

STATE OF ALASKA
DEPARTMENT OF COMMUNITY AND ECONOMIC DEVELOPMENT
DIVISION OF INSURANCE

In the Matter of:)	
)	
PREMERA BLUE CROSS CONVERSION)	
)	
No. R 03-07)	Findings of Fact,
_____)	Conclusions of Law, and
)	Final Order

I. INTRODUCTION

This proceeding came before the Alaska Director of Insurance (the "Director") on the application of Premera Blue Cross ("PBC") and its sole member, PREMERA (collectively referred to as "Premera") in support of the proposed conversion of PBC from a non-profit hospital medical service corporation to a for-profit health insurer. Premera's proposal presents a potential for significant benefits to Alaska. As Alaska's chief insurance regulator, the Director is charged with enforcing the insurance code, which has as its underlying purpose the protection of Alaska's insurance consumers. An important part of consumer protection is a healthy marketplace. Alaska's demographics, geography, and costs of services present unique challenges to insurers. It is in Alaska's interest to attract and keep financially strong insurers in the market place. To the extent Premera's proposal further strengthens its financial standing and opens the door for increased services in Alaska or even additional competition in the state, it is in Alaska's interest to give serious consideration to the proposal and to fully explore how the proposal might be implemented in Alaska to best serve Alaska's insurance consumers and the public. The funding of an Alaska Health Foundation as part of the conversion plan presents a significant opportunity to impact the unmet health needs in this state. However, the Director is compelled at this time to disapprove the application of Premera, because in its present form it is

unfair and unreasonable to Alaska policyholders and not in the public interest. Also certain aspects of the proposal are unfair and unreasonable to the Alaska Health Foundation that will be created as a part of the conversion. But, unlike her counterpart in Washington, the Director believes the reasons that lead her to disapprove the transaction can be mitigated by conditions and/or amendments to the Form A filing.

Despite the disapproval of the proposed conversion by the Washington Commissioner, the Director has concluded it is appropriate to go forward with a decision in this matter given that Premera has not withdrawn its application and given that substantial time, money, and resources have been devoted to the review process.

II. BACKGROUND

The following narrative gives an overview of the procedural and factual background. It does not include all material facts. Section IV of this decision contains detailed factual findings based upon the record in this proceeding.

On May 30, 2002, Premera advised the Director of its intent to reorganize Premera and certain of its affiliates from Washington nonprofit corporations to for profit corporations. Based on this stated intent, the Alaska Division of Insurance (the "Division") commenced an examination of PBC under the authority of AS 21.06.120.

On September 17, 2002, Premera filed a "Statement Regarding the Acquisition of Control of a Domestic Health Carrier and a Domestic Insurer" with the Division. This statement is referred to as a "Form A" and represents the formal application for approving the proposed conversion. Premera supplemented its Form A Statement on September 27, 2002 and October 25, 2002. Public comment meetings were held in October and November of 2002 to inform the public about the proposed conversion and to solicit input.

Premera filed an Amended Form A Statement on February 5, 2004 ("Amended Form A Statement").

To assist the Division in reviewing and evaluating Premera's Form A filings and

the proposed conversion, expert consultants were retained, at Premera's expense. Those consultants issued preliminary and final reports relating to the proposed conversion, dated October 2003 and February 27, 2004, respectively. Premera also hired various consultants to review and evaluate the proposed conversion. Those consultants also issued preliminary and final reports relating to the proposed conversion, dated January 7, 2004 and March 8, 2004, respectively.

As the regulator responsible for approving or disapproving the Amended Form A in Alaska, the Director established a "wall" between herself and the Division staff who were authorized to review the proposed conversion. Upon establishment of this "wall," the Division staff did not communicate with the Director regarding substantive issues relating to the proposed conversion. The Director also ordered that a public hearing would be held regarding Premera's Form A filings and the proposed conversion pursuant to AS 21.22.030 and following the procedures in AS 21.06.210. Premera and the Division staff were designated as parties to the proceeding.

By Order No. 2, interested persons were given an opportunity to intervene as parties to this proceeding subject to establishing that the person's pecuniary interests would be directly and immediately affected by the final order in this proceeding. Theresa Nangle Obermeyer, the Anchorage Neighborhood Health Center, United Way of Anchorage, John Garner, by and through Barbara Garner, and the University of Alaska moved to intervene in these proceedings. In Order No. 3, the Director denied the motions to intervene, but granted each of the proposed intervenors status as *amicus curiae* in these proceedings. In Order No. 14, the Director denied the motion by the *amicus curiae* for reconsideration of their motions to intervene. Pursuant to Order Nos. 3 and 16, certain of the *amicus curiae* were granted a limited role in participating at the Hearing (the "represented *Amici* group"). See Order No. 16 of the Director, at 1.

The public hearing was held before the Director regarding the Amended Form A from June 7, 2004 through June 11, 2004. During the hearing, the Director heard testimony

from witnesses presented by (i) Premera, (ii) the Division Staff, and (iii) the represented *Amici* group, as well as comments from the public.

III. APPLICABLE LAW

Premera's proposed conversion is subject to review under AS 21.22.010, because it involves the merger or acquisition of control of a domestic insurer. Under AS 21.22.030, the Director shall approve a merger or other acquisition of control unless, after a public hearing, the Director finds that:

- (1) after the change of control, the domestic insurer referred to in AS 21.22.010 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;
- (2) the effect of the merger or other acquisitions of control would be substantially to lessen competition in insurance in this state or tend to create a monopoly in this state;
- (3) the financial condition of an acquiring party is such that it might jeopardize the financial stability of the insurer or prejudice the interest of its policyholders or the interests of any remaining securityholders who are unaffiliated with the acquiring party;
- (4) the terms of the offer, request, invitation, agreement, or acquisition referred to in AS 21.22.010 are unfair and unreasonable to the securityholders of the insurer;
- (5) the plans or proposals that 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
- (6) 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.

For purposes of AS 21.22.030(a), AS 21.22.030(c) further provides that "the director may consider relevant factors including market shares, volatility of ranking market

leaders, number of competitors, trend of concentration in the industry, and ease of entry into and exit out of the market.”

The proposed conversion also will involve transactions between a newly formed domestic insurer and other affiliates within the Premera holding company system. Accordingly, AS 21.22.080 governs approval of these transactions and among other things requires that the terms of the transactions are fair and reasonable.

In addition to the holding company statutes, AS 21.09.135 applies because as a result of the proposed conversion, PBC will be surrendering its existing certificate of authority as a nonprofit hospital medical service corporation and will be transferring its in force Alaska business to the new for profit domestic insurer, Premera Blue Cross Blue Shield of Alaska Corp (“PBC-AK”). The agreement under which the business is transferred must meet the following criteria:

- (1) insurance coverage has not deteriorated from the policies existing at the time of the transfer;
- (2) the assuming insurer is of equal or better financial standing; and
- (3) the assuming insurer is admitted to do business in this state unless the requirement is waived by the director.

Because PBC is a foreign nonprofit corporation, certain provisions of Alaska’s Non Profit Corporations Code (AS 10.20.455 – 10.20.615) also may apply to it.

IV. FINDINGS OF FACTS

A. History of Premera

1. Washington Hospital Service Association, the predecessor of PBC was founded in 1945. In 1969, the company changed its name to Blue Cross of Washington-Alaska, Inc. It underwent a second name change in 1978 when it became known as Blue Cross of Washington and Alaska. *Division Ex. 3, p. 2 (Navigant September 23, 2003 Report); Division*

*Ex. 37, pp. 6-10 (Amended Form A).*¹ Blue Cross of Washington and Alaska was registered as a health care service contractor in May 1945 in Washington and was issued a certificate of authority in 1952 in Alaska. It began selling health care coverage in Washington State in 1948 and in Alaska in 1957. *Id.*

2. In 1994, Blue Cross of Washington and Alaska affiliated with Medical Services Corporation of Eastern Washington (MSC), the Blue Shield plan based in Spokane. At that time, PREMERA was formed as the upstream holding company of Blue Cross of Washington and Alaska and MSC. *Id.*

3. In 1998, MSC and Blue Cross of Washington merged, and the name was officially changed to Premera Blue Cross. PREMERA remains the sole voting member of PBC. *Id.*

4. PREMERA and PBC are licensees of the Blue Cross Blue Shield Association (BCBSA). Through that license, PBC operates in both Washington and Alaska using the Blue Cross and Blue Shield trademarks. It operates in Alaska under the name Premera Blue Cross Blue Shield of Alaska. *Id.*

5. The PREMERA family of companies also provides health care coverages, benefit administration, and life insurance coverages through entities that are not licensed to use the Blue marks or names. For example, LifeWise Health Plan of Oregon has been a member of the PREMERA family since 1994. Premera also recently announced plans to expand services to Arizona through an affiliate to be known as LifeWise Health Plan of Arizona. *Id.*

6. Through its various affiliates, Premera currently provides health care coverage and administrative services to over 1.4 million customers in Washington, Oregon, and

¹ Premera, Division staff, and the Represented Amici Group filed separate sets of exhibits. They are cited herein as "Ex. P-___," "Division Ex. ___," and "Amici Ex. ___," respectively.

Alaska through a wide range of health benefit products, including traditional indemnity, PPO, point-of-service, managed care, Medicare Supplement, and individual plans. *Id.*

B. Corporate Status and Purpose

7. PREMERA is a Washington, nonprofit corporation created in 1994 under RCW 24.06. *Id.*

8. PBC is a Washington nonprofit corporation incorporated under RCW 24.03. It operates as a foreign nonprofit corporation in Alaska.

9. In Washington, PBC is licensed as a health care service contractor. In Alaska, PBC is licensed as a Hospital and Medical Service Corporation under AS 21.87. *Id.*

10. Although AS 21.87 only provides for the authorization of domestic hospital medical service corporations, PBC is permitted to operate in this state as a foreign hospital medical service corporation by virtue of a "grandfather clause" in AS 21.87.350. In all other respects, PBC is subject to regulation under AS 21.87.

11. In Articles of Incorporation of Blue Cross of Washington and Alaska (PBC's predecessor), the purpose of the company was, in relevant part, stated as:

The particular business and object of the corporation shall be to establish, maintain and operate, with no individual being entitled to any of the net income thereof, a non-profit hospital service plan whereby hospital care shall be provided to persons who become subscribers to the plan of the corporation under contract entitling each subscriber to certain hospital care by and at the hospitals with which the corporation may from time to time contract, to contract with such hospitals as may be approved by and selected by the Board of Trustees for the purpose of acting as their agent, to provide hospital care to the subscribers of the plan; to promote the general and social welfare of such persons as may become subscribers of the plan, and to do all things necessary, proper or convenient for the purpose of promoting, establishing and operating such non-profit hospital service plan, to furnish to individuals, on a non-profit basis, prepaid medical, surgical, dental, other therapeutic services and home nursing care by this corporation....

Public Comment, Consumers Union, Scott Benbow, letter dated June 25, 2004, Ex. 1, attached thereto.

12. In 1979, the purpose of Blue Cross of Washington and Alaska in its

Restated Articles of Incorporations was stated as:

The purposes of the corporation are to provide, and to indemnify and reimburse for, health care services to groups and individuals under the applicable laws of the states of Washington and Alaska; to act as agent for governmental entities conducting health care programs; to provide administrative-services to other entities engaged in activities similar to its own; and to conduct other activities desirable for the promotion of the general and social welfare of the public as are allowed by law.

Id.

13. In 1998, PBC's Restated Articles of Incorporation stated its purpose as

The Corporation is organized for the purposes of engaging in health care-related services, including, but not limited to, conducting the activities of a health care service contractor as provided under Chapter 48.44 of the Revised Code of Washington, as amended, and as a hospital and medical service corporation under Chapter 21.87 of the Alaska Statutes, as amended, and may engage in any other purpose or purposes permitted under the Washington Nonprofit Corporation Act and applicable law of the states in which the Corporation conducts its business.

Id.

14. The 1998 Restated Articles of Incorporation of PBC also contain an

Article VIII with the heading "Nonprofit Status and Dissolution/Liquidation," which reads:

No part of the net income or surplus of the Corporation shall ever inure or be distributable to any director, officer, or other individual, nor shall any dividends ever be paid. On dissolution or final liquidation of the Corporation, its net assets shall be applied and distributed to the sole voting member for the purposes for which the Corporation has been established, subject to any limitations consistent with the federal tax status of the Corporation which are in effect at the time of such distribution.

Id. See also Ex. P-58, Steel Supplemental Report, p. 18.

15. Article XII of the Restated Articles of Incorporation of PREMIERA, in turn, states that "Upon the winding up and dissolution of the corporation, the assets of the

corporation remaining after payment of or provision for payment of all debts and liabilities of the corporation shall be distributed to one or more non-profit corporations or other non-profit entities to be used exclusively for purposes consistent with the purposes for which this corporation has been established[.]” See, *Tr. 200:2-12 (Barlow)*.

16. Premera states that it is not a charity; it is a commercial enterprise and a taxable provider of health care coverage to those who pay premiums for such coverage. *Ex. P-6 (Barlow Pre-Filed Rebuttal)*, pp. 1-2; *Tr. 160 (Barlow)*; *Tr. 92-93, 125 (Jewell)*. Premera does not solicit or receive charitable contributions, and it does not provide free or reduced-fee services. *Ex. P-6 (Barlow Pre-Filed Rebuttal)*, pp. 2, 5. It does not alter its prices according to a subscriber’s ability to pay. *Ex. P-6 (Barlow Pre-Filed Rebuttal)*, p. 5.

17. According to Premera, Congress recognized this fact when, in 1986, it withdrew the federal income tax exemption previously enjoyed by Blue plans, recognizing that the activities of Blue Cross Blue Shield Association (“BCBSA”) licensees that provide healthcare insurance were “so inherently commercial” that their tax-exempt status should be revoked. See H.R. Rep. No. 426, 99th Cong., 1st Sess. at 664 (1985). *Ex. P-58, p. 12*.

C. Premera’s Form A Filings

18. On September 17, 2002, Premera filed a “Statement Regarding the Acquisition of Control of a Domestic Health Carrier and a Domestic Insurer” with the Division (the “Initial Form A”). Premera supplemented the Initial Form A on September 27, 2002 and October 25, 2002. *Division Ex. 37*.

