

**BEFORE THE COMMISSIONER OF INSURANCE
OF THE STATE OF KANSAS**

In the Matter of the Conversion and)
Acquisition of Blue Cross and Blue Shield)
of Kansas, Inc.)

Docket No. 3014-DM

FINAL ORDER

Statement of Case

Blue Cross and Blue Shield of Kansas, Inc. ("BCBSKS") submitted a draft plan of conversion ("Draft Plan") to the Commissioner of Insurance ("Commissioner"), Kathleen Sebelius on May 31, 2001, for review and comment prior to the adoption of such plan by the Board of Directors of BCBSKS.

On July 27, 2001, Anthem Insurance Companies, Inc. ("Anthem") filed a "Form A - Statement Regarding the Acquisition of Control of or Merger with a Domestic Insurer" ("Form A"), seeking the approval of the Commissioner of Insurance. K.S.A. 40-3304.

The Board of Directors of BCBSKS formally adopted a formal plan of conversion ("Plan") on October 25, 2001. That plan was formally submitted to the Commissioner on October 26, 2001 for her approval.

The Plan proposes to convert BCBSKS from a mutual insurance company owned by its policyholders to a stock insurance company. In the demutualization, policyholders would receive cash consideration as required by K.S.A. 40-4004(b). The Form A contemplates that Anthem will purchase all of the stock of BCBSKS created in the demutualization.

An evidentiary hearing on this matter was conducted January 7, 8, and 9, 2002 in accordance with K.S.A. 40-3304, K.S.A. 40-4004 and 77-501 *et seq.*

BCBSKS's application for approval of conversion and Anthem's application for approval of acquisition of control of BCBSKS are contemplated as a single transaction, referred to as a sponsored demutualization. Therefore, only one final order will be issued and all issues related to the proposed single transaction, sponsored demutualization, will be addressed herein.

Issue

The issue is whether the sponsored demutualization of BCBSKS proposed by BCBSKS and Anthem satisfies the provisions of the demutualization statute and the Kansas Insurance Holding Companies Act.

Procedural History

A. History of Blue Cross and Blue Shield of Kansas

BCBSKS has its roots in two companies that began operations in the 1940s. Blue Cross of Kansas originated following legislation in 1941, and Blue Shield of Kansas was established in 1946. Both companies were established as nonprofit service corporations. BCBSKS was formed in 1983 by the consolidation of Blue Cross of Kansas and Blue Shield of Kansas.

In 1992, BCBSKS ceased being a nonprofit organization and became a mutual life insurance company. In connection with the termination of its nonprofit status, BCBSKS was required to make a one-time special payment of approximately \$75 million for charitable purposes. This payment extinguished BCBSKS charitable obligations. Under the settlement

agreement, BCBSKS's former nonprofit status "shall not in itself" result in differential treatment by the Commissioner.

BCBSKS is currently the largest health insurer in Kansas. More than 715,000 Kansas residents in all Kansas counties, except Johnson and Wyandotte, the two Kansas counties incorporated into the Kansas City Metropolitan area, have private health care coverage insured or administered by BCBSKS. Through administration of government programs, Medicare and Medicaid, BCBSKS administers health care coverage for 640,000 additional Kansans, some of whom also carry the Medicare Supplemental coverage. In all, more than one million Kansas residents rely on BCBSKS to administer their health care coverage.

In 2000, BCBSKS had premiums of \$873.0 million, surplus of \$328.5 million, net income of \$5.8 million and assets of \$730.8 million. For the six months ended June 30, 2001, BCBSKS had premiums of \$484.1 million, surplus of \$310.4 million, net loss of \$14.4 million, and assets of \$698.1 million.

B. History of Anthem Insurance Company

Anthem was formed in 1944 under the name of Mutual Hospital Insurance, Inc., commonly known as Blue Cross of Indiana. In 1946, Mutual Medical Insurance Inc., also known as Blue Shield of Indiana, was incorporated as an Indiana mutual insurance company. In 1985, these two companies merged under the name Associated Insurance Companies, Inc.

In 1993, Southeastern Mutual Insurance Company, a Kentucky-domiciled mutual insurance company doing business as Blue Cross and Blue Shield of Kentucky, was merged into

Associated Insurance Companies, Inc. In 1995, Community Mutual Insurance Company, an Ohio-domiciled mutual insurance company doing business as Community Mutual Blue Cross and Blue Shield, was merged into Associated Insurance Companies, Inc.

In 1996, Associated Insurance Companies, Inc. changed its name to Anthem Insurance Companies, Inc. In 1997, Blue Cross and Blue Shield of Connecticut, Inc., a Connecticut-domiciled mutual insurance company, was merged into Anthem Insurance Companies, Inc. In 1999, Anthem completed its purchases of New Hampshire-Vermont Health Service, which did business as Blue Cross and Blue Shield of New Hampshire, and Rocky Mountain Hospital and Medical Service, which did business as Blue Cross and Blue Shield of Colorado and Nevada. In 2000, Anthem completed its purchase of Associated Hospital Service of Maine, which did business as Blue Cross and Blue Shield of Maine.

On November 2, 2001, Anthem converted from a mutual insurance company to a stock insurance company. Anthem became a wholly-owned subsidiary of Anthem, Inc., a new Indiana stock corporation created for the purpose of being a public holding company for the Anthem companies. Anthem, Inc. conducted an initial public offering and became a public company, and Anthem compensated its eligible statutory members in the form of cash or stock of Anthem, Inc.

In 2000, Anthem had revenues of \$8.7 billion, surplus of more than \$1.9 billion, net income of \$226.0 million and assets of \$5.7 billion. For the six months ended June 30, 2001, Anthem had revenues of \$5.1 billion, surplus of more than \$2.0 billion, net income of \$143.0 million and assets of \$5.8 billion.

C. Procedural Timeline

On May 30, 2001, BSBSKS and Anthem ("applicants") entered into an Alliance Agreement ("Agreement"), which contemplated a sponsored demutualization of BCBSKS and the acquisition by Anthem or its designated affiliate of all BCBSKS common stock.

On May 31, 2001, in accordance with K.S.A. 40-4002(b), BCBSKS submitted the Draft Plan to the Commissioner for review and comment prior to the adoption of such the Draft Plan by the Board of Directors of BCBSKS. The Draft Plan was subsequently amended to address concerns expressed by the Kansas Insurance Department Testimonial Team (the "KID Testimonial Team").

On July 25, 2001, Anthem filed its Form A with the Commissioner seeking approval to acquire BCBSKS in accordance with K.S.A. 40-3304.

On August 21, 2001, the Commissioner issued a Procedural and Scheduling Order to govern the further course of these proceedings. The Order also explained that the Commissioner had retained independent special counsel and independent advisors and had appointed certain members of her legal and technical staff to investigate, review, and comment on the sponsored demutualization, and to participate in the hearing, as the KID Testimonial Team. The following individuals served on the KID Testimonial Team: Kathy Greenlee, General Counsel of the Department and KID Testimonial Team Leader; Patrick H. Cantilo, Cantilo & Bennett, LLP, Special Counsel for the KID Testimonial Team; Linda Sheppard; Assistant General Counsel of the Department; David M. Platter, Senior Managing Director in the Investment Banking Division and Head of the Financial Institutions Group of Bear Stearns & Co., Inc. ("Bear Stearns");

Kenneth M. Beck, a principal with the Actuarial and Insurance Management Solutions practice of PricewaterhouseCoopers LLP ("PwC"); Denise G. Essenberg, Certified Public Accountant and partner with PwC; Sandra S. Hunt, a principal of PwC who specializes in government health policy, statistical modeling, Medicaid managed care plans, and developing models for new health care delivery systems; and Mark H. Kovey, attorney and partner in the law firm of Scribner, Hall & Thompson, who specializes in taxation and tax law.

During late September 2001, the Kansas Medical Society ("KMS"), Kansas Hospital Association ("KHA"), Kansas State Nurses Association ("KSNA"), the Kansas Association for the Medically Underserved ("KAMU") and William A. Dakan ("Dakan") filed petitions to intervene in this proceeding.

On October 23, 2001, the Commissioner found that the Kansas Administrative Procedures Act ("KAPA") mandated that KMS, KHA, and KSNA be allowed to intervene in this proceeding. She also exercised her discretion in allowing KAMU to intervene. In the Order on Intervention, the Commissioner expressly limited the intervenors' respective rights of participation in this proceeding. The Commissioner denied the Dakan petition.

On October 25, 2001, the Board of Directors of BCBSKS "unanimously approved and adopted the Plan to enhance the Company's strategic and financial flexibility, and to make possible a distribution of the value of the Company to Eligible Policyholders." In relevant part, the Plan proposed to extinguish all membership interests of BCBSKS policyholders in exchange for valuable consideration, including certain payments to eligible members, and to otherwise effectuate the conversion of BCBSKS into a stock company.

Pursuant to the Plan, BCBSKS would convert to a stock company upon the approval of the Commissioner and BCBSKS policyholders eligible to vote ("Eligible Policyholders"). After the conversion, all policyholders' membership interests would be extinguished.

