Independence
Blue Cross

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May 17, 2007

Senator Patrick Leahy
Chairman United States Senate Judiciary Committee
224 Dirksen Senate Office Building
Washington, D.C. 20510

Attn: Jennifer Leathers, Hearing Clerk

Re: Responses to Supplemental Written Questions of the United States Senate Judiciary Committee Regarding "Examining Health Care Mergers in Pennsylvania"

Dear Mr. Chairman and Committee Members:

Please accept the following response to the supplemental written questions from members of the United States Senate Judiciary Committee on behalf of Independence Blue Cross ("IBC"). Because the same questions were addressed to both IBC and Highmark, and because certain of those questions concern plans for the new, consolidated company, IBC has worked together with Highmark on preparing certain responses where appropriate.

Question 1: According to publicly available information, Highmark has around $3.1 billion in reserves and Independence has around $1.4 billion in reserves. At the same time, policy holders have complained about skyrocketing rates and doctors and hospitals have complained about declining reimbursement rates. How do you respond to critics that claim your reserves are too high?

Response: IBC believes that criticism over the size of its reserves (*i.e.*, surplus)[1] is misplaced. These critics lack an appreciation for both the level of regulatory scrutiny that IBC and the other Pennsylvania Blue Plans are subjected to regarding their surplus levels, and the vital roles that surplus plays. As a not-for-profit insurer, IBC's surplus is

1 As a matter of insurance terminology, "reserves" typically refer to monies that have been set aside to pay for claims that have been incurred or are expected, but which have not yet been paid; whereas "surplus" refers to the accumulated amount of capital that remains after all liabilities have been deducted from the company's assets. See, e.g., Determination of the Insurance Department of the Commonwealth of Pennsylvania, Misc. Dckt. No. MS 05-02-006, February 9, 2005. An accumulated surplus, therefore represents the net results of both underwriting profits and investment gains. Id. at 17. We believe that the Committee's questions relate to IBC's surplus, and have responded accordingly.

used to ensure the payment of medical claims in the event of unforeseen contingencies (*e.g.*, contingencies that may range from terrorism events and pandemics, to new government mandates, changes in utilization patterns and sustained underwriting losses), and to fund the new growth and investment opportunities necessary to bring new products and services to its members. Thus, as the Insurance Department of the Commonwealth of Pennsylvania ("PID") summarized in its Determination and Order regarding the Pennsylvania Blues Plans Surplus Levels (the "Determination"):

> [T]he maintenance of appropriate levels of surplus is important for many reasons. Some are specific to each Blue Plan, but the most important reason is applicable to all, and that is to remain adequately solvent. Protection of these companies' financial health is paramount for the millions of citizens in the Commonwealth who receive health insurance and other services from the Blue Plans.

Id. at 9.

The PID's Determination was the culmination of a multi-year investigation and analysis of the Pennsylvania Blue Plans' respective surplus levels conducted under the PID's statutory authority, 40 Pa. C.S.A. Sections 6101, 6301, *et seq*. That review and investigation included extensive public comments, an independent review of the Plans' financial reporting practices, and the employment of independent actuarial and financial experts. At the conclusion of that review and investigation, the PID determined that for IBC, a "sufficient surplus operating range" would be between 550-750% of its Risk Based Capital ("RBC"). In its Determination, the PID rejected any notion that IBC's surplus was excessive, and found, instead, that IBC was operating within an "efficient" range of surplus.

Contemporaneous with the PID surplus investigation, the Pennsylvania House of Representatives passed a resolution that tasked the Legislative Budget and Finance Committee ("LBFC") to "examine options and alternatives available to the Commonwealth with respect to the regulation, oversight and disposition of reserves and surpluses of health insurers." The LBFC, in turn, retained the health care research and consulting firm, the Lewin Group, to conduct that study. After reviewing the PID's analysis and conducting its own, independent study, the Lewin Group reached the conclusion that an RBC ratio of 887% would be needed to have a 95% confidence of maintaining reserves above the BCBSA minimum level in a seven year insurance down cycle. Based on that determination they found that surplus levels producing "RBC ratios in the range of 500% to 900% can be justified to protect against underwriting swings that could jeopardize a Blue plan's standing with state insurance regulators and the Blue Cross Blue Shield Association." (Lewin Report at iv). Accordingly, the Legislature's commissioned study concluded, in summary, that;

> [PID] Commissioner Koken's February 2005 [Determination] set reasonable bounds on the Pennsylvania Blue Plans' accumulation of surplus. Further, it is not likely that the ruling will disrupt the Pennsylvania insurance market, as the process set forth for managing surplus offers both the Blues and the Commissioner sufficient latitude to act prudently.

