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Capital BlueCross RECEIVED CHIEF COUNSEL
PA INSURANCE DEPT.

RECEIVED
Insurance Product Regulation
and Market Enforcement

August 31, 2004

SEP 02 2004

Pennsylvania
Insurance Department

The Honorable Diane Koken
Insurance Commissioner
C/O 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 for Capital BlueCross

Dear Commissioner Koken:

This letter is Capital Blue Cross's ("CBC") response to the first set of public comments filed in response to the Department's invitation for public input on the surplus applications filed by the Pennsylvania Blue Plans¹ with the Department under the Department's Notice 2004-1. As is evident from some of the comments, there is already confusion and uncertainty concerning the Department's surplus application process. Consequently, CBC welcomes the opportunity to respond to these public comments and to provide clarification in connection with its own application.

Given the number of public comments that the Department anticipates receiving and given that many of these comments raise many of the same issues, we plan to respond by category of issues raised in the comments, especially where those comments are directly related to CBC and its application. With that said, we note that comments have been filed by counsel for plaintiffs in furtherance of the administrative complaints in the matter of Lawrence S. Herman, *et al.* Many of these comments simply reiterate legal arguments made by the plaintiffs in their pleadings. CBC does not believe it appropriate to engage in public debate with plaintiffs counsel on these specific points because this matter is currently pending before the Pennsylvania Commonwealth Court.

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

A. Basis for RBC Range

One of the comment letters questions the Department's rationale and basis for selecting the 350% to 650% RBC range to measure whether a Pennsylvania Blue Plan's surplus is "excessive." The comment states that the Department conducted "no financial analysis" to support the proposed maximum surplus levels.

We too are confused by the apparent lack of financial analysis on the part of the Department in supporting its selection of the 350%-650% RBC range. As CBC has stressed in its application, we believe that RBC is an inappropriate measure of a company's maximum surplus levels and we are further unclear as to the Department's methodology in establishing its selected RBC range. Not only is the Department statutorily precluded from using RBC to measure maximum surplus levels, such a measure is contrary to the National Association of Insurance Commissioner's intent in creating a Model RBC Act – which was to serve as an early-warning solvency monitoring tool. As already noted in our application, CBC also believes this matter is of such import that it requires legislation or at least the adoption of a formal regulation – not the notice process the Department has employed.

B. CBC's Financial Condition

One commenter raised a concern about the "financial stability" of CBC and suggested that we have experienced a rapid decline in our surplus and, as a result, have been placed on a Department "watch list."

CBC is not on any Department "watch list." CBC is a financially stable and well-managed company. As disclosed in our application, however, CBC was one of only two members of the Blue Cross and Blue Shield system that suffered a net operating loss in calendar year 2003, in large part resulting from our transition to a full service health insurance carrier, our commitment to comply with the mandates of the Health Insurance Portability and Accountability Act of 1996 (HIPAA) and the level of competition in the local health insurance market. We have used our surplus and reserves to absorb these operating losses and not passed them on to our customers. One of our concerns with the Department's attempt to set arbitrary limits on our surplus is that CBC may be deprived of the financial flexibility necessary to remain competitive, and may, in the future, need to pass such costs directly on to customers if we do not have the benefit of our surplus to absorb losses. Our surplus serves as a "backstop" for unforeseen contingencies, such as unanticipated increases in health services costs, litigation, epidemics, and other catastrophes. Furthermore, our surplus is the principal source of funding for the development of new infrastructure, products and services that benefit our members and foster competition.

Accordingly, while CBC is currently a financially sound company, we are concerned that attempts to limit our surplus may lead to a number of negative consequences, including a diminished financial position, decreased competition, and fewer products and services in Central Pennsylvania and the Lehigh Valley.

C. Proposed Uses of “Excess” Surplus

The comments included several suggestions on how to spend any Department-deemed “excess” surplus of the Pennsylvania Blue Plans. Several worthy programs were mentioned, including increasing funding for AdultBasic– a program for which CBC has provided administrative services. These suggestions, however, demonstrate another one of the problems inherent to the Department’s process. As discussed above, we maintain surplus as a way to absorb losses stemming from increased competition and for unforeseen contingencies. CBC’s only statutorily prescribed purpose is to operate a nonprofit health plan. Therefore, the purpose of surplus is to protect our operations to ensure that we are here for our members in the long-run – not to provide lump sums of cash for the state government to use to fund governmental programs, no matter how worthy.