Eligible Policyholders, as determined under the Plan, would receive a special distribution (the "Special Distribution") that would be no greater than the amount, by which the book value of BCBSKS at the date the Conversion becomes effective (the "Closing Book Value") exceeds \$155 million. The Special Distribution would be paid in cash to the Eligible Policyholders.

Subject to the Plan, Eligible Policyholders would also receive the sum of \$190 million (the "Purchase Price"). Of the Purchase Price, \$142 million would be distributed to Eligible Policyholders. The remaining \$48 million of the Purchase Price would be deposited into an Escrow Fund pending the resolution of the Contingent Litigation Matter (the "CLM"). Amounts left in the Escrow Fund after that resolution and satisfaction of certain related liabilities, would also be distributed to Eligible Policyholders.

On November 9, 2001, BCBSKS and Anthem amended the Agreement, which is an exhibit to the Plan of Conversion and the Form A. The Agreement was amended to reflect changes or modifications in at least three areas: (a) the amount of the Purchase Price to be deposited into escrow; (b) the appointment procedures for the Policyholder Committee; and (c) tax matters related to the escrow account and the CLM.

Between November 19, 2001, and November 27, 2001, BCBSKS mailed to 171,403 Eligible Policyholders the Policyholder Information Statement, the Policyholder Instruction Guide, and the Plan 65 Information document.

On November 9, 2001, the Commissioner issued the Notice of the Public Hearing and the Notice of Public Comment Meetings in this proceeding. The Commissioner held public comment meetings in the following locations: Hays, Kansas, on December 4, 2001; Garden City, Kansas, on December 4, 2001; Wichita, Kansas, on December 5, 2001; Pittsburg, Kansas on December 13, 2001; and Topeka, Kansas on December 14, 2001. The Commissioner's Notice of Public Hearing was subsequently published, as required by the Procedural and Scheduling Order and K.S.A. 77-518, in the following newspapers: Topeka Capital-Journal, Lawrence Journal World, Pittsburg Morning Sun, Salina Journal, Wichita Eagle, Hays Daily News, Garden City Telegram and Colby Free Press. Proof of publication has been properly filed of record in these proceedings.

At the public comment meetings, BCBSKS, Anthem and the KID Testimonial Team presented fifteen-minute presentations on the sponsored demutualization and the remainder of the time was reserved for public comment. Over 1,200 Kansans attended these meetings, many of them choosing to voice their opinions, either in person or with written statements. Interested persons were allowed to make sworn statements part of the record. No sworn statements were received. Hundreds of other persons submitted letters or phone calls to the Commissioner and the Department voicing their opinions on these sponsored demutualization. The correspondence received by the Commissioner and the Department raised many different issues and concerns. The parties have substantially addressed all issues raised; therefore, the Commissioner did not rely upon these statements in reaching her decision.

The public hearing was held from January 7 through 9, 2002 in the Capitol Plaza Hotel, 1717 SW Topeka Boulevard, Topeka, Kansas. The Commissioner personally served as the Presiding Officer for the public hearing.

In accordance with the timetable set forth in the Procedural and Scheduling Order, the parties and intervenors submitted pre-filed written testimony, in lieu of opening statements, and hearing memoranda to assist in the prompt and orderly conduct of the public hearing. After the hearing, in lieu of closing arguments, the parties submitted written proposed findings of fact, conclusions of law and post-hearing memoranda, within 10 days after the final transcript became available.

D. Plan approval process

BCBSKS suggests that the Commissioner's authority to approve or disapprove the Plan is diminished by the fact that the BCBSKS Board of Directors and the Eligible Policyholders have approved the sponsored demutualization. This argument disregards the statutory requirements set out in K.S.A. 40-4001 *et seq.* The statute contemplates that the Plan must go through a three-step process for the plan to be considered completely approved. Each step in the process is separate and independent of the other.

First, the statute sets out that two-thirds of the majority of the entire Board of Directors must approve the Plan. Upon approval of the Board of Directors, the Plan is submitted to the Commissioner for approval, pursuant to K.S.A. 40-4002. The Commissioner shall then conduct a public hearing in accordance with KAPA to determine whether she will approve the Plan. K.S.A. 40-4004 enumerates the factors that the Commissioner must consider in deciding whether

the Plan should be approved or disapproved. The Plan shall also be approved by the Eligible Policyholders. The requirements for that process are set out in K.S.A. 40-4002. Approval must be obtained at each step or the Plan fails.

Moreover, the statute contemplates that the Commissioner should have broad discretion in interpreting and applying the statute, as the applicable statute states, "this act shall be liberally construed to effect the legislative intent set forth in this section and shall not be interpreted to limit the powers granted to the Commissioner by the other provisions of law." K.S.A. 40-4001. This gives the Commissioner the authority to approve or disapprove the Plan, independent from the two steps provided for in the statute.

Summary of the Evidence

A. Exhibits

The parties submitted 75 exhibits that were admitted into evidence; the exhibit list is appended to the Final Order.

The Commissioner took official notice of the Form A filed by Anthem.

B. Witnesses

BCBSKS presented evidence in support of the Conversion and Acquisition Applications, including sworn testimony from John W. Knack, Jr., President and Chief Executive Officer of BCBSKS; Michael M. Mattox, Executive Vice President of BCBSKS; Donald R. Lynn, Vice President of Finance of BCBSKS; William H. Pitsenberger, Vice President and General Counsel of BCBSKS; Paul G. Adams, Managing Director of Dresdner Kleinwort Wasserstein, Inc.

("DrKW"); Daniel J. McCarthy, Consulting Actuary, Milliman, USA ("Milliman"); Henry N. Butler, J.D., Ph.D.; and David Feldstein, Ph.D., Professor, Graduate School of Management, University of California at Irvine. BCBSKS was represented at the hearing by Gary D. McCallister and Thomas Kelliher of Gary D. McCallister & Associates; Eric Unrein of the law firm of Davis, Unrein, McCallister, Briggs and Head, L.L.P; and James Scoville and Carl Micarelli of the law firm of Debevoise & Plimpton.

Anthem presented evidence in support of its Acquisition Application, including sworn testimony from Larry C. Glasscock, President and Chief Executive Officer of Anthem; Michael L. Smith, Executive Vice President and Chief Financial Officer of Anthem; Dr. Samuel R. Nussbaum, M.D., Executive Vice President and Chief Medical Officer of Anthem; Donna O. Moore, Vice President, Health Care Management-East Operating Region of Anthem; and David R. Frick, Executive Vice President and Chief Legal and Administrative Officer of Anthem. Anthem was represented by Randall J. Forbes and John C. Frieden of the law firm of Frieden, Haynes and Forbes, and Douglas R. Fauth, Vice President of Anthem Insurance Companies, Inc.

The KID Testimonial Team presented evidence including testimony from David M. Platter, Kenneth M. Beck, Denise G. Essenberg, Sandra S. Hunt, Mark H. Kovey and Kathy Greenlee. The KID Testimonial Team was represented by its Special Counsel, Patrick H. Cantilo of the law firm of Cantilo & Bennett, L.L.P.

Intervenors KMS and KHA presented testimony from Marvin M. Fairbanks, Director for Contracted Care at Stormont-Vail Healthcare, and Carl J. Schramm, an economist and lawyer. KMS was represented by Charles R. Hay of the law firm of Goodell, Stratton, Edmonds &

Palmer, L.L.P. and KHA was represented by Douglas S. Laird of the law firm of Polsinelli Shalton & Welte, P.C.

Intervenors KNA and KAMU presented testimony from Dawn M. Touzin, Director of the Community Health Assets Project at Community Catalyst. KNA and KAMU were represented by Karen A. Eager of the Law Offices of Theodore J. Lickteig.

Findings of Fact

The Commissioner makes the following findings of fact:

Demutualization

1. BCBSKS submitted the Draft Plan of conversion to the Commissioner of Insurance, Kathleen Sebelius, on May 31, 2001.
2. BCBSKS Board of Directors unanimously approved the Plan on October 25, 2001.
3. The Plan was submitted to the Commissioner on October 26, 2001.
4. BCBSKS engaged DrKW, an investment firm, to evaluate whether the total consideration to be distributed to Eligible Policyholders pursuant to the Agreement is fair and equitable.
5. DrKW issued a fairness opinion on May 24, 2001. From a financial point of view, the aggregate cash consideration to be paid to Eligible Policyholders pursuant to the Agreement is fair.
6. DrKW issued a second opinion on November 9, 2001, based on updated information. From a financial point of view, the aggregate of the purchase price and the special distribution to be paid to Eligible Policyholders is fair.
7. Bear Stearns, the financial advisor for the KID Testimonial Team, also determined from a financial point of view, that the aggregate consideration to be distributed pursuant to the Agreement to Eligible Policyholders is fair.
8. BCBSKS engaged the actuarial firm of Milliman to devise a fair and equitable method of allocating consideration to Eligible Policyholders in connection with the proposed demutualization of BCBSKS.