19. On February 5, 2004, Premera filed “Change Number 1 to Form A” with the Division, which contained amendments to the Initial Form A (the “Amended Form A”). The Initial Form A and Amended Form A were also filed with the Washington Office of the Insurance Commissioner (the “OIC”). *Id.*

20. The Initial Form A and the Amended Form A each contain, as an exhibit, a "Prior Notice of a Transaction or Request for Director's Approval of a Transaction" (the "Form D") in connection with various agreements between affiliated entities within Premera's holding company system that are associated with the proposed conversion. *Id. at Ex. G-9.*

21. The Initial Form A and Amended Form A set forth information relating to the structure of the proposed conversion, as required by the Alaska Insurance Holding Companies Act, AS 21.22.010, *et seq.* (the "HCA"), specifically AS 21.22.020 and 3 AAC 21.060.

22. The HCA provides for a timeframe during which the director may approve or disapprove Premera's proposed conversion once the filing of the Form A Statement required by AS 21.22.010(b) has been made. In this matter, the applicable timeframe for decision was established, with Premera's consent, by Order No. 6.

23. The Division staff and its consultants conducted an extensive review of Premera's proposed reorganization over the course of almost two years. They requested and received over 40,000 pages of documents, and they conducted numerous interviews of Premera's management and staff. The Division staff's consultants issued reports on the original Form A Statement in the fall of 2003. Those reports were filed on February 2, 2004. *See* Order No. 6.

24. Premera also engaged independent experts to evaluate the Form A Statement. Those experts issued reports that reviewed Premera's proposal and responded to the reports of the Division staff's consultants on January 7, 2004. *See* Order No. 6.

25. As set forth in the Amended Form A, Premera seeks to convert PREMERA and PBC from Washington non-profit corporations organized under titles 24.06 and

24.03 of the Revised Code of Washington, respectively, to Washington for-profit corporations organized under title 23B of the Revised Code of Washington. Generally, the conversion will be effected in a number of steps that include the transfer of the assets and liabilities of the existing non-profit corporations to certain newly created for-profit corporations and the subsequent dissolution of the non-profit entities.

26. PREMERA will first amend its Articles of Incorporation to provide that the Washington Foundation Shareholder, a Washington nonprofit corporation, and the Alaska Health Foundation, an Alaska non-profit corporation, will become members of PREMERA. *Division Ex. 37, pp. 2-9.*

27. PBC will transfer certain of its assets and liabilities directly relating to its operations in Alaska to the newly- formed wholly-owned Alaska subsidiary, New PBC-AK in exchange for 100% of the stock of New PBC-AK.² New PBC-AK is a for-profit corporation licensed to write health insurance in Alaska. The Division issued a certificate of authority to New PBC-AK on January 31, 2003 that was conditioned upon the approval of the proposed conversion by the Washington Insurance Commissioner and the Director. *Id.*

28. PBC next will transfer all of its assets and liabilities, including the stock of New PBC-AK and its health care service contractor registration in the State of Washington, to its other newly formed wholly owned subsidiary, New Premera Blue Cross Corp., a Washington for-profit corporation ("New PBC"), in exchange for 100% of the stock of New PBC. As a result of that transfer, New PBC-AK will become a direct wholly owned subsidiary of New PBC. PBC will then perform a statutory liquidation and distribute the New PBC stock to PREMERA. New PBC will transfer 100% of the stock of New PBC-AK to PREMERA, which

² In this order, for-profit companies are distinguished from their nonprofit counterparts by use of the term "New" before each company name.

results in New PBC and New PBC-AK becoming direct wholly owned subsidiaries of PREMERA. *Id.*

29. PREMERA will then transfer all its assets and liabilities to its newly formed wholly owned for-profit subsidiary, New PREMERA, in exchange for 100% of the stock of New PREMERA. PREMERA will then perform a statutory liquidation and distribute the New PREMERA stock to its sole members, the Washington Foundation Shareholder and the Alaska Health Foundation. *Id.*

30. After completion of the conversion transaction, the Washington Foundation Shareholder and Alaska Health Foundation collectively will own 100% of the initial capital stock of New PREMERA, according to an allocation percentage that has yet to be determined, and, thereby, indirectly own 100% of the stock of New PBC, New PBC-AK and the other Acquired Companies. New PREMERA will directly or indirectly control the Acquired Companies, including New PBC-AK. *Id.*

31. According to the Amended Form A, the Foundations "would be dedicated to health initiatives for the citizens of PBC's Washington and Alaska service areas." *Id.*

32. One of the conditions to completing the proposed conversion set forth in the Plan of Conversion, which is attached as Exhibit A-4 to the Amended Form A, is that PREMERA must receive, on behalf of New PREMERA "approval of the [Amended] Form A and Form D from" the Washington Insurance Commissioner, Alaska Division of Insurance, and Oregon Insurance Division "pursuant to orders . . . that are in form and substance acceptable to the Board of Directors of PREMERA and PBC." *Division Ex. 37, at Ex. A-4, § 4.3.*

D. The "Technical Drafting Corrections" and Additional Proposed Revisions to the Transaction Documents Offered During The Alaska Hearing

33. Since the filing of the Amended Form A, Premera has proposed certain terms, provisions, and revisions relevant to the structure of the proposed conversion that are not contained in the Amended Form A. As a result, to determine the currently proposed structure of the proposed conversion, one must review: (1) the Initial Form A; (2) the Amended Form A; (3) the Pre-Filed Direct Testimony of Kent Marquardt and attached "technical drafting corrections" submitted therewith; (4) the testimony of Mr. Marquardt at the Hearing; (5) the illustrative exhibit, Premera Exhibit 41, that was offered into evidence during Mr. Marquardt's testimony at the Hearing; and (6) the revisions offered by Premera in its Post-Hearing Brief in the OIC proceedings that are attached to Premera Exhibit 41. All of these items must be reviewed in the proper order to determine the terms of the proposed conversion that the Director is being asked to review. *Division Ex. 37; Ex. P-34; Tr. 558:23-652:23 (Marquardt); Ex. P-41.*

34. The terms, provisions and revisions that Premera has proposed since it filed the Amended Form A are not merely technical corrections to its documents. Many of the terms, provisions and revisions are quite significant and material to the Director's consideration of the Amended Form A. For example, Premera suggested for the first time at the Hearing that the BCBSA might be willing to permit the Alaska Health Foundation to nominate its own Designated Member (as opposed to jointly nominating a Designated Member with the Washington Foundation) to serve on the New Premera Board of Directors. Premera also proposed -- again for the first time at the Hearing -- that, if Premera lost its special tax deduction afforded under Section 833(b) of the Internal Revenue Code (the "833(b) Deduction") as a result of the proposed conversion, it would agree not to pass through any costs associated with that loss to its policyholders, provided the Director conditioned approval of the Conversion on such a

commitment by Premera. *Tr. 592:22-24 (Marquardt)*. Neither of these terms is contained in the Amended Form A, yet both are significant to an analysis of whether the proposed conversion meets the standards for approval, *e.g.*, is fair to policyholders and in the public interest.

35. Premera remains willing to make changes to its Amended Form A. *Tr. 193:14-16 (Barlow)*.

E. Premera's Reasons for Conversion

36. Premera is pursuing conversion to a for-profit company so that it may raise capital through access to the equity markets. *Tr. 85:14-16 (Jewell)*.

37. Premera has given three reasons for wanting to raise capital are: (1) to strengthen its reserves; (2) support membership growth; and (3) to provide funds for investment in infrastructure, technology, and the development of new products. *See, Tr. 85:20-22 (Jewell); Tr. 146:9-19 (Barlow)*.

38. Premera witnesses testified that the access to equity markets as a result of conversion would support Premera's reserves and allow it to grow its membership (thereby spreading costs over a larger membership base), and provide the capital to invest in products and services to better serve its subscribers. *Ex. P-3 Pre-Filed Direct, pp. 12-15 (Barlow); Tr. 84-86, 111 (Jewell)*.

39. According to Premera, having additional capital will enable it to grow and to offer its products and services to more of the insurance-buying public in all of its markets. *Ex. P-3 (Barlow Pre-Filed Direct), p. 12; Tr. 146, 150 (Barlow); Ex. P-34 (Marquardt Pre-Filed Direct), p. 12; Tr. 560-561 (Marquardt)*.

40. Premera states it needs to continue to invest in infrastructure, information technology, and innovative products and services in order to compete with other providers of health insurance. *Ex. P-3 (Barlow Pre-Filed Direct), p. 14; Ex. P-34 (Marquardt Pre-Filed*

Direct), pp. 12-17). Premera also states that the proposed conversion will help provide the capital the company needs to continue investing in its innovative care facilitation, disease management, and other healthcare quality programs. *Ex. P-1 (Jewell Pre-Filed Direct)*, p. 29; *Ex. P-3 (Barlow Pre-Filed Direct)*, p. 12; *see also Ex. P-24 (Davis Pre-Filed Direct)*, pp. 12-14; *Tr. 314-315 (Davis); Tr. 146 (Barlow)*.

41. According to Premera, having a broader base of subscribers will enable Premera to spread the costs of necessary investments in infrastructure and programs such as care facilitation, moderating upward pressures on premiums due to health care cost trends. *Tr. 90-91 (Jewell); Ex P-3 (Barlow Pre-Filed Direct)*, pp. 12-13, 15; *Tr. 146 (Barlow)*.

42. Premera also has a goal to increase its Risk Based Capital (RBC) level closer to the average RBC level of Blues Plans.

43. RBC is a measure of surplus (capital) that is needed by an insurance entity to be sound. It was developed by the National Association of Insurance Commissioners. The formula takes account of the various risks of a type of insurer. It also looks at the whole operation and puts all risks together to develop, by formula, a target that is specific to a company. *Tr. 1152:1-25 (Drennan)*. The target or capital requirement is then compared to actual capital of the insurer, resulting in an RBC ratio typically ranging from 200% to over 900%. *Ex. P-48, p.4 (NovaRest Consulting Report dated January 7, 2004)*.

44. Statutory requirements are considered minimal levels and are levels at which regulators and insurers have specified duties to address the insurer's future viability. The levels where state RBC requirements demand action are set at lower percentages (70%-200%). *Id. See also AS 21.14.030 -.050, .200(5) and (11)*.

45. The Blue Cross Blue Shield Association requires an RBC ratio of 375% to avoid monitoring by the association. *Ex. P-48 at 3*. In 2002, Premera's RBC level was 406 %. At the end of 2003, Premera's RBC level was approximately 433 %. *Tr. 148:1-2 (Barlow); Ex. P-34 at 6, Ex. P-46 at 1, 10, 15; Ex. P-48 at 5, 13*. The average RBC of other Blue Cross Blue Shield plans was in the range of approximately 600% in 2002 and 700% at the end of 2003. *Tr. 148:4-9 (Barlow)*.

46. Premera seeks access to equity capital to raise its RBC level to 500-600%. *Ex. P-3 (Barlow Pre-Filed Direct), p. 13; Tr. 148 (Barlow); Tr. 560-561, 567 (Marquardt)*. Premera and Division witnesses testified that increasing Premera's RBC to that level was an appropriate target. *Ex. P-46 (Novak Pre-Filed Direct), p. 10; Ex. P-48 (NovaRest Report), pp. 3-4, 8 and 26; Ex. P-42 (Lusk Pre-Filed Direct), pp. 7-8; see also Drennan, Tr. 667, 698-699, 701.*) As a public company, Premera projects it needs \$150 million in new capital to raise its RBC to 600%. *Tr. 564-565 (Marquardt)*.

47. A Blue Plan need not be for-profit to maintain an RBC level that is significantly above 375 %. For example, Regence Blue Shield in Washington is a non-profit company, and its RBC ratio in 2002 was 570 %. *Tr. 234:16-25 (Novak)*.

48. As a nonprofit company, Premera's options for raising capital include generating additional earnings through its operations, selling some of its assets, acquiring or merging with another health plan better capitalized, or financing new debt. *Division Ex. 3, p. 5, n.13 (Navigant September 23, 2003 Report)*.

49. Premera witnesses testified that higher RBC levels will improve Premera's ability to withstand underwriting loss cycles that are inherent in the insurance industry and that Premera itself has experienced. *Tr. 390-392 (Lusk)*.

50. According to Premera, a higher RBC resulting from Premera's Conversion and subsequent IPO will benefit Premera's subscribers by giving them greater security that their claims will be paid. *Ex. P-3 (Barlow Pre-Filed Direct)*, p. 13; *Ex. P-46 (Novak Pre-Filed Testimony)*, pp. 11-12; *Tr. 315-317 (Davis)*. See also *Ex. P-3 (Barlow Pre-Filed Direct)*, p. 8.

51. Other than generalized assertions, Premera has "not laid out specific uses" for the IPO proceeds, *Tr. 606:6-8 (Marquardt)*. In fact, "[t]here are no specific items that [the proceeds from the IPO] might be used for." *Tr. 118:25-119:1 (Jewell)*.

52. Premera also submitted no evidence indicating how or when Alaska subscribers or policyholders will directly and tangibly benefit from the IPO or from Premera increasing its RBC level.

53. If Premera does not convert, there are no specific projects in which Premera cannot engage from a capital standpoint. *Tr. 116:8-14 (Jewell)*.

54. Premera's Chief Financial Officer testified that "most likely" none of the projected growth in membership will occur in Alaska. *Tr. 607:8-10 (Marquardt)*.

55. Some of the potential uses for the IPO proceeds that Premera cited are mutually exclusive. For example, Premera acknowledged that if it spent money on information technology or other infrastructure, that investment would typically not increase Premera's RBC level. *Tr. 232:15-233:6 (Novak)*.

56. Premera does not know what new products it will be able to provide with the capital raised in the IPO, other than to generally state that Premera would invest in products that "will be valuable to our existing and prospective customers" and "consumer directed health plan products . . . that are competitive with the marketplace." *Tr. 186:24-187:9 (Barlow)*.

57. The current plan is initially to invest the proceeds from the IPO in three to four percent bonds. *Tr. 606:12-17 (Marquardt)*. Premera's five year projections, filed with the Amended Form A, show no other use for the proceeds. *See Division Ex. 37*.

