

1 **Q. PLEASE STATE YOUR NAME, POSITION AND BUSINESS ADDRESS.**

2 **A.** My name is James P. Galasso. I am President & Consulting Actuary of Actuarial
3 Services & Financial Modeling, Inc. ("ActMod"). My business address is 90 West
4 Wieuca Road NE, Suite 220, Atlanta, Georgia, 30342.

5 **Q. HOW LONG HAVE YOU BEEN WITH ACTMOD?**

6 **A.** The company was founded in October, 2000. I was a founder of the company.

7 **Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND,**
8 **QUALIFICATIONS AND EXPERIENCE.**

9 **A.** I graduated with honors from the State University of New York at Stonybrook with
10 majors in both Theoretical and Applied Mathematics. I am in good standing as a Fellow
11 of the Society of Actuaries, a Member of the American Academy of Actuaries and a
12 Chartered Enterprise Risk Analyst. I have over 30 years of experience in health care,
13 serving at various times as a Chief Financial Officer, Chief Actuary, and as an Actuarial
14 Consultant. I was also a Partner with Ernst & Young LLP, managing E&Y's southeast
15 actuarial healthcare practice. I have performed actuarial and related consulting services
16 for numerous commercial insurance carriers, Blue Cross and Blue Shield plans, Health
17 Maintenance Organizations, governmental entities, health care providers and large
18 employers.

19 **Q. HAVE YOU PREVIOUSLY TESTIFIED IN FORMAL PROCEEDINGS BEFORE**
20 **AN OFFICER OF THIS STATE OR IN FORMAL PROCEEDINGS IN**
21 **ANYOTHER STATE OR THE FEDERAL GOVERNMENT?**

1 A. Yes, I have testified before the Insurance Commission of Florida and the Insurance
2 Commission of Kentucky.

3 **Q. PLEASE PROVIDE A BRIEF SUMMARY OF YOUR TESTIMONY.**

4 A. I will testify on behalf of applicants in this proceeding, Blue Cross and Blue Shield of
5 Montana, Inc. ("BCBSMT") and Health Care Service Corporation, a Mutual Legal
6 Reserve Company ("HCSC"), with regard to the actuarial appraisal I performed for
7 BCBSMT of expected cash flows associated with certain health care contracts
8 underwritten and administered by BCBSMT ("Modeled Business Segments").

9 **Q. ARE YOU FAMILIAR WITH THE TRANSACTION THAT IS THE SUBJECT**
10 **OF THE PROCEEDING?**

11 A. Yes, I have become aware that a potential transaction is pending between BCBSMT and
12 HCSC.

13 **Q. WHAT IS YOUR INVOLVEMENT IN THE TRANSACTION THAT IS THE**
14 **SUBJECT OF THE PROCEEDING?**

15 A. I was retained by BCBSMT in August, 2012 to assist it in its discussions with potential
16 acquirers by developing an independent appraisal of the expected cash flows associated
17 with the Modeled Business Segments and to assist BCBSMT in related responses to any
18 regulatory or other proceedings or inquiries regarding the appraisal.

19 **Q. HAD YOU OR YOUR FIRM BEEN RETAINED BY BCBSMT OR HCSC TO**
20 **PERFORM ANY OTHER SERVICES PRIOR TO YOUR ENGAGEMENT FOR**
21 **THIS VALUATION?**

22 A. No.

1

2 **Q. WERE YOU INVOLVED IN THE NEGOTIATIONS OF THE PROPOSED**
3 **TRANSACTION BETWEEN HCSC AND BCBSMT? IF SO, DESCRIBE YOUR**
4 **INVOLVEMENT.**

5 **A.** No. I became aware of the transaction from press reports.

6 **Q. DID YOU PERFORM THE ACTUARIAL APPRAISAL OF EXPECTED CASH**
7 **FLOWS ASSOCIATED WITH THE BCBSMT HEALTH CARE CONTRACTS**
8 **THAT YOU WERE RETAINED BY BCBSMT TO PERFORM?**

9 **A.** Yes, I did. I prepared a Report dated November 9, 2012, regarding Actuarial Appraisal of
10 Certain Health Care Contracts with Appraisal Dates of January 1, 2013, and June 30,
11 2012, attached as Exhibit 5 to the Application for Approval of Alliance, filed jointly by
12 BCBSMT and HCSC on or about November 15, 2012 (the "Cash Flow Appraisal.").