9. The proposed allocation and consideration is fair and equitable to Eligible Policyholders.
10. No person associated with BCBSKS can expect, or will receive, any compensation, stock, or other benefit as a result of the sponsored demutualization.
11. BCBSKS executive officer compensation will not change as a result of the sponsored demutualization. No officer, director, company agent or employee will be compensated other than for services performed.
12. The only employment commitment made by Anthem is that it intends to offer employment to all individuals employed by BCBSKS after the closing of this transaction. There is no commitment that this employment will be in Kansas
13. BCBSKS is the dominant health insurer in Kansas.
14. In all, more than one million Kansas residents rely on BCBSKS to administer their health care coverage.
15. In 2000, BCBSKS had premiums of \$873.0 million, surplus of \$328.5 million, net income of \$5.8 million and assets of \$730.8 million. For the six months ended June 30, 2001, BCBSKS had premiums of \$484.1 million, surplus of \$310.4 million, net loss of \$14.4 million, and assets of \$698.1 million.

Acquisition

16. Anthem was formed in 1944 under the name of Mutual Hospital Insurance, Inc., commonly known as Blue Cross of Indiana.
17. In 1946, Mutual Medical Insurance Inc., also known as Blue Shield of Indiana, was incorporated as an Indiana mutual insurance company.
18. In 1985, these two companies merged under the name Associated Insurance Companies, Inc.
19. In the early 1990s, Associated Insurance Companies, Inc. acquired BCBS of Kentucky and Community Mutual BCBS, an Ohio-domiciled insurance company.
20. In 1996, Associated Insurance Companies, Inc. changed its name to Anthem Insurance Companies, Inc.
21. Since 1997, Anthem Insurance Companies, Inc. has acquired BCBS of Connecticut, BCBS of New Hampshire, BCBS of Colorado and Nevada, and BCBS of Maine.

22. On November 2, 2001, Anthem converted from a mutual insurance company to a stock insurance company.
23. Anthem became a wholly-owned subsidiary of Anthem, Inc., a new Indiana stock corporation created for the purpose of being a public holding company for the Anthem companies.
24. Anthem, Inc. conducted an initial public offering and became a public company. Anthem compensated its eligible statutory members in the form of cash or stock of Anthem, Inc.
25. In 2000, Anthem had revenues of \$8.7 billion, surplus of more than \$1.9 billion, net income of \$226.0 million and assets of \$5.7 billion. For the six months ended June 30, 2001, Anthem had revenues of \$5.1 billion, surplus of more than \$2.0 billion, net income of \$143.0 million and assets of \$5.8 billion.
26. On May 30, 2001, BCBSKS and Anthem entered into an Agreement, which contemplated a sponsored demutualization of BCBSKS and the acquisition by Anthem or its designated affiliate of all BCBSKS common stock.
27. On July 25, 2001, Anthem filed its Form A with the Commissioner seeking approval to acquire BCBSKS.

Sponsored Demutualization

28. BCBSKS's application for approval of conversion and Anthem's application for acquisition of control by BCBSKS compose a single transaction.
29. BCBSKS has accumulated a considerable surplus, which has allowed it to operate without maximizing its underwriting margins.
30. Currently, BCBSKS has a surplus estimated at \$286 million.
31. BCBSKS intends to distribute an estimated \$131 million to policyholders, leaving \$155 million in surplus.
32. Anthem will not restore the estimated \$131 million of the surplus distributed to Eligible Policyholders.
33. Anthem capitalizes its subsidiaries at substantially lower levels than those maintained by BCBSKS. Anthem will reduce BCBSKS's surplus to approximately \$90 to 112.5 million dedicated to Kansas policyholders.

34. After the sponsored demutualization, BCBSKS policyholders will be protected by a surplus less than half the current amount.
35. BCBSKS will be weaker financially after the implementation of the sponsored demutualization.
36. The sponsored demutualization will not lessen the company's exposure to local events.
37. The combined Anthem companies would be subject to local events in nine states, rather than just Kansas.
38. The sponsored demutualization would not produce significant economies of scale.
39. BCBSKS has been able to recruit and retain sufficient competent staff and management.
40. PwC conducted a market impact analysis of the sponsored demutualization.
41. One purpose of PwC's analysis was to gain an understanding of likely changes that would occur in the health insurance market in Kansas if the sponsored demutualization was approved.
42. Specific issues that PwC analyzed were "choices, availability and cost of insurance coverage, provider contracting arrangements, administrative processes, employment levels in Kansas and factors likely affecting Anthem's general performance."
43. PwC requested information from Anthem and BCBSKS, obtained information from the Departments of Insurance in other states in which Anthem operates, interviewed individuals who represent medical associations and hospital associations in states in which Anthem operates, and reviewed public documents available through web sites and other sources.
44. PwC determined that with relation to choice, availability and cost of insurance, the levels of insurance that are available today would likely continue, but that there would be premium rate increases significantly higher than would occur in the absence of the transaction.
45. Several factors affect underwriting margins: medical expenses or claim cost; administrative expenses or overhead; membership enrollment; benefit design; and premium rates.
46. Reducing medical expenses requires more aggressive contracting with providers than has been BCBSKS's practice.

47. The sponsored demutualization will not reduce BCBSKS's medical costs.
48. BCBSKS's current administrative-expense ratio is approximately 9%.
49. Anthem's current administrative-expense ratio is approximately 11.5%, when calculated similarly to BCBSKS.
50. The administrative-expense ratio of the Anthem West Region is 13.7%, down from 26.8% in 1999.
51. Anthem presented no substantial evidence on how material reductions in BCBSKS's administrative expenses could be achieved. The evidence shows that BCBSKS has lower administrative costs than Anthem.
52. Anthem presented no evidence on how it will materially grow membership in Kansas.
53. BCBSKS's benefit design will not change as a result of the sponsored demutualization.
54. Due to rising medical costs, health insurance rates will increase whether or not the sponsored demutualization is approved. This increase is referred to as "trend" in the market.
55. If the sponsored demutualization were approved, Anthem would become the dominant health insurance carrier in Kansas as BCBSKS is today.
56. Over the last six years, BCBSKS had negative underwriting margins of 2 to 3%.
57. BCBSKS's has projected is that it would achieve positive underwriting margins of 0.4% by 2005.
58. BCBSKS used this initial projection in valuing the company.
59. Due to worse than expected underwriting performance by BCBSKS during 2001, BCBSKS's best projection now is that it will achieve 0% underwriting margin by 2005.
60. As a mutual insurance company, Anthem achieved underwriting margins of 2 to 3%.
61. Anthem's primary corporate objective is to match or exceed its top competitor across several criteria, including underwriting margins. Anthem's investor-owned competitors have underwriting margins of 4.5 to 5%.

62. Neither BCBSKS nor Anthem provided any substantial evidence regarding what strategies they would use to achieve an improvement in underwriting gains in the future as a result of the sponsored demutualization.
63. As a result of the sponsored demutualization, premium rates will increase above trend and will be greater than those that would occur under BCBSKS's current management.
64. Anthem will not increase premium rates above trend for the large group business, because it is more competitive than the small group and individual markets and it is experience-rated.
65. Rates are unlikely to increase, above trend, in the Medicare block of business, because the Medicare Supplement market is more competitive than the small group and individual markets, and is already profitable.
66. Anthem's premium rate increases will be concentrated in the small group and individual markets, on which BCBSKS is currently losing money. These rate increases will occur as follows:
 - To achieve an increase in underwriting margins from negative 2% to 2.5% by 2005, Anthem would increase premium rates will increase by 14% above trend.
 - To achieve an underwriting margins 2.5% by 2005, Anthem's premium rates would be 7% higher than those required for BCBSKS to achieve its 0% underwriting projection.
 - BCBSKS premium rates will increase by at least 6% to 7% above the levels that would be expected without the sponsored demutualization.
 - To achieve Anthem's goal of underwriting margins of 4.5 to 5%, by 2005, the premium increases, above trend, would be significantly higher than 14%.

Discussion

A. Statutory Requirements

The review of the sponsored demutualization is governed by two statutory provisions.

The relevant statutes provide in pertinent part:

Demutualization: K.S.A. § 40-4004

- (a) The Commissioner shall approve the plan if the Commissioner finds that:
 - (1) The plan of conversion is fair and equitable to policyholders;
 - (2) The plan of conversion complies with the provisions of this act;
 - (3) The plan of conversion does not unjustly enrich any director, officer, agent, or employee of the insurer; and
 - (4) The new stock insurer would meet minimum requirements to be issued a certificate of authority by the Commissioner to transact business in this state, and the continued operations of the new stock insurer would not be hazardous to existing or future policyholders or the public.
- (b) The amount of consideration provided by the converting insurer to policyholders shall be deemed to be fair and equitable pursuant to subsection (a), if the consideration is at least the amount of statutory surplus attributable to contributions of policyholders.

Acquisition: K.S.A. § 40-3304. (d)(1) The Commissioner of insurance shall approve any merger or acquisition of control referred to in subsection (a) of this section unless, after an Evidentiary Hearing thereon conducted in accordance with the provisions of the Kansas administrative procedure act, the Commissioner finds that:

- (A) After the change of control the domestic insurer referred to in subsection (a) of this section would not be able to satisfy the requirements for the issuance of a license to write the line or lines of insurance for which it is presently licensed;
- (B) the financial condition of any acquiring party is such as might jeopardize the financial stability of the insurer or prejudice the interest of its policyholders;
- (C) the plans or proposals which the acquiring party has to liquidate the insurer, sell its assets or consolidate or merge it with any person, or to make any other material changes in its business or corporate structure or management, are unfair and unreasonable to policyholders of the insurer and not in the public interest; or
- (D) the competence, experience and integrity of those persons who would control the operation of the insurer are such that it would

not be in the interest of policyholders of the insurer and of the public to permit the merger or other acquisition of control; or

- (E) the acquisition is likely to be hazardous or prejudicial to the insurance-buying public.

