

Blue Cross Blue Shield of Delaware
Affiliation Financial Pro Formas
August 31, 2011

Overview

On August 20, 2010, Blue Cross Blue Shield of Delaware (BCBSD) announced it had signed an affiliation agreement with Pennsylvania-based Highmark Inc. (Highmark) that will position BCBSD to remain a strong local leader in the health care marketplace. This announcement was the culmination of a four-year corporate strategic planning process for BCBSD.

The affiliation will allow BCBSD to retain its not-for-profit status, enhance operations, maintain financial stability and continue to provide the high level of local services that its customers and providers have come to expect. This relationship will afford both companies greater economies of scale and the ability to streamline operations, while maintaining their strong local presence and focus on community support. Specifically, an affiliation with Highmark will allow BCBSD to make investments in business processes, human capital and information technology on a more cost effective basis than by purchasing these services on a stand-alone basis. Additionally, the affiliation will enable BCBSD to implement, more timely and effectively, the significant changes that are required as a result of the health care reform legislation.

The accompanying pro forma statutory financial statements were prepared under two different scenarios:

- Affiliation Basis Scenario – Assumes that the BCBSD/Highmark affiliation will be approved effective January 1, 2012.
- Stand Alone Scenario – Assumes that BCBSD will continue to remain independent.

The specific assumptions utilized in preparing the pro formas are outlined in the attached notes. BCBSD has not completed the work necessary to fully analyze the reform impacts to BCBSD or its market, and as such, we do not represent to have captured all market impacts within the pro formas related to health care reform. The primary difference between the two scenarios is the cost and timeline for BCBSD to obtain needed capability enhancements and how those costs are funded. Additionally, the Affiliation Basis pro formas assume a slight increase in enrollment during 2013, 2014 and 2015 due to the enhanced capabilities and products that BCBSD will be able to offer. Conversely, the Stand Alone Basis projects a steady decline in enrollment as a result of not being able to provide the required capabilities and products. As a result of the above factors, the projected risk-based capital varies significantly between the two scenarios.

The Affiliation Basis pro forma assumes that the affiliation becomes effective January 1, 2012 and that Highmark and BCBSD begin the work necessary to complete the migration to Highmark's technology platforms and other capabilities immediately thereafter. The migration is projected to be completed by October 1, 2013. The projected five year capital costs under this scenario are approximately \$51 million. By December 31, 2015, BCBSD's risk-based capital ratio is projected to be consistent with today's current level. The scenario assumes that BCBSD will be allocated costs annually by Highmark for management services and information technology and that these costs will be more than offset by savings obtained from the integration of various corporate functions, operational efficiencies and the ability to take advantage of Highmark's scale and more favorable vendor contract terms. The parties have established various affiliation teams consisting of representatives from both companies that have been working to develop recommendations regarding integration and the future end state for each major function.

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The Stand Alone Basis pro forma assumes that BCBSD will implement the various capability enhancements recommended by Deloitte in a study performed in 2008 and recently updated. Given BCBSD's relatively small size and the significant investments required, it is anticipated that it will take BCBSD approximately five years to complete the implementation of the capability enhancements. The projected five year capital costs under this scenario are approximately \$130 million – a \$79 million increase over the Affiliation Basis scenario. The Stand Alone Basis pro forma also assumes that BCBSD will need to recoup a portion of its capital costs through higher premium increases than under the Affiliation Basis scenario beginning in 2014. Even with the slightly higher premium increases, BCBSD's risk-based capital ratio is projected to decline [REDACTED]

The significant savings (\$79 million) in capital costs as a result of obtaining the needed capability enhancements through the affiliation will have a very positive impact on BCBSD's reserves, risk-based capital and overall financial condition. Additionally, an affiliation with Highmark will enable BCBSD to bring enhanced capabilities to the marketplace much sooner than on an independent basis and will provide BCBSD with the resources and expertise necessary to reposition the Company to respond to the massive changes required as a result of health care reform. Finally, BCBSD's customers will benefit from the affiliation in the form of lower projected premium increases than would have otherwise occurred on a Stand Alone Basis.

