



NEW JERSEY HOSPITAL ASSOCIATION

March 26, 2009

VIA Overnight Delivery and Regular Mail

The Honorable Steven Goldman
Commissioner
Department of Banking and Insurance
State of New Jersey
P.O. Box 325
Trenton, NJ 08625-0325

The Honorable Anne Milgram
Attorney General
State of New Jersey
Richard J. Hughes Justice Complex
25 Market Street
8th Floor, West Wing
Trenton, NJ 08625-0080

RE: Horizon Blue Cross Blue Shield

Dear Commissioner Goldman and Attorney General Milgram:

The undersigned organizations are writing to provide you with our preliminary observations with respect to Horizon Blue Cross Blue Shield's ("Horizon") responses to the information your agencies requested as part of your October 14, 2008, determinations that the Horizon conversion application ("application") and foundation plan ("plan") were incomplete in numerous material respects. Our analysis is divided into four sections. The first section discusses Horizon's claims of confidentiality or privilege for much of the information the state has asked for. The second section reviews the state's questions as to what Horizon could accomplish if it converted that it cannot accomplish today as a nonprofit entity, and discusses the issues raised by Horizon's responses to those questions. The third section analyzes, to the extent possible in view of the degree to which Horizon continues to claim confidentiality and privilege, the most important issues raised by Horizon's substantive responses. Finally, the fourth section discusses Horizon's answers on other issues.

Our conclusion—and yours, we hope—is that the Horizon application remains incomplete despite the additional information submitted by Horizon. As troubling, the Horizon responses do not make the conversion process more transparent, but rather less

so, and do so in ways that we believe transgress the conversion statute's careful balancing of the public's right to know against the applicant's need to preserve information that is truly proprietary or privileged.

I. Horizon's claims of confidentiality

As you know, the New Jersey statute governing conversions requires Horizon to submit all information the state asks for and mandates that all such information be made public unless it falls within one of four categories. Horizon's responses to your October 14 letters in many cases fail to comply with either of these requirements¹. Horizon not only claims confidentiality for a great deal of information that the statute requires to be public, but also in many cases fails entirely to submit such information to the state. Rather, it demands that the state come to its offices to view that information. Below we explain why Horizon may not decline to submit information to the state and may not properly claim confidentiality to the extent that it has.

A. Horizon must submit to the state all information sought by the state

The statute requires Horizon to "file with" the Department of Banking and Insurance ("DOBI") nine enumerated types of information plus "any other additional information that the commissioner in his sole discretion deems appropriate." N.J.S.A. 17:48E-51(a), (b) (10) (emphasis supplied). Similarly, the statute requires Horizon to "submit to" the Attorney General ("AG") a petition that includes the foundation plan and "any other information that the AG requests." N.J.S.A. 17:48E-67(a) (1) (emphasis supplied). The statute does not provide for any exceptions permitting Horizon to make available certain documents only for "inspection" at its office rather than "filing" them with the Commissioner or "submitting" them to the AG. Nor does any other pertinent statute contain such an exception. Thus, although Horizon may reasonably argue that certain information is confidential and should not be disclosed to the public, it cannot reasonably argue that it has no duty to submit that information to the Department in the first instance. Horizon's refusal to produce information requested by the state and instead to insist that the state come to its offices to inspect those documents thus does not appear to be in compliance with the law.

B. With four exceptions, all information sought by the state is presumptively a public record; most of what Horizon has claimed is confidential does not fit within any exception and thus must be made public.

The statute makes all documents that must be filed or submitted to DOBI or the AG public records, with four exceptions. Those exceptions are as follows:

¹ Because the business plan filed with the application is confidential under the statute, DOBI's findings of incompleteness with respect to the business plan were sent to Horizon in a separate, confidential letter. In preparing this analysis have not had the opportunity to review that letter, or Horizon's response to it, if any,

- * Documents deemed confidential by statute or regulation;
- * The business plan;
- * Financial projections;

* Any other information the Commissioner and AG jointly determine could result in harm to the health service corporation, harm to the converted insurer or parent corporation, or harm to the public interest, if disclosed.

N.J.S.A. 17:48E-58.