B. Standard of Review

The Commissioner shall render a decision based upon substantial evidence. See K.S.A. 77-621(c)(7). The appellate courts have defined substantial evidence as “such legal and relevant evidence as a reasonable person might accept as being sufficient to support a conclusion.” *Karns v. Kansas State Bd. of Ag.*, 22 Kan. App. 739, , 923 P.2d 78 (1996)(citations omitted).

Under Kansas law, the Commissioner has broad discretion in reviewing the conversion of a domestic insurer from a mutual company to a stock company. K.S.A. 40-4001 *et seq.* The conversion statute recognizes the position that the Commissioner holds in the regulation of domestic insurance companies and defers to her specific knowledge, as the statute states, “Because it is not possible to anticipate all of the circumstances and considerations which may arise incident to a conversion from a mutual insurer to a stock insurer, the Commissioner has broad authority in reviewing such conversion, and the procedures and criteria to be applied by the Commissioner are flexible within the parameters of this act.” K.S.A. 40-4001. The statute further conveys the legislative intent the Commissioner’s authority not be impeded in this area, as it states, “This act shall be liberally construed to effect the legislative intent set forth in this section and shall not be interpreted to limit the powers granted to the Commissioner by other provisions of law.” K.S.A. 40-4001.

The Kansas Insurance Holding Companies Act further set forth the public policy of Kansas when foreign insurers seek to acquire or purchase a domestic insurance company. Under

the Kansas Insurance Holding Companies Act, the Legislature has identified five factors of acquisitions that may be in the public interest, as the statutes reads:

(a) It is hereby found and declared that *it may not be inconsistent* with the public interest and the interest of policyholders to permit insurers to:

- (1) Engage in activities which would enable them to make better use of management skills and facilities;
- (2) Diversify into new lines of business through acquisition or organization subsidiaries;
- (3) Have free access to capital markets which could provide funds for insurers to use in diversification programs;
- (4) Implement sound tax planning conclusions; and
- (5) Serve the changing needs of the public and adapt to changing conditions of the social, economic and political environment, so that insurers are able to compete effectively and to meet the growing public demand for institutions capable of providing a comprehensive range of financial services. K.S.A. 40-3301 (emphasis added).

Anthem places great emphasis on these provisions as establishing that an acquisition must be approved if any of these five conditions is shown. A careful reading of the statute indicates that these are factors that the Commissioner may consider in making her determination, but are not unequivocal public policy statements.

While the Legislature indicated factors that may be in the public interest, the statute expressly provides for factors that are not in public interest, as the next section of the statutes reads:

(b) It is further found and declared that the public interest and the interests of the policyholders *are or may be adversely affected* when:

- (1) Control of an insurer is sought by persons who would utilize such control adversely to the interests of policyholders;

- (2) acquisition of control of an insurer would substantially lessen competition or create a monopoly in the insurance business of this state;
- (3) an insurer which is part of a holding company system is caused to enter into transactions or relationships with affiliated companies on terms which are not fair or reasonable; or
- (4) an insurer pays dividends which jeopardize the financial condition of such insurer. K.S.A. 40-3301 (emphasis added).

While the statutory language in this section is stronger, the Legislature again left the ultimate determination of the public interest to the Commissioner's discretion.

The final legislative purpose put forth in the Kansas Insurance Holding Companies Act is a set of public policy declarations to be promoted by the Act. These declarations are unequivocal, as the provision reads:

(c) It is hereby declared that the policies and purposes of this act *are to promote the public interest* by:

- (1) Facilitating the achievement of the objectives enumerated in subsection (a) of this section;
- (2) requiring disclosure of pertinent information relating to changes in control of an insurer;
- (3) requiring disclosure by an insurer of material transactions and relationships between the insurer and its affiliates, including certain dividends paid by the insurer;;
- (4) providing standards governing material transactions between the insurer and its affiliates. K.S.A. 40-3301 (emphasis added).

These public policy statements indicate that the types of disclosures required by foreign insurance companies and the types of evidence that the Commissioner should take into consideration when making her determination.

C. Burdens of Proof

When reviewing both a demutualization and an acquisition, the Commissioner must utilize two different burdens of proof. Under the legislation, the burden required to approve the respective transaction differs upon whether it is a conversion or an acquisition. Under the applicable laws, the Department has the express authority to retain outside, independent experts to review both the demutualization and the acquisition. The Department also has the authority to present evidence and make recommendations based upon its review of the transaction.

When a domestic mutual insurance company seeks to convert to a stock insurance company, it has the burden of proving that the conversion should be approved. The applicable law specifically states:

The Commissioner shall approve the plan if the Commissioner finds that:

- (1) The plan of conversion is fair and equitable to policyholders;
- (2) the plan of conversion complies with the provisions of this act;
- (3) the plan of conversion does not unjustly enrich any director, officer, agent or employee of the insurer; and
- (4) the new stock insurer would meet minimum requirements to be issued a certificate of authority by the Commissioner to transact business in this state and the continued operations of the new stock insurer would not be hazardous to existing or future policyholders or the public. K.S.A. 40-4004(a)

Thus, the statute requires an affirmative showing by the applicant domestic mutual insurance company of these four factors.

While the domestic mutual insurance company has the burden under the demutualization statute, a foreign insurance company, either stock or mutual, has no such burden of proof under the Kansas Insurance Holding Companies Act. Under the Kansas Insurance Holding Companies

Act, the Commissioner, after conducting a hearing, must approve the acquisition, unless one of five conditions is found, as the Act states:

(d)(1) The Commissioner of insurance shall approve any merger or other acquisition of control referred to in subsection (a) of this section unless, after a public hearing thereon conducted in accordance with the provisions of the Kansas administrative procedure act, the Commissioner finds that:

(A) After the change of control the domestic insurer referred to in subsection ((a) of this section would not be able to satisfy the requirements for the issuance of a license to write the line or lines of insurance for which it is presently licensed;

(B) the financial condition of any acquiring party is such as might jeopardize the financial stability of the insurer or prejudice the interest of its policyholders

(C) the plans or proposals which the acquiring party has to liquidate the insurer, sell its assets or consolidate or merge it with any person, or to make any other material change in its business, or corporate structure or management, are unfair and unreasonable to policyholders of the insurer and not in the public interest; or

(D) the competence, experience and integrity of those persons who would control the operation of the insurer are such that it would not be in the interest of policyholders of the insurer and of the public to permit the merger or other acquisition of control; or

(E) the acquisition is likely to be hazardous or prejudicial to the insurance-buying public. K.S.A. 40-3304.

Therefore, the foreign insurance company has no burden of proof when presenting a proposal to acquire a domestic insurance company.

D. Sponsored demutualization as a single transaction

The parties contemplate that the demutualization and acquisition (the “sponsored demutualization”) be one integral transaction. Part of the consideration to be paid to Eligible Policyholders in satisfaction of the statutory requirement for demutualization is proposed to be a payment by Anthem. While the payment by BCBSKS to its Eligible Policyholders is expected to be no more than \$131 million, Anthem is expected to add another \$190 million. Were it not for

the contribution by Anthem to the policyholder distribution, the demutualization would not satisfy the statutory fairness standard set forth in K.S.A. § 40-4004(b). This is but one illustration of the importance of treating the demutualization and acquisition as one single, and indivisible, transaction and reorganization.

E. Weighing of the Evidence

Although the parties agreed on many issues, some issues evaded consensus, particularly the issues of potential rate increases and cost-savings. Without a consensus from the parties, the Commissioner must weigh the evidence. The KID Testimonial Team has proposed a balancing test. The applicable statutes, however, do not supply such a balancing test, nor does legislative history support the use of such a test. The Commissioner, therefore, will not adopt such a test, but rather will give the evidence the weight that it merits.

The KID Testimonial Team asked the applicants' to provide projections on any cost-savings, efficiencies, or economies of scale that might be achieved through this acquisition. The KID Testimonial Team specified the type of information that it needed to sufficiently evaluate this transaction. The Applicants presented little evidence of any efficiencies that could be achieved. The evidence consisted of two one-page documents that listed roughly \$7 million in cost-savings, efficiencies, or economies of scale. Anthem offered no substantial explanation of any costs saving attributable to the sponsored demutualization. The cost savings information in the documents could not be properly evaluated or analyzed by the KID Testimonial Team, intervenor-parties, or the Commissioner. Little weight is accorded the documents.

1. Potential Benefits

a) Access to capital and enhanced financial flexibility

The record reflects that the stated benefits or advantages of the sponsored demutualization are conclusory and largely inure to the benefit of Anthem and its investors, not the policyholders and the insurance-buying public. The primary example of this is the notion that the sponsored demutualization will enhance BCBSKS's strategic and financial flexibility. Anthem will not even restore the \$131 million that will be distributed to Eligible Policyholders. BCBSKS testified that Anthem has not agreed to put any money into the company's surplus.