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Pro Forma Income Statements - Statutory Basis
August 31, 2011

(Amounts in Thousands)

Affiliation Basis	2010	2011	2012	2013	2014	2015
Member months	1,333	1,326	1,350	1,384	1,462	1,557
Premiums earned	\$ 498,775	\$ 518,872	\$ 546,381	\$ 583,986	\$ 639,306	\$ 708,781
Claims incurred	421,491	440,964	463,772	495,537	542,881	602,088
General and administrative						
SG&A expenses						
Self funded and other fees						
Capability enhancement expense	-	700	2,327	5,243	13,297	11,667
Total general and administrative	69,677	73,754	79,176	83,252	92,991	97,187
Total claims cost and expenses	491,168	514,718	542,948	578,789	635,872	699,275
Underwriting gain (loss)	7,607	4,154	3,433	5,197	3,434	9,506
Investment income, net	11,455	8,791	8,235	8,346	8,877	9,852
Income (loss) before income taxes	19,062	12,945	11,668	13,543	12,311	19,358
Provision (benefit) for income taxes	3,827	2,736	2,334	2,709	2,463	3,872
Net income	\$ 15,235	\$ 10,209	\$ 9,334	\$ 10,834	\$ 9,848	\$ 15,486

Stand Alone Basis	2010	2011	2012	2013	2014	2015
Member months	1,333	1,326	1,313	1,252	1,181	1,131
Premiums earned	\$ 498,775	\$ 518,872	\$ 540,772	\$ 544,209	\$ 540,984	\$ 547,029
Claims incurred	421,491	440,964	458,861	461,751	459,230	464,219
General and administrative						
SG&A expenses						
Self funded and other fees						
Capability enhancement expense	-	700	2,327	5,368	12,880	31,625
Total general and administrative	69,677	75,124	77,181	81,307	91,716	113,909
Total claims cost and expenses	491,168	516,088	536,042	543,058	550,946	578,128
Underwriting gain (loss)	7,607	2,784	4,730	1,151	(9,962)	(31,099)
Investment income, net	11,455	8,791	8,070	7,240	6,408	5,708
Income (loss) before income taxes	19,062	11,575	12,800	8,391	(3,554)	(25,391)
Provision (benefit) for income taxes	3,827	2,461	2,560	1,678	(711)	(5,078)
Net income (loss)	\$ 15,235	\$ 9,114	\$ 10,240	\$ 6,713	\$ (2,843)	\$ (20,313)

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Pro Forma Income Statements - Statutory Basis
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(Amounts in Thousands)

Affiliation Fav/(Unfav.) to Stand Alone	2010	2011	2012	2013	2014	2015
Member months	-	-	37	132	281	426
Premiums earned	\$ -	\$ -	\$ 5,609	\$ 39,777	\$ 98,322	\$ 161,752
Claims incurred	-	-	(4,911)	(33,786)	(83,651)	(137,869)
General and administrative						
SG&A expenses						
Self funded and other fees						
Capability enhancement expense	-	-	-	125	(417)	19,958
Total general and administrative	-	1,370	(1,995)	(1,945)	(1,275)	16,722
Total claims cost and expenses	-	1,370	(6,906)	(35,731)	(84,926)	(121,147)
Underwriting gain (loss)	-	1,370	(1,297)	4,046	13,396	40,605
Investment income, net	-	-	165	1,106	2,469	4,144
Income (loss) before income taxes	-	1,370	(1,132)	5,152	15,865	44,749
Provision (benefit) for income taxes	-	(275)	226	(1,031)	(3,174)	(8,950)
Net income (loss)	\$ -	\$ 1,095	\$ (906)	\$ 4,121	\$ 12,691	\$ 35,799

