

BEFORE THE COMMISSIONER OF INSURANCE
OF THE STATE OF KANSAS

In the Matter of the Conversion and)
Acquisition of Blue Cross and Blue Shield) Docket No. 3014-DM
of Kansas, Inc.)

REPORT OF HENRY N. BUTLER, J.D., Ph.D.

My name is Henry N. Butler. I am currently employed at Chapman University in Orange, California where I am the James Farley Professor of Economics, Dean of the George L. Argyros School of Business and Economics, and Chairman of the Law and Organizational Economics Center. I received a B.A. in Economics from the University of Richmond in 1977, a M.A. and Ph.D. in Economics from Virginia Tech in 1979 and 1982, and a J.D. from the University of Miami in 1982. I have held academic positions at Texas A&M University (1982-86), the University of Chicago (1985-86), George Mason University (1986-93), and the University of Kansas (1993-2001). Prior to joining Chapman University in July 2001, I was the Fred and Mary Koch Distinguished Professor of Law and Economics (tenured in both the Law School and the Business School) and Director of the Law and Organizational Economics Center at KU. The Law and Organizational Economics Center (LOEC) runs the Economics Institute for State Judges – a two-week residential program that teaches judges the principles of economics, finance, accounting and statistics. Almost 1,000 judges from 48 states have participated in LOEC programs since 1995. My primary areas of research are antitrust, financial services, corporate governance, and the impact of government regulations on business. I have taught a wide variety of courses in business schools and law schools, including Antitrust Law and Economics, Insurance Law and Regulation, Contracts, Law and

Economics, Industrial Organization Economics, and the Legal Environment of Business.

A copy of my vita is attached as Exhibit A.

I have been engaged by Blue Cross and Blue Shield of Kansas, Inc. (“BCBSKS”) to analyze and offer my expert opinion concerning the economic impact of the proposed sponsored demutualization of BCBSKS and subsequent acquisition by Anthem Insurance Companies, Inc. (“Anthem BCBS”). In reaching the opinions presented here, I have applied my professional knowledge as an economist and a lawyer to the facts presented in numerous documents (see Exhibit B). The opinions I express herein or later in my testimony should be considered to be expressed within a reasonable degree of legal and economic certainty. I have concluded that completion of the proposed transactions would be in the public interest because its effects on competition, and hence on consumer welfare, would either be neutral or beneficial.

The Kansas Health Insurance Market

The starting point for the economic analysis of the competitiveness of any market is a consideration of the supply and demand conditions in the market. The Kansas health insurance market, which technically may be defined as the Kansas health care financing market, reflects structural characteristics indicating that the market is competitive.

On the supply side of the Kansas health insurance market, the leading role of BCBSKS is readily apparent. I have seen numerous market share measures in the documents and materials that I have reviewed. Regardless of which measure is used,

BCBSKS is the largest health insurer in Kansas. BCBSKS has an extensive network of providers and a strong brand name. These characteristics warrant further examination.

BCBSKS has developed an extensive network of doctors, hospitals and other health care providers. For example, a very high percentage of doctors and hospitals have contracts with BCBSKS. These provider contracts are voluntary agreements and, thus, presumably mutually beneficial. Moreover, it must be recognized that the BCBSKS contracts with providers are not exclusive so that many doctors and hospitals have provider contracts with other networks.

Those other provider networks are an important source of competition for BCBSKS. Provider networks often provide access to or “rent” their networks to insurance companies, third party administrators, and direct employer contractors. In particular, the ability to quickly tap into an established network means that a large number of national insurance companies can quickly enter the Kansas market if BCBSKS’ premiums get too high. The credible threat of entry – a market condition that industrial organization economists refer to as “contestable” – imposes a severe constraint on BCBSKS’ ability to raise prices above the competitive level.

On the demand side of the health insurance market, it is obvious that there are thousands of potential purchasers of health insurance policies. Many of the buyers are sophisticated large employers who are very sensitive to their health care costs. They are

willing to change health care insurers – they are mobile and not brand loyal.¹ For example, in July 2001 (effective January 1, 2002), a large Wichita and national employer, Raytheon, switched from its incumbent insurer, Coventry Health Systems, to Preferred Plus of Kansas, due to apparent price sensitivity, notwithstanding an aggressive price competitive bid submitted by BCBSKS. Similarly, in the small group market, many of the buyers are small businesses which are sensitive to health care costs. Because of requirements to guarantee issue to all groups of 2 to 50, to not impose new pre-existing conditions when moving from insurer to insurer, to accept all persons in the group and not underwrite or rider individuals within the group, small groups can change carriers in with impunity. Such low-cost switching by group purchasers is an important source of competitive pressure on insurers.²

