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BEFORE THE COMMISSIONER OF SECURITIES AND INSURANCE
OFFICE OF THE STATE AUDITOR
STATE OF MONTANA

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

DIRECT TESTIMONY OF

MARK A. BURZYNSKI
SENIOR VICE PRESIDENT AND CHIEF FINANCIAL OFFICER
BLUE CROSS AND BLUE SHIELD OF MONTANA, INC.

MARCH 5, 2013

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

A. My name is Mark A. Burzynski. I am a Senior Vice President and the Chief Financial Officer of Blue Cross and Blue Shield of Montana, Inc. ("BCBSMT"). My business address at BCBSMT is 560 North Park Ave, Helena, Montana 59601.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND.

A. I received my bachelor's degree from Marquette University in 1975. I received a master's degree in Business Administration from the University of Wisconsin in 1979 and a master's degree in Health Services Administration from the University of Wisconsin in 1980. I became a certified public accountant in 1983. I have also attended the following executive training programs: (i) the Managed Care Strategy Executive Program at Northwestern University's Kellogg Graduate School of Management; (ii) the Program for Executives in Managed Care at the Harvard University School of Public Health; and (iii) the Executive Program in Managed Care at the University of Missouri-Kansas City National Center for Managed Care Administration.

Q. ARE YOU A MEMBER OF ANY PROFESSIONAL ORGANIZATIONS OR ASSOCIATIONS?

A. Yes. I am a Fellow in the American College of Healthcare Executives, an Advanced Member of the Healthcare Financial Management Association, and am a member of the American Institute of Certified Public Accountants.

Q. PLEASE DESCRIBE YOUR EMPLOYMENT HISTORY.

A. I am currently BCBSMT's Senior Vice President ("VP") and Chief Financial Officer ("CFO"). Prior to being BCBSMT's Senior VP, I served as BCBSMT's CFO. In the

roles of Senior VP and CFO, I am and was responsible for the operations and finance areas of BCBSMT. I was BCBSMT's External Affairs Officer from December of 2007 to January of 2010. In this role, I was responsible for government relations, public relations, corporate communications, internal audit, performance reporting, provider relations, including provider satisfaction, contracting, credentialing, the development and implementation of compensation strategies, methodologies, and levels for network providers. I also have served as BCBSMT's VP of Health Affairs from 2005 to December of 2007 and as its VP of Health Care Management from April of 2000 to December of 2004. Prior to working for BCBSMT, I served as the CFO of St. Vincent Healthcare, the Chief Executive Officer of the Billings Physician Hospital Alliance, Inc. (currently doing business as Rocky Mountain Health Network), and Chief Executive Officer of Yellowstone Community Health Plan, all in Billings, Montana.

Q. HAVE YOU PREVIOUSLY TESTIFIED IN FORMAL PROCEEDINGS IN MONTANA OR IN ANY OTHER STATE?

A. No, I have not.

Q. PLEASE PROVIDE A BRIEF SUMMARY OF YOUR TESTIMONY.

A. My testimony will provide insights, perspectives, and facts in support of the approval from the Montana Commissioner of Insurance and the Montana Attorney General of the proposed Alliance ("Alliance") between BCBSMT and Health Care Service Corporation, a Mutual Legal Reserve Company ("HCSC") for the acquisition of identified BCBSMT assets and liabilities for which HCSC will pay approximately $17.6 million ("M"). BCBSMT and HCSC's request for approval was made in the filing of their joint

Application in this matter under Title 50, chapter 4, part 7, MCA ("Conversion Statute"), on November 15, 2012. My testimony will include: (1) a brief discussion of the financial reasons that BCBSMT needs an alliance with another Blue Cross Blue Shield health plan; (2) how the Alliance will improve BCBSMT's financial results and strengthen its financial condition; (3) the consequences to BCBSMT and its policyholders if the Alliance is not approved; (4) how the proposed Alliance is structured; and (5) facts relating to certain financial and other applicable statutory requirements.

Q. WHY DID BCBSMT START TO SEARCH FOR AN ALLIANCE PARTNER?

A. It became apparent to the leadership of BCBSMT during the past couple of years that there were several critical factors that clearly indicated BCBSMT would need to change its business model.

Q. WHAT WERE THOSE FACTORS?

A. BCBSMT leadership identified the following challenges as key factors in its decision to pursue a change to its business model: (i) administrative cost structure challenges brought on by a lack of scale; (ii) increased competition in Montana from national competitors with significant financial resources and geographic diversification; (iii) insufficient access to capital to adequately expand capabilities and services; and (iv) increased risk exposure, heightened by the health care reform measures enacted under the Patient Protection and Affordable Care Act ("ACA") such as guaranteed issue, Medical Loss Ratio ("MLR") restrictions, and the elimination of annual and lifetime maximums.

Q. CAN YOU PLEASE ELABORATE ON THOSE FACTORS?

A. BCBSMT has been reducing its administrative expenses since 2007, when statutory administrative expenses were $85.6M, and BCBSMT had 664 employees. Despite these reductions, BCBSMT's administrative costs remain higher than many others in the industry. This is due in large part to its small size and lack of economies of scale. Lower administrative expenses are increasingly important under ACA because insurers are limited by the percentage of premium they may retain. Post ACA, an insurer's ability to generate a positive margin will depend largely on lowering administrative expenses. Insufficient scale and access to capital makes it difficult for BCBSMT to innovate and expand on its capabilities and services offered to members.

In addition, BCBSMT has identified an estimated $100M in capital requirements and incremental operating expenses that it needs to make to successfully compete in the changing marketplace, improve operational efficiency, meet the BCBSA standards and comply with applicable laws and regulations. Without sufficient access to capital, BCBSMT will be unable to invest in these capital requirements.