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Pro Forma Balance Sheets - Statutory Basis
August 31, 2011

(Amounts in Thousands)

Affiliation Basis	2010	2011	2012	2013	2014	2015
Cash & short-term Investments	\$ 33,727	\$ 36,727	\$ 36,727	\$ 36,727	\$ 38,727	\$ 40,727
Investments	231,243	228,989	224,573	235,324	254,928	291,029
Uncollected premiums	11,351	12,389	13,249	14,171	15,592	17,421
Amounts receivable from uninsured plans	11,719	12,059	12,662	13,295	13,960	14,658
Property and equipment, net	4,785	5,240	5,017	5,225	5,794	6,788
Other	13,893	13,893	13,893	13,893	13,894	13,893
Total admitted assets	\$ 306,718	\$ 309,297	\$ 306,121	\$ 318,635	\$ 342,895	\$ 384,516
Unpaid claims & claim adjustment expense	\$ 37,914	\$ 36,600	\$ 38,492	\$ 41,130	\$ 45,059	\$ 49,973
Accounts payable	44,931	44,025	45,552	46,311	47,916	51,125
Premiums received in advance	13,794	10,324	11,041	11,809	12,994	14,518
Other liabilities	38,948	43,678	43,793	45,209	43,762	42,633
Capital & surplus	171,131	174,670	167,243	174,176	193,164	226,267
Total liabilities, capital & surplus	\$ 306,718	\$ 309,297	\$ 306,121	\$ 318,635	\$ 342,895	\$ 384,516

Risk-Based Capital %

Stand Alone Basis	2010	2011	2012	2013	2014	2015
Cash & short-term Investments	\$ 33,727	\$ 23,977	\$ 25,095	\$ 25,395	\$ 25,795	\$ 27,395
Investments	231,243	235,852	208,323	188,405	160,800	148,324
Uncollected premiums	11,351	16,519	17,131	17,010	16,605	16,550
Amounts receivable from uninsured plans	11,719	12,059	12,662	13,295	13,960	14,658
Property and equipment, net	4,785	5,361	4,488	3,934	3,143	2,674
Other	13,893	13,894	13,894	13,893	13,893	13,893
Total admitted assets	\$ 306,718	\$ 307,662	\$ 281,593	\$ 261,932	\$ 234,196	\$ 223,494
Unpaid claims & claim adjustment expense	\$ 37,914	\$ 36,600	\$ 38,086	\$ 38,325	\$ 38,116	\$ 38,530
Accounts payable	44,931	43,664	43,995	44,495	45,787	46,836
Premiums received in advance	13,794	10,324	10,707	10,631	10,378	10,344
Other liabilities	38,948	38,379	39,201	37,359	35,148	38,659
Capital & surplus	171,131	178,695	149,604	131,122	104,767	89,125
Total liabilities, capital & surplus	\$ 306,718	\$ 307,662	\$ 281,593	\$ 261,932	\$ 234,196	\$ 223,494

Risk-Based Capital %

Affiliation Fav/(Unfav.) to Stand Alone	2010	2011	2012	2013	2014	2015
Cash & short-term Investments	\$ -	\$ 12,750	\$ 11,632	\$ 11,332	\$ 12,932	\$ 13,332
Investments	-	(6,863)	16,250	46,919	94,128	142,705
Uncollected premiums	-	(4,130)	(3,882)	(2,839)	(1,013)	871
Amounts receivable from uninsured plans	-	-	-	-	-	-
Property and equipment, net	-	(121)	529	1,291	2,651	4,114
Other	-	(1)	(1)	-	1	-
Total admitted assets	\$ -	\$ 1,635	\$ 24,528	\$ 56,703	\$ 108,699	\$ 161,022
Unpaid claims & claim adjustment expense	\$ -	\$ -	\$ 406	\$ 2,805	\$ 6,943	\$ 11,443
Accounts payable	-	361	1,557	1,816	2,129	4,289
Premiums received in advance	-	-	334	1,178	2,616	4,174
Other liabilities	-	5,299	4,592	7,850	8,614	3,974
Capital & surplus	-	(4,025)	17,639	43,054	88,397	137,142
Total liabilities, capital & surplus	\$ -	\$ 1,635	\$ 24,528	\$ 56,703	\$ 108,699	\$ 161,022

