Capital BlueCross

October 8, 2004

MAIL AND ELECTRONIC MAIL

Blues Reserve/Surplus Application
Pennsylvania Insurance Department
Office of Insurance Product Regulation and Market Enforcement
1311 Strawberry Square
Harrisburg, PA 17120

Re: Response to Public Comments

This letter is Capital BlueCross' response to the final sets of public comments filed in conjunction with the Pennsylvania Insurance Department's ("Department") invitation for input on the surplus applications filed by the Pennsylvania Blue Plans[1] pursuant to Notice 2004-1. As with our other responses, this letter responds to general "categories" of issues raised by the following groups and organizations: (1) The comments that were jointly filed by 13 public interest organizations ("PIO Comments"); (2) the comments filed by the Pennsylvania Medical Society ("PMS Comments"); (3) comments of the Insurance Federation of Pennsylvania ("IFP Comments"); and (4) the Pennsylvania College of Internal Medicine's comments ("PCIM Comments") (collectively the "Commentators"). To the extent the final set of public comments relate to issues discussed in any of our previous responses, we refer readers to our other letters which are available on the Department's website.[2]

A. Preliminary Observations

Before responding to specific issues, we would like to offer some preliminary observations resulting from our consideration of the many different and often conflicting concerns and solutions suggested by the Commentators.

Dramatically rising health care costs, the affordability of health insurance and access to health for the uninsured or underinsured are all extraordinarily complex and important public policy issues. Dealing with these critical issues should be done as part of a public policy conversation involving all of the various stakeholders (*i.e.*, the public, the legislature, regulators, doctors, hospitals, insurers, pharmaceutical companies and others). *The root causes of rising health costs must be honestly addressed by all*

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1 "Pennsylvania Blue Plans" refers collectively to Capital BlueCross, Highmark, Independence Blue Cross, and Blue Cross of Northeastern Pennsylvania.

2 http://www.ins.state.pa.us/ins/lib/ins/whats_new/2004bc/Capito__Blue_Cross_261-271.pdf

contributors to the problem and by all of the constituencies in the health care arena – *each accepting appropriate responsibility and appropriately contributing to the solution*.

Unfortunately, the Notice process has raised expectations that reducing the level of surplus of the Pennsylvania Blue Plans will solve all of these problems. Clearly it will not. If Capital BlueCross were to be dissolved today and its entire surplus distributed to policyholders (or diverted for use by the many other conflicting potential public uses suggested by various commentators), the effect would be insignificant in terms of premium reduction, but catastrophic in terms of our members. We should not confuse the specific question being addressed with these broader issues.

(1) Fundamental Disagreements

We fundamentally disagree with many of the basic assumptions underlying recent public comments.

- We believe the Commentators misunderstand: (i) the nature of a non-profit hospital plan corporation and its mission; (ii) the authority to govern its financial affairs (its Board of Directors versus the Department); and (iii) the nature of its relationship to the many and varied constituencies suggested by public commentators.

- We strongly differ with many commentators who overestimate the supposed competitive advantages of the Pennsylvania Blue Plans and others who underestimate the competitive challenges presented for a company like Capital BlueCross.

- We strongly differ over the best approach for evaluating appropriate levels of surplus – and, as discussed below, our approach is markedly different from those suggested by the public comments.

The Department's process cannot and will not lead to a reasoned evaluation or understanding of these issues because a fair and balanced public policy conversation concerning these fundamental issues can only take place through the legislative process.

(2) The Department's Process isn't Working

We have previously pointed out basic flaws in the Department's January 16, 2004 Notice and the process launched by the Notice. But, as we review more public comments, it becomes clearer and clearer to us that the Department's process is defective beyond repair. To cite just a few examples:

- The Department has never clearly explained to the public that, despite the actual words of the Notice, the Department has now conceded that: (i) *disclosure of RBC levels is actually prohibited by Pennsylvania law*; (ii) *RBC was never intended by the Department as the sole method of determining*

excess surplus; and (iii) *Capital BlueCross is free to propose other methods for determining reserves and surplus.* **So, it is not surprising to us that public commentators are complaining about the different presentations in the applications submitted by the different Blue Plans. The Notice simply doesn't reflect the Department's actual requirements, with inevitable confusion for everyone reading the applications as a result.**

- There has been no honest recognition by the Department that the disclosure of data requested concerning Capital BlueCross could seriously undermine the competition we have worked so hard to create in our service area *or that a court upheld Capital's confidentiality concerns over the objections of the Department for perfectly valid reasons*. **So, it is no wonder that certain commentators are confused and suggest that our application is incomplete – in some cases, they are not even aware that we have provided the requested data on a confidential basis to the Department.**

- This process is broken and it needs to be fixed. For a number of reasons (including some very basic questions we have about the authority of the Department to set a maximum surplus level), the only way this matter can be addressed is through the *Pennsylvania General Assembly*. **We again note that every other state that has addressed the issue of maximum surplus did so under an explicit legislative scheme – not by use of the completely novel notice procedure of the type adopted by the Department.**

B. While We are Committed to Supporting Programs in our Service Area, Capital BlueCross is Not a Public Charity and its Surplus is not a Charitable Asset.

