCBS of Delaware is being prepared to
 15 effectively communicate the change to the market
 16 in a way that results in minimal disruption to
 17 members, providers, and employees.

18 The rebranding efforts will consist
 19 of several stages. The start and end dates are
 20 dependent on the transaction close date and the
 21 integration schedule. In the early stages items
 22 such as the corporate advertisements, website,
 23 envelopes and letterhead, some marketing
 24 materials and forms which can be rebranded

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1 quickly will reflect the Highmark BCBS Delaware
 2 name. This will be accompanied by a supporting
 3 brand recognition campaign that would explain
 4 that the name has changed but nothing else has:
 5 the same great service, coverage, and employees
 6 from BCBSD remain.

7 Regarding the brand name, references
 8 to Blue Cross Blue Shield of Delaware will
 9 eventually be replaced with Highmark Blue Cross
 10 Blue Shield of Delaware. References to Delaware
 11 will be replaced with Highmark Delaware.
 12 References to BCBSD will be replaced with
 13 Highmark DE or Highmark BCBS DE. This brand
 14 strategy is consistent with the strategy recently
 15 deployed successfully in West Virginia.

16 Q. What is the desired time frame for the
 17 closing of the affiliation, and why is that
 18 important?

19 A. Highmark and BCBSD believe that the
 20 closing of the affiliation needs to occur by year
 21 end 2011 so that BCBSD is able to fully comply
 22 with a new federal mandate known as ICD-10 which
 23 was mentioned earlier by Mr. Constantine by the
 24 October 2013 deadline. ICD stands for

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1 International Classification of Diseases.

2 Currently healthcare transactions are
 3 completed in a standard format known as ICD-9.
 4 The federal government is requiring that all
 5 entities processing healthcare transactions do so
 6 in an expanded format known as ICD-10 effective
 7 October 1st, 2013.

8 The work to transition from ICD-9 to
 9 ICD-10 is extensive, and if the closing of the
 10 affiliation is delayed beyond year end 2011, to
 11 comply with ICD-10 on a stand-alone basis. That
 12 work estimated by BCBSD at two to two and a half
 13 million dollars would all be discarded if the
 14 affiliation with Highmark was ultimately approved
 15 and BCBSD migrated to Highmark's systems.

16 Q. In your opinion, Ms. Hanlon, is the
 17 financial condition of Highmark such as might
 18 jeopardize the financial stability of BCBSD or
 19 prejudice the interest of its policyholders, and
 20 if not, what's the basis for your answer?

21 A. No. Highmark has an A rating from both
 22 A.M. Best and Standard & Poor's. As of
 23 December 31st, 2010, Highmark's statutory
 24 financial statement reflected that Highmark had

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1 over \$3.7 billion in surplus and its net income
 2 for 2010 was over \$281 million. As of
 3 December 31st, 2010, Highmark's RBC was at the
 4 higher end of the range defined as sufficient,
 5 550 percent to 750 percent of the authorized
 6 control level by the Pennsylvania Insurance
 7 Department.

8 As of June 30, 2011, Highmark's
 9 quarterly financial statements reflected that
 10 Highmark had over \$4 billion in surplus and that
 11 its net income was over \$138.5 million.

12 In addition, we project that BCBSD's
 13 surplus will be significantly higher if BCBSD
 14 affiliates with Highmark versus if BCBSD remains
 15 a stand-alone entity.

16 Q. What plans, if any, does Highmark have to
 17 liquidate BCBSD, sell its assets or consolidate
 18 or merge it with any person or make any other
 19 material change in its business or corporate
 20 structure or management?

21 A. First, Highmark has no plans or proposals
 22 to liquidate BCBSD, sell its assets or
 23 consolidate or merge it with any other person or
 24 entity.

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1 As previously stated after the
 2 affiliation, BCBSD will remain as it is now, a
 3 Delaware not-for-profit corporation, and a
 4 totally separate entity from Highmark or any
 5 other Highmark subsidiary or affiliate.
 6 BCBSD will continue to provide health
 7 insurance products under the BCBS brand in
 8 Delaware and will continue to be regulated as a
 9 Health Service Corporation by the DOI. Its
 10 corporate structure will change only in the
 11 manner previously described as to the Business
 12 Affiliation Agreement, with its Certificate of
 13 Incorporation and bylaws amended to provide that
 14 Highmark shall become the sole member and,
 15 therefore, becoming the sole person with the
 16 right to elect BCBSD's board of directors.
 17 Therefore, postaffiliation, Highmark
 18 will control BCBSD from a corporate structure
 19 standpoint and BCBSD will become a member of
 20 Highmark's insurance company holding company
 21 structure as reflected in the postaffiliation
 22 organization chart which is attached as Exhibit 7
 23 to the Statement of Affiliation.
 24 Highmark has no current plans to

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1 replace the current officers of BCBSD as a result
 2 of the affiliation. The present officers of
 3 BCBSD will remain in place, including Tim
 4 Constantine as president, who will also become a
 5 member of BCBSD's board as the president
 6 director. Mr. Constantine will report directly
 7 to Deborah Rice, executive vice president, health
 8 services of Highmark, who is one of eight
 9 Highmark senior officers that report directly to
 10 Highmark's CEO, Dr. Kenneth Melani.
 11 Importantly, though, as a result of
 12 the affiliation, BCBSD will have access to the
 13 expertise of a broadly experienced management
 14 team at Highmark. The business of BCBSD will
 15 remain focused as it is today, providing
 16 individual and group health insurance coverage
 17 and administrative services for self-insured
 18 health plans throughout the state of Delaware.
 19 Highmark will, however, bring to BCBSD the
 20 ability to introduce new and innovative products
 21 to the Delaware marketplace. Some of these
 22 products will be offered directly by BCBSD as the
 23 insurer and others will be products issued by
 24 other Highmark affiliates. These products may

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1 include Medicare Advantage coverage, a managed
 2 care option for Medicare recipients, additional
 3 Medicare supplement product offerings, and
 4 Medicaid coverage.
 5 BCBSD will also be in a position to
 6 facilitate the availability of other ancillary
 7 health benefit products that are offered by other
 8 Highmark subsidiaries or affiliates.
 9 These products may include dental,
 10 vision, and stop loss coverages, which are
 11 provided through United Concordia companies,
 12 Inc., Davis Vision, and HM Insurance Group,
 13 respectively.
 14 The affiliation will bring other
 15 significant and substantial benefits to BCBSD.
 16 Among those benefits are, one, maintenance of
 17 Delaware preference. Highmark and BCBSD have
 18 committed to maintaining a significant Delaware
 19 presence and to maintain the BCBSD corporate
 20 headquarters in Delaware.
 21 Furthermore, the parties have agreed
 22 to use commercially reasonable efforts to
 23 maintain employment levels that are proportionate
 24 to those in other Highmark service areas for

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1 health business.
 2 Confirming this, Highmark is
 3 committed to the following regarding employment
 4 stability for BCBSD if the affiliation is
 5 approved: Highmark will assure the total
 6 full-time employee, or FTE positions, in Delaware
 7 will be the same after implementation if the
 8 affiliation is complete approximately 18 months
 9 as it was at the start of the affiliation
 10 integration activities. The positions will be
 11 either BCBSD positions or Highmark positions
 12 located in Delaware provided, however, Highmark
 13 will not be responsible to replace any lost
 14 positions resulting from a significant decrease
 15 in BCBSD's enrollment or market share during the
 16 implementation period; for example, from the loss
 17 of a large customer that results in any loss of
 18 positions.
 19 Any BCBSD employees whose positions
 20 are eliminated due to the implementation will be
 21 given the first opportunity to fill any new
 22 positions that are created in Delaware.
 23 Highmark will also make good-faith
 24 efforts to locate additional FTE positions in

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1 Delaware as Highmark's business opportunities
2 arise.

3 Highmark has also agreed as a
4 condition to the approval of the affiliation that
5 it will, for four years after the effective date
6 of the affiliation, take such actions as
7 necessary to ensure that there is not a material
8 decrease in the quality of BCBSD's provision of
9 account and broker management, customer service,
10 and provider service to Delaware customers by
11 Delaware-based staff under the immediate
12 supervision of Delaware-based staff, it being
13 understood, however, that additional support may
14 be provided by Highmark or other Highmark
15 affiliates during periods of additional need as
16 deemed to be necessary or appropriate to derive
17 optimum client satisfaction.

18 The second substantial benefit to
19 Delaware is reduced IT investment costs. With
20 the Highmark affiliation, BCBSD would expect to
21 invest approximately \$35 million between 2013
22 and -- I'm sorry -- between 2011 and 2015 to
23 migrate onto Highmark technology and business
24 platforms.

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1 This represents a substantial savings
2 to BCBSD and its stakeholders from the estimated
3 \$130 million in capital expenditures that the
4 BCBSD's consultant Deloitte has indicated that
5 the company would need to expend on IT upgrades
6 as an independent health insurer.

7 The third benefit is the claims
8 guarantee. Under the affiliation, Highmark must,
9 pursuant to BCBSA rules guarantee to the full
10 extent of its assets all of the contractual and
11 financial obligations of BCBSD to its customers
12 as BCBSD would become a controlled affiliate of
13 Highmark. This guarantee would provide an extra
14 layer of protection for BCBSD's customers.

15 Fourth, the benefits to particular
16 Delaware stakeholders. Particular Delaware
17 stakeholders will greatly benefit from Highmark's
18 state-of-the-art technology systems including the
19 following: members. BCBSD's members will have
20 access to Highmark's member portals -- My Blue
21 Link, a web-based resource center, and Blues on
22 Call, by which a health coach, a registered nurse
23 provides information about specific
24 health-related topics.

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1 Employers: BCBSD's employer groups
2 will have access to Highmark's employer portal --
3 Highmark Online, which allows them to view
4 membership and group information, update
5 eligibility, view their claims bill online,
6 e-mail customer service and leverage online
7 reporting functionality to track employee FSA and
8 HRA balances.

9 Providers: BCBSD providers will have
10 access to Highmark's provider portal -- NaviNet,
11 which enables providers to: obtain information
12 regarding fee schedules, check member eligibility
13 of claims status, and submit changes resulting in
14 direct updates into the appropriate system.

15 Providers will also greatly benefit
16 from Highmark's real-time solutions which include
17 real-time estimation which allows providers to
18 determine accurate member liability, real-time
19 claim adjudication which allows providers to
20 submit a claim that is processed in real-time at
21 the point of service, and accelerate a payment
22 which increases speed of payment to providers if
23 they participate in real-time and EFT, which is
24 electronic funds transfer, and paperless

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1 programs.

2 Producers. BCBSD's brokers and
3 agents will have access to Highmark's producer
4 portal through which they may use the small group
5 quoting tool for prospective small group
6 business, obtain online quotes and applications
7 for individual products, and leverage online
8 commission statements and agency-related
9 reporting.

10 The fifth benefit is lower premium
11 increases. Current projections anticipate that
12 premiums will increase in the Delaware health
13 insurance marketplace regardless of the financial
14 status -- or of the affiliation status of BCBSD.
15 However, BCBSD and Highmark have projected in the
16 financial pro formas that these rate increases
17 will be lower, about 3 percent, under the
18 affiliation scenario than if BCBSD were to
19 continue on a stand-alone basis.

20 BCBSD and Highmark do not project any
21 changes in the costs charged by providers to
22 their patients or their patients' insurers as a
23 result of the affiliation.