See, Considerations for Regulating Surplus Accumulation and Community Benefit Activities of Pennsylvania's Blue Cross and Blue Shield Plans, Legislative Budget and Finance Committee, June 2005.

In summary, the surplus levels of IBC, Highmark and the other Pennsylvania Blue Plans have been and continue to be actively scrutinized and regulated by the Pennsylvania Insurance Department. The PID's Determination not only rejected the notion that IBC's surplus was "excessive," but found it to be at an "efficient" level. Every year, the surplus levels of IBC and the other Pennsylvania Blue Plans are reviewed by the PID, and those surplus levels are a factor considered by the PID as part of their approval of new rate requests. In March 2007, the PID published its statement regarding the 2006 surplus levels, and again, found that IBC's surplus remains at an "efficient" and appropriate level.

Question 2: In a competitive market, profit margins are constantly being pushed down. Yet, IBC and Highmark have accumulated reserves that many have characterized as excessive. Given your assertion that you have significant competition from major national insurers, how do you explain the tremendous reserves that the two companies have accumulated?

- Dr. Burns has indicated in his written testimony that your companies use your reserves to generate investment income, which helps to keep premiums down. However, in a sufficiently competitive market, IBC and Highmark would have been under competitive pressure to keep premiums down in the first instance, making the accumulation of large reserves difficult. Given the significant reserves that your companies have accumulated, do you believe the markets in which you compete are sufficiently competitive?

Response: At the outset, IBC does not accept any characterization of its surplus as either "excessive" or "tremendous" relative to the risk it is underwriting for the reasons set forth in response to Question 1, above. Indeed, after extensive study and analysis, the PID concluded that IBC's surplus was at and remains at an "efficient" level based on its RBC.

It should also be noted that IBC's surplus was accumulated over more than a sixty (60) year period of continuous operations and service to Pennsylvania. Thus, as the reference to Dr. Burns' testimony implies, IBC's surplus is the accumulated result of both its net operating margins, and the successful investment and management of its

surplus over time. The investment income that IBC earns on its surplus does allow IBC to hold down the level of its premiums, as well as to fund investments in new products, technologies or services to better serve IBC's members, as well as to fund its social mission. Because a surplus is used to guarantee the payment of claims and to fund investments for the benefit of both IBC's members and the community, it is not appropriate to equate a surplus with "profits" that constitute a return to shareholders.

With respect to the suggested correlation between IBC's accumulation of surplus over time and the level of competition in the marketplace, IBC believes that the markets it participates in are sufficiently competitive. To the extent that operating margins may be deemed a useful indicator of the intensity of that competition, IBC's profit margins are modest and range from 2% to 3%. By contrast, while it is difficult to isolate particular geographic areas or lines of business, it is important to note that United, Aetna, Cigna and Coventry have all reported considerably higher profit margins than IBC, ranging from 5% to more than 7%.[2]

Question 3: Highmark and Independence Blue Cross claim that the proposed merger will result in over $1 billion in cost savings to the combined company. The companies have asserted that some cost savings will come from the combined company. The companies have asserted that some cost savings will come from the combined company's ability to bargain for better prices with drug companies and to eliminate duplicative administrative costs. Please provide the Committee with a detailed, written explanation of how the merger will produce savings of over $1 billion.

Response: Highmark and IBC have engaged in extensive study and analysis of their cost-saving opportunities, and concluded that the consolidation will result in over $1 billion in net economic benefits over the first six years of the new company's operations. These benefits are made up of a combination of certain revenue growth opportunities and cost savings that will flow directly from the consolidation.

