



Premera Blue Cross's Proposed Conversion to For-Profit Status:

Key Issues and Findings of Expert Consultants in the Review Process

INTRODUCTION

In May 2002 Premera Blue Cross applied to the Washington State insurance commissioner to convert to for-profit status. The application was denied in 2004. In the course of the review process, both parties as well as certain opponents of the conversion enlisted their own expert consultants to help inform the decision-making process.

The Washington State Insurance Department commissioned seven different studies: four by PricewaterhouseCoopers (PwC); one by the Blackstone Group, an investment banking advisor; one by Cantillo and Bennett (C&B), a Texas law firm; and one by Keith Leffler, PhD, a member of the Commission's staff.

Four groups concerned about the proposed conversion (Premera Watch Commission, the Washington State Hospital and Medical Associations, and the Alaska Blue Cross Conversion Task Force) came together to commission two studies by the Health Policy Analysis Program (HPAP) of the University of Washington's School of Public Health and Community Medicine. The Washington Hospital Association, in collaboration with the Association of Washington Hospital Districts, also commissioned a report by Steven Larsen, the former Maryland Insurance Commissioner who denied CareFirst BlueCross Blue Shield's proposed conversion.

Premera commissioned seven of its own studies, generally to counter the findings in the reports commissioned by the Insurance Department and by the above groups concerned about the conversion. Premera's consultants included: E. Lewis Reid, former President and CEO and current Board member of the California Endowment, the largest private foundation created by a Blues conversion; Bank of America Securities LLC (BAS), the investment banking arm of Bank of America with experience with BCBS companies; NovaRest Consulting, an Illinois consulting firm specializing in financial and actuarial analyses; Milliman USA, a Seattle actuarial consulting firm; National Economic Research Associates, Inc. (NERA); Towers Perrin, a human resources and executive compensation consulting firm; and John Steel, a Seattle lawyer specializing in corporate and securities law with experience in acquisitions/mergers and initial public offerings.

PURPOSE OF THIS REPORT

This report presents a summary of the findings and conclusions of the major consultant reports commissioned in the course of these deliberations. These studies are noteworthy not only because they undoubtedly had a major bearing on the commissioner's decision, but also because they provide a fascinating and informative illustration of the range and complexity of the major issues—philosophical, strategic, and technical—that merit attention in analyzing and reaching decisions on any proposed conversions.

THE ISSUES

All of the reports by the consultants commissioned by the Insurance Department, as well as those commissioned by the external groups noted above, expressed strong concerns about some or many major elements or potential impacts of such a conversion. These potential impacts and elements can be categorized as follows:

- Need for capital
- Need to attract or retain management talent

- Fundamental nonprofit versus for-profit orientation and community benefits
- Medical loss and administrative cost ratios
- Access to insurance (premium rates, underwriting practices, types of benefit products and geography)
- Provider rates and relationships
- Quality and customer service
- Local versus national ownership
- Fair market value and the proposed nonprofit conversion foundation

A summary of the consultant reports is presented below under these categories.

SPECIAL NOTE

The study prepared by the Health Policy Analysis Program (HPAP) merits some explanation, as it appears to contain one of the most extensive, if not the most extensive, reviews of the research surrounding previous Blues conversions (actual and proposed), focusing on 10 of those cases. HPAP supplemented this literature review with interviews of consumer and provider leaders in six of those cases, four national experts, experts on local and state insurance markets in Washington State and Alaska, and many providers in both states. HPAP chose the 10 cases (CA, CO, GA, KA, ME, MD, MO, NH, NC, and VA) based on their relative currency and the availability of relatively good information. HPAP notes that there were particularly significant policy analyses in the Kansas, North Carolina, and Maryland proposals, and that the North Carolina case also included extensive interviews with experts in the California, Georgia, Missouri, and Virginia cases.