24 The sixth benefit is fortification of

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1 BCBSD financial condition long term. The pro
 2 forma financial projections also demonstrate the
 3 positive impact that the affiliation is expected
 4 to have on BCBSD's financial position long term.
 5 Q. What impact will the affiliation have on
 6 BCBSD's continued commitment to community support
 7 and charitable activity?
 8 A. The affiliation will not interfere with
 9 BCBSD's ongoing community supports and charitable
 10 activity commitments. Highmark will work with
 11 BCBSD to develop programs that leverage the
 12 lessons learned by both parties in community and
 13 charitable initiatives.
 14 Q. Ms. Hanlon, does Highmark have any plans
 15 or intentions whatsoever to gain access to
 16 BCBSD's assets or to transfer any of BCBSD's
 17 assets to Highmark or any subsidiary or affiliate
 18 of Highmark?
 19 A. No. Highmark has no plans or intentions
 20 to gain access to BCBSD's assets or to transfer
 21 any of BCBSD's assets to Highmark or any
 22 subsidiary or affiliate of Highmark.
 23 Further, upon affiliation, pursuant
 24 to recent Delaware legislation, BCBSD will become

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1 subject to the Delaware Insurance Holding Company
 2 System Registration Act and its provisions with
 3 regard to filing an approval of material
 4 interaffiliate agreements and transaction was the
 5 Delaware Department of Insurance.
 6 In addition, there are agreed-to
 7 conditions whereby the Department of Insurance
 8 will review and approve the estimated cost
 9 allocation charges using a fair and reasonable
 10 standard and will approve any overages exceeding
 11 \$500,000.
 12 In addition, Highmark and BCBSD have
 13 agreed as a condition to the affiliation that
 14 Highmark shall not improperly use the assets of
 15 BCBSD for the benefit of Highmark rather than the
 16 benefit of BCBSD and its subscribers.
 17 This condition specifically provides
 18 that the only economic transfers that BCBSD is
 19 permitted to make to Highmark are payments for
 20 BCBSD's integration to Highmark's system, ongoing
 21 payments under the Administrative Services
 22 Agreement, and payments pursuant to the line of
 23 credit.
 24 Contrary to causing the removal of

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1 assets out of BCBSD, the affiliation by
 2 partnering with BCBSD with a much larger
 3 not-for-profit entity, having a state-of-the-art
 4 information technology platform, will enable
 5 BCBSD to preserve tens of millions of dollars
 6 that it would otherwise expend making IT capital
 7 improvements and other capability enhancements.
 8 By the end of 2015, the parties
 9 project that BCBSD's surplus will be \$226 million
 10 on an affiliation basis versus \$89 million on a
 11 stand-alone basis.
 12 Q. Would you please comment, Ms. Hanlon,
 13 regarding the competence, experience and
 14 integrity of the persons who would control the
 15 operation of BCBSD after the affiliation?
 16 A. The qualifications of Highmark's board of
 17 directors and executive management team are
 18 described in the biographical affidavits filed
 19 with the Statement of Affiliation.
 20 These affidavits demonstrate that the
 21 Highmark board of directors and management team
 22 is highly qualified to competently govern and
 23 manage Highmark and all of its affiliates.
 24 Timothy Constantine, the current president of

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1 BCBSD, will continue to fill this role
 2 postclosing.
 3 With regard to the BCBSD board of
 4 directors postaffiliation, the four Class A
 5 directors will each be selected by BCBSD from the
 6 members of the present BCBSD board, all of whom
 7 are prominent Delawareans and have successfully
 8 governed BCBSD for many years.
 9 Three of the four proposed BCBSD
 10 Class B directors, Highmark's CEO Dr. Kenneth
 11 Melani, Highmark treasurer and CFO Nanette
 12 DeTurk, and Highmark executive vice president of
 13 health services, Deborah Rice, will come from the
 14 ranks of Highmark's experienced executive
 15 management.
 16 The final Class B director, which
 17 must be a Delaware resident, will be named in the
 18 near future.
 19 Q. Do you know any reason why the proposed
 20 affiliation might likely be hazardous or
 21 prejudicial to the Delaware insurance-buying
 22 public?
 23 A. I do not.
 24 Q. What's the basis for your response?

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1 A. For all the reasons I have previously
2 stated, I believe the affiliation will be
3 extremely beneficial to the Delaware
4 insurance-buying public. BCBSD will
5 significantly upgrade its infrastructure while
6 gaining access to the efficiencies and scale
7 associated with a larger company. The
8 alternative of pursuing the infrastructure
9 upgrades on a stand-alone basis is far less
10 beneficial to the Delaware insurance-buying
11 public.

12 Additionally, Highmark's resources
13 allow it to focus significant attention on
14 broader issues such as compliance with federal
15 and state healthcare reform initiatives.

16 For example, Highmark presently has
17 an office of healthcare reform and multiple work
18 teams and consultants dedicated to the study and
19 analysis of and compliance with healthcare reform
20 requirements imposed by President Obama's recent
21 healthcare reform legislation. BCBSD will get
22 access to all of the knowledge gained by these
23 efforts. All of these facts combined will allow
24 BCBSD to continue to offer innovative

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1 cost-effective products in the Delaware market.

2 Perhaps the best evidence of the
3 likelihood that the affiliation will be of
4 significant benefit to the Delaware
5 insurance-buying public is the demonstrable
6 success of the similar affiliation of Highmark
7 and Highmark West Virginia. In the time that
8 Highmark West Virginia has been affiliated with
9 Highmark, it has improved significantly
10 financially, grown enrollment, gained
11 efficiencies, and has been able to offer new
12 products and programs that it otherwise would not
13 have been able to offer its customers.

14 Lastly, but importantly, Highmark has
15 agreed with the DOI to a number of proposed
16 conditions to approval of the affiliation. These
17 proposed conditions are responsive to concerns
18 raised by the DOI's consultants, Blackstone and
19 KPMG and would impose restrictions under
20 requirements postaffiliation that will be in
21 addition to those already applicable under
22 Delaware insurance laws and regulations.

23 Q. Ms. Hanlon, I'd also like to ask you a
24 couple of questions to follow up on some

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1 cross-examination of Mr. McConnell this morning
2 of Mr. Constantine.

3 Could you tell us what is the nature
4 of the commitment or requirement in Pennsylvania
5 as to Highmark's charitable contributions when
6 RBC exceeds 750 percent?

7 A. Yes. The Pennsylvania Insurance
8 Department has outlined ranges for different size
9 insurance companies in Pennsylvania that it
10 believes are appropriate as it relates to
11 risk-based capital.

12 The range for a company that is of
13 Highmark's size, the sufficient range is defined
14 as 500 to 750 percent. For a smaller company,
15 the sufficient range would be 750 to 950 percent.

16 If you exceed the top end of that
17 sufficient range, what you have to do is put a
18 plan in place and present it to the insurance
19 department regarding what you're going to do with
20 the surplus that has you over the maximum amount
21 of the range.

22 So that's the essence of the
23 agreement. There are other ranges defined within
24 the order that they laid out. The range that I

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1 defined is sufficient as the top end. There are
2 other points that are down below sufficient that
3 are laid out in their requirements, as well.

4 Q. Would the plan that Highmark or a similar
5 company would have to come up with, would that
6 necessarily mean a charitable contribution of
7 some sort?

8 A. It could.

9 Q. Are there other options?

10 A. It could. It could be a variety of
11 items. I don't think any of the plans in
12 Pennsylvania have found themselves in a place of
13 having to present a plan yet, or Highmark hasn't.
14 I'll speak for Highmark. We have not found
15 ourselves in the place of having to present a
16 plan. But the plan could most likely also
17 include rate decreases on new business or
18 existing business in addition to something like
19 charitable contributions.

20 Q. Again, in Pennsylvania the range for a
21 smaller plan, I think you said, might be 750 to
22 900 percent RBC. Is that correct?

23 A. Yes.

24 Q. Would that probably include a plan about

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1 the size of BCBSD, for example?
2 A. Yes.
3 Q. I think there was also a comment earlier
4 this morning in previous testimony that Highmark
5 would have to, perhaps, approve BCBSD's
6 charitable contributions after the affiliation is
7 effected. Is that technically correct?
8 A. No. Really, the BCBSD board of directors
9 would approve charitable contributions subsequent
10 to the affiliation, just as presumably they would
11 today. So it would be the board of directors of
12 that company that would actually have to give the
13 approval.
14 Q. Just one other question.
15 I think you were asked this morning
16 concerning the potential transaction that's been
17 mentioned in the press of a combination or the
18 affiliation between Highmark and Western
19 Pennsylvania Allegheny Health System.
20 I think the question Mr. McConnell
21 asked was it's been reported that \$75 million was
22 going to be donated in connection with that
23 transaction to, I think, a medical school
24 education in Pennsylvania.

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1 And that being the case, why wouldn't
2 you look in a similar way at making some
3 contribution with regard to the BCBSD affiliation
4 here in Delaware? Could you respond to that
5 question, please?
6 A. Yeah. Highmark is a
7 Pennsylvania-domiciled company, a
8 Pennsylvania-regulated company. The monies that
9 are being referred to, the deal that's being
10 referred to is a decision being made around
11 preserving choice and competition in a
12 Pennsylvania market. And so that's why the funds
13 are being focused out of Highmark for that
14 initiative.
15 MR. FOSTER: That's all I have, Madam
16 Hearing Officer.
17 THE HEARING OFFICER: Thank you,
18 Mr. Foster.
19 Miss Hanlon, would you like a moment
20 to get a drink of water?
21 MS. HANLON: I'm okay.
22 THE HEARING OFFICER: Mr. McConnell?
23 MR. McCONNELL: Meredith Tweedie will
24 be cross-examining.

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1 THE HEARING OFFICER: You may
2 process.
3 - - - -
4 CROSS-EXAMINATION
5 - - - -
6 BY MS. TWEEDIE:
7 Q. Good afternoon, Ms. Hanlon. You stated
8 that Blue Cross Blue Shield of Delaware will
9 remain totally separate and Highmark will control
10 Blue Cross Blue Shield from the corporate
11 structural standpoint and Blue Cross will become
12 a member of Highmark's insurance company holding
13 structure.
14 Does Highmark expect to influence
15 company policy at Blue Cross Blue Shield?
16 A. It will to the extent that the -- we use
17 consistent policy across. Ultimately all of the
18 authority, the decisions are really signed off
19 and approved by the BCBSD board of directors, but
20 to the extent that you're talking about
21 management policies down at the departmental
22 level, those would be signed off and approved by
23 whoever the management in that department would
24 be. That could be a Delaware person, it could be

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1 a Highmark person.
2 But the big items typically are
3 policies that you really take to your board and
4 get approval for. Things like spending policy,
5 signing authority. Those types of things would
6 go to your board of directors and it would be the
7 BCBSD board of directors.
8 Q. Is there any threshold at which -- just
9 on the spending policy or on the issue of
10 spending, would a budget item annually of
11 \$750,000 for charitable contributions, that would
12 need to be approved by Highmark or --
13 A. It would not be approved by Highmark.
14 Highmark would not approve -- would not have any
15 reason or need to approve the BCBSD charitable
16 contributions. It would be a BCBSD policy that
17 its board has signed off on that would suggest if
18 \$750,000 is the right threshold or some other
19 number, I'm not sure what their policy says
20 today, but it would really be up to that board to
21 define at what level it wants to have involvement
22 in the decision-making around something like
23 that.
24 Q. And on the issue of reserves, is there a

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1 level at which Highmark might view Blue Cross's
2 reserves as excessive?
3 A. No. I mean, I don't think it would.
4 Been quite a bit of testimony here today around
5 the reserves obviously, and it's an important
6 issue. I think BCBSD has stated that they have
7 had an independent study done that suggests a
8 range that's consistent with the range that they
9 are in today. We would not view that as
10 excessive. We think that that is an appropriate
11 range.
12 Q. If Blue Cross were to go substantially
13 over that range, would that change the analysis?
14 A. You have to look at the business
15 developments at that time. I really -- sitting
16 here today, I couldn't speculate what they might
17 face five years down the road to say is 1,200 a
18 number that's too high at that point or 1,500 or
19 900. You'd really have to assess it given the
20 business conditions at that point.
21 Q. You said that the affiliation will not
22 interfere with -- we were talking about this --
23 Blue Cross's ongoing community support and
24 charitable activity commitments and that Highmark

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1 would work with Blue Cross to develop at least
2 some of the recipient programs.
3 How active would that participation
4 by Highmark be in approving the recipient
5 programs?
6 A. I'll speak to it to the degree that I'm
7 able, maybe mostly using the context of
8 West Virginia because that's probably the most
9 appropriate.
10 Highmark has ruled out certain
11 programs in Pennsylvania and we look for -- try
12 to focus on programs where they're going to be
13 demonstrable outcomes. And so in the case of
14 West Virginia, there has been quite a bit of
15 dialogue between Fred Earley, who will testify
16 later, and the area within Highmark that handles
17 charitable activities, community giving, those
18 types of things. And I think one of the things
19 that they have talked about is what programs have
20 been rolled out in Pennsylvania, what's worked
21 well, what hasn't worked so well, are the needs
22 in West Virginia similar to or different from the
23 needs in Pennsylvania, and based on that what do
24 they think would be the most appropriate programs

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1 in West Virginia.
2 So it's kind of dialogue about what's
3 worked well, what hasn't worked well, what are
4 your needs, let's try to line everything up and
5 put the best programs in place.
6 Q. So you expect Highmark's direction over
7 the charitable activities contributions to be
8 similarly managed to how they are in the Mountain
9 State affiliation?
10 A. Yeah.
11 Q. Would you anticipate that Highmark's
12 charitable foundation governance documents would
13 be revised to include Delaware as they were
14 revised to include West Virginia?
15 A. You're referring to the Highmark
16 foundation specifically?
17 Q. Yes.
18 A. They could be. That's something that we
19 have talked about internally. I think the
20 Highmark foundation would be agreeable to talking
21 to BCBSD about it. So they could be.
22 Q. And then at the time Mountain State was
23 affiliated with Highmark, I think -- or in the
24 time, I'm sorry, that Mountain State has been

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1 affiliated with Highmark, would it be fair to say
2 that its finances, its situation has improved
3 considerably?
4 A. Yes.
5 Q. At the time of the West Virginia
6 affiliation, the West Virginia plan was not
7 nearly as well-capitalized as the Delaware Blue
8 plan is now. Are there terms in this affiliation
9 that were negotiated that are different from
10 those in West Virginia as a result of Blue Cross
11 Blue Shield of Delaware's substantially better
12 financial position?
13 A. You know, unfortunately I wasn't a party
14 to the initial conversations back -- certainly
15 not in 1999 or in 2004 with the West Virginia
16 plan. So it's possible that some of those things
17 that you talk about once just as you're getting
18 the affiliation going and then you don't talk
19 about them a whole lot more after that, there are
20 differences, and I'm just not aware of them.
21 Fred Earley probably could offer you some better
22 perspective on that.
23 When I think about the discussions
24 that we have with West Virginia today, the model

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1 that we have with West Virginia today and the
2 model that we're envisioning for BCBSD, it is
3 largely similar. I hesitate to say it's totally
4 the same because there might be a minor
5 exception, but I can't think of one right now.
6 So it's very consistent in terms of current
7 activity.

