

BEFORE THE COMMISSIONER OF INSURANCE STATE OF KANSAS

IN THE MATTER OF THE CONVERSION AND ACQUISITION
OF BLUE CROSS AND BLUE SHIELD OF KANSAS, INC.

CASE NO. 3014-DM

TESTIMONIAL TEAM'S PRE-FILED BRIEF

TO THE HONORABLE KATHLEEN SEBELIUS, COMMISSIONER OF INSURANCE:

The Kansas Insurance Department (the "KID") respectfully submits this brief for purposes of conveying to the honorable Kathleen Sebelius, Commissioner of Insurance (the "Commissioner"), the results of the KID Testimonial Team's (the "Testimonial Team") evaluation of, and recommendations to the Commissioner regarding, the "Plan of Conversion of Blue Cross and Blue Shield of Kansas, Inc.," dated as of October 25, 2001 (the "Plan"), whereby Blue Cross and Blue Shield of Kansas, Inc., (the "Company" or "BCBSKS") would convert to a stock insurance company, contingent upon the acquisition of all of the Company's stock by Anthem Blue Cross and Blue Shield, or a subsidiary thereof ("Anthem" - together the conversion and acquisition are referred to herein as the "Proposed Transaction"). This brief considers in detail the Plan, Kansas law, and other applicable laws, including certain federal tax laws applicable to the Plan. Specifically, this brief is directed to those transactions or matters provided for or contemplated by the Plan which require approval by the Commissioner. References are made in this Brief to the pre-hearing testimony filed by the Company on December 17, 2001, and by the Testimonial Team on or about December 31, 2001, as well as to other documents related to the Plan. The pre-filed testimony of the Testimonial Team is summarized beginning at page 5.

TESTIMONIAL TEAM'S PRE-FILED BRIEF

TABLE OF CONTENTS

I.	EXECUTIVE SUMMARY	4
	A. ORGANIZATION OF THE TESTIMONIAL TEAM'S BRIEF	4
	B. SUMMARY OF REVIEW PROCESS	4
	C. SUMMARY OF TESTIMONY	5
	D. SUMMARY OF OBSERVATIONS AND CONCLUSIONS	13
	E. SUMMARY OF RECOMMENDATION	13
II.	BRIEF HISTORY OF THE COMPANIES	13
	A. BLUE CROSS AND BLUE SHIELD OF KANSAS	14
	B. ANTHEM BLUE CROSS AND BLUE SHIELD	15
III.	HISTORY OF THE CONVERSION PLAN	16
IV.	STATED PURPOSE OF THE PLAN	16
V.	SUMMARY OF THE PLAN	17
VI.	APPLICABLE LEGAL STANDARDS	19
	A. THE CONVERSION, OR DEMUTUALIZATION (I.E., THE CONVERSION OF BCBSKS FROM A MUTUAL LIFE INSURANCE COMPANY TO A STOCK INSURANCE COMPANY).	19
	B. THE ACQUISITION	20
VII.	THE TESTIMONIAL TEAM'S REVIEW	20
VIII.	CHANGES TO THE TRANSACTION RESULTING FROM THE TESTIMONIAL TEAM'S REVIEW	22
	A. CHANGES REGARDING DISCLOSURES	22
	B. CHANGES TO TERMS OF THE PLAN	22
IX.	THE TESTIMONIAL TEAM'S OBSERVATIONS AND CONCLUSIONS	28
	A. FAIRNESS OF THE AGGREGATE CONSIDERATION	28
	B. ALLOCATION OF CONSIDERATION	32
	C. ACCOUNTING, AUDITING, AND INFORMATION TECHNOLOGY ISSUES	32
	D. MARKET IMPACT	33
	E. TAX ISSUES	34
	F. LEGAL/REGULATORY ISSUES	34

X.	CONCLUSION AND RECOMMENDATIONS	35
A.	DETERMINATION OF FAIRNESS	35
B.	RECOMMENDATION OF APPROVAL CONDITIONS	38

I. EXECUTIVE SUMMARY

For the convenience of the Commissioner and the Hearing Officer Team, the Testimonial Team's brief is summarized in this section.

A. ORGANIZATION OF THE TESTIMONIAL TEAM'S BRIEF

The Testimonial Team's brief is organized so as to provide: 1) a brief history of Blue Cross and Anthem, 2) a brief history, discussion of the stated purpose, and summary of the Plan of Conversion, 3) a recitation of the applicable legal standards, 4) a description of the Testimonial Team's review of the Proposed Transaction and changes resulting from that review, and 5) a discussion of the Testimonial Team's findings and recommendations. More detail for many of these areas is found in the pre-filed testimony and documents of the parties. The Testimonial Team has sought to balance the value of brevity with the convenience of a consolidated presentation of the relevant issues.

B. SUMMARY OF REVIEW

Commencing in August, the Testimonial Team and its advisors have devoted themselves intensely first to the compilation of documentary and other information relevant to issues presented by the Proposed Transaction, second to discussion of resulting issues with BCBSKS, Anthem and the Intervenors, and finally to the formulation of findings, opinions, and recommendations presented in this brief and the Testimonial Team's pre-filed testimony and documents. In a process of this nature, there is never truly an end to the compilation of issues and information that might be analyzed by insurance regulators. The Testimonial Team has conducted its review in the context of the accelerated schedule governing this proceeding and with the goal of addressing all the material issues relevant to the statutory requirements applicable to the Proposed Transaction. It has not been possible to address all the issues of interest to all the parties who have expressed concerns and opinions about the conversion.

C. SUMMARY OF TESTIMONY

Filed contemporaneously with this brief is the testimony of six witnesses, which can be summarized as follows:

1. Kathy Greenlee

Kathy Greenlee, General Counsel to KID, led the Testimonial Team in its review and analysis of the Plan. Ms. Greenlee retained for the Testimonial Team, on behalf of KID, several accounting, actuarial, investment banking, legal, and tax consultants to assist in the evaluation the Plan. She also supervised and coordinated the work of the Testimonial Team's consultants since their engagement. The Testimonial Team's review and analysis of the Proposed Transaction have included extensive analyses of the voluminous information provided by BCBSKS and Anthem regarding the Plan. In addition, members of the Testimonial Team have engaged in numerous telephone conferences, meetings, and written correspondence with BCBSKS and Anthem representatives and consultants regarding the various elements of the Proposed Transaction. The work of the Testimonial Team was designed to reach a determination as to whether the Proposed Transaction would violate any of the statutory requirements to which it is subject under applicable provisions of the Kansas Insurance Code.

During the course, or as a result, of the work performed by the Testimonial Team in its review of the Proposed Transaction, changes were made to the Plan. Some changes made by BCBSKS and Anthem as a result of the Testimonial Team's comments were to the structuring of the Plan and its component parts, while other changes focused on improvements in the process of fully informing policyholders and other interested persons of the risks and consequences associated with the Plan. Most significantly, changes were made to the following components of the Plan's structure: (a) the composition and oversight of the Policyholder Committee; (b) the amount of the Purchase Price to be deposited in the Escrow Fund pending resolution of the Contingent Litigation Matter; (c) the amount of the Special Distribution to Eligible

Policyholders; and (d) the methodology for calculating the allocation of the Special Distribution and Purchase Price among individual policyholders.