Also, the implementation of various provisions of ACA, or health care reform, adds greater uncertainty, risk exposure and therefore additional financial strain on smaller, single-state insurers like BCBSMT, because they lack sufficient scale to implement these reforms and remain competitive. Finally, increased competition from large, national insurers, and regional multistate insurers has put pressure on BCBSMT's membership levels.

Q. CAN YOU ELABORATE ON THE ESTIMATED CAPITAL INVESTMENTS REQUIRED FOR BCBSMT?

A. Yes. BCBSMT has identified an estimated $100M in capital requirements and incremental operating expenses over the next five years to successfully compete in the changing marketplace, improve operational efficiency, and meet various applicable laws and regulations. Some of the largest projects, accounting for a significant portion of the financial requirements, include:

- an ICD-10 compliant claims system and data warehouse as a result of ACA;
- physician incentive programs to introduce patient-centered medical homes to approximately 50,000 members;
- an upgraded computer system to interface with the ACA health insurance exchange infrastructure;
- an upgrade to BCBSMT's Federal Employees Health Benefits Plan ("FEP") processing technology;
- an improved online information and transaction portal;
- an information analytics platform;
- upgraded financial systems, including cost accounting, budgeting, and financial reporting tools;
- various medical and care management programs, including a wellness website update, new utilization management software, and new medical oncology management software beginning in 2013; and
- excess of loss coverage.

Q. DOES BCBSMT HAVE THE CAPITAL OR RESERVES TO MAKE THESE INVESTMENTS?

A. No, BCBSMT does not have the capital resources to make these investments and still retain its ability to weather potential adverse claim experience and preserve its current financial strength. BCBSMT's reserves are held for the protection of policyholders for those times when there is significant adverse claim activity. The new ACA requirements for guaranteed issue, MLR restrictions, rating constraints and removal of yearly and lifetime claim limits will potentially put pressure on BCBSMT's capital level. But, for the purpose of this response, if BCBSMT did fund the estimated capital investments of $100M, these investments would reduce its reserves to an unacceptable level in light of future risk factors. This would not allow BCBSMT to prudently assume the risk of new members nor cover unexpected growth in claims and/or trends.

Q. IF THE ALLIANCE IS APPROVED, WILL THE CAPITAL EXPENDITURES AND INCREMENTAL OPERATING EXPENSES YOU DISCUSSED BE INCURRED?

A. No. Almost all of the estimated $100M capital expenditures and incremental operating expenses I mentioned will not be incurred.

Q. DOES BCBSMT HAVE ACCESS TO OUTSIDE CAPITAL TO OBTAIN THE FUNDS NECESSARY TO MAKE THESE REQUIRED INVESTMENTS?

A. No. As a local, small nonprofit health insurer, BCBSMT has very limited access to capital markets. Therefore, smaller health plans such as BCBSMT are often relatively undercapitalized compared to larger health plans. For context, the average Risk Based Capital ("RBC") ratio of non-investor owned ("NIO") Blue plans with less than 500,000 members is 881%, while the average RBC ratio of Blue plans with more than 500,000

members is 911%. In 2011, BCBSMT's RBC ratio was 577%. This was the third lowest of the nonprofit Blues. For 2012, BCBSMT's RBC ratio further declined to 532%. In further contrast, for-profit equity insurers have access to capital through a variety of capital markets.

Q. YOU MENTIONED "RBC" SEVERAL TIMES. WHAT IS "RBC"?

A. RBC is a measurement tool that has been developed to uniformly measure insurance companies relative to the degree of risk assumed by a company within their business operations and to determine whether or not the capital that has been accumulated by the insurer is sufficient to pay policyholder claim liability, cover administrative expenses and support required capital investments. The RBC metric is used by insurance regulators to set capital requirements for an insurer in order to protect policyholders.

Q. WHY IS RBC IMPORTANT?

A. The basic role of an insurance company is to pay claims in exchange for a premium. If an insurer was 100% certain that its business activities would be profitable on a sustainable basis, there would not be a need for capital or reserves available to make up shortfalls. However, there are adverse fluctuations in profitability that can arise in a variety of ways including incorrectly predicting claim utilization, catastrophic claims, or the deterioration of invested assets. Sufficient capital capacity must be established in order to protect against these adverse fluctuations to ensure: (1) that obligations to policyholders will be met; and (2) that capital investments can be made to support business needs. Accordingly, RBC is important because it measures the financial strength of an insurance company. For Blue plans such as BCBSMT, part of the requirements for licensure with

Blue Cross Blue Shield Association ("BCBSA") is that the plan must maintain an even more stringent capital capacity than required by the State of Montana. BCBSA would begin to monitor BCBSMT long before any regulatory review would be triggered by its RBC results under Montana law. Plans that find themselves under BCBSA scrutiny are inevitably faced with the prospect of losing their licensure.

Q. WHAT IS BCBSMT'S RBC?

A. As previously mentioned, BCBSMT has the third lowest RBC ratio of the nonprofit Blues at 532%. This metric is for 2012, and is the most current metric available. BCBSMT's RBC ratio has declined over the past five years: 2007 at 760%; 2008 at 645%; 2009 at 618%; 2010 at 654%; and 2011 at 577%. BCBSMT's RBC ratio is not at risk of approaching the minimum value required by BCBSA or the minimum rate set by Montana law.

Q. DO YOU KNOW HCSC'S RBC?

A. Yes, I do.

Q. WHAT IS HCSC'S RBC?

A. I understand that HCSC had an RBC ratio of 1,227% at the end of 2011.

Q. WILL THE ALLIANCE HELP BCBSMT'S RBC?

A. Yes. When BCBSMT becomes a division of HCSC, BCBSMT will be part of HCSC's RBC. This will ensure the sustainability of a financially strong nonprofit Blue plan in Montana and improve the protection and security of BCBSMT's members.