As a threshold matter, Capital BlueCross is proud of its record of service to the residents of Central Pennsylvania and the Lehigh Valley. We have already described in our Application the many activities we have traditionally and voluntarily engaged in for the benefit of the residents and communities in our service area. That commitment is, in a very real sense, part of the fiber of our organization and it contributed, in no small measure, to our decision to remain an independent health plan focused on the needs of the region we serve.

It is important to keep this background in mind, because there is a central, but incorrect, theme which underlies most of the arguments made by the Commentators, namely that Capital BlueCross is a public charity that has a social mission, and therefore *Capital BlueCross' surplus is a charitable asset which should be used to benefit the public at large*. These comments are simply wrong because: (1) our sole corporate and statutory purpose is to operate a nonprofit hospital plan for the benefit of our members, not to run a public charity for the benefit of the general public; (2) the term "social mission" has no statutory or legal meaning; and (3) our surplus may only be used to further our corporate and statutory purpose as a nonprofit hospital corporation.

(1) Capital BlueCross' Sole Corporate and Statutory Purpose is to Operate a Nonprofit Hospital Plan.

In reaching their conclusion that Capital BlueCross has "excessive" surplus, the Commentators start with the incorrect premise that Capital BlueCross is a public charity. In support of this assertion they rely primarily on 40 Pa.C.S.A. §6103(b), which states:

> (b) Tax laws. – Every hospital corporation holding a certificate of authority under this chapter is hereby declared to be a charitable and benevolent institution, and all of its funds and investments shall be exempt from taxation by the Commonwealth and its subdivisions.

Many of the Commentators focus on the words "declared to be a charitable and benevolent institution," for the purpose of arguing that Capital BlueCross is an institution of purely public charity. This is an incorrect interpretation of this Section.

Through Section 6103, the legislature exempted Capital BlueCross from taxation as permitted by the Constitution of Pennsylvania.[3] Section 6103 does not make Capital BlueCross a public charity rather, the General Assembly declared the proscribed activities of Capital BlueCross and other hospital plan corporations (*i.e.*, operating non-profit hospital plans) as charitable and benevolent.

The Pennsylvania General Assembly clearly provided that Capital BlueCross' only role as a nonprofit hospital plan corporation is to operate a nonprofit hospital plan – nothing else. If the General Assembly had intended that we have some broader role in serving the community it would have done so as part of our enabling legislation (just as it did for Blue Shield plans). One of our concerns with the Department's application process is that it impermissibly expands our corporate and statutory purpose to include mandatory charitable obligations never envisioned by the General Assembly.

We believe further evidence that we are not a public charity is the General Assembly's exemption of Blue Cross and Blue Shield Plans from the provisions of the Institutions of Purely Public Charity Act, 40 P.S. §§371-386 (the "IPPC Act."). The General Assembly's intent in enacting the IPPC Act was to eliminate inconsistent application of eligibility standards for charitable tax exemptions by creating set criteria for organizations to qualify as "institutions of purely public charity."[4] In doing so, the General Assembly specifically exempted Pennsylvania Blue Plans from the Act:

> This act shall not apply to nor affect 40 Pa.C.S. §6103 (relating to exemptions applicable to certified hospital plan corporations) or 6307 (relating to exemptions applicable to certificated professional health service corporations) or the entities subject to those sections.[5]

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3 Article VIII, §§ 2(a)(i), (c)(v).

4 *See* 10 P.S. §372(b).

5 10 P.S. §385(a).

The significance of this exemption is that while a nonprofit hospital plan is a tax exempt entity, it is not an institution of purely public charity – as both the PIO Comments and PMS letter would suggest. Rather, the only obligation of a nonprofit hospital plan corporation is to operate a nonprofit hospital plan. In looking at the question of whether a hospital plan corporation is a charity, one Pennsylvania decision concluded that a Blue Cross plan met the definition of a "charitable and benevolent institution" simply by fulfilling its statutory role of operating a nonprofit hospital plan.[6]

Significantly, the language set forth in section 6103(b) is not unique to hospital plan corporations. Almost identical language exists for fraternal benefit societies[7] and Health Maintenance Organizations ("HMOs").[8] None of the Commentators have suggested that either of these two other types of entities are public charities whose surpluses should be distributed for the public good. To the extent this type of provision makes a nonprofit corporation a public charity, which we believe it does not, then all HMOs and fraternals would also be public charities, a result the Commonwealth Court rejected in *Maillie v. Greater Delaware Valley Health Care, Inc.*, 156 Pa. Cmwlth. 582, 628 A.2d 528 (1993) ("Although the HMO as a charitable and benevolent institution was exempt from taxation, there is yet no clear basis for concluding that its assets were charitable assets of the public; rather they constituted insurance premiums paid on behalf of the subscribers for insurance coverage.") As the Commonwealth Court found in M*aillie,* Section 6103(b) deals only with Capital BlueCross' tax status – not its corporate purpose, which the Pennsylvania General Assembly defined as: "A corporation not-for-profit incorporated for the purpose of establishing, maintaining and operating a nonprofit hospital plan."[9]

More recent decisions in other states have unequivocally concluded that hospital plan corporations are not public charities. For example, a very recent Texas appellate decision dealt with this very issue under laws similar to Pennsylvania and concluded that the Blue Cross/Blue Shield Plan was not a public charity.[10]

In *Abbott*, the Attorney General of Texas sued to prevent the merger of Blue Cross Blue Shield of Texas ("BCBST") with a Illinois Blue Plan. The Texas Attorney General argued that BCBST was a common-law charity that must preserve its assets for charitable purposes to benefit the general public good. In making this argument, the Texas Attorney General relied in large measure on a section of Texas law providing that: "[c]orporations may be created as charitable, benevolent and nonprofit corporations to furnish hospital services to its members."[11] The court rejected the Attorney General's

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6 *See Board of Assessment App. v. Hospital Service Ass'n*., 327 A.2d 883, 885 (Pa. Commw. Ct. 1974) (holding that "once appellee proves itself under the umbrella of the Nonprofit Hospital Plan Act of 1937, thereby being a legislatively determined charitable organization, it enjoys the benefits of the presumption. . . .").