Risk-Based Capital %

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General Comments and Assumptions

Pro Forma Versions

Pro forma financial statements were developed based on a successful affiliation effective January 1, 2012 (“Affiliation Basis” scenario) and on the assumption that BCBSD remains independent, referred to as the “Stand Alone Basis” scenario.

Updated Pro Forma Versions

BCBSD was requested by consultants for the Delaware Department of Insurance to update the pro forma financial statements for each scenario. These revisions included incorporating the:

- actual results for 2010
- a current forecast for 2011
- expected impact on enrollment of BCBSD’s competitive capability with and without Highmark’s processes and technologies.

Use of Estimates

The pro forma statements are based on estimates and assumptions developed by management based on factors currently known but involve significant risk and uncertainties. Actual results could materially differ from the enclosed pro forma statements due to factors outside the control of management. These factors include but are not limited to federal and state laws and regulations, changes in economic and business conditions, competitor strategies and products, as well as customer needs.

Products & Services - The pro forma financial statements reflect BCBSD’s existing products and services.

Health Care Reform

The following high-level assumptions were made with respect to Health Care Reform:

- The pro forma assumes that health care reform will not have a significant effect on enrollment through 2015, [REDACTED].
- It is assumed BCBSD will comply with the minimum Medical Loss Ratios reflected in the legislation (80% for individual and small group, 85% for large group)

Capital Expenditures

Capital expenditures for each version of the pro forma include the 2011 capital expenditures approved by the BCBSD Board of Directors, annual routine capital expenditures of \$2 million and capability enhancements, developed separately for each version as follows:

- Affiliation Version - The capability enhancements were developed by Highmark.
- Stand Alone Version - This version incorporates capability enhancements recommended by Deloitte based on a study performed in 2008. Deloitte has provided a recent update that incorporates estimates for ICD-10 and Health Care Reform.

The total capital expenditures, as defined above, include the following amounts in each scenario (\$ in thousands):

	2011	2012	2013	2014	2015	Total
Affiliation Basis	\$ 13,000	\$ 22,400	\$ 11,600	\$ 2,000	\$ 2,000	\$ 51,000
Stand Alone Basis	8,000	41,245	37,317	33,538	9,900	130,000
Affil. Favorable to Stand Alone	\$ (5,000)	\$ 18,845	\$ 25,717	\$ 31,538	\$ 7,900	\$ 79,000

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Income Taxes

The pro forma assumes the following with respect to income taxes or payments made in lieu of income taxes:

- BCBSD will maintain its Section 833 status, thereby maintaining its effective tax rate of 20%, and
- BCBSD will accrue and make payments to the Delaware Community Foundation in lieu of state income taxes.

Financial Statement Assumptions –Statements of Income (Statutory Basis)

Member Months

Enrollment for 2011 was developed based on assumptions regarding new sales, terminations and in-force changes by market segment. Enrollment for 2012 through 2015 was developed based on discrete high level estimates. The impact of health care reform has yet to be fully understood and as such the impact reflected on the pro forma financial statements was minimal.