F. The Obligation to Transfer Premera's Full Value to the Foundations

58. Premera claims that it has no obligation to transfer its assets to the foundations because it is not a charity. *See, e.g., , Tr. 92:16-93:2 (Jewell); Tr. 926:6-927:23 (Johnson); Ex. p-6, at 1*. Based on this conclusion and its desire to keep its BCBSA license, Premera maintains that it is entitled to place restrictions on the Alaska Health Foundation's shareholder rights and that such restrictions do not render the proposed conversion unfair or against the public interest because, in essence, the public is receiving more than it is entitled to receive or otherwise would receive. *See Tr. 1079:6-11 (Johnson)* (analogizing the Alaska Health Foundation to a situation where someone makes a "gift" of a house subject to a mortgage).

59. Notwithstanding Premera's position, the Amended Form A is premised on its commitment to transfer the full value of its assets to the Washington and Alaska foundations upon conversion. *See Division Ex. 37, pp. 4, 9*. Premera's Plan of Reorganization also states that Premera will distribute 100% of its assets, including all of the stock of New Premera to the foundations. *Id. at Ex. G-19, p. 1*.

60. As stated earlier, PREMERA'S Articles of Incorporation state that upon winding up and dissolution, its assets shall be distributed to "one or more nonprofit corporations or other nonprofit entities to be used exclusively for purposes consistent with the purposes" of PREMERA. *Id.*

61. The Alaska members of Premera have helped build Premera's assets over the years. *Tr. 129-130 (Jewell)*.

62. Premera, like other Blue Cross Blue Shield Association ("BCBSA") plans (hereinafter referred to as "Blue Plans"), as a non-profit health insurer, has been given favorable federal and state tax treatment over the years. Premera was exempt from federal income tax until 1986. *Tr. 188:23-25 (Barlow); Tr. 849:15-17 (Ashley)*. In addition, Premera currently pays 0.70 percentage points less in Alaska premium taxes than for-profit insurers. *Tr. 189:4-7 (Barlow)*.

63. During the November 19, 2002 Alaska public meeting relating to the proposed conversion, Herbert Randle Brereton "Gubby" Barlow, the President and Chief Executive Officer of Premera and PBC, stated that by providing "100 % of the initial stock" of New PREMERA to the Alaska and Washington Foundations, "the full worth of the company, including good will, is reflected." *Tr. 177:8-12 (Barlow); Division Ex. 43*. Mr. Barlow prefaced this statement by noting that in some BCBSA conversions, there were "debates over the value of the companies." *Id.* By linking the two statements, Mr. Barlow was suggesting that a similar debate over the value of Premera was unnecessary, because the mechanism proposed by Premera for transferring value to the Foundations would reflect "the full worth of the company, including good will[.]" *Id.*

64. The testimony indicated that transferring the full value of the company to a foundation is consistent with the precedent available from other BCBSA conversions. In addition, when the Board first began considering the proposed conversion, it consulted experts from other BCBSA conversions and learned that the previous conversions involved creation of foundations. The Board considered the transferring of "100 % of the value of the stock of the company . . . to the citizens that had supported the operating margins that had built up [in] the company over time" to be "a very elegant solution." *Tr. 91:22-92:9 (Jewell)*.

G. The Washington Proceedings

65. PREMERA and PBC are Washington-domiciled companies and the OIC is PBC's primary regulator. Accordingly, the Initial Form A and Amended Form A were filed concurrently with the Director and the OIC (the "Washington Form A"). *Division Ex. 37, at 5-6.*

66. As set forth above, the proposed conversion contemplates, among other things, the creation of certain Washington-domiciled for-profit companies and the transfer of a percentage of the stock of New PREMERA to the Washington Foundation. *Id. at 4-5.*

67. The Washington Insurance Commissioner held public hearings on the Washington Form A from May 3-18, 2004.

68. At the Washington public hearings, the OIC Staff recommended that the Washington Form A be disapproved or, in the alternative, approved only with conditions. *Tr. 191:25-192:4 (Barlow).*

69. On July 15, 2004, Washington Insurance Commissioner, Mike Kriedler, issued his decision denying Premera's request to reorganize, including converting from nonprofit to for-profit status.

H. Economic Viability of New PBC-AK

70. Premera is currently a viable company. *Tr. 192:12-14 (Barlow).*

71. As set forth above, Premera has created an Alaska subsidiary, New PBC-AK, into which it intends to transfer certain of its assets and liabilities directly relating to its operations in Alaska. *Division Ex. 37, at 4.*

72. PBC-AK will be initially capitalized at a level sufficient to give it a risk-based capital ("RBC") ratio of 375 %. *See Division Ex. 37, at 4* (stating that New PREMERA will "guarantee the obligations of PBC-AK transferred to it by PBC and the claims obligations

of PBC-AK to its insureds; and, for a specified period, New PREMERA will make capital contributions to PBC-AK to ensure that PBC-AK maintains a stated risk-based capital level.”)

73. Following the proposed conversion, the consolidated Premera entity and New PBC-AK will continue to be economically viable, and are projected to remain profitable for the years set forth in Premera's projections (which are 2002 to 2007). Although New PBC-AK would continue to be profitable into the future, its financial performance would not be as strong as Premera's Alaska operations have been in the past. *Tr. 756:24-757:4, 18-21 (Miller); Division Ex. 8; Division Ex. 3, at 8, 10.*

74. New PREMERA will execute a guaranty in favor of PBC-AK pursuant to which it will guaranty that New PBC-AK will remain capitalized at a level sufficient to maintain an RBC ratio of 375 % for three years after the proposed conversion., *Tr. 170:8-14 (Barlow); Division Ex. 37, at Ex. G-8.*

75. At the hearing, testimony was submitted regarding whether this guaranty should be extended. Premera's witnesses testified that extending the guaranty would place the Company at a disadvantage relative to its competitors. Premera further contended that an extension of the guaranty was unnecessary because pursuant to the Plan of Conversion, New PREMERA will guarantee, to the full extent of its assets, all of the contractual and financial obligations of New PBC-AK to its insureds as well as the expenses, liabilities and other obligations of PBC that were transferred to New PBC-AK in the event that New PBC-AK was unable to pay or provide for such expenses, as required by the BCBSA. *See Tr. 596:20-597:5 (Marquardt); see also Tr. 168:2-13 (Barlow).*

76. The Division's economic consultants testified that a three-year guaranty is insufficient because of New PBC-AK's small size and because the proposed initial funding is at

the threshold for avoiding placement on the BCBSA "watch list," rather than at a higher level commensurate with either Premera's average RBC level or the level of historical capital contributions derived from the Alaska operations. Extending this guaranty to five-years is reasonable because the underwriting cycle is five years and, therefore, extending the guaranty will allow PBC-AK to withstand changes through one complete underwriting cycle., *Tr. 758:8-24, 799:16-800:2 (Miller)*.

77. The Director finds the testimony of the Division's economic consultants on this point to be credible and supported in the record.

I. The Proposed Conversion and Competition in the State

78. The proposed conversion does not involve a merger, combination, or purchase of any entity, line of business or other action that contemplates an aggregation of membership and should not, therefore, impact Premera's market share in the State of Alaska. *Division Ex. 37, p.11 (Navigant September 23, 2003 Report)*. In the absence of such a merger or combination, the economic consultants analyzed the impact the conversion would have on policyholders, including individuals who are in the individual insurance market and people living in rural areas. *Tr. 789:4-16 (Miller)*. The results of such analysis are set forth later in this order.

79. The economic consultants for the Division and Premera agree that Premera does not have "monopoly" power as that term is used for antitrust purposes. *Tr. 790:6-14 (Miller)*.

J. The Proposed Conversion and Financial Stability

80. The proposed conversion does not contemplate exposing New PBC-AK to the financial condition of any entity that is not currently affiliated with Premera. *See Division Ex. 37*.

81. The consolidated Premera group, would be economically viable. *Division Ex. 4, at 10.*

K. The Impact of the Proposed Conversion on Premium Rates

82. The oral and written public comments entered into the record overwhelmingly expressed concerns about the possibility that, although the proposed conversion may benefit Premera, it will result in increased premiums, and there will be no corresponding benefits to the public or policyholders, such as better service or increased benefits. *See, e.g., Fisher, Tr. 55:8-14* (raising concern about increases in premiums); *Purdue, Tr. 64:5-6* (raising concern that less of the premium dollar will be going to health care); *Schuerch, Tr. 434:21-435:24* (stating that Premera could act in a prudent, reasonable manner, and there still is risk of more uninsureds and higher premiums); *Sykes, Tr. 720:22-721:24* (stating the proposed conversion will lead to higher rates and profits for the company and less regulation and fewer opportunities for insurance); *McGuire, Tr. 728:24-730:7* (stating the company may become more efficient at subscribers' expense).

83. The actuarial consultants for both the Division and Premera considered the potential effect of the proposed conversion on premium rates and followed the same general approach of analyzing the possible impact of the proposed conversion on the components of Premera's premium rate structure. However, the methodology and factors considered by the actuarial consultants differed, as did their conclusions.

84. In analyzing the possible impact of the proposed conversion on premiums, Premera's actuarial consultants considered the possible impact on Premera's overall premium rates. Specifically, they did not analyze the potential impact on premiums in Alaska, specific lines of business in Alaska, or members in Alaska. *Tr. 396:11-16, 396:21-397:7 (Lusk)*. They also did not consider certain potential costs associated with the proposed conversion, such as the

possible change in Premera's effective federal income tax rate upon the loss of the 833(b) Deduction and compliance costs associated with the proposed conversion. *Tr. 399:9-20 (Lusk)*.

85. The actuarial consultants for Premera concluded that "[o]ther than a relatively small increase in Alaska premium tax, the [proposed conversion] is unlikely to generate changes in the components of PBC's premium rate structure." *Ex. P-44 at 21*. They also concluded that the proposed conversion "is not likely to result in any material impact on its premium rates." *Id.* In reaching its conclusions, Premera's actuarial consultants assumed that immediately upon the completion of the proposed conversion, Premera's surplus would be increased by \$100 million. They stated that this assumption results in decreasing pressure to increase surplus in general, including the pressure to increase surplus through premium rate action. *Tr. 388:15-389:6 (Lusk)*. Moreover, Premera's actuarial consultants considered the investment income from the additional \$100 million in their post-conversion calculations. *Ex. P-44, at 18*. As discussed below, however, Premera has speculated that the IPO proceeds may be used for other purposes, some of which would not raise Premera's RBC level, contribute to its surplus, or generate investment income. *See Tr. 232:15-233:6 (Novak)* (acknowledging that money spent on information technology or other infrastructure would typically not increase Premera's RBC level). If that is the case, the entire \$100 million could not be included in the post-conversion model.

86. The actuarial consultants for the Division considered the impact of the proposed conversion on the premiums in Alaska specifically and found that it is very possible and very likely that Premera would increase premiums after the expiration of the economic assurances relating to rates (discussed below). *Tr. 675:21-23 (Drennan)*; *see also Division Ex. 10, at 7*. Specifically, they found that the proposed conversion could increase premium rates by

2 to 5 %, depending on the resolution of certain factors. *Tr. 673:1-7 (Drennan); Division Exs. 8 and 10.* The primary factors that the Division's actuarial consultants believe would be instrumental to any such rate increase are: (1) the increase in the Alaska premium tax rate; (2) the increase in Premera's effective federal income tax if Premera were to lose the Section 833(b) Deduction; and (3) the increased pressure Premera will face from shareholders to produce a growth in profits if it is permitted to convert to a public company. *See Division Exs. 74, 75.* Each of these factors is discussed in more detail below.

87. The Director finds the testimony of the Division's actuarial consultants on each of these points to be credible and supported by the record.

1. The Increase in Premium Tax Rate

88. Premera currently pays 0.70 percentage points less in premium tax than its for-profit competitors in Alaska. If Premera converts, its premium tax rate will increase from 2.0 % to 2.7 %, which is a 35 percentage increase in premium tax. *Tr. 189:4-7 (Barlow); Tr. 662:11-14 Drennan).*

89. Holding all other factors constant, the proposed conversion could result in an increase in premium rates due to the 0.70 % point increase in Premera's premium tax rate. *Tr. 370:2-12 (McCarthy); see Ex. p-44, at 21.*

90. The effect of the increase in premium tax rate would be to increase premium rates by between 0.82 % to 0.89 %, depending on the line of business. *Division Ex.10, at 7; Tr. 663:19-23 (Drennan).* In dollar figures, this increase translates to a total increase of approximately \$1.5 million to \$2 million overall per year, or approximately \$30 a year for an average individual subscriber or \$75 a year for an average family. *Tr. 663:23-664:5, 693:23-694:23 (Drennan).* This premium increase would not be a one time occurrence, but would last

for as long as the subscriber continues to maintain health insurance coverage from Premera. *Tr. 695:15-20 (Drennan)*.

91. The evidence indicates that Premera intends to include this premium tax rate increase as a rate factor. In its individual rate filing dated May 1, 2003, Premera filed for an increase in premiums that included the 2.7 % premium tax as an expense factor. Premera subsequently withdrew that rate filing as premature, claiming that the filing had been made upon the assumption that the proposed conversion would be effective by July 1, 2003. This rate filing strongly suggests that Premera intends to pass the premium tax increase through directly to its Alaska policyholders. *See Tr. 663:6-9 (Drennan); Division Ex. 8, at 17*. In addition, Premera's own consultants testified that it is possible this increase in premium tax rate will be passed through to policyholders. For example, Premera's economic consultant stated that "[i]t is possible that the proposed conversion will result in an increase in premiums." *Tr. 370:2-12 (McCarthy)*. Premera's actuarial consultant similarly concluded that "[o]ther than a relatively small increase in Alaska premium tax, the conversion is unlikely to generate changes in the components of PBC's premium rate structure." *Ex. P-44, at 6*.

2. Possible Loss of the 833(b) Deduction

92. Premera is currently afforded the Section 833(b) Deduction. That special deduction lowers Premera's effective federal tax rate from 35 % to 20 %. To receive the 833(b) Deduction, Premera must not experience what is called a "material change" in either its structure or operations. *Tr. 849:24-850:2 (Ashley)*.