Horizon has refused to file a substantial amount of information with the state that clearly does not fall into any of the above four categories. That information includes:

- * Employment, severance, and consulting agreements (Foundation Plan Question ("FPQ") 14, 15);
- * Documents reflecting Blue Cross association policies affecting Horizon and agreements with Horizon (Conversion Question ("CQ") 12, FPQ 32);
- * Documents showing subscribers by product type by year (FPQ 35);
- * Agreements involving post-conversion financial benefits to executives (FPQ 45).

Clearly, these documents are not Horizon's business plan; they do not contain financial projections; they are not deemed confidential by statute or regulation; and the commissioner and the AG have issued no joint determination of which we are aware finding that the disclosure of any of the above information could harm Horizon or the public. By refusing to produce such information, therefore, Horizon appears to be in violation of N.J.S.A. 17:48E-51 and 17:48E-67.

Three additional types of documents which Horizon has declined to submit to the state consist primarily of presumptively public information that may well contain certain financial projections that Horizon might well argue should be kept confidential, but only upon a joint determination of the Commissioner and the AG. Those documents include

- * Minutes of and Presentations to the Board and its committees (FPQ 4, 5a, 5b);
- * Documents regarding potential affiliations involving Horizon (FPQ 17, 18, 28, 29);
- * Documents regarding Horizon's expansion plans (FPQ 20).

Rather than the course it chose--declining to submit those documents in their entirety-- Horizon was required by the statute to have submitted them to the state with any financial projections contained therein, and requested them to be deemed confidential. With those projections redacted only to the extent necessary to protect confidential information, all such documents should be made public.

Horizon also claims privilege for certain documents. Horizon may properly withhold from the state advice it has received from its lawyers pursuant to the attorney-client privilege, which the statute expressly recognizes. N.J.S.A. 17:48E-51(a) (5). However, Horizon appears to claim privilege for much more than advice of counsel. For example, FPQ 7b asks for presentations to the Board by counsel, consultants or experts. Horizon responds that "Per agreement with the Office of the AG's representatives, privileged materials will not be produced." If Horizon is claiming privilege with respect to presentations made by non-lawyer experts and consultants, it is difficult to see how the attorney-client privilege applies to those presentations.

Similarly, FPQ23 asks for documents upon which the Board based its decision to pursue the conversion. Horizon's response is that with the exception of the material it submitted on Aug. 15, 2008, all the documents it now submits are protected by the attorney-client and work-product privilege. Again, if Horizon is claiming that work done by non-lawyers is subject to attorney-client privilege or the attorney work product privilege, that claim would not appear to be a valid one.

We would also note that in the interest of its stated goal of maximizing transparency, Horizon, like any client, has the option of waiving attorney-client privilege. This was the course of action followed by CareFirst, Inc., the Maryland Blue Cross plan, in connection with its proposed conversion to for-profit status and acquisition by WellPoint.

Importantly, the documents that Horizon has declined to submit to the Department and the AG are directly relevant to the factors N.J.S.A. 17:48E-67(c) requires the AG to consider in reviewing the plan. Those factors include:

- * Whether the health service corporation exercised due diligence in deciding to effectuate the conversion, selecting any other party to the conversion or related transactions, and negotiating the terms and conditions of the conversion;

- * Whether the procedures used by the health service corporation in approving the conversion, including whether expert assistance was used, were appropriate; and

- * Whether the health service corporation established appropriate criteria in deciding to pursue a conversion and considered the proposed conversion as the only alternative or as the best alternative in relation to carrying out its mission and purposes.

N.J.S.A. 17:48E-67(c)(1), (2), (6). The documents Horizon has declined to submit are exactly those documents that the AG must review most carefully in making the above

determinations; forcing her to come to Horizon's office to conduct her review will inevitably hinder that analysis. Moreover, "inspection" is not a permissible option under the statute: Horizon, as noted above, must submit the required documents to the AG as part of its foundation plan. Equally important, by refusing to submit those documents to the state, which may in turn determine that these documents should be made publicly available, Horizon is making it impossible for any non-state party to meaningfully comment on whether Horizon has exercised the due diligence the statute requires of it. Ultimately, Horizon's failure to submit these documents would frustrate yet another critical requirement of the statutory review process: review and approval of the plan by a state court, upon its determination that the plan meets the requirements of the statute and is in furtherance of the public interest. Horizon's failure to submit these documents to state regulators would ultimately mean that the record before that court would likewise not contain the very documents that are at the core of its jurisdiction and determination.

