BEFORE THE INSURANCE COMMISSIONER
FOR THE STATE OF DELAWARE

In Re: The Proposed Affiliation of	**)**	
BCBSD, INC., doing business as	**)**	**Docket No.: 1509-10**
Blue Cross Blue Shield of Delaware	**)**	
with HIGHMARK INC.	**)**	

DIRECT TESTIMONY OF JAMES HYNEK,

CALLED BY BCBSD, INC. AT THE HEARING HELD OCTOBER 5 – 7, 2011

Q *Mr. Hynek, can you state your name and title for the record?*

A. My name is James Hynek. I am the Vice President, Chief Financial Officer and Treasurer of Blue Cross Blue Shield of Delaware.

Q. *What are your Professional Credentials?*

A. I obtained my Certified Public Accountant Certificate in Illinois. I am also currently a Registered Certified Public Accountant in Illinois.

Q. *Please describe your professional experience.*

A. I have public accounting experience with Deloitte Haskins & Sells; I have internal audit experience with PepsiCo, Inc. and United Technologies Corporation, and I have health insurance experience of approximately twenty years, including Aetna Health Plans in a variety of financial roles, Preferred Care as Controller, Unity Health Plans as Chief Financial Officer and Coventry Health Care of Delaware as Chief Financial Officer. I joined BCBSD as the Director of Financial Planning & Analysis in March 2009. I became the Chief Financial Officer in March 2010.

EXHIBIT
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Q. ***Mr. Hynek, did you assist in the preparation of Exhibit 9 of the Affiliation Statement on file with the Department, and if so, please describe its purpose.***

A. I developed the format and methodology used to prepare the financial statements used for the preparation of Exhibit 9. Input used to develop these statements was obtained from both BCBSD and Highmark personnel. The Exhibit consists of two pro forma financial statements for BCBSD with projections through 2015. One projection reflects an affiliation with Highmark and is referred to as the Affiliation Version. The other projection assumes BCBSD will remain an independent entity and is referred to as the Stand Alone Version. The objective of Exhibit 9 is to give the Department of Insurance comparative financial statements in order to assess the financial impact of BCBSD's proposed affiliation with Highmark.

Q. ***Mr. Hynek, can you explain why Exhibit 9 of the Affiliation Statement on file with the Department, was revised.***

A. Exhibit 9 was first prepared in late 2010 and originally filed with the Department in January of this year. The Department advised that it would be most helpful to their review if BCBSD management would: (1) update the *pro formas* to reflect the actual financial results for 2010; (2) provide an updated forecast for 2011 that reflected management's best financial assessment of what would actually happen in the standalone versus the affiliation scenarios; and (3) develop separate enrollment projections for each version.

Q. ***Can you walk us through some of the key assumptions in the Exhibit?***

A. Certainly. The financial statements are based on the actual financial results for 2010. The financial statement projections for 2011 through 2015 were developed based on GAAP basis and converted to a statutory basis, the same basis that BCBSD reports its financial results to the Department on a quarterly basis. The more significant assumptions are related to enrollment, minimum loss ratio requirements, capital expenditures and community contributions.

Enrollment is expected to increase during the forecast period in the Affiliation Version based on Highmark's product development, data analysis and employer reporting capabilities. The latter is essential to providing information to both fully insured and self funded large employer groups. Conversely, the continued enhancement of the aforementioned capabilities by our competitors will adversely impact BCBSD's competitive position resulting in a projected decline in enrollment in the Stand Alone Version.

Under either version of the pro forma financial statements, it is assumed BCBSD will comply with the minimum loss ratio requirements of the new health care reform law, as well as the minimum loss requirements mandated by Internal Revenue Code Section 833.

The cost of capability enhancements needed by BCBSD for the Affiliation Version and Stand Alone Version were obtained from Highmark and Deloitte, respectively. Routine capital expenditures were assumed to approximate $2 million per year. Total capital expenditures for the Affiliation Version were $51 million through 2015, summarized as follows:

- $35.0 million - Highmark integration project capital expenditures;
- $5.8 million - 2011 capability enhancement capital expenditures;
- $2.2 million - 2011 routine capital expenditures; and

- 8.0 million – 2012 through 2015 routine capital expenditures.

Total capital expenditures for the Stand Alone Version were $130 million through 2015. As such, the Stand Alone Version requires $79 million more in capital expenditure than the Affiliation Version through 2015, summarized as follows:

- 114.0 million – Deloitte recommended capability enhancements;
- 5.8 million - 2011 capability enhancement capital expenditures;
- 2.2 million - 2011 routine capital expenditures; and
- 8.0 million – 2012 through 2015 routine capital expenditures

With respect to community contributions, BCBSD will continue to accrue and make payments to the Delaware Community Foundation in lieu of payment of state income tax, as well as additional community contributions.