Q. DO BCBSMT'S RESERVES DECREASE ITS ABILITY TO CONTINUE OFFERING INSURANCE AND/OR FUTURE COMPETITIVENESS?

A. Yes. With limited reserves, BCBSMT will struggle to create the appropriate level of reserves to assume the insurance risk of new members, cover unexpected claims growth and trends, and invest in necessary infrastructure, such as information technology. As a result, BCBSMT will struggle with innovation for the benefit of its members and Montana residents. The key for a small plan like BCBSMT is to be locally focused with big plan capability.

Q. WILL BCBSMT BE ABLE TO COMPETE WITHOUT ACCESS TO CAPITAL?

A. Without increasing its access to capital, BCBSMT can only create capital through its net income. This represents a limited source of capital given the risk inherent in the insurance business, BCBSMT's limited service area and population, the inability to create required economies of scale, and BCBSMT's history of underwriting losses in eleven of the last fifteen years, totaling approximately $63M. Given those facts, BCBSMT will be very challenged to generate the income necessary to build its reserves and serve as a source of capital.

Q. WILL ALIGNING WITH HCSC HELP BCBSMT'S ACCESS TO CAPITAL?

A. Yes. HCSC has already begun to make many of the required capital investments for its own business that I previously identified that BCBSMT must make if it is going to remain competitive in the Montana marketplace. Since BCBSMT will become a division of HCSC, BCBSMT will have access to these HCSC investments. BCBSMT will avoid having to individually fund its own investments and instead will share the costs with HCSC.

The Alliance with HCSC also offers BCBSMT access to capital for corporate development projects (acquisitions to support core business, joint ventures aimed at innovation, etc.) which will permit BCBSMT to remain competitive well into the future. As the largest nonprofit Blue plan, HCSC is in a very strong capital position, allowing it to continue to fund the types of technology and servicing investments expected by the market and required by ACA. During the last ten years, HCSC has invested over $2.4 billion ("B") in information technology systems and improvements which is approximately equivalent to a cost of $20 per member per month. If BCBSMT were to have invested $100M over that same period, the per-member-per-month cost would be almost twice as high, the technology would not be as capable, and BCBSMT would not be able to maintain or upgrade the system without adding administrative expense. HCSC has over $9.5B of surplus as of September 30, 2012, and has evidenced its ability to access the public debt markets, as demonstrated by its issuance of $500M in ten-year notes in 2011.

Q. WILL HCSC'S ABILITY TO ACCESS CAPITAL HELP BCBSMT BEYOND FUNDING NECESSARY CAPITAL EXPENDITURES?

A. Yes. Improved access to capital will help in two other significant ways. First, HCSC's balance sheet strength will enhance BCBSMT's risk-taking abilities, allowing it to underwrite more insured-market business and thus contribute to increasing BCBSMT's membership base as well as its net income. Second, HCSC's reserves provide greater coverage for unexpected growth in claims and trends. To put this in perspective, HCSC has reserves of approximately $2,500 for each one of its fully insured members, while

BCBSMT has approximately $680, so the coverage for members is increased more than threefold. Third, the surplus of HCSC may be invested in new subsidiaries that will meaningfully increase BCBSMT's capabilities and operations. Fourth, in an uncertain economy, HCSC's reserves allow it to reduce its investment risk significantly when compared to a small investor like BCBSMT, which faces security and liquidity pressures given its size. A diversified investment of reserves creates a more predictable income stream to support core operations and build reserves consistent with claim trends.

Q. YOU ALSO IDENTIFIED HEALTH CARE REFORM, OR ACA, AS AN IMPORTANT FACTOR FOR THE ALLIANCE. CAN YOU PLEASE ELABORATE ON THAT POINT?

A. Yes. The passage of ACA requires insurers to implement various market reform provisions contained in the law and regulations, many of which increase risks for insurers, but particularly so in the case of small insurers. The market reforms include such provisions as guaranteed issue, MLR restrictions, rating constraints, elimination of annual and lifetime maximums, and the health insurance exchanges. Nationally, ACA will provide an opportunity for individuals who are currently uninsured to buy coverage on health insurance exchanges with the assistance of subsidies. These reforms, among others, will create greater operational and financial uncertainty and higher compliance costs for a small, single-state plan such as BCBSMT.

Q. CAN YOU PLEASE EXPLAIN HOW THESE NEW MARKET REFORMS, INCLUDING GUARANTEED ISSUE, WILL GENERATE GREATER UNCERTAINTY FOR BCBSMT?

A. Yes. As already mentioned, BCBSMT has not generated an underwriting gain in eleven of the last fifteen years due to the progression of claims utilization over the period and the lack of scale. This occurred despite the fact that BCBSMT increased membership and cut administrative costs during the same period. Guaranteed issue, one of the new market reforms, requires insurers to issue insurance policies to any person. Many of the currently uninsured expected to obtain insurance are anticipated to have pent-up demand for medical care, particularly those with chronic conditions. These individuals will represent a more costly segment of the newly insured population to treat, resulting in higher claims utilization. Given BCBSMT's continued difficulty in generating underwriting gains over the last ten years, guaranteed issue is likely to result in more financial uncertainty and will place even greater strain on BCBSMT's operations and reserves.

Q. YOU MENTIONED CHALLENGES FOR BCBSMT DUE TO ACA MLR REQUIREMENTS. PLEASE EXPLAIN THOSE CHALLENGES?

A. ACA's MLR requirements provide that for every dollar in premium, at least 80 or 85 cents are to be spent on medical claims and certain other specified expenses. The 80 or 85 cents depends upon the market segment. The rules to calculate a MLR have a level of complexity. Historically, a loss ratio was determined by dividing the incurred claims by the premium for a given period of time. The ACA MLR calculation starts with the historical loss ratio and then makes adjustments to both the incurred claims (numerator) and the premium (denominator). The adjustment to the numerator reflects certain expenses that are deemed to be "improvements in quality" and, as such, are added to the

claim benefits. The adjustment to the denominator reflects allowed taxes and fees to be removed from the premium amount. This "adjusted loss ratio" is the MLR, which is slightly different than the historical claims loss ratio.