Regarding the process by which policyholders and other interested persons were informed of the risks and consequences associated with the Plan, at the recommendation of the Testimonial Team, the Procedural Order entered by the Commissioner on August 21, 2001, provided that in addition to holding a formal hearing of the proposed transaction as required by K.S.A. §§ 40-4004 & 40-3304, the Commissioner would hold one or more public comment hearings at which any person might make oral or written statements or comments upon the Plan. Furthermore, the Testimonial Team made numerous comments pertaining to the various drafts of the Policyholder Information Statement and other disclosure documents, press releases, and other communications proposed by BCBSKS to be used in connection with their policyholder vote solicitations. Comments of the Testimonial Team prompted BCBSKS to change substantially the Policyholder Information Statement and other materials which now more completely describe the potential risks involved with the Plan.

As a result of its work, the Testimonial Team has concluded that the Plan complies with law and is both generally fair and equitable to policyholders and not contrary to the public interest. That conclusion, however, is subject to premium rate concerns articulated fully in a later section of this brief and in the *Assessment of Market Impact of the Anthem, Inc. Purchase of Blue Cross Blue Shield of Kansas* prepared by PricewaterhouseCoopers. The new stock insurer, after the change of control, would meet minimum requirements to be issued a Certificate of Authority by the Commissioner to transact business in this state, and to write the lines of insurance for which it is presently licensed, and the continued operations of the new stock insurer would not be hazardous or prejudicial to existing or future policyholders or the public. In addition, Anthem has represented that it has no present plans or proposals to liquidate BCBSKS, sell its assets (other than such sales of assets as may be contemplated in the ordinary course of

BCBSKS' business), or consolidate or merge it with any person, or to make any other material changes in its business or corporate structure or management. The Testimonial Team has no reason to believe otherwise.

Ms. Greenlee testifies that the Testimonial Team's conclusion is that given the state of the record as it currently exists, the exercise of the Commissioner's discretion could justify either approval of the Proposed Transaction or its rejection as unfair because of the additional rate increases. If the Commissioner determines that the Proposed Transaction should be approved, the Testimonial Team recommends that any approval be conditioned in several ways described at the end of this brief and in Ms. Greenlee's testimony.

2. David Platter

Mr. Platter led the Bear Stearns team which was asked to render an opinion as to whether the Aggregate Consideration to be received by Eligible Policyholders of BCBSKS in the Proposed Transaction is fair, from a financial point of view, to such policyholders, as a group (the "Opinion"). The review conducted by Bear Stearns for this purpose included analysis of voluminous financial and other information provided by Blue Cross and Anthem as well as extensive discussions with representatives of those companies and the Testimonial Team. In addition, Bear Stearns reviewed publicly available information about the health care and insurance industries. Bear Stearns determined that Eligible Policyholders will receive aggregate consideration consisting of: (1) a special distribution declared by the Board equal to the amount, if any, by which the consolidated closing book value of BCBSKS exceeds \$155,000,000, which BCBSKS currently estimates to be \$131,000,000 (the "Special Distribution") and (2) up to \$190,000,000 (the "Purchase Price"), \$142,000,000 of which will be paid to Eligible Policyholders upon consummation of the Sale and \$48,000,000 of which will be deposited into an escrow fund, subject to later distribution to Eligible Policyholders as more fully described in the Plan and Alliance Agreement. Bear Stearns has concluded that, as of December 14, 2001, the

Aggregate Consideration to be received by the Eligible Policyholders of BCBSKS in the Transaction is fair, from a financial point of view, to such policyholders, as a group. That opinion is based upon, and subject to, the assumptions and limitations explained more fully in Bear Stearns' written Opinion.

3. Ken Beck

Mr. Beck led the PricewaterhouseCoopers ("PwC") actuarial team that was asked to review the Plan and assess the merits and fairness of the proposed allocation among the individual Eligible Policyholders of the consideration to be paid to the policyholders as a group as a result of this transaction. Throughout the course of this review PwC, has requested numerous items of actuarial and financial information from BCBSKS and its affiliated companies and participated in meetings and telephone conferences with the other members of the Testimonial Team and BCBSKS representatives. PwC reviewed accounting and actuarial information relevant to the Plan prepared by BCBSKS and its advisors, participated in discussions with Milliman USA ("Milliman"), the actuarial advisor for BCBSKS, and assessed the merits and fairness of the proposed allocation of consideration among Eligible Policyholders. During the course of this work, the actuarial methodology employed by BCBSKS underwent numerous improvements resulting from PwC recommendations. Mr. Beck has concluded that, with respect to the aspects of the Plan that PwC has reviewed, the proposed allocation of consideration to be received by the Eligible Policyholders pursuant to the Plan will be fair to such policyholders, as required by Chapter 40 of the Kansas Statutes Annotated, if implemented in accordance with actuarial principles and formulas proposed by Blue Cross and approved by PwC.

4. Mark Kovey

Mr. Mark Kovey of Scribner, Hall & Thompson, LLP ("Scribner") presented pre-filed testimony addressing the Testimonial Team's tax review of the Plan. Among other things,

Scribner was asked to assist in the Testimonial Team's review by (1) evaluating and analyzing the information provided to the Testimonial Team and Scribner by BCBSKS and Anthem for appropriateness and credibility; (2) evaluating the consequences under federal income tax concepts and rules of the sponsored demutualization to BCBSKS and its policyholders; (3) evaluating the tax opinions and memorandum regarding the transaction submitted to the Testimonial Team by BCBSKS and Anthem; and (4) assisting the Testimonial Team in conducting tax due diligence on BCBSKS and Anthem.

Due to Scribner's tax review, BCBSKS has made several significant changes to the Plan. First, the transaction has been changed to require that BCBSKS must deposit into the Escrow Fund, and thereby make available for the benefit of Eligible Policyholders, the net after tax amount of all tax savings to BCBSKS from tax deductions for any interest added by BCBSKS to the payments to be received by the Eligible Policyholders under the Plan. Previously, BCBSKS was allowed to retain the full benefit of the tax deduction. Second, the review process that will be followed by the Policyholder Committee for items that will be paid from the Escrow Fund to BCBSKS for reimbursement of expenses, which expenses reduce the funds available to be paid to the Eligible Policyholders, has been improved by virtue of certain definitions added to the documents to clarify the tax treatment of the expenses and the reformation of the Policyholder Committee process. By virtue of such changes there likely will be far fewer disputes which should result in the payment of a larger amount to the Eligible Policyholders with fewer delays. Next, the portion of the Purchase Price that will be paid to the Eligible Policyholders, without being made subject to the risks of nonpayment and delays in payment that encumber amounts deposited in the Escrow Fund, has been increased in part because the Testimonial Team requested that BCBSKS and Anthem give consideration to alternative forms of payment to Eligible Policyholders that would not be taxable when received. Lastly, independent counsel for

BCBSKS provided the Testimonial Team a legal memorandum that supported the federal income tax law opinion issued to BCBSKS and was included in the Policyholder Information Statement.

Mr. Kovey testified that there do not appear to be any outstanding tax issues that raise a material concern as to the financial capacity of the parties to undertake the transactions and fulfill their obligations under the Plan. He also concluded that the tax related representations contained in the Policyholder Information Statement, which detail the expected tax consequences to Eligible Policyholders generally, are accurate and should provide the policyholders with sufficient information to make the necessary decisions or to consult with their tax advisors, as is recommended in the statement. Finally, he is satisfied that the memorandum prepared by Debevoise & Plimpton provides reasonable support for the legal opinion of the firm that is attached to the Policyholder Information Statement.