¹ Although brand loyalty is often recognized as a source of competitive advantage of the Blue Cross and Blue Shield brand name, most purchasers of group insurance are not subject to the same emotional ties and it is reasonable to consider them to be mobile and not brand loyal. Of course, because the employer's provision of health insurance benefits is derived from their efforts to attract employees, the employees' brand loyalty to Blue Cross and Blue Shield is not completely ignored by the employer in selecting a group health care insurer.

² In general, individuals do not have the same degree of mobility between insurers. For individuals, or those with Medicare supplement coverage, insurers can underwrite or refuse to insure individuals, and those that develop health conditions while covered cannot go elsewhere in many cases (they would be rejected) or – if they can – will pay increased rates as substandard risks. For Medicare supplement policies, insurers must guarantee issue in the first six months after one becomes eligible for Medicare, but thereafter may underwrite the coverage. However, because insurers pool rate these product lines (separately, of course) (in fact, Kansas law requires a form of pool rating at KSA 40-2244, calling for pooling a closed block with open blocks), raising the rates for existing insureds requires raising the rates for new entrants; doing that tends to reduce the attractiveness of the product compared to those of competitors, and the insurer will lose both new, healthier entrants as well as those who can qualify for medical underwriting with a new insurer, leaving a less healthy pool and the proverbial death spiral in rates.

The combination of contestability on the supply side and price sensitive buyers on the demand side means that robust competition is present in the Kansas health insurance market. This conclusion is consistent with the FTC's quick approval of the transaction.

The Nature of Competition in the Kansas Health Insurance Market

The structural dimensions discussed above are only part of the picture of competition in the Kansas health insurance market. It is important to recognize that competition in the Kansas health insurance market takes place on many dimensions. The broadest dimensions of competition are price and quality:

- Price competition in the form of competition for writing policies by offering lower premiums, deductibles, and co-payments is probably what most people think of first when they think of competition between health insurance companies.
- Quality competition in the form of competition through covered procedures, exclusions, availability of insured services, extent of managed care, filing requirements, payment rates, customer service, and the size and scope of the provider network.

Market competition allows insurers to compete by offering different combinations of price and quality. Indeed, many insurers (including BCBSKS) make different combinations of price and quality available to policyholders. "BCBSKS delivers a complete portfolio of healthcare coverage options to all customer types (small and large groups, individuals and government plans). BCBSKS' broad offering of health products include Traditional, PPO, POS and HMO. The company also has a range of ancillary

products such as dental, hospital indemnity, cancer, and LTC.” See DKW at HSR BC000298.

Insurers also compete through offering extensive health provider networks to potential policyholders. The underlying premise is that insurance policies that offer consumers more choices of health care providers will be valued more highly by a substantial portion of consumers. Insurers invest millions of dollars in developing networks of health care providers. Obviously, Anthem BCBS would have a strong profit incentive to maintain the valuable and well-functioning network of providers that has been developed over the years by BCBSKS.

The health care providers are well aware of their essential role in the health care system – the health insurers need the health care providers as much as the providers need the payment system. Consequently, health care providers have established their own networks that they then market to health insurers. The existence of independent (that is, networks not owned or established by a specific insurer) and hybrid (that is, networks affiliated with provider-owned insurers) health care networks is an important factor in lowering the barriers to entry of new insurers into a market. Examples of provider-owned networks include Wichita Preferred Provider Association and Kansas Health Plan. Hybrid networks include Preferred Health Care and, until recently, Horizons/Heartland Health – a failed for-profit enterprise sponsored by the Kansas Medical Society that is now in receivership.

The mutual interdependence of the insurers and the provider networks is a competitive constraint in both markets. These parties voluntarily cooperate to combine health care financing with health care delivery. Such voluntariness as well as the freedom to experiment with alternative price-quality combinations are important aspects of competition that results in increased consumer welfare through variety in product line and prices. For example, some insurers might believe they can offer a more competitive product with a tighter panel of providers and lower premiums. In order to implement this strategy, they would have to negotiate more restrictive contracts than other insurers in order to achieve lower costs (through lower fees or through care management provisions). Whether the resulting lower-premium lower-quality product is attractive to enough consumers to be profitable will be determined in the marketplace. Of course, consumer preference for a broader panel of providers at a higher premium may make the new product unattractive. Regardless, so long as there are alternatives in the market, consumers are not harmed. In order for the market to function properly, insurers and health care providers need the freedom to experiment with new product lines.

