

Highmark's Form A Regarding the Acquisition of Control of BCNEPA and Subsidiaries

TAB F

Overview of BCNEPA Business Perspective

**HOSPITAL SERVICE ASSOCIATION OF NORTHEASTERN PENNSYLVANIA d/b/a
BLUE CROSS OF NORTHEASTERN PENNSYLVANIA (“BCNEPA”) OVERVIEW OF
PERSPECTIVE ON A MERGER WITH HIGHMARK INC. (“HIGHMARK”)**

As an independent licensee of the Blue Cross Blue Shield Association, BCNEPA does business as Blue Cross of Northeastern Pennsylvania in 13 counties in northeastern and north central Pennsylvania (the “BCNEPA Service Area”).¹ BCNEPA’s mission “is to provide integrated health care services and products to improve the quality, accessibility and affordability of health care in the BCNEPA Service Area.” The company strives to be a leader in innovation and delivery of improved health management and financing services, with the ultimate goal of improving the health of the individuals residing in northeastern and north central Pennsylvania.

Driven by evolving market forces and accelerated by the initial implementation of the federal Affordable Care Act (“ACA”), transformational change is sweeping both the national and regional health care environments. Payors and providers alike are recognizing that in this new environment, they must explore every opportunity that can strengthen their ability to continue delivering the services that consumers, businesses and communities deserve and expect.

BCNEPA recognizes that it must transform in order to continue to best serve the residents of northeastern and north central Pennsylvania now and in the future. BCNEPA has proactively evaluated potential strategic affiliations, guided by its commitment to:

- Customers (world class services and products)

¹The BCNEPA Service Area includes the counties of: Wayne, Pike, Monroe, Carbon, Luzerne, Lackawanna, Wyoming, Susquehanna, Bradford, Sullivan, Lycoming, Clinton and Tioga.

- Community (continuing mission, employment, economic impact)
- Company (strong performance, strong future)
- Brand (maintaining and enhancing the value of the Blue brand)

Why BCNEPA Is Pursuing a Merger

BCNEPA has a strong 75-year history of serving northeastern and north central Pennsylvania. Industry and marketplace changes pose serious challenges to BCNEPA's long term viability, sustainability and ability to continue serving its customers and providers with the same high level of performance they have come to expect. In addition, BCNEPA is an important local employer with approximately 750 employees, an "anchor" employer in downtown Wilkes-Barre and an economic engine for the region evidenced by its approximate \$1.7 billion dollars in total revenue and \$1.5 billion dollars in payments to health care providers.

In the current uncertain, volatile and highly competitive health care market, BCNEPA believes that an affiliation with a larger organization will strengthen the combined entity's ability to serve the long-term needs of residents of northeastern and north central Pennsylvania. With BCNEPA's strong membership base, surplus in excess of \$300 million as of year-end 2013, risk based capital ("RBC") safely above required minimums, and a robust brand built over the past 75 years, BCNEPA is an attractive affiliation candidate.

BCNEPA is faced with the following environmental and business challenges:

- **Pressure on Operating Results.**

Due to market pressures, BCNEPA generated a small gain from operations (before investment income and realized gains) of approximately \$8 million in 2013, roughly one-third of what it realized in 2012. Medical care cost trends were in the low single digits for 2013, as a result of significant management initiatives in the prior 36 months, but are expected to increase to high single digits in 2014. Key performance drivers include increased benefits and an elevated risk pool due to the ACA, increased provider consolidation, and increased cost-shifting to commercial insurance due to government program reimbursement pressures.

The ACA is expected to accelerate an ongoing, significant membership mix shift to markets with negative or low margins, intensifying the need for administrative scale. It is projected that underwritten business will continue to migrate to self-funded business, there will be a high propensity of small groups dropping coverage resulting in employees migrating to individual coverage, and some uninsured will purchase individual coverage stimulated by the financial subsidies and penalties that are part of the ACA. These market segment shifts are expected to challenge BCNEPA's ability to generate necessary margins in the future. As an example, BCNEPA generated losses of approximately \$94 million over the 5-year period 2008-2012 on its individual community commitment products. Projections are that the risk of the ACA products will mirror that of these community commitment products.

In addition, significant provider consolidation has occurred throughout BCNEPA's Service Area, which has led to increased provider costs for BCNEPA. Specifically, Geisinger Health System (an integrated health delivery system with a health plan), Community Health Systems (the largest for profit hospital chain in the country), and Susquehanna Health (in Williamsport) have all recently acquired formerly independent hospitals. BCNEPA's provider costs have increased as these health systems have grown, which further emphasizes the need for operating efficiencies.

