

C. Talbot Heppenstall, Jr.
Executive Vice President, UPMC
and Treasurer
President, UPMC Enterprises

U.S. Steel Tower, Suite 6226
600 Grant Street
Pittsburgh, PA 15219
T 412-647-4894
F 412-578-9104
heppenstalltc@upmc.edu

January 19, 2016

Mr. Joseph DiMemmo, CPA
Deputy Insurance Commissioner
Office of Corporate and Financial Regulation
Pennsylvania Insurance Department
1345 Strawberry Square
Harrisburg, PA 17120

Dear Mr. DiMemmo,

Though I have not had the privilege of meeting you, I am writing in reference to the Department's excellent response of January 14, 2016 regarding Highmark's "Final AHN Corrective Action Plan." As we testified during the May hearing on the \$175 million Grant Request, UPMC supports the Department's efforts to improve Highmark's financial transparency as a key to ensuring that all stakeholders, including consumers, employers and credit rating agencies, can make appropriate decisions at this crucial time in Western Pennsylvania healthcare. We also shared our views, as summarized in the attached written analysis, with Raymond James during a meeting on December 10, 2015. The analysis has been provided to the Commissioner. The Department's response is another positive step towards remedying Highmark's startling lack of transparency. We agree with the conclusion that the Final Corrective Action Plan ("Final CAP") does not fully comply with Condition H and that, as detailed in Exhibit 1, Highmark was not fully responsive to four of the specific requirements of Condition H and did not respond at all to five of the other specific requirements. These responses will help the Department better understand how Highmark intends to address its unsustainable Operating Run Rate Losses as summarized in the attached analysis.

We note, however, that the Department did not ask Highmark to provide further information with regard to Condition H(3) which required "an opinion as to the reasonableness of the value assigned by Highmark Health and/or Highmark to Highmark's investments in AHN." We believe this is an oversight permitting a significant overstatement of the Highmark surplus with attendant consequences.

As summarized in Section 3 of the attached analysis, Highmark Insurance's statutory filings include investments in, and commitments to, AHN valued at more than \$1.75 billion as of September 30, 2015. Our presumption is that the Department requested the third party opinion to verify that these assets and liabilities are correctly reflected on the statutory filings. To comply with the Department's request, Grant Thornton stated that AHN's book value (Total Net Assets) on July 31, 2015 of \$181.0 million was a reasonable "value" to assign to Highmark Insurance's investments in AHN.¹ Grant Thornton further stated that this "value" was projected to increase to \$229.3 million by December 31, 2015.²

¹ See excerpt from *Allegheny Health Network, Assessment of Final Corrective Action Plan, Grant Thornton, September 30, 2015*, pages A-2 and A-3.

² *Ibid*, page A-6,

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Page Two

Since the projected Total Net Assets on December 31, 2015 include \$287.9 million of AHN's Restricted Net Assets, we believe a more accurate measure of this "value" would have been AHN's negative Unrestricted Net Assets of (\$58.9 million). We would additionally point out that Highmark reported to the Departments that AHN's Unrestricted Net Assets decreased to (\$130.2 million) and were \$30 million lower than Grant Thornton's projections on the same day the Final CAP was released.³

Accordingly, based on the Grant Thornton valuation, we believe that Highmark's policyholder surplus was indeed overstated by at least \$1.75 billion, or 46%, as of September 30, 2015 as the value of the AHN assets is less than zero and not the \$1.75 billion recorded on the Highmark statutory filing. Policyholder surplus, as reported in statutory filings, is a key metric used by many interested parties, including credit rating agencies, to make judgements about Highmark's financial condition. The December 31, 2015 surplus will be used to calculate the important annual risk-based capital ratios (RBCs). As noted on page 4 of the analysis, we believe this surplus should be approximately \$2 billion, not the \$3.8 billion presented by Highmark in September.

This discrepancy is in part a function of the method previously approved by the Department to account for the \$700 million PNC term loan (the "Loan") collateralized by Highmark and used to pay off the West Penn Allegheny bonds which matures in May of 2019. The Department currently has sufficient information, including the Grant Thornton valuation, to modify its May 20, 2014 approval of the Loan to require that Highmark accurately and transparently reflect its financial condition by excluding from its policyholder surplus the inflated value of its AHN investments before its December 31, 2015 statutory filing. This Loan, as well as previous direct investments of Highmark, are indeed uncollectible and there is no indication in the Final CAP that AHN will generate enough funds to repay its obligations.

We appreciate the Department's challenging role in this unfolding situation with the 2013 Approving Order and related conditions which place Highmark Health, AHN, and the Department at risk should they fail to protect consumers. I would be pleased to come to Harrisburg to meet with you, your colleagues at the Department and Raymond James to further detail our concerns. The discrepancy between Grant Thornton's valuation and Highmark's permitted statutory accounting is not only material but perhaps definitive to the future of healthcare in Western Pennsylvania.

Thank you for your consideration and I look forward to meeting you.

Sincerely,



C. Talbot Heppenstall, Jr.

cc: Commissioner Miller
Eric D. Coburn, Raymond James
Patrick T. DeLacey, Raymond James

³ See excerpt from *Highmark Health Non-Confidential Benchmark Report, October 30, 2015*, page B-2.

