

BEFORE THE COMMISSIONER OF INSURANCE OF THE STATE OF KANSAS

In the Matter of the Plan of Conversion of
BLUE CROSS AND BLUE SHIELD OF
KANSAS, INC.

Docket No. 3014-DM

WRITTEN STATEMENT OF JOHN W. KNACK, JR.

I. Introduction and Background

My name is John W. Knack, Jr. I am President and Chief Executive Officer of Blue Cross and Blue Shield of Kansas, Inc. (“BCBSKS” or the “Company”). In that capacity, I am responsible for directing the management of the Company and for guiding the Company in the development of its business plans and strategies. I was appointed President and Chief Executive Officer of BCBSKS in March 1997. Prior to serving as President and CEO, I was an Executive Vice President of the Company from 1990 to 1997, and I have been with BCBSKS since 1971.

I am involved in several health care industry organizations in varying capacities, including the following:

- Director of the Blue Cross and Blue Shield Association Board;
- Chairman of the National Employee Benefits Administration Committee-BCBSA;
- Member of the American Association of Health Plans;
- Executive Committee Member of the TriWest Healthcare Board;
- Vice Chair of the Kansas Insurance Education Foundation; and
- Member of the Prime Therapeutics, Inc. Board.

This statement is submitted in support of BCBSKS’ request that the Commissioner of Insurance of the Kansas Insurance Department (the “Commissioner”)

approve the Plan of Conversion and the acquisition of BCBSKS by Anthem Insurance Companies, Inc. (“Anthem”). Under the Plan of Conversion, the Company will change its organizational structure from a mutual life insurance company to a stock life insurance company. This process of conversion is sometimes called “demutualization.”¹ The Plan also provides that upon conversion, pursuant to the Alliance Agreement between Anthem and BCBSKS, dated as of May 30, 2001, as amended as of September 28, 2001 and November 9, 2001 (the “Alliance Agreement”), Anthem West, Inc., a subsidiary of Anthem, will acquire 100% of BCBSKS stock, making us an indirect, wholly-owned subsidiary of Anthem. This process of conversion and acquisition is called a “sponsored demutualization.”

We believe that the sponsored demutualization under the Plan of Conversion is in the best interests of our policyholders and will ensure the continuing financial strength of our Company. It will strengthen BCBSKS by providing more efficient access to the capital markets and allow the Company to compete more effectively and adapt to a rapidly changing business environment in ways not currently available to us. I want to emphasize at the outset that policy and contract rights will not be changed in any way as a result of the conversion and the acquisition. Any changes to policy benefits and premiums will continue to be governed by the terms of the policies and by applicable law.

¹ Capitalized terms used in this statement, unless otherwise defined herein, have the meanings set forth in the Plan of Conversion.

Under the Plan of Conversion, the proposed sponsored demutualization will strengthen the Company's ability to meet its commitments to policyholders. It will provide BCBSKS with financial flexibility to support future growth and financial strength and ensure that policyholder interests are properly preserved and protected. As described below, as a result of the conversion, Eligible Policyholders will receive cash consideration for their Membership Interests, which are otherwise illiquid. Membership Interests include the right to vote for BCBSKS' directors and to receive a distribution of any surplus in the unlikely event of a solvent liquidation of the Company.

II. Summary of Statement

This statement provides an overview of BCBSKS and outlines the reasons why the Company is pursuing the sponsored demutualization under the Plan of Conversion. It also describes the significant benefits and protections that BCBSKS and its policyholders will receive if the sponsored demutualization is accomplished. In addition to this statement, the Company's Executive Vice President, Vice President of Finance, and Vice President/General Counsel and our outside actuarial and financial advisors have submitted separate statements addressing certain financial, legal and actuarial aspects of the proposed sponsored demutualization.