7 40 P.S. §991.2462.

8 40 P.S. §1563.

9 40 Pa.C.S.A. §6101.

10 *See Abbott v. Blue Cross and Blue Shield of Texas*, 113 S.W.3d 753 (Tex. Ct. App. 2003).

11 *Abbott* at 761.

reliance on the "charitable and benevolent" language and concluded that BCBST was not a public charity and not subject to the charitable trust powers of the Attorney General.[12]

In reaching its decision, the court in Abbot looked at both BCBST's corporate charter and Texas's Blue Cross statute. The court noted that BCBST's charter provided that the corporation was formed "for the purposes of establishing, maintaining and operating a nonprofit hospital service plan whereby hospital care may be provided to the members by said corporation through an established hospital or hospitals and sanitariums with which it has contracted for such care."[13] The court held:

> We reject the Attorney General's contention that "Blue Cross/Texas's status as a common-law charity was irrevocably formed at the moment of its inception." **Simply stated, we hold that where the law allows a nonprofit corporation to be operated solely for the benefit of its members, the corporation cannot be deemed as a matter of law to be a public charity.[14]**

The court further cited cases in several other states that reach the same conclusion.[15]

While we have a long-standing commitment to support worthy community, health-related, and civic endeavors in our service area, Capital BlueCross is not a public charity. As detailed in our Application, we give millions of dollars every year to charitable and Commonwealth health programs. The Pennsylvania General Assembly has said, however, that our only purpose is to operate a nonprofit hospital plan corporation for the benefit of our subscribers. The Commonwealth Court has held that the "charitable and benevolent" language of Section 6103 does not convert subscriber premiums into charitable assets. Like BCBST, our corporate charter states that our purpose is to "establish, maintain and operate a nonprofit hospital plan whereby hospitalization may be provided to subscribers of such plan." Because our corporate charter and Pennsylvania law provide that our hospital plan is to be operated for the benefit of our subscribers, we are not a public charity.

(2) While We Support Programs in Our Service Area, We Do Not Have a Statutory "Social Mission."

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12 *Id.*

13 *Abbot* at 761.

14 *Abbott* at 764 (emphasis added).

15 *United Hosps. Serv. Ass'n v. Fulton County*, 216 Ga. 30, 114 S.E.2d 524, 527 (1960) (holding that "this is pure and simple insurance in direct competition with private concerns which are engaged in the same business but enjoy no tax-exemption benefit."); *Illinois Hosp. & Health Serv., Inc. v. Aurand,* 58 Ill.App.3d 79, 15 Ill.Dec. 549, 373 N.E.2d 1021, 1025 (1978) ("It can thus be seen that this corporation, laudable and desirable as it may be, is for the benefit of those members who make their payments. If they do not pay they are dropped from the rolls. No provision is found under this plan whereby any charity is dispensed to those members who do not pay, or to any destitute member of society in general."); *ABC for Health, Inc. v. Commissioner of Ins.,* 250 Wis.2d 56, 640 N.W.2d 510, 515- 16 (App.2001) (Wisconsin Blue Cross Blue Shield organization not a charity because not operated exclusively for charitable purposes but for benefit of individuals who paid premiums).

Many of the Commentators argue that we have a charitable obligation to use our surplus for the benefit of the public because of our "social mission." For example, the IFP states that the "Insurance Department should develop and enforce clear requirements for the Blues as to their social mission contributions."

"Social mission" is a meaningless term as it is does not appear anywhere in Pennsylvania's insurance laws. Typically the term is used to refer to the specific obligations Professional Health Service Plan Corporations must provide to low income citizens under 40 Pa. C.S.A. §6303. This provision does not apply to hospital plan corporations (*i.e.*, "Blue Crosses").[16] Only the General Assembly, not the Insurance Department, can create such obligations. As we also stated in our Application, however, Capital BlueCross has voluntarily undertaken activities intended to benefit the residents of our service area. For example, we serve as an "insurer" of last resort, and we provide an individual program that is not medically underwritten, in a market where few others are even willing to enter. Both of these actions are consistent with our corporate and statutory purpose.

The fact, however, that we make contributions to charities and community programs as any other corporation would do in the normal course of business, does not make us a charity. Moreover, in all the years the Department has regulated us, never once (until now) did they suggest we are a "public charity." We have never been asked to make health care available for free – only to make it available. Moreover, (until now) we have never once been required to give money away to a charity. Where the General Assembly has wanted us to be involved in a particular charitable or benevolent program (*e.g.*, CHIP, AdultBasic), it has done so through specific legislation. Therefore, the Commentators are simply incorrect when they state that Capital BlueCross, as a nonprofit hospital plan, has a statutory obligation to use its surplus for any purpose other than that dictated by the General Assembly, namely to operate a nonprofit hospital plan.