ALLEGHENY HEALTH NETWORK

ASSESSMENT OF FINAL CORRECTIVE ACTION PLAN

September 30, 2015



Grant Thornton

An instinct for growth™

- Market Approach – Uses direct comparisons to other enterprises to estimate Fair Market Value. The market approach bases the Fair Market Value measurement on what other similar enterprises or comparable transactions indicate value to be.
- Income Approach – Sometimes referred to as the Discounted Cash Flow (“DCF”) method explicitly recognizes that the current value of an investment is premised on the expected receipt of future economic benefits such as periodic income, or sale proceeds. In valuing a business enterprise, indications of value are developed by discounting future net cash flows available for distribution to their present worth at a rate that reflects both the current return requirements of the market and the risk inherent in the specific investment.

Grant Thornton reviewed and analyzed audited and unaudited historical financial statements of AHN and the goodwill impairment tests dated December 31, 2013 and December 31, 2014. The draft of the goodwill impairment test for June 30, 2015 was also provided and analyzed. The forecasted financial statements of AHN included in the Final CAP and the projected Book Value as of December 31, 2014. Grant Thornton is providing an opinion on the end of forecast period Book Value based on the reasonableness of the forecasted financials and the reasonableness of the historical Book Value as of December 31, 2014.

With respect to the strategic value Highmark Health assigns to AHN, Grant Thornton assessed the Final CAP’s effect on potential cost savings and downstream value to Highmark Health.

Conclusions

Grant Thornton believes management is focused on the appropriate initiatives and actions in the Final CAP and that these initiatives, along with continued attention to operating the IDFS, are sufficient to achieve the Plan Objectives. Further, in our assessment of sufficiency, we analyzed the potential downside scenario and the ability of the AHN management to take other actions to maintain adequate cash levels in the event that actual performance deviates significantly from the forecasts. We analyzed whether at this lower level of forecasted cash, the Final CAP is still reasonable and sufficient to achieve the Plan Objectives. These contingency plans might include, but are not limited to, a change to provider-based billing, and delaying capital expenditures in later periods, and seeking other sources of external funding. It is Grant Thornton’s opinion that management has sufficient levers in its control to respond to the downside scenario and still achieve the Plan Objectives.

It is Grant Thornton’s opinion that with the caveats and limitations noted throughout this Report, the projected net income and cash balances in the financial forecasts as presented in the Final CAP appear reasonable.

The Final CAP provides evidence that the plan will continue to support and extend the benefit to Highmark policyholders documented in the IDN Savings Report as well as support the strategic value of AHN to Highmark Health in its execution of the IDFS strategy. **The book value of AHN as of July 31, 2015, is \$181.0 million.** AHN Forecasts book value to increase by \$77.1 million through the projection period, to a value of \$258.1 million by the end of 2017.

Highmark’s investment in AHN and the reasonable value assigned by Highmark Health from an accounting perspective can reasonably be expected to maintain or increase value from multiple perspectives: in the form of increased book value of AHN, through Highmark’s enhanced strategic position and competitive profile, which will enable Highmark to compete effectively in retaining and attracting policyholders, and by lowering the cost to patients,

9/30/2015

both Highmark members and others, in the communities AHN serves. These actions will support Highmark's competitive profile in the market, allow continued patient access in Southwestern Pennsylvania to the high quality AHN providers and provide value to its policyholders through moderated cost growth of premiums.

As a result of our analysis and methodology described in detail in this Report, we conclude that to the best of our knowledge and belief that:

1. the Final CAP appears reasonable;
2. the Final CAP is sufficient to meet the Plan Objectives;
3. there will continue to be benefits to Highmark and its policyholders; and
4. the value assigned by Highmark Health and/or Highmark to Highmark's investment in AHN as presented to the PID is reasonable.

ASSESSMENT OF VALUE

Value

The June 19 Approval Letter calls for “an opinion as to the reasonableness of the value assigned by Highmark Health and/or Highmark to Highmark’s investment in AHN. In our opinion, the value of AHN to both Highmark and Highmark Health relates primarily to the role that AHN plays in allowing Highmark Health to function as an IDFS. The creation of the IDFS has allowed Highmark Health to provide the residents of Southwestern Pennsylvania, including Highmark’s policyholders, choice, competition and access.

VALUE TO HIGHMARK

The book value of AHN as of July 31, 2015, is \$181.0 million. As shown in the financial projections, AHN plans to increase book value by \$77.1 million through the projection period, to a value of \$258.1 million by December 31, 2017. The expected improvement of AHN’s financial position, including the various initiatives in the Final CAP appear reasonable.

VALUATION TESTING METHODOLOGY

The testing of Highmark Health’s stipulated value is based on the following accepted valuation methods:

- **Market Approach** – uses direct comparisons to other enterprises to estimate Fair Market Value. The market approach bases the Fair Market Value measurement on what other similar enterprises or comparable transactions indicate value to be. Two commonly used methods of the market approach include the Guideline Public Company Method (“GCM”) and the Precedent Transactions Method (“PTM”). Use of the GCM involves identifying and selecting publicly traded enterprises with financial and operating characteristics similar to the subject company being valued. Once publicly traded enterprises have been identified and selected, valuation multiples can be computed, adjusted for comparability, and applied to the subject company to arrive at an indication of value. The PTM involves a determination of valuation multiples from sales of business enterprises with similar financial and operating characteristics as the subject company and applying those multiples to the subject company to arrive at an indication of value.