8 Q. So is it safe to say that the financial
9 strength of the affiliation target is not
10 particularly relevant to the question of how much
11 control is local versus --

12 A. No. I think that's fair to say. I think
13 in both cases, whether it be long ago when
14 West Virginia was not in such a great financial
15 place or now, Highmark has had control for
16 sometime in West Virginia, still thinks that that
17 is an important element of the affiliation, and,
18 in fact, I think the BCBSA requires it to have to
19 have the license transfer, to have the marks
20 assigned to Highmark, and we think it's important
21 in the case of Delaware as well.

22 Q. Does it make any difference -- the
23 financial stability target, does it make any
24 difference in terms of the charitable

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1 contribution that Highmark would be willing to
2 make?

3 A. Highmark is not making charitable
4 contributions in Delaware. It certainly is
5 important in terms of Blue Cross Blue Shield of
6 Delaware, and I would expect that if Blue Cross
7 Blue Shield of Delaware was not in a sound
8 financial state, that its board of directors
9 would be exerting all of its influence, frankly,
10 to make sure that it was only entering into those
11 commitments as it was prudent given the financial
12 condition there at the time.

13 So I wouldn't say that you can
14 disregard the financial condition now or in the
15 future when you're talking about community
16 commitments. They go hand-in-hand.

17 Q. I guess along those lines, when Highmark
18 entered into the affiliation with West Virginia,
19 it was made possible for the Highmark foundation
20 to actively support West Virginia charitable
21 activities. But it doesn't appear as part of
22 this affiliation that it's going to be made
23 possible for the Highmark foundation to support
24 Delaware charities in the same way.

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1 Do you know why that is?

2 A. Frankly I think it's just because we
3 haven't gotten to it. That was my comment
4 earlier, that the Highmark foundation in our
5 discussions internally, and it's a private
6 foundation with its own board of directors, so
7 I'm not prepared to speak on behalf of that board
8 of directors, but the conversation that we have
9 had internally around the Highmark foundation and
10 Blue Cross Blue Shield of Delaware has been,
11 yeah, when the time's right, when we get an
12 affiliation signed and approved, we can talk
13 about the Highmark foundation working, expanding
14 its service area to include Delaware.

15 We haven't gotten to the right point
16 in the conversation yet.

17 Q. Back to something you said earlier. You
18 said that the projected surplus of Blue Cross on
19 an affiliation basis in 2015 was I think it was
20 \$226 million versus about \$89 million. Has
21 Highmark similarly projected what Blue Cross Blue
22 Shield of Delaware's RBC would be on an
23 affiliation versus stand-alone basis?

24 A. That is in the pro formas. I think that

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1 was something that was marked as confidential and
2 redacted. We didn't -- Highmark didn't project
3 it. Blue Cross Blue Shield of Delaware projected
4 it. But we participated obviously.

5 Q. You also stated that the -- in terms of
6 the board after the affiliation that the final
7 Class B director who must be a Delaware resident
8 will be named in the near future. Do you have
9 any anticipation of when Highmark will expect to
10 name that director?

11 A. The near future was probably about as
12 much as I could get on it. So I think they
13 actually are currently in discussions about
14 people that are interested, talking to people
15 that they think would be good candidates. So
16 hopefully in the next couple of weeks or few
17 weeks.

18 Q. I have one final question and that is we
19 have been discussing the conditions. You are a
20 party to the negotiation process of the
21 37 conditions that were agreed upon.

22 A. Right.

23 Q. Were there conditions that the DOI
24 proposed that aren't being proposed to the

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1 Hearing Officer today because Highmark or Blue
2 Cross wouldn't agree to them?
3 A. Gosh. Yeah, there are. Yes.
4 Q. Can you summarize what those conditions
5 related to?
6 A. I was stretching to think of one, because
7 there's 37 that we did agree to. So I can't
8 recall how many there were that we weren't. I
9 thought of one which is why I answered yes.
10 We did have discussion regarding -- I
11 can't recall exactly what the words in the
12 condition were, but we did have a fair amount of
13 discussion regarding the control of the board of
14 directors, and I think there was a sense by the
15 Department of Insurance that they wanted Highmark
16 to have less control of the board of directors
17 and that was not something that Highmark could
18 live with. And, frankly, neither could the Blue
19 Cross Blue Shield Association.
20 So that was one area that I can
21 recall. Probably others, but I can't remember
22 now what they were.
23 MS. TWEEDIE: Thank you. May we have
24 one moment?

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1 THE HEARING OFFICER: Yes, you may.
2 MS. TWEEDIE: We don't have any
3 further questions. Thank you.
4 - - - - -
5 CROSS-EXAMINATION
6 - - - - -
7 BY MS. POLIZOTI:
8 Q. I have a few questions. I'd like to try
9 to give this to you without tripping over myself.
10 Ms. Hanlon, I have handed you what
11 has been marked as Joint Exhibit 113. These are
12 the Department of Insurance proposed conditions.
13 You've seen this document before,
14 right?
15 A. Yes.
16 Q. This document contains the conditions
17 that the Department of Insurance has proposed in
18 this proceeding; is that right?
19 A. Uh-huh.
20 Q. Is it your understanding that Highmark
21 has agreed to all 37 of the conditions that are
22 set forth in this document?
23 A. Yes.
24 Q. I just would like to go through a couple

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1 of the conditions with you.
2 If you could turn to page 3, I'd like
3 to look at condition No. 9. I'd like to direct
4 your attention to the first sentence of this
5 condition which says that "Highmark shall not
6 improperly use the assets of Blue Cross Blue
7 Shield of Delaware for the benefit of Highmark
8 rather than the benefit of Blue Cross Blue Shield
9 of Delaware and its subscribers."
10 Highmark agrees to that condition; is
11 that right?
12 A. Yes.
13 Q. Moving further in this, condition No. 9,
14 would you agree with me that this condition says
15 that without Department of Insurance approval,
16 there are only three ways that Blue Cross can
17 transfer monies to Highmark?
18 A. Yes.
19 Q. Let's go through each of those three
20 ways.
21 The first way is Blue Cross is
22 allowed to make payments to Highmark for Blue
23 Cross's integration on Highmark's technology
24 systems, right?

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1 A. Yes.
2 Q. The second way is that Blue Cross is
3 allowed to make ongoing payments to Highmark
4 under the Administrative Services Agreement.
5 That's right?
6 A. Yes.
7 Q. And the final way is Blue Cross is
8 allowed to make whatever payments are due,
9 principal, interest under the line of credit
10 should it be drawn upon?
11 A. Yes.
12 Q. Now, do you agree that, aside from those
13 three transfers that we just talked about,
14 there's no other way that Blue Cross can transfer
15 monies to Highmark without the approval of the
16 Delaware Department of Insurance?
17 A. Yes.
18 Q. Now, let's go down and talk about each of
19 these three types of economic transfers.
20 So the first one, this is the one
21 where Blue Cross is making payments for the
22 integration of Highmark's IT systems. If you
23 could go to page 4, condition No. 17. Do you
24 have an understanding that the payments for Blue

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1 Cross's migration onto Highmark's IT systems are
 2 capped at \$42 million?
 3 A. Yes.
 4 Q. Do you have an understanding that the
 5 current estimates for those integration payments
 6 are between 35 and 37 million dollars?
 7 A. Yes.
 8 Q. Then let's talk about the second type of
 9 economic transfer, and these are the ongoing
 10 payments under the Administrative Services
 11 Agreement. If you could actually turn back to
 12 page 3, I'd like to direct your attention to
 13 conditions 10 and 11.
 14 So you understand that one condition
 15 to the affiliation, and let me specifically --
 16 I'll start with 10. That one condition to the
 17 affiliation is that Highmark and Blue Cross are
 18 going to submit this cost allocation methodology
 19 formula to the Department of Insurance prior to
 20 the closing of the affiliation if it's approved,
 21 right?
 22 A. Yes.
 23 Q. You also understand that Blue Cross is
 24 going to on an annual basis file a copy of the

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1 budget that's been approved that relates to the
 2 charges pursuant to the Administrative Services
 3 Agreement, right?
 4 A. Yes.
 5 Q. And you understand, and now this is going
 6 into condition 11, you understand that the
 7 Department of Insurance gets to annually both
 8 review and approve that budget, correct?
 9 A. Yes. It reviews and approves the planned
 10 Highmark charges.
 11 Q. Exactly. And those planned Highmark
 12 charges are the Highmark charges that are under
 13 the Administrative Services Agreement, right?
 14 A. Yes.
 15 Q. And the standard that the Department
 16 applies is the fair and reasonable standard?
 17 A. Yes.
 18 Q. If we can take a look at condition 12
 19 that's still on page 3. Do you agree with me
 20 that this condition indicates that after the
 21 budget has been approved by the Department of
 22 Insurance, if there's an overage in the budget
 23 which overage exceeds \$500,000, that Blue Cross
 24 has to submit information and paperwork to the

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1 Department of Insurance so that the Department of
 2 Insurance can approve the overages?
 3 A. Yes.
 4 Q. Just a couple more.
 5 Next on page 4, condition
 6 No. 13. Is it your understanding of this
 7 condition that, if Highmark essentially fronts
 8 costs for Blue Cross in excess of a hundred
 9 thousand dollars, the Department of Insurance has
 10 to review and approve those costs?
 11 A. Yes.
 12 Q. And then the third type of economic
 13 transfer, we have just gone through the first
 14 two, the third one is the payments under the line
 15 of credit agreement. So this is a line of credit
 16 that Highmark is extending to Blue Cross, right?
 17 A. Yes.
 18 Q. And it's only to be used for Blue Cross's
 19 migration onto Highmark's IT systems?
 20 A. Yes.
 21 Q. And you heard Mr. Constantine's testimony
 22 earlier this morning that Blue Cross doesn't
 23 intend to draw upon this line of credit?
 24 A. Yes.

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1 Q. Is it your understanding that, even if
 2 Blue Cross does draw upon this line of credit,
 3 there are a few conditions that the Department
 4 has proposed that relate to the line of credit,
 5 and let me just direct your attention
 6 specifically to page 8, conditions 27, 28, and
 7 29. I'll just restate my question because it got
 8 kind of long.
 9 Is it your understanding that these
 10 three conditions, meaning 27, 28, and 29, would
 11 apply if the affiliation is approved?
 12 A. Yes.
 13 MS. POLIZOTI: No further questions,
 14 Your Honor.
 15 THE HEARING OFFICER: Thank you.
 16 MS. TWEEDIE: May I ask one follow-up
 17 question?
 18 THE HEARING OFFICER: Yes.
 19 - - - - -
 20 RE-CROSS-EXAMINATION
 21 - - - - -
 22 BY MS. TWEEDIE:
 23 Q. Would you mind turning back to
 24 condition 11 just momentarily? States "The

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1 Delaware Department of Insurance will annually
 2 review and approve the planned Highmark charges
 3 which shall be fair and reasonable and in
 4 accordance with provisions of 18 Delaware Code
 5 Section 5005.

6 The term "planned Highmark charges,"
 7 can you explain how that differs from cost
 8 allocation methodology?

9 A. Well, the cost allocation methodology
 10 would determine the planned Highmark charges. So
 11 we will be filing a budget per the earlier
 12 condition, condition 12 there. Delaware will
 13 annually file a copy of the budget approved by
 14 its board of directors.

15 Included in that budget will be two
 16 components of cost. One will be all the costs
 17 that originated at Blue Cross Blue Shield of
 18 Delaware, all of their employees, facilities,
 19 everything that goes into their administrative
 20 budget. And the second component of the costs
 21 would be the planned charges from Highmark, and
 22 those would be arrived at as we estimate them for
 23 budget purposes by understanding what the cost
 24 allocation methodologies are and making an

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1 estimate of what those charges would be based on
 2 those methodologies and what the Blue Cross Blue
 3 Shield of Delaware planned activities are.

4 And then the further condition,
 5 condition 12, then, suggests that as we progress
 6 throughout the year, if we find that those
 7 Highmark planned charges are going to exceed --
 8 are going to be greater than what we had included
 9 in the budget by \$500,000 or more, then we have
 10 to come back to the Department for approval of
 11 that amount.

12 So the allocation methodologies will
 13 include both what the planned Highmark charges
 14 are that go into the budget and clearly will
 15 derive what the actual charges are that will
 16 ultimately assess to Delaware.

17 MS. TWEEDIE: Thank you.

18 THE HEARING OFFICER: Anything
 19 further from anyone?
 20 (No response.)
 21 THE HEARING OFFICER: Ms. Hanlon, are
 22 you aware of any plans that Highmark may have to
 23 convert to a for-profit?
 24 THE WITNESS: No. No.

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1 THE HEARING OFFICER: Thank you.
 2 Then you may resume your seat and catch your
 3 breath.