(3) Our Surplus May Only Be Used to Further Our Purpose as a Nonprofit Hospital Plan Corporation.

Perhaps one of the more contentious issues raised by many of the Commentators is: *Who has a right to the surplus of the Pennsylvania Blue Plans*. The PIO Comments, for example, contend that the surplus is a charitable asset which should be disgorged and used for purely public charitable purposes, including providing additional funding to the AdultBasic Program. The PMS Comments also state that "[t]he assets of the Blues are dedicated to 'public' charitable purposes."[17] The PMS, an organization that represents doctors, suggests that the surplus not go to subscribers but (not surprisingly) to physicians through increased Medicaid provider payments.[18] Similarly, the IFP states that the surplus should be used to further the Pennsylvania Blue Plans' social missions.[19] The IFP, however, argues that subscribers should not benefit from the surplus through

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16 *Id.* §6301(b).
17 PMS Comments at 5.
18 PMS Comments at 19.
19 IFP Comments at 4.

reduced premium costs. Finally, PCIM states that the surplus is a charitable asset and must be "dedicated to charitable purposes."[20]

The law in Pennsylvania and elsewhere supports our position that our surplus is not a charitable asset. As noted above, in the only Pennsylvania case we could find touching on this issue, the Commonwealth Court held that the assets of a nonprofit HMO, its assets were not charitable assets of the public.[21] Our surplus exists to protect our subscribers and to ensure that we are here for the long-term in order to fulfill the role as a nonprofit hospital plan set out by the General Assembly and by our charter.

We also think it appropriate to use our surplus to mitigate against premium increases as we have done in the past. Our use of our surplus to mitigate premium increases for our subscribers is part of our continuing commitment to employ our funds responsibly and in the best long-term interests of our customers. Conversely, we do not believe that we have a legal obligation to use our surplus for purposes that do not further our statutory role in operating a nonprofit hospital plan. We do not believe it appropriate for the Commonwealth, or any organization, to use our critical surplus as a "piggy bank" to fund charitable programs or to suggest it is the cure all to the health care crisis in this Commonwealth. The General Assembly has said that our role in this Commonwealth is to operate a hospital plan corporation. Accordingly, we believe that our surplus can be used only to further that and related purposes and for no others.

In sum, Capital BlueCross is a nonprofit hospital plan corporation – not a public charity. We have undertaken a voluntary commitment to help worthy programs in our service area – but we do not have a statutory "social mission." Our surplus can only be used to further our nonprofit purpose in operating a hospital plan for the benefit of our subscribers – not as a funding source for government programs, no matter how worthy.

C. Department's Authority to Establish Maximum Surplus Levels

All of the Commentators argue that the Department has the authority to require the Pennsylvania Blue Plans to distribute surplus of the companies it deems "excessive." In support of this argument, they point to: (1) Pennsylvania law; (2) the actions of other states; and (3) the Highmark consolidation. While we do not dispute that the Department has the authority to regulate our surplus levels, we do not believe that any of the sources of authority the Commentators point to give the Department the power to take the extraordinary action it has taken in its Notice.

(1) Pennsylvania Law Does Not Give the Department the Authority to Regulate Surplus in the Manner Set forth in its Notice.

All of the Commentators appear to take it for granted that Pennsylvania law gives the Department the authority to take the action set forth in its Notice. Yet not one of the

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[20] PCIM Comments at 2.

[21] *Maille v. Greater Delaware Valley Health Care, Inc.*, 628 A.2d 528 (Pa. Commw. Ct. 1993).

Commentators can point to a Pennsylvania statute which expressly gives the Department such important and expansive authority.

As the PMS Comments note, there is one provision in the Hospital Plan Corporations Act which gives the Department authority to "approve" the reserves held by the Pennsylvania Blue Plans.[22] This provision, however, says nothing about a maximum surplus level or otherwise gives the Department the authority to require Pennsylvania Blue Plans to distribute surplus the Department deems excessive. In fact, the Hospital Plan Corporations Act requires the Department to establish through formal regulation the proper procedure for approval of reserves.[23] The Department's Notice is not a formal regulation, and as a result we believe it is not valid or enforceable.

While on the one hand arguing that the Department has the authority to require Pennsylvania Blue Plans to distribute excess surplus, many of the Commentators on the other hand question the Department's authority to do so. Consider the following statements:

- "We recognize the Insurance Department is embarking into unchartered territory with this proceeding, with relatively little regulatory precedent."[24]
- "The Insurance Department should develop and enforce clear requirements for the Blues as to their social mission contributions."[25]
- "If there is any question about this, the Legislature should promptly clarify the Department's responsibilities regarding the surplus of the Blues in order to remove the questions and objections that have been offered during the debate on this issue."[26]
- "We recommend adoption of a standard that normalizes surplus levels with reference to underwriting deductions . . . on the basis of the number of days of expenses held in surplus."

In fact, a number of Pennsylvania legislators have written comments identifying the need for legislation giving the Department the authority to regulate maximum surplus levels. For example, Representative Michael Veon, Democratic Whip wrote:

> I believe it is now the time for the legislature to act on this issue. Since the legislature initially dealt with the issue of maintaining minimum surpluses it is appropriate that it now deal with the issue of limiting those surpluses when they are deemed excessive in the marketplace. I believe

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22 40 Pa.C.S.A §6124(a). Capital BlueCross is not subject to 40 Pa.C.S.A. §6321 which arguably gives the Department greater control over the reserves of a professional health services plan corporation.