In addition to the above, and to the extent a business's capital stock is actively and publicly traded on a recognized exchange, one may also consider the share price of such capital stock and the overall market capitalization value implied by the publicly traded value of such shares.

- **Income Approach** – sometimes referred to as the Discounted Cash Flow (“DCF”) method explicitly recognizes that the current value of an investment is premised on the expected receipt of future economic benefits such as periodic income, or sale proceeds. In valuing a business enterprise, indications of value are developed by discounting future net cash flows available for distribution to their present worth at a rate that reflects both the current return requirements of the market and the risk inherent in the specific investment.

The DCF method consists of estimating annual future cash flows and individually discounting them back to present value. If the cash flows continue beyond the foreseeable future, an estimate is made for the residual value of the business, which is then capitalized and discounted to the present value. The summation of the annual cash flows plus the residual value after capitalization and discounting indicates the current value of the business enterprise.

VALUATION, STUDIES, AND ANALYSES

Grant Thornton conducted studies, analyses, and due diligence we deemed necessary.

CONCLUSION – VALUE AT JULY 31, 2015

Based upon the documents reviewed, discussions with Highmark Health and AHN management and our performed procedures, it is our opinion that the value of Highmark's investment in AHN as presented to the PID in the Highmark Health consolidating balance sheet as of July 31, 2015, falls within a reasonable range of value and, therefore, is deemed to be reasonable.

Value – December 31, 2016 and December 31, 2017

Management's comprehensive PFI includes both a forecast balance sheet and cash flow statement. The forecast balance sheet reflects changes in the asset and liability accounts, as well as the impact of any positive or negative earnings on the net asset value. Grant Thornton reviewed the forecast balance sheets as a part of our overall review of management's forecast submitted to the PID. **Given the reasonableness of the PFI, the net asset value of \$282.9 million and \$258.1 million as of December 31, 2016 and December 31, 2017, respectively presents a reasonable estimate of investment value from a book value perspective.** We note that this value does not reflect the impact of any changes in the capital or financial markets.

In addition to the reasonable accounting treatment and book value of Highmark's investment in AHN, there is extensive strategic value in the IDFS strategy that Highmark and AHN both receive. This strategic value is both quantifiable (as in the IDN Savings Report) and non-quantifiable in terms of other components of the triple aim.

National Trends

Highmark's vertical integration strategy is consistent with trends observed nationally, in Pennsylvania and within the Pittsburgh market. Several organizations have operated successfully as integrated financing and delivery systems, including Kaiser Permanente, Dean Clinic, and Geisinger. UPMC has pursued a similar strategy by developing an insurance arm to further develop its market position in and around Pittsburgh. Among national examples of recent provider acquisitions by health insurers, United Health Group has purchased numerous physicians practices to develop portable care models to extend to other markets.

\$ in millions

	2014A	2015F	2016F	2017F
Assets				
Current assets				
Cash and cash equivalents	\$133.6	\$102.3	\$94.0	\$96.3
Short-term investments	102.7	21.5	22.7	22.7
Current portion of assets whose use is limited	12.6	12.4	12.4	12.4
Patient accounts receivable, net	237.8	258.7	244.8	247.3
Other receivables	80.7	53.0	54.1	54.8
Inventory, net	45.4	47.7	48.7	49.4
Prepaid expenses and other current assets	33.2	45.1	45.1	45.0
Total current assets	\$646.0	\$540.7	\$521.7	\$527.9
Unrestricted assets - board designated				
Temporarily restricted assets	18.8	19.4	19.5	19.6
Permanently restricted assets	264.2	268.5	268.6	268.8
Investments	145.5	249.6	257.4	182.4
Investments in affiliates	57.4	62.0	62.0	62.0
Property and equipment, net	997.2	1,071.8	1,090.1	1,090.0
Goodwill and other intangible assets, net	102.2	118.4	118.4	118.4
Other assets	114.4	111.7	113.7	111.7
Total assets	\$2,551.4	\$2,607.8	\$2,611.1	\$2,534.4
Liabilities and Net Assets				
Current liabilities				
Accrued salaries and benefits	\$95.3	\$98.8	\$98.8	\$99.3
Accounts payable and accrued expenses	207.6	219.6	222.1	224.6
Current portion of other liabilities	39.0	38.8	38.8	38.8
Total current liabilities	\$341.9	\$357.2	\$359.7	\$362.7
Long-term debt				
Benefit plan liabilities	426.3	379.8	333.9	286.9
Other long-term liabilities	222.1	214.5	214.5	212.0
Total liabilities	\$2,430.7	\$2,378.5	\$2,328.2	\$2,276.3
Net assets				
Unrestricted net (deficit) assets	\$(162.3)	\$(58.6)	\$(5.2)	\$(30.2)
Temporarily restricted net assets	18.8	19.4	19.5	19.6
Permanently restricted net assets	264.2	268.5	268.6	268.8
Total net assets	\$120.7	\$229.3	\$282.9	\$258.1
Total liabilities and net assets	\$2,551.4	\$2,607.8	\$2,611.1	\$2,534.4