4 Let's take a short break before we go
 5 on to the next witness.
 6 (A recess was taken.)
 7 THE HEARING OFFICER: Mr. Foster, do
 8 you want to call your next witness, please?
 9 MR. FOSTER: Thank you, Madam Hearing
 10 Officer. I would call Mr. Kenneth Gebhard.
 11 KENNETH B. GEBHARD,
 12 the witness herein, having first been
 13 duly sworn on oath, was examined and
 14 testified as follows:
 15 - - - - -
 16 DIRECT EXAMINATION
 17 - - - - -
 18 BY MR. FOSTER:
 19 Q. Mr. Gebhard, would you please state your
 20 full name for the record?
 21 A. Kenneth B. Gebhard.
 22 Q. By whom are you employed and where?
 23 A. I'm employed by Highmark, Inc., which I
 24 refer to in the remainder of my testimony as

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1 "Highmark" at the company's location in Camp
 2 Hill, Pennsylvania.
 3 Q. What is your job title with Highmark?
 4 A. I'm the vice president cost management
 5 and analysis.
 6 Q. Could you give us your educational
 7 background, please?
 8 A. I completed an undergraduate degree in
 9 business from Embry-Riddle University, an M.B.A.
 10 from the University of Pittsburgh, and J.D. from
 11 the Widener University School of Law.
 12 Q. Do you hold any professional
 13 designations?
 14 A. I am a certified management accountant
 15 and a member of the Pennsylvania bar.
 16 Q. How long have you been employed by
 17 Highmark?
 18 A. I have been employed by Highmark and its
 19 predecessor, Pennsylvania Blue Shield, for just
 20 over 25 years.
 21 Q. Where were you employed prior to that
 22 time?
 23 A. Prior to working at Highmark I was
 24 employed by Neumann Services, Inc., a hospital

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1 holding company a Bon-Ton Stores, Inc., a retail
2 chain.

3 Q. Mr. Gebhard, what other positions have
4 you held during your career at Highmark?

5 A. My entire career at Highmark has been in
6 corporate finance with an emphasis on cost and
7 budget activities. I began as a financial
8 analyst and have held positions as a manager,
9 director, and vice president.

10 Q. How long have you held your present
11 position as vice president, cost management and
12 analysis?

13 A. I have held my present position since May
14 2009.

15 Q. Could you describe your duties as vice
16 president of cost management and analysis at
17 Highmark?

18 A. As vice president, cost management and
19 analysis, my accountabilities include
20 administering the company's budgeting, cost
21 accounting, and administrative cost forecasting
22 activities. In addition, my duties include
23 accounts payable, 1099 reporting and Federal
24 Employee Program cost compliance.

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1 Q. Mr. Gebhard, would you tell us to whom
2 you report at Highmark and to whom does that
3 person report?

4 A. I report to Karen L. Hanlon, Highmark
5 senior vice president, financial planning and
6 analysis. Karen reports directly to Nanette P.
7 DeTurk, Highmark's executive vice president,
8 chief administrative and financial officer.

9 Q. Mr. Gebhard, have you been a part of the
10 Highmark team that has worked on the proposed
11 affiliation between Highmark and BCBSB that's the
12 subject of today's hearing?

13 A. Yes.

14 Q. What role have you played on behalf of
15 Highmark in the development and analysis of this
16 proposed transaction?

17 A. Early on I supported the due diligence
18 process by reviewing BCBSB's administrative cost
19 information and based on this information
20 performing high-level analysis to determining the
21 potential impact of the affiliation on Highmark's
22 administrative costs.

23 Once the definitive agreements were
24 signed in August 2010, I supported Karen Hanlon,

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1 Highmark's senior vice president, financial
2 planning and analysis, Jim Hynek, BCBSB's chief
3 financial officer, in the development of input to
4 use in preparing the affiliation version of the
5 financial pro formas.

6 This input included developing
7 estimates of the potential postaffiliation cost
8 synergies, service charges that would be
9 applicable to BCBSB for administrative services
10 to be provided by Highmark to BCBSB, and the
11 costs to BCBSB of integrating BCBSB on the
12 Highmark's IT systems and operating platform.

13 Subsequent to this work I worked with
14 Karen and Jim to update this input based on
15 information coming out of the integration
16 planning process for inclusion in the updated
17 financial pro formas. I was also on the
18 financial analysis team which validated output
19 coming from the integration planning process.

20 I have also participated in
21 discussions with the Department of Insurance
22 advisors relative to Highmark's cost allocation
23 methodologies and the cost information included
24 in the financial pro formas as described above.

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1 Q. Then you are familiar with the
2 Administrative Services Agreement proposed
3 between Highmark and BCBSB?

4 A. Yes.

5 Q. Can you describe the nature and purpose
6 of that agreement?

7 A. The purpose of the Administrative
8 Services Agreement, ASA, is to establish a
9 contractual relationship between BCBSB and
10 Highmark relative to services that Highmark may
11 provide to BCBSB following the affiliation. The
12 ASA describes the scope of services that Highmark
13 may provide to BCBSB, the manner in which
14 Highmark will be compensated for providing these
15 services, the term of the ASA, events that
16 trigger a termination, requirements related to
17 maintenance of records and access to data, and
18 other matters, including but not limited to a
19 dispute resolution process -- a resolution
20 process in the event of dispute arising out of
21 the ASA.

22 Q. With regard to the manner in which
23 Highmark will be compensated by BCBSB for
24 services under the ASA, are you familiar,

<p style="text-align: right;">Page 258</p> <p>1 Mr. Gebhard, with Article II.A of the ASA which 2 provides, in part, "BCBSD shall compensate 3 Highmark for Highmark's provision of the services 4 in an amount equal to BCBSD's fair and reasonable 5 allocable share of the total actual cost without 6 provision for profit to Highmark of providing a 7 of services. Such costs shall include, without 8 limitation, employee salaries, employee benefits, 9 and other direct and indirect administrative 10 costs, including reasonable charges for corporate 11 overhead. BCBSD's allocable share of the cost of 12 the services shall be determined in accordance 13 with Highmark's established cost accounting 14 practices in effect from time to time"?</p> <p>15 A. Yes. In simpler terms, that provision 16 means that Highmark will provide services to 17 BCBSD at cost without provision for profit to 18 Highmark.</p> <p>19 Q. Is this compensation for services that 20 we're describing here, is that reflected in the 21 cost information that's included in the pro 22 formas you mentioned earlier?</p> <p>23 A. Yes.</p> <p>24 Q. Mr. Gebhard, would you please try to</p>	<p style="text-align: right;">Page 260</p> <p>1 Other business segments include the 2 nonhealth business such as vision, dental, as 3 well as Highmark Medicare services.</p> <p>4 Home Office expenses largely consist 5 of either centralized service functions such as 6 information technology or staff management of 7 certain activities that benefit either the entire 8 enterprise or multiple, though not necessarily 9 all, business segments such as corporate finance.</p> <p>10 The first step of the methodology for 11 allocating Home Office expenses is to allocate 12 centralized service functions to segments on the 13 basis of the service furnished to or received by 14 each segment. Allocation of centralized service 15 expenses is followed by the allocation of the 16 staff management functions which are first 17 allocated based on specific activities provided 18 in support of an identifiable business segment.</p> <p>19 When this is impossible to the nature 20 of the activity, residual Home Office expenses 21 are allocated using a methodology reflective of 22 the beneficial or causal relationship between 23 such expenses and the receiving segments.</p> <p>24 As noted previously, for cost</p>
<p style="text-align: right;">Page 259</p> <p>1 describe for us in detail Highmark's cost 2 allocation practices and how those practices 3 would be applied in regard to BCBSD under the 4 Administrative Services Agreement?</p> <p>5 A. Highmark's cost allocation framework as 6 provided in Exhibit 26 of the prehearing 7 memorandum of the Delaware Department of 8 Insurance differentiates between costs 9 originating in Highmark's home office and those 10 originating in the various business segments 11 within Highmark's holding company system.</p> <p>12 Home Office refers to functions or 13 activities responsible for managing or serving 14 two or more business segments. The Business 15 Segments represent divisions of the overall 16 Highmark enterprise that are identified with 17 producing a particular product or service.</p> <p>18 In Highmark's cost allocation 19 framework, BCBSD business will reside in the 20 commercial health business segment which also 21 includes Highmark West Virginia and the central 22 and western Pennsylvania regional business, 23 senior markets, and national business of Highmark 24 Inc.</p>	<p style="text-align: right;">Page 261</p> <p>1 accounting purposes, BCBSD will reside in the 2 commercial health business segment. Costs that 3 will be allocated within the commercial health 4 segment include costs originating in that segment 5 itself, as well as those allocated to that 6 segment from the Home Office as described above.</p> <p>7 Cost allocations within the 8 commercial health segment then follow an 9 allocation sequence as follows: Expenses are 10 directly assigned to a particular market -- for 11 example, West Virginia, western Pennsylvania, 12 central Pennsylvania -- to the maximum extent 13 possible. For example, sales.</p> <p>14 Expenses that are not directly 15 allocated to a particular market because they 16 support multiple markets are accumulated into 17 logical and relatively homogeneous pools to be 18 allocated on bases reflecting the relationship of 19 the expenses to the markets concerned, such as 20 claims or customer service systems.</p> <p>21 Remaining expenses are allocated each 22 market in proportion to its share of the total 23 cost allocated either directly or through a 24 homogeneous pool as described above. For</p>

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1 example, health governance.
2 As described above, these cost
3 allocation methodologies will determine the
4 intercompany charges from Highmark to BCBSD. All
5 intercompany charges will be at actual cost
6 without provision for profit consistent with the
7 terms of the Administrative Services Agreement.
8 In addition, Highmark and Blue Cross
9 have agreed to certain conditions relating to
10 cost allocation including allowing department
11 approval of the annual charges to be assessed
12 against Blue Cross, as well as department
13 approval of any payments for charges materially
14 in excess of approved charges.
15 Q. Mr. Gebhard, go kind of off chart here
16 for a second. I think you were here this morning
17 and listened to the testimony of Mr. Constantine,
18 correct, and Mr. Hynek?
19 A. Correct.
20 Q. And you heard the cross-examination of
21 Mr. McConnell, correct?
22 A. Correct.
23 Q. And one of the statements I think made in
24 the cross-examination was that the increase

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1 involved the statement that there was not a
2 formal agreement as to Highmark's cost allocation
3 methodology to which BCBSD would be a party, and
4 then further questioning whether BCBSD had the
5 ability to know whether future administrative
6 fees would be fair and reasonable.
7 Would you please clarify this issue,
8 if you can, from Highmark's perspective?
9 A. In the terms of whether there's an
10 agreement, the Administrative Services Agreement
11 lays out that the compensation will be the fair
12 and reasonable allocable share based on our
13 existing practices.
14 There's also conditions in place that
15 we would present our methodologies to the
16 Department of Insurance preclose, as well as
17 presenting our charges or BCBSD will present our
18 charges to the Department of Insurance annually,
19 and presumably those charges will be accompanied
20 by a description of what they're based upon,
21 which will be the cost allocation methodologies
22 because as laid out within the ASA, compensation
23 is based on Highmark cost accounting system.
24 So there will be a lot of

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1 communication back and forth between us, BCBSD,
2 and the department based on the way the
3 conditions have been set out.
4 Q. So these costs have to be allocated
5 reasonably based on Highmark's cost allocation
6 methodologies.
7 A. Correct.
8 Q. But those cost allocation methodologies
9 cannot be reduced to contractual language; is
10 that correct? Or typically are not.
11 A. A couple points there.
12 One, they are -- they evolve as the
13 business evolves. To lay them out specifically
14 as though they were going to be in place for the
15 entire duration of the agreement that hopefully
16 has a long life, it would be impossible because
17 they would be constantly changing to keep up with
18 the changes in the business.
19 The other thing that becomes relevant
20 here is that Highmark must have a single set of
21 cost accounting practices. So we have multiple
22 customers and we have multiple ASA's where our
23 compensation is based on our cost accounting
24 practices. It would be impossible for us to

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1 separately negotiate cost accounting practices
2 with each of our customers because from our point
3 of view, whether it's Delaware, West Virginia,
4 Blue Cross Northeastern Pennsylvania, whoever our
5 customers are, the important thing about the cost
6 accounting is the consistency, and that's what
7 we're basically maintaining through the
8 discipline of the cost accounting methodologies
9 that we have in place.
10 Q. Okay. As pointed out through
11 cross-examination, Ms. Polizoti of Ms. Hanlon,
12 according to condition 10 proposed by the DOI,
13 prior to closing, BCBSD and Highmark will file
14 with the Department of Insurance the cost
15 allocation methodology and formula; is that
16 correct?
17 A. That's correct.
18 Q. Do those documents already exist, so to
19 speak?
20 A. They do. For our Home Office
21 allocations, there are CAS disclosure statements
22 that we make to the federal government which
23 really we're basically committing to come back
24 and test us to verify that that's the way we're

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1 doing the allocations.
 2 And then for the -- as I mentioned,
 3 BCBSD will sit in the commercial health segment.
 4 There are cost pools within the commercial health
 5 segment, the homogeneous pools and the GNA pools.
 6 All those pools have pool documentation that
 7 basically outlines what services are provided in
 8 the pools, what the allocation methodology is,
 9 who receives the allocation, because they benefit
 10 from those services.
 11 And I would expect that what will be
 12 provided to the Department of Insurance through
 13 that filing would just be the documentation that
 14 currently exists relative to the cost allocation
 15 pools, although I would anticipate that it will
 16 be accompanied by probably a personal interaction
 17 to actually walk through the application of just
 18 the documentation.
 19 Q. And would that compilation of the
 20 documentation be fairly substantial, do you
 21 think?
 22 A. Yes.
 23 Q. Just give us how large of documents
 24 you're talking about.