23 *See* 40 Pa.C.S.A. §6124(b) (stating that: "[e]very application for such approval shall be made to the department in writing and shall be subject to the provisions of subsections (c) through (f) of section 6102 of this title."). Correspondingly, 40 Pa.C.S.A. §6102(c) states: "Every application for a certificate of authority under this section shall be made to the department in writing **and shall be in the form and contain such information as the regulations of the department may require**." (Emphasis added).

24 IFP Comments at 3.

25 IFP Comments at 10.

26 PMS Comments at 6, n. 4.

> that any action that is taken must be thoroughly developed since any proposal that is adopted affecting the surpluses will have a rippling effect on other healthcare insurance services and benefits offered in this state.[27]

Representative Veon, like some other state legislators who have submitted comments or made public statements, also states that he intends to shortly introduce legislation addressing this issue. We believe that these comments from state legislators demonstrates a recognition that currently Pennsylvania law does not permit the Department to take the action it has taken. We would welcome the opportunity to work with the General Assembly on this issue, or even with the Department to discuss appropriate regulations. The current ad hoc process is flawed both substantively and procedurally. Echoing Representative Veon's comments, we too believe that any proposal must be thoroughly developed given its impact on the entire healthcare landscape.

(2) The State Actions Cited By the Commentators Are Not Relevant to this Matter.

The Commentators make much of the fact that other states have taken action similar to Pennsylvania in reviewing the maximum surplus levels of Blue Plans. The Commentators reliance is misplaced due to the fact that, unlike Pennsylvania, these states have specific legislation giving regulators the authority to regulate maximum surplus.[28]

Our position, as stated in our Application, is that the Department does not have express or implied authority to compel us to file a plan for distributing excess surplus to plan participants and the Commonwealth's uninsured and underinsured. We believe that our position, not the Commentators, is strengthened by the fact that in other jurisdictions where courts have affirmed the authority of an Insurance Department to compel a plan to disgorge excess surplus, there was an explicit legislative scheme that established maximum surplus levels and required the filing of, and compliance with, an approved plan to correct any surplus imbalance. The Pennsylvania General Assembly has not given the Department comparable authority to require the Blue Plans to distribute surplus the Department deems to be "excessive."

Equally misplaced is the PIO Comment's reference to the Blue Cross/Blue Shield for-profit conversions that have occurred in a number of states as grounds for requiring

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[27] Comments of the Honorable Michael Veon dated September 23, 2004.

[28] See, e.g., In the Matter of the Excess Surplus Status of Blue Cross and Blue Shield of Minnesota, 624 N.W.2d 264 (Minn. 2001) (affirming decision of Minnesota Insurance Commissioner requiring use of premium rebates to return excess surplus generated by settlement of lawsuit against tobacco companies); cf. In the Matter of New York State Conference of Blue Cross and Blue Shield Plans v. Muhl, 253 A.D.2d 158 (N.Y. A.D. 1999) (statutory scheme explicitly authorized consideration of whether requested rates would produce amounts greater than required to maintain solvency). *See also*, C.G.S.A. § 38a-199, KRS §304.32-130, MD Code, Insurance, § 14-117, M.C.L.A. §550.1204a(5), N.C.G.S.A. §58-65-95(d), NDCC §26.1-17.09 (all providing maximum surplus levels and authority to state regulator to address excessive surplus levels).

the Pennsylvania Blue Plans to distribute their surplus for charitable purposes.[29] These cases have nothing to do with the Pennsylvania Insurance Department's authority to regulate excess surplus. The vast majority of these cases involve Blue Cross/Blue Shield Plans that were planning to convert to for-profit companies. What the PIO Comments also neglects to mention is again the presence of specific statutes in the cases it cites regulating the conversion of Blue Cross/Blue Shield plans. For example, Maine, New York, New Jersey, North Carolina and others all have such laws. A common provision in these statutes is the requirement that the Blue Cross/Blue Shield Plan establish some form of charitable foundation as a condition to its conversion to a for-profit entity.

Applying the Blue Cross/Blue Shield conversion cases here is an apples to oranges proposition – it's neither a fair nor appropriate analogy. Capital BlueCross is not converting to a for profit entity. Accordingly, there is no need to replace the nonprofit role we are playing the community with a charitable foundation funded out of our surplus. To the contrary, we need our surplus to ensure that we can continue to play our role in our service area for the long-term. As we have said in our Application, our ability to run a competitive hospital plan that offer our subscribers the best possible products and services will be threatened were the Department to require us to distribute a substantial amount of our surplus.

(3) The Highmark Consolidation Order Does Not Establish a Precedent for the Other Pennsylvania Blue Plans.

The requirements placed on Highmark as part of its 1996 consolidation and change in control, including committing 1.25% of direct premiums to social or charitable endeavors, do not set a binding or controlling precedent for other Pennsylvania Blue Plans not subject to that Order. Several of the Commentators argue that the 1996 Highmark Order[30] sets a charitable standard to which all Pennsylvania Blue Plans are subject.[31] It does not.