5. Denise Essenberg

The PwC team led by Ms. Essenberg was engaged by the Testimonial Team to review the accounting, auditing, and information technology aspects of the proposed reorganization of BCBSKS. In particular, they were asked to review and advise (1) whether the financial condition of Anthem is such as might jeopardize the financial stability of BCBSKS or prejudice the interest of its policyholders; (2) whether the competence and experience 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 acquisition of control; (3) as to the accuracy and completeness of financial information contained in the Policyholder Information Statement (“PIS”); (4) evaluate whether executive compensation matters comply with applicable statutory requirements; (5) whether voting and tabulation procedures were fair and equitable to policyholders; and (6) a host of other accounting and related issues. Based on this review, PwC has not encountered any matters or issues that have not been resolved to the satisfaction of the Testimonial Team. It is anticipated that, if the Proposed Transaction is approved, the work of

PwC will continue after the Evidentiary Hearing to assure continued compliance with statutory requirements and any conditions contained in the Commissioner's order approving the Plan.

6. Sandra Hunt

PwC was engaged by the Testimonial Team to assess the potential market impact of the purchase of BCBSKS by Anthem. The market impact analysis was structured to address questions related to potential changes in insurance coverage in Kansas resulting from the transaction. In particular, PwC examined issues and assessed their likely impact as a result of the proposed transaction relating to 1) choices, availability, and cost of insurance coverage; 2) provider contracting arrangements; 3) administrative process; 4) employment levels in Kansas; and 5) factors likely affecting Anthem's general performance. The PwC market impact team, consisting of Jean Wodarczyk and Sandra Hunt, examined issues related to the current circumstances in Kansas and the practices of Anthem in other states where it has purchased other Blue Cross plans. Economic conditions in Kansas and other states in which Anthem operates were examined to discern possible differences in performance. Current changes in the health care and health insurance markets were assessed in connection with potential changes, both with and without a transfer of ownership of BCBSKS.

Based on this review, PwC reached the following conclusions. 1) It is likely that insurance coverage would remain available at current levels, but that premium rates would increase by 6% to 7% above the levels that might be expected in the absence of the Anthem acquisition, with broad variation by market segment. Alternatively, benefits designs would change, or fewer people would purchase insurance. 2) PwC's review of Anthem's contracting practices showed only modest differences from the approach taken by BCBSKS. 3) Complaint ratios against Anthem plans are generally below those of other plans operating in the same states relative to market share. 4) From the data available, it would appear there is little reason to believe jobs would be moved from Kansas to other locations, although improvements in

productivity hold the potential for reducing the number of employees. 5) Anthem would hold a dominant market share in Kansas if the Proposed Transaction were consummated. As the dominant insurance plan in most of the other states in which it operates, Anthem is often able to affect common provider contracting arrangements and service delivery. Anthem intends to continue to expand its operations over the next several years, and that goal has the potential to affect all aspects of Anthem's operations.

D. SUMMARY OF OBSERVATIONS AND CONCLUSIONS

The Testimonial Team has concluded that the Proposed Transaction is likely to result in increases in BCBSKS' premium rates, above those that would occur in the absence of the Proposed Transaction ("additional rate increases"). These additional rate increases are likely to be of sufficient magnitude to justify a finding that they outweigh any benefits expected from the Plan. In the absence of adequate evidence to the contrary presented at the Evidentiary Hearing, the Commissioner would therefore be justified in concluding that, on that basis, the Plan will not be fair and equitable to policyholders and instead may be hazardous or prejudicial to the insurance-buying public. Aside from the issue of additional rate increases, it appears that the proposed conversion and acquisition satisfy the applicable statutory requirements.

E. SUMMARY OF RECOMMENDATION

The Testimonial Team recommends that the Commissioner evaluate carefully the evidence adduced before and at the Evidentiary Hearing to ascertain whether the anticipated benefits of the Proposed Transaction outweigh the anticipated additional rate increases. If the Commissioner concludes that the conversion and the acquisition should be approved, the Testimonial Team recommends that the approval be conditioned on certain matters described more fully beginning at page 38, below.

II. BRIEF HISTORY OF THE COMPANIES

Over their approximately 60 year histories, BCBSKS and Anthem have each gone through several permutations of form and name, which are here reviewed briefly.

A. BLUE CROSS AND BLUE SHIELD OF KANSAS

The Company was originally formed in Kansas in 1941 under the name Kansas Hospital Service Association, a not-for-profit corporation with the purpose of entering into contracts with hospitals to provide services to subscribers. In 1945, Kansas Physician's Service was formed as a not-for-profit corporation for the purpose of entering into contracts with physicians to provide services to subscribers. During the 1950s, Kansas Hospital Service Association changed its name to Blue Cross of Kansas, and Kansas Physicians Service changed its name to Blue Shield of Kansas. In 1983, Blue Cross of Kansas and Blue Shield of Kansas consolidated into one corporation, Blue Cross and Blue Shield of Kansas. In 1992, BCBSKS became a mutual life insurance company through legislation enacted by the Kansas Legislature. In 1997, BCBSKS filed a lawsuit against the Kansas Attorney General, seeking a declaration that BCBSKS had no charitable obligation. In 2000, BCBSKS and the Kansas Attorney General arrived at a settlement to the litigation, whereby BCBSKS paid \$75 million to fund the Sunflower Foundation, a new Kansas charitable health foundation, thereby fulfilling any BCBSKS charitable obligations.

BCBSKS is currently the largest health insurer in Kansas, providing or administering private health coverage for 715,000 Kansas residents in all Kansas counties except Johnson and Wyandotte. BCBSKS administers Medicare and Medicaid health care coverage for an additional 640,000 Kansans, some of whom also carry BCBSKS's Medicare Supplemental coverage. In 2000, BCBSKS had premiums of \$873.0 million, statutory surplus of \$328.5 million, net income of \$5.8 million, and assets of \$730.8 million. For the six months ended June 30, 2001, BCBSKS

had premiums of \$484.1 million, statutory surplus of \$310.4 million, net loss of \$14.4 million, and assets of \$698.1 million.

B. ANTHEM BLUE CROSS AND BLUE SHIELD

Anthem Blue Cross and Blue Shield was originally formed in Indiana in 1944 under the name of Mutual Hospital Insurance, Inc., d/b/a Blue Cross of Indiana. In 1946, Mutual Medical Insurance, Inc., d/b/a Blue Shield of Indiana, was incorporated as an Indiana mutual insurance company. In 1985, the two companies merged under the name Associated Insurance Companies, Inc., d/b/a Blue Cross and Blue Shield of Indiana. In 1993, Southeastern Mutual Insurance Company, a Kentucky-domiciled mutual insurance company, d/b/a Blue Cross and Blue Shield of Kentucky, was merged into the company. In 1995, Community Mutual Insurance Company, an Ohio-domiciled mutual insurance company, d/b/a Community Mutual Blue Cross and Blue Shield, was merged into the company. In 1996, the company changed its name to Anthem Insurance Companies, Inc., d/b/a Anthem Blue Cross and Blue Shield. In 1997, Blue Cross and Blue Shield of Connecticut, Inc., a Connecticut-domiciled mutual insurance company, was merged into Anthem. In 1999, Anthem purchased New Hampshire-Vermont Health Service, d/b/a Blue Cross and Blue Shield of New Hampshire. In the same year, Anthem purchased Rocky Mountain Hospital and Medical Service, d/b/a Blue Cross and Blue Shield of Colorado and Nevada. In 2000, Anthem purchased Associated Hospital Service of Maine, d/b/a Blue Cross and Blue Shield of Maine. In 2001, Anthem converted from an Indiana-domiciled mutual insurance company to an Indiana-domiciled stock insurance company and became a wholly-owned subsidiary of Anthem, Inc., a new Indiana stock corporation and public company created for the purpose of being the public holding company for the Anthem family of companies.