2014 Consolidated Balance Sheet results contain reclassifications to conform to AHN internal financial statements.

409 North Second Street
Suite 500
Harrisburg, PA 17101-1357
T 717 237 4800
F 717 233 0852
www.bipc.com

Jack M. Stover
717 237 4837
jack.stover@bipc.com

October 30, 2015

VIA HAND DELIVERY

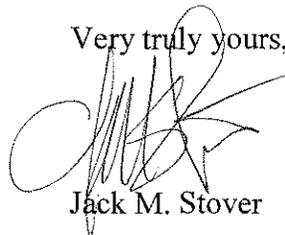
Mr. Stephen J. Johnson, CPA
Deputy Insurance Commissioner
Office of Corporate and Financial Regulation
Pennsylvania Insurance Department
1345 Strawberry Square
Harrisburg, PA 17120

Re: *Order No. ID-RC-13-06*
June 19, 2015 Approval Letter, Section III(D)

Dear Deputy Commissioner Johnson:

Pursuant to Section III(D) of the above-captioned Approval Letter, Highmark Health is filing with the Department the attached non-confidential Benchmark Report.

Very truly yours,



Jack M. Stover

JMS/gmt
Enclosure

cc: Lawrence J. Beaser, Esquire (via email: Beaser@BlankRome.com)
Eric Coburn (via email: Eric.Coburn@RaymondJames.com)

RECEIVED
Corporate & Financial Regulation
OCT 30 2015
Pennsylvania
Insurance Department

Allegheny Health Network
Consolidated Balance Sheet - UNAUDITED
September 30, 2015
(Dollars in Thousands)

	ACTUAL	CAP*
ASSETS		
Cash & Cash Equivalents	\$ 154,800	\$ 72,272
Net Patient Accounts Receivable	281,532	269,300
Other Receivables	54,881	61,732
Inventory, Net	50,211	47,100
Prepaid Expenses & Other Current Assets	37,545	45,120
Total Current Assets	<u>578,969</u>	<u>495,524</u>
Unrestricted - Board Designated Funds	168,844	175,620
Temporarily Restricted	18,590	19,400
Permanently Restricted	255,548	268,500
Total Assets Restricted As To Use	<u>442,982</u>	<u>463,520</u>
Property, Plant & Equipment - Net	1,018,482	1,045,702
Investments	263,283	278,400
Goodwill and Other Intangible Assets, Net	118,892	118,400
Other Assets, Net	153,473	173,700
Total Long-Term Assets	<u>1,554,130</u>	<u>1,616,202</u>
TOTAL ASSETS	<u>\$ 2,576,081</u>	<u>\$ 2,575,246</u>
LIABILITIES & NET ASSETS		
Accounts Payable and Accrued Expenses	\$ 257,543	\$ 219,600
Accrued Salaries and Benefits	103,411	98,800
Total Debt	1,426,639	1,427,925
Benefit Plan Liabilities	383,702	389,110
Other Liabilities	260,823	253,300
Total Liabilities	<u>2,432,118</u>	<u>2,388,735</u>
Unrestricted Net Assets	(130,175)	(101,389)
Temporarily Restricted Net Assets	18,590	19,400
Permanently Restricted Net Assets	255,548	268,500
Total Net Assets	<u>143,963</u>	<u>186,511</u>
TOTAL LIABILITIES & NET ASSETS	<u>\$ 2,576,081</u>	<u>\$ 2,575,246</u>

*Corrective Action Plan

UPMC'S UPDATED ANALYSIS OF VARIOUS HIGHMARK FILINGS AND DISCLOSURES

December 10, 2015

Highmark Health's decision to create an IDFS by acquiring failing hospitals has irrevocably damaged Highmark Insurance and is unsustainable.

As reflected in UPMC's May 4, 2015 statement to the Pennsylvania Department of Insurance ("PID") and the related addendum (the "UPMC Testimony"), UPMC estimated that Highmark's integrated health care delivery system (the "Highmark IDFS") operated at a run rate loss of **(\$375 million)** in 2013 and that this run rate loss ballooned to **(\$678 million)** in 2014. UPMC also estimated that nearly 50% of Highmark Insurance's \$3.8 billion Pennsylvania policyholder surplus was pledged or invested in the Allegheny Health Network ("AHN") on December 31, 2014.¹

Based on various public filings and recent events, UPMC now estimates that the Highmark IDFS operating run rate loss may have been more than **(\$800 million)** in 2014 and will be nearly **(\$750 million)** for 2015. In addition, this information indicates that 52% of Highmark Insurance's Pennsylvania policyholder surplus is now exposed to AHN credit risk. Highmark's Final Corrective Action Plan ("Final CAP") currently under review by the PID did not address these issues and actually confirmed that the value of Highmark Insurance's investments in AHN are **overstated by more than \$1.5 billion**. Finally, absent regulatory intervention as part of the Final CAP approval process, health care industry trends combined with the recent resolution of three issues governed by the 2014 Consent Decrees – although touted as victories by Highmark Insurance – will exacerbate the Highmark IDFS financial issues until an inevitable crisis occurs in the spring of 2019.

I. Highmark's IDFS may have operated at a run rate loss of greater than (\$800 million) in 2014, and that run rate loss remains at nearly (\$750 million) in 2015.