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1 A. I think what we would do is lay out all
 2 the allocations within the commercial health
 3 segment, recognizing we have to explain that in
 4 the early years postaffiliation, before BCBSD is
 5 actually up on our platforms, there's not going
 6 to be an allocation for many of those pools. I
 7 would still want to lay out the methodologies
 8 that we do use for all pools in the commercial
 9 segment.
 10 Q. Give us some idea of the complexity or
 11 detail of this, roughly. Can you guess how many
 12 pages that might amount to when you lay it on the
 13 insurance department's table?
 14 A. 300 maybe.
 15 Q. Back on script now.
 16 Are Highmark's cost accounting
 17 practices audited by any government entities?
 18 And if so, please explain how that happened.
 19 A. Yes. Highmark's cost accounting
 20 practices are audited by several government
 21 entities.
 22 Two of Highmark's business segments,
 23 Highmark Medicare services and United Concordia
 24 Dental, have contracts with the federal

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1 government that are covered by the federal
 2 government's cost accounting standards or CAS.
 3 Because a share of Highmark's Home office costs
 4 flow to these contracts, Highmark's Home Office
 5 cost allocations must be compliant with the CAS.
 6 As a result, Highmark must disclose its
 7 accounting practices to the federal government.
 8 This disclosure is then subject to audit to
 9 verify that Highmark is allocating costs
 10 consistent with its disclosure statement and that
 11 allocation practices are consistent with the CAS.
 12 These audits are performed by the Defense
 13 Contract Audit Agency, DCAA, on behalf of the
 14 Centers for Medicare and Medicaid Services and
 15 Department of Defense, DOD. The DCAA has found
 16 Highmark's Home Office cost accounting practices
 17 to be adequate and compliant and that Highmark's
 18 methodology for allocating the Home Office
 19 Residual pool results in an equitable allocation
 20 to business segments.
 21 The Federal Employee Program, FEP,
 22 which sits in Highmark's commercial health
 23 business segment, the same segment in which BCBSD
 24 will reside, is audited by the Office of

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1 Personnel Management's Office of the Inspector
 2 General. The objectives of this audit are to
 3 determine whether administrative costs charged to
 4 Federal Employees Health Benefits Program were
 5 actual, allowable, necessary, and reasonable in
 6 accordance with the terms of the contract and
 7 applicable laws and regulations, such as the
 8 federal acquisition regulations. FEP
 9 administrative costs are also audited by Blue
 10 Cross Blue Shield Association.
 11 Since Highmark does not have
 12 CAS-covered contracts in its commercial health
 13 business segment, allocation methodologies within
 14 this segment are not disclosed to the federal
 15 government. However, markets including Delaware
 16 benefitting from the activities provided in any
 17 expense pool within the commercial health segment
 18 will receive consistent cost allocations based on
 19 common methodologies and statistics.
 20 Q. Mr. Gebhard, how long has this cost
 21 accounting system been in place at Highmark?
 22 A. Highmark's cost allocation system has
 23 been in place since January 1998. Revisions to
 24 the allocation methodologies within the overall

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1 framework have been made as necessary to align
 2 with organizational and operational changes over
 3 time.
 4 Q. How was this cost accounting system
 5 developed?
 6 A. The cost accounting system was developed
 7 by first looking at what requirements exist as to
 8 information coming out of the system and then
 9 determining the best approach for addressing
 10 these requirements. Since Highmark has both
 11 commercial and government business each with a
 12 unique set of requirements, the system was
 13 designed to address the needs of both. However,
 14 the overall objective of consistent, fair, and
 15 equitable cost allocations to businesses based on
 16 the beneficial or causal relationship between
 17 such costs and the receiving business applies to
 18 both commercial and government business.
 19 On the commercial side, information
 20 coming out of the cost accounting system is used
 21 to assess financial performance and as input to
 22 the pricing of our products and services.
 23 On the government side, cost
 24 information must be compliant with government

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1 regulations and is often the source for
 2 determining reimbursements.
 3 With this in mind, the system that
 4 was implemented in January 1998 was developed
 5 with the support of Arthur Andersen & Company who
 6 provided expertise pertaining to the development
 7 of a system and associated methodologies that
 8 were structured to be fair and equitable while
 9 enabling compliance with the federal government's
 10 cost accounting standards.
 11 The system was built using Highmark's
 12 PeopleSoft tool to facilitate the efficient
 13 integration of allocated cost information into
 14 the monthly financial closing process.
 15 Q. How often are the allocation
 16 methodologies revised, and what would be an
 17 example of a revision to the cost allocation
 18 methodologies?
 19 A. Allocation methodologies are revised on
 20 an as-needed basis to meet the overall objective
 21 of fair and equitable allocations to businesses
 22 based on the beneficial or causal relationship
 23 between such costs and receiving businesses.
 24 There are a number of factors that could trigger

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1 the need to review and possibly revise cost
 2 allocation methodologies.
 3 At the Home Office level, examples of
 4 these factors include introduction of a new
 5 technology or centralized service,
 6 reorganizations to impact the businesses
 7 supported by an existing cost pool,
 8 organizational changes resulting from an
 9 acquisition or divestiture.
 10 Within the commercial health segment
 11 there are also factors that could influence the
 12 need to analyze potential revisions to the
 13 allocation methodologies. These include, but are
 14 not limited to, introduction of a new product
 15 line or organizational changes that impact the
 16 manner in which segments and/or products are
 17 supported from both governance and operational
 18 perspectives.
 19 We recognize that predictability and
 20 stability of cost allocations are important to
 21 our business segments. Unless something of a
 22 material nature takes place during the course of
 23 the year that would otherwise result in an
 24 inequitable allocation, we generally limit

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1 allocation methodology changes to the January
 2 allocation cycle of each calendar year. This
 3 better enables us to incorporate anticipated
 4 allocation changes into the annual financial
 5 planning process and significantly minimizes the
 6 impact of cost allocation methodologies on
 7 financial results. This also facilitates
 8 satisfaction of our CAS disclosure requirements.
 9 Q. What business is included in the
 10 commercial health business segment?
 11 A. The commercial health business segment
 12 includes business reporting to Highmark's
 13 executive vice president, health services. This
 14 includes western and central Pennsylvania
 15 regional markets, West Virginia markets, national
 16 markets, and senior markets.
 17 Within the cost allocation framework
 18 Delaware markets will be part of the commercial
 19 health business segment postclosing.
 20 Q. And are the cost allocation methodologies
 21 within the commercial health business segment
 22 applied on a consistent basis?
 23 A. Allocation methodologies within the
 24 commercial health business segment are applied

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1 consistently to all businesses within the
2 segment. Each cost pool allocates to the various
3 markets and products based on a common
4 methodology using consistent statistics or other
5 allocation basis. The allocations are driven
6 entirely by objective application of these
7 statistics to all markets and products
8 benefitting from the services provided by the
9 respective cost pools.

10 For example, in the Highmark claims
11 adjudication jobs cost pool, which is allocated
12 based on the number of claims processed, if
13 10 percent of the claims processed relate to the
14 West Virginia business, then 10 percent of the
15 expenses in the cost pool will be allocated to
16 West Virginia business. This is true for each of
17 the large operational cost pools.

18 For the general and administrative
19 cost pools, a total cost input, TCI, basis of
20 allocation is generally used and is applied
21 consistently with all businesses benefitting from
22 the pools' activities. For TCI pools, each
23 business receives a share of pool's allocated
24 costs proportionate to the costs already

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1 allocated to the business in earlier stages of
2 the cost allocation process.

3 Q. Mr. Gebhard, are Highmark's cost
4 accounting practices unique or unusual or are
5 they more representative of customary or
6 mainstream cost accounting practices for health
7 insurance companies?

8 A. Highmark's cost accounting practices are
9 in conformity with customary insurance accounting
10 practices. However, within the overall framework
11 of customary insurance accounting practices,
12 companies have discretion to develop their cost
13 accounting practices to best suit unique
14 requirements given their specific business model.

15 As mentioned previously, Highmark's
16 cost accounting practices have been significantly
17 impacted by its government contracts and the
18 compliance requirements therein. Also the
19 existence of multiple markets within the
20 commercial health business segment has influenced
21 Highmark's cost accounting practices.

22 Q. Does Highmark have an Administrative
23 Services Agreement in place with Highmark
24 West Virginia, and does that Administrative

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1 Services Agreement contain a similar provision to
2 that contained in the proposed ASA between
3 Highmark and BCBSD as to compensation paid to
4 Highmark for services being based on Highmark's
5 cost accounting practices?

6 A. Yes. Highmark has an Administrative
7 Services Agreement in place with Highmark
8 West Virginia. The ASA states that MSBCBS shall
9 compensate Highmark for Highmark's provision of
10 services in an amount equal to MSBCBS's fair and
11 reasonable allocable share of the total cost to
12 Highmark providing the services. Such costs
13 include without limitation employee salaries,
14 employee benefits, and other direct and indirect
15 administrative costs, including charges for
16 corporate overhead.

17 MSBCBS's allocable share of the costs
18 of the services shall be determined in accordance
19 with Highmark's established cost accounting
20 practices as in effect from time to time.

21 MSBCBS also shall reimburse Highmark
22 for any and all direct third-party costs incurred
23 by Highmark for the benefit of MSBCBS.
24 This language is essentially

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1 identical to the language in the proposed ASA
2 between Highmark and BCBSD.

3 Q. Just to clarify again, does Highmark
4 include any provision for profit in its cost
5 accounting system for charges to any affiliates
6 for services rendered?

7 A. No, Highmark does not include any
8 provision for profit in its cost allocation
9 processes. Therefore, charges to affiliates
10 would not include a provision for profit.

11 Q. Mr. Gebhard, is the Highmark cost
12 accounting system one that's entirely a matter of
13 mechanical application of a prescribed formula or
14 is there ever any subjectivity involved? And
15 secondly, if subjectivity is sometimes involved,
16 please describe the circumstances when
17 subjectivity might come into play and who has the
18 power to exercise such subjectivity.

19 A. Highmark makes every effort to make the
20 cost allocation process as objective as possible.
21 Our goal, as stated previously, is for the
22 process to result in cost allocations that are
23 fair and equitable and based on the beneficial
24 and causal relationship between such costs and

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1 the businesses receiving the allocation.
 2 That being said, there is always some
 3 level of subjectivity in the allocation process
 4 as some functions do not bring with them a
 5 logical set of statistics upon which to base the
 6 allocations as to other functions.
 7 Highmark takes a variety of steps to
 8 mitigate the inherent subjectivity in the
 9 allocation of costs for certain functions. These
 10 include the establishment and execution of
 11 consistent allocation methodologies to all
 12 businesses based on available input. This input
 13 includes discussions at least annually with cost
 14 center managers to understand their activities
 15 and get their perspectives on their businesses
 16 benefitting from these activities.
 17 On the back end, business owners,
 18 which would include BCBSD, have the ability to
 19 challenge cost allocations which would result in
 20 further review of allocation methodology for a
 21 particular cost element.
 22 As related to the BCBSD transaction,
 23 the most significant allocations from Highmark to
 24 BCBSD will be related to technology costs

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1 associated with the core applications.
 2 Allocations of these costs tend to be the most
 3 objective by their very nature due to the
 4 availability of common statistics that are used
 5 to logically allocate these cost pools.
 6 Examples, claims processed for the
 7 claims adjudication jobs pool, inquiries for the
 8 customer service jobs pool, and so on.
 9 Q. Please describe the process, then, for
 10 any affiliated entity such as BCBSD to challenge
 11 the amount or the nature of the cost allocated to
 12 them from time to time by Highmark.
 13 A. I will use Highmark West Virginia as the
 14 basis for describing how the process would work
 15 as to a cost allocation issue that might arise as
 16 to BCBSD or any other Highmark affiliate.
 17 Each month Highmark West Virginia
 18 receives an invoice from Highmark with details
 19 supporting the cost allocations from Highmark.
 20 This invoice is reviewed by the Highmark
 21 West Virginia president's financial support
 22 staff.
 23 If this review results in questions
 24 regarding the appropriateness of a particular

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1 cost allocation, the Highmark West Virginia
 2 president's financial support staff would work
 3 directly with the Highmark cost accounting
 4 reporting department which reports to the
 5 director of cost accounting and reporting who
 6 reports directly to me to address the issue or
 7 address the questions.
 8 If the issue cannot be resolved at
 9 this level, the Highmark West Virginia president
 10 would be made aware of the issue and likely raise
 11 the issue at a monthly executive financial review
 12 meeting attended by the Highmark West Virginia
 13 president and senior Highmark financial staff.
 14 If still unresolved, the next step in
 15 the resolution process would be for the Highmark
 16 West Virginia president to raise the issue to the
 17 attention of Highmark's executive vice president
 18 of health services who would work with Highmark's
 19 chief financial officer to resolve the issue.
 20 While issues of this nature have
 21 never reached this level in West Virginia, if the
 22 issue was still unresolved, it would be raised to
 23 Highmark's CEO and Highmark's West Virginia's
 24 president for resolution and to the respective

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1 boards if still unresolved.
 2 Q. Is this the process that would be
 3 followed by BCBSD to challenge the amount or
 4 nature of costs allocated to it by Highmark?
 5 A. Essentially. The primary difference
 6 between the process that West Virginia follows
 7 and the process that Delaware would follow is
 8 that if a dispute is unable to be resolved by
 9 Highmark's CEO and BCBSD's president, and then is
 10 unable to be resolved by the BCBSD board of
 11 directors, then the Delaware Department of
 12 Insurance would resolve the dispute. This is due
 13 to a condition that the Delaware Department of
 14 Insurance has proposed and to which Highmark and
 15 BCBSD have agreed.
 16 Q. Mr. Gebhard, is that condition that you
 17 just referred to, I believe condition 19, then,
 18 of Joint Exhibit 133?
 19 MS. POLIZOTI: 113.
 20 MR. FOSTER: I'm sorry, 113.
 21 THE WITNESS: Yes, it is.
 22 MR. FOSTER: Thank you, Mr. Gebhard.
 23 That's all, Madam Hearing Officer.
 24 THE HEARING OFFICER: Thank you.