The financial uncertainty from MLRs exists when one looks at health insurance issuers from a long-term perspective. Prior to the advent of specific MLR requirements, an issuer could realize a long-term 80% loss ratio by experiencing both an equal number of years where the claim ratio was 70% and 90%, for example. If you look at the realized margin in this example, the company either experienced margin that was at the 10% level or at the 30% level. So presuming an 80% MLR threshold, those 30% margin years are no longer possible, which previously offset the "bad" years. Those "good" years will require rebating to members up to the 80% MLR threshold. There will no longer be the possibility of "good" years offsetting "bad" years. This will result in the need for issuers to have a stronger ongoing capital position.

Q. YOU ALSO MENTIONED THE ELIMINATION OF ANNUAL AND LIFETIME POLICY LIMITS. PLEASE ELABORATE HOW THAT DEVELOPMENT IMPACTS BCBSMT?

A. Prior to the last several years, BCBSMT very seldom saw members whose claims for a single incident of care exceeded $2M. However, recently, BCBSMT's experience with large claims (i.e., those in excess of $100,000) has increased significantly, with one BCBSMT member sadly experiencing an episode of care which exceeded $6M, and another member, $3M. With ACA's elimination of annual and lifetime policy limits, contractual constraints will no longer be available to control those claim occurrences of

truly catastrophic magnitude. This will increase BCBSMT's risk significantly. BCBSMT simply will not be able to effectively spread the costs of these unlimited catastrophic claims across a membership base of approximately 130,000 fully insured members in marked contrast to national for-profit health carriers with millions of members. To put this in further perspective, the two BCBSMT members referred to above would require over 7% of BCBSMT's reserve base. These same members would have required less than 0.1% of HCSC's reserves. Montanans will simply be more securely protected through this Alliance.

Q. WHAT ARE HEALTH INSURANCE EXCHANGES?

A. Health insurance exchanges were created by ACA. A health insurance exchange is essentially an electronic marketplace that will allow individuals to purchase health insurance. The exchange is designed to facilitate the comparison of largely predefined policies amongst insurers based on price and benefits.

Q. WILL HEALTH INSURANCE EXCHANGES AFFECT COMPETITION AMONG INSURERS?

A. Yes. First, as an independent and locally operated Blue Cross and Blue Shield licensee, BCBSMT will be limited on the health insurance exchanges to offering its products and services to the residents of the State of Montana and to employers headquartered in the State of Montana. This limits BCBSMT's market potential to approximately 500,000 members in a state with an aging population per the U.S. Census Bureau. This geographic service area barrier restricts BCBSMT's ability to create effective economies of scale and generate the cash flow necessary to invest in its future and in the future of Montanans. In

the past, the big national, for-profit insurers had not paid too much attention to a large geographic state with a relatively small population like Montana. However, these insurers are now looking for ways to boost their enrollment as they too implement the same health care reform requirements under ACA. Expanding their geographic reach into "new" consumer markets like Montana has become considerably easier for them with the electronic health insurance exchanges, which are expected to be operational in late 2013 for coverage commencing in 2014. The exchanges will facilitate entry into new markets by making products easy to list and market and creating a consumer experience that will make purchasing insurance less complicated and simple. Second, exchanges will make low administrative costs even more important because retail customers will be looking for affordable products and will be price sensitive. Greater pricing competition on health insurance exchanges will put even further financial strains on BCBSMT, in its attempt to compete against the large national, for-profit carriers. It should also be noted that with the advent of the health insurance exchanges and the possible disaggregation of the small group market, most purchases of insurance policies could be done on an individual basis rather than a group basis. This will drive up the per unit costs of administering a policy as compared to the larger "scale" of a group, further emphasizing the need to create effective economies of scale. To the extent we see the disaggregation of the small group market, this may also increase BCBSMT's risk due to potential adverse selection as the older and/or less healthy (at risk) members of the group have greater incentive to secure coverage (due to guaranteed issue and with the help of subsidies) than the younger and/or more healthy members of that small group. One of the primary advantages of "group

insurance" is that coverage is secured for the vast majority of the group, which would typically include healthy, less healthy, young, old, male, and female. However, a person buying individual coverage on his or her own will weigh various factors when choosing coverage including health status and financial position.

Q. WHAT IMPACT WILL THESE COMPETITIVE CHANGES HAVE ON PRICE IN THE FUTURE?

A. I expect that price competition will be heightened, and especially for business sold through the health insurance exchanges. The large national, for-profit insurers and regional multistate insurers will bring with them utilization from non-Montana markets and a geographically diverse membership that mitigates risk and maximizes economies of size and scale, with innovative and proven technology and strong reserves. With a lack of scale, insufficient capital, and increased risk exposure, BCBSMT will be increasingly challenged to succeed in this new marketplace.

Q. WHAT IMPACT DOES THE SIZE OF THE INSURER HAVE IN A POST-ACA MARKETPLACE?

A. As illustrated by BCBSMT's difficulty in generating underwriting profits, size and scale really do matter in the health insurance industry. Large insurers and regional multistate insurers generally achieve higher membership growth rates and better underwriting margins than small insurers. This is due to larger insurers having a greater ability to absorb and spread risk, better per-member cost structures, and unlike their smaller counterparts, a greater ability to invest in cost effective technology.

Q. HOW WILL ALIGNING WITH HCSC BENEFIT BCBSMT WITH RESPECT TO THE IMPLEMENTATION OF THE VARIOUS MARKET REFORM PROVISIONS OF ACA?