Currently, BCBSKS has surplus equal to approximately \$286 million. After the Special Distribution to Eligible Policyholders, BCBSKS's surplus will be \$155 million. Anthem testified that its philosophy is to capitalize its subsidiaries at substantially lower levels. Anthem will not restore the surplus from its depleted level of \$155 million, and will further deplete that surplus to approximately \$90 to \$112.5 million. The current surplus is set aside for the sole benefit of all Kansas policyholders. After the sponsored demutualization, all Kansas policyholders will be protected by a surplus substantially less than half the current amount. The record reflects that BCBSKS will be weaker financially after implementation of the sponsored demutualization.

The Applicants argue that Anthem will offer guarantees that achieve the stated goal of enhanced strategic and financial flexibility. The guarantees offered, however, do not extend beyond the company's obligations to policyholders. The company's creditors would experience

a company that is not as well capitalized, as before the sponsored demutualization. This evidence is given little weight.

b) Membership growth

BCBSKS also argued that the company must convert in order to grow and, therefore, be able to spread its costs over a "sufficiently large" policyholder base. BCBSKS testified that the company has a strategy for increasing membership without the sponsored demutualization, namely by offering "un-branded" products in other markets. BCBSKS offered no evidence as to why its growth strategy is insufficient.

The Applicants argue that the sponsored demutualization will allow BCBSKS to grow membership through access to national accounts. This argument ignores the factual reality that the Applicants already have the opportunity to provide service to any national accounts already in their respective service areas. BCBSKS already has access to all national accounts headquartered in Kansas. Anthem already has access to all national accounts headquartered in Maine, New Hampshire, Connecticut, Kentucky, Ohio, Nevada, Colorado, and Indiana. Neither applicant has identified any national account that will be accessible after the sponsored demutualization that is not already accessible.

The Applicants did not explain or demonstrate how the sponsored demutualization will result in growth in enrollment, enhance efficiencies, or "spread costs" more effectively. Anthem points to its track record of increasing enrollment following its other acquisitions, but did not demonstrate how its growth in other states is relevant to potential growth in Kansas. Anthem presented no plan or projections about potential membership growth in Kansas. The Applicants

also presented no evidence to the effect that an inability to spread costs is currently a problem or that policyholders would benefit by increasing cost-spreading ability. This evidence is given little weight.

c) Exposure to local events and diversified geographical base

BCBSKS suggested that the conversion will result in a diversified geographical base providing increased flexibility in responding to the company's susceptibility to local illness, adverse local legislation, natural disaster, or targeted pricing by competitors. BCBSKS readily admitted that the sponsored demutualization will not lessen the company's exposure to such events. It testified that the combined company would be subject to such events in nine states, rather than just Kansas. The Applicants offer no explanation about how this will be a benefit or advantage to policyholders or the insurance-buying public. More importantly, other than stating that the sponsored demutualization will have this effect, BCBSKS and Anthem provide no analysis as to how it is a benefit and do not attempt to quantify its anticipated value. This evidence is given little weight.

d) Payments to Eligible Policyholders

The payments to Eligible Policyholders are arguably the most direct benefit to policyholders. BCBSKS testified that these payments will only be made to approximately 25% of BCBSKS's insureds. These recipients are not principally the policyholders who would face the disproportionate rate increases, caused by the sponsored demutualization.

e) Economies of scale and decreased administrative costs

Anthem relied upon its past performance following other acquisitions as its only evidence that it would achieve lower administrative costs and other cost-savings following this acquisition. Little financial data was presented to support this contention. Anthem's previous acquisitions differ significantly from the proposed acquisition of BCBSKS. Anthem's other acquisitions involved troubled companies. BCBSKS is not a troubled company. This evidence is given little weight.

f) Better career paths

BCBSKS suggested that, as part of the Anthem companies, it would offer better career paths to its current and potential employees. If this is an advantage at all, its value inures to the benefit of the company and its staff, and only indirectly, if at all, to policyholders or the insurance-buying public. There was no evidence that BCBSKS has had trouble recruiting and retaining sufficient competent staff and management. It contends that they have excellent staff and that this issue has not prevented them from operating safely and for the benefit of policyholders. A significant BCBSKS asset is its remarkable experience and expertise in the Kansas health insurance market. The BCBSKS management team has 281 years of service to BCBSKS. This evidence is given little weight.

g) Best practices

BCBSKS testified that the conversion would enable it to take advantage of "best practices" in use at Anthem. While the adoption of best practices directly benefits the company, the Applicants do not demonstrate, or attempt to quantify, how this will benefit policyholders or the insurance-buying public.

BCBSKS acknowledged that it would seek to implement such practices, with or without the conversion, whenever it learned of them. The benefit appears to be in gaining access to “best practices” about which it could not otherwise learn. Anthem testified that it would likely adopt BCBSKS’s best practices. Only conclusory statements have been offered as to the parties’ expectations regarding such practices. While some “best practices” might result in benefits for policyholders, particularly the improvement of any of the company’s operations that directly touch the consumer, the evidence does not support the conclusion that any “best practices” will produce significant policyholder benefits. This evidence is given little weight.

2. Potential premium rate increases, above trend

To determine the likely impact of the sponsored demutualization on underwriting margins, it is helpful to understand the factors that influence those underwriting margins. These factors fall into five categories: (1) medical expenses or claims costs; (2) benefit design; (3) administrative expenses or overhead; (4) membership enrollment; and (5) premium rates.

a) Medical expense or claims costs

Anthem will not reduce medical expenses. Reducing medical expenses typically requires more aggressive contracting with providers than has been BCBSKS’s practice. Anthem consistently emphasized that provider contracting will be left in the local hands of BCBSKS. No evidence supports a proposition that the sponsored demutualization will reduce medical costs. Neither did it appear from the evidence that an increase in medical costs would inevitably follow implementation of the transaction.

b) Benefit design

Anthem presented no evidence that it will change the benefit design following the sponsored demutualization. Anthem now argues that such changes may be made following the sponsored demutualization, but no evidence exists to show how such changes would result in reduced costs.

c) Administrative costs or overhead

BCBSKS has lower administrative costs than Anthem, as percentage of premium. The record does not support Anthem's contention that it will achieve material reductions in administrative expenses. The evidence demonstrates that Anthem will affiliate BCBSKS with Western Region, which has the highest administrative costs of the Anthem regions. The Applicants provided no substantial evidence of reduced administrative costs.

d) Membership growth

Beyond the Applicants' assertion, nothing within the evidence supports the contention that Anthem will be able to increase BCBSKS's membership. Anthem asserts that it has increased enrollment, but the evidence does not demonstrate how that past experience is relevant to Kansas. Anthem seeks to purchase a well-managed health insurance company that clearly dominates the Kansas health insurance market.

e) Premium rate increases

The lack of evidence supporting a conclusion that Anthem will reduce medical expenses, change benefit design, increase membership or lower administrative expenses, necessarily points the analysis toward premium rate increases.

BCBSKS presented expert economic testimony from two economics professors, Paul Feldstein and Henry Butler. The evidence focused on economic theories and the theoretical contestability of health insurance markets. Neither witness did any actual comparative study of the Kansas health insurance market to identify any potential competitors. Neither of the witnesses analyzed the entry and exit of actual competitors in the Kansas health insurance market. The Applicants' testimony does not establish a link between the theoretical contestability of health insurance markets, generally, and the premium rates charged by BCBSKS. The Commissioner gives this testimony little weight.

BCBSKS testified about its historical underwriting performance and its future financial projections. BCBSKS has had underwriting losses over the last 6 years of 2% or higher. Despite these underwriting losses, BCBSKS has managed to accumulate a surplus estimated at \$286 million. BCBSKS also has managed to keep its administrative costs low. The record reflects that BCBSKS has lower administrative costs, as a percentage of premium, than Anthem – 9% and 11.5%, respectively.

BCBSKS has stated that it intends to improve its underwriting performance. BCBSKS stated its goal of achieving underwriting margins of 2.5% by 2007. Despite setting this goal, BCBSKS's best projection was that it could achieve positive underwriting margins of 0.4% by 2005. BCBSKS adjusted this projection downward to a break-even point by 2005, due to worse than expected underwriting performance by BCBSKS.

As a mutual insurance company, Anthem has achieved underwriting margins of 2 to 3%. As a public company, Anthem has made clear that a primary corporate objective is to match or

exceed its top competitor. Anthem's top investor-owned competitors achieve underwriting margins of 4.5 to 5%.

The KID Testimonial Team provided a substantial review of the Kansas health insurance market. This review analyzed how BCBSKS has responded to the Kansas market, and how Anthem operates in its markets. The PricewaterhouseCoopers (PwC), *Assessment of Market Impact of the Anthem, Inc. Purchase of Blue Cross Blue Shield of Kansas*, analyzed a variety of aspects of BCBSKS operations, including: its market share as a percentage of premium written in Kansas; its competition, including apparent barriers to entry; its financial performance broken down by product line; and its administrative costs. PwC compiled comparable information for Anthem and its operations in its other markets. PwC especially focused on two segments of the health insurance market when evaluating potential rate increases: the small group and individual markets. PwC did not focus on the other product lines, because those markets are profitable and rate increases would not be appropriate at this time.

