



# BlueCross of Northeastern Pennsylvania

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November 9, 2004

Ms. Sandra L. Ykema, Esquire  
Pennsylvania Insurance Department  
1341 Strawberry Square  
Harrisburg, PA 17120

Re: October 21, 2004 Inquiries Regarding Previous Submissions

Dear Ms. Ykema:

Hospital Service Association of Northeastern Pennsylvania, d/b/a Blue Cross of Northeastern Pennsylvania ("BCNEPA") is in receipt of your October 21, 2004, letter ("October 21 Letter"), wherein you posed several inquiries regarding information previously provided by BCNEPA to the Insurance Department ("Department") relating to BCNEPA's surplus. This letter responds to the October 21 Letter.

Please be advised that BCNEPA asserts confidentiality protection for this response of its exhibits based in part upon the Order from Judge Pellegrini issued on July 21, 2004, requiring that certain portions of the submission by BCNEPA be maintained by the Insurance Department in a confidential basis until further order of court. Other information is confidential under applicable law. Per our discussions with the Department, we are submitting herewith a version of this response, redacted consistently with the Judge's Order and applicable law. It is our understanding that only the redacted version will be made publicly available by the Department.

1. For each year from 1993 to 2003, please specify, separately, the amount of Pennsylvania premium tax, Pennsylvania corporate net income tax and federal income tax paid by each of the following corporations:
  - a. Hospital Service Association of Northeastern Pennsylvania
  - b. HMO of Northeastern Pennsylvania

The following table reflects the tax liability of Hospital Service Association of Northeastern Pennsylvania d/b/a Blue Cross of Northeastern Pennsylvania (BCNEPA) and HMO of Northeastern Pennsylvania d/b/a First Priority Health (FPH) for 1993 through 2003 (in millions of \$):

	<u>BCNEPA</u>	<u>FPH</u>
PA Premium Taxes	Not Applicable	Not Applicable
PA Corporate Net Income Taxes	Not Applicable	Not Applicable
Federal Income Tax Paid (Refunded)		
1993	\$ 13.2	\$ 2.9
1994	9.5	0.3
1995	9.2	2.2
1996	8.1	(5.0)
1997	13.4	(8.0)
1998	17.8	(11.2)
1999	9.4	(14.3)
2000	10.6	(8.0)
2001	6.5	10.5
2002	5.9	(0.4)
2003	1.0	-
Total	\$ 104.6	\$ (31.0)

BCNEPA is exempt from taxation by the Commonwealth and its political subdivisions pursuant to 40 Pa. C.S.A. Section 6103 as it is a hospital plan corporation.

HMO of Northeastern Pennsylvania is a Pennsylvania nonprofit health maintenance organization and, similar to other nonprofit HMOs operating in Pennsylvania, is exempt from premium taxes or income taxes in the Commonwealth. However, HMO of Northeastern Pennsylvania is a wholly-owned subsidiary of BCNEPA and is included in the consolidated federal income tax return of BCNEPA.

- 2. In your application, you stated that employee volunteerism was part of the satisfaction of your social mission. For those hours/dollars for which you claim credit, identify: (a) the activities performed; (b) which of those hours were during normal business hours, or in lieu of normal business hours; and (c) which of those hours were compensated as regular hours worked.**

Blue Cross and its employees are committed to their communities in northeastern and north central Pennsylvania and strive to make positive differences in those communities through the BCNEPA employee volunteer program. The volunteer time is provided to nonprofit, charitable organizations in northeastern and north central Pennsylvania, including the United Way and its "Day of Caring" program where volunteers from BCNEPA participate in projects that benefit the organizations served by the United Way. Among other things, time is volunteered to soup kitchens, assisting the homeless, working with food banks, providing gifts for needy children, providing services to the elderly, along with facility maintenance that includes painting, site clean-up, planting trees and shrubs. Approximately 3,000 hours of volunteer work were performed during the past two years. The volunteered time took place during normal business hours, and the employees were compensated at their respective individual rates.

- 3. On page 00219 of your application, you provided dollar figures for amounts of "premium tax forgiveness" utilized to produce lower premium rates. Explain how these amounts were calculated.**

The value of BCNEPA's premium tax exemption is passed on, dollar for dollar, as savings to its non-group subscribers. [REDACTED] As a nonprofit hospital plan corporation BCNEPA is exempt from state taxation, and subscribers get the direct benefit of those savings.