Neither the 2014 Audit nor the 2013 Audit that Highmark provided to the PID include any consolidating financial statements, let alone consolidating statements that would show the results of the Highmark IDFS in a transparent manner. In the absence of any sort of Highmark transparency, UPMC previously estimated an operating run rate by piecing together data from the 2014 Audit and the Highmark Inc. December 2014 bondholder disclosure. This calculation revealed that the Highmark IDFS experienced an operating run rate loss of **(\$678 million)** in 2014 (see **UPMC Testimony, Addendum, Figure 1**), which was a further degradation from its operating run rate loss of **(\$375 million)** in 2013 (see **UPMC Testimony, Addendum, Figure 2**).

On November 6, 2015, a panel of the American Arbitration Association found unanimously in favor of UPMC in binding arbitration regarding Highmark's unilateral reduction of oncology payments beginning in April 2014. The panel also concluded that Highmark acted in bad faith by attempting to implement this reduction, which Highmark called the "nuclear option." Although the arbitration involved Highmark's unilateral reductions at only one UPMC hospital, UPMC and Highmark agreed in advance that the panel's decision would apply to the Highmark reductions at all UPMC hospitals. Accordingly, the panel's award in favor of UPMC will require Highmark to pay UPMC in excess of \$200 million for the period from April 2014 through November 2015. Of that \$200 million award, approximately 2/3 of the amount is applicable to 2014 payments and 1/3 is applicable to 2015 payments. Based on Highmark Insurance's bondholder and statutory disclosures for September 2015, Highmark plans to pay about \$90 million of the award itself and to back-bill

¹ See attached UPMC Testimony of May 4, 2015.

its customers for the remaining \$110 million. Assuming the customer back-billing does take place, the Highmark IDFS 2014 operating run rate loss would further decline to **(\$738 million)**. If the customer back-billing does not occur, the 2014 operating run rate loss would exceed **(\$800 million)** (see **Figure 1**).

**Figure 1: UPMC’s Revised Estimate
of the Highmark IDFS Operating Run Rate for 2014**

(dollars in thousands)

Highmark IDFS Operating Run Rate from UPMC Testimony	(\$678,238)
Adjustment of (\$60,000) if Oncology Settlement is Partially Billed to Customers	(\$738,238)
Adjustment of (\$133,000) if Full Oncology Settlement is Paid by Highmark	(\$801,238)

UPMC estimated the Highmark IDFS operating run rate for 2015 based on the first three quarters of various Highmark financial disclosures using methods consistent with those described in the UPMC Testimony (see **Exhibit 1**). **Figure 2** below summarizes these results and shows that, if the fourth quarter is consistent with the third quarter, the Highmark IDFS operating run rate loss for 2015 will be nearly **(\$750 million)**.

**Figure 2: UPMC’s Estimate of the
Highmark IDFS Operating Run Rate for 2015**

(dollars in thousands)

First Quarter	(\$102,839)
Second Quarter	(\$212,211)
Third Quarter	(\$217,406)
Fourth Quarter	(\$217,406)
Total	(\$749,862)

II. More than 52% of Highmark Insurance’s \$3.8 billion Pennsylvania surplus is or will be pledged or invested in AHN. Additionally, this surplus is rapidly declining in spite of the PID-approved merger with Blue Cross of Northeastern Pennsylvania (“NEPA”).

As more fully detailed in the UPMC Testimony, Highmark has approached the PID on at least three separate occasions for permission to provide substantial additional funds to AHN since the Department’s Approving Determination and Order of April 29, 2013. **Figure 3** shows that, as of September 2015, Highmark has invested or committed to invest over \$2.4 billion in the creation of the Highmark IDFS. More than \$1.9 billion of that amount represents Pennsylvania policyholder surplus that is currently exposed to AHN’s credit or will be in the future.

Figure 3: Highmark’s Financial Commitments to AHN

EXPOSED POLICYHOLDER RESERVES	<u>December 2014</u>	<u>September 2015</u>
Loans to WPAHS	\$300,000,000	\$300,000,000
Term Loan Collateral	\$1,084,423,000	\$928,117,867
Jefferson Reg. Med. Center (“JPMC”) Liabilities	\$228,012,751	\$190,154,614
Existing HMPG Line of Credit	\$179,123,693	\$202,299,170
Existing EHR Loan	\$71,778,784	\$135,395,755
Subtotal:	\$1,863,338,228	\$1,755,967,406
FUNDS ALREADY SPENT		
JPMC Foundation	\$77,609,178	\$77,609,178
Sisters of St. Joseph	\$10,000,000	\$10,000,000
Forgiven Interest on Loans to WPAHS	N/A	\$11,780,137
AHN \$175 million Grant	\$0	\$43,700,000
WPAHS	\$175,000,000	\$175,000,000
JPMC Capital	\$62,720,000	\$79,110,000
St Vincent Health System	\$25,000,000	\$25,000,000
Subtotal:	\$350,329,178	\$422,199,315
FUTURE COMMITMENTS		
WPAHS Rate Increases	\$50,000,000	\$50,000,000
Future HMPG Line of Credit	\$45,376,307	\$22,200,830
Future EHR Loan	\$106,521,216	\$42,904,245
Future JPMC Capital Expenditures	\$37,280,000	\$20,890,000
AHN \$175 million Grant	\$175,000,000	\$131,300,000
Subtotal:	\$414,177,523	\$267,295,075
TOTAL FINANCIAL COMMITMENTS:	\$2,627,844,929	\$2,445,461,796

As shown in **Figure 4**, Highmark Insurance’s Pennsylvania policyholder surplus in June 2011 was more than \$4 billion. Highmark’s misguided strategic decision to build an insurance-centric IDFS drove it to make two major tactical errors: (1) increasing its financial commitments to AHN; and (2) aggressively pricing insurance products in an attempt to steer patient volume to AHN. As predicted by PID’s consultants in 2013, Highmark’s strategy has created significant financial stress for Highmark Insurance as evidenced by the nearly **(\$1 billion)** drop in Pennsylvania policyholder surplus since September 2014. This drop is even more precipitous because, as noted on the chart, it was mitigated in the last two quarters by the more than \$300 million of *added* surplus as a result of the merger with Blue Cross of Northeastern Pennsylvania (“NEPA”). This financial stress was verified in Highmark’s press release of August 2015 confirming the loss of **(\$318 million)** in the first six months of 2015 from its exchange products.