In the Highmark Order, then Commissioner Kaiser approved the merger of Western Blue Cross and Pennsylvania Blue Shield into a new entity called Highmark. Because Highmark was a combination of both a Blue Cross Plan and a Blue Shield Plan, Commissioner Kaiser characterized the new entity as a hybrid of both called a "Health Plan Corporation." As a professional health service plan corporation, Pennsylvania Blue Shield was subject to the "social mission" obligations under 40 Pa.C.S.A. §6303. Commissioner Kaiser required Highmark to undertake Pennsylvania Blue Shield's social mission obligations by requiring it to use 1.25% of its direct written premium for "social or charitable endeavors."

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[29] See Appendix A to PIO Comments.

[30] *In Re: Application of Medical Service Association of Pennsylvania, et. al.*, Docket No. MS96-04-098 ("Highmark Order").

[31] The PIO Comments, the PCIM Comments, and the IFP Comments all make reference to the Highmark Order.

Capital BlueCross was not a party to the Highmark Order and is clearly not bound by its provisions. Moreover, the Highmark Order does not set any form of universal standard applicable to all of the Pennsylvania Blue Plans. To the contrary, that provision was imposed by the Department upon Highmark only after Commissioner Kaiser reviewed all of the facts and circumstances unique to Highmark, its service area, and that transaction, including the social mission obligation Highmark inherited from Pennsylvania Blue Shield. Accordingly, we do not believe that a standard that was tailored for Highmark to allow it to continue to fulfill its mandatory social mission obligations has any application to a hospital plan corporation with no such statutory obligations.

(4) The Department has Already Been Approving Capital BlueCross' Surplus Levels.

Even assuming the Department has the authority to set and approve maximum surplus levels for the Pennsylvania Blue Plans, we believe that through the Department's approval of our rates and business plans it has consistently approved our surplus levels over the years and would now be estopped from claiming that they are excessive.

In upholding the dismissal of a recent policyholder class action, the Commonwealth Court recognized the application of the "filed rate doctrine" to insurance rates.[32] The Commonwealth Court held:

> Rates and reserves are related concepts. The Insurance Department considers the amount of an insurer's reserves when approving rates, and the collection of premiums based on the rates must inevitably be a factor in the accumulation of excessive reserves. Any determination that Blue Cross has accumulated excessive reserves would necessarily require the recalculation of the approved rates. **Because we conclude that the plaintiffs' cause of action is not independent of the rates approved by the Insurance Department, or of its approval of Blue Cross's reserves and investments, the filed rate doctrine bars the plaintiffs' breach of contract, breach of fiduciary duty, and nonprofit corporation law claims, and Blue Cross's demurrer should have been sustained.**[33]

The court's holding explicitly recognizes that in reviewing our rates over the last years, the Department has also been reviewing our surplus levels. Accordingly when it approves a rate increase for Capital BlueCross, as it has done as recently as November 2002, the Department correspondingly approves our surplus levels. The Department acknowledged the connection between rates and surplus when it denied a rate increase we sought in 2003:

> Issues related to Capital BlueCross's surplus, its level, and the appropriate use of the surplus for these products and for other social mission activities,

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32 *Ciamaichello v. Independence Blue Cross*, 814 A.2d 800 (Pa. Commw. Ct. 2002).

33 *Id.* at 805 (emphasis added).

> were raised and discussed during the public informational hearings on these rate filings. However, these issues were not fully or adequately addressed in the information and responses provided to the Department. Without this information, the Department is unable to determine if the proposed rate increases are excessive, inadequate, or unfairly discriminatory.[34]

In essence, the filed rate doctrine holds that any filed rate – that is, one approved by the governing regulatory agency – is per se reasonable and unassailable – even by the regulator after the fact. Likewise, our surplus levels once approved as part of a rate increase become equally unassailable.

With respect to Capital BlueCross, the Department's tacit approval of our surplus levels goes beyond simply approving our rates. The Department also reviewed our surplus in 2001 as part of the termination of our joint operating agreement with Highmark and as part of our business plan going forward from that date. At that time, the Department expressed no concern about whether Capital BlueCross had excessive surplus, in fact it was more interested in whether we had enough surplus to compete with Highmark.

We have relied upon the Department's approval of our surplus in structuring our short term and long term business plans. We feel that we and our subscribers would be harmed were the Department now to turn around and advise us that previously acceptable surplus levels were now "excessive" and had to be distributed in a manner not consistent with our business strategy. Had we known four years ago that the Department thought our surplus was trending to a level it considered "excessive," we would have certainly taken such information into consideration when structuring our plans.

Finally, the Department reviews our surplus level several times a year when we file both our audited and unaudited financials statements, including our RBC information. Accordingly, the Department has already had in place a process for analyzing our surplus levels. Simply because the Department has now come up with a new method of reviewing our surplus does not allow the Department to now retroactively disapprove surplus levels it previously determined were appropriate under its prior system.

D. Responses to Technical Comments and the Kirsh Report

Finally, we have serious questions about the accuracy of the data and the validity of the analysis contained in some of the public commentary. We are very aware of the compressed time frame for comments. Accordingly, we attribute many of the errors in the public commentary to the flawed and hurried process that the Department has employed.

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[34] Letter to Joseph N. Romano from Geoff Dunaway, Director of Accident and Health Bureau dated December 26, 2003.