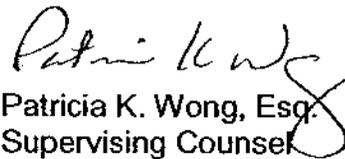
D. Anticompetitive Effects of Application Process

One comment letter expressed concerns over the possible anticompetitive effect that the application process might have on smaller health insurers. This comment indicates that any order by the Department requiring a Pennsylvania Blue Plan to use its excess surplus either to reduce group rates or to increase payments to participating providers would have dramatic negative effects on competition. While we offer no conclusions on this point, this letter illustrates that the Department’s application process will have a number of consequences on insureds, providers, and the competition in the health insurance marketplace.

The comment also highlights the discriminatory nature of the Department’s action since the Department has not asked other not-for-profit health insurers or health plan corporations to justify their surplus levels. Nor has the Department asked insurers with tax-exempt subsidiaries (RANLIs) to explain how they are living up to their state granted tax exemption. Like the Pennsylvania Blues, there are other non-profit insurers that share certain characteristics, including a non-profit status and an exemption from paying premium taxes. As stated, we believe that the Department’s notice is defective for many reasons. One of these concerns is that the process is discriminatory since it focuses on only one class of not-for-profit health plans – i.e., the Pennsylvania Blue Plans, and ignores other, non-Blue health plans controlled by the same statutory provisions.

Again, we appreciate the opportunity to respond to the public statements filed with the Department on this important issue. We look forward to receiving and replying to the next set of comments.

Sincerely,



Patricia K. Wong, Esq.
Supervising Counsel

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Dear Commissioner Koken:

In two news releases, one dated August 6, 2004 and the other dated August 26, 2004, the Pennsylvania Insurance Department (the "PID") encourages the submission of public comments on the Reserves / Surplus Applications which the PID has required each of the Blue plans in the Commonwealth of Pennsylvania to file. I am writing, on behalf of Capital BlueCross, to submit our comments in response to the PID's invitation. Along with the rest of the public, we have now had the benefit of access to the applications of the other Pennsylvania Blue plans. As a result of our review of those applications, we are in a position for the benefit of the public: (i) to further discuss certain threshold matters relating to this important public-policy issue; (ii) to highlight substantial areas of agreement among the Pennsylvania Blue plans; (iii) to point out certain features in the applications that are unique to Capital BlueCross; and (iv) to invite the public (particularly our members and providers) to address any questions they might have regarding our application directly to us.

Threshold Matters

(1) Competition

Capital BlueCross is in a unique competitive position among Blue plans in Pennsylvania. We are proud of the fact that Capital BlueCross' Board and senior management demonstrated their commitment to our corporate mission and our community by delivering a solid choice for health insurance to the market. This resulted in a new, higher level of competition that directly benefits the residents and providers in our 21 county service area in Central Pennsylvania and the Lehigh Valley. Not only do we compete with a number of commercial carriers and HMOs, we are also the only Blue plan competing against another Pennsylvania Blue plan – which has far greater financial resources at its disposal and a statewide market as well. Despite these challenges, we have emerged as the market leader in our service area. Thus, it is essential for us to ensure that the PID's process does not diminish this vibrant competition by giving our many competitors an unfair advantage.

We are pleased that concerns over publication of our confidential information have been addressed by the agreement between the PID and Capital BlueCross on certain sections of our application that must be considered confidential and proprietary in order to preserve healthy competition. Even with these important protections, we are confident that our public

application (which we have voluntarily posted on our website at www.capbluecross.com) contains sufficient information for the public to arrive at its own determination concerning this important issue, which has significant implications for our region's health-care marketplace and its overall economy.

(2) Underwriting Losses

Capital BlueCross fully appreciates the wide-ranging impact of increases in health care premiums caused by the recent unprecedented escalation of health care costs nationally and in Central Pennsylvania and the Lehigh Valley. This directly affects our customers on many different fronts, such as the competitiveness of Pennsylvania products and services, employment in our service area, and the very existence of a health insurance safety net for many Pennsylvanians.

These increasing health-care costs have affected us at Capital BlueCross, as well. Our application clearly demonstrates that for the last seven years, Capital BlueCross has not generated an underwriting profit (i.e., not made a profit on insurance premiums). To the extent there has been growth in our unassigned surplus, it is attributable solely to investment earnings.

What this means for the public is that not one penny of premium dollar has gone into our surplus in the last seven years. To the contrary, we have used surplus funds, during this period, to mitigate the rate of increase in our customers' premiums. This is part of our continuing commitment to employ our funds responsibly and in the best long-term interest of our customers. When health care costs escalate wildly and competition among payors intensifies—and without prompting from outsiders—we use our investment income and surplus to hold down the level of health care premiums for our subscribers. If our surpluses were arbitrarily limited, during times like today when health care costs are rapidly increasing, we would be forced to directly pass on even higher increases to our customers, than we have.