HPAP found one or more of the following reasons given to justify the conversion in these 10 cases: access to capital, economies of scale, broader markets to serve multi-state employers, diversification of risk, and retention of talented management. Some observers in some of these cases were reported to believe that an unstated reason for the conversion was to enrich the senior executives through stock, severance arrangements and/or other financial incentives.

HPAP notes a complicating factor in analyzing many of the proposed or actual conversions that could lessen the observed

or projected impacts of a conversion. HPAP reported that many of these cases (e.g., NC, GA, MO, VA) involved changes in behavior by the plans well before they announced their intent to convert. National experts that HPAP interviewed attributed this to a planned strategy to put the plans in the strongest possible financial position to enhance the value of stock at the time of conversion. A second complicating factor noted in these analyses was that many of these conversions were followed in a few years by sales to Anthem or Wellpoint, making it difficult to separate the impacts of conversion from nonprofit to for-profit versus change from local to national ownership. HPAP felt it was important to take into account both of these complicating factors in its analyses, because the previous cases suggested a high probability that Premera would be acquired by a national for-profit company if it were to convert to for-profit status.

FINDINGS OF CONSULTANTS ON THE ISSUES

Need for Capital:

Various consultants engaged by the Insurance Commission or the concerned coalitions reported that Premera had not made a convincing case to convert in order to secure more capital:

- Steven Larson stated that the business case made by Premera was not compelling and had few specifics, and therefore could not be considered a mitigating factor to offset likely negative impacts of the conversion.
- PricewaterhouseCoopers (PwC) noted that added capital might be used in large part to allow Premera to grow outside the two states, not benefiting their residents.
- The Blackstone Group (BG), while acknowledging some benefits associated with strengthening reserves and having greater access to capital and increased financial flexibility, also felt that Premera had not demonstrated a clear need in the near-to-medium term for the amount of capital contemplated (\$100–150 million). BG found that cash flow from operations was sufficient to meet Premera's short-term and medium-term needs. BG also stated that some added capital was possible through increased debt financing and sale/lease-back of assets.

- The Health Policy Analysis Program (HPAP) stated that those proposing to convert typically argue that new capital will allow them to grow in size and realize economies of scale, but that size does not necessarily lead to lower administrative costs. Integration of claims and other data systems is complex and costly, and profit levels in health insurance companies are highly related to local market knowledge.

In contrast, Premera's consultants posited as follows:

- Bank of America Securities (BAS) stipulated that all health insurance companies undergoing IPOs over the past 13 years that raised capital did not have a specific stated purpose for most of the added capital other than for strategic flexibility.
- NovaRest Consulting argued that Premera's risk-based capital (RBC) ratio of 406% was only slightly better than Blue Cross Blue Shield Association's required minimum of 375% to avoid monitoring, and that an RBC of 500% or more was a good rule of thumb to address fluctuations in earnings, capital projects, and future growth. Of the options available for increasing capital (increasing profits, selling assets, borrowing, conducting acquisitions/mergers, or selling stock), NovaRest stated that raising capital through the equity market was superior because it did not have to be repaid. It acknowledged, however, that increased earnings would be necessary to pay dividends or increase the value of the stock to satisfy investors.

Need to Attract or Retain Management Talent:

Two of the consultants engaged by the Insurance Commission reported that Premera had not demonstrated that the conversion was needed to attract or retain management talent:

- Cantillo and Bennett (C&B) found a very favorable (low) management turnover ratio, which they felt "raised the specter of a conflict of interest."
- PwC found that Premera's turnover rates were significantly lower than industry standards, with its executive compensation practices already above market, in terms of base salary, total cash (base salary plus bonus) and total direct compensation (total cash compensation plus long-term incentives). PwC also noted that Premera had not provided, as of this reporting, sufficient information on what the CEO and other executives could "walk away

with” as a result of the conversion (e.g., provisions for stock or stock options, expected changes in annual and long-term incentive plans or in retirement plans).