Figure 4: Highmark Insurance’s Pennsylvania Surplus and Current AHN Investments



III. Highmark Insurance’s Surplus is overstated by \$1.5 billion, according to the Final CAP.

The exposure of Highmark Insurance’s Pennsylvania policyholder surplus to AHN-related investments is over \$1.7 billion as reported in Highmark Insurance’s statutory statements of September 30, 2015. As part of its approving order for the \$175 million Grant Request, PID required Highmark to obtain a third-party valuation of these investments. **Figure 5** includes excerpts from the Final CAP that conclude that the “value of Highmark’s investment in AHN as presented to the PID” of \$181 million as of July 31, 2015 is “reasonable.” This valuation is more than \$1.5 billion *lower* than the amounts included in Pennsylvania policyholder surplus and likely represents a significant concern under Pennsylvania insurance regulations. The dashed blue line in **Figure 4** above shows that Highmark’s Pennsylvania policyholder surplus net of this AHN exposure is close to \$2 billion – or nearly one-half of what is shown on Highmark Insurance’s statutory statements.

Figure 5: Grant Thornton Valuation Excerpts from Final CAP

<i>Value</i>
<p>The June 19 Approval Letter calls for “an opinion as to the reasonableness of the value assigned by Highmark Health and/or Highmark to Highmark’s investment in AHN. In our opinion, the value of AHN to both Highmark and Highmark Health relates primarily to the role that AHN plays in allowing Highmark Health to function as an IDFS. The creation of the IDFS has allowed Highmark Health to provide the residents of Southwestern Pennsylvania, including Highmark’s policyholders, choice, competition and access.</p> <p>VALUE TO HIGHMARK</p> <p>The book value of AHN as of July 31, 2015, is \$181.0 million. As shown in the financial projections, AHN plans to increase book value by \$77.1 million through the projection period, to a value of \$258.1 million by December 31, 2017. The expected improvement of AHN’s financial position, including the various initiatives in the Final CAP appear reasonable.</p>
<p>VALUATION, STUDIES, AND ANALYSES</p> <p>Grant Thornton conducted studies, analyses, and due diligence we deemed necessary.</p> <p>CONCLUSION – VALUE AT JULY 31, 2015</p> <p>Based upon the documents reviewed, discussions with Highmark Health and AHN management and our performed procedures, it is our opinion that the value of Highmark’s investment in AHN as presented to the PID in the Highmark Health consolidating balance sheet as of July 31, 2015, falls within a reasonable range of value and, therefore, is deemed to be reasonable.</p>

IV. Burdened with a failing AHN and a dwindling insurance market presence, Highmark is immobilized into a lose-lose strategy.

Highmark planned to create an IDFS from its position as the dominant insurer in Western Pennsylvania by steering its subscribers, which then represented nearly 60% of the insurance market, to rebuild AHN primarily through inpatient admissions. National and local health care market forces, however, have confounded that strategy. Technology and market changes are dramatically reducing the need for hospital beds as reflected in declining inpatient admissions across the country. In addition, since 2011, the national insurers have firmly entrenched themselves in Western Pennsylvania, garnering about one-third of the insurance market share. Moreover, national insurers’ mergers will also have a negative impact on inpatient discharges as they manage utilization more aggressively. Lastly, UPMC is likely to be the largest insurance company in Western Pennsylvania in 2016 with a market share just over one-third. This, combined with the national insurers’ entry into the market, leaves Highmark with only one-half of the subscribers it planned to have to rebuild AHN.

The combination of many of Highmark’s tactics, including the failed introduction of its “no UPMC” Community Blue Medicare “bait-and-switch” products, irrationally aggressive pricing on exchange products in 2014, manipulation of the Continuity of Care provisions, and their “nuclear option” oncology fee reduction, will likely result in a **\$5 billion reduction** of Highmark’s annual revenue by 2016. Highmark’s dwindling market presence confirms the fundamental problem with its IDFS strategy from inception; Highmark cannot sell insurance without unimpeded access to UPMC and it cannot sustain AHN with unimpeded access to UPMC.

V. Recent events suggest that the Highmark IDFS financial desperation will peak before June 2019 from the contemporaneous end of the Consent Decrees and the \$700 million balloon payment within AHN's capital structure.

Three events have occurred over the last 60 days which, although touted to the public as “wins” by Highmark Insurance, will make the financial issues outlined above for the Highmark IDFS even worse because Highmark’s ability to get the needed patient volumes to AHN will be limited. These three events are:

- Arbitration of rates through June 30, 2019,
- Settlement agreements regarding Continuity of Care, and
- The Supreme Court’s decision on Medicare Advantage customers.