93. Premera received an opinion from its tax advisors that it was "more likely than not" that Premera would be able to retain its 833(b) Deduction. Testimony from the Division's tax consultants indicated that a "more likely than not" opinion means that there is at least a 51 % chance that Premera will retain this deduction and, therefore, there is "a

considerable degree of risk" (as much as 49 %) that the deduction will be lost. Most companies would prefer stronger opinions on significant tax issues such as this. *Tr. 849:24-852:6 (Ashley)*.
Premera's witnesses acknowledged that there is a "risk that this [833(b) Deduction] might be lost[.]" *Tr. 592:9-13 (Marquardt)*.

94. WellChoice, Inc. ("Wellchoice") listed the possible loss of the 833(b) Deduction as a risk factor in its financial disclosures. *Tr. 860:21-861:7 (Ashley)*.

95. The Internal Revenue Service has provided informal comments that indicate conversion transactions, like the proposed conversion, will in fact result in a material change in structure and a loss of the benefits. *Tr. 850:14-18 (Ashley)*.

96. Because of this risk that Premera's effective federal tax rate will increase significantly, the Division's actuarial consultants were asked to assume in their premium impact analysis that Premera would lose the 833(b) Deduction. They concluded that, if Premera lost the 833(b) Deduction and passed on that cost to policyholders, the impact on premium rates would be an increase of between 0.58 % and 0.94 %, depending on what Premera's effective federal premium tax rate is after losing the deduction. *Division Ex. 8, at 20; Tr. 666:6-10 (Drennan)*.

97. As set forth above, the actuarial consultants for Premera did not consider this possible change in Premera's effective federal income tax in reaching their conclusions regarding possible premium impacts. *Tr. 399:6-18 (Lusk)*.

98. Premera states that it would be willing to exclude as a rating component any change in its effective federal income tax rate resulting from a loss of the 833(b) Deduction due to the proposed conversion. *Tr. 592:22-593:1 (Marquardt)*. However, because Premera does not include federal income tax as a separate item in its premium rate formula, it would be

difficult to determine if any increases in Premera's effective federal tax rate are passed on to its policyholders. *Division Ex. 10, at 5 n.9.*

3. Loss of Rate Review

99. Currently, Premera is subject to rate review by the Division pursuant to AS 21.87.190. AS 21.87.190 provides that Premera "shall, before use, file with the [D]irector (1) a schedule of subscription rates, fees, or payments of any kind to be charged subscribers; (2) every rating manual, schedule, plan, rule, or formula; and (3) any modification to the rating manual, schedule, plan, rule, or formula." AS 21.87.190. It further provides, among other things, that the "rates, fees, and payments to be charged . . . may not be excessive, inadequate, or unfairly discriminatory." *Id.* After the proposed conversion, Premera will not be subject to rate review.

100. Notwithstanding this rate review by the Division in the individual and small group markets, Premera has been able to maintain a very substantial market share and a high rate of profitability in such markets. *Tr. 786:2-6 (Miller).*

101. Under the current rate review framework, in 2003, the Division told Premera to reduce its premium rates in the small group line. *Tr. 379:23-380:15 (McCarthy).*

102. If Premera is permitted to convert, it will no longer be subject to rate filings or be subject to the requirement that rates in the individual markets not be excessive or unreasonable. *Tr. 674:1-6 (Drennan).*

4. Pressure from Shareholders and Premera's Stated Long-Term Goal of Increasing Its Operating Margins

103. As discussed below, there was uniform testimony that public companies face greater pressures to perform on behalf of their shareholders than do non-profit companies because of the duty owed to shareholders. The evidence in the record also supports this finding.

See, e.g., *Ex. P-21, p.4 (Milbank Quarterly: "The Impact of Blue Cross Conversions on Accessibility, Affordability, and the Public Interest" Vol. 81, No. 4, 2003).*

104. The testimony at the hearing indicated that, as a public company, Premera will likely make profit projections. If it makes "overly optimistic projections and it misses those projections" the value of the company's stock could be adjusted downward. *Tr. 125:17-24 (Jewell); see also Tr. 615:1-7 (Marquardt).* In addition, for public companies, "stock market analysts and the pressures of the market [are] an added burden that management [of public companies] has to address[.]" *Tr. 127:4-6 (Jewell).*

105. Specifically, if Premera converts to a for-profit company, its shareholders would expect to see both growth in profits and a rate of return on capital in the range of approximately 10 to 15 %. *Tr. 285:25-287:4 (Kinkead)* (stating that getting a 10 to 15 % return on investment would be considered a successful IPO); *Tr. 440:3-5 (Barlow)*, (summarizing Mr. Kinkead's testimony to say that a 10 to 15 growth in profits would be acceptable to the marketplace); *Tr. 607:4-7 (Marquardt); see also Tr. 125:17-24 Jewell,*).

106. In addition, the Division's actuarial consultant testified that it is important for Premera to increase its operating margins and that, as a public company, it will face even greater pressure to do so. *Tr. 667:7-23 (Drennan).* Premera's financial projections indicate that it expects 20 % annual growth in operating margin and 15 % annual growth in annual income. *Ex. P-34, at 24.*

107. Although Premera states that it faces pressures to perform even as a non-profit company, the pressures faced by public, for-profit companies to increase profits are greater than those felt by non-profit companies. *Tr. 698:9-14 (Marquardt).* WellPoint's Chief Executive Officer stated that when WellPoint converted and became listed on the stock

exchange, for the first time ever, it faced increased pressures to achieve its quarterly earnings goals. *Tr. 784:9-15 (Miller)*.

108. Premera's operating margin is approximately 2 %, whereas the median operating margin for its peer group in 2003 is estimated to be approximately 6.9 %. *Tr. 668:2-8 (Drennan); Division Ex. 8, at 23, Table 7*. If Premera were to increase its operating margin by increasing revenue, that increase would generally include an increase in premium rates because it would be difficult to achieve material increases in operating margin by other means, such as reductions in expenses or claim costs. *Tr. 669:14-19 (Drennan)*.

109. The Division's actuarial consultants found that it would take a 1.1 % increase in premium rates to gain a 1 percentage point increase in operating margin. For example, to move from the current 2 % operating margin for the Alaska operations to 3 %, premiums would have to increase by 1.1 %. *Tr. 670:21-671:3 (Drennan); Division Ex. 10, at 6*.

110. Although possible demands for increased profits could be met by using capital raised from the IPO, Premera has not provided plans that show it would be able to do so. *Division Ex. 3, p. 120 (Navigant September 23, 2003 Report)*.

111. The Division's actuarial consultants testified that, as a direct result of the proposed conversion, "it's very possible and very likely that" Premera would increase premiums after expiration of the economic assurances relating to rates and rate review. *Tr. 675:16-23 (Drennan)*. As set forth above, they reached this conclusion after considering the increase in premium tax rate, the possibility of losing the 833(b) Deduction, and the additional pressures from shareholders to increase profits faced by a public company, and concluded that the total projected impact of the proposed conversion on premium rates is that premiums will probably increase by 2 to 5 % over time. *Tr. 673:1-7 (Drennan); see also Division Exs. 8 and 10*.

112. Because Premera's actuarial consultants (i) did not consider the potential impact of the proposed conversion on Alaska separately, (ii) failed to analyze certain factors that are concededly a "risk," such as the potential loss of the 833(b) Deduction, and (iii) based their analysis on assumptions that may not occur, the Director finds the analysis performed by the Division's actuarial consultants to be more credible and compelling. Indeed, even Premera's actuarial consultants concede that premium rates may increase due to the increase in the premium tax rate, although they disagree as to the materiality of that increase.

113. Premera's witnesses testified that any increase in rates would be inconsequential and likely offset by savings generated by administrative cost efficiencies. *Tr.* 353-354 (*McCarthy*); *Ex P-14, (McCarthy Pre-Filed Direct), p. 12; Ex P-16 (NERA Report), pp. 36-38; Tr. 387-388 (Lusk)*. Premera witnesses also suggested that investment income realized after receipt of funds from the IPO would offset the any impact of the change in state and federal tax rates. However, Premera presented no actuarial analysis or projection supporting these contentions.

114. Therefore, the Director finds that the proposed conversion will very likely result in an increase in premium rates. (*Ex. P-44, at 11-21*).

5. Premera's Ability to Increase Premium Rates and Maintain Membership and Profitability

a. Competition in Alaska and the Alaska Health Insurance Market

115. Although, as noted above, Premera does not have "monopoly power" from an antitrust perspective, the Division's economic consultants explained that an antitrust analysis is not relevant to their analysis of the proposed conversion because Premera is not combining with another company, changing its market position, applying new funds to the Alaska market, or even changing management. *Tr. 790:6-14 (Miller)*.

116. The Division's economic consultants determined, therefore, that the relevant inquiry was whether the conversion would impact affordability, accessibility, and availability and whether Premera had the ability to pass through rate changes without significant loss of membership or reduced profitability. Looking first at the impact of the proposed conversion on the affordability (accessibility and availability are discussed below) of health insurance in the State of Alaska (*i.e.*, the price or cost of health insurance), the relevant consideration cannot be the total market for health insurance in the State, but rather the lines of business in the state. *Division Ex. 1, at 11.*

117. The inapplicability of a typical antitrust analysis to the inquiry of whether Premera has the ability to raise premium rates without a significant loss of membership is demonstrated by the testimony of Premera's economic consultant. Dr. Thomas McCarthy testified on behalf of Premera that an insurer with a 95 % market share in the individual market, but only a 31 % overall market share, might not have market power, as he defined the term. *Tr. 365:23-366:10 (McCarthy).*

118. Dr. McCarthy also acknowledged that health insurance products are typically categorized into the large group, small group, and individual lines of business, *Tr. 357:19-25 (McCarthy)* and that not every health insurer in Alaska competes in all lines of business *Tr. 358:11-19 (McCarthy)* and there are varying levels of profitability in the different lines. *See Ex. P-14, at 13.* In fact, of the five lines of business listed by Premera's economic consultants, only Premera sells all five lines in Alaska. *See Ex. P-16, at 14.*

119. The propriety of considering the lines of business separately is supported by the testimony during the hearing. *Tr. 805:24-806:12-23 (Miller); Tr. 357:19-25 (McCarthy).*

120. In addition, as a general proposition, individuals cannot easily substitute one line of health insurance for another. For example, an individual generally cannot switch to large group, unless that individual experiences a change in personal circumstances such as obtaining a job with an employer with large group coverage or receiving coverage through his or her spouse. *Tr. 358:1-10 (McCarthy)*.

121. In addition, competition is restricted in Alaska. Few current insureds of Premera could switch to a competitor if Premera raised premium rates. For example, it would be very difficult, if not impossible, for a Premera subscriber with diabetes or heart disease to obtain coverage from a competitor. *Tr. 320:21-321:4 (Davis)*. Because these subscribers are least able to find alternative coverage, they have no choice but to maintain their insurance coverage with Premera and pay any increases in premium rates, to the extent they are able. *Tr. 784:23-785:3 (Miller)*.

122. For these same reasons, an increase in premiums may lead to an increase in the number of uninsureds. That is because some current Premera subscribers who are unable to obtain alternate coverage from a competitor because of underwriting issues might not be able to pay the premium rate increases. *See, Tr. 320:21-321:4 (Davis); 358:1-10 (McCarthy)*. In 1999, when Premera raised its rates in the individual market by 22 %, there was a subsequent drop in enrollment of 11 %, but Premera does not know how many of that 11 % became uninsured. *Tr. 321:20-322:6 (Davis)*.

123. The Division's actuarial consultants found that, given the highly concentrated nature of the individual and small group markets in particular, it is possible that competitive forces will not provide sufficient resistance to attempts by PBC-AK to increase premiums in response to any factors relating to the proposed conversion. *See Division Ex. 8*.

124. Indeed, in Alaska, Premera's small group operating margin increased steadily during the past few years without loss of membership and, as of 2002, was approximately 20.2 %. *Division Ex. 3, at 81, Table 14.*

125. The impact of rate increases arising out of the conversion are more acute when viewed in the context of rate increases that will be required to offset increases in health care costs. New PBC-AK is projected to increase premiums substantially each year from 2003 through 2007. *Division Ex. 3, p. 119 (Navigant September 23, 2003 Report).* Although health care cost increases may force premiums higher with or without conversion, the additional increases in premium required for a publicly traded health insurer would clearly reduce affordability of coverage. *Id at 120.* Premium increases beyond those already projected by Premera could create hardship to employers and individuals in Alaska. *Id.*

126. Alaska has the nation's lowest population per square mile, with approximately one person per square mile. Approximately half of the population of the State is located in the greater Anchorage area. *Tr. 1136:20-24, 1137:3-5 (Davis).* Accordingly, the population density for the remainder of the State is even lower than one person per square mile.

127. Alaska's unique geography and relatively small market size make it difficult, in a practical sense, to sell in rural or remote areas. *Tr. 791:9-14 (Miller).*

128. Alaska has a lower ratio of physicians and providers per person than most other states. *Tr. 327:12-18 (Davis).*

129. The foregoing facts affect competition by impacting the decisions of insurers to enter and exit Alaska. Several carriers have left the small group market in Alaska, including Employers Health, Guardian, Pioneer, and New York Life. Other insurers, such as Principal Insurance and Humana, have also withdrawn from the Alaska market recently. These

insurers left the market because of, among other reasons, PBC-AK's broad network and dominant presence within the state and the costs of doing business in Alaska. *Division Ex. 3, at 48 n.104*. Premera's economic consultant confirmed that several insurers have left the Alaska market, including Guardian in 2001. *See, Tr. 359:22-361:6 (McCarthy)*.

130. Premera currently has approximately 110,000 members in Alaska. *Tr. 140:6-8 (Barlow); Tr. 562:15 (Marquardt)*. The number of individuals who are fully insured in Alaska is approximately 200,000. *Tr. 1136:16-17 (Davis)*.

131. Premera currently has approximately 70 % of the market share of the entire health insurance market in Alaska. *Division Ex. 3, at 31*. Premera currently has approximately 60 to 64 % of the market share in the individual market and approximately 50 to 54 % of the market share in the small group market. *Tr. 317:9-318:2 (Davis); Tr. 783:23-25 (Miller)*. In the large group insured market, Premera had approximately 74 % of the market share in 2001. *Tr. 783:25-784:1 (Miller); see also Division Ex. 3, at 32*.