Premiums Earned

The premium forecast is based on the aforementioned membership assumptions and premium yield developed on a pMpm (per member per month) basis. Premium pMpm's for 2011 were developed based on actual experience through June 2011 and adjusted budgeted amounts for the remainder of 2011. Premium yields for both versions of the pro forma statements for 2012 through 2015 were developed based on 2011 and incorporate changes in premium yield by market segment that range between [REDACTED]. In addition, in 2014 the Stand Alone pro formas incorporate additional rate increases to recoup a portion of the cost of capital expenditures, to the extent allowed under the minimum loss ratios established within health care reform and compliance with Internal Revenue Code Section 833(b). In the Affiliation Basis pro formas projected rate changes in 2013 and beyond will be favorably impacted by projected pharmacy contract savings that will be passed on to BCBSD members. The projected premiums in the Affiliation Basis pro formas in 2014 and 2015 are on average 3% lower than in the Stand Alone scenario for the reasons noted above.

Claims Incurred

The claims incurred (medical expense) forecast is based on the aforementioned enrollment and medical expense assumptions developed on a pMpm basis. Medical expense pMpm's for 2011 were developed based on actual experience through June 2011 and adjusted budgeted amounts for the remainder of 2011. Medical expense pMpm's for 2012 through 2015 were developed based on 2011 and incorporated pMpm increases each year by market segment that range from [REDACTED].

Selling, General & Administrative Expenses

Selling general & administrative expenses are composed of broker commissions, G&A expenses and community related expenses. The basic assumptions are as follows:

- Broker Commissions - Broker commissions for 2011 and 2012 represent existing or expected commission arrangements that are essentially based on a percentage of premiums. [REDACTED]. No differences in strategy exist between the Stand Alone and Affiliation pro forma financial statements.
- General & Administrative (G&A) - G&A for 2011 is based on actual results through May 2011 and adjusted budgeted amounts through the remainder of 2011. The Forecast for 2012 through 2015 is based on an increase of [REDACTED] per member per month basis (except for the Stand Alone Version for 2013 through 2015, for a lower increase was assumed to achieve administrative cost savings required to mitigate the impact of losses anticipated in 2014 and 2015). The Stand Alone Basis pro formas reflect annual costs for

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maintenance and support of the capital expenditures included in that scenario, based on assumptions provided by Deloitte. The Affiliation Basis pro forma financial statements include one-time costs associated with the affiliation and the annual cost to BCBSD for services provided by Highmark, which include the ongoing maintenance and support of all information technology, an estimate of BCBSD's share of the cost of future technology investments and management services. Operating synergies from the relationship with Highmark more than offset the annual cost of Highmark services. As a result of the synergies, the G&A expenses are lower in the Affiliation Basis pro formas than in the Stand Alone scenario.

- Community Related Expense - The annual forecast amounts represent the combination of amounts payable to the Delaware Community Foundation in lieu of state income taxes and other budgeted community contributions of [REDACTED].

Self Funded and Other Fees

Self funded and BlueCard host fees were developed for 2011 based on discrete estimates. [REDACTED]

[REDACTED]. Self funded fees are based on enrollment, [REDACTED].

Capability Enhancements

Capability enhancement expenses represent depreciation expense associated with the capital investments noted on page six of this document.

Investment Income

Investment income was calculated based on a yield of [REDACTED], which was used for both the Stand Alone and Affiliation Basis pro forma financial statements. The variance in investment income between both versions is due to the difference in funds available for investment, as a result of the higher level of capital investments necessary in the Stand Alone version of the pro forma financial statements.

Financial Statement Assumptions – Balance Sheets (Statutory Basis)

The balance sheets were developed based on the statutory balance sheet as of December 31, 2010 and adjusted for expected changes for certain line items based on the line item's relationship to the income statement. The estimated impact of non-admitted assets and other statutory adjustments were for 2011 through 2015 were based on the amounts reported for 2010 and adjusted to address changes in balance sheet accounts. For property and equipment, non-admitted assets were adjusted annually to reflect the impact of capital expenditures and depreciation.

Risk-Based Capital (RBC)

RBC was estimated based on the projected statutory capital and surplus and an estimate of the authorized control level (ACL). The ACL for 2010 was based on the ACL reported in the BCBSD annual statement as of December 31, 2010. The ACL was adjusted annually based on an estimate of the impact of growth in underwriting risk.