Common Elements

The applications filed by each of the Pennsylvania Blue plans reflect some important common elements.

(1) The Need for Surplus

The public should consider the special circumstances facing Capital BlueCross and the other Blue plans concerning the need for surplus. As one example, the PID has determined that under the applicable statute, Capital BlueCross and the other Blue plans are not permitted to participate in the Pennsylvania [Insurer] Guarantee Fund (a financial safety net that pays customer's claims should a commercial insurer become insolvent). So, there is no back-up funding mechanism available to pay claims if, as a result of unforeseen circumstances, Capital BlueCross could not. Our customers' only "safety net" is our surplus.

In addition, as a not-for-profit organization, Capital BlueCross does not have access to the capital markets to raise funds. As a result, we rely solely on our surplus to fund enhancements in our services, new product offerings and infrastructure improvements. We would not be able to improve and/or innovate our products and services without surplus.

Further, Capital BlueCross does not have stockholders. We are not like a publicly traded health insurance corporation that is accumulating surplus funds to pay dividends to shareholders. Instead, the purpose of our surplus is to protect our operations and, as a result, our customers. This means that in these uncertain times, Capital BlueCross' surplus is the only protection it has against unanticipated increases in utilization of health services arising out of such events as epidemics, terrorist activities and other catastrophes.

As a quick and simple example of this, if a viral outbreak—such as Severe Acute Respiratory Syndrome (SARS)—were to occur in our service area and a mere 5% of our subscribers were to need the standard medical treatment, our surplus would be completely wiped out. Another example would be an accident or targeted act of terrorism resulting in a partially contained or uncontained leak at one of the nuclear power plants located in our 21-County service area we would be facing serious and debilitating short and long-term health consequences for our members. In even a moderate incident, the medical costs could result in significantly increased expenditures that would more than exhaust our current level of surplus.

(2) A Flawed Process

In over sixty years of monitoring the Blue plans in Pennsylvania, the PID has never previously asserted that it had the authority to establish the *maximum* level of surplus to be maintained by a Blue plan. Indeed, as would be expected, the PID's classic concern was whether the Blues had *sufficient* levels of surplus to meet their obligations.

Having decided to undertake a dramatic change in policy and procedure, the PID is implementing this proposed policy in a manner that we believe is fundamentally flawed in important and meaningful ways. All of the applications filed by the Blues agree that there is no statutory authority that grants the PID the power to establish a maximum level of surplus or to require solvent insurers to file plans for distributing any "excess" surplus. These types of determinations are the legitimate concern of the legislature – not the exclusive and arbitrary province of an executive-branch state agency. In every other state where maximum surpluses have been established, it has been accomplished through the adoption of specific legislation. The elected members of the Pennsylvania General Assembly, who represent the regions that this proposed policy would so powerfully affect, have not been allowed to exercise their Constitutional authority to consider this critical public policy issue. In addition, the General Assembly never gave the PID the authority to distribute surplus the PID may deem "excessive."

We are also deeply concerned about the arbitrary nature of these proceedings. The first and most logical step in any such proceeding would have been to establish a clear standard the PID intends to use in evaluating whether any plan has "excess" surplus – either through the public (speaking through the Legislature) or at the very least through a clear regulation that had been formally adopted through proper channels – channels that include important safeguards and reviews. In our view, the PID's chosen approach has the effect of bypassing the processes already in place to protect the interests of the public, including the Pennsylvania Blue plans. As a result, we think it is clear that the procedures being followed by the PID violate our rights, and any determination made by the PID by means of this process will be inherently flawed. For these and other reasons, the PID proceedings effectively amount to a taking of our property without due process or just compensation.

For these reasons, we believe any failure on our part to challenge the PID's actions to date would be imprudent and even amount to a failure on our part to exercise sound stewardship of Capital's hard-earned assets for the benefit of its subscribers.

(3) *Risk Based Capital*

The Department's method of calculating appropriate surplus levels is also flawed. The PID's notice indicates that each Blue plan's surplus should fall within a certain range as determined by a technical calculation called "Risk Based Capital" ("RBC"). While the subject may be technical, it is quite clear that RBC was originally formulated and has *always* been intended as a method of determining whether a plan was in danger of insolvency. RBC was never intended to measure maximum surplus limits. This is a crucial difference. The determination of whether a company's surplus is excessive at any given point in time must take into account such factors as the company's competitive marketplace and the long-term business plan necessary to preserve that competition. RBC does not even look at such factors.