Much attention has been paid to the high concentration in this market. Yet, it is important to keep in mind the wide range of choices that are available to purchasers of group insurance.³ In particular, large employers have the option of self insurance if the

³ Of course, many of the policyholders are employers who purchase health insurance as a benefit to their employees. Employers provide this benefit to their employees because they have learned that employees prefer to take some of their wages in the form of benefits that are excluded from the Internal Revenue Code's definition of taxable income. Although it is tempting to conclude that employers simply search for the least expensive health insurance plan for the employees, the evidence is clear that employers provide much more than "bare bones" policies to their employees. The reason

market rates for traditional insurance are excessive. This is a major constraint on the ability of BCBSKS to charge premiums above the competitive market rate. Moreover, there is plenty of evidence of active competition in the Kansas health insurance market. For example, BCBSKS maintains a large sales force to attract and retain policyholders, BCBSKS closely monitors its retention rate of group policyholders, and national insurers are always looking for opportunities to compete for business in Kansas.

There is no reason to believe that the competitive landscape of the Kansas health care market will be adversely affected by the completion of the proposed transaction. To see this point, it might be helpful to separate the competitive analysis of the sponsored demutualization from the analysis of the acquisition of BCBSKS by Anthem BCBS. Viewed in isolation, the conversion from a mutual insurer to a stock insurer cannot raise any anticompetitive concerns. There is no plausible way that such a change in ownership structure would increase the market power of BCBSKS. This is merely a change in form, not a change in substance. The competitive structure of the Kansas health insurance market would be the same after the completion of the demutualization as it was before the conversion. Moreover, the public policy of the state of Kansas clearly allows such transactions. Next, the acquisition of the stock insurer by Anthem BCBS is simply a change in ownership structure and does not raise any anticompetitive concerns. Unlike many mergers of firms within a geographic market, which necessarily increase market

employers do this is because it is cheaper for them to provide quality health insurance than it is to compensate their employees with higher wages. In other words, competition in labor markets forces employers to provide attractive health insurance policies to their employees.

concentration, the acquisition of BCBSKS by Anthem BCBS is not a merger of competitors because the firms do not operate in the same geographic market. Therefore, it neither increases market concentration nor threatens competition. The acquisition by Anthem BCBS, however, does have the potential to increase competition if potential cost savings are translated into lower rates. By breaking down the analysis into its component parts, it becomes clear that there are no legitimate anticompetitive concerns raised by the proposed demutualization and acquisition.

Competition in the Kansas health insurance market is robust. Neither BCBSKS nor Anthem BCBS can charge supra-competitive premiums, reduce coverage, or reduce services without there being a profound risk of losing a substantial amount of their business. The proposed transactions do not pose any anticompetitive threats and thus should be presumed to be in the public interest.

The Consumer Welfare Standard and the Public Interest

Over the years, the Supreme Court of the United States has developed a standard for evaluating the legality of various practices challenged under the antitrust laws. The “consumer welfare standard” holds that antitrust laws are intended to protect competition that benefits consumers. In this view, the ultimate goal of the antitrust laws is to protect consumers. This perspective is a helpful device to ensure that the antitrust laws are not misused for the benefit of protecting competitors from competitive threats. The laws are concerned with protecting competition, not protecting competitors. Using the antitrust laws to protect competitors is likely to harm competition and, ultimately, consumers.

Application of the consumer welfare standard to the proposed transactions is useful. Of course, the Anthem BCBS acquisition of BCBSKS is not an antitrust case. However, the consumer welfare standard can still inform the analysis of the policyholder and public-interest questions. After all, the broad base of consumers who are the pinnacle of the consumer welfare standard are pretty much the same people who should be considered in any meaningful definition of the public interest.