An independent study by a nationally recognized consultant engaged by BCNEPA (the "Independent Consultant") concluded that as these trends continue, they will continue to negatively impact BCNEPA's operational results and the financial strength BCNEPA needs in order to continue to fulfill its mission at a high level.

- **Heightened exposure to risk.**

BCNEPA's limited Blue branded service area (13 counties) restrains its ability to grow its membership base in an increasingly competitive and transformational market and affects its ability to withstand the risks associated with the ACA. This becomes a disadvantage in serving fully-insured members by limiting BCNEPA's ability to spread the risk of large claims and higher-risk members over a larger base, in order to lower costs for all participants. As more individuals and small groups begin purchasing coverage through the health exchanges, including those who did not have coverage before, the potential for higher utilization and larger claims will further increase risk. For example, Aetna, a national insurer competing in BCNEPA's market, can spread risk

across more than 18 million medical subscribers compared to BCNEPA's total base of less than 550,000.

The Massachusetts experience with health care reform resulted in significant losses for insurers for several years post-implementation, and BCNEPA expects a similar experience with the ACA.

- **Need for significant investment.**

Based on a study by the Independent Consultant, BCNEPA should expect to spend significant capital over the next five years including, but not limited to, the following areas:

- Readiness for, and ongoing compliance with, the ACA. As the marketplace changes, significant capital for both risk and investment is needed to comply with ACA requirements. Investments in technology solutions for ACA readiness are particularly complex and costly. Recent and anticipated essential spending for BCNEPA includes, but is not limited to:
 - Enrollment and billing connectivity with the Exchange
 - Significant upgrades to enrollment and billing systems
 - Product changes; new network/product configurations
 - Public and private marketplaces (the on-line "Blue Cross Store")

- Development of a defined contribution platform for group customers
 - NCQA & URAC accreditation for First Priority Life Insurance Company, Inc. products
 - Implementation of Essential Health Benefits (EHB)
 - Implementation of coverage and cost-sharing transparency/disclosure requirements
 - Direct marketing and individual sales
 - Visibility campaign and pre-exchange advertising/promotion
 - Upgrades to BCNEPA.com for new customer acquisition and retention
- Transformation to accountable care. BCNEPA has been exploring opportunities to implement new business models with the provider community based on aligned economic incentives to manage unit care costs and increase value to the consumer. It has implemented new programs such as innovative contracting and payment methodologies and transparency efforts that help members make more informed health care decisions. Additional investments will be necessary in the following areas:
- Creating an integrated approach to care across independent hospitals and physicians, including Patient Centered Medical Home (PCMH) and

- Accountable Care Organization (ACO) models, and a Health Information Exchange (HIE) to use data more effectively across multiple settings
- Better managing care for chronically-ill individuals and improving overall population health to help lower care costs
 - Developing financial relationships that reward providers for quality outcomes and improve the patient experience (pay for value)
 - Reducing the outmigration of care from northeastern and north central Pennsylvania where appropriate (comparable quality for lower cost)
 - Supporting the expansion of primary care access
- Enhancing the customer experience. Significant investments will be necessary for BCNEPA to continue to provide a high-quality, seamless, competitive experience for its customers. This will be especially critical for the expanding retail marketplace associated with the full implementation of the ACA. New or enhanced services, tools, and technologies will be critical in areas such as:
- Transparency of comparative cost & quality information on providers
 - Reduction of customer effort to improve their experience
 - Real-time access to information and feedback
 - Support for health & wellness activities
- Maintenance and upgrade of IT systems. Considerable investment is also needed for the technology to support these new models, enhance services for groups and members, and develop systems that share data effectively across providers and settings, including investing in IT systems for clinical management infrastructure

for additional connectivity (e.g., cloud technologies for virtual patient data, real time data processing) and establishing electronic medical records systems for primary care physicians.

- **Capital Strength of Competitors.**

Competition from well capitalized competitors will put a strain on BCNEPA's financial resources. National and regional competitors are using their financial strength to position themselves favorably in the new environment:

- Aetna purchased Coventry Healthcare for \$5.8 billion in 2012 primarily to expand its government business. It is also putting money and energy into developing accountable care organizations (ACOs).
- United Healthcare, which is gaining share in the BCNEPA Service Area, spent \$1.45 billion to purchase regional providers in 2011 alone.
- Geisinger Health Plan is affiliated with the Geisinger Health System; whose parent (the Geisinger Health System Foundation) held a fund balance as of June 30, 2012 of approximately \$1.4 billion dollars. As stated earlier, Geisinger continues to expand its provider presence through affiliations and acquisitions.

- Humana is investing in integrated delivery systems and recently acquired Metropolitan Health Networks for \$500 million.
- Cigna acquired HealthSpring for \$3.8 billion to boost its Medicare and Medicaid products.