BCNEPA calculated the amount of premium tax forgiveness as follows:

- (1) Non-group premium rates approved by the Department were multiplied by the number of contracts in force for 2003 and 2002 to arrive at annual premium revenue that would have been subject to premium tax [REDACTED] had BCNEPA been organized as a Pennsylvania for-profit taxable insurance company.
- (2) The annual premium revenue was multiplied by the premium tax rate of 2% to arrive at an estimate of the premium tax assessment that would have been paid by BCNEPA and passed on to non-group customers in their premium rates had BCNEPA been organized as a Pennsylvania for-profit taxable insurance company [REDACTED]

- 4. Please calculate and set forth the surplus and authorized control level risk-based capital of your corporation and all Pennsylvania domestic health plan corporations, health maintenance organizations and insurance companies that you own or control, directly or indirectly, for the years 2002 and 2003. Calculate and set forth the surplus and authorized control level risk-based capital on a: (a) parent company alone basis, and (b) consolidated parent and subsidiary basis. Describe, in detail, the methodology used to compute the surplus and authorized control level risk-based capital on both a parent alone basis and a consolidated parent and subsidiary basis.**

Surplus and authorized control level risk-based capital ("ACL") amounts for the years ending December 31, 2003, and 2002, for Blue Cross of Northeastern Pennsylvania (BCNEPA), First Priority Health (FPH), and First Priority Life Insurance Company (FPLIC) as reflected in each entity's respective Annual Statement filed with the Department are summarized below:

<u>Entity</u>	<u>2003</u> <u>(In Millions of \$)</u>		<u>2002</u> <u>(In Millions of \$)</u>	
	<u>Surplus</u>	<u>ACL</u>	<u>Surplus</u>	<u>ACL</u>
[REDACTED]				

Surplus was calculated in accordance with statutory accounting practices prescribed or permitted by the Commonwealth of Pennsylvania and in accordance with the National Association of Insurance Commissioners ("NAIC") *Accounting Practices and Procedures Manual*, which has been adopted as a component of prescribed or permitted practices by the Commonwealth. ACL was calculated in accordance with the *NAIC Health Risk-Based Capital Report Including Overview and Instructions for Companies Manual* ("NAIC RBC Manual").

NAIC accounting and reporting practices do not prescribe procedures to calculate surplus and ACL on a (a) parent company alone basis and (b) consolidated parent and subsidiary basis.

Nevertheless, to comply with the Pennsylvania Insurance Department's request for such items, BCNEPA has calculated the amounts utilizing the following methodology:

Statutory surplus for each of BCNEPA's insurance subsidiaries, FPH and FPLIC, was calculated and removed from the statutory surplus of the parent, BCNEPA, to arrive at BCNEPA stand-alone surplus. The removal of affiliate surplus from the parent is essential because statutory accounting practices require the parent to report surplus for both itself and its subsidiaries as an all-inclusive amount on the parent's statutory report.

ACL for each of BCNEPA's insurance entities BCNEPA, FPH and FPLIC was calculated exclusive of any affiliate risk. The exclusion of affiliate risk is necessary to report stand-alone ACL for each insurance company.

The individual company surplus amounts and ACL amounts were aggregated in the consolidated total. The resulting individual company and consolidated surplus and ACL amounts are reflected in the table below:

<u>Entity</u>	<u>2003</u> <u>(In Millions of \$)</u>		<u>2002</u> <u>(In Millions of \$)</u>	
	<u>Surplus</u>	<u>ACL</u>	<u>Surplus</u>	<u>ACL</u>
[REDACTED]				

**5. For each type of “social mission activity” or charitable or community contributions you identified in your response to the Department’s January 5, 2004, letter subparagraph (d), explain your rationale for considering that type of activity or contribution as part of your social mission and/or your statutory designation as a charitable and benevolent institution.**

BCNEPA pursues its mission of “Making Better Health Easier,” a mission that focuses on its customers and provides for healthy outcomes, access to medical care, and service excellence at the most affordable premium cost. In regard to the “Description of Social Mission Activity” as provided in attachment 19 to the March 22, 2004, letter to the Department, the following is our rationale for including each of the items listed<sup>1</sup>:

Reserve Appreciation Credit

Reserve Appreciation Credits have significantly reduced premium rates for the past four years and represent a key element of BCNEPA’s surplus management strategy. Surplus is directed for the benefit of subscribers, and health care insurance is made more affordable.

Premium credits for underwritten customers and premium equivalent reductions for self-funded customers allow for a more affordable health care product to group subscribers in the service area. In returning surplus to subscribers, a focus is on our customers and not the bottom line. Unlike commercial, for-profit public insurers that concentrate on shareholder return, BCNEPA has utilized its strong financial position and nonprofit status for the direct benefit of its members.

Surplus Funded Initiatives

The pricing impact of costly government compliance and infrastructure investments are mitigated in customer’s premiums as BCNEPA funds these initiatives from its surplus as part of its ongoing surplus management plan.

BCNEPA recognizes that improvements in information technology capabilities and compliance with new federal mandates come with significant costs. Understanding the impact that these expenses may have on the total cost of health insurance to its members, BCNEPA funds these one-time, non-recurring initiatives through its surplus. By not passing these costs along to customers, we are able to keep service levels high and premiums lower.