A. HCSC has already begun to implement many of the modifications in its four states that will be required to be successful in the ACA environment, e.g., exchange readiness and connectivity. As part of the Alliance, BCBSMT will become a division of HCSC, and HCSC will therefore ensure that BCBSMT and its policyholders benefit from HCSC's implementation of its proven technology, systems, service programs, and other attributes.

Q. YOU IDENTIFIED BCBSMT'S LACK OF SCALE AS AN IMPORTANT FACTOR IN THE DECISION TO FORM AN ALLIANCE. CAN YOU ELABORATE ON THAT POINT?

A. Yes. The challenge for the smaller competitors in any market is being able to manage required infrastructure cost effectively. For example, financial accounting, enrollment, and claims systems do not vary in the cost of implementation and operations proportional to the number of members served. This is often the case as well with compliance with regulatory requirements. Therefore, to effectively reduce the "per unit" cost, the costs must be spread over as many members as possible. Another cost dimension is the inability to effectively and sufficiently resource subject matter experts such as actuaries, information technology personnel, physicians, and nurses over a small membership base. For example, analysis of trends and the setting of premiums require the same basic work effort whether the membership base is 10,000 or 100,000.

Q. PLEASE CLARIFY HOW LACK OF SCALE HURTS BCBSMT'S COMPETITIVENESS IN THE MARKETPLACE?

A. Attributes such as greater economies of scale, strong reserves, and advanced technology deliver lower costs per member for large non-profit Blue plans, such as HCSC, and for-profit insurers. These characteristics create a distinct competitive advantage over small, single-state plans like BCBSMT. During the period 2010 to 2011, the percentage of net premium revenues (not including "Administrative Services Only" or "ASO" revenues) spent on total administrative costs net of ASO margins (including premium and other non-income taxes, state insurance fees, etc.) was approximately 1.5% higher for small, single-state NIO Blues than for multi-state Blues and public plans. The spread between BCBSMT and HCSC was even larger at approximately 3.5% to 4%. Simply put, BCBSMT's administrative costs on a per member basis are much higher than HCSC's administrative costs. Based on HCSC's administrative rate, it is estimated that BCBSMT's administrative cost reduction could be conservatively estimated at $10M to $15M per year.

Q. WHAT DOES ASO MEAN?

A. Self-funded plans are referred to in the industry by the acronym "ASO" meaning "administrative services only." In clarification, an employer has several options for financing their employees' health benefit plans, including fully-insured or self-insured financing options. If the employer chooses to self-fund, the employer will usually contract with a third party to process claims and perform other administrative services.

The third-party administrator does not assume the risk for the employer's health benefit plan. The third-party administrator is not an insurer with respect to these employer plans.

Q. WHAT WOULD BCBSMT NEED TO DO TO REMAIN COMPETITIVE IF THERE WAS NO ALLIANCE WITH ANOTHER HEALTH PLAN?

A. To remain competitive with other insurers in Montana, BCBSMT needs to increase scale and reduce administrative expenses as a percentage of premium revenues. Excluding non-income tax items (real estate, state, local, premium, payroll, and other non-income taxes) and regulatory authority fees, BCBSMT's statutory administrative expense when compared to its statutory premiums has decreased from 16.3% to 12.8% during the period of 2007 to 2011.

Q. WHAT HAS BCBSMT DONE TO REDUCE ITS ADMINISTRATIVE EXPENSES?

A. As I mentioned previously, cost controls are very important for health insurance carriers, and especially so for small, non-profit plans like BCBSMT. BCBSMT has been working hard to control all of its costs, including administrative costs, and has made some headway there. In absolute dollars, administrative expenses were reduced 3% in 2008, increased around 1% in 2009, reduced 5% in 2010 and reduced 2% in 2011. BCBSMT also engaged a process improvement consulting firm for assistance with these efforts in 2011 and 2012. However, as I previously mentioned, despite BCBSMT's ongoing containment efforts, the challenges of decreasing membership, lack of scale and a progression of claims utilization over recent years has made these efforts less effective

and more difficult to realize than BCBSMT had hoped. Again, the efficiencies of scale we are looking for in this Alliance will help us further our efforts.

Q. WHAT IMPACT WILL THESE IMPROVEMENTS YOU MENTIONED IN ADMINISTRATIVE EXPENSES HAVE ON BCBSMT'S COMPETITIVE POSITION?

A. Unfortunately, less than we would like. Despite the improvements, BCBSMT still trails HCSC by approximately 3.5% to 4% in its administrative expense ratio. This difference in administrative expense ratio is significant for BCBSMT. In addition, BCBSMT would have to invest in technology (e.g., exchange) which would reduce its reserves and RBC significantly. Therefore to achieve economies of scale, eliminate potential duplicative investment in technology and systems, and access key subject matter experts, BCBSMT would need to outsource services, resulting in the elimination of employment positions. BCBSMT would also be forced to reevaluate low margin product lines to determine whether it should withdraw those products from the market.

Q. WHY IS THE DIFFERENCE IN ADMINISTRATIVE EXPENSE SO SIGNIFICANT?

A. If BCBSMT had operated at HCSC's statutory expense ratio during the five years ending 2011, it might have been able to help mitigate premium rate increases or increased its underwriting margin by approximately $130M during that time period. Decreasing the expense ratio would make BCBSMT more financially stable and more price competitive, especially for its self-funded clients and price-sensitive retail customers.

Q. WHAT MININAL EMPLOYEE SIZE IS NEEDED FOR AN EMPLOYER TO CONSIDER A SELF-FUNDED ARRANGEMENT?

A. There is none. Not so long ago, the self-funded route would have been recommended only for employers and association plans with at least one hundred or more employees. Recently, however, we are seeing companies with as few as 51 employees consider self-funding as an option for their health plans.

Q. WHY DO YOU THINK THAT CHANGE IS OCCURRING IN THE MARKET?

A. BCBSMT believes that because of anticipated tax changes in 2014 required by ACA that more employers are offering and will consider offering self-funded plans.