PwC's detailed analysis of BCBSKS's book of business projected rates at three potential underwriting margins by 2005: a 2% underwriting loss (BCBSKS's current performance), a 0% underwriting margin (BCBSKS's current projections) and a 2.5% underwriting gain (a conservative estimate of Anthem corporate performance). These projections show that to increase underwriting margins from negative 2% to 2.5%, by 2005, premium rates will increase by 14%. To achieve an underwriting margins 2.5% by 2005, Anthem's premium rates would be 7% higher than those required for BCBSKS to achieve its 0% underwriting projection. Premium

rates will increase by 6% to 7% above the levels that would be expected without the sponsored demutualization.

PwC considered a conservative estimate of Anthem's corporate performance and did not take into account Anthem's stated corporate objective of matching or exceeding its investor-owned competition, which operates at the 4.5 to 5% underwriting margins. PwC performed the only systematic, analytic review of the Kansas health insurance market. Therefore, it is given substantial weight.

KMS and KHA presented expert testimony from Carl Shramm, a professional economist. Dr. Shramm's testimony had similar deficiencies as Professors Feldstein and Butler, namely that it was general in scope and provided no analysis of the Kansas insurance market. Therefore, Dr. Shramm's testimony is given little weight.

KMS and KHA also presented the testimony of Marvin Fairbanks, the Director of Contracted Care at Stormont-Vail Healthcare in Topeka. Mr. Fairbanks presented general testimony about Anthem handling of claims. This testimony goes to issues beyond the statutory review of this acquisition; therefore, it is given little weight.

3. Fair Market Value/Conflict of Interest

KMS and KHS argue that the "fairness opinion," authored by DrKW, as to the purchase price is tainted because of a potential conflict of interest. DrKW also was involved in the initial public offering of Anthem. No credible evidence was presented to discredit the fairness opinion offered by DrKW. This argument is given no weight.

F. Rate Stabilization Fund

In its post-hearing brief, Anthem proposed to set up a Rate Stabilization Fund to deal with potential rate increases from the acquisition. The Commissioner will not consider this Fund in her deliberations, because it is not evidence. Therefore, no basis exists to review its sufficiency, efficacy and legality. K.S.A. 77-526(d); K.S.A. 77-523(b).

G. Rules of Statutory Interpretation

When interpreting the applicable statutes, certain fundamental rules of statutory interpretation apply. The most fundamental rule of statutory construction, to which all other rules are subordinate, is that the legislative intent governs the statutory interpretation. See *In re Marriage of Killman*, 264 Kan. 33, 42, 955 P.2d 1228 (1998). The statutory language is the best indicator of that legislative intent, as the Kansas Supreme Court has said:

The Legislature is presumed to have expressed its intent through the language of the statutory scheme it enacted. When a statute is plain and unambiguous, the court must give effect to the intention of the Legislature as expressed, rather than determine what the law should or should not be. Stated another way, when a statute is plain and unambiguous, the appellate courts will not speculate as to the legislative intent behind it and will not read such a statute so as to add something not readily found in the statute. *Id.* (internal citations omitted).

When reviewing the statutory language, a “rule of strict construction” requires that “ordinary words are to be given their ordinary meaning.” *Director of Taxation v. Kansas Krude Oil Reclaiming Co.*, 236 Kan. 450, 455, 691 P.2d 1303 (1994). When construing various statutes, or sections of those statutes, *in pari materia*, the statutes “must be construed together with a view of reconciling and bringing them into workable harmony, if possible.” *Unrau v. Kidron Bethel*

Retirement Services, Inc., ___ Kan. ___, 27 P.3d 1 (2001); see also *State v. Engles*, 270 Kan. 530, 17 P.3d 355 (2001); see also *State v. Bolin*, 266 Kan. 18, 24, 968 P.2d 1104 (1998).

The sponsored demutualization is structured as a “sponsored demutualization.” The domestic mutual insurance company converts to a domestic stock company and then the acquiring foreign stock insurance company purchases all of the stock of the issued by the domestic stock insurance company. Throughout the evidentiary hearing, both Applicants, BCBSKS and Anthem, represented that this proposal as one transaction. The acquisition will not proceed without the demutualization and the demutualization will not proceed without the acquisition. Both must be approved for the transaction to proceed.

The structure of the transaction necessarily implicates two different statutory schemes, K.S.A. 40-4001 *et seq.* (the demutualization statute) and K.S.A. 40-3301 *et seq.* (the Kansas Insurance Holding Companies Act). The fundamental rules of statutory interpretation must work to not only interpret these statutes, but also integrate the statutes in a workable manner.

H. Analysis of the Kansas demutualization statute

K.S.A. 40-4004 requires consideration of whether:

1. The plan of conversion is fair and equitable to policyholders;

BCBSKS has established that the Plan is fair and equitable to policyholders. The Plan distributes consideration that is deemed, by the statute, to be fair and equitable to policyholders. The Plan distributes that consideration using ASOP 37, which has been shown to be fair and equitable.

The KID Testimonial Team presented evidence that the sponsored demutualization will likely result in rate increases and argued that this fact implicates the statutory fair and equitable standard. The Commissioner has considered the KID Testimonial Team's argument. While the arguments put forth have merit, and will be discussed more fully under other statutory standards, the KID Testimonial Team's reliance on this statutory factor is misplaced. Many of the KID Testimonial Team's arguments implicate the Kansas Insurance Holding Companies Act, rather than the demutualization statute. Under the demutualization statute, enacted by the Kansas legislature, the evidence shows that the Plan is fair and equitable.

2. The plan of conversion complies with the provisions of this act;
BCBSKS has established that the Plan complies with the other provisions of the demutualization statute. The only caveat offered, by the KID Testimonial Team, was the potential rate increases that could occur under this Plan. That caveat applies to the Kansas Insurance Holding Companies Act, not the demutualization statute.

3. The plan of conversion does not unjustly enrich any director, officer, agent or employee of the insurer, and
BCBSKS has established that no director, officer, agent or employee of BCBSKS will be unjustly enriched under the Plan.

4. The new stock insurer would meet minimum requirements to be issued a certificate of authority by the commissioner to transact business in this state and the continued operations of the new stock insurer would not be hazardous to existing or future policyholders or the public.
BCBSKS has established that the converted company will meet the minimum requirements for issuance of a certificate of authority.

I. Analysis of the Kansas Insurance Holding Companies Act – K.S.A. 40-3304(d)(1)

The analysis of the Kansas Insurance Holding Companies Act (“Act”) does not require a discussion of each of the statutory standards. It calls on the Commissioner to consider the acquisition’s effects on Kansas policyholders and the insurance-buying public, and to determine whether these effects create certain unacceptable conditions. These conditions are enumerated in the statutory standards. If any of those conditions exist, the Commissioner may disapprove the acquisition.

The following discussion will focus on the two of the sponsored demutualization’s primary effects and the two standards these effects implicate.

1. Effects of the acquisition

Anthem’s acquisition of BCBSKS would have two effects that would implicate the standards of the Act. These effects are that (a) Anthem would severely deplete BCBSKS’s surplus; and (b) Anthem would raise premium rates on individuals and small groups at a substantially higher pace than BCBSKS would without the acquisition.

(a) Depletion of BCBSKS’s surplus

Anthem plans to severely reduce BCBSKS’s surplus. BCBSKS currently has a surplus of approximately \$286 million. The Special Distribution to Eligible Policyholders will reduce the surplus to \$155 million. BCBSKS testified that this level of surplus would be inappropriate for an independent insurance company. According to its corporate policy, Anthem will not replenish the \$131 million of the surplus distributed to Eligible Policyholders, and will further deplete that

surplus to an amount between approximately \$90 to \$112.5 million, substantially less than half of its current surplus.

(b) Likely additional premium rate increases

The issue that received the most attention at the hearing is whether Anthem would raise premium rates in Kansas at a faster pace than BCBSKS would without the sponsored demutualization.¹ The record reflects that Anthem would raise premium rates faster than BCBSKS.

Anthem would increase rates faster than BCBSKS because it would seek higher underwriting margins than BCBSKS. Several factors affect the underwriting margins achieved by an insurance company: (1) medical expenses or claims costs; (2) benefit design; (3) administrative expenses or overhead; (4) membership enrollment; and (5) premium rates. The evidence reflects that Anthem does not plan to reduce medical expenses or change its benefit design. The evidence does not demonstrate that Anthem would reduce BCBSKS's already low administrative costs. The evidence does not demonstrate that Anthem would significantly increase membership. The KID Testimonial Team, however, presented substantial evidence that Anthem would raise premium rates significantly.

For the past six years, BCBSKS has had underwriting losses. The evidence indicates that BCBSKS currently operates with an underwriting loss of 2% or higher. Although BCBSKS has

¹ This discussion does not arise from the premium rate increases that will be necessary because of medical cost inflation and the rising costs of doing business, otherwise referred to in the industry as "trend." These trend increases will be the same with or without the sponsored demutualization. Rather, this issue focuses on whether the sponsored demutualization would cause additional premium rate increases that would not occur without the sponsored demutualization—that is, whether Anthem would raise premium rates faster than BCBSKS would have.

stated that it seeks to achieve underwriting gains of 2.5% by 2007, BCBSKS's own best projection is that it would only achieve a 0.4% underwriting gain by 2005. BCBSKS adjusted this projection downward to 0% by BCBSKS because it is currently suffering worse underwriting margins than previously anticipated.