Towers Perrin (TP), Premera’s consultant, countered that the total direct compensation for executives was at or below the market median in aggregate and individually in all but a few cases. TP also disagreed that the executive severance protection was above market and that post-conversion commitments were unreasonable or too generous compared to those in other IPO transactions. In presenting the rationale for its positions, TP criticized PwC’s analytic techniques (i.e., using only Blues plans as the comparison group and not factoring in Premera’s lack of a COO position, the duties of which were shared among several Premera executives).

Fundamental Nonprofit Versus For-Profit Orientation:

The consultants engaged by the coalitions concerned with the conversion felt strongly that a change from nonprofit to for-profit ownership would fundamentally change the inherent values and motivations, and consequent behaviors, of the organization, with potentially significant adverse impacts (including reduced community benefits) on providers, policyholders and the public.

- Steven Larsen contended that, while there are certain similarities in how both types of organizations operate, including when necessary withdrawing from lines of business and raising rates, nonprofits take these actions in a broader context and with the ultimate objective of serving the nonprofit mission, not maximizing value for outside investors or owners. He stated that this distinction in mission provides the nonprofit with greater flexibility to act in a way that lessens or ameliorates potential negative impacts on its stakeholders.
- HPAP, noting that the community benefits provided by health plans are often informal and difficult to measure, nonetheless found that “available information suggests that nonprofit health plans are more likely than for-profits to provide benefits to the community, including safety net services, targeting programs to low-income neighborhoods, and providing more charitable contributions”. While having no access to information about Premera’s current level of community benefits, HPAP cited examples of views similar to Steven Larsen’s from its own interviews and those conducted by other consultants in the 10 cases:

- o “When we were dealing with BCBS (of Maine), the plan supported things like community rating, but now it is a constant fight. When you keep a plan nonprofit, you’re keeping the values viable.”
- o “For 9 out of 10 decisions...they’ll (nonprofits and for-profits) decide the same thing, but the issue is what is the impact of the 1-in-10 decision where they will differ?”
- o Some experts interviewed about the North Carolina case said that it is “easier to regulate nonprofits and to get them to work for the public good since you can ask more of them regarding pricing and access for vulnerable population groups”.

One of Premera’s consultants, National Economic Research Associates (NERA), stated that Premera would not behave any differently following conversion regarding pricing, product design, lines of business or geography because it is competition, not ownership status, that shapes and constrains a health insurer’s actions.

Medical Loss and Administrative Cost Ratios:

- Supplementing its findings on the more intangible, inherent values of nonprofit ownership, HPAP stated, based on empirical comparisons of nonprofit Blues with for-profit Blues and commercial insurers, that “a converted Premera will likely reduce its medical loss ratio...and increase its administrative cost ratio in order to attain and maintain adequate profit margins”. HPAP projected that as much as 10% of Premera’s revenues (\$200 million annually) would be shifted from payment for actual health care to other purposes. HPAP noted that for-profit health insurers typically seek underwriting gains of 2–3 percent. Those gains must come from lower medical payments or lower administrative costs, yet for-profit insurers typically have higher administrative costs. With average medical loss ratios of 74% and 80% respectively for for-profit Blues and for-profit commercial insurers, compared to 84% for nonprofit Blues (Premera’s was 85% in 2002), HPAP stated that unless the for-profits were managing care much better to account for their higher administrative costs, of which there was no evidence, then their higher administrative costs were “likely to include profits and their distribution to shareholders”.

Access to Insurance:

The following consultants engaged by the Insurance Commission and the coalitions expressed concerns about reductions in access to insurance:

- PwC stated that as a public company Premera “would be expected to reach target operating margins over time for each line of business, whereas currently some appear to be subsidized.”
- HPAP found a “mixed picture” of the effects of conversion on insurance access, noting that in four cases the converted Blues plans continued to cover their entire geographic regions and individual as well as group markets. HPAP also found no evidence that the converted plans had exited public program business to any greater degree than the nonprofit plans. Ultimately, however, HPAP concluded that the overall weight of the empirical evidence across the 10 cases fell on the side of negative impacts on insurance access. Accordingly, it expressed the same concern as PwC, as well as noted the increased likelihood that a converted Premera would become more aggressive in benefit design and underwriting practices, especially impacting the individually insured and people with greater medical needs. Also, while noting that empirical research from publicly available information had not been conducted to verify predictions of premium increases, HPAP also cautioned that Premera might selectively employ this practice.
- Steven Larsen contended that Premera’s dominance in the individual market in certain areas gave it market power over both purchasers of health insurance and providers in those areas, and that such market power would inevitably be exploited more aggressively by a for-profit Premera.