BCNEPA's ability to successfully deliver on its mission in the future will depend on its ability to compete with these well capitalized players, in both the commercial and government market segments.

- **Scale limitations.**

A critical success factor in the new health care environment is scale. Larger players have scale which permits them to operate more efficiently and spread risk and administrative costs over a larger population. To continue to offer products that meet the needs of consumers, BCNEPA must find ways to increase scale and reduce its administrative costs.

Group membership is expected to continue to migrate toward self-funded or administrative services only (ASO) arrangements, where the risk stays with the employer and net income for the plan is based not on managing risk but on keeping administrative costs below the fees received. This market segment represents almost a third of BCNEPA's controllable membership.

Compounding this issue has been the growth of Blue Card membership in the region (subscribers living in the BCNEPA Service Area carrying a Blue Card other than BCNEPA's).

Finally, several aspects of the ACA will place even more pressure on margins and administrative costs including medical loss ratio (MLR) limitations and new taxes and fees (e.g. Health Insurer Tax).

- **An expanding government marketplace.**

BCNEPA must have a larger footprint and greater scale to compete for a chance to serve the growing number of individuals covered under government programs like Medicaid, Medicare, Pennsylvania Employees Benefit Trust Fund (PEBTF) and the new public Exchange products.

The Medicare population in the BCNEPA Service Area, approximately 215,000 as of BCNEPA's latest estimate, continues to grow as baby boomers turn 65 and older. If Pennsylvania decides to expand Medicaid eligibility, another 50,000-75,000 individuals could be added to the existing 210,000 Medicaid eligible individuals resident in the BCNEPA Service Area. Finally, BCNEPA expects to enroll approximately 90,000 individuals in Exchange products by 2016.

Overall, it is estimated that approximately 45% to 50% of the BCNEPA region's 1.2 million residents will be covered by one of these government programs by 2016.

BCNEPA does not have the size, scale or footprint to participate independently in

managed Medicaid (HealthChoices) or managed Medicare (Medicare Advantage) programs. Therefore, it developed joint ventures with other Blue health plans:

- Medicaid: AmeriHealth Northeast, LLC, a 50%/50% joint venture with AmeriHealth Caritas (owned by Independence Blue Cross and Blue Cross & Blue Shield of Michigan).
- Medicare: Freedom Blue, a joint risk sharing agreement with Highmark.

Neither of these arrangements includes a significant operational role for BCNEPA and both programs have a larger footprint than BCNEPA's current 13 county service area.

BCNEPA's Conclusion:

These environmental and business challenges seriously impact BCNEPA's long term viability and sustainability as a trusted solution for its customers, a reliable partner with its providers and a major contributor to the local economy. Therefore, BCNEPA chose to seek a transaction that would address these challenges and meet the goals outlined in the following pages.

BCNEPA's Goals for a Transaction

BCNEPA's goals for a transaction – guided by its commitment to Customers, Community, Company and Brand – include:

- 1. Enhance value to the customer** through a transaction that can provide new consumer tools, a wider range of affordable product offerings, stronger

technological capabilities, and enhanced capabilities to support health and wellness.

2. **Enhance BCNEPA’s ability to implement new delivery models can be implemented** with provider systems in order to hold down costs and ensure quality care for customers. This is essential as providers continue to consolidate and grow larger.
3. **Preserve its not-for-profit model and its mission** to improve the quality, accessibility and affordability of health care in the populations served. BCNEPA wants to preserve the not-for-profit, non-investor owned status it has held for the last 75 years, and wants to ensure that decisions will continue to be driven by what is best for its customers and the community, not by quarterly earnings, share prices and other short-term financial metrics.
4. **Preserve and enhance the strength of the Pennsylvania and national Blue brands**, which BCNEPA has represented over the last 75 years. Over that time, the people of northeastern and north central Pennsylvania have come to trust the Blue brand to provide reliable, affordable and high-quality health care coverage, while maintaining a strong commitment to customers and the community. BCNEPA is seeking a transaction that will continue to enhance the Blue brand through a combination with another nonprofit Blue company.

5. **Expand scale so a combined entity can optimize administrative infrastructure, reduce operational costs and better manage risk** to deliver value for customers. Scale provides greater ability to manage unit care costs and unit administrative costs and manage risk in preparation for expected membership shifts.
6. **Increase access to capital** for investments necessary to continue to fulfill the mission well into the future. BCNEPA has surplus as of year-end 2013 in excess of \$300 million. This is within appropriate levels set by the Pennsylvania Insurance Department but is far less than its larger competitors and inadequate to fund necessary future investments, manage future risks and comply with regulatory reserve requirements.
7. **Maintain BCNEPA's economic impact and substantial work force in northeastern and north central Pennsylvania.** BCNEPA currently employs approximately 750 workers in northeastern and north central Pennsylvania and is an economic leader in the region. A partner must have an understanding of the importance of maintaining a local workforce and continuing an investment in the economy of the region.
8. **Avoid or minimize duplicative capital investments** that will be necessary to fulfill its mission well into the future (e.g., IT).