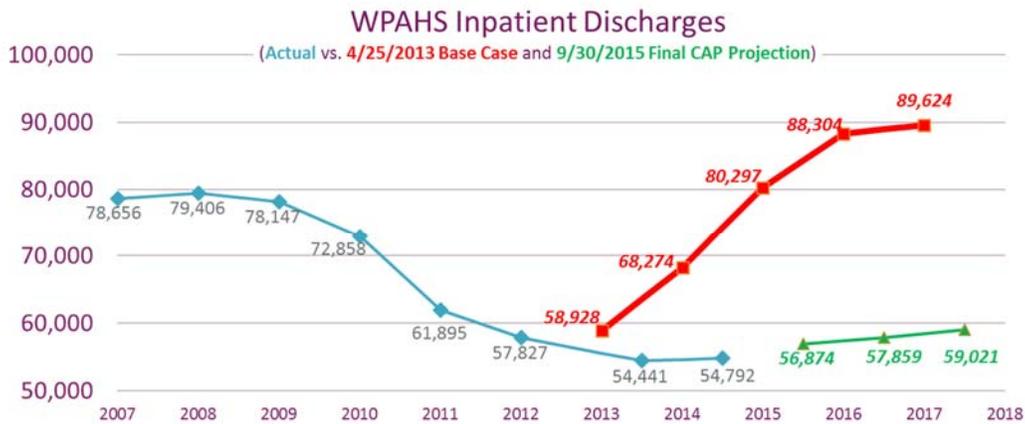
Rate Arbitration – UPMC and Highmark submitted best and final offers for in-network rates to a panel of arbitrators for the period from January 1, 2016 through June 30, 2019. After the arbitrators chose the Highmark offer over the UPMC offer, Highmark touted the outcome publicly as a “victory for the community,” claiming (as part of its bid to get its ASO customers to pay for the Oncology Settlement above) that it had obtained oncology rate reductions from UPMC. The actual rates included in Highmark’s “winning” offer as a whole are, in fact, market rates. Both the actual outcome of the arbitration and Highmark’s misleading suggestion that its members can now access UPMC oncology services at reduced rates undercut its strategy to rebuild AHN. As for the market rates Highmark must now pay, they limit the funds that Highmark has available to invest in AHN. And, as noted above, its marketing strategy – selling insurance by touting access to UPMC – only diminishes its members’ interest in seeking care at AHN.

Continuity of Care – UPMC and Highmark recently agreed to provisions guaranteeing broad in-network access to UPMC by Highmark subscribers in a continuing course of treatment with UPMC. That agreement reaffirmed that patients and their UPMC physicians – not Highmark – will make the initial determination as to whether the patient can continue to receive in-network care at UPMC. As above, Highmark’s marketing of this access to potential insurance subscribers and its members runs directly contrary to the needs of the Highmark IDFS to build patient volume at AHN.

Supreme Court Decision on Medicare Advantage – Finally, the recent Pennsylvania Supreme Court decision, which preserves in-network access to UPMC for Highmark Insurance’s Medicare Advantage subscribers, creates only more financial hurdles for the Highmark IDFS. In the unlikely event that Highmark maintains the 180,000 enrollees through the current enrollment period, those seniors’ unfettered freedom to receive care at UPMC further diminishes AHN’s prospects of a turn-around.

Figure 6 summarizes both the magnitude of the unsustainability of Highmark’s efforts to resurrect AHN and the fallacy of the Final CAP. The Final CAP provides PID with no actions – let alone corrective actions – that can be taken to reverse the use of policyholder surplus to sustain what was an unsustainable business decision by Highmark to create an insurance-centric IDFS.

Figure 6: Patient Volumes



As more fully described in the UPMC Testimony, in May 2014, the PID permitted Highmark Insurance to pledge Pennsylvania policyholder surplus as collateral for a loan from PNC and a group of other banks that shortened the maturity of West Penn Allegheny Health System’s (“WPAHS”) 2007 Bonds from the year 2046 to May 2019 – just one month before the end of the Consent Decrees. WPAHS currently has less than one-half the amount needed to repay this loan, needs some portion of that money to operate its business, is unlikely to be generating and accumulating excess cash at any time over the next three years as disclosed in the Final CAP, and is not scheduled to pay any principal on this \$700 million loan before its balloon maturity in May 2019. Consistent with Highmark’s tactics at the May hearing regarding the \$175 million AHN Grant request, Highmark will likely attempt to put PID in the position no later than the spring of 2019 to either agree to allow Highmark Insurance to pledge more of its Pennsylvania policyholder surplus as collateral for a new loan or, failing that, be blamed by Highmark for the demise of AHN.

VI. Conclusion

In the Final CAP, Highmark states that its long-term strategy is under review. Highmark’s strategy to date seems to have been a “political” one that does not focus on the promised rebuilding of AHN. Rather, Highmark’s strategy has been designed to villainize UPMC in the hopes of stoking government intervention to force a system-wide contract and otherwise diminish UPMC. Recent publications and remarks from Highmark regarding threats of yet another oncology lawsuit point to a continuation of their feckless strategy, which has backfired at every turn.