132. Premera's economic expert testified that, typically, once a competitor has a market share that is above 50 %, deeper consideration of the competitive process is necessary. *Tr. 383:21-25 (McCarthy)*.

133. There are indications that competitors follow Premera's lead in setting premium rates. *Tr. 784:3-4 (Miller)*.

b. Premera's Past Experience with Premium Increases

134. Past experience shows that Premera has previously raised premium rates significantly, indicating that it has the ability to do so without jeopardizing membership. For example, during a public comment session held on the first day of the Hearing, Joan Fisher, the Executive Director of the Anchorage Neighborhood Health Center (the "ANHC"), stated that

Premera raised the premiums of the ANHC this year by 24 %, which is the equivalent of approximately \$160,000. *Tr. 55:1-4 (Fisher)*.

135. Recent experience by Premera demonstrates that it can become more profitable after an increase in premium rates, even if membership levels fall after the premium rate increase. In May 1999, when Premera increased premium rates in the individual market by 22 %, there was a subsequent drop in enrollment of 11 %, which means that 89 % of the individual market membership stayed with Premera notwithstanding the premium rate increase. *Tr. 321:20-322:6 (Davis)*. After the premium rate increase in 1999, Premera's operating income increased by approximately 150 %. *Tr. 324:1-6 (Davis)*. Moreover, testimony at the hearing indicated that Premera does not know whether the 11 % of the membership that did not renew went to competitors or became uninsured. *Tr. 321:20-322:6 (Davis)*.

136. It is unclear whether this 11 % decrease in membership was related to the 22 % increase in the individual lines. From 1997 through 2000, Premera's individual membership fell from between 8 % to 14 % each year. *Division Ex. 3, at 79, Table 13*.

c. Premera's Competitive Advantages in Alaska

137. Premera's statewide provider network, which is the only one in Alaska, provides it with a significant competitive advantage, including protecting its members from balance billing. *Tr. 325:17-23, 327:22-25 (Davis); Tr. 780:8-9 Miller*.

138. Premera derives a competitive advantage from use of the Blue Cross/Blue Shield name and marks, which includes the benefit of out-of-area coverage for its members through the BlueCard Worldwide Program. *Tr. 210:23-211:11 (Barlow); Division Ex. 6, at 6*.

139. The Director finds the testimony of the Division's consultants regarding Premera's ability to increase premium rates and maintain membership and profitability to be credible and supported by the record.

140. Based on Premera's high market share and influence over the Alaska health insurance market, its competitive advantages, the unique market in Alaska, and past experience, the Director finds that Premera has the ability to increase premium rates and remain profitable, even if the increase in premium rates results in some loss of membership.

141. Even if Premera currently enjoys those same competitive advantages now, the increased pressures to meet its projected targets after the proposed conversion will make it more likely that Premera will seek to utilize those advantages to raise premium rates.

L. Economic Assurances

142. In response to concerns initially raised by the Division's consultants, Premera agreed to certain economic impact assurances in its Amended Form A, *see Division Ex. 37, at Ex. E-8*, including economic assurances relating to premium rates and rate review and to availability and accessibility of coverage.

1. Assurances Relating to Rates and the Total Projected Impact of the Proposed Conversion on Premium Rates

143. Premera stated that it "does not intend to increase its premium rates in Alaska as a direct result of the reorganization." *Id.* Premera agreed to subject itself to regulatory rate review pursuant to AS 21.87.190 and will file rates at least annually in the individual and small group lines for a period of two years after the effective date of the proposed conversion (unless they terminate sooner by mutual consent or operation of law). *Id.*

144. For the same two year period of time, Premera also made assurances that it would not: (i) increase the expense assumptions in its individual and small group rate filings as a direct result of the proposed conversion; or (ii) increase the expense assumptions used in the development of rates for the large group lines for the same period of time. Encompassed within these economic assurances is the assurance that the amount charged to its policyholders will not

reflect the 0.70 percentage point increase in premium tax rate for the duration of the economic assurances relating to rates. *See id.*

145. The Division's actuarial and economic consultants believe that the economic assurances relating to rates and rate review should be extended to three to five years. These longer periods will delay the risk that Premera will respond to pressure from shareholders by increasing premium rates. The Division's economic consultant testified that the burden on Premera of complying with these assurances should be minimal because Premera has been able to maintain a high market share and a high rate of profitability in the individual and small group markets while being subject to rate review over the past few years. Moreover, extending these assurances to over three years is not unusual. In the conversion transactions reviewed by the Division's economic consultants, whenever required, assurances were always established for three or more years. *See Tr. 785:11-786:11 (Miller).*

146. Premera maintains that extending these assurances relating to rate review beyond two years will put the Company at a competitive disadvantage because its competitors are not subject to the same requirement. Premera offers no other reason for why this assurance puts it at a competitive disadvantage. *Tr. 616:4-17 (Marquardt).* However, as a nonprofit, PBC has gained market share over its competitors even with rate review. The economic consultants also concluded that competitors follow PBC's lead in setting rates or prices for its products. Accordingly, to that extent, rate review of PBC has the effect of keeping the rates of competitors in check as well. Moreover, in the conversion of Empire Blue Cross Blue Shield (the "WellChoice Transaction"), the Public Asset Fund was subject to rate review for a period of five years for its Medicare supplemental and small group policies. *Tr. 785:24-786:1 (Miller).* Despite this rate review, WellChoice's stock has appreciated from its initial IPO price to the

public of \$25.00 per share (on November 8, 2002) to \$41.00 per share (as of closing on June 24, 2004).

147. Premera also maintains that extending the assurances relating to rates beyond two years would put the Company at a competitive disadvantage because its competitors are not subject to a similar restriction. However, this assurance relates solely to increases in premium rates that directly result from the proposed conversion and, "in actuality, most of the conversion costs will have been gone" by the end of the two-year period. *Tr. 617:13-15 (Marquardt)*. This assurance is *not* a rate guarantee and does not prevent Premera from raising rates in response to external factors that are unrelated to the proposed conversion, such as increases in medical cost trends. *Tr. 407:7-19 (Lusk); Tr. 674:16-675:2 (Drennan)*. While the consultants agree that these assurances are beneficial while they are in force, once they expire the actuarial consultants have expressed concern as to how Premera will fund what the consultants believe are necessary increases to its operating margin. *Tr. 675:17-19 (Drennan)*.

148. Even if the economic assurances relating to rates and rate review are extended, the available evidence demonstrates that it is very possible and very likely that Premera will increase premiums as a result of the proposed conversion after the expiration of these economic assurances. *Tr. 675:21-23 (Drennan); see also Division Ex. 10, at 7*.

149. If Premera is permitted to convert, its management has stated that it may or may not increase premiums after certain economic assurances made by Premera relating to rates expire two years after the effective date. *Tr. 191:5-7 (Barlow)*.

150. The Director therefore finds that the testimony of the Division's consultants on this issue is more credible than that offered by Premera, and that the testimony of the Division's consultants is supported by the record.

2. Availability and Accessibility of Coverage and Related Economic Assurances

151. The Division's economic consultants found that, because providers are in scarce supply, they have significant leverage in contract negotiations and that the balance between Premera and the providers is unlikely to change as a result of the Conversion. *Tr. 780:1-5 (Miller)*. They also found that it was unlikely Premera would reduce provider payment rates as a means to reduce medical costs and increase profits and concluded that Premera's large provider network provides it with a competitive advantage. Although they noted that it is unlikely that Premera would attempt to reduce the size of this network, they found that a reduction in the size of the network would likely result in an increase in out-of-pocket expenses by consumers, who would face balance billing by physicians and others who were no longer in the network. *Tr. 780:8-15 (Miller)*.

152. Nonetheless, the economic consultants recommended obtaining an assurance from Premera that it would continue to serve all of its existing customers' geographic segments, maintain its underwriting procedures, and continue to maintain current product offerings to its existing customers for 3 to 5 years. *Division Ex. 3, at 23, 120*.

153. In response to these concerns raised by the Division's economic consultants, Premera included an economic impact assurance in its Amended Form A that New PBC-AK will use reasonable efforts to maintain its provider networks in Alaska for two years, subject to market and other factors and conditions applicable to the ability of a health plan or insurer to develop or maintain a provider network in Alaska. *See Division Ex. 37, at Ex. E-8, § 3.3*.

154. In considering the potential impact of the proposed conversion on the availability of coverage, the Division's economic consultants found that it was unlikely that

geographic service areas or products offered by Premera to specific customer segments would be affected by the conversion. They also concluded that underwriting procedures and product offerings were not expected to change as a result of the conversion. *Tr. 781:22-782:4 (Miller)*.

155. As a result, the Division's economic consultants recommended obtaining an assurance from Premera that it would continue to serve all of its existing customers and geographic segments, not change the underwriting procedures and continue to maintain its current products and underwriting procedures for three to five years after the proposed conversion. *Division Ex. 3, at 120*.

156. In response to these concerns, Premera included economic impact assurances in its Amended Form A in which it agreed to, for a two year period: (i) continue to offer Blue Cross Blue Shield trademarked products on a statewide basis, unless PBC-AK is prohibited from using the Blue Cross Blue Shield names or marks; (ii) maintain or offer substantially similar products for the small group market; (iii) file a status report for its group business, other than small group, including the information set forth in the assurance; (iv) continue Premera's current practice of using statewide broker commission schedules for its individual and small group regulated products in the state of Alaska; and (v) file with the Division its underwriting questionnaires in use in Alaska and the sections of its Underwriting Guidelines pertinent to its Alaska business at least annually and provide an explanation of any changes in such questionnaires or Underwriting Guidelines. *Division Ex. 37, at Ex. E-8, § 2*.

157. The Division's economic consultants believe these assurances relating to availability are appropriate measures to monitor the continued availability of coverage after the proposed conversion, but recommended a period of three to five years instead. *Tr. 782:13-25 (Miller)*. The testimony indicated that extending such economic assurances beyond a two year

period is consistent with other BCBSA conversions. For example, when Blue Cross Blue Shield of Maine converted, it was required to maintain product offerings forever, subject to approval by the insurance commissioner. When Blue Cross Blue Shield of New Hampshire converted, it was required to maintain existing products for three years. *Tr. 783:2-7 (Miller)*. In addition, WellPoint and Anthem have recently submitted undertakings to the California Insurance Department in connection with their proposed merger that would guarantee that the domestic insurer would maintain the existing products for three years. *See 06/21/04 Notice of Investigatory Hearing Regarding Proposed Merger of Wellpoint Health Network Inc. and Anthem Holding Corp. of the California Insurance Department.*

158. Premera acknowledged that the assurance relating to Premera continuing to offer BCBSA trademark products on a statewide basis does not put Premera at a competitive disadvantage. *Tr. 617:21-618:3 (Marquardt)*. Because offering BCBSA trademark products is one of Premera's primary competitive advantages, Premera's concern that extending this assurance will harm Premera from the perspective of its investors is unfounded. *See, Tr. 618:8-13 (Marquardt)*.

M. Creation of the Alaska Health Foundation

159. As stated above, after completion of the proposed conversion, the Alaska Health Foundation and the Washington Foundation will collectively own 100% of the issued and outstanding shares of New PREMERA allocated according to a formula to be determined by the States.

1. The Legal Form of the Alaska Health Foundation

160. The Articles of Incorporation of the Alaska Health Foundation provide that the Alaska Health Foundation will be "organized exclusively for the promotion of social

welfare and charitable purposes within the meaning of Section 501(c)(4) of the Internal Revenue Code of 1986[.]" *Division Ex. 37, at Ex. E-3, Art. III, § 1.*

161. During the Hearing, the Division, Premera, and the represented *Amici* group introduced evidence regarding the relative merits of forming the Alaska Health Foundation as a 501(c)(4) organization, as opposed to an organization formed under Section 501(c)(3) of the Internal Revenue Code of 1986. *See, e.g., Tr. 865-887 (Lundy); Tr. 949:23-962:24 (McMillian); Tr. 1080:19-1098:9 Mahoney).* The represented *Amici* group believes that a 501(c)(3) organization is the more desirable form for the Alaska Health Foundation. *See, generally, Tr. 949:23-962:24 (McMillian); Tr. 1080:19-1098:9 (Mahoney).*

162. A 501(c)(4) structure has a number of advantages. First, a 501(c)(4) entity does not have to pay income tax on the proceeds from a sale of stock, whereas a 501(c)(3) organization would be subject to an excise tax of approximately 2 % on gains from sales of the stock. In addition, any other income derived from those proceeds will also be subject to the 2 % tax. Also, a 501(c)(4) organization is not subject to certain restrictions on the use and distribution of funds derived by the Alaska Health Foundation. *See, Tr. 877:5-878:7 (Lundy).*

163. Testimony and public comment was received indicating that a 501(c)(3) organization can work more easily with other charitable groups and can accept donations from philanthropic groups and others that a 501(c)(4) may not. *See, e.g., Tr. 959:16-960:22 (McMillian).*

164. Another difference is that 501(c)(3) organizations are subject to so-called minimum distribution requirements that require them to give away, generally, 5 % of the average value of the foundation's assets each year. This requirement may cause a particular

problem for foundations, such as the Alaska Health Foundation, that are required to sell stock over time to fund their operations. *Tr. 878:17-879:4 (Lundy)*.

165. In the WellPoint transaction, the California Health Care Foundation, which is a 501(c)(4) organization, received all of the initial stock of the converted company. Upon a sale of the California Health Care Foundation's WellPoint stock, the California Health Care Foundation retained 20 % of the proceeds from the sale and transferred 80 % of the proceeds to the California Endowment, which is a 501(c)(3) organization. *Tr. 414:16-415:2 (Reid)*.

2. Restrictions on the Alaska Health Foundation

166. The New PREMERA stock that will be held by the Alaska and Washington Foundations after the conversion will be subject to certain restrictions. According to PREMERA, these restrictions, primarily voting and divestiture requirements, are necessary for the orderly sell-down and voting of the stock and will not degrade the value of the Foundations' stock when sold on the market. *See generally Ex. P-52 (Banc of America Supp. Report), pp. 7-10; Tr. 247-248 (Kinhead); Ex. P-55 (Steel Pre-Filed Direct), pp. 20-21; Tr. 529-531 (Steel)*.