Furthermore, Horizon is withholding many documents from the public record that ultimately would be made public at such time as they would proceed with SEC rules and an S-1 filing for a public stock offering. It is difficult to understand how potential investors should be allowed greater visibility into Horizon's operations, agreements, and business plans than the public in reviewing the conversion itself.

II Horizon's continuing inability to articulate why the conversion is necessary

With respect to several different aspects of Horizon's business, DOBI asked Horizon what it would be able to do after the conversion that it cannot do today as a nonprofit health services corporation. Horizon never specifically answers any of the DOBI's questions, but rather answers with a variation of the general response that conversion will enable it to raise more money and thus to more easily fund whatever it needs to fund. While the statute does not expressly require Horizon to demonstrate that it cannot fulfill its purposes unless it converts, it does require DOBI to find that the conversion would be in the public interest, and specifically requires the AG to determine whether Horizon "considered the proposed conversion as the only alternative or as the best alternative in relation to carrying out its mission and purposes." N.J.S.A. 17:48E-52(a)(12); 17:48E-67(c)(6). Arguably, if Horizon cannot demonstrate that it must convert in order to accomplish its purposes, then the AG cannot pursuant to the statute find that Horizon considered the proposed conversion as the best or only alternative in relation to carrying out its mission and purposes. In addition, it is hard to imagine how DOBI could conclude that the conversion would further the public interest if it has no basis upon which to conclude that Horizon would be unable to fulfill its purposes without converting. The following are examples of Horizon's conclusory and inadequate responses to questions asking it what it cannot accomplish without converting that it could accomplish if it did convert:

* How remaining an HSC would prevent Horizon from being the best health plan in New Jersey (CQ 9):

The investments that may be required are expected to significantly increase Horizon BCBSNJ's normal spend on infrastructure and needed flexibility to fund through means that would be easier to secure as a converted Company.

* How conversion will make Horizon a better health plan (CQ 10a):

Conversion will better position the Company to realize the goal of providing the financial flexibility to fund additional capability investments that will enable it to continue to provide market leading products and services to its groups, members and providers.

* How conversion will enable Horizon to respond better to health insurance reform (CQ 10e):

Flexibility and agility will be required as reform efforts transform the nation's health care system. As New Jersey's largest health insurer, Horizon BCBSNJ needs to have the same tools at its disposal as its competitors.

* How not converting would prevent further improvements in the quality of health care (CQ 11):

Further innovation to improve quality requires ongoing funding and investment. Without the flexibility to access capital markets, and the influx of the monetary support needed for infrastructure and human capital development, the quality of health care in the State will lag behind other parts of the country.

* How conversion would affect Horizon's ability to tier its provider network (CQ 28):

Investments are necessary to capture data to establish best practices, identify best performers, create new networks and develop systemic capability to offer products with tiered networks. As described elsewhere, capital needed for such investments is more accessible in a scenario in which Horizon BCBSNJ is a converted company.

III. Key substantive issues raised by Horizon's responses

A. Horizon's surplus levels

Both DOBI and the AG asked Horizon to explain why it believes its present surplus level is necessary. Interestingly, Horizon offers inconsistent responses to your agencies.

Specifically, DOBI's Conversion Question 22 asks Horizon to explain why it feels that its present surplus level is necessary, and to produce the actuarial studies that support that level. Horizon says only that "it would not be prudent to allow the company's reserves to drop below their current levels." (Horizon uses the term "reserves" rather than "surplus." As you know, the legally correct term is "surplus.") Horizon goes on to say that the actuarial studies are confidential.

