

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

PREFILED TESTIMONY OF KENNETH M. BECK

Credentials

Q. Please state your name.

A. Kenneth M. Beck

Q. Please identify your employer and state your position.

A. I am a Principal with the Actuarial and Insurance Management Solutions (“AIMS”) practice of the firm of PricewaterhouseCoopers LLP (“PwC”).

Q. Please describe your professional background.

A. I have 30 years of experience as a senior executive and consultant to the insurance industry. Currently, I am a consulting actuary and a Principal of PwC. I have held this position at PwC and one of its predecessors, Coopers & Lybrand, L.L.P. (“C&L”) since 1989. C&L merged with Price Waterhouse to form PwC in 1998. For the sake of simplicity, I will refer in this testimony only to PwC, which should be understood to include C&L during the period prior to the merger.

Since 1989, I have directed a number of PwC’s major consulting assignments for life and health insurance companies, including assignments relating to mergers, acquisitions, strategic and financial planning efforts, and mutual-to-stock conversions. I am familiar with the actuarial issues and relevant literature relating to the conversion of mutual insurance companies to stock insurance companies. Specifically, I am familiar with the actuarial issues and literature relating to the allocation of consideration among policyholders.

Prior to joining PwC, I served as the Executive Vice President and part owner in Insurance Marketing Corporation of America, an insurance organization that specialized in life and health insurance business generated using direct response marketing techniques. Before that, I served as Executive Vice President and Chief Actuary with National Liberty Corporation.

I am a Fellow of the Society of Actuaries. I am also a Member of the American Academy of Actuaries.

Q. Have you previously been engaged to perform actuarial reviews of demutualizations and acquisitions of health care related insurance companies?

A. Yes. PwC has been engaged, in the past several years, as actuarial advisor by numerous insurers, regulators and others in connection with insurance company reorganizations and conversions from mutual to stock form. In conjunction with these engagements, I have directed or had significant oversight responsibilities for PwC's actuarial work in connection with the demutualization or conversion of health care companies such as Blue Cross and Blue Shield of Virginia, Inc. and Blue Cross and Blue Shield of Colorado, Inc., as well as with the demutualizations of other insurance companies such as the Equitable Life Assurance Society of the United States, State Mutual Life Assurance Company of America, Ameritas, Pacific Mutual, the Mutual Insurance Company of New York, and the Metropolitan Life Insurance Company, among others. Most of these transactions involved the allocation of consideration among policyholders. I have provided consulting and technical support either to the management and the Board of Directors of the companies which were reorganizing, or to the insurance departments which were reviewing the reorganizations.

In addition, I have directed and participated in PwC's work in other matters, such as mutual company mergers, including The New England/MetLife and Home Life/Phoenix Mutual. I have also directed and participated in PwC's work in connection with feasibility studies for mutual life insurance companies considering either demutualization or the formation of a mutual holding company structure. I have supported insurance companies and/or investment bankers in the strategic and financial assessment of potential acquisitions and divestitures, and have testified before regulators at public hearings concerning actuarial matters, including matters relating to life insurance company plans of reorganization.

Q. Have you been engaged by the Kansas Insurance Department ("KID") to assist it in the evaluation of the proposed Plan of Conversion and Acquisition (the "Plan") of Blue Cross and Blue Shield of Kansas, Inc. ("BCBSKS")?

A. Yes. PwC has been engaged by KID to assist the KID Testimonial Team as its independent accounting, actuarial, and information technology advisor in connection with its review of the Plan.

Summary of Testimony

Q. Specifically, what were you asked to review with respect to the Plan?

A. I was asked to review the Plan and assess the merits and fairness of the proposed allocation among the Eligible Policyholders of the consideration to be paid to the policyholders as a group as a result of this transaction.

Q. Are you prepared to provide some testimony in connection with that work?

A. Yes.

Q. Please summarize your review briefly.

A. Throughout the course of our engagement, PwC has requested numerous items of actuarial and financial information from BCBSKS and its affiliated companies. Other PwC representatives and I, acting as advisors to KID, participated in meetings and telephone conferences with the other members of the KID Testimonial Team (the "Team") and BCBSKS representatives. We reviewed accounting and actuarial information relevant to the Plan prepared by BCBSKS and its advisors. We also 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. I have concluded that, with respect to the aspects of the Plan that we have 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.

Description of Work Performed

Q. Please describe the specific actuarial and other work you have performed in the review of the Plan.

A. The PwC actuarial team, consisting primarily of Robert Matczak, Richard Ashley, Bruce Ogg, Stephen Zaharuk, Michael Zwerling, and myself, serving as advisors to KID in evaluation of the Plan, was asked to determine whether the principles, assumptions, methodologies, and formulas used to allocate consideration among the Eligible Policyholders of BCBSKS are reasonable and appropriate, and whether the resulting allocation of consideration is fair and equitable to the Eligible Policyholders. During the period since PwC's engagement we have received and reviewed extensive information relating to BCBSKS' past and present financial experience and the characteristics of its policies. We have also participated in numerous meetings, and telephone conferences, and written communications with BCBSKS and Milliman regarding issues raised by the

Plan and the actuarial assumptions and methodologies utilized by BCBSKS to determine the allocation of consideration to policyholders. We relied on the accuracy and completeness of the data and assumptions supplied by BCBSKS and Milliman, and did not independently verify that information.