With respect to the cost-saving aspects, the consolidation will enable the new company to generate over $820 million in scale-based economies over a six year period. These savings opportunities include cost reductions in information technology spending on claims management, medical management, informatics, enrollment, and corporate systems; consolidation of IT and desktop infrastructure; and consolidation of data

2 As the LBFC concluded in its June 2005 report, it is difficult to make an accurate comparison of the surplus levels of a not for profit Blue Plan, like IBC, and a publicly-traded for-profit insurer. "For-profit insurers tend to retain surplus at lower levels than non-for-profit Blue plans because they find it less advantageous in having big surpluses. First, these insurers must show investors highest possible return on equity [so surplus can be used] to buy[] back shares – [to] lower the denominator in the return on equity formula and raise the result. For-profit insurers also can sell shares to raise cash, something that not-for-profit insurers cannot do. Further, [in the case of] for-profit insurers . . .. the entities holding state licenses are wholly-owned subsidiaries that usually pass their profits up the line quickly. This action creates the impression of low surplus by the entity that files reports with state regulators." Lewin Group Report at iii.

centers (with avoided costs in new data center investments and upgrades).[3] Additional material savings will be realized through the consolidation of back-office and corporate management and administration functions. In addition, the parties have estimated that the consolidation should produce approximately $285 million in pharmacy cost savings over the first six years of operations. These savings will be a function of increased scale which should enable the new company to secure higher rebates and pharmacy discounts, and lower PBM administration and dispensing fees as compared to their stand-alone operations.

Question 4: Highmark and Independence Blue Cross have stated that they plan to use the cost savings to keep insurance premiums stable, keep drug costs down and to help expand access to health insurance for Pennsylvania's uninsured population. Please provide the Committee with a detailed, written explanation of how the combined company would allocate the cost savings resulting from the merger.

Response: As referenced in my earlier testimony at the April 9 hearing, IBC and Highmark have proposed to use the more than $1 billion in anticipated savings from the consolidation to hold down the cost of and increase access to health care for Pennsylvanians. First, the new company will extend and expand upon IBC's and Highmark's current commitments to the Community Health Reinvestment Agreement (CHRA) through 2013. That Agreement was designed to target the expansion of health insurance coverage for Pennsylvania's low income and uninsured through programs such as adultBasic coverage. By extending that agreement through 2013, the new company will contribute an additional $350 million to the CHRA. Second, the new company will contribute an additional $300 million over six years to existing programs targeting the uninsured (*e.g.*, Children's Health Insurance Program ("CHIP")) or to new initiatives aimed at expanding healthcare coverage by providing uninsured and small business employees with affordable coverage.

In addition to specific programs to assist the low income and uninsured, the savings generated by the consolidation will be used to help control the cost of health care for our members. In particular, we have committed to keeping our per-member per-month administrative fees for our employer group customers flat for two years after the new company is formed. We anticipate that this initiative will save our customers approximately $300 million in premiums. By passing along the savings achieved in the pharmaceutical area, we expect to save our customers an additional $285 million over

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3 By way of example, the proposed consolidation will avoid the need for duplicative investments in new tools to serve Highmark and IBC subscribers and providers. At present, both companies are investing in new automated capabilities to meet customer demands, and in many cases these investments are, or would be, redundant. For example, both of the Plans are investing tens of millions of dollars in building parallel and largely overlapping capabilities in informatics, medical management programs, investments in consumer driven health plans, electronic health records, personal health records, and other similar initiatives.

six years in reduced prescription drug costs. Finally, the consolidation will eliminate the certain fees related to the costs of claims processed between Highmark and IBC, generating savings of another $36 million.

Question 5: Physicians, hospitals and other health care providers have repeatedly complained that health insurers in Pennsylvania have so much market power that they can dictate reimbursement rates for providers. After the merger, what safeguards will exist to ensure that the combined company does not exercise too much market power when dealing with providers? Can you explain why you think an antitrust exemption for doctors and other health care providers (for purposes of negotiating reimbursement rates with insurance companies) would be a good idea, or not?