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1 MS. TWEEDIE: Few questions,
 2 Your Honor.
 3 - - - - -
 4 CROSS-EXAMINATION
 5 - - - - -
 6 BY MS. TWEEDIE:
 7 Q. Good afternoon, Mr. Gebhard.
 8 What percentage of the total costs
 9 are allocated to Blue Cross's direct costs?
 10 A. Allocated to Blue Cross Blue Shield of
 11 Delaware?
 12 Q. Right.
 13 A. Very little, because in a postaffiliation
 14 environment, even after migration, roughly
 15 85 percent of Blue Cross Blue Shield of
 16 Delaware's administrative costs will actually
 17 originate in Delaware. So what we have in
 18 Pennsylvania that is a direct cost that allocates
 19 to our business there, those costs actually will
 20 not come from Highmark to BCBSD because they will
 21 be direct costs to BCBSD in this -- in the local
 22 market.
 23 For example, sales and provider
 24 relations, provider contracting, community

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1 affairs, all those types of things that are
 2 direct costs will be here so that it's very
 3 little direct costs.
 4 Most of the costs coming from
 5 Highmark to BCBSD will be the homogeneous pools
 6 and their share of the systems that they're
 7 using.
 8 Q. So you would say the majority would be
 9 more indirect costs including technology like IT?
 10 A. Yes. Of the Highmark charges, definitely
 11 most of it is -- most of it is information
 12 technology.
 13 Q. What about administrative costs, Home
 14 Office charges?
 15 A. Home Office charges? 10 to 20 percent
 16 probably of what goes from Highmark to BCBSD will
 17 be kind of indirect costs versus coming out of
 18 the direct services it provides.
 19 Q. Part of that is the cost of the salary of
 20 the CEO of Highmark?
 21 A. Correct.
 22 Q. You have stated that Highmark's cost
 23 accounting practices are audited by several
 24 different governmental entities.

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1 A. Yes.
 2 Q. When was the most recent audit?
 3 A. The audits are ongoing. The most -- we
 4 have them every year. So each of our disclosure
 5 statements, each of our CAS disclosure statements
 6 is audited. At this point we're on CAS
 7 disclosure statement No. 8, and that's for 2011.
 8 That has not been audited. Will be at some
 9 point. But 6 and 7 have both been audited which
 10 would have been the prior two years. And the
 11 DCAA -- we know that there's no findings, but
 12 they haven't filed their reports yet.
 13 So the audits have been completed.
 14 We don't have --
 15 Q. You don't have findings?
 16 A. Right. We would know if there were
 17 findings at this point. Just a matter of getting
 18 the report issued.
 19 Q. Has Highmark ever changed or ever in
 20 recent years changed its cost methodologies or
 21 policy -- has Highmark ever changed its cost
 22 methodologies or allocation policies as a result
 23 of a recommendation from an audit?
 24 A. I hate to answer that no, but I can't

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1 think of an example of when, as a result of an
 2 audit, we were found to be noncompliant or there
 3 was an issue that we had to make a change.
 4 Q. I believe you stated that approximately
 5 three years ago Highmark hired a consulting firm
 6 regarding cost allocation?
 7 A. Yes.
 8 Q. And that the consultant's conclusion was
 9 that Highmark's established cost accounting
 10 practices were generally conforming with the best
 11 practice in the industry?
 12 A. Right.
 13 Q. Since that time you stated that Highmark
 14 has made several changes to the cost allocation
 15 methodologies?
 16 A. Yes.
 17 Q. Are you certain that Highmark would still
 18 be in compliance with best practices?
 19 A. Yes.
 20 Q. After the changes?
 21 A. Yes. We did not make structural changes.
 22 The only changes we have made subsequent to when
 23 we worked with the consulting firm were the types
 24 of changes required as a result of operational

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1 changes that we were just kind of -- we need to
2 be reactive to the way the business changes and
3 allocate costs consistent with organizational and
4 operational changes. And those are basically the
5 nature of the changes that we have made since
6 then.
7 Q. You stated that Highmark takes steps to
8 make sure that its cost allocation practices are
9 as, I believe the words you used were, fair and
10 equitable as possible.
11 A. Yes.
12 Q. And applied consistently. The
13 determination of what would be a fair and
14 equitable allocation is within Highmark's
15 discretion; isn't that right?
16 A. It's within Highmark's discretion. It's
17 actually within the discretion of Highmark
18 finance, because just as Highmark West Virginia
19 and BCBSD are recipients of these costs, so are
20 the various market segments within Highmark. And
21 as you can imagine, each has their own reason why
22 they would like to see costs allocated elsewhere.
23 So we are like the independent
24 source -- we work with each of the markets so

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1 they understand the allocations, but it's a
2 finance function. It's not a function of any of
3 our -- the markets within Highmark or outside of
4 Highmark. Integrity and consistency are critical
5 to what we're doing.
6 Q. There are procedures in place for the
7 affiliation partners or the customers of Highmark
8 to challenge the cost allocation. You talked
9 about that.
10 A. When you say "customers of" -- if we
11 have --
12 Q. I can repeat the question.
13 You stated -- you were talking a bit
14 about the procedures for challenging the cost
15 allocation and you were speaking about
16 West Virginia specifically. And you stated that
17 West Virginia has never actually made a challenge
18 or West Virginia has never actually challenged
19 the cost allocation in your relationship with
20 Highmark. Right?
21 A. No. I said it never reached the level
22 where we were talking to the Highmark's CEOs or
23 executive vice presidents. West Virginia does
24 look at their monthly invoice which has detailed

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1 allocations to them, and based on that invoice
2 they work with our cost accounting department and
3 ask questions. And more so than challenging it,
4 it's to understand as opposed to that.
5 But I can't say there was never a
6 challenge. There's ongoing discussion when they
7 get the invoice and they have the opportunity to
8 raise questions.
9 Q. And if it was ever found -- I guess if a
10 dispute was ever resolved in favor of
11 West Virginia or Blue Cross Blue Shield of
12 Delaware or not in favor of Highmark, would there
13 be penalties for the overcharging of
14 administrative services?
15 A. I wouldn't define them as penalties. I
16 would say that whatever -- in your case, whatever
17 was overcharged would be returned. But I don't
18 think there's -- we don't have a lot of penalties
19 going back and forth between our affiliated
20 companies.
21 Q. Changing topics slightly.
22 As vice president of cost management
23 and analysis, you were involved in the
24 development of the pro forma projections for the

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1 postaffiliation Blue Cross Blue Shield of
2 Delaware?
3 A. Yes.
4 Q. And in those pro formas the projected
5 increase in Blue Cross's surplus in the time
6 period of 2011 to 2015 was approximately
7 32 percent; is that right?
8 A. When I say I was involved, I was involved
9 with certain aspects of it. I don't think I'm
10 the best person to answer that question.
11 Q. Fair enough.
12 You stated also that the cost
13 allocation, the document memorializing the cost
14 allocation methodology would be approximately
15 300 pages; is that right?
16 A. Yeah. That's what I envisioned we would
17 be providing to the Department of Insurance with
18 all the cost pools and the attachments.
19 Q. That gets delivered prior to closing of
20 the affiliation?
21 A. Yes. That's the way I understand the
22 conditions.
23 Q. Do you understand the conditions to say
24 that it needs to be delivered in advance -- seven

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1 days in advance of closing or 14 days, or is it
 2 just in advance of closing?
 3 A. I believe it's preclosing.
 4 MR. FOSTER: No. 10.
 5 THE WITNESS: Prior to closing.
 6 BY MS. TWEEDIE:
 7 Q. I think I have one last question and that
 8 is, just to sum up, while there's no provision
 9 for profit in the Administrative Services
 10 Agreement between Blue Cross and Highmark,
 11 Highmark has basically full discretion in
 12 allocating the costs in determining the cost
 13 allocation?
 14 A. Only to the extent that they're fair and
 15 reasonable. I think we have -- we have a
 16 contractual obligation to have fair and
 17 reasonable allocations. So I don't think that
 18 gives us complete discretion. We're going to set
 19 the methodologies in Highmark finance, but as I
 20 said, the BCBSD or the Highmark West Virginia,
 21 their contracts, the ASAs, say that the cost
 22 allocations have to be fair and reasonable, they
 23 have access to all the information.
 24 So I would think that it's not

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1 complete discretion on our part.
 2 MS. TWEEDIE: Thank you. I don't
 3 have any further questions.
 4 MR. HOUGHTON: No questions,
 5 Your Honor.
 6 MR. TEICHMAN: No questions,
 7 Your Honor.
 8 THE HEARING OFFICER: You are
 9 excused, Mr. Gebhard. Thank you for your
 10 testimony.
 11 Mr. Campbell, is it my understanding
 12 you're going to call this witness?
 13 MR. CAMPBELL: Yes, ma'am. We would
 14 call Mr. Fred Earley.
 15 THE HEARING OFFICER: Mr. Earley?
 16 J. FRED EARLEY, II,
 17 the witness herein, having first been
 18 duly sworn on oath, was examined and
 19 testified as follows:
 20 - - - - -
 21 DIRECT EXAMINATION
 22 - - - - -
 23 BY MR. CAMPBELL:
 24 Q. Good afternoon, Mr. Earley.

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1 A. Good afternoon.
 2 Q. Would you state your full name?
 3 A. J. Fred Earley, II.
 4 Q. By whom are you employed, and in what
 5 capacity?
 6 A. I'm employed by Highmark West Virginia
 7 which does business as Highmark Blue Cross Blue
 8 Shield West Virginia. I'm the president of that
 9 company.
 10 Q. Describe your duties as president of
 11 Highmark West Virginia.
 12 A. As president I have overall
 13 responsibility for all West Virginia market
 14 functions, including sales and marketing,
 15 provider reimbursement relations, government
 16 relations, public relations, and regulatory
 17 affairs. I also serve as a member of the board
 18 of directors for Highmark West Virginia.
 19 Q. What is your education?
 20 A. I have a Bachelor of Science degree in
 21 business administration from West Virginia
 22 University and a law degree from The Washington
 23 and Lee University School of Law.
 24 Q. Prior to joining Highmark West Virginia

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1 where did you work?
 2 A. Prior to joining Highmark West Virginia
 3 in 1989 I worked as a revenue agent for the
 4 Internal Revenue Service; a senior tax consultant
 5 for Arthur Andersen & Company in the Washington,
 6 D.C., office; and I worked as an attorney for law
 7 firms in Washington, D.C., and in Parkersburg,
 8 West Virginia.
 9 Upon joining the predecessor company
 10 to Highmark West Virginia, I served as general
 11 counsel and later vice president of managed care.
 12 I was later promoted to senior vice president of
 13 external operations, corporate compliance
 14 officer, corporate secretary, and general counsel
 15 before being appointed president of the company
 16 in 2009.
 17 Q. Mr. Earley, please describe Highmark
 18 West Virginia.
 19 A. As West Virginia's largest health
 20 insurance carrier, Highmark West Virginia is a
 21 nonprofit West Virginia health services
 22 corporation and operated exclusively under the
 23 Blue Cross Blue Shield service marks.
 24 Highmark West Virginia serves all of

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1 West Virginia's 55 counties and one county in
 2 Ohio, Washington County, and is an independent
 3 licensee of the Blue Cross Blue Shield
 4 Association and affiliate of Highmark Inc.
 5 The company headquartered in
 6 Parkersburg, West Virginia, has approximately
 7 875 employees with additional offices in
 8 Charleston and Wheeling, West Virginia, and
 9 provides or administers coverage to more than
 10 585,000 individuals. Approximately one half of
 11 those members are interplan program, i.e., Blue
 12 Card enrollment.

13 Q. Please describe the history of the
 14 association between Highmark West Virginia and
 15 Highmark.

16 A. Blue Cross Blue Shield of west central
 17 Virginia, I'll refer to as the Parkersburg plan,
 18 acquired certain assets pursuant to the
 19 liquidation of the Blue Cross Blue Shield of
 20 West Virginia plan which I'll refer to as the
 21 Charleston plan, which had been placed into
 22 liquidation by the Office of the Insurance
 23 Commissioner of the state of West Virginia, which
 24 I'll refer to hereafter as either the

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1 West Virginia Insurance Commission or the
 2 insurance commission. That occurred on
 3 October 26, 1990.

4 At that time the name of the
 5 Parkersburg plan was changed to Mountain State
 6 Blue Cross Blue Shield, which I'll refer to as
 7 Mountain State.

8 Early in 1991 a second-tier
 9 subsidiary of the company Medical Mutual of Ohio,
 10 which was formerly known as Blue Cross Blue
 11 Shield Mutual of Ohio, or BCBSMO, provided
 12 capital to Mountain State in the form of a
 13 surplus loan. BCBSMO through its CEO and chief
 14 executive officer appointed a board of directors
 15 of Mountain State, and various administrative
 16 agreements existed between Mountain State and
 17 BCBSMO or its affiliates during that
 18 relationship.