The role of PwC's actuarial team throughout the review process has been to analyze and understand BCBSKS' Plan from an actuarial point of view. We did not advise BCBSKS on how it should structure its Plan nor did we suggest what data or assumptions should be utilized to develop the Plan. We also did not determine whether the amount of the consideration to be allocated among Eligible Policyholders was fair and/or reflective of true or fair market value.

During our review, PwC representatives met with various employees and advisors of BCBSKS. In addition, written and oral communications were exchanged. PwC's correspondence and participation in meetings was intended to gather the data necessary to complete our actuarial review, and to make inquiries necessary to clarify our understanding of the Plan and of the assumptions and methodologies used to develop the proposed allocation of the consideration among Eligible Policyholders. At times the data provided raised questions which caused us to seek and obtain corrections and clarifications.

Specifically, in the course of our analysis we have met with certain members of BCBSKS' senior management ("Management") and with members of Milliman, both in person and by telephone, to discuss the operations, historical financial statements, and future prospects of BCBSKS and its affiliates. My testimony addresses matters involving the allocation of consideration among Eligible Policyholders from an actuarial point of view. PwC's actuarial review of the "market" impact of the Plan on BCBSKS' policyholders and the citizens of Kansas will be presented and summarized in Ms. Jean Wodarczyk's testimony, and pertinent accounting matters will be presented and summarized in Ms. Denise Essenberg's testimony. To the extent I employ the use of undefined capitalized terms, I intend to ascribe the same meaning to such terms as does the Plan of Conversion of BCBSKS dated October 25, 2001 ("Plan of Conversion"), the Alliance Agreement between BCBSKS and Anthem Insurance Companies, Inc. ("Anthem") dated May 30, 2001 (as amended) ("Alliance Agreement"), and the exhibits to both documents (collectively referred as the "Plan Documents").

No specific guidance is given in Chapter 40 of the Kansas Statutes Annotated ("K.S.A.") for the allocation among policyholders of consideration in a reorganization. Accordingly, we have conducted our review of the proposed allocation of consideration among Eligible Policyholders under the standard set out in K.S.A. § 40-4004, which requires that "The plan of conversion [be] fair and equitable to policyholders."

In connection with its role as an actuarial advisor to KID, the PwC actuarial team completed the following:

1. Assisting the KID Testimonial Team in the analysis of the actuarial aspects of the Transaction;
2. Evaluating and analyzing the actuarial information furnished to KID and PwC for appropriateness and credibility;
3. Assisting the KID Testimonial Team in evaluating the Plan, as submitted to KID;
4. Providing KID with additional information, where appropriate, in order to facilitate its evaluation of the Plan and in order for KID to determine its appropriateness from a regulatory point of view; and
5. Reviewing in detail the principles, assumptions, methodologies, and formulas used to allocate consideration among the Eligible Policyholders of BCBSKS.

The PwC actuarial team was also asked to form an actuarial opinion as to whether the proposed allocation of consideration among the Eligible Policyholders is fair and equitable to such policyholders.

Q. Please describe how you were provided information about BCBSKS' Plan.

A. Management or BCBSKS' representatives provided our team filed copies of the Plan Documents as well as several preliminary and interim drafts of the proposed Plan Documents, including the Actuarial Contribution Memorandum. In addition, our team members participated in a number of meetings and telephone conferences regarding the Plan and various transactions related to the Plan. Finally, BCBSKS has provided our team literally thousands of pages of additional documents related to the Plan.

Q. Has any of the information that you have received related to the issues about which you have been consulted by KID?

A. Yes. A considerable amount of information provided by BCBSKS concerned the actuarial methodology proposed by BCBSKS for the allocation of consideration among the Eligible Policyholders as part of the Plan.

Q. Have you also been provided with the prefiled testimony of Daniel McCarthy?

A. Yes I have.

Q. Have you met Mr. McCarthy?

A. Yes. I understand that Mr. McCarthy is BCBSKS' actuarial consultant with Milliman in connection with the Plan. We have had several meetings and discussions with Mr. McCarthy and other actuarial advisors who have worked with BCBSKS on the development of its Plan.