9. **Participate in a growing government business segment with a larger footprint.** BCNEPA must be prepared for the growing Medicare, Medicaid and Exchange markets, particularly as Pennsylvania continues to age, considers Medicaid expansion and implements Exchange products in 2014.

The Selection Process BCNEPA Utilized

BCNEPA engaged in a rigorous process to explore its options for a strategic affiliation and to select a transaction partner that best positions the company to continue serving the long-term needs of its customers and the community.

- BCNEPA conducted a structured, deliberative process since late 2012 to select the best strategic affiliation partner. The company began by identifying the goals for an affiliation and developing a process and criteria for assessing prospective candidates for affiliation. BCNEPA established a structured project team that included the BCNEPA Board of Directors, a dedicated subcommittee of the Board, Executive Management and other key personnel.
- The company retained experts to support its decision-making, which included Cain Brothers, an investment banking firm with specific experience and expertise in the health care industry, as well as legal counsel Cozen O'Connor, a top national firm with attorneys skilled in both health care law and complex business transactions.
- BCNEPA developed a comprehensive Request for Proposal (RFP) document relating the overall process and goals for entering into a potential relationship. This RFP process was used to solicit and receive proposals from three prospective candidates.

- Each proposal was evaluated for responsiveness to BCNEPA’s affiliation goals. BCNEPA then worked through Cain Brothers to respond to any questions from the candidates as well as to provide requests for additional information back to the candidates. Following this period of information sharing, BCNEPA arranged face-to-face meetings with each candidate. These meetings allowed each candidate to present their proposal as well as for the BCNEPA Board to engage directly with the candidates to address their specific and clarifying questions.
- A series of meetings was utilized by the BCNEPA Board of Directors to consider the candidate proposals, using the affiliation criteria as a basis, and select one candidate to continue exclusive negotiations.
- Each candidate was given the opportunity to update their proposal based on feedback from BCNEPA delivered separately to each candidate by Cain Brothers.
- Throughout the process, the BCNEPA Board of Directors and its dedicated subcommittee of the Board held more than 40 meetings, demonstrating the care and diligence associated with the process and the decision.

BCNEPA Selection of Highmark

After careful review and consideration, the BCNEPA Board of Directors concluded that a merger with Highmark is in the best interests of its customers, employees and the community. A merger with Highmark is the best option for achieving BCNEPA’s goals and is the logical next step in a long and successful relationship between the two companies.

- A merger will position the merged company to continue providing the affordable, high-quality health care options and excellent customer service that BCNEPA customers have come to expect, all under an enhanced Blue brand. BCNEPA and Highmark have worked cooperatively for more than 70 years to serve the needs of customers across northeastern and north central Pennsylvania by jointly providing Blue Cross/Blue Shield coverage.
- A merger will continue BCNEPA's longstanding mission as part of a nonprofit, community-based and community-minded company, while at the same time adding the scale that draws on the merged company's long-term financial strength and ability.
- A merger will expand access to capital for new investments to benefit BCNEPA subscribers through: innovative tools and technology that improve care quality and patient wellness; more cost-effective and quality-driven partnerships with providers; and expanded access to health insurance as the ACA is implemented, with efficiencies that can be passed on to customers.
- A merger will provide the larger geographic footprint that will be necessary to effectively compete for commercial and government business.
- A merger can be implemented with minimal disruption to customers and the health care providers with whom BCNEPA works, given that BCNEPA is already utilizing certain Highmark systems and IT infrastructure to support its operations.

- Highmark has a proven track record of integrating organizations for mutual success including Blue Health plans in West Virginia and Delaware.

- Finally, Highmark’s proposal includes significant commitments that were important to BCNEPA:
 - Presence: Maintenance of regional operations, minimum staffing levels for four years and efforts to grow new employment opportunities.

 - Input: Local advisory board that will have a voice in matters related to the transition and on-going operations and local representation on the Highmark Inc. Board of Directors.

 - Employee Protections: 18 month commitment to existing employees for continued employment or severance should they be displaced.

 - Financial Commitment: The agreement allows BCNEPA to provide significant funding to one or more charitable organizations to be used to support health care, economic and community development and other purposes that complement or supplement the historic mission of BCNEPA.