Regarding the conversion from mutual insurer to stock insurer, there are no plausible anticompetitive stories that suggest that merely changing the ownership form will adversely affect competition in the market. Thus, consumer welfare is unchanged and the public interest is not harmed. Regarding the proposed acquisition by Anthem BCBS, there are no plausible anticompetitive stories that explain how Anthem BCBS's ownership of BCBSKS will translate into increased market power of the type that the antitrust laws are concerned. Consumer welfare is not adversely affected. It is not at all surprising that the proposed transaction breezed through the FTC's Hart, Scott, Rodino pre-merger filing process.⁴ Moreover, to the extent Anthem BCBS is able to achieve the economies of scale in administration, the merger could result in lower costs to BCBSKS and lower prices to consumers. Consumer welfare would be enhanced under this scenario, because greater competitive pressure would be faced by all Kansas health

⁴ The pre-merger notification was filed on August 28, 2001 and the early termination of the waiting period was granted on September 18, 2001.

insurance companies as a result of the acquisition of BCBSKS by Anthem BCBS. Thus, in my opinion, the proposed transaction is in the public interest.

The consumer welfare standard also helps constrain the scope of the analysis. For example, although some of Anthem BCBS' lower costs might come at the expense of Kansas health care providers, the consumer welfare standard tells us that those parties should not be considered in determining whether the transaction is pro-competitive or anticompetitive (promotes or harms the public interest). Thus, anticompetitive concerns raised by special interest groups – such as doctors, nurses, hospitals, and other health care providers – should be seen as efforts to protect them from competitive markets rather than efforts to promote the public welfare. The interest groups are engaged in what economists call “rent seeking” – the use of political activities to gain profits (or “rents”) that they would not be able to earn through normal market exchanges. Rent seeking substitutes government coercion for voluntary market transactions. In my opinion, the interest groups' arguments presented thus far should be afforded little or no weight (unless they relate specifically to alleged harm to consumers).

In my opinion, the public interest (as embodied in the consumer welfare standard) at stake in the proposed transaction is adequately protected by the competitive forces at work in the Kansas health insurance market. The power of market forces to constrain Anthem BCBS' behavior should not be taken lightly. Anthem BCBS is assumed to be a rational economic entity. Ultimately, Anthem BCBS will have to continue to appeal to Kansas BCBS policyholders by offering an attractive mix of price and quality. In order

to provide that mix, Anthem BCBS must maintain a large, well-functioning provider network. If Anthem BCBS attempts to impose “unfair” terms on providers, some providers will leave the network. If providers leave the Anthem BCBS network, then three things will happen. First, Anthem BCBS will become less attractive to policyholders and some will go to other insurers. Second, other insurers will be able to expand their networks and make their policies more attractive to policyholders. Third, new entry into the Kansas health insurance market will become more attractive to national insurers. All three outcomes would be bad for Anthem BCBS. Consequently, I would not expect for Anthem BCBS to attempt to impose terms on providers that cause harm to consumers. Just as competition will prevent Anthem BCBS from charging supra-competitive prices, competition will keep Anthem BSBS from ramming below market reimbursements down the throats of Kansas health care providers.

Consumer welfare and the public interest are protected by the an triangle of competition – competition for policyholders, competition for providers, and potential competition from new entry. Anthem BCBS must be mindful of these forces or it will be punished by them.

Mutual Insurer versus Stock Insurer

In theory, the conversion from a mutual insurer to a stock insurer should have no impact on the competitive position of the insurer. The reason for this is straightforward – the competitive pressures that served to control price and quality prior to the demutualization would still be present after the demutualization. Prior to the

demutualization, the mutual insurer's combination of price and quantity would result in the sale of a given number of policies. Presumably, the management of the mutual insurer was selling the most policies it could at the chosen mix of price and quality. If the newly created stock insurer attempted to raise price or reduce quality, it would lose many policyholders to competing health insurance companies that offered close substitutes. The competition would make such a strategy unprofitable.

This is not to say that prices will not change as a result of the current transaction. It is my understanding that BCBSKS' financial history shows that it was not a profit maximizer – that it has subsidized rates with investment income in recent years. This was a management choice selected by the management of BCBSKS. The choice was not dictated by organizational form. Indeed, BCBSKS management could change this decision at anytime even if the transaction does not go through, subject to its ability to raise rates in a competitive market.

It is tempting to think that a stock health insurer must necessarily have higher premiums than a mutual insurer. After all, they must earn a profit! However, economic logic suggests that ownership form is not an important determinant of pricing because each insurer in a competitive market is a price taker. Price takers select the quantity they are willing to sell at the market price. Because of the availability of close substitutes and the threat of entry of new competitors (“contestability”), they do not have the ability to profitably raise their price above the market price. Higher prices do not always translate into higher profits. Higher prices lead to fewer customers and lower aggregate profits.