As discussed during the May hearing on the \$175 million AHN Grant and alluded to by Highmark in the Final CAP, downsizing or divesting AHN appears to be the only way to stem the Highmark IDFS losses and to reposition Highmark for its inevitable future as a significantly diminished insurance company and AHN as part of a smaller provider network in Western Pennsylvania. This option will not be viable very long and will be impossible as the end of the Consent Decrees approaches in 2019. The longer that Highmark is permitted to put good money after bad by spending its Pennsylvania policyholder surplus to pursue a failed strategy, the further limited its options become. As time passes, Highmark’s failed strategy poses not only increased risks for Highmark Insurance and its policyholders, but also presents a significant regulatory challenge to the PID and its consultants.

Exhibit 1
UPMC's Estimate of Highmark's IDFS Operating Run Rate
Table 1a - 3rd Quarter 2015

Dollars in thousands

	AA	BB	CC	DD
	CY2015 3Q Consolidated ⁴	Diversified	Insurance	AHN
Reported Net Income (Loss)	(\$133,429)	\$60,300	(\$162,200)	(\$31,529)
Reported Investment Income	\$7,949		\$17,400	(\$9,451)
BCNEPA Merger	\$0		\$0	
Other Adjustments	(\$31,224)		(\$33,200)	\$1,976
Operating Income (Loss) *	(\$172,602)	\$60,300	(\$212,800)	(\$20,102)
Non-Operating Expenses				\$0
Change in PDR			(\$24,200)	\$0
CY2014 Claims Adjustment			\$0	\$0
Tax Effect of ACA Fee ¹			(\$12,304)	\$0
Oncology Adjustment			\$90,000	\$0
CY2015 Oncology Adjustment			(\$10,000)	\$0
Risk Corridor Adjustment			(\$28,000)	\$0
Operating "Run Rate"		\$60,300	(\$197,304)	(\$20,102)
			3rd Quarter CY2015 Insurance and AHN Operating Run Rate Total:	(\$217,406)

Exhibit 1
UPMC's Estimate of Highmark's IDFS Operating Run Rate
Table 1b - 2nd Quarter 2015

Dollars in thousands

	AA	BB	CC	DD
	CY2015 2Q Consolidated ⁴	Diversified	Insurance	AHN ²
Reported Net Income (Loss)	\$123,313	\$51,300	\$61,000	\$11,013
Reported Investment Income	\$114,057		\$108,400	\$5,657
BCNEPA Merger	\$229,300		\$229,300	
Other Adjustments	\$22,209		\$41,100	(\$18,891)
Operating Income (Loss) *	(\$197,836)	\$51,300	(\$235,600)	(\$13,536)
Non-Operating Expenses				\$828
Change in PDR			\$58,400	\$0
CY2014 Claims Adjustment			\$0	\$0
Tax Effect of ACA Fee ¹			(\$12,304)	\$0
Oncology Adjustment			\$0	\$0
CY2015 Oncology Adjustment			(\$10,000)	\$0
Risk Corridor Adjustment			\$0	\$0
Operating "Run Rate"		\$51,300	(\$199,504)	(\$12,707)
			2nd Quarter CY2015 Insurance and AHN Operating Run Rate Total:	(\$212,211)

Exhibit 1
UPMC's Estimate of Highmark's IDFS Operating Run Rate
Table 1c - 1st Quarter 2015

Dollars in thousands

	CY2015 1Q Consolidated ³	Diversified	AHN				HMPG/OTHER ¹
			Insurance	WPAHS	JRMC	SVHS	
Reported Net Income (Loss)	\$110,181	\$77,100	\$54,000	(\$7,183)	\$3,931	(\$3,029)	(\$14,639)
Reported Investment Income	\$144,590		\$138,200	\$4,558	\$1,740	\$1,241	(\$1,149)
BCNEPA Merger	\$0		\$0				
Other Adjustments	\$31,803		\$25,600	\$2,001	\$1	\$364	\$3,837
Operating Income (Loss) *	(\$2,607)	\$77,100	(\$58,600)	(\$9,740)	\$2,192	(\$3,906)	(\$9,653)
Non-Operating Expenses ¹							(\$828)
Change in PDR			\$0				\$0
CY2014 Claims Adjustment			\$0				\$0
Tax Effect of ACA Fee ¹			(\$12,304)				\$0
Oncology Adjustment			\$0				\$0
CY2015 Oncology Adjustment			(\$10,000)				\$0
Risk Corridor Adjustment			\$0				\$0
Operating "Run Rate"		\$77,100	(\$80,904)	(\$9,740)	\$2,192	(\$3,906)	(\$10,481)
1st Quarter CY2015 Insurance and AHN Operating Run Rate Total:							(\$102,839)
Annualized CY2015 Insurance and AHN Operating Run Rate Total:							(\$749,861)
<i>(Equal to 1st Quarter Results plus 2nd Quarter Results plus 2x 3rd Quarter Results)</i>							

*For this estimate, Interest expense is included in the calculation of operating income (loss).

¹ Represents one-quarter of CY2014 results

² Represents the nine-month published results less 3rd quarter published results less our estimate for 1st quarter

³ Represents the sum of published results for Highmark Inc., St. Vincent, Jefferson & WPAHS plus the estimate discussed in footnote #1 for HMPG/Other

⁴ Represents the sum of published results for Highmark Inc. & AHN

Note: The summation of our 1st and 2nd quarter Operating Income differs from the six-month results published in the 6/30/15 Press Release by < \$3M