(1) Report of Economist

As part of our efforts to be responsive, and to put some of the more recent economic and technical issues raised by the public commentary in perspective, we have attached as **Exhibit A** a report by an independent economist, Douglas B. Sherlock, CFA, of Sherlock Company. Mr. Sherlock's report addresses the impact that some of the Commentators' suggestions would have on Capital BlueCross and the marketplace. In particular, Mr. Sherlock's report responds to the filed comments relating to market issues that assert:

- The Commissioner should supersede market forces and establish the maximum level of surplus that should be retained by the Pennsylvania Blue Plans.

- The Commissioner should compel the Blue Cross Blue Shield Plans to "disgorge the excess surplus" to fund certain activities.

- Regulatory intervention is necessary since Blues' accumulation of surplus results from an inefficient, uncompetitive market, one aspect of which stems from the lack of investors who would otherwise force management to pay dividends, thereby reducing surplus.

(2) Commentators' Reliance on RBC as a Measure of Surplus

Another issue we feel compelled to address is the suggestion made by several of the Commentators that the Insurance Department establish a maximum RBC far lower than the likely range of 350% - 650% set forth in their January 16th Notice. Capital BlueCross has previously outlined its objection to the use of RBC as a measurement of excess, as opposed to minimum, surplus. These comments illustrate why using RBC for a purpose for which it was not created, leads to confusion and misinformation about the relationship of RBC to a company's overall financial condition.

The Department itself has acknowledged that "RBC is a financial tool developed by the NAIC to measure the risks faced by insurers and to identify a level of surplus necessary to minimize the threat of insolvency resulting from the measurement of level of risk." In other words, the Department has acknowledged that RBC was designed to prevent insolvency, not to measure optimum or appropriate levels of capital for ongoing companies. The Department has further stated, to the very Commentators who nevertheless have advocated a 200% maximum RBC level, that "RBC levels set forth in the Health Insurance RBC statute outline a minimum level of capital that an insurer should have. That is, a 200% RBC level triggers required action by the company and the Department due to a concern over solvency." [Emphasis in the original].

Thus, the Commentators are making the facially absurd proposition that Capital BlueCross operate at a level where one dollar of loss would put into a category of financially impaired companies. The NAIC, the Blue Cross Blue Shield Association, the rating agencies, and all recognized authorities agree that 200% of RBC is a minimum

capital. Suggesting that a health insurer, operating in a volatile and competitive marketplace operate a 200% level is simply irresponsible. Such a reckless proposal cannot be taken seriously.

In suggesting that a 200% RBC represents an appropriate level of surplus, it appears that the Commentators fail to consider some recent examples of how quickly insurance companies can "fall through" the 200% level and into insolvency—namely Reliance Insurance Group and Legion. In fact, there has been much written by organizations such as A.M. Best and Standard and Poor's certifying the 200 percent early warning level as too low. As a result, there has been movement at the NAIC to re-evaluate the adequacy of the first level of regulatory monitoring. In addition, the Commentators seem to be unaware of the fact that a Blue Cross/Blue Shield Plan that falls below the 200 percent RBC level will likely have its license to operate as a BC/BS Plan terminated. The revocation of this license would be devastating on the company and the subscribers in its service area.

Finally, Mr. Kirsh in his "*Report to the Pennsylvania Insurance Department Concerning the Applications of Blue Cross Plans for the Approval of Reserves and Surplus"* recognizes that a static measure such as RBC is an inappropriate measure of optimum capital. He suggests a framework for surplus analysis that takes a "forward looking" view of each plan's expected consolidated financial results. We agree with Mr. Kirsh in two respects. First, that future capital needs must be measured based on forward looking criteria. In addition, we believe that it is appropriate to look at the financial results on a consolidated basis and all of the financial information presented by Capital Blue Cross has in fact been on a consolidated basis. We disagree, however, with Mr. Kirsh, about the nature of the market in which Capital BlueCross operates. When the company looks forward it believes the health insurance marketplace is headed for a period of volatility, much more like the 1980s, than the most recent past and indeed the cyclical nature of health insurance, supports our contention.

(3) Capital BlueCross' Financial Reports are on a Consolidated Basis

One of the criticisms raised by several of the Commentators is that the financial reports included as part of our Application do not reflect the "consolidated" surplus of Capital BlueCross and its affiliates. In fact, they do.

Contrary to the Commentators allegations that we were somehow trying to hide our consolidated surplus, we reported our financials just as we are required to do by the Department. The financial forms we submitted as part of our Application were done in a Department approved format and according to Department instructions. It appears that the Commentators do not have a proper understanding of statutory accounting and the differences between the "consolidated" basis of accounting and the "equity method" of accounting.

Under consolidated accounting, the assets, liabilities, revenues and expenses of a parent company and its subsidiaries are presented in the financial statements. Intercompany transactions are eliminated to avoid "double counting." Under the equity method of accounting, only the parent company's assets, liabilities, revenues and expenses are reflected in the financial statements. Subsidiary company balances are netted in the parent company's financial statements. Thus, the net equity of the subsidiaries are reported as "Investment in Subsidiaries" on the balance sheet and the subsidiary's net income is reported as "Gain/Loss from Subsidiary Operations" on the parent company's income statement.

The Department requires us to use statutory accounting, which in turn uses of the equity method of accounting. Therefore, the statutory financial statements of Capital BlueCross only reflect the revenues and expenses of that entity. The revenues and expenses our subsidiary companies are netted and reflected in our Income Statement as "Gain/Loss from Subsidiaries." Likewise, the assets and liabilities reported in our statutory financial statements "net" the gross assets and liabilities of our subsidiary companies and report them as a single amount on our balance sheet, "Investment in Subsidiaries." Regardless of whether consolidated or equity method accounting is used, there is no difference in the "surplus" of the parent company.