Response: Although IBC appreciates the fact that hospitals and other health care providers may comment that IBC and/or other health insurers can effectively dictate their reimbursement rates, that assertion is unfounded. Provider reimbursement rates are determined in a competitive market and by a process of negotiations that results in fair and reasonable compensation of providers. Indeed, as Dr. Mark Piasio, M.D., President of PMS recently noted in his recent May 2007 interview with Physicians News Digest, IBC does negotiate reimbursement rates with providers.

As noted in our prior testimony, IBC's business practice of negotiating with its provider community reflects the market realities that the interests of providers and insurers are more often aligned than opposed. IBC has focused on making available to its members the broadest possible physician and hospital network – a feat that could not be achieved without the participation of almost all providers in a given service area. This focus on accessibility (which will remain a central pillar of the future consolidated entity) creates a delicate interdependency between IBC and health-service providers that must be carefully balanced and maintained. Ultimately, this interdependency serves as the most effective "safeguard" of the providers' interests, and that relationship between IBC and its provider network will be unaffected by the consolidation.[4] In addition, hospitals and other providers have gained negotiating power as a result of the backlash against restrictive managed care organizations, as well their own consolidations and new business models (e.g., integrated delivery systems). Beyond these market "safeguards," both the Department of Justice and the Pennsylvania Insurance Department will have the opportunity to analyze all aspects of this transaction for its impact on competition *before* the transaction is approved, including considering any impact on providers. The antitrust laws will continue to apply

4 IBC, like any other health insurer or managed care entity, is able to negotiate better rates with providers because of its ability to deliver its members to those providers who are willing to participate in its provider networks. Here, because of the different geographies covered by Highmark and IBC and their respective memberships, there will be relatively little impact on providers in any particular part of the state, and thus, little change in the negotiating dynamics.

to the conduct of the parties *after* the consolidation is complete.

Finally, with respect to any proposed legislation to allow physicians or other providers to bargain collectively, IBC would need to see the specific proposal, including any limitations designed to protect consumers, before it could comment in full. As an entity committed to delivering broad access to health insurance benefits at the lowest costs to the greatest number of people, however, IBC would be concerned with the impact such an exemption for collective bargaining could have on prices for health care services and the quality of medical care provided to our members.

IBC generally supports proposals, legislative or otherwise, that are designed to promote the more efficient provision of quality health care services in Pennsylvania. A blanket collective-bargaining proposal for one group of professionals, however, appears to do little on the surface to help promote this goal or advance the interests of consumers of health care. A fundamental purpose of any such proposal would be to raise reimbursement rates, and thus, would necessarily raise costs to health care consumers. Such a cost increase, in turn, threatens to decrease access to health care, either because insurers will simply not be able to meet all of the provider demands, or because the increased cost of care will further reduce the number of employers offering health care coverage. Lastly, while IBC strongly supports measures designed to align higher quality of care with reimbursement rates, a general antitrust exemption does nothing to raise quality or decrease utilization in a manner that may help offset any anticipated rate increase.

Based on the same concerns outlined above with respect to the impact such legislation would likely have on affordability, access and quality of health care, we also point out that the federal antitrust agencies strongly oppose provider collective bargaining, most notably in the joint DOJ/FTC Report, "Improving Health Care: A Dose of Competition":

> Some physicians have lobbied heavily for an antitrust exemption to allow independent physicians to bargain collectively. They argue that payors have market power, and that collective bargaining will enable physicians to exercise countervailing market power. The Agencies have consistently opposed these exemptions, because they are likely to harm consumers by increasing costs without improving quality of care. The Congressional Budget Office estimated that proposed federal legislation to exempt physicians from antitrust scrutiny would increase expenditures on private health insurance by 2.6 percent and increase direct federal spending on health care programs such as Medicaid by $11.3 billion.[5]

5 A Dose of Competition at p. 14 of Executive Summary.

For these reasons, the DOJ and FTC recommended that: "Governments should not enact legislation to permit independent physicians to bargain collectively. Physician collective bargaining will harm consumers financially and is unlikely to result in quality improvements."[6]

As a mission-based company dedicated to increasing access to affordable, high quality health care for the citizens of Pennsylvania, IBC would have the same concerns as expressed by the DOJ and FTC regarding any such proposed legislation that fundamentally impacts the health care delivery system – how would it affect cost, accessibility and the quality of care provided.