Anthem is currently one of the nation's largest health benefits companies, serving over seven million members, or customers, primarily in Indiana, Kentucky, Ohio, Connecticut, New Hampshire, Maine, Colorado, and Nevada, in which states Anthem owns the exclusive right to

market its products and services using the Blue Cross and Blue Shield names and marks. In 2000, Anthem had revenues of \$8.7 billion, surplus of more than \$1.9 billion, net income of \$226.0 million, and assets of \$5.7 billion. For the six months ended June 30, 2001, Anthem had revenues of \$5.1 billion, surplus of more than \$2.0 billion, net income of \$143.0 million and assets of \$5.8 billion.

III. HISTORY OF THE CONVERSION PLAN

BCBSKS began pursuing a strategic partnership with interested parties in the third quarter of 2000. After evaluating several possible alliances, the BCBSKS Board of Directors (the “Board”) approved the proposed definitive agreement with Anthem (the “Alliance Agreement”). The Alliance Agreement was executed on May 30, 2001, and amended on September 28, 2001, to extend, from September 30, 2001, to November 30, 2001, the date by which the Plan was required to be adopted by the Board. The Board adopted the Plan on October 25, 2001, and formally submitted it to the KID on October 26, 2001, for approval. Informal discussions regarding the proposed transaction had been ongoing between the KID and BCBSKS since the Summer of 2001.

The Alliance Agreement was further amended on November 9, 2001, to reflect changes or modifications in at least three areas: (a) the amount of the Purchase Price to be deposited into escrow; (b) the appointment procedures for the Policyholder Committee; and (c) tax matters related to the escrow account and the Contingent Litigation Matter (“CLM”).

IV. ISTATED PURPOSE OF THE PLAN

The Plan provides for the conversion of BCBSKS to a stock insurance company under Article 40 of the Kansas Statutes Annotated and the simultaneous sale of all outstanding shares to Anthem pursuant to Article 33 of the Kansas Statutes Annotated. BCBSKS has indicated that the reasons underlying the Plan are certain limitations placed upon the Company by its current structure, including the inability to expand geographically in order to spread costs and risks over

a sufficiently large policyholder base, and increased competition in the Kansas market from national corporations. BCBSKS has represented that its Board believed that by converting to a stock insurance company and becoming part of a substantially larger, multi-state insurer, BCBSKS would be able to benefit its policyholders in several ways, including:

- Providing the Company with sufficient capital to compete with national commercial companies, and access to a larger total capital pool with which to acquire other health plans or related businesses;
- Enabling the Company to take advantage of economies of scale by eliminating duplicative resources and streamlining regulatory compliance efforts;
- Allowing the Company to become part of Anthem’s diversified geographical base, which would give BCBSKS:
 - increased flexibility in responding to localized adverse risk events; and
 - better positioning to offer insurance for multi-state accounts.
- Enabling BCBSKS to offer a greater variety of career paths to its employees, in turn permitting BCBSKS to continue to attract and retain the kinds of employees needed to provide quality services to policyholders;
- Allowing BCBSKS to take advantage of best practices in health insurance from Anthem and its other health insurance affiliates; and
- Enabling the Company to pay cash consideration to Eligible Policyholders in exchange for their otherwise illiquid membership interests in the Company, in its current status as a mutual insurance company.

See Policyholder Information Statement at 18.

V. SUMMARY OF THE PLAN

Pursuant to the Plan, BCBSKS would convert from a mutual insurance company to a stock insurance company contingent upon Anthem’s purchase of all of BCBSKS’ outstanding stock. BCBSKS would distribute, as the Special Distribution, the amount by which the Closing

Book Value exceeds \$155 million, plus \$142 million of the Anthem Purchase Price, to Eligible Policyholders as soon as reasonably practicable after resolution of the Final Closing Balance Sheet. The Plan provides that Anthem would cause BCBSKS to deposit \$48 million in escrow for the payment of all CLM costs, certain tax matters (see §2.08(c)(iv) of the Alliance Agreement), and such other amounts as may be specified in the Escrow Agreement and the Alliance Agreement.

The CLM entails contingent litigation related to a subpoena dated February 28, 2001, that the Company received from the Office of the Inspector General, U.S. Department of Health and Human Services pursuant to 5 USC App. 3 Section 6(a)(4). The subpoena seeks documents related to an investigation of possible improper BCBSKS claims against Medicare. BCBSKS' financial advisors determined that because of the inherent uncertainty of the CLM, prospective purchasers of the Company would likely have assumed the "worst case" scenario, resulting in an artificially low Purchase Price for the Company, or the unwillingness of some prospective purchasers to offer to purchase BCBSKS at any price. Use of an escrow fund also was intended to permit the proposed transaction to be pursued without the need to wait until final resolution of the CLM, which may take several years. Pursuant to the original Alliance Agreement, the entire Initial Purchase Price was to have been placed in an escrow fund, pending final resolution of the CLM. Pursuant to November 9, 2001 amendments to the Alliance Agreement, the amount to be held in escrow would be reduced to \$48 million of the total \$190 million Purchase Price. The \$48 million in escrow would be used to pay all costs, expenses, and liabilities related to the CLM, to pay related taxes which might become payable, and to pay all costs and expenses (including taxes) of the escrow. All remaining escrow amounts would be distributed to Eligible Policyholders following final resolution of the CLM. A Policyholder Committee, consisting of five members appointed by the Commissioner (required by the Alliance Agreement to be acceptable to Anthem), would oversee the conduct of the CLM and the operation of the Escrow

Fund. If, after final resolution of the CLM, the costs of distribution in relation to the amounts to be distributed would make the distribution of any remaining escrow funds impracticable, the remaining funds would be distributed to a charitable foundation selected by the Policyholder Committee.

If the Plan is approved by the Eligible Policyholders and by the Commissioner, closing would take place on the earliest practicable date after the parties have satisfied or waived the conditions set forth in the Plan and the Alliance Agreement, but no later than September 30, 2002.

VI. APPLICABLE LEGAL STANDARDS

Each of the two steps of the Plan, the conversion and the acquisition, is governed by a separate set of statutes, as described below.

A. THE CONVERSION, OR DEMUTUALIZATION

The proposed conversion of BCBSKS from a mutual life insurance company to a stock insurance company is governed by Article 40 of the Kansas Statutes Annotated (“Conversion Statute”). Under K.S.A. § 40-4004(a), the Commissioner shall approve the conversion if she finds that:

1. The plan of conversion is fair and equitable to policyholders;
2. the plan of conversion complies with the provisions of the conversion statute;
3. the plan of conversion does not unjustly enrich any director, officer, agent or employee of BCBSKS; and
4. the new stock insurer would meet the minimum requirements to be issued a Certificate of Authority by the Commissioner to transact business in this state and the continued operations of the new stock insurer would not be hazardous to existing or future policyholders or the public.