Q. WHAT SHIFTS, IF ANY, HAVE OCCURRED IN BCBSMT'S MEMBERSHIP FROM FULLY-INSURED PLANS TO SELF-FUNDED PLANS?

A. BCBSMT lost 12.4% of its fully-insured membership (15,571 members) between 2007 and 2011. During that same period, BCBSMT increased its self-funded/ASO membership.

Q. WHAT EFFECT DOES A MEMBERSHIP SWITCH FROM FULLY-INSURED TO ASO BUSINESS HAVE ON AN INSURER?

A. In ASO business, the spread between fees collected and administrative costs is the only determinant of profitability since the risk on claim liability remains with the employer. Unlike fully-insured business, there is no possibility of an underwriting gain on ASO business. Self-funded plans typically have lower profit margins, which will further limit BCBSMT's opportunities to cover its administrative costs and needed capital expenditures.

Q. WHAT OTHER PRICING TRENDS ARE OCCURRING IN THE COMMERCIAL GROUP BUSINESS THAT ARE AFFECTING YOUR MARKET SHARE?

A. For the first time since 2009, the spread between fully-insured group pricing and medical cost trend turned negative in first quarter of 2012 for NIO Blues. As this spread decreases, a plan's MLR increases and underwriting margin drops unless there is a corresponding decrease in administrative costs. Unfortunately, administrative cost reductions cannot fully offset increases in utilization, as administrative expenses increase with the number and complexity of claims processed and are typically only 10% to 15% of claim dollars paid.

Q. HAS THIS TREND IMPACTED BCBSMT?

A. Yes. The effect of this trend is severe for BCBSMT. BCBSMT received a below-average positive spread between premium revenues and medical costs over the last ten years. This means that BCBSMT's commercial group MLR decreased at a slower rate than that of other NIO Blues. While the NIO Blues experienced a decrease in commercial group MLR of 4.6% from 2009 to 2011, BCBSMT's commercial group MLR decreased by only 2.4%. The net effect of the above factors on BCBSMT and other small, single-state NIO Blues is that small plans have comparatively lower statutory underwriting margins if they have any profit at all.

Q. PLEASE PROVIDE MORE DETAIL ABOUT BCBSMT'S RECENT UNDERWRITING MARGINS.

A. During the past fifteen years, BCBSMT has experienced underwriting losses in eleven of those years, with aggregate losses approximating $63M. BCBSMT's statutory underwriting losses as a percentage of premium were 1.17%, 0.96% and 1.67% in 2010, 2011 and 2012 respectively. During this period, many large insurers, including HCSC, experienced solid underwriting gains which have fortified their current capital positions. The industry now heads into an evolving market landscape where competition is expected to be strong with the entrance of new competitors. The new market landscape and associated dynamics will increase the need for sufficient capital to weather the future uncertainty.

Q. WHAT ARE SOME OF THE OTHER FACTORS THAT MADE BCBSMT SELECT HCSC AS ITS ALLIANCE PARTNER?

A. First and foremost, HCSC was organized as a mutual health insurance company formed for the purpose of operating a nonprofit health care service plan under the Blue Cross and Blue Shield brand. HCSC's leadership strongly emphasized to the BCBSMT Board of Directors and management its commitment to remaining a nonprofit plan, and its history and culture supported this commitment. That fact was incredibly important to the Board and management, given BCBSMT's history of over 70 years of operation as a nonprofit insurer in Montana. Second, the affiliation with HCSC will allow BCBSMT to maintain its local management and presence in Montana, which reflects HCSC's and BCBSMT's shared belief that service is best delivered on a local level, while capitalizing on the enterprise-wide efficiencies and cost savings. It is also important to remember that

enterprise related services and support can be provided at any one of HCSC's locations, whether that is in Texas, Illinois, Oklahoma, New Mexico, or Montana.

Q. ARE THERE OTHER FACTORS THAT WOULD BENEFIT BCBSMT FROM AN ALLIANCE WITH HCSC?

A. Yes. HCSC's actuarial competency will help ensure BCBSMT's growth in a fiscally responsible manner. HCSC also has one of the best industry track records selling business to large and national accounts, as evidenced by its addition of over 660,000 commercial risk, non-ASO members during the period 2007 to 2011, a time when most large, national for-profit insurers were experiencing a significant shift from risk to ASO business. In addition, the services and technologies offered by many HCSC subsidiaries will improve the core health insurance business in Montana by better managing the rise in health care costs and improving administrative expense efficiency, which could help to mitigate premium increases over the long-term to benefit current and future Montana members. BCBSMT can leverage the services and technologies of HCSC's subsidiaries to offer a wider range of ancillary products including life and dental insurance, underwritten by HCSC's life company, Dearborn National, and its dental administrator Dental Network of America. The care management programs of HCSC's subsidiary MEDecision can improve the management of medical expenses for the chronically ill and improve overall managed care capabilities. The private exchange platform of HCSC's partially-owned subsidiary, Bloom Health, will offer Montana employers an exchange-based defined contribution solution including group and individual plans. Hallmark, HCSC's individual/retail business administrator, can reduce administrative expenses on a per

member basis and improve internal operations for BCBSMT's 30,000 individual members.

Q. PLEASE DESCRIBE THE PROPOSED TRANSACTION BETWEEN HCSC AND BCBSMT.

A. The Asset Purchase Agreement ("APA") specifies the terms of the transaction, including customary provisions such as representations and warranties, covenants, indemnities, and termination events. Under the terms of the APA, BCBSMT will transfer and HCSC will acquire certain insurance and ASO assets owned by BCBSMT, including its contracts ("Acquired Business"). HCSC will assume certain specified liabilities of BCBSMT, including liabilities under BCBSMT's insurance and ASO contracts, provider contracts, and specified pension liabilities ("Assumed Liabilities"). HCSC will assume liabilities of BCBSMT in the approximate amount of $180M and at closing, BCBSMT will transfer to HCSC approximately $180M in assets and cash to support the liabilities. In consideration of the sale of the Acquired Business by BCBSMT to HCSC, HCSC is to pay BCBSMT the purchase price of $17.6M.