Investment Income Credit

100% of interest and dividend income earned is applied to reduce customer’s premiums.

When calculating the premiums charged to customers, BCNEPA applies a credit to rates equal to 100% of the interest and dividend income earned by the company’s investments. Whereas for-profit competitors may consider interest and dividends to be a contributor to bottom-line profits, BCNEPA uses these sources of funds to directly reduce premium rates to our customers.

Subsidized Products

Individual, non-group products are offered at less than cost through significant subsidization.

In an effort to keep premiums affordable, BCNEPA provides insurance to the non-group, individual market that is significantly lower than the cost of the product.

[REDACTED]

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<sup>1</sup> “Social mission” is not defined in the Hospital Plan Corporations Act (40 P.S. §6101 et seq.) or in the Pennsylvania Nonprofit Corporation Law of 1988, as amended, 15 PA.C.S. §5301 et seq. Furthermore, the Department did not define “social mission” in the January 5, 2004 Letter or the January 17, 2004 Bulletin Notice.

Additionally, administrative expenses charged to individual customers in their rates are also lower than our actual costs. Taken together, these subsidies contribute significantly toward a more affordable premium for BCNEPA's customers.

Blue Ribbon Foundation

Initiatives sponsored by the Blue Ribbon Foundation will improve the health of the communities in northeastern and north central Pennsylvania and lead to more affordable health insurance.

BCNEPA recognizes that it is in the best interest of all constituencies to promote better health for residents of our 13-county service area, customers and non-customers alike. The intent of the Blue Ribbon Foundation is to fund innovative programs that will improve the health and wellness of our communities, which will improve the quality of one's life. This will ultimately reduce the costs of medical care and, in the long run, result in more affordable health insurance.

Caring Foundation

BCNEPA and Highmark use the Caring Foundation to administer the Children's Health Insurance Program (CHIP) in BCNEPA's 13-county service area in Pennsylvania, providing health care benefits to the children of needy families. This program provides coverage to children at little or no cost to the parents. Those children, who otherwise would likely be uninsured, are thereby afforded access to care and wellness in accordance with our corporate mission.

Premium Tax Forgiveness

Insurers generally need to cover all of their expenses in their insurance rates, including taxes of any kind. Because BCNEPA is exempt from paying premium taxes, we are able to pass those savings on to the non-group, individual customers through lower premiums. Improved affordability and access to care are both byproducts of the premium tax exemption.

Community and Other Programs

Approximately 1,000 people are employed by BCNEPA and encouraged to participate in volunteer service that supports nonprofit charities focused on health, human services, families, children and education. Employee participation promotes the image and mission of BCNEPA as a good corporate citizen, interested more in the health and well-being of all residents of northeastern and north central Pennsylvania than in providing returns to shareholders.

6. If you identified one or more foundations in your response to the Department's January 5, 2004, letter subparagraph (d) specify:
- a. any and all expenses that the foundation(s) pay for CHIP, adultBasic or any other state or government funded program;
  - b. what role, if any, the foundation(s) play in handling claims arising from CHIP, adultBasic or any other state or government funded program.

The Blue Ribbon Foundation of Blue Cross of Northeastern Pennsylvania (Blue Ribbon Foundation) was formed in 2001 under section 501(c)(3) of the Internal Revenue Code and operates within 13 counties of northeastern and north central Pennsylvania. Its purpose is to serve as a catalyst for change by funding innovative programs targeted at improving the health and wellness of the communities we serve. Success of the Blue Ribbon Foundation will enhance one's quality of life as well as help make healthcare more affordable by lowering the rate of growth in future health care costs. The Blue Ribbon Foundation does not pay any expenses for CHIP, adultBasic or any other state or government funded program, nor does it play any role in handling claims for these programs.

The Caring Foundation of Northeastern Pennsylvania (Caring Foundation) administers the Children's Health Insurance Program (CHIP) in BCNEPA's 13 county service area. Organized under 501(c)(3) of the Internal Revenue Code, its purpose is to promote primary health care for the children of those unemployed or underemployed families who are not eligible to participate in publicly funded programs and are unable to purchase private health insurance. The Caring Foundation provides coverage for approximately 11,000 children in northeastern and north central Pennsylvania. The Caring Foundation does not pay any administrative expenses directly. All administrative expenses of the Caring Foundation are incurred and paid for by BCNEPA and Highmark Blue Shield, the sole members of the Caring Foundation. The Caring Foundation receives funding from the Commonwealth and utilizes the funds to purchase health care coverage from HMO of Northeastern Pennsylvania and Highmark Blue Shield. The Caring Foundation does not play any role in handling CHIP claims or claims of any other state or government funded program.