Thus, the transformation from a mutual insurer to a stock insurer does not necessarily mean that the stock insurer will charge premiums higher than would have been charged by the mutual insurer under the same market conditions.

The view that shareholder demands for a return on their investment will lead to higher premiums by stock insurers than by mutual insurers is flawed for the same reason. Premium competition constrains the ability of firms to charge whatever premiums their investors might theoretically desire. Instead, the strong profit incentives in stock health insurers should lead to greater operational efficiencies than are found in not-for profit insurers. For-profit insurers have a stronger incentive to do a better job in all dimensions of the health insurance business –design of product lines, underwriting risk, risk assessment, analysis of employer risk pools, marketing, assembling networks of providers, negotiation of network contracts, claims processing, management of care, and so forth. Although for-profit insurers may have stronger incentives to be hard bargainers and attempt to negotiate lower fee schedules and payments to health care providers, the bottom line is that the shift from not-for-profit to for-profit does not impact the ability of such firms to negotiate more favorable terms. The reason is straightforward – the form of the insurer does not determine its market power and, thus, market power (or bargaining power) cannot be increased by merely changing the ownership status of the insurer.

Finally, with regard to the impact of the conversion from mutual insurer to stock insurer, it must be understood that any statements about the conversion not having an impact on premiums does not mean that a stock insurer will not charge higher premiums.

The stock insurer might charge higher prices for the same reason that a mutual insurer might charge higher prices. Indeed, as long as medical trends continue to rise, prices will rise – regardless of the organizational form of the insurer. The important point of the analysis is that the change in organizational form does not change the ability of the insurer to increase prices above those of the competition.

Is the Transaction Fair and Equitable to the Policyholders?

The statutory procedure for policyholder approval of the demutualization appears to provide adequate protection to the policyholders. It is important to recognize that different policyholders might have different, yet legitimate, perspectives on the merits of the transaction. For example, some policyholders might prefer a cash payment today even though they believe that there is a chance that the conversion could result in higher premiums and lower quality service; while other policyholders might not be willing to take such a perceived risk. I believe that the risk of the transaction causing higher premiums and lower quality service is slight. But, as an economist, I cannot tell the voters how to think about the tradeoff between the cash payment and that risk. Personally, I would vote in favor of the transaction. The voting mechanism allows a weighting of the various shareholder perspectives. Assuming voters have the opportunity to be fully informed, the outcome produced by the voting mechanism should be viewed as fair and equitable within the statutory framework.

A Final Caveat – Beware of the Law of Unintended Consequences

Several of the Intervenors have suggested that the Commissioner should put various restrictions on the operation of BCBSKS as a condition of the completion of Anthem BCBS' acquisition of BCBSKS. Such proposed restrictions, although purported to be in the public interest, have the potential to distort competition in the Kansas health insurance market to the detriment of the public.⁵ Any restrictions that hobble BSBSKS' ability to compete with other health insurers will reduce competition in the market and could result in higher health insurance premiums for all Kansans. For example, restrictions on amounts payable to providers could mean that while provider welfare is momentarily increased, an insurer paying for services at a higher level than it could otherwise negotiate decreases consumer welfare in losing margins in could pass on to consumers. The unintended consequences of such restrictions may be a reduction in consumer choice and an increase in premiums – an unintended harm to an otherwise vibrant health insurance market.

⁵ Insurance regulation is replete with examples of the unintended consequences of regulatory actions and judicial decisions. Perhaps none is more infamous than the District of Columbia's ordinance that prohibited insurers from either testing for HIV or rejecting health insurance applications from applicants whose application information suggested that they were in the HIV-positive risk pool. The result was that thousands of HIV-positive individuals moved to Washington to get insurance coverage for the treatment of AIDS and insurers tried to exit the local market. The legislation was repealed after the extent of the crisis became clear. The situation would have been even worse if the D.C. regulations applied to only a few of the insurance companies. The covered insurance companies would be destroyed. Other regulations and judicial decisions are more subtle and less dramatic. For example, judicial decisions that refuse to enforce clear contract terms result in higher premiums and insurance companies refusing to write policies that would otherwise have been written prior to the judicial decision.

In my expert opinion, the proposed acquisition of BCBSKS by Anthem BCBS is in the public interest. Therefore, I respectfully recommend that the Commissioner of Insurance grant approval of the transaction.

I declare under penalty of perjury under the laws of the State of Kansas that the foregoing is true and correct.

Executed on this 15th day of December, 2001.

Henry N. Butler