Question 6: You have publicly committed $650 million in savings from the merger to help fund health insurance for uninsured Pennsylvanians. Is this commitment in excess of the combined amount that both of your companies have previously committed to contribute toward health insurance for uninsured Pennsylvanians under the Community Health Reinvestment Agreement (CHRA) – which provides funding to the "adult basic" program – through 2010?

- Mr. Frick's written testimony indicates that only $350 million of the $650 million will go toward extending your commitment to the CHRA; what will the other $300 million go toward?

Response: Yes. As I testified at the April 9 hearing, the $650 million that we have proposed to commit to help cover uninsured Pennsylvanians as a result of the consolidation is above and beyond either companies' existing commitments to the Community Health Reinvestment Agreement. Those existing commitments expire in 2010. As a result of the savings over six years achieved through consolidation, the new company will extend that commitment by an additional $350 million through 2013. In addition, the remaining $300 million will be spent on other programs to help the uninsured and low income families of Pennsylvania enjoy access to health care. Although these funds have not been specifically earmarked at this time, the companies anticipate further contributions to existing programs such as non-profit health clinics and funding for CHIP, as well as other new programs. The new company anticipates working cooperatively with government and community stakeholders on how best to address the needs of this segment of the population.

Question 7: At the hearing, Professor Burns questioned your ability to extract additional savings from your pharmaceutical costs. Given the market power that your companies already wield, do you believe that it is realistic to expect that you will be able to extract additional savings from your drug spending?

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6 Id. at 23, "Recommendation 4" (emphasis in the original)

Response: Yes. The companies believe that their pharmaceutical savings estimates are realistic and achievable. The estimated savings were the result of a careful and detailed study of all of the potential cost saving opportunities that could be achieved in a consolidation, including the impact on each company's respective pharmaceutical purchases. The estimated annual savings represents only 2% of the combined companies' annual spending on pharmaceuticals, and most of the estimated savings are based upon a direct comparison of each company's actual purchase prices and rebate levels.

As to the anticipated sources of pharmaceutical savings, the companies anticipate the savings to result from the following changes: use of best pricing across the newly consolidated organization to provide enrollees with better discounts; cost reductions by lowering pharmacy benefit management administrative fees (prescription claims processing expenses); cost reductions achieved by negotiating lower dispensing fees; cost reductions by routing specialty drugs through their pharmacy (as opposed to treating as medical costs); and rebate increases by virtue of comparing rebate per claim by formulary.

Finally, it should be noted that while Highmark and IBC may each be relatively significant purchasers of pharmaceuticals in terms of the dollars spent, their separate purchases represent at most a small fraction of the total sales by the pharmaceutical manufacturers who sell nationwide (and, indeed worldwide). Thus, the companies do not possess significant "market power" as purchasers of pharmaceuticals.

Question 8: You have stated that you expect to achieve around $1 billion in savings, but that you do not plan to integrate the company's headquarters and other administrative functions. Given that, how do you expect to achieve the savings you have promised?

Response: In analyzing the opportunities for synergies and cost savings that could be achieved as a result of the consolidation of Highmark and IBC, both companies were cognizant of trying to balance the interests of their various stakeholders, including their employees, customers, and community leaders, and both companies were adamant about preserving their core values, which include their not-for-profit status, their respective social missions, and their strong focus and commitment to their respective local communities. Accordingly, the plan for a consolidation with Highmark presents many opportunities for strategic growth and cost savings, but not at the expense of sacrificing either company's core values. One reflection of the companies' commitment to those core values was their decision to maintain a significant local presence, in terms of the new company's leadership, employment, board membership, and direct community involvement in each of the Pittsburgh, Camp Hill and Philadelphia regions.