Q. WHAT BCBSMT ASSETS AND LIABILITIES ARE EXCLUDED FROM THE TRANSACTION?

A. Certain assets not primarily related to BCBSMT's core insurance business are excluded from the transaction ("Excluded Assets"). Those assets include BCBSMT's surplus, its principal subsidiary holding company CBMI (the 100% owner of WSI, whose principal assets were recently sold to Payne Financial Group), current buildings, and certain other assets. Certain pre-closing liabilities ("Excluded Liabilities") are excluded from the

transaction, such as litigation liabilities, which will continue to be held by the remaining corporate BCBSMT entity.

Q. HOW DID BCBSMT DETERMINE THE FAIR MARKET VALUE OF THE ACQUIRED BUSINESS THAT HCSC IS PURCHASING FROM BCBSMT?

A. BCBSMT hired independent valuation experts. Dr. James Galasso, with Actuarial Services & Financial Modeling, Inc., is an independent actuarial valuation expert with extensive experience in the health insurance industry. He prepared a report to summarize his valuation and findings, including discussion of methodologies and assumptions. His valuation focused on the cash flow value of BCBSMT's nine health care contract business segments, i.e., Individual, Small Group, Large Group, Medicare Supplement, Medicare Part D, Federal Employee Program, Students, Self-Funded and Stop Loss ("Book of Business"). This report was attached as Exhibit 5 to the Application for Approval of Alliance jointly filed by BCBSMT-HCSC on November 15, 2012. BCBSMT also hired Moss Adams LLP to value BCBSMT in its entirety. Moss Adams also issued a valuation report. The Moss Adams report was attached as Exhibit as Exhibit 7 to the Application for Approval of Alliance jointly filed by BCBSMT-HCSC on November 15, 2012.

Q. WHY DID BCBSMT HIRE TWO VALUATION EXPERTS?

A. Dr. Galasso was retained to help value the Book of Business. He is a recognized expert on the valuation of insurance companies' books of business/revenue streams (i.e., financial results).

Moss Adams was engaged to value BCBSMT as a whole including all of its assets and liabilities. Moss Adams is experienced in valuing businesses.

Q. HAS ACTUARIAL SERVICES & FINANCIAL MODELING EVER PERFORMED WORK FOR BCBSMT OR HCSC PRIOR TO PERFORMING ITS VALUATION?

A. No.

Q. HAS MOSS ADAMS EVER PERFORMED WORK FOR BCBSMT OR HCSC PRIOR TO PERFORMING ITS VALUATION?

A. No.

Q. WHAT APPRAISAL VALUE DID DR. GALASSO ASSIGN TO THE BOOK OF BUSINESS?

A. $17.6M.

Q. IN REGARD TO ACTUARIAL SERVICES & FINANCIAL MODELING'S ASSUMPTIONS, DO YOU CONSIDER ANY OF THEM OPTIMISTIC?

A. Yes. In summary, I believe the discount rate, reserves, earning rates, agent commission, medical loss ratio, capital investment cap, and possibly the replacement rate are optimistic assumptions. Furthermore, BCBSMT recently learned that it will be subject to an Exchange fee of 3.5%. While this information was not available when Dr. Galasso prepared his report, it will account for an estimated $5.25M per year in additional expenses.

Q. DID BCBSMT PERFORM ANY DUE DILIGENCE WITH RESPECT TO ANY OF ITS INDEPENDENT VALUATIONS?

A. Yes. BCBSMT engaged Milliman to conduct an external peer review of the Actuarial Services & Financial Modeling's valuation of BCBSMT's lines of business.

Q. WHAT DID BCBSMT REQUEST MILLIMAN TO DO?

A. Milliman was requested to confirm the reasonableness of the data inputs used by Actuarial Services & Financial Modeling as described in the expert report, the reasonableness of its assumptions, methodologies, and models, and the correctness of the calculations.

Q. DID MILLIMAN ALSO CONDUCT A DUE DILIGENCE REVIEW OF MOSS ADAMS' VALUATION REPORT?

A. No. An internal peer review was conducted on the valuation report submitted by Moss Adams' Calvin E. Swartley, Chartered Financial Analyst and Accredited Senior Appraiser, to BCBSMT.

Q. MONTANA LAW PROVIDES CERTAIN CRITERIA FOR THE DISTRIBUTION OF ASSETS. WILL THOSE CRITERIA BE ADDRESSED IN THIS PROCEEDING?

A. The criteria related to the distribution of assets will be discussed, but not at this hearing. Pursuant to the procedural order issued by the Hearing Examiner on December 19, 2012, the proceeding regarding the approval of the proposed alliance has been bifurcated. The purpose of this proceeding relates to the approval of the proposed alliance between BCBSMT and HCSC. If the proposed alliance is approved, then there will be a Phase 2 of the public hearing at which time there will be a discussion regarding how the

remaining assets and liabilities of BCBSMT will be distributed, as well as the statutory requirements related to the asset distribution.

Q. WILL THE FAIR MARKET VALUE OF BCBSMT's ASSETS BE PRESERVED AND PROTECTED?

A. Yes. BCBSMT's assets will be preserved and protected by the provisions of the Conversion Statute and oversight by the Montana Attorney General and the Montana Commissioner of Insurance.

Q. WILL THE FAIR MARKET VALUE OF BCBSMT'S ASSETS BE INVESTED WITH REASONABLE PRUDENT CONSIDERATION OF THE POTENTIAL RISK OF FINANCIAL LOSS ASSOCIATED WITH THE CONVERSION TRANSACTION?