13 **Q. WHAT VALUE DID YOU PLACE ON THE MODELED BUSINESS SEGMENT**
14 **CASH FLOWS AS OF A JUNE 30, 2012, APPRAISAL DATE?**

15 **A.** For the June 30, 2012, appraisal date, I appraised the single and specific value of the
16 Modeled Business Segments to be \$17.6 million.

17 **Q. WHAT VALUE DID YOU PLACE ON THE MODELED BUSINESS SEGMENT**
18 **CASH FLOWS AS OF JANUARY 1, 2013, APPRAISAL DATE?**

19 **A.** For the January 1, 2013, appraisal date, I appraised the single and specific value of the
20 Modeled Business Segments to be \$18.6 million.

21 **Q. HOW DID YOU ARRIVE AT THOSE APPRAISED VALUES?**

1 A. Using various assumptions developed from discussions with BCBSMT management and
2 industry analysis, I developed four appraisal scenarios for nine health care contract
3 business segments (Individual, Small Group, Large Group, Medicare Supplement,
4 Medicare Part D, Federal Employee Program, Students, Self-Funded and Stop Loss) to
5 produce independent cash flow appraisal values for the June 30, 2012 appraisal date, the
6 appraised cash flow values ranged from \$0.0 million to \$39.5 million. From this range, I
7 determined that a reasonable single and specific appraisal value was \$17.6 million. For
8 the January 1, 2013 appraisal date, the appraised cash flow values ranged from \$0.1
9 million to \$41.6 million. From this range, I determined that a reasonable single and
10 specific appraisal value was \$18.6 million.

11 Q. **WHAT INFORMATION DID YOU RELY ON IN ARRIVING AT YOUR**
12 **APPRAISALS?**

13 A. I relied on thirty months of detailed BCBSMT historical financial information, by
14 relevant business segments. In addition to source financial data originally reported in
15 Annual Statutory Financial Statements (“STAT” Statements), BCBSMT also provided
16 “Management GAAP Reported” and “Management GAAP Recast” financial statements
17 to both more consistently reflect General Accepted Accounting Principles and, in
18 “recasting,” to update claim liability estimates with information not available at the time
19 the “reported” estimate was made. These adjustments allowed for a more credible basis
20 for financial analysis. I also relied on company information provided by Mark
21 Burzynski, BCBSMT’s Chief Financial Officer, James Spencer, BCBSMT’s Chief
22 Actuary and Chris Manger, BCBSMT’s Controller.

1 I then used two ActMod proprietary health care models (“Segmenter Model” and
2 “Optimizer Model”) developed specifically for the purpose of evaluating both historical
3 and projected financial results for short-term health care policies, which are the types of
4 policies in the nine Modeled Business Segments. The historical financial information
5 provided by BCBSMT was used to develop the starting points for the projections
6 developed in my analysis. I ran projections under four appraisal value scenarios to
7 generate appraisal ranges for present values of net income, cost of capital and divestiture
8 value.

9 The base scenario (Scenario One) took into account, but was not limited to, the following
10 factors and assumptions: discount rates; medical loss ratio (“MLR”) and BCBSMT
11 actuarial medical trends; FEP business fee projections; policy/business lapse rates, new
12 business generation assumptions, risk-based capital levels, interest earnings, provider
13 contract assignability, administrative expenses, premium taxes, commissions and
14 Affordable Care Act fees. Scenarios Two and Three were identical to Scenario One but
15 varied the discount rates assumed in Scenario One. Scenario Four varied the assumed
16 MLRs for the Individual and Small Group Business Segments used in Scenario One.
17 Using these projections under the four scenarios, I arrived at single unique appraisal
18 values of \$18.6 million and \$17.6 million for January 1, 2013 and June 30, 2012,
19 respectively, which represent the average of the four scenarios we analyzed.

20 **Q. DID YOU PROVIDE ANY OTHER OPINIONS TO BCBSMT IN YOUR**
21 **REPORT?**

22 **A.** Yes.