In addition, as set forth above in responses to Questions 3 and 7, and in Mr. Frick's original testimony, the $1 billion in savings anticipated over six years as a result of the consolidation comes primarily from scale-based efficiencies (e.g., consolidated IT spending, elimination of duplicative investments, reduced administrative expenses, and pharmacy cost savings). These savings are not based upon, and are not contingent on significant job losses or an overall consolidation of the new company's work force.

Question 9: You have argued that IBC and Highmark are not competitors. However, there is no reason why IBC and Highmark could not compete with one another. As the two largest insurance companies in Pennsylvania, IBC and Highmark must each look over their shoulders at each other to some extent. Doesn't the fact that IBC and Highmark are each other's biggest potential competitive threat help keep prices down? If the companies merge, those competitive pressures will dissipate, correct?

Response: Given their respective geographic focus, IBC and Highmark are not competitors. Since its inception, IBC has focused on serving the Philadelphia area, consistent with the scope of its license from the Blue Cross and Blue Shield Association (BCBSA). IBC's targeted expansion efforts outside of its BCBSA service area (i.e., without using its Blue Cross trademark) have been limited, and have enjoyed their greatest success by serving the Philadelphia commuter suburbs in New Jersey. In contrast with those commuter suburbs to Philadelphia, there is little in common between the Philadelphia and Pittsburgh areas in terms of their economic base, employer groups, provider networks, demographics or media markets. IBC has never seriously considered an expansion into the Pittsburgh area or Western Pennsylvania. In addition, IBC does not regard Highmark a likely entrant into IBC's service area in southeastern Pennsylvania, and thus, IBC's product pricing is not influenced by any perceived competition from Highmark. More fundamentally, as set forth below in response to Request No. 10, IBC's prices are restrained by the many actual competitors actively participating in its market area, and not by the theoretical possibility of future entry by any other insurer.

Question 10: Why have the "major, national, publicly traded, highly capitalized companies" that you compete with had such a difficult time gaining a foothold in the Pennsylvania health insurance markets?

- Do you think there is any truth to the allegations that Highmark's close relationship with the University of Pittsburgh Medical Center (UPMC) has prevented competing insurers from gaining a foothold in Allegheny County and other parts of Western Pennsylvania?

Response: With respect to IBC's core service area in the greater Philadelphia region, IBC sees no shortage of major, national, publicly-traded competitors. These competitors include United Healthcare (the largest health insurer in the U.S.), Aetna,

Cigna and Coventry. Cigna and Aetna (including through its acquisition of U.S. Healthcare) have been major competitors in the Philadelphia area for many years; whereas United and Coventry are relatively recent entrants. United's entry, in particular, we believe is illustrative of the mistaken premise of the question.

According to a story published by HeathLeaders-Interstudy in May 2006: "national insurance giant UnitedHealthCare has tagged Pennsylvania as a major growth market, and is moving aggressively to establish a greater presence there. According to the latest issue of Pennsylvania Health Plan Analysis, United regards Pennsylvania as among its best growth opportunities nationally." Pursuant to that strategy, United purchased the Fidelity Insurance Group for approximately $20 million in 2004, established a joint venture with the Jefferson Health System for consumer directed health plans in 2006, and has quickly emerged as a major competitor for commercial business in the Philadelphia area, evidenced, in part, by its active pursuit of the state employees' contract. As the United experience demonstrates, there are no structural impediments to competition in the Philadelphia region. Accordingly, IBC believes that any alleged difficulties that these firms may claim to encounter in growing their presence can be attributed to the highly competitive markets in which IBC participates, and their own internal strategies and profitability levels demanded by their shareholders.

Finally, IBC has no independent information regarding allegations concerning the Highmark-UPMC relationship on competition in Allegheny County, and thus, defers to Highmark for its response.

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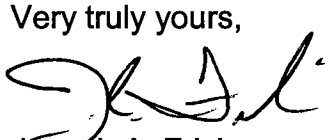
In conclusion, we appreciate the opportunity to address and respond to this Committee's questions and to help convey the opportunities that this consolidation offers to improve the state of health care in Pennsylvania.

Very truly yours,



Joseph A. Frick
President & CEO