19 Mountain State was committed to the
 20 traditional values of the Blue Cross Blue Shield
 21 Association system and the service marks it
 22 represented. That commitment contributed heavily
 23 to our separation from BCBSMO in March of 1997.
 24 BCBSMO lost its right to utilize the Blue Cross

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1 Blue Shield marks in the second quarter of 1997
 2 after a long fight with the Blue Cross Blue
 3 Shield Association concerning a proposed
 4 transaction between BCBSMO and Columbia HCA which
 5 ultimately did not materialize. Subsequent to
 6 those events BCBSMO changed its name to Medical
 7 Mutual of Ohio.

8 As Mountain State began the process
 9 of separation from BCBSMO, the strategy included
 10 the resignation of Ohio executive from the board
 11 of directors, the naming of a new chairman in
 12 West Virginia, a change in the corporation's
 13 officers and general counsel, and a restructure
 14 of the corporate organization. These and other
 15 issues were addressed to meet the licensure
 16 requirements of the association and to reaffirm
 17 our corporate commitment to maintaining
 18 traditional values of a Blue Cross Blue Shield
 19 plan.

20 In 1997 Mountain State solicited
 21 affiliation proposals from a number of Blue Cross
 22 Blue Shield plans. Ultimately Highmark was
 23 selected because it met the primary objectives of
 24 Mountain State.

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1 These objectives were: Commitment to
 2 nonprofit Blue Cross Blue Shield values, a
 3 commitment to the employees of Mountain State, a
 4 commitment to the state of West Virginia, and a
 5 commitment to improving the capital position of
 6 Mountain State.

7 That transaction was officially
 8 submitted as a Form A filing with the
 9 West Virginia Insurance Commission on March 19th,
 10 1999. The parties had worked closely with the
 11 insurance commission to shape the transaction
 12 that would be approved. The transaction called
 13 for a financing via a surplus note in an amount
 14 not to exceed \$10 million to retire the surplus
 15 note with Medical Mutual of Ohio and to meet the
 16 statutory reserve requirement.

17 The agreement also called for the two
 18 plans to negotiate exclusively for two years for
 19 a closer affiliation and transfer the primary
 20 Blue Cross Blue Shield Association license for
 21 the state of West Virginia from Mountain State to
 22 Highmark.

23 The transfer of the primary license
 24 and the granting of a smaller controlled

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1 affiliate license resulted in Mountain State's
2 minimum capital requirements becoming
3 significantly lower.
4 In conjunction with this, Highmark
5 was required to provide a guarantee of
6 contractual and financial obligations of Mountain
7 State to its customers in accordance with the
8 association guidelines.
9 The transaction enabled Highmark to
10 establish a governance role in Mountain State by
11 having representation on the board, coupled with
12 certain supermajority voting requirements for
13 specific corporate actions.
14 Mountain State also agreed to
15 financial and operational benchmarks which, if
16 not met, would allow Highmark to further increase
17 its representation on the board.
18 The affiliation also resulted in
19 administrative services agreements between the
20 two parties, and each agreement reflected
21 economic value to Mountain State. Any
22 administrative agreement entered into was subject
23 to approval by the insurance commission. The two
24 parties had executed a master services agreement

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1 and numerous agreements which were put into place
2 until 2009.
3 On March 4th of 2002 the Mountain
4 State board of directors unanimously passed a
5 resolution stating that Mountain State had
6 determined it to be in its best interest to
7 develop a closer corporate relationship with
8 Highmark and it agreed to the terms and
9 conditions of a proposed closer relationship to
10 be evidenced by a formal agreement. A target
11 date of May 2004 was established for the closer
12 relationship to become effective.
13 Mountain State submitted an
14 agreement, which I'll refer to as the agreement,
15 with the insurance commission in September of
16 2002 that designated Highmark as the sole
17 corporate member of Mountain State with the
18 authority to appoint and remove members of the
19 Mountain State board of directors.
20 In addition, the agreement set out
21 the framework for implementing the closer
22 affiliation. After over a year of review and
23 discussions between Highmark, Mountain State and
24 the insurance commission, including a review by

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1 its outside counsel, the insurance commission
2 requested a public hearing. That public hearing
3 was held on December 4th, 2003, in Charleston,
4 West Virginia, and the transaction was approved
5 on December 31st, 2003.
6 Under the terms of the existing
7 surplus note agreement authorized in the 2009
8 approval order, Mountain State could at any time
9 after May 13th, 2004, request that it had been --
10 that it be reestablished as the primary licensee
11 of the Blue Cross Blue Shield marks in the state
12 of West Virginia.
13 The closer affiliation filing
14 provided that Mountain State would no longer have
15 this right with one exception: Although not
16 contemplated at this time, in the event that the
17 board of directors of Highmark determined that it
18 would be in Highmark's best interest to convert
19 from a not-for-a-profit to a for-profit
20 corporation, the five independent directors of
21 Mountain State may exercise the right to require
22 that Highmark withdraw as the sole corporate
23 member of Mountain State and reestablish Mountain
24 State as the primary licensee in the state.

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1 This right is subject to the approval
2 of the Blue Cross Blue Shield Association, and
3 it's conditioned upon the repayment to Highmark
4 of all surplus note balances, of which there are
5 currently none, and subsidies provided to
6 Mountain State.
7 The terms of this repayment
8 obligation are set forth in the first amendment
9 to the surplus note agreement between the two
10 parties.
11 On May 1st, 2004, Highmark became the
12 sole corporate member of Mountain State. The
13 company continues to do business as Mountain
14 State. However, the legal name of the entity was
15 changed to Highmark West Virginia, Inc.
16 As the sole corporate member of
17 Mountain State, Highmark has the authority to
18 select all members for board of directors of the
19 corporation. On May 17th, 2004, Mountain State
20 held its initial board meeting with the newly
21 elected board members.
22 In March of 2009 Gregory Smith, the
23 plan CEO and president since 1995, announced his
24 retirement to be effective July 1st, 2009.

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1 Mr. Smith has remained chairman of the board of
2 directors and I was named as his replacement as
3 president by the Mountain State board in
4 May 2009.

5 Since that time Highmark
6 West Virginia has worked closely with Highmark to
7 further integrate core functions, and the
8 company's d/b/a name was officially changed to
9 Highmark Blue Cross Blue Shield West Virginia in
10 January of 2011.

11 Q. Would it be fair to say that there were
12 three stages of the affiliation between Highmark
13 West Virginia and Highmark?

14 A. Yes. First in 1999 a surplus note
15 agreement was entered into with Highmark Inc. to
16 allow Mountain State to provide financing to,
17 among other things, pay off its indebtedness to
18 Medical Mutual of Ohio. At that time Highmark
19 obtained representation on the Mountain State
20 board of directors along with certain enumerated
21 supermajority voting requirements. The bylaws
22 were amended and restated to reflect this change,
23 as well as other corporate structural changes
24 relating to that closer affiliation.

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1 Highmark became the primary licensee
2 in the state of West Virginia for the Blue Cross
3 Blue Shield Association, with Mountain State
4 being a controlled affiliate.

5 Second, in 2004 Mountain State
6 entered into a closer affiliation agreement which
7 further integrated the two companies including
8 Highmark being designated the sole corporate
9 member of Mountain State. This agreement
10 included a task order for the BluePRINT systems
11 migration. I'll describe that further in a
12 moment. The reporting relations between the two
13 companies were changed and set forth cost
14 allocations between the two companies.

15 Finally, in 2009 the affiliation of
16 the two companies was further solidified by a
17 restructuring that occurred and integrated
18 operational and finance areas and other support
19 functions from both Highmark West Virginia and
20 Highmark in order to optimize efficiencies and
21 performance levels.

22 Additionally, at this time Highmark
23 and Highmark West Virginia entered into
24 reciprocal administrative service agreements with

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1 the approval of the West Virginia Insurance
2 Commission to better provide for the framework
3 and flexibility needed to maximize efficiencies
4 and streamline work flows between the respective
5 companies.

6 Q. What is the process for Highmark
7 West Virginia disaffiliating with Highmark?

8 A. In the event Highmark converts to a
9 for-profit corporation, Highmark West Virginia
10 shall have the right exercisable by a vote of its
11 five independent board of directors and subject
12 to certain conditions to require that Highmark
13 withdraw as the sole corporate member of Highmark
14 West Virginia and that Highmark West Virginia be
15 reestablished as the primary licensee of the Blue
16 Cross Blue Shield trademarks in the state of
17 West Virginia.

18 Q. You mentioned the BluePRINT systems
19 migration a moment ago. Can you tell us what the
20 BluePRINT program is?

21 A. BluePRINT is the terminology used to
22 refer to the claims processing, customer service,
23 membership, enrollment, utilization management
24 and related systems developed, maintained, and

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1 operated by Highmark.

2 Q. Why was it needed by Highmark
3 West Virginia?

4 A. BluePRINT was necessary for Highmark
5 West Virginia to stay competitive and keep up
6 with the changing environment in order to meet
7 customer demands which were becoming increasingly
8 difficult using our legacy systems.

9 Q. What were the results of implementing
10 BluePRINT in West Virginia?

11 A. The program exceeded our expectations in
12 several ways. First, it increased functionality
13 and automation. For example, we became more
14 capable of delivering a sophisticated benefit
15 plan design previously unavailable under our
16 legacy systems.

17 Second, it improved operational
18 service, efficiency, new product development, and
19 better interaction with customers and providers.
20 For example, our claims throughput rates
21 increased dramatically, as did our capacity to
22 accept claims via electronic format.

23 Third, it was minimizing the cost of
24 future regulatory compliance by allowing us to

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1 take advantage of Highmark's scale and expertise.
2 And fourth, finally, it's increasing
3 revenue growth by giving us increased
4 capabilities to meet the demands of an expanding
5 base of customers.
6 Q. What was the cost for BluePRINT, and what
7 process did the West Virginia Insurance
8 Commission follow to approve those costs?
9 A. The costs for BluePRINT was over
10 \$30 million, including internal personnel costs.
11 The insurance commission reviewed the costs of
12 the system by means of a Form B filing which was
13 approved in late 2003.
14 Q. Describe the regulatory approval process
15 for affiliate transactions between Highmark and
16 Highmark West Virginia.
17 A. Various Form B filings had been submitted
18 and approved by the insurance commission over the
19 term of the affiliation. These were required for
20 certain transactions between companies involving
21 cost allocations.
22 One such Form B filing, as an
23 example, was the Administrative Services
24 Agreement between the two companies which governs

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1 how Highmark West Virginia compensates Highmark
2 for services rendered. Specifically it provides
3 that this compensation shall be in an amount
4 equal to the fair and reasonable allocable share
5 of the total cost of Highmark of providing these
6 services. Such costs shall include, without
7 limitation, employee salaries, employee benefits
8 and other direct and indirect administrative
9 costs, including charges for corporate overhead.
10 Highmark West Virginia's allocable share of the
11 cost of the services shall be determined in
12 accordance with Highmark's established cost
13 accounting practices as in effect from time to
14 time. Highmark West Virginia shall also
15 reimburse Highmark for any and all direct
16 third-party costs incurred by Highmark for the
17 benefit of Highmark West Virginia.
18 Q. Are there regular meetings between
19 Highmark West Virginia and the Highmark
20 West Virginia Insurance Commission?
21 A. Throughout the duration of our
22 affiliation with Highmark, both Highmark and
23 Highmark West Virginia have maintained an
24 unwavering commitment to open up transparent

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1 communications with the insurance commission. In
2 furtherance of this commitment, I meet regularly
3 with the insurance commission personnel on both a
4 formal and informal basis. Finances, including
5 the cost allocation concerns or issues, are
6 reviewed annually with the insurance commission.
7 Annually Highmark West Virginia is
8 also required to file Form B and Form C under the
9 Insurance Holding Company Systems Act. These
10 filings include disclosure of relationships
11 between all members of the holding company
12 system, as well as disclosure of financial
13 reports and any annual reports produced.
14 Partially, as a result of these
15 regular meetings with the commission, no ongoing
16 approvals of Highmark's service charges under the
17 Administrative Services Agreement are required.
18 Candidly, the success of our
19 affiliation with Highmark and its impact on
20 West Virginia has resulted in our commitment to
21 transparency becoming second nature to us.
22 As the information contained in
23 several of the exhibits indicates, Highmark
24 West Virginia has experienced exceptional growth

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1 in enrollment, gains in efficiency and enhanced
2 financial stability. Measuring back to 2004, the
3 time of our closer affiliation transaction,
4 Highmark West Virginia has seen it's overall
5 enrollment grow by one-third, its statutory
6 reserves triple and its risk-based capital
7 percentage almost double. We have also
8 demonstrated significant gains in operating
9 efficiencies as reflected in our increase in
10 electronic claims submission and claims
11 pass-through rates.
12 Also notable is our relocation into
13 our new corporate headquarters in Parkersburg in
14 2009 by which we were able to combine employees
15 from four separate and outdated offices into one
16 state of the art facility. This development has
17 proven to be a significant factor and continued
18 economic development in the downtown area of
19 Parkersburg, with a variety of other local
20 businesses and property developments having
21 occurred in the last two years in the vicinity of
22 our new headquarters.
23 Additionally, and perhaps most
24 significantly, our affiliation with Highmark has

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1 provided Highmark West Virginia the advantages,
 2 economies of scale, and access to expertise
 3 needed to address the unprecedented challenges
 4 and changes associated with healthcare reform,
 5 while at the same time maintaining an
 6 organizational structure designed to serve the
 7 specific needs of the West Virginia markets.

