

BEFORE THE COMMISSIONER OF SECURITIES AND INSURANCE

MONTANA STATE AUDITOR

IN THE MATTER OF THE CONVERSION OF) Case No.: INS-2012-238
BLUE CROSS AND BLUE SHIELD OF) **DIRECT TESTIMONY OF PHIL DALTON**
MONTANA, INC., AND ALLIANCE WITH)
HEALTH CARE SERVICE CORPORATION)
Applicants.)

Q: Please state your name, current occupation and business location.

A: My name is Phil Dalton and I am President and CEO of Medical Development Specialists, LLC (MDS), a health care consulting firm, located in Torrance, California.

Q: Please describe your education, qualifications and experience.

A: I obtained a BS from Portland State University, an MPH from the University of Minnesota, and an MS from Harvard University in health policy and management. I have worked in the fields of strategic consulting and market analysis since 1978. I have published several articles on the health care industry. Concerning the Affordable Care Act (ACA) in particular, I have attended numerous seminars relating to the ACA and the health care industry, and our firm sponsors an annual conference that recently focused on the ACA. The conference, entitled "Navigating the Road to the Future: Transforming the Way Hospitals, Physicians and Health Plans Conduct Business," focused on the innovative

approaches, models and new strategies designed to drive higher quality and value in healthcare. The conference was designed to help leaders tackle the changing dynamics of the marketplace and develop healthcare strategies that will help them succeed. Leaders from healthcare organizations also presented their progress and outcomes regarding healthcare reform to date. In addition, emerging themes discussed included clinical integration, new strategies for hospital, physician, health plan and employer alignment, the impact of health insurance exchanges, bundled payments and Medicaid managed care.

Q: Have you provided a copy of your resume?

A: Exhibit 1 is an updated copy of my Curriculum Vitae which outlines more fully my experience and education.

Q: On whose behalf are you appearing?

A: I have been asked by the Montana Attorney General's Office to provide an economic overview of the health care market in conjunction with the Application for Approval of Alliance submitted by Blue Cross and Blue Shield of Montana (BCBS) and Health Care Service Corporation.

Q: Have you testified previously in any formal proceedings in Montana or in any other state?

A. I have not previously testified in any formal proceeding in Montana. However, I have testified in California.

Q: Can you give us a brief economic overview of the national health insurance market?

A: Nationally, the health insurance market is dealing with the changes brought on by healthcare reform and overall is likely to be in a favorable position. As the economy slowly improves more people will be purchasing health insurance.

Additionally, increased efficiencies in the health care industry, both from providers and payers, will positively affect the profitability of health insurance companies.

The biggest change in the market, in my opinion, is the Affordable Care Act (ACA), which presents both challenges and opportunities for the health insurance industry. While there are new rules and requirements, there is also a significant expansion in the number of people that will be insured.

Q: How does ACA most directly affect the health insurance industry?

A: The creation of insurance exchanges, the push towards bending or reducing the cost curve of health care expenditures, an emphasis on quality and payment reform, consolidation in the industry, an emphasis on new models of service for Medicare healthcare delivery, such as accountable care organizations, and an aging of the population all affect or will affect the industry. Payment reform, an integral part of the ACA, will affect the direction of commercial payers toward population health management, narrow networks and financial risk sharing.

Q: How will insurance exchanges primarily affect the market?

A: For those insurers that participate, the exchanges will present a new source of insureds and revenue as well as, potentially, a new source of competition.

Insurers that do not have a strategic response to an increase in the retail market may lose market share.

Q: And in your opinion, will the exchanges be a benefit or detriment to the profitability of the health care industry?

A: I think they will ultimately be beneficial for the industry.

Q: Why do you think exchanges will be beneficial?

A: Because I believe the benefit of additional consumers facilitated by the exchanges combined with improvements in efficiency will outweigh the potential downside of increased competition.

Q: Can you explain what you mean by bending the cost curve and how it will affect the market?

A: Bending the cost curve means reducing the rate of the cost increases for health care expenditures by establishing new models of care, payment reform and implementing greater cost efficiencies and cost effectiveness. This will reduce the rate of health care cost increases and hence decrease the rate of growth of expenses for health insurance companies.