B. THE ACQUISITION

The proposed acquisition by Anthem of all of BCBSKS' outstanding stock is governed by Article 33 of the Kansas Statutes Annotated ("Acquisition Statute"). Under K.S.A. § 40-3304(d)(1), the Commissioner shall approve the acquisition by Anthem unless she finds that

1. After the change of control BCBSKS would not be able to satisfy the requirements for the issuance of a license to write the lines of insurance for which it is presently licensed;
 2. Anthem's financial condition is such as might jeopardize the financial stability of BCBSKS or prejudice the interest of its policyholders;
 3. Anthem's plans or proposals to liquidate BCBSKS, sell its assets or consolidate or merge it with any person, or to make any other material changes in its business or corporate structure or management, are unfair and unreasonable to BCBSKS' policyholders and not in the public interest;
1. the competence, experience and integrity of those persons who would control the operation of BCBSKS are such that it would not be in the interest of BCBSKS' policyholders and of the public to permit the merger or other acquisition of control; or
 1. the acquisition is likely to be hazardous or prejudicial to the insurance-buying public.

VII. THE TESTIMONIAL TEAM'S REVIEW

The Plan is lengthy and complex, and the review by the Testimonial Team has required the expertise of many persons with specialization in the diverse fields of law, accounting, actuarial science, insurance regulation, information systems, tax, investment banking, and the health care market. To review the Plan, the KID assembled the Testimonial Team under the leadership of Kathy Greenlee, KID General Counsel. The Testimonial Team is comprised of firms and individuals possessing the necessary experience to review the complex matters

connected with the Plan, and to engage in the continuing dialogue and written communications vital to a thorough review and report to the Commissioner.

The Testimonial Team has conducted what it believes to have been an extensive review of the Plan. The Testimonial Team engaged representatives from both BCBSKS and Anthem in constructive meetings, telephone conferences, and correspondence regarding the various drafts submitted by BCBSKS in connection with the Plan. In addition to reviewing the Plan itself and exhibits thereto, the Testimonial Team has reviewed other categories of information, including but not limited to the following:

1. Applicable laws
2. The Policyholder Information Statement, other proxy materials, and other forms of communications made to policyholders (*i.e.*, phone scripts)
3. Financial data of both BCBSKS and Anthem
4. Anthem's Form A filing
5. Plan documents from other transactions comparable to the proposed transaction
6. Documentation regarding Anthem's operations in other states
7. Documentation regarding the health care and insurance markets in Kansas and throughout the Nation.

VII. CHANGES TO THE TRANSACTION RESULTING FROM THE TESTIMONIAL TEAM'S REVIEW

Prior to BCBSKS's formal submission of the Plan, the KID was provided with draft versions of Plan documents for comment. Many of the Testimonial Team's preliminary comments were taken into account by BCBSKS in modifying the draft Plan prior to formal submission of the Plan to the KID on October 26, 2001. In addition, Testimonial Team comments to the Plan, as filed on October 26, 2001, resulted in certain amendments to the Plan

TESTIMONIAL TEAM'S PRE-FILED BRIEF

on November 9, 2001. The following is a brief summary of certain material changes to the Plan made by BCBSKS and Anthem as the result of the Testimonial Team's review and comments.

A. CHANGES REGARDING DISCLOSURES

At the behest of the Testimonial Team, a number of improvements were made to the public disclosure process. The draft Policyholder Information Statement, after review and comment by the Testimonial Team, was amended in a number of respects. Perhaps the most important revision was to disclose as an additional risk factor that the Plan, if approved, could result in future premium increases and/or other changes intended to increase profitability (see page 12 of the Policyholder Information Statement). In addition, the Policyholder Information Statement was amended to provide enhanced disclosures of the tax treatment, for policyholders, of the Special Distribution and distribution of the Purchase Price (see pages 32-34 of the Policyholder Information Statement).

C. CHANGES TO TERMS OF THE PLAN

1. Policyholder Committee

Originally, the Plan provided that the Policyholder Committee, which is to oversee the Escrow Fund and the conduct of the CLM, was to be appointed by BCBSKS' Board and was to be comprised of five individuals who were members of the Board immediately prior to the Closing Date and who were acceptable to Anthem. At the urging of the Testimonial Team, BCBSKS amended the Plan to provide that the Policyholder Committee would be appointed by the Commissioner and be comprised of five members, all of whom shall be insureds of BCBSKS, provided that at least two of the initial members of the Policyholder Committee would be selected from a slate recommended by the Board prior to the Closing Date. In addition, as requested by the Testimonial Team, the Plan was amended to strengthen the Commissioner's oversight over the Policyholder Committee and to empower the Policyholder Committee to select its own accountants and other advisors. Despite objection by the Testimonial Team, the

parties have retained in their agreement the requirement that the Commissioner's appointments to the Policyholder Committee be acceptable to Anthem. As will be seen, the Testimonial Team recommends deletion of that requirement before approval of the Plan of Conversion.

2. Distribution of Consideration to Eligible Policyholders

At the urging of the Testimonial Team, the portion of the \$190 million Purchase Price to be placed in escrow pending final resolution of the CLM was reduced from the entire \$190 million to \$48 million, enabling \$142 million of the Purchase Price to be distributed to Eligible Policyholders, together with the Special Distribution, as soon as reasonably practicable after resolution of the Final Closing Balance Sheet. In addition, the Plan was amended to insure that the Special Distribution would consist of the entire amount by which the Closing Book Value exceeds \$155 million. As originally proposed, the Special Distribution would have consisted of some lesser portion of that amount determined by BCBSKS' Board, with a later distribution to Eligible Policyholders of a deferred Additional Purchase Price equal to 30% of the Closing Book Value in excess of \$155 million after payment of the Special Distribution.

3. Enhancements To The Methodology For Calculating The Allocation of the Special Distribution and Purchase Price Among Individual Policyholders.¹

As a result of the review and comment of the Testimonial Team's actuarial consultant, PwC, BCBSKS reassessed elements of the Plan and the resulting proposed allocation of consideration among Eligible Policyholders in numerous respects, including those described below:

- a. During the course of PwC's actuarial review, it was recognized that the initial net statutory surplus as of 7/1/92 ("net" of the settlement of the Charitable Asset litigation) is not readily attributable to the current policyholders and, in fact, arose primarily from surplus earned at an earlier time and investment return on that surplus over many years. As a result, the allocation

¹See pre-filed testimony of Kenneth M. Beck.

among policyholders of the initial net statutory surplus is no longer a component of the calculation of actuarial contributions (“AC”);

- b. The following changes were made to the AC models of BCBSKS for merit-based (*i.e.*, experience-rated) group cases, which resulted in allocation of relatively smaller distributions to those cases which did not meet targeted/pricing profit margins compared to those cases which did meet targeted profit margins:
 - (1) Historical AC methodology has been revised to reflect three components:
 - (a) The “normal level” of profits attributable to profits meeting pricing targets, with excess profits above targets booked as statutory liabilities through the experience refund reserves (this component is calculated on a “socialized” basis across all merit-rated cases); plus
 - (b) An “extra contribution” to surplus (whether positive or negative) beyond the “normal level” of profit, measured as the change in any negative experience refund reserve during that year (this is calculated on a case-by-case basis); minus
 - (c) Historical write-offs of negative experience refund balances (also calculated on a case-by-case basis);
 - (2) Prospective AC methodology has been revised to reflect the expected recovery of negative experience refund balances outstanding as of 12/31/00.
- c. Profits earned on “side funds” (or, bank accounts) held by BCBSKS on behalf of two merit policyholders had been ignored in the historical AC model developed by BCBSKS. PwC believed that this was neither fair nor equitable to these two policyholders since BCBSKS earned profits on the spread between the investment income rates earned on the assets backing these side funds and the interest rates credited to the policyholder balances in these side funds. The profits earned on these side funds will be recognized as an additional source of AC in the final version of the historical AC model.