Q. In arriving at your opinion, what factors did you take into account?

A. In arriving at my opinion, I have taken into account a number of factors, including, but not limited to:

1. Whether the principles, methodologies, and formulas used to allocate consideration among the Eligible Policyholders of BCBSKS are reasonable and appropriate, as well as consistent with generally accepted actuarial principles, most notably Actuarial Standard of Practice number 37, the "Allocation of Policyholder Consideration in Mutual Life Insurance Company Demutualizations;"
2. Whether the actuarial contribution method chosen by BCBSKS was implemented in a reasonable manner, consistent with the past and present business practices of BCBSKS;
3. Whether the actuarial assumptions and methodologies utilized in the development of prospective actuarial contributions are consistent with those inherent in the current Business Plan we were advised is espoused by the management of BCBSKS;
4. Whether the actuarial assumptions and methodologies used in the development of historical actuarial contributions, and the allocation to lines of business of the components of historical statutory earnings, are consistent with the emergence of the actual historical statutory earnings of BCBSKS; and
5. Whether the methods utilized in the historical actuarial contribution model to allocate the various components of statutory earnings (*i.e.*, premiums, benefits, and expenses) to lines of business are consistent with the allocation methods utilized by BCBSKS in preparing historical line-of-business financial statements.

In conducting our analysis, we have also relied upon and assumed, without independent verification, the accuracy and completeness of the financial and other information, including without limitation the projections and actuarial reports, provided to us by BCBSKS and Milliman.

- Q. What changes have been made in the proposed transaction as a result of the work performed by the PwC actuarial team?
- A. Our review of information and discussions with employees and advisors of BCBSKS have, in several instances, caused BCBSKS to reassess elements of the Plan and the resulting proposed allocation of consideration among Eligible Policyholders. Some areas of change are outlined below.
1. During the course of PwC's actuarial review, it was recognized that the initial net statutory surplus as of July 1, 1992, ("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 among policyholders of the initial net statutory surplus should not be, and is no longer a component of the calculation of actuarial contributions ("ACs");
 2. The following changes were made to the AC models of BCBSKS for Merit-rated (*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 than to those cases which did meet targeted profit margins:
 - a. Historical AC methodology has been revised to reflect three components:
 - i. 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
 - ii. 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
 - iii. Historical write-offs of negative experience refund balances (also calculated on a case-by-case basis).
 - b. Prospective AC methodology has been revised to reflect the expected recovery of negative experience refund balances outstanding as of December 31, 2000.
 3. Profits earned on "side funds" (or bank accounts) held by BCBSKS on behalf of two Merit policyholders had been ignored in the historical and prospective AC models developed by BCBSKS. We believe that this would not have been fair or

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.

4. Our review of the actuarial projections underlying the development of AC-factors for the Long Term Care (“LTC”) product line uncovered three methodological errors which have been corrected by BCBSKS:
 - a. The calculation of Federal Income Tax did not account for differences between tax-basis reserves and statutory reserves;
 - b. 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
 - c. The impact of the 50% coinsurance agreement with MedAmerica was not properly reflected.
5. 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.
6. 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 made consistent with the Management Projections.
7. Other changes to the historical AC model which affect all product lines:
 - a. Impact of reinsurance ceded – PwC determined and reported that this item had not been handled properly. It has been corrected by BCBSKS.
 - b. Derivation of historical net investment earnings rates has been revised:
 - i. Changes in unrealized capital gains/losses had been excluded, and have now been added to the calculation of historical rates.
 - ii. The asset base used in the calculation of historical net investment earnings rates has been re-defined to more properly reflect invested assets.

- iii. Various technical corrections have been made to bring data inputs in line with data sources.
 - c. 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:
 - i. Proper amount of tax not being allocated to non-member lines of business;
 - ii. Statutory-to-tax differences not being reflected properly; and
 - iii. Tax not being allocated to actual-versus-modeled differences.
 - d. Various technical corrections were made to the model as a result of errors identified by PwC.
8. Other changes to the prospective AC model which affect all product lines:
- a. 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.
 - b. 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.
 - c. A correction has been made to the derivation of the assumed prospective net investment income rate.
 - d. Various technical corrections were made to the model as a result of errors identified by PwC.

Q. Is your review complete?

A. Our review of the proposed allocation methodology is complete insofar as the proposed actuarial principles underlying the Plan is concerned. However, our review is far from complete as to how the proposed methodology will be implemented to assure that each policyholder is actually allocated what is contemplated by the methodology and the model. We propose to continue this review throughout the allocation and distribution process and to report to the KID Testimonial Team the results of this review.

Conclusion

Q. In connection with your work, have you reached a conclusion?

A. Yes. Based on the foregoing and such other matters as we deemed relevant, it is my opinion that the actuarial model, principles, and formulas used to allocate consideration among the Eligible Policyholders of BCBSKS are reasonable and appropriate, and that the resulting allocation of consideration will be fair and equitable to the Eligible Policyholders if it is implemented in accordance with such model, principles and formulas.

Q. Have you prepared a written actuarial opinion as to whether the allocation of consideration is fair and equitable?

A. Yes. We submitted a written actuarial opinion to KID on December 31, 2001. Our opinion is based upon, and subject to, the assumptions and limitations explained more fully in the written opinion itself.

Q. Is a copy of that actuarial opinion attached to your testimony as Schedule 1?

A. Yes.

Thank you Mr. Beck.