Q: In your opinion, will a focus on bending the cost curve increase the profitability of the health care industry?

A: Yes it will.

Q: And why will it increase profitability?

A: Because it will decrease the costs that insurance companies pay providers for health care services and improve administrative efficiencies allowing for a greater margin of profit.

Q: How will the ACA lead to consolidation in the health care market?

A: In general, larger organizational size can allow for better efficiencies, access to capital, marketing, geographic coverage, human resource recruitment and retention, etc. As competition increases, health care companies will attempt to gain these benefits by acquisition, merger or partnership.

Q: And how has that affected the valuation of health care companies in general?

A: In general it has led to higher valuations.

Q: And why has consolidation led to higher valuations?

A: With an industry trend towards consolidation, the competition for mergers and acquisitions has led to higher valuations.

Q: Can you estimate whether increased competition has directly affected BCBS's valuation?

A: No, I cannot.

Q: How has the focus on Medicare coverage and the increase in accountable care organizations affected the market?

A: Medicare is one of the largest payers for health care services, and the Accountable Care Organization ("ACO") is a new service delivery model aimed at serving the fee-for-service Medicare market. So organizations that have branched into this market and developed accountable care organizations will see new sources of market share and revenue.

Q: Have you researched the market conditions of the health insurance industry in Montana?

A: Other than my two day trip to visit BCBCMT, and my reading of the reports submitted in this proceeding, no, I have not.

Q: Are you in a position to provide an opinion as to Montana's health insurance market?

A: No, I am not.

Q: What can a health insurance provider do to best position themselves to benefit from the changing health care market?

A: The most important thing is to have a plan to address the key issues of health reform and hopefully take advantage of these changes. For example, an organization could have plans to participate in a health exchange, develop an accountable care organization, or partner with providers in new models to reduce cost and improve quality.

Q: When you visited BCBS, did you ask their management about whether they have a plan to address any of these changes?

A: I did and I was surprised that they did not have a specific plan for whether and how they were going to participate in the exchanges, or for how they planned to partner with providers to reduce costs. They did mention that they were developing primary care medical homes and sought to get back into the Medicare market, but they did not explain how or to what extent it might impact revenues or expenses.

Q: Based on those conversations, how would you characterize the economic outlook of BCBS's management?

A: Overall I would characterize it as overly pessimistic.

Q: Do you think BCBS's lack of plans and general pessimism affected their revenue estimate for the company?

A: The lack of plans and general pessimism may have affected the reasonableness of their projections and resulted in a lower revenue estimate than is otherwise warranted by the circumstances.

Q: What are the mechanisms that health insurance companies are using to negotiate lower rates?

A: In the past insurance companies relied on a reimbursement methodology where the insurer would enter into a contract with providers on a discounted fee for service basis. The industry, however, has moved away from this reimbursement model and embraced prospective value-based or risk-sharing arrangements which generally result in lower health care utilization and costs.

Q: Is it more difficult to negotiate rates in rural areas where there is a shortage of health care providers, as is the case in parts of Montana?

A: Yes it generally is, but BCBS has a large enough commercial market share, as reported in the NERA Antitrust Report, that it should have the power to negotiate more cost effective reimbursement rate with providers.

Q: Does this conclude your testimony?

A: Yes.

VERIFICATION

I, Phil Dalton, being first duly sworn, upon my oath, state that I have read, know and understand the contents of the foregoing testimony and that the statements contained therein are true and correct to the best of my knowledge, information, and belief.



PHIL DALTON

SUBSCRIBED AND SWORN to before me this ___ day of February, 2013.

See Attachment

(SEAL)

NOTARY PUBLIC for the State of California.

Printed Name: _____

Residing at _____, California.

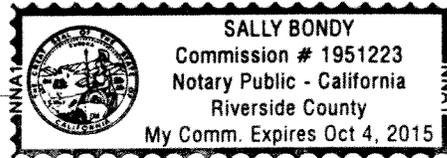
My Commission expires: _____

STATE OF CALIFORNIA
COUNTY OF RIVERSIDE

Subscribed and sworn to (or affirmed) before me on this 7th day of February, 2013, by Phil Dalton, proved to me on the basis of satisfactory evidence to be the person who appeared before me.

Signature

Sally Bondy



(Seal)