7. For each year from 1998 to 2003, and for the first six months of 2004, provide a specific accounting of any and all direct or indirect premium or other subsidies that you or your subsidiaries have provided for all individual, senior, or group health insurance products including, but not limited to, CHIP, adultBasic, Special Care, and group conversion products. For each subsidy:

7(a) identify the manner in which the premium or other subsidy is apportioned among the expenses or payments associated with the product, including, but not limited to, administrative expenses and underwriting losses;

From 1998 through 2004 BCNEPA/FPH have extended to its non-group subscribers over \$46 million of subsidies to make health insurance more affordable. Listed below is a chart reflecting the dollars applied to the non-group products:

	Security 65	Basic Blue Cross Non Group	Special Care	Major Medical Non Group	FPH: Blue Chip	Adult Basic	Total
1998							
1999							
2000							
2001							
2002							
2003							
2004 - estimated							
Grand Total							

[REDACTED]

Items 1 through 3, below, describe the various subsidies pertaining directly to the non-group products.

7(a)(1) Non-group subsidies – direct reduction of premium rates for our Medigap supplemental products, individual products, Special Care and conversion products

**REDACTED**

The subsidy credit is applied to the entire premium and is not apportioned between administrative expenses or medical care costs. The following table lists the subsidy dollars applied based upon rate approval from the Department:

Non-group Subsidy Dollars : (In thousands of \$)

	Security 65	Basic Blue Cross Non Group	Special Care	Major Medical Non Group	FPH: Blue Chip	Adult Basic	Total
1998							
1999							
2000							
2001							
2002							
2003							
2004 - estimated							
Grand Total							

[REDACTED]

7(a)(2) Administrative expense subsidies – the difference between the actual administrative expenses incurred by BCNEPA and FPH compared to the expenses approved by the Department in rating filings for various non-group products.

Subsidy Dollars : Actual administrative costs vs PID approved used to set Premium Levels (In thousands of \$)

	Security 65	Basic Blue Cross Non Group	Special Care	Major Medical Non Group	FPH: Blue Chip	Adult Basic	Total
1998							
1999							
2000							
2001							
2002							
2003							
2004 - estimated							
Grand Total							

[REDACTED]

7(a)(3) Plan Surplus Subsidy – represents further rate reductions in non-group premium rates initiated by BCNEPA and funded through the use of plan surplus.

Subsidy Dollars : Use of Plan Surplus in PID approved Premium (in thousands of \$)

	Security 65	Basic Blue Cross Non Group	Special Care	Major Medical Non Group	FPH: Blue Chip	Adult Basic	Total
1998							
1999							
2000							
2001							[REDACTED]
2002							
2003							
2004 - estimated <sup>1</sup>							
Grand Total							

7(a)(4) Other Subsidies - To maintain the ability to operate as a viable insurance entity, BCNEPA is required to invest in information technology capabilities, to comply with new state and federal mandates (i.e., HIPAA), and is subject to one-time, extraordinary charges. Management and the Board of Directors evaluate the impact these investments and expenses may have on insurance rates and frequently elect to fund the projects through application of surplus, rather than insurance rates. The following table reflects the dollars funded through plan surplus (in thousands of \$):

2001	
2002	
2003	[REDACTED]
2004 - Forecast	
Total	

7(a)(5) Reserve Appreciation and Rate Mitigation Credits - Beginning in 2001, BCNEPA began applying a direct credit to groups renewing to help mitigate the impact of rising health care costs.  
[REDACTED]

At the end of 2003, BCNEPA instituted the "Rate Mitigation Strategy" to further help group customers as health care costs continued to increase. Instead of a credit in the 2004 group rate renewals, BCNEPA removed any contribution to reserve, tax and risk charges that would have been a normal part of a group rate.

[REDACTED]

<sup>1</sup> In December 2003, the Department did not approve the rate increases requested by BCNEPA; accordingly the premium deficits for Blue Cross and Major Medical Non-group products were funded by BCNEPA surplus.

Listed below are the subsidy amounts associated with the Reserve Appreciation Credit and Rate Mitigation Strategy which were funded directly out of surplus (in thousands of \$):

	<u>BCNEPA</u>	<u>FPH</u>	<u>Total</u>
2001			
2002			
2003			
2004 - Forecasted			
Total			

[REDACTED]

**7(b) specify the actual amount of the expenses or payments associated with the product, including, but not limited to, CHIP, adultBasic, Special Care, and group conversion products;**

Part 1 - Actual claims expense for subsidized products in (thousands of \$)

	Security 65	Basic Blue Cross Non Group	Special Care	Major Medical Non Group	FPH: Blue Chip	Adult Basic	Total
1998							
1999							
2000							
2001							
2002							
2003							
2004 - Forecasted							
Grand Total							

[REDACTED]

Part 2 - Actual administrative expense for subsidized products (in thousands of \$)

	Security 65	Basic Blue Cross Non Group	Special Care	Major Medical Non Group	FPH: Blue Chip	Adult Basic	Total
1998							
1999							
2000							
2001							
2002							
2003							
2004 -Forecasted							
Grand Total							

[REDACTED]

Total Claims and Administrative Expenses

	Security 65	Basic Blue Cross Non Group	Special Care	Major Medical Non Group	FPH: Blue Chip	Adult Basic	Total
1998							
1999							
2000							
2001							[REDACTED]
2002							
2003							
2004 - Forecasted							
Grand Total							

**7(c) specify whether those expenses or payments were covered under the terms of the contracts for each product;**

Under our contracts with the Commonwealth of Pennsylvania, our filed FPH Blue Chip and Adultbasic administrative costs are limited to 10% of developed premium.