In contrast, in FPQ 12 the AG asks Horizon to set forth its surplus for each of the last four years and to show how that surplus compares to the NAIC and Blue Cross Blue Shield Association ("BCBSA") guidelines regarding surplus. Horizon's response is shown in the following table:

	2008	2007	2006	2005
Surplus (statutory basis)	\$1,338	\$1,548	\$1,423	\$1,254
NAIC company action level (200%)	498	466	406	354
Excess	840	1082	1017	900
BCBSA monitoring level (375%)	934	874	761	664
Excess	404	674	662	590
BCBSA guidelines for strong plans (500%)	1245	1165	1015	885
Excess	93	383	408	369

While these numbers are of course subject to varying interpretations, the table above supports a fairly compelling argument that Horizon could quite prudently fund \$100 million to \$150 million over five years out of surplus, and yet maintain its BCBSA ranking as a "strong plan." First, even after one of the worst years for the financial markets in history, Horizon's surplus as of year-end 2008 was still 7 percent greater than it was in 2006. That is because Horizon is required by law to hold most of its assets in fixed-rate investments, and permitted to hold very little in stock. Given these regulatory constraints, Horizon's surplus will likely continue to retain most of its value even if the stock market continues to decline.

Second, the amount Horizon says it needs to invest is a small fraction of its total surplus and a small fraction of its surplus exceeding the BCBSA's monitoring level. According to Horizon's application, it is reasonable to assume that Horizon intends to spend an additional \$125 million--the mid-point of its \$100 million to \$150 million range--over the next five years. Spending this \$125 million would still leave it with

more than \$1.2 billion in total surplus, with \$279 million in surplus beyond the \$934 million it needs to meet the BCBSA's monitoring level, and with only \$32 million less in surplus than it would need to meet the Blue Cross Association's guidelines for strong plans.

Third, Horizon would be spending this \$125 million not all at once but gradually over five years. Thus, even if Horizon's surplus does not increase, for the first three years Horizon's surplus would continue to exceed not only the NAIC standard and the Blue Cross monitoring level but also the Blue Cross Association's guidelines for strong plans. In addition, Horizon's surplus would necessarily increase to a greater extent if it reduced its surplus by only \$25 million a year for five years rather than by \$125 million in the first year, since it would have more surplus to invest in the subsequent years under the former scenario than under the latter.

Finally, the larger the carrier the less of a surplus cushion as a percentage of its minimum required surplus, since the larger the carrier the greater its spread of risk. When Horizon describes the NAIC company action level as "200 percent," the BCBSA monitoring level as "375 percent," and the BCBSA guidelines for strong plans as "500 percent," the denominator on which each of those percentages is derived is the NAIC's so-called "authorized control level," which is the bare minimum an insurer must have to avoid being taken over by the state. The BCBSA guidelines indicate that for a Blue Cross plan to be considered a strong company it must have surplus of at least five times that amount. This makes sense for relatively small plans--since one or a few aberrationally large claims could have a significant impact on their surplus--but it makes much less sense for the largest plans, like Horizon, which have a broad enough spread of risk to withstand such aberrational claims.

B. Horizon's pricing strategy

Horizon explains that during part of 2005 it priced below trend--i.e., below its projected costs-- to gain market share (CPQ 19, 25) and to increase its leverage with providers (CPQ 25), but that it is now pricing at or above cost (CPQ 19) and that it projects that its underwriting profits will increase over time (CPQ 25). This may be a lawful pricing strategy, but whether the conversion would make it easier for Horizon to price below cost at certain times and above cost at other times is clearly relevant to whether the conversion would be in the public interest.

It should also be noted that Horizon's willingness to share its past and current pricing strategy seems inconsistent with other claims in its responses where it invokes confidentiality based upon the proprietary nature of the response. Horizon would appear to be selective in invoking that standard.

C. Horizon's loss ratio

CPQ 21 asks Horizon to quantify the effect the additional expense of operating as a publicly traded company would have on Horizon's loss ratio. Horizon answers—without any supporting documentation -- that any additional expense would be insignificant, and therefore would not cause Horizon any problems in meeting the minimum loss ratio requirements of S-1557. However, loss ratios of nonprofit plans are typically substantially higher than the loss ratios of for-profit HMOs, and Horizon projects that its underwriting profits will increase following the conversion. We would urge you to seek additional information from Horizon that would permit you to consider carefully whether the increased costs of operating as a for-profit would truly be insignificant, and to also consider the effect both of any such increased costs and of Horizon's increasing underwriting profits on its loss ratio.