8 Q. How are cost allocation issues between
 9 Highmark and Highmark West Virginia addressed
 10 with the insurance commission?

11 A. We're required to file annual reports
 12 with the insurance commission to substantiate
 13 that the costs allocated to Highmark
 14 West Virginia by Highmark are within the
 15 parameters established and approved by the
 16 insurance commission.

17 Q. What is the process for preparing
 18 Highmark West Virginia budgets, business and
 19 strategic plans?

20 A. The Highmark West Virginia budgeting and
 21 business strategic planning process are now fully
 22 integrated into those processes within Highmark.
 23 Annual approval of the corporate budget and plan
 24 by the Highmark West Virginia board is required.

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1 Q. How do you communicate with Highmark?
 2 A. The overall communication process for
 3 Highmark West Virginia has been integrated in
 4 with Highmark's overall communication structure.
 5 The various areas of operations within Highmark
 6 West Virginia report up to their respective areas
 7 within Highmark with all of health services,
 8 which includes a significant majority of the
 9 employees of operations reporting into the health
 10 services area under Deborah Rice, executive vice
 11 president of health services.

12 Q. What decisions are made locally by
 13 Highmark West Virginia?

14 A. I have overall responsibility for the
 15 West Virginia market functions, including sales
 16 and marketing, provider reimbursement and
 17 relations, government relations, public
 18 relations, and regulatory affairs, in addition to
 19 my responsibilities as a member of the board for
 20 Highmark West Virginia.

21 Q. How does Highmark West Virginia monitor
 22 Highmark service charges?

23 A. Specifically on the fourth working day of
 24 each month Highmark West Virginia's director of

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1 financial planning and analysis, a gentleman
 2 named Mark Mazzone receives an e-mail with a pdf
 3 attachment of the summary of service charges
 4 along with a supporting schedule. Also included
 5 in the attachment is an Excel spreadsheet of
 6 historical invoicing for his review.

7 Mr. Mazzone reviews the information
 8 for reasonableness, and if he has any questions,
 9 he contacts Highmark's cost accounting and
 10 reporting department to get that situation
 11 resolved.

12 On the 15th of each month Mr. Mazzone
 13 sends an e-mail to the cash management department
 14 approving the payout of the invoice to Highmark.

15 Q. If Highmark West Virginia has a dispute
 16 with Highmark about a service charge, what is the
 17 dispute resolution process?

18 A. In addition to the process described in
 19 my previous answer, our administrative services
 20 agreement Form D filing states that Mountain
 21 State reserves the right at any time and from
 22 time to time to review and inspect appropriate
 23 records of Highmark relating to Highmark's costs
 24 of providing the services and any other amounts

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1 due and owing to Highmark as provided herein.
 2 The initial step in this process will
 3 be for me to place a call to Karen Hanlon, the
 4 senior vice president, financial planning and
 5 analysis.

6 Q. How have stakeholders in West Virginia,
 7 that is the policyholders, providers, employees,
 8 and citizens, benefited by the affiliation of
 9 Highmark and Highmark West Virginia?

10 A. Highmark West Virginia continues to gain
 11 operational efficiencies and increased quality
 12 through automation and process improvement due to
 13 the integration process. The synergies between
 14 Highmark West Virginia and Highmark have
 15 leveraged best practices to gain cost
 16 efficiencies.

17 Specifically Highmark West Virginia
 18 has gained the ability to offer new products and
 19 features of products through more efficient
 20 product development, expanding reporting
 21 capabilities and management programs for clients.
 22 Some of these new capabilities and offerings
 23 include a Medicare Advantage product for
 24 West Virginia, tiered benefits for hospital

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1 organizations, value-based and consumer choice
 2 benefit designs, a Blue-branded dental, Blues On
 3 Call Plus, and other wellness initiatives,
 4 patient center medical home pilots, as well as
 5 radiology, oncology, and pharmacy benefit
 6 management administration programs.
 7 Additionally, Highmark West Virginia
 8 has been able to leverage Highmark's electronic
 9 portal capabilities for both employer and
 10 employees, and while introducing the provider
 11 portal NaviNet to the provider community as well.
 12 Other organizational/operational
 13 integration activities have resulted in the
 14 offering of more wellness and care management
 15 programs for members and groups.
 16 Highmark West Virginia has also
 17 gained access to favorable contractual terms by
 18 leveraging Highmark relationships for pharmacy
 19 benefit administration, care management,
 20 informatics, and others.
 21 The company continues to see
 22 increases in its market share, financial strength
 23 and stability, consistency within its procurement
 24 processes and is better prepared to maintain a

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1 better compliant working environment.
 2 Several economic benefits to the
 3 state of West Virginia have also been derived
 4 from the Highmark affiliation.
 5 First, over 300 jobs were created
 6 specifically for the services provided to
 7 Highmark that paid associated wages in excess of
 8 \$9 million annually.
 9 Also, the affiliation impacted the
 10 local economy in the annual amount in excess of
 11 \$21 million and resulted in local and business
 12 occupational tax revenues of over \$1 million for
 13 the last six years.
 14 Q. In your opinion, has the affiliation
 15 between Highmark West Virginia and Highmark been
 16 good for the citizens of West Virginia?
 17 A. Yes. As I believe my responses to the
 18 previous questions demonstrates, I can say
 19 without any hesitation that the affiliation has
 20 been beneficial to our customers and providers
 21 and has provided an overall benefit to the state
 22 of West Virginia, as well as its citizens.
 23 MR. CAMPBELL: Thank you. I have no
 24 further questions.

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1 THE HEARING OFFICER: Thank you.
 2 - - - - -
 3 CROSS-EXAMINATION
 4 - - - - -
 5 BY MS. TWEEDIE:
 6 Q. Mr. Earley, as the president of Highmark
 7 West Virginia, were you aware of any discussion
 8 of Mountain State's charitable assets and what
 9 should be done with them at any point leading up
 10 to the signing of the affiliation agreement with
 11 Highmark?
 12 A. I'm sorry, can you define for me what you
 13 mean by "charitable assets"?
 14 Q. I mean assets that were in the
 15 organization that were there as a result of
 16 Mountain State having favorable tax treatment by
 17 the federal government.
 18 A. I don't recall that there were ever any
 19 discussions around that through the review
 20 process.
 21 Q. And it's my understanding that Mountain
 22 State or now Highmark West Virginia receives
 23 charitable commitments in West Virginia from the
 24 Highmark foundation. Is that right?

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1 A. Not yet. That is under discussion now
 2 with the understanding that the foundation may be
 3 expanding its areas of operation into
 4 West Virginia, and that's contemplated for 2012.
 5 Part of that discussion will be, which I need to
 6 have with the Highmark West Virginia board of
 7 directors, is our commitment to putting funds
 8 into the foundation that would be used for the
 9 benefit of specific charitable purposes and
 10 programs in West Virginia.
 11 But at this point in time no funds
 12 from the foundation have been distributed in
 13 West Virginia, to the best of my knowledge.
 14 Q. You also stated that, in the event of a
 15 dispute in the area of cost allocation, you would
 16 contact Karen Hanlon at Highmark, the senior vice
 17 president.
 18 A. That's correct.
 19 Q. Has there ever been such a dispute?
 20 A. Not really to that level. I think, as
 21 Mr. Gebhard mentioned earlier, there are monthly
 22 meetings, what you call an executive financial
 23 review, where we go over the financial
 24 performance not only of Highmark West Virginia

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1 but all of the markets. And going over the
2 administrative costs as part of that meeting, if
3 there were questions I had, I would also have the
4 ability to raise them in that meeting as well.
5 And there's been some discussion around that.
6 One example I can think of is earlier
7 this year we were looking at some variations
8 between what was the allocable amounts that were
9 forecasted, what the actual results were early on
10 in the year. Through discussions in that meeting
11 it was made clear that those appeared to be
12 timing in nature and appeared to be true, because
13 over the last several months they did even out.
14 But through that process I was able to rest on
15 the probability of going through a formal
16 process.
17 Q. Is it fair to say that as president of
18 Highmark West Virginia you could be removed for
19 cause or without cause?
20 A. I am reappointed to my position hopefully
21 on an annual basis by our board of directors.
22 Q. My last question is: Has there ever been
23 an independent review by Highmark West Virginia
24 independent of Highmark or an independent audit

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1 of the cost allocation methodologies that are
2 established by Highmark?
3 A. Those cost allocation methodologies were
4 subject to the approval of our insurance
5 commission when those administrative services
6 agreements were put into effect in 2009. They
7 are subject to certain caps put in place in terms
8 of how the costs can increase from year to year,
9 and we review the results on an annual basis with
10 the Department.
11 To the best of my knowledge, since
12 they were approved in 2009, roughly two plus
13 years ago, there's not been a formal review that
14 has been undertaken to look at that.
15 Q. Can you explain what you mean by, you
16 said there were caps in place?
17 A. Well, the overall cost associated with
18 the allocations. Some commitments were made that
19 how much they could increase from year to year,
20 and I believe it's a CPI plus 2 percent cap
21 allocation in terms of how much they can go up
22 from year to year. And that was something that
23 was discussed as part of our understanding with
24 the West Virginia Insurance Commission, and that

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1 is part of the understanding.
2 Q. So that was something that was mandated
3 by the West Virginia Insurance Commissioner.
4 A. It was something we agreed to.
5 MS. TWEEDIE: Thank you. I don't
6 have any further questions.
7 MR. HOUGHTON: No questions.
8 MR. CAMPBELL: No questions.
9 THE HEARING OFFICER: Mr. Earley,
10 thank you. I appreciate your testimony.
11 THE WITNESS: Thank you.
12 THE HEARING OFFICER: And your travel
13 to Delaware.
14 THE WITNESS: You all come visit us.
15 THE HEARING OFFICER: I believe that
16 Blue Cross has asked for some time to put
17 something on the record, and I will permit them
18 to do that at this time and then we will break
19 for the day.
20 MR. SWAYZE: I'll make this brief,
21 Your Honor. Thank you very much.
22 I want to discuss something that was
23 not the subject of any testimony today, and I
24 raise it because there had been questions as to

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1 why it was not raised. Specifically legislation.
2 And the legislation was Senate Bill 56, actually
3 senate substitute for Senate Bill 56, was adopted
4 which essentially requires that in a transaction
5 such as this, that the resultant insurer be
6 required to adopt a plan which is similar to any
7 buy-in plan under the CHIPs program, which is the
8 Children's Health Insurance Program, the federal
9 program, on essentially the same terms and
10 conditions as is offered in the home state of the
11 affiliate.
12 Highmark has, in fact, such a program
13 in the state of Pennsylvania, a buy-in program.
14 It's basically a subsidized premium program which
15 permits insurance for children who are not
16 otherwise insured, and there are 22,000 such
17 children in the state of Delaware.
18 As a result of the passage of that
19 legislation, and should this transaction be
20 approved, it will be Blue Cross Delaware's
21 obligation to, in fact, establish a buy-in
22 program that mirrors the terms and conditions of
23 the buy-in program that Highmark has in
24 Pennsylvania.

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1 We did not offer testimony, although
 2 it is mentioned in our memorandum, in our joint
 3 memorandum with Highmark at page 33, but we
 4 didn't offer testimony on this point and we did
 5 not at any time suggest, nor did the Department
 6 of Insurance, that it be a condition because it
 7 is, in fact, a mandate. It is triggered
 8 automatically by the ultimate approval of this
 9 transaction.
 10 But I do want to state for the record
 11 that it is Blue Cross's intention to abide by its
 12 statutory obligation, and should this transaction
 13 be approved, Blue Cross Delaware will, in fact,
 14 establish a buy-in program that mirrors the terms
 15 and conditions of that in effect through Highmark
 16 in the state of Pennsylvania.
 17 THE HEARING OFFICER: Thank you,
 18 Mr. Swayze. Is that legislation the most recent
 19 General Assembly or has it been around for a
 20 while?
 21 MR. SWAYZE: That was passed this
 22 past session. As were a number of bills that had
 23 some impact on us.
 24 THE HEARING OFFICER: Sounded like a

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1 busy session.
 2 I thank you, all. We will break for
 3 the day and we will come back at 9:00 a.m.
 4 tomorrow. Knock on wood, but I believe we're
 5 going to be able to finish most of this phase of
 6 the hearing tomorrow hopefully and then Friday we
 7 will take public comments.
 8 So I thank you, all.
 9 (Hearing adjourned at 4:30 p.m.)
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CERTIFICATE
 STATE OF DELAWARE)
)
 NEW CASTLE COUNTY)
 I, Kimberly A. Hurley, Registered
 Merit Reporter and Notary Public, do hereby
 certify that the foregoing record, pages 1 to 325
 inclusive, is a true and accurate transcript of
 my stenographic notes taken on Wednesday,
 October 5, 2011, in the above-captioned matter.
 IN WITNESS WHEREOF, I have hereunto
 set my hand and seal this 5th day of October,
 2011, at Wilmington.

Kimberly A. Hurley

PRINTED DATE
 The original was electronically signed
 using RealLegal technology

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