**7(d) delineate the source of any and all premium or other subsidies, as apportioned;**

For the non-group subsidies noted previously in 7(a)(1), the sources are as follows:

[REDACTED]

For the subsidies noted in responses 7(a)(2) through 7(a)(5), the funding source is BCNEPA's surplus.

**7(e) chart the flow of monies from all products that contributed monies for premium or other subsidies to all products that received rate subsidies**

Listed below is a summary of the flow of subsidy dollars being transferred from our group business to non-group business:

[REDACTED]

**7(f) explain the formula by which you calculate any and all premium or other subsidies for each product**

Below is the formula filed and approved with the department pertaining to the calculation of the non-group subsidies generated from our commercial group business.

[REDACTED]

The subsidy amounts are allocated to the products as follows:

A.

[REDACTED]

B.

- 8. **For each year from 1998 to 2003, and for the first six months for 2004, specify, by county and by company name, the number of lives you covered for any and all products and ASO and ASC services provided by you or your subsidiaries in the Commonwealth of Pennsylvania. For each county, include the total number of lives covered for all products and ASO and ASC services and break out the number of lives covered by each particular product and ASO and ASC, service you provide in the county. Include the number of lives in any county that are covered by a product that you offered jointly with another Pennsylvania Blue Plan. For each such product you offered jointly with another Pennsylvania Blue Plan, specify the total number of lives covered and the identity of the other Pennsylvania Blue Plan.**

An analysis of BCNEPA members by counties within our service area is contained in exhibits A-1 through A-8 for the period 1998 through June 2004. The exhibits reflect enrollment for Blue Cross and First Priority Health. First Priority Life Insurance Company has not initiated operations and currently has no enrollment.

Blue Cross membership is reflected for four products: Traditional, Access Care, Comprehensive Major Medical, and 65 Special. These four Blue Cross products are jointly offered with Highmark Blue Shield in our 13 county service area. The products are further categorized by Group Fully Insured, Non-group Fully Insured, and Group Self-Funded. The Group Self-Funded represents BCNEPA's ASO business.

First Priority Health membership is reflected in two products: FPH HMO and FPH POS. The two First Priority Health products are solely offered by FPH in our thirteen county service area. The products are further categorized by Group Fully Insured, Non-group Fully Insured, and Group Self-Funded. The Group Self-Funded represents FPH's ASO business.

Membership associated with Erin Group Administrators, Inc. (EGA), a Third Party Administrator wholly owned by BCNEPA is shown on exhibit B-1 by county.

- 9. **Specify what, if any, arrangements your corporation has made for the protection of its policyholders or members in the event that your corporation becomes insolvent.**

[REDACTED]

BCNEPA also has hold harmless provisions in its provider contracts which preclude a contracted provider from seeking payment from a subscriber should BCNEPA become insolvent.

**10. Specify what, if any, arrangements your corporation has made with other Pennsylvania Blue Plans for the payment of claims submitted by its policyholders and members.**

BCNEPA has made no arrangement with the other Pennsylvania Blue Plans for payment of claims submitted by its policyholders or members. We rely on our strong financial position to maintain an ability to meet subscribers' claims obligations.

**11. Explain the reasons you believe your corporate structure is advantageous to your statutory mission as a health insurer. Stated differently, what is the advantage, if any, to your policyholders of the corporate structure you have created. Your discussion should include specific comment with regard to advantages engendered by your investment in other than health insurers and also in for-profit entities.**

BCNEPA's nonprofit orientation creates a management and operating environment that is conducive to community awareness and focus. To fulfill its mission to the communities in northeastern and north central Pennsylvania, BCNEPA has initiated efforts to develop new products and innovative programs over the past couple decades that have necessitated the formation of an expanded BCNEPA corporate structure. Despite its more complex form, BCNEPA's corporate structure still operates within the framework of its original not-for-profit mission.