D. Executive compensation

DOBI's Conversion Question 2 asks what safeguards Horizon has taken to ensure that its executives will be compensated after conversion at no more than fair market value. Horizon explains the procedures it goes through in setting executive compensation and says that those procedures will not change after the conversion. Notably, Horizon states that it has always been "very conservative" in its approach to executive compensation, that over the last five years its executive compensation has been 7.5 percent below market, and that RSM McGladrey conducted an examination of its executive compensation in 2007 and 2008 and found that the compensation of its top five officers was below market by 17.5 percent.

Whether executive compensation is "below market," however, depends on how one defines the market. The \$4,983,254 compensation of Horizon's CEO in 2007 was the **fourth highest** among all Blue CEOs--it was exceeded only by the CEOs of Wellpoint, which is for-profit and covers 17 states; of HCSC, which includes the Texas, Illinois, Oklahoma and New Mexico plans; and of the Florida Blue Cross plan. See AIS Report on Blue Cross and Blue Shield Plans, November 2008, at 10. Thus, if Blue Cross plans are viewed as the market, the Horizon CEO's compensation is at the top of the market, not below market. It is therefore important to determine what comparables Horizon and its consultants have used to determine that Horizon's executive compensation is below market and for the Commissioner to determine whether those comparables are in fact comparable. These determinations will require additional information from Horizon, and this information should be made publicly available.

It should also be noted that in response to FPQ 27, which asks for engagement letters, compensation and all documents relating to the services provided by each of the consultants Horizon has retained in connection with the conversion, Horizon names Towers Perrin but provides none of the information about Towers Perrin the question calls for. Towers Perrin provides various types of consulting services, but it has gained the most notoriety for its executive compensation consulting. Among other things,

Towers Perrin was the Enron Corporation's lead compensation consultant and opined that Enron's executive compensation was "conservative." See Letter from Towers Perrin to Charles LeMaistre, Enron Compensation Committee Chairman, Dec. 3, 2001. Given this history, both the state and the public have a right to know whether Towers Perrin is Horizon's compensation consultant and, if so, how much it is being paid for such consulting and what it has advised.

E. Whether Horizon holds charitable assets

The questions from the state rightly presume that Horizon is a charity and holds charitable assets, and the health service corporation law provides that a health service corporation is "a charitable and benevolent institution." 17:48E-41. Inexplicably, Horizon takes the contrary position that it has no charitable assets (FPQ 25) and that it is not a charity (FPQ 12). Since the 1992 community rating/guaranteed issue legislation, Horizon has not been the sole insurer of last resort in New Jersey, but rather all insurers have had an obligation to write all individuals and small groups regardless of health status (although not necessarily at affordable rates). Horizon's status is thus different than, for example, the status of Blue Cross plans in Pennsylvania, which requires Blue Cross plans there to insure those who the commercial carriers refuse to insure. Does the fact that Horizon is not the sole insurer of last resort in New Jersey affect the answer to the question whether Horizon holds charitable assets? We believe it does not and therefore raises serious concerns about whether Horizon, in its current nonprofit configuration—is fulfilling its legal obligations arising from its status as a charity. While conversion would render those concerns moot, since all such assets however they may be characterized will be held by a foundation dedicated exclusively to expanding access to care and promoting improvements in health status, N.J.S.A. 17:48E-67(d)(1)(c), for Horizon to maintain as it does that it is not now a charity and holds no charitable assets at the very least warrants additional investigation by the AG with respect to these important questions.

IV. Horizon's responses to other substantive issues

1. The different types of reimbursement arrangements healthcare providers are expecting, and how conversion would affect Horizon's ability to amend its reimbursement arrangements (CQ 20)

Horizon says that some hospitals have asked to be reimbursed using DRG groupers rather than Horizon's standard negotiated per diems. It also says that physician groups have asked for administrative simplification. Horizon says that its current ability to provide for these arrangements is limited, and that it "must develop more sophisticated data collection and system capabilities not yet supported by current infrastructure." It does not, however, explain why as a nonprofit corporation it could not satisfy these requests and therefore why it must convert to for-profit status in order to do so.