- d. PwC’s review of the actuarial projections underlying the development of AC-factors for the Long Term Care product line uncovered three methodological errors, which have been corrected by BCBSKS:
 - (1) The calculation of Federal Income Tax did not account for differences between tax-basis reserves and statutory reserves;
 - (2) The discount rate used in the calculation of the present value of projected profits was a pre-tax rate rather than an after-tax rate; and
 - (3) The impact of the 50% coinsurance agreement with MedAmerica was not properly reflected.
- e. The prospective AC projections for the Small Group Rate Reform product line have been revised to eliminate assumed premium rate increases which were deemed to be overly aggressive. This will result in a more appropriate allocation of prospective ACs to all product lines.
- f. The underwriting gains inherent in the prospective AC calculations were discovered by PwC to be inconsistent with management’s prospective view for BCBSKS (as portrayed in their “Management/Board Financial Projections”). As a result, the prospective AC calculations were revised to be consistent with the Management Projections.²
- g. Other changes to the historical AC model that affect all product lines:
 - (1) Impact of reinsurance ceded – PwC determined and reported that this item had not been handled properly. It has been corrected by BCBSKS.
 - (2) Derivation of historical net investment earnings rates has been revised:

²See also pre-filed testimony of Sandra S. Hunt.

- (a) Changes in unrealized capital gains/losses had been excluded, and have now been added to the calculation of historical rates.
 - (b) The asset base used in the calculation of historical net investment earnings rates has been re-defined to more properly reflect invested assets.
 - (c) Various technical corrections have been made to bring data inputs in line with data sources.
- (3) Allocation of Federal Income Taxes to member lines of business will be revised because PwC discovered that the current allocation is too high due to:
 - (a) Proper amount of tax not being allocated to non-member lines of business;
 - (b) Statutory-to-tax differences not being reflected properly; and
 - (c) Tax not being allocated to actual-versus-modeled differences.
- (4) Various technical corrections were made to the model as a result of errors identified by PwC.
- h. Other changes to the prospective AC model that affect all product lines:
 - (1) PwC discovered that no recognition had been made in the calculation of prospective net investment income for the time lag between the incurral/reporting of claims and the actual payment of claims. This item has now been incorporated into the prospective model.
 - (2) PwC also discovered that the prospective model did not reflect investment income earned on assets backing experience refund reserves. This item has now been incorporated into the prospective model.
 - (3) A correction has been made to the derivation of the assumed prospective net investment income rate.

- (4) Various technical corrections were made to the model as a result of errors identified by PwC.

4. Tax Treatments³

Review and comment by the Testimonial Team's tax consultant, Scribner, resulted in refinements in certain of the Plan's tax treatments, including:

- a. The transaction has been changed to require that BCBSKS must deposit into the Escrow Fund, and thereby make available for the benefit of Eligible Policyholders, the net after tax amount of all tax savings to BCBSKS from tax deductions for any interest added by BCBSKS to the payments to be received by the Eligible Policyholders under the Plan;
- b. The review process that will be followed by the Policyholder Committee for items that will be paid from the Escrow Fund to BCBSKS for reimbursement of expenses, which expenses reduce the funds available to be paid to the Eligible Policyholders, has been improved by virtue of certain definitions added to the documents to clarify the tax treatment of the expenses and the reformation of the Policyholder Committee process;
- c. The portion of the Purchase Price that will be paid to the Eligible Policyholders, without being made subject to the risks of nonpayment and delays in payment that encumber amounts deposited in the Escrow Fund, has been increased (to more than twice the amount proposed originally) in part because the Testimonial Team requested that consideration be given by the parties to alternative forms of payment to Eligible Policyholders that would not be taxable when received; and
- d. Independent counsel for BCBSKS provided to the Testimonial Team a legal memorandum that supported the federal income tax law opinion issued to BCBSKS and included in the Policyholder Information Statement.

³See pre-filed testimony of Mark H. Kovey.

VIII. THE TESTIMONIAL TEAM'S OBSERVATIONS AND CONCLUSIONS

The Testimonial Team's observations and conclusions may be subdivided into the following categories: (1) fairness, from a financial point of view, of the aggregate consideration to Eligible Policyholders as a group; (2) merits and fairness of the proposed allocation of the aggregate consideration; (3) accounting, auditing, and information technology aspects of the Plan; (4) tax aspects of the Plan; (5) market impact; and (6) legal/regulatory, including whether the Plan is, overall and in every material respect, fair and equitable to policyholders and complies with all other statutory requirements. In its review of the Plan and formulation of its observations, conclusions, and recommendations, the Testimonial Team has relied upon the representations made by BCBSKS, Anthem, and their agents.

A. FAIRNESS OF THE AGGREGATE CONSIDERATION

The consideration that will be paid to Eligible Policyholders has two components, a portion of the Purchase Price to be paid by Anthem for the acquisition of BCBSKS, and a partial distribution of BCBSKS' current surplus. The applicable legal requirement is that the amount of consideration provided by BCBSKS to Eligible Policyholders be at least the amount of statutory surplus attributable to contributions of policyholders. See K.S.A. § 40-4004(b). Information provided by the parties indicates that this condition will be satisfied. The aggregate consideration paid to Eligible Policyholders is expected to be at least approximately \$273 million, substantially more than the expected surplus of \$235 million as of the Effective Date. However, the evaluation of the reasonableness of the Anthem Purchase Price may be relevant to the Commissioner for other reasons as well.

Anthem has agreed to pay \$190 million for BCBSKS if it receives \$155 million in surplus as part of the sale. This represents a nominal Purchase Price of \$190 million and a "premium" of \$35 million. The full \$190 million can be considered the Purchase Price because that amount will be added to policyholder consideration and therefore invested in BCBSKS'

purchase by Anthem. From Anthem's perspective, that full amount will become unavailable for other investments. The \$155 million it would receive in surplus as part of the proposed transaction, as is true of all of BCBSKS's assets, can only be invested in compliance with applicable insurance laws. In essence the reasonableness of the transaction for Anthem depends on evaluation of the return it can realize from investing the \$190 million Purchase Price in BCBSKS compared to other possible investments Anthem might make. Other such investments include not just other acquisitions but also the stock and bond markets. It is widely recognized that sophisticated investors, such as Anthem, expect to be compensated for investment risk. Thus, if the BCBSKS acquisition presents materially greater risks than do the stock and bond markets, Anthem will reasonably expect greater profits, or returns on its investment.