The process of sponsored demutualization has a number of technical details that are addressed in the statements submitted by others, but in broad outline, our Plan of Conversion is quite straightforward. Upon its conversion to a stock company, all of BCBSKS' stock will be sold to Anthem. As a result, Eligible Policyholders will receive cash consideration in exchange for their Membership Interests. If the Plan of Conversion

becomes effective, (1) BCBSKS will become a wholly-owned subsidiary of Anthem (subsequent to the conversion BCBSKS' name will change to Anthem Health Plans of Kansas); and (2) the Company's Eligible Policyholders will receive a cash payment as consideration for relinquishing their Membership Interests. As I mentioned, the conversion will not change any policy and contract rights. Any changes to policy benefits and premiums will continue to be governed by the terms of the policies and by applicable law. Additionally, I want to reassure the Commissioner and all Eligible Policyholders that neither BCBSKS executives nor Board Members have been offered any financial incentives in exchange for their recommendations regarding the conversion and acquisition.

III. Overview of Blue Cross and Blue Shield of Kansas

BCBSKS has its roots in two companies that began operations in the 1940s. Blue Cross of Kansas originated following legislation in 1941, and Blue Shield of Kansas was established in 1946. Both companies were established as nonprofit service corporations. BCBSKS was formed in 1983 by the consolidation of Blue Cross of Kansas and Blue Shield of Kansas.

In 1992, BCBSKS ceased being a nonprofit organization and became a mutual life insurance company. In connection with the termination of its nonprofit status in 1992, BCBSKS was required to make a one-time special payment of approximately \$75 million for charitable purposes.

BCBSKS is currently the largest health insurer in Kansas. More than 715,000 Kansas residents in all Kansas counties except Johnson and Wyandotte, two counties near

Kansas City, have private health coverage insured or administered by us. Through government programs administration of Medicare and Medicaid, we administer health care coverage for 640,000 additional Kansans, some of whom also carry our Medicare Supplemental coverage. In all, more than one million residents of Kansas rely on us to administer their health care coverage.

IV. Purpose of the Sponsored Demutualization

After assessing the competitive conditions in the health insurance and services industries, our Board of Directors determined, and I concur, that the Company needs to enhance its strategic and financial flexibility. After extensive consideration and evaluation, the Company's Board of Directors settled on sponsored demutualization as an effective way of achieving these goals, and one that would make possible a distribution of value to Eligible Policyholders. On May 30, 2001, after negotiation and evaluation of alternatives, BCBSKS entered into an Alliance Agreement with Anthem calling for Anthem to acquire BCBSKS in a sponsored demutualization. On October 25, 2001, the Board unanimously approved and adopted the Plan of Conversion, recognizing it as serving the best interests of the Company and its policyholders.

If we are to continue to provide high quality insurance services at reasonable costs to our policyholders in a health insurance market that has become national in scope, we must spread our costs over a sufficiently large policyholder base. However, we hold a certificate of authority to sell insurance only in Kansas. Even if we were to seek to sell coverage in other states, we could not use the valuable Blue Cross and Blue Shield names and service marks to do so, for those names and service marks are controlled by the Blue

Cross Blue Shield Association, whose licensees are provided exclusive areas within which they may use those names and marks. In addition to being unable to expand geographically, we find that our potential customer base within the state shrinks every year, as national corporations purchase or supplant local businesses. As we are unable to diversify our risks geographically, we are susceptible to an adverse local illness, or adverse local legislation, or a natural disaster, or targeted pricing for market share by competitors, all of which could have substantial impacts on our financial soundness.

The sponsored demutualization, in which we become a part of a substantially larger, multi-state insurer, offers BCBSKS several ways to expand its market and products, and to improve its service to existing and future policyholders.

- The sponsored demutualization provides us with sufficient capital to compete with national commercial companies as well as access to a larger total capital pool with which to acquire other health plans or related businesses.
- The sponsored demutualization enables us to take advantage of economies of scale by eliminating duplicative resources and streamlining our compliance efforts in an increasingly complex regulatory environment.
- By virtue of our becoming part of the diversified geographical base of Anthem that results from the sponsored demutualization, we will have increased flexibility in responding to localized adverse risk events, avoiding the twin perils of decreased financial stability or excessive increases in rates to avoid financial instability. A corollary of having such a diversified base would also be our ability to participate better in insurance offerings to multi-state accounts.
- We will be able to offer a greater variety of career paths to our employees, with the potential for greater and more varied challenges, which in turn should permit us to continue to attract and retain the kinds of employees needed to provide policyholders with quality service.
- The sponsored demutualization will allow us to take advantage of best practices in health insurance from Anthem and its other health insurance affiliates.