Our application contains a more detailed discussion of the historical development of RBC. As we explain in our application, the RBC formula was developed by a Committee of the National Association of Insurance Commissioners (NAIC) that in turn commissioned an Advisory Committee of insurance industry experts to prepare a recommendation. Since the RBC formula was developed to represent a minimum acceptable level of capital (and not a maximum level), the NAIC repeatedly confirmed the concerns of the Advisory Committee and cautioned:

"The Working Group discussed problems associated with using RBC results for other purposes... Tying other regulatory provisions to surplus amounts above the RBC thresholds is problematic in that ***the formula was not developed to measure financial strength or capital adequacy beyond a minimum regulatory requirement*** (emphasis added)."¹

"The formula that is proposed is a threshold capital formula rather than a target capital formula. It has been designed to identify companies with capital levels that require regulatory attention. The formula has not been designed to differentiate among adequately capitalized companies. Therefore ***it would be entirely inappropriate to use this formula to rate or rank adequately capitalized companies*** (emphasis added)."²

"Section 8 [of the draft NAIC RBC Model Act] has been amended to include a prohibition on the use of RBC Instructions, RBC Reports, Adjusted RBC Reports, RBC Plans and Revised RBC Plans as evidence in rate proceedings or to calculate or derive any element of an appropriate premium level or rate of return. As noted in earlier reports, the [Model Law Resource Group] believes that unless such a provision is included[,] ***commissioners in some states adopting the model will make the 'floor' capital established by the model into a 'ceiling' for rate making and rate [of] return purposes*** (emphasis added)."³

¹ NAIC Proceedings 1993 3rd Quarter, page 228.

² NAIC Proceedings 1992 4th Quarter, page 557.

³ NAIC Proceedings 1993 3rd Quarter, page 290.

And, in fact, because of the sensitivity of solvency questions and the potential to cause unintended concern and confusion of policyholders, the statute establishing the RBC methodology in Pennsylvania limits the disclosure of RBC levels. **Under current Pennsylvania law, the PID is, in fact, prohibited from disclosing RBC levels. And the PID has now agreed that this information will not be made publicly available.**

(4) Voluntary Contributions to the Commonwealth

Pennsylvania's Blue plans make extraordinary contributions to the public good – contributions that are unique within the health-insurance industry in scale and scope, and that should appropriately be part of this public discussion. The application of each of the Blue plans adequately documents each plan's long-standing and multi-million dollar contributions for the public benefit, whether in the form of financial assistance to organizations that promote health or health education or subsidies that have reduced the premiums our members would otherwise have had to pay.

For its part, Capital BlueCross provides financial and other assistance to organizations that promote health such as the Children's Miracle Network, the Salvation Army, Special Olympics, the American Red Cross, the American Diabetes Association, the Susan Byrnes Health Education Center and the United Way – just to name a few examples. This, of course, is in addition to Capital BlueCross' dramatic and long-standing commitment to the individual marketplace, which includes programs such as CHIP, AdultBasic, Special Care and Direct Pay – programs operated at a loss.

In the case of Capital BlueCross, this is in addition to our payment of various Federal and State taxes and our voluntary payment of local property taxes to municipalities. As examples, Capital BlueCross' wholly owned subsidiary, Capital Advantage Insurance Company is subject to payment of the Pennsylvania premium tax, and Capital Blue Cross' wholly owned health maintenance organization, Keystone Health Plan Central, is subject to payment of Pennsylvania corporate income tax.

We refer you to the application of Capital BlueCross and each of the other Blue plans for more details concerning these activities.

(5) Use of Excess Surplus

While perhaps differently addressed, all of the Blue plans appear concerned with the PID's proposed process for determining "excess" surplus. Capital BlueCross reiterates its strong belief that the use of its assets is a matter reserved under law exclusively for the Capital BlueCross Board of Directors – not the PID. Our Board has a record over many decades of utilizing those funds responsibly and with a keen eye toward the public good.

In addition, we are highly concerned by any prospect that assets acquired and maintained for the benefit of the residents of our 21 county service area would be directed by the PID or others for use by other parts of the state.

Finally, we would point out that this is not an abstract policy debate. There have been a number of insolvencies of Pennsylvania domiciled insurers in recent years. These insolvencies have left literally hundreds of thousands of insureds with unpaid claims (as well as the responsibility of finding insurance with other companies). It would be extraordinarily unfortunate if an insurer were required by the government to reduce its surplus level below

what it judged to be necessary, and then was unable to meet its commitments to its customers, should unforeseen catastrophe strike. Indeed, the promise to be there amid catastrophe is at the core of the promise we make to our customers. We feel strongly that the traditional and more proper focus of the PID should be whether insurers licensed in Pennsylvania are meeting minimum standards in order to avoid further insolvencies and the related market disruption.