The determination of fair market value for an enterprise such as BCBSKS is a complicated process in which judgment often plays a significant role. Nonetheless, among investment bankers and financial advisors, there have evolved a number of accepted principles and practices. Valuation of an enterprise such as BCBSKS is often performed through a combination of accepted methodologies. In this case, Blue Cross' investment bankers, Dresdner Kleinwort Wasserstein ("DKW") relied on comparable company analysis, comparable transaction analysis and discounted cash flow. An important principle common to these methodologies is that the future income earning potential of the enterprise is a key factor in determining its fair market value. It is important in selecting companies and transactions against which BCBSKS and this Proposed Transaction should reasonably be compared. It is also a key component of the discounted cash flow calculations. This makes common sense, after all, since investors buy companies in the hope and expectation of realizing a return on their investment, which will be the result of the company's future profitability. There are a number of accepted

analytical tools utilized in evaluating a company's reasonably predictable future income. Past performance is at times, but not always, an important indicator of that future. Other factors, such as market prospects and operating profitability, can also be important factors in determining an insurer's likely future income and its value.

It is helpful to understand the two major components of an insurer's net income; profits from investment of its assets and underwriting gains from insurance operations. The Testimonial Team assumes that Anthem can realize essentially the same range of investment incomes from the funds constituting its Purchase Price as can BCBSKS itself. Certainly the parties have not presented any information to the contrary. Put simply, to realize only investment income, Anthem could invest its Purchase Price in the stock and bond markets at lower risk, and without the considerable transaction costs and complication of the acquisition. Moreover, once invested in BCBSKS, its Purchase Price would remain dedicated to that use, and Anthem could not reinvest it in other endeavors in response to changing market conditions. Therefore, to justify the additional risk, costs and restrictions, Anthem will expect also to realize material underwriting gains.

As a nonprofit, and later a mutual company, BCBSKS has accumulated a substantial amount of "excess" surplus. Because it did not pay dividends to policyholders and had no shareholders, it had no need to generate net income for investor distributions. It therefore has not had a need to realize the level of profits from insurance operations (*i.e.*, underwriting gains) that might have been necessary in a for-profit company. Indeed, in recent years, BCBSKS has realized little or no underwriting gains. In assessing the company's value, DKW has projected its future underwriting gains at zero or nearly zero, and has suggested that the Testimonial Team

do the same. DKW argues that BCBSKS has not demonstrated an ability to perform more profitably. Bear Stearns, the Testimonial Team's financial advisor, has adopted BCBSKS' requested underwriting gains assumption in its fairness evaluation. That assumption is that BCBSKS will not realize more than .04% in underwriting gains. In a sense, therefore, the Purchase Price and aggregate consideration to be received by Eligible Policyholders are based on the assumption that the Company will not produce greater underwriting gains after the conversion than it has historically. This point is relevant to the fairness issue described below at page 35.

Based upon the analysis performed by, and in the opinion of, Bear Stearns as of December 14, 2001, the aggregate consideration to be received by the Eligible Policyholders of BCBSKS pursuant to the Plan is fair, from a financial point of view, to such policyholders as a group. Bear Stearns' opinion is based upon, and subject to, the assumptions and limitations explained more fully in Bear Stearns' written Opinion. Bear Stearns does not express any opinion regarding whether the amount of aggregate consideration to be provided to Eligible Policyholders is "fair and equitable" as such terms are used in Kansas Insurance Code Section 40-4004 (b).

B. ALLOCATION OF CONSIDERATION

The Testimonial Team's actuarial consultant, PwC, has concluded that the actuarial model, principles, and formulas used to allocate consideration among the Eligible Policyholders of BCBSKS are reasonable and appropriate, and that, if implemented in accordance with that model and those principles and formulas, the resulting allocation of consideration will be fair and

equitable to the Eligible Policyholders, as required by Chapter 40 of the Kansas Statutes Annotated.

C. ACCOUNTING, AUDITING, AND INFORMATION TECHNOLOGY ISSUES⁴

PwC, which also serves as the Testimonial Team's consultant with regard to accounting, auditing, management, and information technology aspects of the Plan has not, to date, encountered any matters or issues in those areas that have not been resolved to the satisfaction of the Testimonial Team. PwC has not determined that any accounting, auditing, or information technology aspect of the Plan reviewed would be unfair or inequitable to policyholders. PwC has found no indication that the financial condition of Anthem is such as might jeopardize the financial stability of the BCBSKS or prejudice the interest of its policyholders. PwC concluded that the Plan does not appear to unjustly enrich any director, officer, agent or employee of BCBSKS. PwC's review of the biographical affidavits of those persons who would control the operation of BCBSKS if the Plan is approved did not reveal any material negative findings regarding the competence or experience of those persons. PwC's work surrounding determination of the closing book value and final distribution and Management's process for distribution is anticipated to be performed in April through June 2002.

D. MARKET IMPACT

⁴See pre-filed testimony of Denise G. Essenberg.

PwC also serves as the Testimonial Team’s consultant regarding the potential impact on market conditions in Kansas if the Plan is approved. With regard to choices, availability, and cost of insurance coverage, PwC concluded that if the Plan is approved, insurance coverage likely would remain available at current levels, but that premium rates would likely increase by 6% to 7% above the levels that might be expected in the absence of the Conversion and Anthem acquisition, with broad variation by market segment. Alternatively, benefit designs would likely change, or fewer people would purchase insurance. With regard to provider contracting arrangements, PwC concluded that it is likely that some level of change in provider contracting will emerge but that there is no evidence to suggest that any broad changes in contracting arrangements or geographic distribution of providers will occur, or that the Plan raises any significant concerns related to changes in provider contracting and network reach. With regard to administrative processes, PwC detected no significant concerns with coverage levels or medical necessity decision-making if the Plan were to be approved. With regard to local employment levels, PwC concluded that there is little reason to believe jobs will be moved from Kansas to other locations, although improvements in productivity hold the potential for reducing the number of employees. With regard to specific conditions on approval that other states have imposed on Anthem, such as limiting Anthem’s ability to change provider networks, or requiring that Anthem’s Medical Director hold a medical license in the relevant state, PwC was unable to determine whether such conditions on approval would directly affect Anthem’s performance.

E. TAX ISSUES

The Testimonial Team’s tax consultant, Scribner, did not observe any outstanding tax issues that raise a material concern as to the financial capacity of the parties to undertake the

transactions and fulfill their obligations under the Plan of Conversion. Scribner has concluded that the tax related representations contained in the Policyholder Information Statement, which detail the expected tax consequences to Eligible Policyholders generally, are accurate and should provide the readers with sufficient information to make the necessary decisions or to consult with their tax advisors, as is recommended in the Policyholder Information Statement. Scribner is satisfied that the memorandum prepared by Debevoise & Plimpton provides reasonable support for the legal opinion of that firm that is attached to the Policyholder Information Statement. However, Scribner has certain outstanding issues and recommendations which are described below with the Testimonial Team's conclusion and recommendations.