In addition to market access, a principal purpose of the sponsored demutualization is that, under the Plan of Conversion, Eligible Policyholders will receive a cash distribution for their otherwise illiquid Membership Interests. Thus, they will realize real economic value from their Membership Interests that is currently otherwise unavailable to them. At the same time that Eligible Policyholders receive these tangible economic benefits, their policy and contract rights will not be changed as a result of the conversion and the acquisition. Any changes to policy benefits, values and premiums will continue to be governed by the terms of the policies and by applicable law.

V. Process of the Sponsored Demutualization

After negotiation and consideration of alternatives, the Company entered into the Alliance Agreement with Anthem on May 30, 2001, calling for a sponsored demutualization. That decision resulted from a determination by the Board of Directors that the sponsored demutualization would be in the best interest of our policyholders because it would give the Company the ability to survive and grow in the highly competitive health insurance and services industries.

To pursue the sponsored demutualization, BCBSKS management, together with a team of outside advisors, spent many months working to draft the Plan of Conversion. These outside advisors included the actuarial firm of Milliman USA, Consultants and Actuaries, formerly known as Milliman & Robertson, Inc. (“Milliman”), the investment banking firm of Dresdner Kleinwort Wasserstein, and the law firm of Debevoise & Plimpton. Representatives of Milliman and Dresdner Kleinwort Wasserstein have submitted separate statements addressing actuarial and financial aspects of the Plan of

Conversion. The Board of Directors actively discussed and resolved issues that arose in its consideration of the Plan of Conversion and heard presentations and reviewed opinions by our outside advisors on various aspects of the sponsored demutualization.

Our management team and outside advisors also engaged in extensive consultations with the testimonial team consisting of staff members of the Kansas Insurance Department (the “KID Testimonial Team”). The KID Testimonial Team retained outside legal, actuarial and financial experts to provide it with independent advice and assistance. These experts include the actuarial and accounting firm of PricewaterhouseCoopers LLP; the investment-banking firm of Bear, Stearns & Co.; the tax counsel of Scribner, Hall & Thompson, LLP; and the law firm of Cantilo & Bennett, L.L.P. The Testimonial Team and its advisors reviewed all aspects of the proposed Plan of Conversion, and its outside advisors conducted detailed actuarial and financial due diligence efforts with the cooperation of BCBSKS and its outside advisors.

On October 25, 2001, the Board of Directors of BCBSKS unanimously approved the Plan of Conversion. Since the adoption of the Plan, our management team and outside advisors have continued to consult with the KID Testimonial Team and its advisors, who have reviewed the written materials delivered to policyholders concerning the sponsored demutualization, including the Notice of Hearing and related materials.

BCBSKS mailed a Policyholder Information Statement dated November 9, 2001 to all Eligible Policyholders (the “Information Statement”). The Information Statement included a detailed description of the sponsored demutualization, selected financial statements of BCBSKS and Anthem, a copy of the Plan of Conversion and the Alliance

Agreement, opinions from outside consultants as to the fairness of certain terms of the sponsored demutualization, a statement of risk factors relating to the sponsored demutualization, and various other information.

During the month of December, the Commissioner solicited comments on the Plan of Conversion and Acquisition at five public comment meetings. BCBSKS provided notice of these meetings to Eligible Policyholders in the Information Statement.

On January 7 through 9, 2002, the Commissioner will hold a public hearing on the Plan of Conversion in accordance with Article 40 of Chapter 40 of Kansas Statutes Annotated (which we refer to as the “Kansas Conversion Law”). Eligible Policyholders received notice of the meeting in the Information Statement. At the meeting, various representatives of BCBSKS, Anthem, and outside consultants will testify to show that the sponsored demutualization is fair and equitable to policyholders, how it complies with the Kansas Conversion Law, that the Plan of Conversion does not unjustly enrich any director, officer, agent or employee of BCBSKS, and that Anthem Health Plans of Kansas will meet the minimum requirements to transact business in Kansas and would not be hazardous or prejudicial to existing or future policyholders or the public. In addition to the testimony of the parties, any interested person may make oral or written statements at the hearing.