23 **Q. WHAT WERE THOSE OPINIONS?**

1 A. My primary opinions were that the recent financial experience of BCBSMT and certain
2 requirements of the Affordable Care Act (“ACA”), especially with regard to smaller
3 managed care organizations (“MCOs”) like BCBSMT, challenged the ongoing financial
4 viability of BCBSMT. BCBSMT is a relatively small MCO, with premiums of less than
5 \$600 million in 2011. BCBSMT also reported net underwriting losses each year from
6 2008 to 2011 ranging from \$0.8 million in 2008 to \$17.6 million in 2009, and a 2011 net
7 underwriting loss of \$5.4 million. Revenues of large national MCOs were 9 to 181 times
8 larger than BCBSMT’s revenue, with workforces 8 to 185 times the size of BCBSMT’s.
9 I opined that scale was very important for BCBSMT from three perspectives: (1)
10 economies of scale are required to maintain profitability and competitive position vis-à-
11 vis the larger MCOs; (2) it is increasingly essential that MCOs make sufficient capital
12 investments to remain competitive while developing innovative health care programs and
13 providing satisfactory services, requiring large fixed investments that will prove difficult
14 if not impossible for smaller MCOs with limited resources; and (3) ACA will make it
15 difficult for smaller MCOs to remain financially viable, and as a result, industry
16 consolidation is very likely if not inevitable.

17 **Q. WHAT AMOUNT OF CAPITAL INVESTMENT DID YOU INCLUDE IN YOUR**
18 **VALUATION AND WHY?**

19 A. Based on information provided by BCBSMT management, I learned that BCBSMT’s
20 recent financial and operating challenges had prevented it from implementing even
21 baseline capital improvements needed with respect to its administrative and claims
22 processing systems. I also learned that ACA demands would require additional capital
23 expenditures above and beyond recurring investments that are essential to BCBSMT’s

1 long term financial and marketplace viability. Based on current financial statements, and
2 more urgent, shorter term ACA needs, I included in my valuation fixed depreciation and
3 amortization expense of \$2M in each of projection years one through five, and \$1M in
4 each of years six through twenty, for a total expense of \$25M. I also estimated an
5 additional \$2M per year in each of years one through twenty for needed future initiatives,
6 for a total additional expense of \$40M. Based on management's descriptions of the
7 scope of investment needed, I believe this \$65M estimate is conservative. For context,
8 the \$2M per year spend we assumed for future initiatives represents a modest 0.3% to
9 0.4% of projected revenues for the Modeled Business Segments.

10 **Q. WHEN WAS YOUR FINAL REPORT DELIVERED TO BCBSMT?**

11 **A.** November 9, 2012.

12 **Q. DID HCSC HAVE ANY INPUT INTO YOUR VALUATION OPINION BEFORE**
13 **YOU DELIVERED THE REPORT TO BCBSMT?**

14 **A.** No.

15 **Q. DID EITHER BCBSMT OR HCSC INFLUENCE YOU OR ATTEMPT TO**
16 **INFLUENCE YOUR OPINION IN ANY WAY?**

17 **A.** I had no conversations or communications with HCSC during the preparation of my
18 report or the formation of my opinions, which have not changed since my report was
19 delivered to BCBSMT on November 9, 2012. As I stated previously, BCBSMT
20 management provided me historical information and discussed with me critical
21 assumptions. BCBSMT did not attempt to and did not influence my opinions.

22 **Q. HOW WERE YOU COMPENSATED FOR YOUR REPORT?**

1 A. My compensation was based solely on my hourly rates for professional services provided
2 and was not contingent upon any of my findings or opinions.

3 Q. **DOES THIS CONCLUDE YOUR TESTIMONY?**

4 A. Yes.

Respectfully submitted this 8 day of February, 2013.

KELLER, REYNOLDS, DRAKE,
JOHNSON & GILLESPIE, P.C.

BY: Jacqueline T. Lenmark
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CERTIFICATE OF SERVICE

I, Jacqueline T. Lenmark, KELLER, REYNOLDS, DRAKE, JOHNSON & GILLESPIE, P.C., certify that on Feb 8 2013, I served a true and correct copy of the foregoing Direct Testimony of James P. Galasso, FSA, MAAA, CERA, by mailing it first class postage prepaid to:

Ms. Sybil Shults
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State Auditor's Office
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Helena MT 59601

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DATED this 8 day of February, 2013.

Jacqueline T. Lenmark
Jacqueline T. Lenmark