The evidence reflects that BCBSKS has historically not focused on maximizing underwriting gains. BCBSKS has chosen to accumulate a considerable surplus in order to allowed it to operate without maximizing its underwriting gains.

In contrast, as a mutual insurance company, Anthem has historically generated substantial underwriting gains. Anthem communicated to BCBSKS that it plans to achieve underwriting gains of at least 3%. Anthem achieved these underwriting gains as a mutual insurance company. It has recently converted to a stock insurance company. As a stock company, Anthem has resolved to match or exceed the underwriting gains of its top investor-owned competitors. These competitors' underwriting gains are between 4.5 and 5%.

From the companies' histories and current postures, the KID Testimonial Team presented evidence that Anthem would seek a higher underwriting margin than BCBSKS, and that it would achieve this higher margin through higher premium rates. The applicants dispute the KID Testimonial Team's analysis and the resulting conclusion. The KID Testimonial Team's assertions, however, are entirely supported by substantial evidence. Neither applicant has denied that Anthem would seek underwriting margins of at least 3% better than BCBSKS's projections and 5% better than BCBSKS's current performance. Neither applicant has presented evidence

that Anthem could achieve these underwriting gains by any means other than premium rate increases.

Substantial evidence demonstrates that that Anthem would achieve these margins through premium rate increases.

2. Application of these Effects to the Kansas Insurance Holding Company Act

(a) K.S.A. 40-3304(d)(1)(C): Material Change in Corporate or Business Management

The Commissioner shall approve the acquisition, unless Anthem's "plans or proposals . . . to make any other material changes in its business or corporate structure or management, are unfair and unreasonable to policyholders of the insurer and not in the public interest." K.S.A. 40-3304(d)(1)(C). When interpreting this provision, several terms must be defined: "material," "unfair," and "unreasonable."

The "strict rule of statutory construction" requires that "ordinary words are to be given their ordinary meaning." *Director of Taxation v. Kansas Krude Oil Reclaiming Co.*, 236 Kan. 450, 455, 691 P.2d 1303 (1994). All of the terms at issue are ordinary words. "Material" is defined, as used in the statute, as "being both relevant and consequential." AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE (3rd Ed. 1996). "Unfair" is defined as "not just or evenhanded." *Id.* "Unreasonable" is defined, as used in the statute as "exceeding reasonable limits; immoderate." Thus, the Commissioner may disapprove the sponsored demutualization upon a finding that Anthem plans to make consequential changes to BCBSKS's management or structure that are not just and are immoderate and not in the public interest.

Anthem would make two substantial changes to BCBSKS's management strategy: it would severely deplete BCBSKS's surplus, and would raise premium rates significantly more than BCBSKS would without the acquisition. These changes would weaken BCBSKS financially and place a significant financial burden on BCBSKS's policyholders and the public. Before the sponsored demutualization, BCBSKS's surplus was used to hold premium rates down. After the sponsored demutualization, the surplus will be depleted to benefit the Anthem holding company, and rates for BCBSKS policyholders will rise significantly. The Commissioner finds that these changes are unfair and unreasonable to policyholders and not in the public interest.

(b) K.S.A. 40-3304(d)(1)(E): Hazardous or Prejudicial

The Commissioner shall approve the acquisition, unless she determines that "the acquisition is likely to be hazardous or prejudicial to the insurance-buying public." K.S.A. 40-3304(d)(1)(E). This section employs three key words: "likely," "hazardous," and "prejudicial."

BCBSKS seeks to restrict the definition of "hazardous or prejudicial" to "a threat to the interests of the insurance-buying public in financially sound and trustworthy insurers." BCBSKS supports this narrow definition by citing other provisions of the insurance code that use the term *hazardous* to refer to an insurer's financial condition. This argument is unpersuasive.

Each of the provisions to which BCBSKS refers explicitly qualifies *hazardous*, in one way or another, to identify the hazard to which it refers as a financial hazard. Some of the provisions make clear that *hazardous* need not refer to a financial hazard at all. To conclude

from these provisions that *hazardous*, unqualified and standing on its own, must inevitably mean “financially hazardous” is simply illogical.

Moreover, restricting *hazardous or prejudicial* to this extremely narrow financial definition is unsound in the context of the statute in which it resides. Another of the five conditions at play in this statute covers the subject of the financial condition of the acquiring insurer. K.S.A. 40-3304(d)(1)(B). To define *hazardous or prejudicial* in this narrow, financial sense would render either K.S.A. 40-3304(d)(1)(B) or 40-3304(d)(1)(E) superfluous.

Anthem also attempts to narrow the definition of *hazardous or prejudicial*. It claims that the legislative history of K.S.A. 44-3304, which it concedes is “meager,” restricts the effect of this statute to “prevent[ing] undesirable parties from gaining control of insurance companies and depleting the assets of the insurer.” This argument is, at best, thinly supported by the legislative history, and is inconsistent with the wording of the statute.

As Anthem states in its post-hearing brief, the legislative history “does not specify any specific need, justification or purpose for authorizing the Commissioner to disapprove an acquisition if she finds that it ‘is likely to be hazardous or prejudicial to the insurance-buying public.’” Neither does the statute itself. Given the explicit statement of legislative intent and public policy in 40-3301, one would assume that if the Legislature intended to restrict the effect of this statute, it would have done so explicitly, either in 40-3301 or 40-3304.

On its face, the statute’s intended effect is broader than Anthem contends. The five criteria in 40-3304(d)(1) cover a broad array of potential pitfalls in a transaction of this sort: the general requirements of licensure for a domestic insurer; the financial condition of the acquiring

party; any plans or proposals the acquiring party has, not merely those to deplete assets; the competence, experience, and integrity of the acquiring party; and, quite broadly, anything else that might be hazardous or prejudicial to the insurance-buying public. To be certain, the Legislature intended for the Commissioner to protect against undesirables seeking to deplete a domestic insurer's assets. But to restrict its meaning to only that effect is a contortion of language and a stretch of reasoning that this Commissioner cannot adopt.

The "strict rule of statutory construction" requires that "ordinary words are to be given their ordinary meaning." *Director of Taxation v. Kansas Krude Oil Reclaiming Co.*, 236 Kan. 450, 455, 691 P.2d 1303 (1994). "Likely," "hazardous" and "prejudicial" are terms in common usage and have ordinary meanings. "Likely" is defined as "possessing or displaying the characteristics or qualities that make something probable." AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE (3rd Ed. 1996). "Hazardous" is defined as "marked by danger; perilous." *Id.* "Prejudicial" is defined as "detrimental; injurious." *Id.* Applying the "strict rule of construction," the Commissioner may disapprove the acquisition upon a finding that it is probable that the insurance-buying public will be in danger or may be injured by the acquisition. The nature of this danger or injury does not matter under the plain, unambiguous language of the statute.

Anthem would severely deplete BCBSKS's surplus, and would raise premium rates significantly more than BCBSKS would without the acquisition. This would weaken the financial standing of the state's dominant health insurer and place a substantial financial burden

on insurance-buying public. The Commissioner finds that these changes would be hazardous and prejudicial to the insurance-buying public.

Conclusions of Law

Based on the foregoing Findings of Facts and Discussion, the Commissioner makes the following conclusions of law:

1. The amount of consideration provided by the BCBSKS to policyholders is fair and equitable. K.S.A. 40-4004(b)
2. The consideration is at least the amount of statutory surplus attributable to contributions of policyholders. K.S.A. 40-4004(b)
3. As defined in the demutualization statute, the plan is fair and equitable to policyholders. K.S.A. 40-4004(a)(1)
4. The plan of conversion complies with the provisions of this act. K.S.A. 40-4004(a)(2)
5. The plan of conversion does not unjustly enrich any director, officer, agent, or employee of the insurer. K.S.A. 40-4004(a)(3)
6. BCBSKS as a converted company will meet the minimum requirements to be issued a certificate of authority by the Commissioner. K.S.A. 40-4004
7. The proposed sponsored demutualization will cause a material change in management that will be unfair and unreasonable to policyholders and not in the public interest. K.S.A. 40-3304(d)(1)(C)
8. The proposed sponsored demutualization is likely to be hazardous or prejudicial to the insurance-buying public. K.S.A. 40-3304(d)(1)(E).

Order

Based on the foregoing Findings of Fact and Conclusions of Law, the Commissioner disapproves the sponsored demutualization of BCBSKS proposed by BCBSKS and Anthem.

Dated: February 11, 2002

A handwritten signature in black ink, appearing to read "Kathleen Sebelius", written over a horizontal line.