Q. ***So describe for us the comparative results***

A. Overall, the projections indicate that it is more favorable for BCBSD to affiliate with Highmark than to remain a standalone company. The primary financial impact of the proposed Affiliation on Blue Cross' financial condition, at least in the period projected in the *pro formas*, will be the difference between the costs incurred by Blue Cross to upgrade its IT systems as an affiliate of Highmark versus those same costs if Blue Cross were to remain a standalone entity. Specifically, Blue Cross is currently estimated to spend $35 million on IT upgrades if it affiliates with Highmark; if Blue Cross remains a standalone entity, estimates range from $88 million to $140 million.

Q. ***Please walk us through the results of the Affiliation case pro formas as compared to the Standalone case pro formas.***

A. Let me start by giving you a few 2010 year-end numbers as a base line. The amounts we will discuss are on a statutory basis. As of December 31, 2010, BCBSD reported earned premium of $499 million with total combined claims costs and general and administrative expenses of $491 million, which resulted in an underwriting gain of approximately $8 million and net income of $15 million. We also reported capital and surplus, sometimes referred to as "reserves," of $171 million and a Risk-Based Capital ratio of 1,056%.

The Affiliation version of the *pro formas* reflects increases in enrollment, premium and claims incurred through 2015. Such growth may be expected to increase the underwriting gain and resulting net income. However, the impact of additional depreciation expense resulting from capability enhancements reduces net income to between $9 and $11 million for 2011 through 2014. In 2015, it is projected that net income will return to approximate the results experienced in 2010 of between $15 and $16 million. Capital and surplus for 2011 through 2013 are projected to remain within $5 million of the $171 million at the end of 2010, with increases in 2014 and 2015. The increases in 2014 and 2015 allow the Risk-Based Capital (RBC) ratio to return to a level that approximates BCBSD's RBC reported at December 31, 2010.

The Stand Alone version reflects a decline in enrollment through 2015. Premium earned and related claims incurred remain relatively consistent for 2012 through 2015. As with the Affiliation version, it should be noted the medical loss ratio maintained during the projection period approximates 85%. Because the implementation period for placing capability enhancement assets in service is longer in the Stand Alone Version than in the Affiliation Version, the more significant impact of depreciation on the Stand

Alone Version does not begin to materially degrade financial performance as noted on the pro forma income statements until 2014 and 2015, when net losses are projected of $3 million and $20 million, respectively. On the pro forma balance sheet, capital and surplus steadily decline from 2012 through 2015 because statutory accounting requirements limit the portion of computer hardware and software assets that can be reflected on the balance sheet. As such, the projected RBC ratio also reflects a decline beginning in 2012.

Q. ***The projections seem to indicate that total selling, general and administrative expense is lower in the standalone scenario. Where are the synergies?***

A. The projections do show that total selling, general and administrative expenses – typically called "SG&A" – for the Affiliation Version are higher than the Stand Alone Version. The reason for this, however, is that the total SG&A expenses in the Affiliation Version are supporting a larger enrollment. In order to put SG&A expenses between both versions on a comparable basis, the expense is divided by the member months for each year. This results in the SG&A expenses being converted to a per-member-per-month or "PMPM' basis. When this comparison is made, the Stand Alone Version SG&A PMPM exceeds the Affiliation version in 2013, 2014 and 2015. This is what you would expect and it demonstrates some of the synergies that we expect to see in the Affiliation.

Q. ***Let's turn to the issue of cost allocations. Can you describe the plan for allocation of costs from Highmark to BCBSD?***

A. The Business Affiliation Agreement between Highmark Inc. and BCBSD, Inc. dated August 19, 2010 reflects the key elements with respect to payments made by

BCBSD to Highmark for services provided by Highmark in under the Administrative Services Agreement. Article II of this Agreement provides that BCBSD's payment to Highmark for services it provides will be "in an amount equal to BCBSD's fair and reasonable allocable share of the total actual cost without provision for profit." This section further provides that BCBSD has the "right at any time and from time to time to review and inspect appropriate records of Highmark relating to Highmark's cost of providing the Services and any other amounts due and owing to Highmark."

Because the executive management team at BCBSD will be evaluated, in part, on the financial performance of the company, we will have an incentive to ensure that BCBSD is receiving only those allocations that are indeed fair and reasonable. To this effect, we will be embarking on a comprehensive evaluation of the Highmark cost allocation methodology in the first quarter following closing in order to determine the substantive testing that will be necessary in order to monitor these allocations over time. We have not done so yet because: (i) the transaction has not been approved; (ii) the evaluation will involve a substantial expenditure of time and energy; and (iii) it may involve access to at least some information that is proprietary and confidential to Highmark. We believe the post closing period is adequate to develop our testing and monitoring protocols. I would also note that the parties have agreed to a number of conditions designed to ensure that allocations under the Administrative Services Agreement are fair and reasonable, including a condition that will result in costs relating to BCBSD's migration onto Highmark's IT platform being capped at $42 million.