167. Restrictions on the voting and selling rights of the Foundations are necessary for New PREMERA to maintain the Blue Cross Blue Shield license, an asset with undisputed value to the company. *Tr. 160-163 (Barlow); Ex. P-51 (Banc of America Report), p. 31; Tr. 241 (Kinhead); Ex. P-52 (Banc of America Supp. Report), pp. 7-8; RP 527 (Steel); Tr. 934 (Johnson)*.

168. Restrictions upon stock in the hands of the Foundations can also serve to increase the value of the stock by giving other investors assurance that the stock will be disposed of in an orderly fashion and that philanthropic organizations will not be interfering in the

management of an insurance company. *Ex. P-52 (Banc of America Supp. Report), p. 7; Tr. 247-248 (Kinkead); Tr. 528-529 (Steel); Tr. 576-579 (Marquardt); Tr. 478-479 (Reid).*

169. Premera's license to use the trademarks of the BCBSA is a very valuable asset. The loss of the right to use those marks would substantially and adversely impact the value that Premera could command in the public markets. *Tr. 243 (Kinkead); Tr. 934 (Johnson).* It would also deprive Premera's subscribers of the right to use the Blue Card system throughout the country, which would be a substantial detriment to them. *Tr. 210-211 (Barlow); see also Tr. 243 (Kinkead).*

170. The BCBSA license forbids any person or entity (other than an institutional investor) from owning more than 5% (-1 share) of the outstanding shares. Any deviation from this standard requires a specific waiver from the BCBSA. *Tr. 163-164, 181 (Barlow).* In this case, the Alaska Health Foundation and the Washington Foundation will each hold more than 5% of the outstanding shares of New PREMERA.

171. Premera witnesses testified that the BCBSA will strip a licensee of its right to use the Blue marks if it proceeds with a conversion on terms that conflict with the provisions of the Blue license, unless each such term is approved as a license exception. *Tr. 161-163 (Barlow); Tr. 576-577 (Marquardt).*

172. Premera's Amended Form A proposal is designed to comply with the requirements of the BCBSA for continuing licensure. Those requirements have been made known through the terms of precedent transactions that the BCBSA has approved (e.g., the WellChoice transaction) and through advice provided by the BCBSA staff and by the Plan Performance and Financial Standards Committee ("PPFSC"), a committee of the BCBSA Board. *Tr. 163 (Barlow); Tr. 576-577 (Marquardt).*

173. The Division's investment banking consultant has recommended that any conditions imposed by the Director in this matter should be designed specifically not to infringe on the ability of Premera and its subsidiaries to retain the use of the BCBSA name and service marks. *Tr. 936 (Johnson); Division Ex.-16, pp. 10, 192; see also Tr. 163 (Barlow).*

174. The BCBSA has advised Premera that it will not grant a waiver that includes terms substantially at variance with those approved in precedent transactions. Specifically, the BCBSA will not approve any change in the following terms, among others:

- The 50.1% threshold for a change-in-control proposal upon which the foundations will have a free vote. *Tr. 577 (Marquardt); see Tr. 941-943 (Johnson);*
- The overall divestiture schedule (namely, that the foundations may not collectively hold more than 80% of the combined stock outstanding on the first anniversary after the IPO; 50% of the combined stock outstanding on the third anniversary after the IPO; 20% of the combined stock outstanding on the fifth anniversary after the IPO; and 5% of the combined stock outstanding on the tenth anniversary after the IPO). *Tr. 578 (Marquardt);*
- The term of the Voting Trust and Divestiture Agreement. *Tr. 579 (Marquardt);*
- The term of the Designated Member(s) nominated by the Foundations (namely, the right to nominate expires on the earlier of five years after the IPO or when the foundation reaches 5% ownership of the combined stock outstanding). *Tr. 579 (Marquardt).*

175. In January 2004, the States' consultants advised Premera that they would like to provide each of the two Foundations with the set of rights previously discussed for the single foundation (collectively known as the "duplicate foundation rights"). These are the right to designate two members of the New PREMERA Board of Directors (or a member and an observer), a separate and independent divestiture schedule for each Foundation, and the right for each to hold a 5% (-1 share) bloc of shares outside the Voting Trust and Divestiture Agreement.

176. At Premera's request, the PPFSC convened a special meeting at which Premera argued for the duplicate foundation rights. The PPFSC thereafter apprised Premera that it would recommend approval of two designated members and would consider two proportional divestiture schedules that, in the aggregate, fulfill the overall divestiture requirements, but that it would not agree to the other requested license exceptions. *Tr. 165-166 (Barlow); Ex. P-3 (Barlow Pre-Filed Direct), pp. 21-22; Exs. P-4 and P-5 (Premera correspondence with BCBSA); Tr. 574-575 (Marquardt).*

177. The technical corrections supplied with the pre-filed direct testimony of Kent Marquardt (Exhibit P-36) address a number of concerns voiced by the Division's investment banking consultant. For example, they provide that conversion will not be effective unless it occurs contemporaneously with the IPO. The technical corrections also reflect that the Foundations will have a free vote on changes to the equity compensation program that are proposed to be effective during the three-year period following the IPO. *Tr. 579-582 (Marquardt); Tr. 1001, 1030 (Johnson).*

178. Premera agrees that the investment banking advisors to the Division may share information with the Alaska Health Foundation. Premera will not object to a shortening of the period during which proposals for changes to the equity compensation plan that will become effective more than three years after the IPO are subject to mirror voting rather than a free vote. Premera also will not object to adding a knowledge qualifier to the anti-solicitation provisions in the Voting Trust and Divestiture Agreement. *Tr. 580-583 (Marquardt); Ex. P-34, pp. 39, 41-42, 44.*

179. Premera has offered compromise language to address concerns about the standard for independence for directors of New PREMERA, the procedures for selection of the

directors designated by the Alaska and Washington Foundations, and the divestiture schedules to be followed by the two Foundations. *Ex. P-41*.

N. **Executive Compensation**

180. Premera presented testimony at the hearing from Richard Furniss of Towers Perrin regarding the compensation arrangements Premera proposes to enter into with certain of its executives in connection with the proposed conversion. The testimony from Mr. Furniss indicates that Towers Perrin views those compensation arrangements as reasonable, and that the arrangements are competitive with those of comparable companies. *Tr. 511:20-514:13 (Furniss)*.

181. Based upon the expectation of an IPO in which approximately \$100 million of primary shares are issued, the Director concurs that the compensation arrangements are reasonable and competitive. *See Division Ex. 17, at 35 (stating the IPO should be no smaller than \$100 million in proceeds)*.

182. There is some testimony in the record, however, indicating that Premera may have to issue as much as \$150 million in primary shares in the IPO. *See Tr. 578, 594 (Marquardt)*. An IPO of this size would effect the compensation arrangements because under the Description of Stock Ownership Plans provided by Premera, the total number of shares for which grants may be made is determined by set percentages of the total number of shares of New PREMERA which are issued and outstanding after giving effect to the IPO. *See, e.g., Division Ex. 37, at Ex. G-10, at 4 (discussing Ongoing Grants, as that term is defined herein)*. As a result, in the event the amount of primary shares issued in the IPO exceeds the \$100 million, the Director will revisit the issue of whether the compensation arrangements are reasonable and proper.

O. Allocation of the Value of Premera Between the States of Alaska and Washington

183. The Alaska operations and Washington operations of Premera have been and are operated together and separate IPOs are not contemplated for Premera's Alaska and Washington operations. *Tr. 911:3-9 (Johnson)*.

184. During the 1990s, Premera's Washington operations were losing money. *Tr. 116:18-21 (Jewell)*. In fact, in the late 1990s, the individual line of business in Washington "was losing a tremendous amount of money[.]" *Tr. 117:7-9 (Jewell)*.

185. Currently, Alaska and Washington have not reached an agreement on the appropriate allocation of the value of New PREMERA between the states. *See Division Ex. 74, 75*.

186. Premera's original recommendation for allocation of the value between the states of Alaska and Washington was that Alaska should received 10 %. *Tr. 194:2-4 (Barlow)*. Premera presented no actuarial, investment banking or any other analysis to support its recommendation that the allocation be 90% to Washington and 10% to Alaska.

187. The actuarial consultants for the OIC recommended an allocation range of 12 to 18 % for Alaska, stating that the midpoint of the range, 15 %, was the most likely outcome. *Tr. 681:13-15 (Drennan)*.

188. The investment banking consultants for the OIC recommended an allocation to Alaska in the range of 11 to 17 %. *Division Ex. 74, at 33*.

189. The OIC Staff recommended to the Washington Insurance Commissioner that, if he were to approve the Washington Form A, any approval should be conditioned upon Washington being allocated 85 % of the value of New PREMERA and Alaska receiving 15 %. *See Tr. 194:18-23, 196:4-14 (Barlow)*.

190. To arrive at their recommended allocation range, the actuarial consultants for the OIC made certain adjustments with which the Division's actuarial consultants disagree. These adjustments included charging Alaska for a "start-up" loan, adjusting the value of the Washington operations upwards because it was allegedly undervalued, and charging Alaska an IPO participation fee. *See Tr. 681:16-682:9(Drennan); Division Ex. 74.*

191. In their final allocation report, the Division's actuarial consultants recommended that 24 % to 28 % of the value of Premera be allocated to Alaska. *Division Ex. 11, at 2.* The midpoint of this allocation recommendation is 26 %.

192. In their final report, the Division's investment banking consultants concluded that the allocation of stock should be in the range of 25.8 % to 29.6 % to Alaska. *Tr. 910:15-24 (Johnson).* The midpoint of this allocation recommendation is 27.7 %.

193. If the assumed value of Premera is \$600 million *see Tr. 280:10-17 (Kinhead)*, then the difference between the allocation recommended by Washington and the midpoint of the allocation ranges recommended by the Division's actuarial and investment banking consultants translates to the difference between the Alaska Foundation receiving \$90 million and approximately \$160.8 million.

194. The Division staff and the Director set forth the differences in the allocation methodologies used by the consultants for the Division and the consultants for the OIC in Division Exhibits 74 and 75. The discussion contained in Division Exhibits 74 and 75 are incorporated by reference into these findings of fact as if fully set forth herein.

195. The Division's consultants raised issues regarding the Unallocated Share Escrow Agreement (the "USEA"), including the concern that the agreement takes away the flexibility of the Foundations to sell as much or as little of their shares as they feel is

appropriate. *Tr. 921:21-922:6 (Johnson)*. If allocation is resolved, issues relating to the USEA become moot.

196. The Director finds the testimony and evidence submitted on allocation by the Division's consultants to be credible and supported in the record.

V. CONCLUSIONS OF LAW

1. The Director "has the power and authority expressly conferred by or reasonably implied from the provisions of" the title of the Alaska Insurance Code. *See AS 21.06.080(b)*. The role of the Director, and the purpose of Alaska's insurance law, is to protect the Alaskan insurance consumer. *See Northern Adjusters v. Dep't of Revenue*, 627 P.2d 205, 207 (Alaska 1981).

2. The HCA requires the Director's approval of any Form A statement filed with the Division. *See AS 21.22.010, et seq.*

3. Accordingly, the Director has broad discretion to carry out her duties, and must review the structure of the proposed conversion in its entirety including the creation, and ongoing rights, of the Alaska Health Foundation. The standards relevant to approval of the Amended Form A, which are set forth and discussed in more detail below, must be applied to the entire Amended Form A submission.

4. As an initial matter, the proposed conversion may not occur since the Washington Insurance Commissioner disapproved the Washington Form A. In absence of Washington's approval, the transfer of assets to New PBC and New PBC-AK cannot occur, PBC cannot dissolve and, in effect, the conversion cannot occur. Accordingly, the Amended Form A before the Director may no longer describe a viable transaction. Premera, however, has not withdrawn its application. Therefore, a decision on the Amended Form A before the Director is appropriate.

5. It is well established that when non-profit health service corporations convert to for-profit status, they must leave the assets they accumulated as non-profit organizations, in this case assets contributed by the public, in the nonprofit sector. *See, e.g.*, Howard S. Levy, "The Conversion of Non-profit Health Maintenance Organizations to For-Profit Status," 16 N. Ky. L. Rev. 361 (1989); Theresa McMahon, "Fair Value? The conversion of Non-profit HMOs," 30 U.S.F. L. Rev. 355 (1996); Joel Ferber, "A Cure for the Blues: Resolving Non-profit Blue Cross," 32 J. Health L. 75 (1999).

6. This precedent is consistent with the law governing non-profit conversions, which is founded on common law doctrines of "charitable trusts." Under this doctrine, the assets of charitable corporations are impressed with a charitable trust, which means they may only be used for charitable or public purposes. *See Taylor v. Baldwin*, 247 S.W. 2d 741, 750 (Mo. 1952); *see also* Building Strong Foundations, Creating Community Responsive Philanthropy in Non-profit Conversions, at 4 (stating that the charitable trust doctrine provides that the assets of the non-profit organization are owned by the public and held in trust by the governing board, as trustees and that the assets can be used to fulfill the company's original public benefit or charitable purpose). This definition of "charitable purpose" does not require the health system to provide uncompensated care. *Id.*

7. Notwithstanding the foregoing, the Director cannot conclude on this record that Premera's assets are subject to a charitable trust and are held on behalf of the public generally. In fact, the law on charitable trusts suggests that even on the facts presented Premera assets are not impressed with a charitable trust, because it did not receive and hold funds for a public purpose and because it has operated solely for its members. *See, e.g., Abbott v. Blue Cross and Blue Shield of Texas*, 113 S.W.3d 753, 764 (Tex. Ct. App. 2003) (to be a public

charity, the corporation "must be organized for the benefit of the public and not for private profit or its own benefit").