Factors Unique to Capital BlueCross

After review of the applications of all of the other Blue plans, we also thought it might be helpful to highlight certain factors that now appear unique to Capital BlueCross and that should be carefully considered by the PID and the public in coming to any conclusion regarding Capital BlueCross' surplus levels.

(1) The Benefits of Competition

By committing to remain independent and by choosing to operate as a fully integrated health plan exclusively focused on the needs of Central Pennsylvania and the Lehigh Valley, Capital BlueCross is responsible for bringing a new and healthy competitive environment to the health insurance market place in Central Pennsylvania and the Lehigh Valley.

It has often been opined by our public officials that more competition is needed among health plans in the Commonwealth. The availability of capital and surplus is crucial to Capital BlueCross' ability to compete successfully. The surplus Capital BlueCross carries today is the surplus that our Board believes is necessary to implement a sustained, long-term presence in this highly competitive marketplace. Any actions by the PID to weaken Capital BlueCross will likely have an unintended consequence -- reducing **competition**. Fostering competition and keeping competitors financially strong go hand-in hand. Weakening Capital BlueCross could even impact the 2,000 family-sustaining jobs it currently makes available in Central Pennsylvania and the Lehigh Valley and could also have a cascading impact on Capital BlueCross's many local vendors.

(2) Difficulties with Using a Single Standard

We note that one of the other Blue plans suggests that the same standard should apply across the board to all Blue plans, which is contrary to the PID's suggestion that different levels could be established for each plan. In this case, we agree with the PID.

Given the lack of some economies of scale and the geographic concentration of the risk pool with small plans, it stands to reason that smaller regional plans, such as Capital BlueCross would have greater relative capital needs. Even more importantly, Capital BlueCross is in a unique position among the Blues, since we are the only Pennsylvania Blue Cross plan that does not operate under a joint venture arrangement with Blue Shield. Given that we actively compete against Highmark in our service area, and having already emerged as the market leader against a plan with considerably larger financial resources, our capital needs will necessarily differ from other Pennsylvania Blue Plans. Given our unique circumstance, Capital Blue Cross's surplus needs will logically and appropriately be higher than the other plans.

(3) Prior Filings with the PID

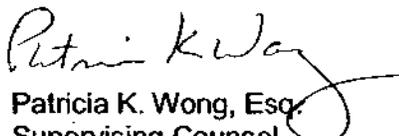
In 2001, when Capital BlueCross was considering evolving into a full-service, fully integrated health plan, the PID requested Capital BlueCross to submit a confidential, five-year business plan. This plan was requested in order to satisfy concerns, repeatedly expressed by senior members of the PID that Capital BlueCross's projected surplus levels might be inadequate to effectively compete against our former business partner and other strong competitors in Central Pennsylvania and the Lehigh Valley.

Three short years ago, the PID's concerns were not that Capital BlueCross had too much surplus, but rather, whether we would have enough. The five-year confidential business plan contained projections, including RBC levels, which in fact were substantially *higher* than they are today. Now we are being told that these levels may be too high – and that we may have to spend those surpluses down, materially affecting our ability to continue to implement the long-term business plan we shared with the PID. As a consequence, we are in the position of being penalized for having relied in our long-term business planning upon the PID's prior position on this matter, which would appear to be diametrically opposed to the PID's current position. We have already invested significant funds in developing infrastructure and we have planned for significant additional expenditures on the assumption that our surplus would be available to fund them. **Indeed, our very decision in 2001 to remain an independent health plan and to launch our new business enterprise as a stand-alone, full-service health insurer committed to the residents of Central Pennsylvania and the Lehigh Valley as our exclusive focus (rather than merge into a larger, multi-state consolidator) was based upon this assumption.** The continued availability of our surplus is, in fact, essential for the successful implementation of our business plan.

Questions and Comments

We trust that this letter will further a better understanding of the important issues raised by the PID's proceedings. It lays out some of the many reasons Capital BlueCross needs to have surplus levels sufficient to allow it to compete in its market and deliver the long term stability our customers expect. We hope that the readers of this letter will also review our application (available on our website www.capbluecross.com), which contains a fuller discussion of these and other issues of great importance to our approximately 1,000,000 subscribers, the public and Capital BlueCross. In conclusion, we invite our customers and providers or any interested parties with questions or comments regarding our application or this letter to e-mail us at surpluscomments@capbluecross.com for further information.

Sincerely,


Patricia K. Wong, Esq.
Supervising Counsel
Capital BlueCross