On January 11, 2002, BCBSKS will hold a special meeting of Eligible Policyholders to vote on the sponsored demutualization, notice of which was included with the Information Statement. Eligible Policyholders may vote in person at the meeting or by the Proxy Cards included with the Information Statement. In accordance with the

Kansas Conversion Law, the Plan of Conversion will be approved if two-thirds of the Eligible Policyholders voting at the special meeting vote in favor of it, unless a majority of all Eligible Policyholders vote in person or by proxy at the special meeting, in which case a majority of those voting will constitute approval.

If the Plan of Conversion is approved by the Commissioner and Eligible Policyholders, the Company will proceed with the sponsored demutualization. The conversion and the acquisition of BCBSKS by Anthem are contingent upon certain conditions required under the Plan of Conversion and the Alliance Agreement. These are explained in greater detail in those documents and in the Information Statement.

VI. The Conversion and Acquisition

Under the Plan of Conversion, we will convert from a mutual insurance company to a stock insurance company in accordance with the Kansas Conversion Law. For the Plan to become effective, it must be approved by a vote of Eligible Policyholders at a special meeting and by the Commissioner following a public hearing. If it becomes effective, our policyholders will have their Membership Interests in BCBSKS extinguished and Eligible Policyholders will be entitled to receive cash consideration.

Immediately upon effectiveness of the conversion, Anthem or a wholly-owned subsidiary will purchase 100% of BCBSKS' stock for \$190 million (the "Purchase Price"). Upon the conversion and sale of the Company's stock, BCBSKS will become a wholly-owned subsidiary of Anthem. The Plan of Conversion is contingent upon the acquisition. Additional financial aspects of the acquisition are discussed in the separate statements submitted by Mr. Donald R. Lynn, BCBSKS' Vice President of Finance; Mr.

Michael H. Mattox, BCBSKS' Executive Vice President; and by Mr. Paul Adams of Dresdner Kleinwort Wasserstein, our outside financial advisor.

VII. Eligible Policyholders and Allocation of Consideration

If the Plan of Conversion becomes effective, Eligible Policyholders will receive cash consideration in exchange for their illiquid Membership Interests. The cash consideration is comprised of two elements: the Purchase Price and a Special Distribution.

In return for relinquishing their Membership Interests, Eligible Policyholders will receive their Proportionate Share of the Purchase Price. As discussed above, upon BCBSKS' conversion to a stock insurance company, Anthem will purchase 100% of BCBSKS' stock for \$190 million. Part of that Purchase Price, \$142 million, will be distributed to Eligible Policyholders as soon as reasonably practicable after the Closing of the transaction. The remainder, \$48 million, will be deposited into an Escrow Fund to pay certain costs and expenses. The balance of the Escrow Fund, if any, will be distributed to Eligible Policyholders. BCBSKS' Vice President/General Counsel, William H. Pitsenberger, and Vice President of Finance, Donald R. Lynn, discuss the operation of the Escrow Fund in more detail in their written testimonies.

The Plan of Conversion provides that in addition to the Purchase Price, Eligible Policyholders will receive their Proportionate Share of a Special Distribution equal to the excess of the Company's Closing Book Value over \$155,000,000 (the "Special Distribution"). We currently estimate the Special Distribution will be \$131 million if the Closing occurs on January 31, 2002, but we cannot guarantee the amount of any Special

Distribution. The amount of the Special Distribution, if any, will be determined and paid as soon as reasonably practicable after the Closing.

The cash consideration will be distributed among Eligible Policyholders based on their Proportionate Share of the Purchase Price and Special Distribution. Eligible Policyholders are policyholders of certain group or non-group insurance policies of BCBSKS on October 25, 2001, the date on which our Board of Directors approved and adopted the Plan of Conversion. An Eligible Policyholder's Proportionate Share is comprised of both a variable component representing the Eligible Policyholder's contributions to the Company's surplus and by a fixed component representing the Eligible Policyholder's proportionate share in relation to the total number of Eligible Policyholders. Mr. Daniel J. McCarthy of Milliman, the Company's outside actuarial advisor, provides a more detailed explanation of the allocation of the Purchase Price and Special Distribution among Eligible Policyholders in his written statement submitted to the Commissioner.