8. However, PBC and Premera's Articles of Incorporation require that PBC's assets be distributed consistent with the purposes of the nonprofit corporation under which it did business in this state. As a foreign nonprofit in this state, PBC is bound by the same duties, restrictions, penalties, and liabilities imposed upon a domestic corporation of like character. AS 10.20.465. In Alaska, a nonprofit corporation is required to adopt a plan of distribution that is not inconsistent with AS 10.20. AS 10.20.295 provides for the distribution of assets, as follows:

- (1) all liabilities and obligations of the corporation shall be paid and discharged, or adequate provision shall be made therefor;
- (2) assets held by the corporation upon condition requiring return, transfer or conveyance, which condition occurs by reason of the dissolution, shall be returned, transferred or conveyed in accordance with the requirements;
- (3) assets received and held by the corporation subject to limitations permitting their use only for charitable, religious, eleemosynary, benevolent, educational or similar purposes, but not held upon a condition requiring return, transfer or conveyance by reason of the dissolution, shall be transferred or conveyed to one or more domestic or foreign corporations, societies or organizations engaged in activities substantially similar to those of the dissolving corporation, under a plan of distribution adopted as provided in this chapter;
- (4) other assets, if any, shall be distributed in accordance with the provisions of the articles of incorporation or bylaws to the extent that the articles of incorporation or bylaws determine the distributive rights of members, or any class or classes of members, or provide for distribution to others;
- (5) any remaining assets may be distributed to persons, societies, organizations or domestic or foreign corporations, whether for profit or nonprofit, as may be specified in a plan of distribution adopted as provided in this chapter.

9. Washington law has the same or similar requirements. RCW 24.03.225; RCW 24.06.265. Accordingly, at the very least, Premera is obligated under Alaska and Washington law to distribute its assets in a manner consistent with its Articles of Incorporation.

10. PBC also is subject to the requirements of AS 21.87. Despite its foreign nonprofit status, PBC is regulated like a domestic hospital medical service corporation.

11. There are no provisions within AS 21.87 that directly provide for the conversion to a for profit entity. However, AS 21.87.300 provides direction on the permissible use of PBC assets. Specifically, upon express authorization by its board of director, PBC may use surplus funds (1) to liquidate on a uniform and pro rata basis charges for services by participant providers or participant hospitals not paid in full upon the settlement of bills in previous years; (2) to pay off any part or the whole of an outstanding contribution of working capital to the corporation, the payment to be prorated on a uniform basis among all the outstanding contributions; or (3) to reduce the rates thereafter to be charged subscribers, or to expand the services or benefits thereafter to be provided under subscription contracts.

12. Additionally, AS 21.87.340 makes various other provisions of the insurance code applicable to PBC and, with respect to those provisions, PBC is treated as a mutual insurance company. Specifically, AS 21.69.600, 21.69.520, and 21.69.630 apply to hospital medical service corporations, but on their face they apply to domestic mutual insurers.

13. The significance of being treated as a mutual is that policyholders become members of the insurer. *See, e.g.*, AS 21.69.280. Under case law, policyholders as members of a mutual insurer, may be treated as equitable owners of the insurer and may be, entitled to distribution of assets. *See e.g., Mutual Fire Ins. Co. of Germantown v. United States* 142 F.2d 344, 348 (3rd Cir. 1944); *cert. denied* 323 U.S. 729 (1944); *Huber v. Martin, et al.*, 105 N.W. 1031, 1032 (Wisc. 1906). This principle is reflected in chapter 78 of the insurance code (AS 21.78) related to the rehabilitation and liquidation of insurers, which is made applicable to hospital medical service corporations under AS 21.87.340.

14. Under AS 21.78.260, members of mutual insurers are entitled to distribution of an insurer's assets, except as limited by law. AS 21.69.630 provides for the distribution of assets upon liquidation of a domestic mutual to persons who were an insurer's members at any time within 36 months immediately preceding the date the liquidation was authorized or ordered, or date of last termination of the insurer's certificate of authority, whichever date is earlier. The distributive share of each member must be in proportion to the aggregate premiums earned by the insurer on policies of the member according to a formula set forth in the statute.

15. While the above provisions may not have direct application here, they provide guidance in deciding whether the proposed conversion is fair and reasonable to PBC's Alaska subscribers and in the public interest under the HCA standards.

16. In light of the foregoing, the Director concludes as a matter of law that she has the right to review the arrangements relating to the ownership and distribution of New PREMERA stock by the Foundations. The Director further concludes that Premera must transfer its assets in a manner and amount that is fair to its subscribers and in the public interest.

17. Under the HCA, the Director is required to approve or disapprove the Amended Form A as it is filed. It does not require the Director to piece together the terms of the proposed conversion from a myriad of documents and sources. *See* AS 21.22.020; 3 AAC 21.060 (requiring that all necessary information about the proposed conversion be submitted on a Form A). Premera must submit an amendment to the Amended Form A setting forth all of the additional terms, provisions, and revisions proposed by Premera, if Premera wishes its Form A application to be considered on the basis of any terms, provisions, or revisions that are not contained in the Amended Form A. *See also* AS 21.22.020(12) (providing

that a Form A filing must contain "any additional information as the director may by order or regulation prescribe as necessary or appropriate for the protection of policyholders and securityholders of the insurer or in the public interest."). If Premera files an amendment to its Amended Form A, the Director expressly retains the authority to review that amendment to ensure it accurately and completely reflects her understanding of the terms and provisions currently being offered by Premera and upon which these findings and conclusions are based.

18. AS 21.22.030(a) sets forth the standards that should be applied in reaching a decision on a Form A application. AS 21.22.030(a) states that the Director "shall" approve the application unless, after a public hearing, she finds that Premera has failed to demonstrate that none of the six conditions set forth in that section exist. The existence of any one of the six conditions set forth in AS 21.22.030(a) can serve as the basis for disapproving the Amended Form A. The Director concludes that AS 21.22.030(a)(4) and (5) provide the bases for disapproving Premera's Amended Form A in its current form.

19. For purposes of AS 21.22.030(4), the Director concludes that the Foundations should be considered the securityholders of New PBC-AK. *See* Notice of Hearing and Invitation for Public Comment, at 2 (dated May 14, 2004). Following the conversion, New PBC-AK will be the direct subsidiary of New PREMERA. In turn, 100 % of the initial stock of New PREMERA will be held by the Alaska and Washington Foundations. On this basis, the Foundations fall within the definition of "securityholder" under AS 21.22.200. Accordingly, the Director is authorized to consider whether the terms and conditions of the proposed conversion, including the structure of the proposed conversion, are fair and reasonable to the Foundations.

20. The Director concludes that the proposed conversion contains restrictions on the Alaska Health Foundation that are unfair and unreasonable and not in the public interest.

While some of the restrictions are required by the BCBSA, other restrictions are admittedly requirements that Premera has imposed on the Alaska Health Foundation without the BCBSA requiring it to do so. *Tr. 611:1-6 (Marquardt)*. Certain of these restrictions have the effect of limiting the independence of the Alaska Health Foundation and its ability to control the timing, amount, and price of its sales of New PREMERA stock and its ability to vote its shares of New PREMERA stock and are, as a result, unfair. Any restrictions that impede the Alaska Health Foundation's right to maximize the value of its shares are not in the interest of the public who will benefit from such maximizing.

21. The Alaska consultants raised a number of legal issues that Premera has chosen to address either by way of filing a technical correction or by indicating that, if necessary, they would amend the documents to address the issue. Assuming that Premera files an amendment to its Amended Form A and that amendment contains either the technical correction or other writing as currently filed by Premera, or otherwise satisfactorily memorializes the understanding of Premera's proposed position described herein, the concerns raised by the Alaska consultants have been satisfied with respect to the aggregate final termination, knowledge qualifier, consultation between the Alaska consultants and the Alaska Health Foundation, independence of directors, Alaska Health Foundation's representations and warranties, Premera grants and loans to the Alaska Health Foundation, guaranty agreement, and voting on the executive compensation plan.

22. The Director concludes that the choice of law provisions in the Alaska Foundation documents are unfair to the Foundation. All documents relating to the Foundation should be governed by, and construed in accordance with, Alaska law, with venue for any dispute in the Superior Court in Anchorage, Alaska. The application of Alaska law is

appropriate in light of the obvious contacts between (1) the Foundation, its participants and beneficiaries and (2) the State of Alaska. *See, e.g.*, Restatement (Second) of Conflict of Laws § 187 (providing that law of the state chosen by the parties to a contract governs unless the state "has no substantial relationship to the parties or the transaction and there is no reasonable basis for" the choice; or it is against public policy); § 188 (providing that, in the absence of a choice of law by the parties, contacts to consider in determining the applicable law include the place of contracting, negotiation, or performance, location of the subject matter, and the place of incorporation of the parties). Venue in Anchorage Superior Court is proper for the same reason.

23. The Director notes the benefits of a 501(c)(4) organization and appreciates the thought that has been given to the appropriate structure by the consultants and Premera. If this conversion were to go forward, the 501(c)(4) structure appears to be fair to the Foundation. The Director notes, however, that as long as access to the market by the Alaska Health Foundation is preserved, that is, as long as Alaska has its own foundation, whether such foundation is a 501(c)(3) or (c)(4) or some combination of the two, as well as who may serve on the Board of such Foundation could be determined after any approval, with input from *Amici*.

24. The Director concludes that if the proposed conversion were to go forward, the Alaska Health Foundation should be formed in accordance with the Amended Form A and the proceeds provided to that foundation. The proposed tax treatment of the Alaska Health Foundation should be proposed by Premera upon consultation with experts and proposed for approval by the Director.

25. With respect to AS 21.22.030(5), the Director must balance the projected negative impacts of the proposed conversion on policyholders and the public against the projected benefits (or absence of benefits) to policyholders and the public. Clearly, it is

impossible to determine with absolute certainty what the impact of the proposed conversion will be. The Director can only make her determination of whether the proposed conversion is fair and reasonable to policyholders and in the public interest based upon the information available to her and the guidance provided by the various consultants.

26. As set forth below, the Director concludes that the proposed conversion, as currently proposed by Premera, is not fair and reasonable to policyholders and not in the public interest. Among other things, the proposed conversion will very likely result in an increase in premium rates, rate review will be lost, and the proposed benefits of the conversion are not sufficient to balance these effects.

27. The record establishes that Premera will face pressure to increase premium rates because of various factors, including the increase in premium tax rate, the risk it will lose its 833(b) Deduction, and pressure from shareholders to increase profits. The Director further concludes that Premera has the ability to increase premiums above their current levels in response to this pressure. Any rate increases arising out of the conversion when coupled with expected rate increases to cover rising health care costs will have a significant adverse impact on the affordability of health insurance offered by Premera.

28. Premera currently has high market shares in all of the fully insured lines of business, has significant competitive advantages, and has demonstrated that it has been able to increase premium rates while remaining profitable. Moreover, policyholders may not necessarily switch easily to one of Premera's competitors in response to premium increases. For example, policyholders typically cannot switch between different lines of business (*i.e.*, from individual to large group), and some policyholders may have underwriting concerns that prevent them from switching within lines as well. Further, after the proposed conversion, Premera will

no longer be subject to rate review. Rate review has been useful in the past. For example, the Division required Premera to reduce rates in its small group line in 2003.

29. The analysis performed by Dr. McCarthy, Premera's economic consultant, does not compel a different conclusion because a typical antitrust analysis is of limited utility, as demonstrated by the fact that Dr. McCarthy testified that an insurer with 95 % market share in one line of business may not have "market power," as that term is defined for antitrust purposes. Regardless of how "market power" is defined for antitrust purposes, it defies logic to state that an insurer with a 95 market share in the individual market might not be able to increase premium rates in that market without a significant loss of membership. As a result, the Director finds the testimony of the Division's economic consultant regarding the ability of Premera to raise premium rates to be credible and to reflect the realities of the Alaskan health insurance market.

30. Even under a traditional antitrust analysis, Premera's focus on whether competitors can offer a supply response to price increases, rather than considering consumers, is misplaced. To the contrary, the antitrust laws have a "traditional concern for consumer welfare and price competition." *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 221 (1993). Moreover, under the *Horizontal Merger Guidelines* issued jointly by the Department of Justice and the Federal Trade Commission on April 2, 1992 (as amended April 8, 1997) (the "Merger Guidelines"), markets are defined by using hypothetical price increases to answer whether consumers would have alternatives in the face of those price increases. The key question is "market" definition, which "focuses solely on demand substitution factors." Merger Guidelines, at § 1.10. See also *Bailey v. Allgas*, 284 F.3d 1237, 1246 (11th Cir. 2002), citing *Brown Shoe v. United States*, 370 U.S. 294, 325 (1962) (stating that "[t]he outer boundaries of a product market are determined by the reasonable interchangeability of use or the cross-elasticity

of demand between the product itself and substitutes for it."). As discussed herein, the various lines of health insurance are not demand substitutes because, generally, subscribers cannot substitute one line for another (e.g., a large group employer cannot switch its policy over to small group coverage in response to premium rate increases and an individual generally cannot switch to group insurance in response to premium rate increases).

31. In addition, like the Division's economic consultant, available case law focuses on the fact-based realities of market entry analysis, rather than focusing solely on abstract principles of market entry. *See, e.g., Rebel Oil Co. v. Atlantic Richfield*, 51 F.3d 1421, 1440 (9th Cir. 1995), cert. denied, 516 U.S. 987 (1995) (even if entry has occurred, it does not preclude the existence of 'significant' entry barriers where a new entrant's output or capacity is insufficient to take significant business away from the predator such that new entrant is not likely to represent a challenge to the predator's market power). As a practical and legal matter, it does not matter whether new insurers are able to enter the Alaska health market if those new insurers are not able to take away any significant business from Premera.

32. The proposed conversion also is not reasonable and fair to policyholders or in the best interests of the public because the number of uninsureds in the State of Alaska will likely increase if Premera increases its premium rates, either because they are unable to obtain alternate coverage from a competitor because of underwriting issues or because alternative lines of coverage are simply not available. *Tr. 320:21-321:4 (Davis); 358:1-10 (McCarthy)*.

33. Although the Division's actuarial consultants did not state definitively that premium rates would increase, those consultants do not work for Premera, are not privy to Premera's internal plans, and cannot be expected to know with certainty what Premera intends to do. At a minimum, the evidence shows that Premera will pass through the premium tax increase

to its policyholders, as shown by the testimony of the consultants and Premera's withdrawn rate filing.

34. With respect to the economic assurances, Premera and the Division's consultants disagree on whether Premera should extend the economic impact assurances set forth in Exhibit E-8 of the Amended Form A and the guaranty that Premera will maintain its RBC level at 375 %. The Director concludes that extending the assurances is consistent with precedents in other BCBSA conversions and that doing so is necessary to protect policyholders.