F. LEGAL/REGULATORY ISSUES

Based upon the review and conclusions performed by the Testimonial Team, and except as discussed below beginning at page , KID's General Counsel has concluded that the Plan is fair and equitable to policyholders and complies with statutory requirements. The new stock insurer, after the change of control, would meet minimum requirements to be issued a Certificate of Authority by the Commissioner to transact business in this state, and to write the lines of insurance for which it is presently licensed, and the continued operations of the new stock insurer would not be hazardous or prejudicial to existing or future policyholders or the public. Members of the Testimonial Team from KID processed the names of Anthem's senior management members, as provided in Anthem's Form A filing, through the sources upon which it relies customarily for such analysis. That review did not yield any material negative findings regarding the integrity of such persons 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. Thus the competence, experience and integrity of those persons who would control the operation of BCBSKS do not appear to be such that it would not be in the interest of BCBSKS policyholders and of the public to permit the Proposed Transaction. Finally, Anthem has represented, in Item 5

of its Form A, that it has no present plans or proposals to liquidate BCBSKS, sell its assets (other than such sales of assets as may be contemplated in the ordinary course of BCBSKS' business) or consolidate or merge it with any person, or to make any other material changes in its business or corporate structure or management. The Testimonial Team has no reason to believe otherwise. Therefore, except as discussed below beginning at page , the Testimonial Team does not believe that there is an issue as to whether any such plans or proposals would be unfair and unreasonable to BCBSKS' policyholders or not in the public interest.

IX. CONCLUSION AND RECOMMENDATIONS

A. DETERMINATION OF FAIRNESS

The determination of whether the Proposed Transaction is fair and equitable to policyholders and the public is far from a simple one. That the determination must be made is clear from reviewing the relevant statutes. See K.S.A. § 40-4004(a)(1) and K.S.A. § 40-3304(d)(1)(C) and (E). However, these statutes do not provides objective standards by which such fairness is to be gauged.

B.. Fairness Factors

The Testimonial Team believes that, fundamentally, the analysis must weigh the reasons for the transaction, and the expected advantages, on the one hand, against potential and expected adverse consequences on the other. The reasons articulated by Blue Cross and Anthem for the Proposed Transaction are general and somewhat speculative in nature. They boil down to an argument that, in the absence of the acquisition, BCBSKS will be unable to grow sufficiently to survive. See Mr. Knack's testimony at pp. 5-6. The expected advantages are essentially the same: the ability of BCBSKS to grow and thus survive. There is no argument advanced that, as was the case in Colorado for example, BCBSKS is in dire financial straits making a transaction of this nature essential to its survival. Indeed, it as been undisputed that the Company has done well and succeeded in accumulating a substantial amount of surplus above that required by

applicable law or for its prudent operations. Indeed, the Proposed Transaction contemplates distributing as much as \$131 million of that surplus to Eligible Policyholders. And despite general statements to this effect, neither Blue Cross nor Anthem have provided adequate evidence that the combination will result in material efficiencies and cost savings. Again, it is undisputed that BCBSKS has been a very efficient operator, realizing administrative expense ratios below those experienced by Anthem and the industry generally. There has been no suggestion that the acquisition will result in an improvement in those ratios.

The Testimonial Team has sought to identify potential risks and disadvantages of the Proposed Transaction and has worked with Blue Cross and Anthem in an effort to assure that, as much as possible, they are disclosed fairly to policyholders. See for example pages 12 - 15 of the Policyholder Information Statement distributed by Blue Cross. It is the view of the Testimonial Team that, for the most part, these risk factors and potential disadvantages do not create a material fairness issue, though they should certainly be taken into account by policyholders as they cast their votes. However, it appears to the Testimonial Team that the Proposed Transaction will probably result in increases in premium rates charged by BCBSKS that would not occur in the absence of the conversion.

C. Premium Rate Increases

It is an unfortunate feature of the current health insurance market that premium rate increases will generally be unavoidable in the foreseeable future. However, as more fully explained in the pre-filed testimony of Sandra Hunt and in the *Assessment of Market Impact of the Anthem, Inc. Purchase of Blue Cross Blue Shield of Kansas* prepared by PwC, *it is likely that insurance coverage would remain available at current levels, but that premium rates would increase by 6% to 7% above the levels that might be expected in the absence of the Anthem acquisition, with broad variation by market segment.* To be sure, neither PricewaterhouseCoopers nor the Testimonial Team have a “crystal ball” enabling them to predict

the consequences of the conversion with certainty or specificity. It is indeed possible that the Proposed Transaction will not result in premium increases of this magnitude. Conversely, it is also possible that premiums will rise more steeply following the conversion. The conclusion reported here, therefore, represents the Testimonial Team's best estimate of one likely effect of the Proposed Transaction. The reason for the conclusion is not mysterious. BCBSKS has operated historically without the need to generate underwriting gains necessary to produce a return on investment for the company's owners. By contrast, publicly traded Anthem will be expected to produce such profits, whether or not it actually pays dividends to its stockholders. This issue has received extensive attention by the Testimonial Team and the parties. Ultimately, BCBSKS and Anthem were unable to assure the Testimonial Team that such rate increase could be avoided.

A. The Balancing Test

The Testimonial Team concludes that, in determining whether the proposed conversion would be fair and equitable to policyholders and whether the acquisition is likely to be hazardous or prejudicial to the insurance-buying public, the projected transaction-related premium rate increases must be balanced against the expected benefits of conversion. No test is promulgated by the applicable statutes for this analysis. Ultimately, it will be left to the discretion of the Commissioner, exercised in the context of all the evidence she receives on this matter. The Testimonial Team believes that the anticipated transaction-related premium rate increases, when compared to the speculative conversion benefits articulated by the parties, are of sufficient magnitude to support a conclusion that the Proposed Transaction will not be fair and equitable to policyholders and instead may be hazardous or prejudicial to the insurance-buying public. However, the Testimonial Team recognizes that sufficient evidence may be presented to the Commissioner at the Evidentiary Hearing to justify the contrary conclusion.

B. RECOMMENDATION OF APPROVAL CONDITIONS

The Testimonial Team has concluded that, subject to the premium rate concerns articulated above, the Plan complies with law and is, both generally fair and equitable to policyholders and not contrary to the public interest. However, in furtherance of the protection of policyholders and the general public, the Testimonial Team recommends that the Commissioner make any approval of the Plan contingent upon the following conditions:

- A. That Blue Cross demonstrate that the amount of consideration to be provided by BCBSKS to Eligible Policyholders will be at least the amount of its statutory surplus on the Effective Date;
- B. That Anthem confirm in writing that it will guarantee all insurance obligations of BCBSKS;
- C. That, contrary to section 6.3(f) of the Plan of Conversion, the appointments by the Commissioner to the Policyholder Committee not be required to “*be reasonably acceptable to*” Anthem;
- D. That the Policyholder Committee have the power to review the tax returns filed for the first three or so tax years following the Conversion Date to ensure that no amount of taxes paid during the last year preceding the Conversion Date is refunded to BCBSKS when, if those taxes had not been paid prior to the Conversion, a larger Special Distribution would have been paid to the Eligible Policyholders under the formula;
- E. That all tax refunds received by BCBSKS after the Conversion for taxes paid in tax years preceding the Conversion be deposited into the Escrow Fund to benefit the Eligible Policyholders unless the amount of such refund was reflected as an asset on the Closing Balance Sheet;

- F. That BCBSKS and Anthem develop an acceptable method for handling the requirement that interest paid to the Eligible Policyholders be reported to the IRS;
- G. That Anthem advise unequivocally whether it intends to deduct for tax purposes the Special Distribution or the Purchase Price paid to the Eligible Policyholders; and
- H. That the allocation of consideration to the Eligible Policyholders be implemented in accordance with the actuarial model, principles and formulas upon which the consulting actuaries for the Testimonial Team and BCBSKS have agreed.

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NOTIFICATION OF SERVICE

A true and correct copy of the foregoing has this 28th day of December 2001, been sent to the below identified counsel or parties electronically and by over night delivery.

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