Thus, if the Plan of Conversion becomes effective, Eligible Policyholders will realize real economic value for Membership Interests that is currently otherwise unavailable to them.

VIII. Additional Benefits and Protections For Policyholders

As I noted at the outset, the sponsored demutualization will not, in any way, change the policy or contract rights of our policyholders. Any changes to policy benefits and premiums will continue to be governed by the terms of the policies and by applicable law. I also want to emphasize that policyholders will benefit substantially not just by the

financial compensation that they will receive under the Plan of Conversion but also because after the sponsored demutualization, the Company will be better able to service them by taking advantage of economies of scale, responding flexibly to localized adverse risk events, attracting and retaining the kinds of employees needed to provide quality service, and using the best practices in health insurance.

IX. Continuing Service to Policyholders

After the sponsored demutualization, our Company intends to continue its focus on customer service. Sponsored demutualization will give us added strength and flexibility that will enable us to serve the needs of our policyholders even better than before. The Company intends to expand its products and services and to invest in technology and infrastructure to provide even greater quality of policyholder service. Maintaining our high standards for serving policyholders after the sponsored demutualization makes good business sense from the point of view of our shareholder as well as our policyholders.

Certain provisions of the sponsored demutualization are specifically designed to ensure our continuing level of service to our policyholders. *First*, Anthem has agreed to use its best efforts to have a candidate from our current Board of Directors nominated and elected to Anthem's Board of Directors. *Second*, Anthem will create and maintain a local advisory board for Anthem's Kansas business. *Third*, Anthem will provide proportionate representation for Kansas residents on a regional advisory board that will contribute to the oversight and development of Anthem's West Region. *Fourth*, Anthem will establish and maintain hospital, medical and dental advisory committees for BCBSKS, each

consisting of similar numbers and qualifications of members as those of our current advisory committees. *Fifth*, Anthem has agreed that all BCBSKS employees as of the Closing Date will be employees of Anthem Health Plans of Kansas, and thereafter Anthem will maintain proportional employment in Kansas as described in the Alliance Agreement.

In my years of experience with BCBSKS, I have observed the health care financing market as being very competitive on the basis of price, provider and hospital networks, quality, health plan design and customer service. In order to successfully compete, BCBSKS must provide a superior product at an affordable price. We must also maintain an active and large sales force to attract and retain policyholders, closely monitoring retention rates of policyholders and groups. While the Blue Cross and Blue Shield mark provides us with a slight competitive advantage, that advantage is diminishing, especially with respect to strong local health plans. In addition, purchasers of group insurance tend to be mobile and not necessarily brand loyal. This is less so with individual purchasers, particularly in the Medicare Supplement market.

Provider networks play a large role in the competitive landscape in Kansas. The mutual interdependence of these voluntary contractual provider networks between insurers and providers create competitive constraints within both markets. In addition, there is a vast array of choices available to purchasers of group insurance in Kansas. These competitive forces, among others, working together in our service area in Kansas create a vibrant and competitive marketplace. These competitive market forces prevent BCBSKS or for that matter any other competitor from charging premiums above

competitive levels or reducing coverage and services below competitive levels without risking the loss of a substantial amount of our business.

X. Conclusion

We are confident about our future and the positive changes that this sponsored demutualization will bring. Our Board of Directors and management team believe that the time to strategically position BCBSKS is at a time of relative strength and when the path to future success is clear. We believe that time is now. It is on the basis of our current strength and our confidence in an even brighter future for our policyholders that the Board of Directors approved the Plan of Conversion. The Plan is designed to position the Company to grow, prosper and flourish in the challenging environment that lies ahead. I strongly concur with the adoption of the Plan of Conversion by our Board of Directors and its approval of the acquisition. I am convinced that the sponsored demutualization is beneficial to our Company, our policyholders and the public. Therefore, we respectfully request that the Commissioner approve the Plan of Conversion and Anthem's acquisition of BCBSKS.

John W. Knack, Jr.

Dated: December 17, 2001
Sworn to before me this 17th day of December, 2001

Notary Public