(4) Response to Erroneous Factual Statements

The Commentators make a number of factually inaccurate statements that we would like to correct, including the following:

- Mr. Kirsh on page 6 of his report states, "[i]t is my understanding that each of the Plans has recommended a minimum threshold target of 375 percent ACL consistent with the BlueCross BlueShield Association membership and trademark standard."

  We have never such a recommendation. The 375 percent ACL referred to above is the level at which the BCBSA begins to "monitor" a Plan's financial performance and works with the Plan to strengthen its capital base. However, in a recently filed letter with the Department, the BCBSA states "We believe that a capital level significantly greater than 375 percent may be required by Plans to ensure that funds are available to satisfy strategies, operational or marketplace needs and to secure strong independent financial strength ratings in order to retain public confidence and competitive borrowing capabilities."

- As support for the proposition that a 200% RBC is a sufficient measure of surplus, Mr. Kirsh asserts that there has been an increase in risk transfer, risk-sharing arrangements with doctors (capitation) and with subscribers (ASO groups). In fact, there has been very little transfer to providers in Pennsylvania, especially Central Pennsylvania, and the benefit plans remain relatively rich, transferring little additional risk to group members. Also, we do not "reinsure"

any of our risk with other insurance companies. Nor are there other "pooling" mechanisms with the other Blue Plans as the Commentators suggest.

- Mr. Kirsh includes a graph in his report showing "CBC Gains and Losses" for the period 1990-2003. In that graph, he shows Capital BlueCross having gains of approximately $60 million for the year ended December 31, 2003. This graph only presents our stand-alone underwriting results. It does not reflect the underwriting losses attributable to our affiliate CAIC. The charts also ignore the fact the surplus accumulation also comes from asset appreciation and investment income.

- On Table 1 appearing on page 16 of the PMS Comments, PMS correctly states our 12/31/03 surplus as $515 million. However, in calculating the annual expense, PMS only uses expenses incurred by the parent company. The proper calculation would be to base the "Days Surplus" based on our consolidated expenses, which were $1.736 billion for the year ended December 31, 2003. That would result in a Days Surplus of 118 vs. the 539.75 cited in their report.

- On Table 4 in the attachments to the PMS Comments, PMS reports a 15.8 percent return on 2002 net worth for calendar year 2003 for Capital BlueCross. This is based on a reported profit of $81,685,984. Again, PMS fails to consider the consolidated operations of Capital BlueCross, which had a pre-tax net loss of $(17,359,365). This would result in a negative return of (3.4) percent. PMS further errors by using the 12/21/03 surplus, $515,476,773, instead of the 12/31/02 surplus, $518,779,000, as its base. Had they used the correct surplus, the negative pre-tax return would be (3.3) percent. It should be noted that on an after-tax basis, our 2003 return on surplus was (8.9) percent.

More than anything else, the comments filed in this Application process prove that the Department's Notice Proceeding is an improper forum for resolution of the technical and public policy issues that have been raised. Because of the lack of statutory authority to proceed as it has, the Department has created a morass of public policy and technical issues that can only appropriately be resolved through the legislative process, or at the very least through the promulgation of a regulation as contemplated by the Hospital Plan Act itself.

E. Conclusion

Ten months ago the Department issued its Notice asking the Pennsylvania Blue Plans to demonstrate that their surplus levels were not excessive. With respect to Capital BlueCross, we believe that we have done that. After looking at our market, our business plans, and many other factors, we strongly believe that our surplus is adequate, not excessive.

However, it is clear from the comments that this process has moved beyond that question. This process has now morphed into something completely different.

Now, it has become debate on the healthcare crisis in Pennsylvania even though the debate does not include any of the other indispensable parties who should be part of this critical discussion.

Now, we are being pointed to as not only as the *cause* of the healthcare crisis in Pennsylvania, but as the *solution*.

Now, we are being characterized as a "public charity" after countless decades of existing without challenge as a hospital plan corporation.

Now, it is being suggested that we have a mandatory obligation to fund charitable programs, even though we have shown an unwavering commitment to support worthy programs in our areas.

Now, the Department after reviewing our surplus year after year through rate and financial filings, is suddenly declaring that our surplus may be excessive.

Is there is a health care crisis in this Commonwealth – **yes**. Are we *part* of the solution to finding a way to address the rising costs of healthcare – **yes**. Are we willing to participate in a discussion with other stakeholders on how to address this crisis – **certainly**! Will we continue to show the same steadfast support for the community programs and services regardless of the outcome of this process – **absolutely**.

What we absolutely don't believe is that the Commonwealth raiding our surplus is somehow the solution many seem to think it to be. In fact, we think such an action could lead to far more harm than good. We do not intend to stand idly by and willingly permit anyone to interfere with our statutory and corporate purpose of operating a hospital plan and serving our subscribers. In short, we will do everything in our power to ensure that Capital BlueCross is here for our subscribers for the long-term.

We thank the Department for the opportunity to respond to these comments.

Very truly yours,

Patricia K. Wong
Supervising Counsel

EXHIBIT A

REPORT OF THE SHERLOCK COMPANY