Hon. Kathleen Sebelius, Commissioner of Insurance

Appeal Rights and Other Administrative Relief

1. Any party or party-intervenor may appeal from this Final Order within the time provided, and pursuant to the procedures provided in the Act for Judicial Review and Civil Enforcement of Agency Actions. K.S.A. 77-601 *et. seq.*
2. If a petition for judicial review is filed, K.S.A. 77-615 and 77-613 requires a copy of the petition be served on the Commissioner of Insurance, Kathleen Sebelius, 420 SW 9th Street, Topeka, Kansas.
3. The Final Order is effective upon service. Service shall be by hand delivery and U.S. mail.
4. Any party within fifteen days after the service of the Final Order, may file a Petition for Reconsideration with the Commissioner of Insurance, stating the specific grounds upon which relief is requested. The filing of the Petition for Reconsideration is not a prerequisite for seeking judicial review of the Final Order. Within twenty days after filing any such petition for reconsideration, the Commissioner of Insurance shall render a written order denying the petition, or granting the petition and dissolving or modifying the final order, or granting the petition and setting the matter for further proceedings. The petition may be granted, in whole or in part, only if the Commissioner states, in the written order, findings of fact, conclusions of law and policy reasons for the decision if it is an exercise of the Insurance Department's discretion, to justify the order. Any order rendered upon reconsideration or any order denying the petition for reconsideration will state the agency officer to receive service of the petition for judicial review. K.S.A. 77-529. An order under this section shall be served on the parties in the manner prescribed by K.S.A. 77-531 and amendments thereto.
5. A party may submit to the Commissioner of Insurance a petition for stay of effectiveness of such final order until the time at which a petition for judicial review would no longer be timely, unless otherwise provided by statute or as stated in the final order. The Commissioner of Insurance may take action on the petition for stay, either before or after the effective date of the final order. K.S.A. 77-528.
6. If the Final Order is served by mail, three days are added to the time limits set out above. K.S.A. 77-531.

NOTIFICATION OF SERVICE

A true and correct copy of the foregoing **FINAL ORDER** dated February 11, 2002, has this 11th day of February 2002, been sent, via first-class mail, to the below identified counsel or parties.

Brent Getty, Staff Attorney to the Commissioner

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APPENDIX A

Exhibit List

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| Exhibit 1 | Plan of Conversion |
| Exhibit 2 | Alliance Agreement |
| Exhibit 3 | Prefiled Testimony of John W. Knack, Jr. |
| Exhibit 4 | PowerPoint slides for John W. Knack Jr.'s testimony |
| Exhibit 5 | Prefiled Testimony of Michael M. Mattox |
| Exhibit 6 | PowerPoint slides for Michael M. Mattox's testimony |
| Exhibit 7 | Not marked |
| Exhibit 8 | Prefiled Testimony of Paul J. Feldstein |
| Exhibit 9 | Curriculum Vitae of Paul J. Feldstein (Exhibit A to prefiled testimony of Paul J. Feldstein) |
| Exhibit 10 | <u>The Effect of Ownership on Health Plan Performance</u> by Paul J. Feldstein (Exhibit B to prefiled testimony of Paul J. Feldstein) |
| Exhibit 11 | Tables 1 through 7 for <u>The Effect of Ownership on Health Plan Performance</u> by Paul J. Feldstein (Exhibit B to prefiled testimony of Paul J. Feldstein) |
| Exhibit 12 | Prefiled Rebuttal Testimony of Paul J. Feldstein |
| Exhibit 13 | Prefiled Testimony of Donald R. Lynn |
| Exhibit 14 | Prefiled Rebuttal Testimony of Donald R. Lynn |
| Exhibit 15 | Prefiled Fairness Opinion of Dresdner Kleinwort Wasserstein, Inc. dated November 9, 2001 |
| Exhibit 15a | Prefiled Fairness Opinion of Dresdner Kleinwort Wasserstein, Inc. dated May 24, 2001 |
| Exhibit 16 | Prefiled Testimony of Paul G. Adams |
| Exhibit 17 | Prefiled Actuarial Opinion of Daniel J. McCarthy |

- Exhibit 18 Prefiled Testimony of Daniel J. McCarthy
- Exhibit 19 Envelope for Notice Materials Mailed to Eligible Policyholders
- Exhibit 20 Policyholder Instruction Guide [and Q/A]
- Exhibit 21 Proxy card; tax payer identification number card; and member record card
- Exhibit 22 Pre-addressed return envelope for proxy card
- Exhibit 23 Policyholder Information Statement
- Exhibit 24 Plan 65 Guide
- Exhibit 25 Affidavit of Mailing of Bob Ware
- Exhibit 26 Federal Trade Commission Early Termination of Waiting Period Letter, transaction identification number 20012361, dated September 18, 2001
- Exhibit 27 Letter from William H. Pitsenberger of Blue Cross and Blue Shield of Kansas ("BCBSKS") to Kathleen Sebelius, Commissioner of Insurance, regarding submission of BCBSKS' Plan of Conversion dated October 26, 2001
- Exhibit 28 October 25, 2001 BCBSKS Board Meeting Minutes
- Exhibit 29 Prefiled Testimony of William H. Pitsenberger
- Exhibit 30 Prefiled Testimony of Henry N. Butler
- Exhibit 31 Curriculum Vitae of Henry N. Butler (Exhibit A to prefiled testimony of Henry N. Butler)
- Exhibit 32 NOT OFFERED
- Exhibit 33 Prefiled Rebuttal Testimony of Henry N. Butler
- Exhibit 34 Prefiled Testimony of Larry C. Glasscock
- Exhibit 35 Prefiled Testimony of Michael L. Smith
- Exhibit 36 Prefiled Testimony of Samuel R. Nussbaum, M.D.
- Exhibit 37 Prefiled Testimony of Donna O. Moore
- Exhibit 38 Prefiled Testimony of David R. Frick

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| Exhibit 39 | Prefiled Rebuttal Testimony of Michael L. Smith |
| Exhibit 40 | Prefiled Rebuttal Testimony of Samuel R. Nussbaum, M.D. |
| Exhibit 41 | Fax from Neal Simpson of BCBSKS to Patrick H. Cantilo, Counsel for the Kansas Insurance Department ("KID") Testimonial Team, with Marketing and Finance Task Force Projections dated November 5, 2001 |
| Exhibit 42 | Under seal |
| Exhibit 43 | Under seal |
| Exhibit 44 | Under seal |
| Exhibit 45 | Under seal |
| Exhibit 46 | Under seal |
| Exhibit 47 | Not identified |
| Exhibit 48 | Under seal |
| Exhibit 49 | Letter dated November 9, 2001 from Randall J. Forbes, Counsel for Anthem Insurance Company ("Anthem"), to Patrick H. Cantilo, Counsel for the KID Testimonial Team, regarding further responses from Anthem to the Form A Due Diligence Request |
| Exhibit 50 | Anthem/BCBSKS Integration Recommendations |
| Exhibit 51 | Prefiled Testimony of Kathy Greenlee |
| Exhibit 52 | Prefiled Testimony of David M. Platter |
| Exhibit 53 | Prefiled Testimony of Mark H. Kovey |
| Exhibit 54 | Prefiled Testimony of Kenneth M Beck |
| Exhibit 55 | Prefiled Testimony of Denise G. Essenberg |
| Exhibit 56 | Prefiled Testimony of Sandra S. Hunt |
| Exhibit 57 | <u>Patients and Profits: The Relationship Between HMO and Financial Performance and Quality of Care</u> by Patricia H. Born and Carol J. Simon |
| Exhibit 58 | <u>Use and Abuse of the Medical Loss Ratio to Measure Health Plan Performance</u> by James C. Robinson |

- Exhibit 59 Settlement Agreement between BCBSKS, KID and State's Attorney General regarding charitable assets
- Exhibit 60 Notice of Public Hearing
- Exhibit 61 Under seal
- Exhibit 62 Letter dated September 7, 2001 and Actuarial Memorandum from David J. Hutchins, Chief Actuary for BCBSKS, to Kathleen Sebelius, Commissioner of Insurance, regarding 2002 rates for Medicare Complementary (Plan 65, Plan 65 Benefit Plans, Disability Benefit Plans: Form Numbers 80-1143, 80-1141, 80-1142, 95-1016, 95-1017, 95-1018, 95-1019, 95-1020 – Revised)
- Exhibit 63 PricewaterhouseCoopers ("PwC") Assessment of Market Impact of the Anthem Purchase of BCBSKS
- Exhibit 64 Not identified
- Exhibit 65 Not identified
- Exhibit 66 Letter dated December 28, 2001 from Gary McCallister, Counsel for BCBSKS to Kathy Greenlee and Patrick H. Cantilo, Counsel for the KID Testimonial Team regarding the draft of the PwC Market Impact Report
- Exhibit 67 Not identified
- Exhibit 68 Draft of pages 58 through 61 of the PwC Market Impact Report dated December 30, 2001
- Exhibit 69 Draft of pages 60 through 64 of the PwC Market Impact Report dated December 30, 2001
- Exhibit 70 Draft of pages 58 through 61 of the PwC Market Impact Report
- Exhibit 71 Implications for Health Care Providers Resulting From the Sale of Kansas Blue Cross Blue Shield by Carl J. Schramm, Ph.D., J.D.
- Exhibit 72 Blue Cross Conversion: Policy Considerations Arising From A Sale of the Maryland Plan by Carl J. Schramm
- Exhibit 73 Prefiled Testimony of Marvin M. Fairbank
- Exhibit 74 Prefiled Testimony of Dawn M Touzin
- Exhibit 75 Supplemental to Prefiled Testimony of Dawn M. Touzin