2. The amount Horizon has paid by accounting classification to each payee in connection with the conversion

FPQ 44a asks for the amount Horizon has paid to each payee in connection with the conversion. It also asks for the amount Horizon has incurred with respect to each payee and for each payee's current balance. Horizon states only that it has incurred approximately \$2.4 million in legal charges, \$2.1 million in consulting charges and \$62,000 in tax-related professional fees. It identifies no payees, no paid amounts and no balances. Similarly, FPQ 44b asks Horizon for the additional amounts it projects it will spend on the conversion, by category and by payee. Horizon does not provide a breakout either by category or by payee, but states only that it "estimates that it will incur an additional \$5 to \$10 million in costs and expenses in connection with the proposed conversion." There does not appear to be any credible legal basis on which Horizon may permissibly withhold the detail by payee the AG has asked for.

3. All approvals Horizon needs in order to effectuate the conversion and all applications for such approvals (FPQ 54)

Horizon discloses that it filed a selective contracting arrangement application for its medical and dental business on Sept. 4, 2008, and that it is currently discussing that arrangement with the Department. However, N.J.S.A. 17B:27A-54 requires that such an arrangement must be approved by the Commissioner before a conversion becomes effective, and to the best of our knowledge, Horizon has not yet provided a copy of its application for the Department's approval.

4. The extent to which public interest groups have been consulted about the proposed conversion, and any comments thereon from such groups or the public (FPQ 55)

Horizon provides only the names of groups it has met with. It provides no detail on any such consultations, provides no comments Horizon has received from such groups, and its responses, if any, to concerns raised by such groups.

5. Whether Horizon will be adopting stock option or grant plans for its executives (CQ 8)

Horizon says that "at this time" it has adopted no such plan "that would be effective upon conversion," but that it is currently evaluating whether it will adopt such a plan on conversion, and that if it does it will produce it. We would submit that no analysis of whether conversion is indeed in the public interest can be complete without specific information regarding any such stock option or grant plans.

6. Whether Horizon's current employment agreements comply with the 24 month limitation in N.J.S.A. 17B:18-52b. (CQ 3)

Horizon says that the above statutory section is not applicable to it, but doesn't say why it is not applicable, and whether if it were, it would be in compliance with it.

7. How the absence of a commitment to cap rate increases, serve the underserved or maintain surplus might affect a finding that the conversion plan is in the public interest. (CQ 6)

Horizon states that imposing such restrictions would place it at a competitive disadvantage, but never explains why such restrictions would not be in the public interest. Because Horizon is by far the dominant carrier in New Jersey, particularly in the Medicaid and underserved markets, we believe it may well be in the public interest to subject Horizon to requirements that other carriers are not subject to. At the very least, Horizon should be required as part of its application to model access and coverage scenarios in the absence of such requirements.

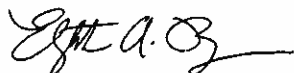
8. Whether Horizon has made any estimate of the market value of Horizon as a whole or of any of its assets (FPQ 37-41)

Horizon says it has not made such an estimate. It is simply not credible to think that Horizon would seek to convert to for-profit status, and in connection therewith to conduct a public offering whose value depends on the market value of Horizon, without making some estimate of that value. Whether that estimation is deemed public or confidential, it is inconceivable that the state would be able to determine whether a Horizon conversion is in the public interest without access to any such estimates, and the assumptions and methodology used to produce them.

As indicated above, this represents our preliminary analysis of Horizon's responses. We remain unconvinced that the Horizon application and plan are "complete" as the statute requires, and are deeply concerned about the lack of transparency that characterizes both Horizon's initial application, and its supplemental responses of March 3, 2009.

We look forward to continuing to work with you, your dedicated staff and your retained consultants as you continue your review of the Horizon conversion application and plan.

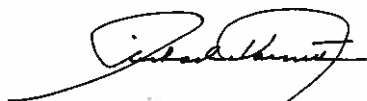
Very Truly Yours,



Elizabeth A. Ryan
President & CEO
New Jersey Hospital Association



Annette Catino
President & CEO
QualCare



Michael Kornett
Executive Director & CEO
Medical Society of New Jersey



Rev. Joseph Kukura
President
The Catholic HealthCare Partnership of NJ



Bruce McPherson
President & CEO
Alliance for Advancing Nonprofit Health Care