BCNEPA's organizational structure is relatively simple. BCNEPA 100% owns or controls only three operational direct subsidiaries and one operational indirect subsidiary. Additionally, BCNEPA owns 100% of a subsidiary that will become operational shortly and controls a 50% interest in another entity. An organizational chart showing these six subsidiaries ("Subsidiaries") is attached hereto (exhibit C).<sup>1</sup>

One Subsidiary is a nonprofit Pennsylvania domestic HMO: HMO of Northeastern Pennsylvania, Inc. Another Subsidiary is a for-profit Pennsylvania domestic life insurance company: First Priority Life Insurance Company, Inc. The Subsidiaries include two nonprofit 501(c)(3) foundations: The Caring Foundation of Northeastern Pennsylvania (controlled 50% by BCNEPA) and The Hospital Service Association of Northeastern Pennsylvania Foundation (a/k/a the Blue Ribbon Foundation). Universal Managed Care, Inc. is a for-profit Pennsylvania general business corporation that operates as the holding company for Erin Group Administrators, Inc. (EGA). EGA operates as a third party administrator (TPA) in Pennsylvania.

BCNEPA was formed as a hospital plan corporation and has been offering traditional indemnity products since its inception. Its not-for-profit status allows a community, and not shareholder, focus, and, as such, BCNEPA has been granted exemption from state premium and income taxes. However, as a hospital plan corporation, BCNEPA is subject to regulatory constraints that escape other commercial insurers in Pennsylvania. These include the rate filing and approval process along with required participation in government sponsored programs. While exemption from state taxation can provide immediate benefit to consumers in the way of more affordable pricing, onerous regulatory requirements can add costs and mitigate such savings.

From its inception to 1986, BCNEPA operated as an insurance company within the Commonwealth and was also exempt from federal income taxes. With tax legislation adopted in 1986, congress recognized the nature of Blue Cross Blue Shield Plans as being predominantly in

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<sup>1</sup> While BCNEPA owns other entities, all of these other entities are either not operational, or are in the process of being wound down. Specifically, Universal Managed Care, LTD, Universal Managed Care Holding Company, Inc. and Eastern Physicians Group, P.C. (all for-profit entities) are currently in the process of being wound down. Eastern American Casualty Insurance Company, a for-profit Pennsylvania domestic insurer, has not commenced operations.

the business of commercial insurance and, as such, revoked its tax-exempt status to create a more level playing field with its commercial, for-profit counterparts. Clearly not a charitable organization, BCNEPA has paid its fair share of income taxes to the federal government.

Product differentiation is important not only from the perspective of BCNEPA's financial stability, but also to assure BCNEPA's policyholders and subscribers have access to a full array of insurance products. Providing a choice of products benefits consumers, who may then select the specific type of health plan that is most suitable to the consumer's needs and desired level of expenditure. Expanded product choices are currently available under HMO of Northeastern Pennsylvania and future product offerings will exist under First Priority Life Insurance Company, Inc.

HMO of Northeastern Pennsylvania (HMO) was formed in 1986 as a not-for-profit health maintenance organization to expand BCNEPA's product offerings beyond traditional indemnity products. While intending to provide consumers with greater choice in meeting their health care needs through HMO and POS products, regulations within the Commonwealth required the managed care company be formed as a separate legal entity. Faced with many of the same regulatory hurdles as BCNEPA, HMO bore the added costs of maintaining its own infrastructure. A more flexible environment that would permit the HMO to operate as a sister product to BCNEPA's products would be more cost effective and beneficial to the marketplace. BCNEPA would continue to advocate for such change. Finally, while mitigating the adverse impact to customers of income taxes that would necessitate higher premium prices to the market, HMO's non-profit status restricts the flow of capital between the parent (BCNEPA) and HMO. The inability to move capital inhibits future business development.

First Priority Life Insurance Company, Inc. (FPLIC) is anticipated to be operational during 2005 and will offer the non-gatekeeper PPO products that are currently written by BCNEPA. First Priority Life is a stock for-profit company. FPLIC's for-profit designation permits the company to operate on a similar basis with competitors in the same market, providing a less onerous regulatory environment than that which would exist if the PPO products were offered within BCNEPA. Also, similar to commercial insurance companies, FPLIC will be subject to premium taxes on revenues it collects. It is anticipated that First Priority Life's earnings over time will contribute positively to the financial condition of BCNEPA and further BCNEPA's not-for-profit mission. Unlike HMO, FPLIC's for-profit designation provides a means to distribute those earnings to the parent (BCNEPA).

Diversification is a key component to an insurer's financial stability. BCNEPA serves a 13-county area in northeastern and north central Pennsylvania. Accordingly, its ability to achieve geographical diversification is limited. BCNEPA's business, and its financial condition, is directly affected by the economic issues, health risk factors, and usage patterns which are unique to its service region, to name just a few of the realities that confront a hospital service plan that serves within a designated locale. Accordingly, business prudence dictates that BCNEPA seek to obtain appropriate diversification in ways other than geographical diversity. Diversification provides an avenue for BCNEPA to experience business growth, enabling any associated profitability and qualitative benefits to be channeled and applied to its core health insurance business within the service area. With limited opportunity to spread fixed costs across a declining population within the service area, it is essential that BCNEPA have such a venue to either spread those costs external to the service area or import external profitability to defray them.