One Insurance Commission consultant, however, Keith Leffler, did not feel that Premera, even in Eastern Washington where it had substantial market power, could or would use it to raise premiums more dramatically if converted.

Premera’s consultants reported that there would be no negative impacts on insurance access:

- NERA stated that Premera had already been focused on the bottom line and offered only products making commercial sense because of competitive and legal

constraints, such that nothing different would occur in its practices following conversion.

- Milliman USA projected no increases, and perhaps a slight decrease, in Premera’s premium rates as a result of conversion.

Provider Rates and Relationships:

The findings and conclusions of the consultants engaged by the Insurance Commissioner and concerned coalition groups included some selective concerns about provider rates and relations:

- HPAP stated that while there was information from the 10 case studies that conversions could increase tensions in relations with providers, other factors, such as the Blues’ historical dependency on broad provider networks, could mitigate against a converted plan taking a more aggressive negotiating stance. In addition to business strategy, HPAP found that market share, more than the corporate form of the owner, might well be the primary factor impacting relations, noting Premera’s significant market power in Eastern Washington and in Alaska.
- PwC noted Premera’s dominance in Eastern Washington and the potential negative consequences for providers of a converted Premera facing increased earnings pressures.
- Keith Leffler, noting an 80% market share in 8 counties of Eastern Washington, and 70% overall in that region of the state, found that Premera had already used its negotiating power in provider fees and “could change its payment and contracting procedures to more fully exploit its market power”.

NERA, one of Premera’s consultants, argued that Premera’s strategic need for a broad provider network, even in areas where it had greater market share, would preclude it from relating differently with its providers post-conversion. NERA stated that its data analyses showed no statistical relationship between high market share and lower rates provided by Premera, with physician fees in Eastern Washington not significantly lower than in Western Washington. NERA also noted that rural hospitals in Eastern Washington were permitted to negotiate collectively with Premera.

Quality and Customer Service:

HPAP, commissioned by the concerned coalitions, was the only consultant that addressed this issue:

- HPAP cited several studies providing some indication that nonprofit and local plans rated higher with customers on some quality and service indicators than did for-profit and national plans. Based on those findings, HPAP extrapolated that a converted Premera could drop in performance relative to patient satisfaction, customer service, attention to certain preventative measures, reports of administrative barriers, and reports of delayed care. HPAP noted that Premera's performance on quality indicators from a Washington public program study showed it to be about average currently.
- HPAP also reported, however, that some national research suggested that a converted Premera might focus greater efforts on providing more information to patients regarding their care management and on better patient-focused information systems.

Local Versus National Ownership:

HPAP was also the only consultant that addressed this issue. Its major findings and conclusions were as follows:

- A converted Premera would likely be purchased by a national for-profit insurer. HPAP noted that 13 of 16 Blues that converted over the past 15 years were now owned by Anthem or Wellpoint. One national expert interviewed by HPAP felt that these national insurers had a new acquisition strategy, delaying involvement until a conversion to a local IPO had already occurred, in order to: avoid being embroiled in that process; reduce the risks of disapproval; and avoid having to "ante up" for a conversion foundation that could lower its stock value. HPAP cited an example where the CEO of a Wisconsin Blues plan publicly stated prior to the conversion to a local IPO that it had no plans to be purchased after the conversion. Later, however, the IPO was purchased by Wellpoint, and the same CEO stated that "when Wellpoint approached us, we had a fiduciary responsibility to our shareholders to investigate the offer".
- HPAP also concluded, based on both theory and the empirical evidence it examined, that a converted Premera purchased by a national for-profit company would "focus more on national accounts than on the unique

circumstances of markets, consumers, and providers of Alaska and Washington." HPAP felt that loss of "localness," including the community orientation of management, could exacerbate the problems created by conversion:

- o Less willingness to continue unprofitable markets that now depended heavily on it and to focus on the unique circumstances of Alaska and rural Washington, where Premera had a large market share and a shared financing role with public sponsors. (Some interviewed by HPAP, however, felt that the larger national companies were in a better position financially to continue unprofitable lines, and would do so to maintain or improve their images and/or to retain or acquire government business (e.g., coverage for public employees).
- o Less support of public initiatives designed to improve overall access or to strengthen the community infrastructure.
- o More contentious interactions with providers over contract terms and payment issues due to financial pressures, with state-based provider service centers moved to regional or national centers (HPAP noted current lawsuits against eight national for-profit insurers by 19 medical societies and 700,000 physicians).

Fair Market Value and the Nonprofit Conversion Foundation:

Several of the consultants engaged by the Insurance Commission and concerned coalitions expressed concerns over the fairness of the value that would be received from the conversion by the IPO and by the foundation proposed to be created by the conversion:

- HPAP cited a study by a consulting firm engaged by the Maryland Insurance Commission in its review of the proposed CareFirst BlueCross BlueShield conversion and sale to Wellpoint. That study found that the amount of funding made available by conversions was very small compared to health system expenditure as a whole and to the assets removed from the public domain. It further found that the asset bases of the Blues conversion foundations in particular represented a very small portion of annual health care expenditures in the states, with the income generated by those assets therefore being virtually negligible when compared to total health care expenditures.

- PwC found the current and projected financial performance for the converted Premera to be weaker than comparable companies. As an untested public company, PwC stated that Premera would have a lower IPO price than that of peers.
- PwC and the Blackstone Group were concerned that the IRS might determine the transaction to be a “material change in structure”, triggering a 35% rather than 20% federal income tax rate. They also noted that the Alaska premium tax would increase from 2% to 2.7% if Premera converted. In addition, they objected to the foundation having to indemnify Premera for any and all added tax obligations.
- In addition to noting important gaps in information (e.g., executive compensation plans) upon which to determine the fair market value, PwC, the Blackstone Group, Steven Larsen, and Cantillo and Bennett found that the foundation would not have sufficient flexibility in determining the most appropriate times, amounts and mechanisms for disposal of their shares. They noted that the foundation would have to divest its stock on a fixed schedule and at a more rapid rate than in other conversions, with a majority of the board’s voting members being nominees from the IPO. It was also noted that the foundation would have no representation on the IPO’s board.
- John Steel stated that based on the experiences of previous Blues conversions, there was little or no risk of the IRS determining the Premera conversion to be a “material change in structure”. He also stated that indemnification by the foundation of any added tax obligations was commonplace in such transactions in Washington State, and would help in the recruitment and retention of the most qualified directors.
- John Steel and E. Lewis Reid also found the Board selection provisions and schedule for divestiture of stock by the foundation to be normal in such transactions.

CONCLUSION

At the outset of the review process, the Washington State insurance commissioner defined the critical issues through the charges he established for the expert consultants he engaged. In his decision to deny Premera’s conversion application, his rationale was consistent with the findings and conclusions of his own consultants as well as those engaged by external groups concerned with the proposed conversion. Following the commissioner’s denial, Premera Blue Cross filed a lawsuit challenging the commissioner’s decision. At the time of this report, the hearing date had been scheduled.

Premera’s consultants responded to the above concerns as follows:

- E. Lewis Reid, citing his experiences with the California Foundation, stated that such conversions had created a “burst” of health philanthropy addressing needs not easily solved by government or traditional insurers.
- BAS found that Premera’s metrics of performance fell well within or near the range of nine recent IPOs and would satisfy investor expectations and be viewed as attractive.