35. In addition, Premera cannot offer any legal reason for deviating from the precedents. Premera's consultants note that there is no competitive reason for not extending the assurance that it will maintain its BCBSA Marks.

36. With respect to the assurance regarding rates, Premera concedes that the assurance is not a rate guarantee and does not prevent it from raising rates in response to external market factors such as medical cost trend, its largest cost component. Moreover, the assurance seeks simply to prevent Premera from passing on the expense of this conversion to their members, an expense which Premera acknowledges will be "gone" by the end of two years. If that is true, extending the assurance should not create a competitive disadvantage. Furthermore, Premera will also not be disadvantaged by extension of the rate review assurances, because it has been able to remain profitable while being subject to rate review. Finally, Premera offers no concrete reason why extending the assurance relating to maintaining products and the RBC guaranty will disadvantage it.

37. Although the Director concludes that fairness and reasonableness to policyholders (and the public interest) require extension of these assurances, she notes that the extensions merely delay the potential negative impacts of the proposed conversion.

38. To determine whether the proposed conversion as a whole is fair and reasonable to policyholders, the Director also considered whether the projected benefits of the proposed conversion might counterbalance any negative impact of the conversion to policyholders or the public. In other words, an increase in premium rates as a result of the proposed conversion by definition may not be unfair if the proposed conversion would result in some tangible benefits to policyholders and the public that would render the proposed conversion, on balance, reasonable and fair to policyholders and in the public interest.

39. However, the Director concludes that, as the proposed conversion is currently structured, Premera has not articulated any concrete benefit that its Alaska subscribers will receive as a result of the proposed conversion. The purported benefits of the proposed conversion cited by Premera are benefits or goals that (i) are not expected to benefit Alaskans directly (*e.g.*, membership growth is not expected to occur in Alaska); or (ii) Premera cannot clearly articulate (*i.e.*, Premera is unable to state what products it intends to offer). Given the regulatory scheme under which PBC has operated in this state, the benefit to subscribers should be economic and quantifiable.

40. Because the proposed conversion will very likely result in premium rate increases, because Premera will no longer be subject to rate review and because Premera has not articulated any concrete benefit to its Alaskan policyholders that might counterbalance the negative impacts of premium rate increases, the loss of regulatory review, and the expected increase in the number of uninsureds in Alaska, the Director concludes that the proposed conversion is unfair to policyholders and not in the public interest. The Director also concludes that these negative effects are not in the public interest because, given Premera's market shares

and longevity in the Alaska market, every Alaskan must be considered a potential Premera policyholder.

41. The Form D requests that the Director not disapprove certain interaffiliate agreements as required by AS § 21.22.085. These agreements are by and between New PBC-AK and the new for-profit Washington companies, New PBC and/or New PREMERA. The agreements will only be necessary if the conversion occurs. As a result, the Form D need not be reviewed unless the Amended Form A is approved.

42. Certain terms and conditions contained (or not contained) in the documents relating to the proposed conversion also render the proposed conversion unfair and unreasonable to policyholders and not in the public interest. For example, the two automatic three-month extensions that the Amended Form A provides to complete the IPO in the event of pending litigation are unfair and unreasonable because they infringe on the Director's right to control the Amended Form A review process and are inconsistent with precedent in other BCBSA conversions. The business and condition of the company could change within three (or six) months, yet there is no mechanism in the Amended Form A for the Director to examine the condition of the company during that period. If Premera needs an extension, it should request one from the Director and provide good cause as to why it should be granted.

43. In addition, the Director concludes that it would be unfair and unreasonable and not in the public interest to (i) condition the closing of the proposed conversion on the Alaska Health Foundation signing the Intellectual Property License Agreement; and (ii) including provisions in the Transfer, Grant and Loan Agreement that relate to the operations of the Foundations, including their use of the Common Stock Proceeds, grant making procedures, and reporting obligations.

44. The IPO monitoring process inherent in preparing the IPO procedures opinion will identify, among other things, the dilutive effect, if any, of the company's participation in the IPO. It will also discuss the marketing process, valuation, and other items. As a result, any approval of the Amended Form A will be conditioned upon receipt of an IPO procedures opinion from Signal Hill Capital Group.

45. Any approval of the proposed conversion will also be conditioned upon the receipt of bring down opinions from the Division's investment banking consultants, economic consultants, and actuarial consultants just prior to the IPO that state there have been no significant adverse changes in Premera's financial status, operations, or the ability to meet the assurances set forth at Exhibit E-8 of the Amended Form A or the Plan of Conversion.

46. Given Alaska's historic contributions and expected future contributions to Premera, during which time Premera has enjoyed the benefits of being a non-profit, including favorable tax reductions, the Director concludes that she cannot determine if the conversion is fair and in the public interest without knowing what percentage of the initial stock of New PREMERA will be allocated to Alaska. Indeed, if the states had not agreed to negotiate allocation and had simply accepted Premera's initial proposal in which Alaska was allocated 10%, Alaska would be receiving approximately \$60 million. Currently, taking the allocation ranges recommended by the OIC Staff and the Division's consultants, Alaska could be allocated anywhere from approximately \$90 million to approximately \$160.8 million. This significant range illustrates the importance of determining the allocation before approval, because each percentage point represents another \$6 to \$7 million to the foundation on an expected IPO value of \$600 million. However, the Director concludes that based on the evidence in the record an allocation in range of 24% to 28% would be fair and reasonable and in the public interest.

47. For the reasons set forth in Division Exhibits 74 and 75, the Director further concludes that the methodologies applied by the consultants by the OIC do not reflect the reality of how Premera's Alaska and Washington operations were run and will be run following the proposed conversion. They also do not accurately reflect the substantial contributions the Alaska operations made in helping to build Premera's assets over the years, including during the years in which the Washington operations were losing significant amounts of money. (See Jewell, Tr. 116:18-21, 129-130).

48. Because at this point Alaska could be receiving anywhere from the equivalent of approximately \$90 million to approximately \$160.8 million, the Director concludes that the determination of allocation must be made before she can conclude whether the proposed conversion is fair and in the public interest. Otherwise, she cannot ensure that Alaska receives an allocation that accurately reflects its contributions to Premera over the years and its expected future contributions.

49. Notwithstanding disapproval of the Amended Form A, the Director concludes that the conversion could be fair and reasonable to Premera's Alaska subscribers and the Foundations and in the public interest if certain conditions and amendments were made to the Amended Form A:

a. Premera must include all of the terms and provisions currently included in the Amended Form A, except those terms and provisions that are explicitly rejected or objected to in these findings of fact and conclusions of law (such as those terms and provisions that are the subject of the conditions set forth below).

b. Premera must include all of the terms and provisions offered by Premera in the following documents and sources, unless a specific term or provision is explicitly

rejected or objected to in these findings of fact and conclusions of law (such as those terms and provisions that are the subject of the conditions set forth below): (1) the Pre-Filed Testimony of Kent Marquardt, including those included in the attached "technical drafting corrections;" (2) Kent Marquardt's testimony during the Hearing; (3) Exhibit P41, the illustrative exhibit introduced at the Hearing; and (4) the corrections offered in Premera's Post-Hearing Brief in the Washington proceedings.

c. Premera must extend the economic impact assurances and the RBC guaranty as follows:

- i. the assurances relating to premium rates must be extended to three years, and the assurances related to rate review must be extended to five years.
- ii. the assurances relating to the availability of health care coverages, as set forth in section 2 (and its subsections) of Exhibit E-8 of the Amended Form A must be extended to three or more years; and
- iii. the RBC guaranty whereby New PREMERA agreed to fund maintain New PBC-AK's RBC level at 375 percent must be extended to five years.

d. Premera must amend the Form A and Plan of conversion to provide some economic benefit directly or indirectly to Alaskan subscribers.

e. Premera must make the following changes relating to restrictions on the Foundations:

- i) the two automatic three month extensions for the closing of the IPO must be deleted from the Plan of Conversion;
- ii) the VTA must include a provision similar to the one included in the WellChoice VTA (cited above), in which the VTA terminated upon loss of the BCBSA Marks provided that the company had no further appeal rights and the loss of the Marks was not due to any act or omission of the Alaska Health Foundation;
- iii) the Alaska Health Foundation must be permitted to control the price, underwriting discount, and commissions, as well as the size of the offering,

- whenever it initiates a Demand pursuant to the Registration Rights Agreement, even if New PREMERA decides to participate (*i.e.*, "tags-along");
- iv) New PREMERA's insider trading policy must either be amended to clearly state that the policy's blackout periods are inapplicable to a Demand registration, or the provisions of the VTA that subject the Alaska Health Foundation to New PREMERA's insider trading policy must be deleted in their entirety.
 - v) Premera must not be able to "veto" all of the nominees that the Alaska Health Foundation proposes as its Designated Member;
 - vi) Premera has testified that a "non-written public offering" refers to an "agency" underwriting. The Director notes, however, that in an agency underwriting situation, it should be the agency, not the company, who declares the need for a holdback. As a result, any approval of the proposed conversion would be conditioned upon the deletion of the language regarding a "non-underwritten offering pursuant to such Registration Statement" from the Registration Rights Agreement;
 - vii) the provision of the VTA that requires that all communication between the Designated Member and the Alaska Health Foundation follow New PREMERA's internal rules and procedures must be deleted (or filed for the Division's review); and
 - viii) the Division and Premera must agree upon language that would condition the closing of the Proposed Conversion upon the contemporaneous closing of the IPO.

f. Premera must obtain approval from the full Board of the BCBSA for all of the terms and provisions that the PPFSC agreed to recommend to the full Board, as well as the terms and provisions that Premera has stated it believes the BCBSA will accept. This condition includes, but is not limited to, Premera obtaining full BCBSA Board approval for: (i) each Foundation to have its own Designated Member; (ii) proportionate divestiture schedules with no cross default provisions; and (iii) removal of the first year divestiture deadline with the understanding that 20 percent of the issued and outstanding stock of New PREMERA will be

sold in the IPO. Premera must also include these provisions in its amendment to its Amended Form A.

g. Premera must delete the provisions of the Transfer, Grant and Loan Agreement that relate to the operations of the Foundations, including their use of the Common Stock Proceeds, grant making procedures, and reporting obligations.

h. The issue of allocation of the shares of New PREMERA stock between the Foundations must be satisfactorily resolved prior to any approval of the proposed conversion. The Director does not condition any approval of the proposed conversion on the Alaska Health Foundation being allocated a specific allocation amount, but does believe that the analyses conducted by the Division's consultants are fair and balanced and, therefore, believes that the midpoint of the ranges of the Division's consultants, or 26.8%, is reasonable.

i. Premera must guarantee that it will not include as a rating component any increase in its effective income tax rate that results from the loss of its 833(b) Deduction due to the proposed conversion and will not otherwise attempt to pass any such increase in its effective income tax rate onto its policyholders.

j. Premera must receive an IPO procedures opinion from Signal Hill Capital Group and bring-down opinions from Signal Hill Capital Group, Reden & Anders and Navigant Consulting. The Director notes that the bring down opinions should be provided by the existing consultants to avoid the additional "learning curve" expenses inherent on hiring new consultants for such an opinion. Although Premera and the Division continue to disagree about the information that Premera must deliver prior to issuance of the bring-down opinions under the Reportable Change provision of the Plan of Conversion, the Director concludes that these issues should be resolved at the time the bring-down opinions would be issued.

k. All documents relating to the Alaska Health Foundation must be governed by, and construed in accordance with, Alaska law, with venue for any disputes in the Superior Court in Anchorage, Alaska.

l. The Alaska Health Foundation should not be required to sign the Intellectual Property License Agreement and the condition to closing of the proposed conversion requiring the Alaska Health Foundation to sign that agreement must be deleted.

m. Premera must obtain approval of the Form D. That approval will be granted, if at all, after any approval of the Amended Form A.

ORDER

For the reasons set forth above, the Director hereby enters the foregoing Findings of Fact and Conclusions of Law disapproving Premera's Amended Form A in its present form as the Final Order in this matter.

Dated: July 25, 2004.



Linda S. Hall

Director of Insurance

I hereby certify that a copy of the document(s) listed below was distributed to the below-listed parties and files by mail, fax, and/or personal delivery.

Findings of Fact, Conclusions of Law, and Final Order, signed by the Director of Insurance on July 25, 2004, In the Matter of Premera Blue Cross Conversion, R 03-07.

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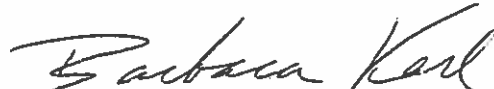
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Dated: July 25, 2004 in Anchorage, Alaska.



Barbara Karl

NOTICE OF FINAL ORDER AND APPEAL RIGHTS

The enclosed Findings of Fact, Conclusions of Law, and Final Order signed by the Director of Insurance is the final order in this action.

Pursuant to AS 21.06.210(e), 21.06.230, and Alaska Appellate Rule 602(a)(2), within 30 days you may either (1) request a rehearing or reargument of this final decision or (2) appeal this final decision.

AS 21.06.210(e) states in part:

Upon written request of a party to a hearing filed with the director within 30 days after an order made pursuant to a hearing has been mailed or delivered to the persons entitled to receive it, the director may grant a rehearing or reargument of the matters involved in the hearing. . . .

AS 21.06.230 states:

A person aggrieved by an order of the director may appeal the order to the superior court, using procedures provided by court rule.

Alaska Appellate Rule 602(a)(2) provides:

An appeal may be taken to the superior court from an administrative agency within 30 days from the date that the decision appealed from is mailed or otherwise distributed to the appellant. If a request for agency reconsideration is timely filed before the agency, the notice of appeal must be filed within 30 days after the date the agency's reconsideration decision is mailed or otherwise distributed to the appellant, or after the date the request for reconsideration is deemed denied under agency regulations, whichever is earlier. The 30-day period for taking an appeal does not begin to run until the agency has issued a decision that clearly states that it is a final decision and that the claimant has thirty days to appeal. An appeal that is taken from a final decision that does not include such a statement is not a premature appeal.

For other applicable rules of court, see Alaska Appellate Rules 601-611.