To this end, BCNEPA owns 100% of Universal Managed Care, Inc., which in turn owns 100% of EGA, a for-profit TPA operating in Pennsylvania. To the extent that Erin Group is profitable, it is anticipated that its service fee income will provide a source of income to BCNEPA, and contribute positively to BCNEPA's financial condition. Further, ownership of Erin Group provides a benefit to those consumers who wish to use the services of a TPA to manage the self-insured portion of

their health care plans. EGA is subject to corporate income taxes within the commonwealth. Despite its for-profit status, EGA 's management and profits are contained within the not-for-profit umbrella of its ultimate parent, BCNEPA.

Finally, the two Foundations further BCNEPA's mission in several ways. First, the Foundations provide a vehicle to which BCNEPA can contribute money and in-kind services, in fulfillment of BCNEPA's statutory role as a nonprofit, community-focused organization. Second, the two Foundations fulfill BCNEPA's stated mission of making better health easier. The Caring Foundation provides the opportunity to afford quality health insurance for children of working families who otherwise could not afford it. The Blue Ribbon Foundation invests in health and quality-of-life initiatives in the communities served by BCNEPA. The Blue Ribbon Foundation's grants are focused on three clearly defined areas: health and human services, children and families health issues, and health education. Targeted funding is expected for areas such as cancer, heart disease, drug, alcohol, and tobacco dependency, end of life care, and mental illness. Clearly, the Foundation's efforts to (i) improve practices that impact the quality, efficacy and cost-effectiveness of health outcomes, (ii) promote research, medical advancements and community, provider and individual education programs, and (iii) support prevention, intervention and wellness programs are all appropriate to BCNEPA's mission as a nonprofit hospital service plan. With health care costs escalating and solutions drastically needed the Foundations' initiatives serve as critical "investments" in the future health of our communities.

While BCNEPA could undertake these charitable activities directly, there are tax / operational / administrative advantages to funding these initiatives in a nonprofit 501(c)(3) corporation. These tax/operational/administrative advantages allow a much greater percentage of the contributions to be used for the Foundations' charitable purposes. Second, the existence of a separate organization allows the opportunity for Board and community participation by a diverse group, beyond persons associated with BCNEPA, to assist the Foundations in maximizing the beneficial effects of their charitable endeavors in the various local communities served by the Foundations.

In sum, BCNEPA does not have far-flung operations that are unrelated to its mission as a nonprofit hospital plan corporation. It owns two insurance companies that offer (for First Priority Life, shortly will offer) health care policies to Pennsylvania consumers, which policies complement and supplement BCNEPA's own product offerings. BCNEPA controls two Foundations, which focus directly on providing health coverage or improving health outcomes, health status and health education. Finally, BCNEPA indirectly owns a for-profit TPA, which organization also serves the health care needs of consumers in Pennsylvania.

Unfortunately, BCNEPA's current structure also inhibits pursuit of its mission. Many constituencies treat "non-profit" and "charitable" as synonymous terms. As offensive as some individuals may find it, BCNEPA clearly is a business, not a charity, and needs to function in that manner. Profits must be generated to continually maintain and replace costly assets, and invest in improvements that ultimately benefit the residents of its service area. The continual scrutiny placed on BCNEPA is largely due to the perception of its being a "charity." Also, the various sub-entities of BCNEPA, e.g., FPH, FPLIC, etc., create a complex, confusing and costly operating environment for both BCNEPA and, more importantly, its customers. A group's desire for a relatively minor benefit modification may necessitate the coverage to be underwritten by a totally different sub-entity, replete with different sets of rules and regulations. There appears to be infinitesimally small benefit from such artificial constructs when compared to related significant costs to establish and operate these entities.

In summary, BCNEPA's current corporate structure is necessary to facilitate its mission. All of the non-charitable affiliates are ultimately owned by BCNEPA. Thus, to the extent that the HMO or for-profit entities generate profit, such profit inures to financial benefit of the ultimate parent, BCNEPA. Ensuring that BCNEPA has a strong financial condition is a great advantage to the

policyholders and subscribers that look to BCNEPA and its Subsidiaries for financial stability and, ultimately, the payment of their health care claims.

- 12. For each year from 1993 to 2003, and for the first six months of 2004, identify the ASO and ASC premium received by you and your subsidiaries. Further, if you define ASO/ASC premiums to include only administrative expenses, please also provide the claims paid data for the ASO/ASC business for each year and each company.**

The premium equivalents associated with BCNEPA's self funded operations is contained in exhibit D. The data is provided for Blue Cross of Northeastern Pennsylvania, First Priority Health, and Erin Group Administrators, Inc. for the period 1993 to June 2004.

We trust that these responses address the Department's inquires. We are hopeful that, with this information, the Department's inquiry into this matter can soon be brought to a conclusion.

Nonetheless, to ensure that BCNEPA continues to protect its legal rights pending a conclusion of the Department's inquiries, please be advised that BCNEPA continues to assert all of the issues and rights raised in its previous Submissions. BCNEPA reserves all of its rights to contest or challenge the issuance of the January 17, 2004, Bulletin Notice and all matters arising thereunder or related thereto, or under the Department January 5, 2004, letter to BCNEPA.

Sincerely,



J. Ken Suchoski  
Vice President, Finance and Chief Financial Officer

Enclosures

JKS/cjs

cc: Denise S. Cesare, President & CEO, BCNEPA  
William C. Reed, Executive Vice President & COO, BCNEPA  
Edwin R. Goodlander, Sr. Vice President Legal & Gov't Affairs General Counsel & Secretary  
Linda Kaiser, Esquire, Cozen & O'Connor















**BLUE CROSS OF NORTHEASTERN PENNSYLVANIA  
ERIN GROUP ADMINISTRATORS, INC. (THIRD PARTY ADMINISTRATOR) ASO BUSINESS  
RESPONSE TO PENNSYLVANIA INSURANCE DEPARTMENT LETTER DATED OCTOBER 21, 2004  
NUMBER OF LIVES COVERED BY COUNTY IN THE COMMONWEALTH OF PA**

**PA Counties in which ASO Business  
for Erin Group is conducted**

**December  
2003**

**June  
2004**

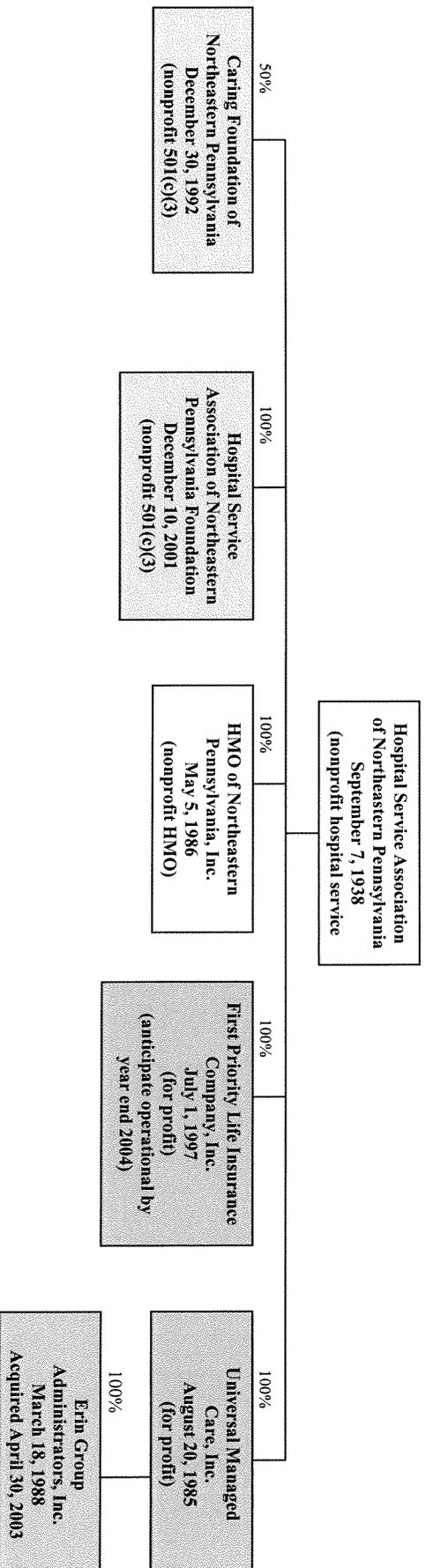
**[REDACTED]**

Total Lives Covered In PA by Erin Group

# Hospital Service Association of Northeastern Pennsylvania

d/b/a Blue Cross of Northeastern Pennsylvania

## Operational Legal Entity Organizational Chart



Not-For-Profit
Not-For-Profit 501(c)(3)
For-Profit

**BLUE CROSS OF NORTHEASTERN PENNSYLVANIA**  
**RESPONSE TO PENNSYLVANIA INSURANCE DEPARTMENT LETTER DATED OCTOBER 21, 2004**  
**REQUEST 12**  
**ASC AND ASO PREMIUM EQUIVALENTS (1)**  
**(\$ IN MILLIONS)**

<u>Year</u>	<u>BCNEPA</u>	<u>HMO</u>	<u>EGA</u>	<u>TOTAL ASC/ASO PREMIUMS EQUIVALENTS</u>
1993				
1994				
1995				
1996				
1997				
1998				
1999				
2000				
2001				
2002				
2003				
YTD June 2004				

[REDACTED]

(1) Premium Equivalents reflect the sum of administrative service revenue and claims paid data.