A. Yes. The Board of Directors will exercise their fiduciary duty in overseeing the assets until an appropriate foundation is determined through the hearing process.

Q. WILL ANY PART OF BCBSMT'S PUBLIC ASSETS INURE DIRECTLY OR INDIRECTLY TO AN OFFICER, DIRECTOR, OR TRUSTEE OF BCBSMT OR OF HCSC OR TO ANY OTHER PERSON THAT IS NOT A FOUNDATION OR NONPROFIT ORGANIZATION APPROVED TO RECEIVE THE ASSETS BY THE ATTORNEY GENERAL?

A. No.

Q. WILL ANY BCBSMT OFFICER, DIRECTOR, OR TRUSTEE RECEIVE ANY IMMEDIATE OR FUTURE REMUNERATION AS A RESULT OF THE PROPOSED CONVERSION TRANSACTION EXCEPT FOR THE

REASONABLE VALUE OF SERVICES RENDERED PURSUANT TO A VALID CONTRACT BETWEEN THE OFFICER, DIRECTOR, OR TRUSTEE AND BCBSMT?

A. No.

Q. WERE THERE ANY MANAGEMENT CONTRACTS ENTERED IN RELATION TO THE BCBSMT/HCSC TRANSACTION?

A. No.

Q. WILL THE REMAINING ENTITY POSSESS SURPLUS IN AN AMOUNT SUFFICIENT TO COMPLY WITH THE SURPLUS REQUIRED UNDER MONTANA LAW AND TO PROVIDE FOR THE SECURITY OF BCBSMT'S POLICYHOLDERS?

A. Yes. HCSC has generally agreed to assume the health claim liability of BCBSMT on the date of closing. HCSC's 2011 RBC represents sufficient surplus under Montana law. The remaining entity ("old" BCBSMT) will no longer be responsible for any health claim liability.

Q. DOES THE APA HAVE A PROVISION THAT REQUIRES THE PAYMENT OF MONEY AS LIQUIDATED DAMAGES IN THE EVENT OF A BREACH OF THE AGREEMENT?

A. The APA has standard indemnification provisions for breaches of the agreement.

Q. ARE THE PROVISIONS IN THE APA, WHICH REQUIRE THE PAYMENT OF MONEY -- AS LIQUIDATED DAMAGES OR OTHERWISE -- IN THE EVENT

OF A BREACH OF THE AGREEMENT BY BCBSMT, IN THE PUBLIC INTEREST?

A. Yes.

Q. WHAT ARE THE IMPLICATIONS FOR THE STATE OF MONTANA IF THE ALLIANCE IS NOT APPROVED?

A. The foundation which would hold the remaining net assets of "old" BCBSMT would not be established. BCBSMT will continue its ASA relationship with HCSC, hopefully through 2018. As a result, BCBSMT will be outsourcing core function and related jobs. Obviously, as mentioned earlier, this will require a significant work-force reduction to balance expenses. In this regard, I imagine the downward economic impact to the Helena area would be tremendous. In addition, the contemplated HCSC Great Falls full-service unit would not materialize. Finally, since consolidation has to occur, this "alliance" process will most likely have to be attempted again at some time by BCBSMT, which would be in synch with Blue plan consolidation history. In the early 1970s, there were over 130 Blue plans. In the early 1980s, there were just under a hundred. Today, there are 38 Blue plans; 14 of which are part of the Anthem for-profit Blue plans and at least another 11 are part of other Blue consolidated plans. In short, there are very few "stand alone" Blue plans remaining. It is noteworthy that there were 2 Blue plans in Montana until 1986 when they combined to address many of the issues addressed in my testimony. In that case, I anticipate BCBSMT's surplus, which old BCBSMT retains in the proposed Alliance, will be lower than today's values meaning less available funds for a foundation. In contrast, if the Alliance is approved, BCBSMT's operational challenges and scale

issues can be addressed, making it a more viable employer and competitor. All of BCBSMT's employees have been promised a HCSC job at their same or current wages. Foundation funding will be at maximum available value. In addition, HCSC is contemplating adding a "full service unit" in Great Falls if the Alliance is approved, estimated to bring in 100-125 new jobs to the State. In summary, if the Alliance is not approved, the economic impact to the State of Montana, in my opinion, would be the loss and forfeiture of significant amounts of salaries, benefits, taxes, and money spent in the state and local economy.

Q. SINCE THE HCSC ASA IS NOT A LONG-TERM SOLUTION, WHAT IMPACT WILL THAT HAVE ON BCBSMT'S OPERATIONS?

A. BCBSMT's ASA relationship with HCSC is not a long-term strategy. As a result, BCBSMT will be required to undergo a second, essentially unnecessary, information system conversion, consuming large amounts of resources and impacting operational efficiencies. Conversions are very difficult and often produce significant negative impacts to groups, members, providers, agents, and employees. The inconvenience and instability associated with large-scale system conversions can lead to the loss of groups and members and create an irritating and a frustrating environment for providers, agents, and employees. RFPs for coverage often ask whether BCBSMT is in the process of completing a system conversion, or anticipating a conversion during the term of the contract. Unfortunately, looking to a plethora of outsource vendors would lead to suboptimal interoperability between systems because few single-source vendors have all the components of a complete system. Integration of disparate systems increases costs,

while decreasing service levels that groups, members, providers, agents, and employees will have experienced while BCBSMT was under the ASA with HCSC. In contrast, through the proposed Alliance, BCBSMT would have been part of a family of states that owned its software and hardware. Under the ASA and then through a contract with a variety of outsourcing vendors, BCBSMT would remain a vendee of vendors, with limited control over its software and hardware as compared to a plan that owns its software and hardware. Such an arrangement exposes BCBSMT to unplanned expenses associated with adjustments to vendor rates, service contracts, and other variables.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

VERIFICATION

STATE OF MONTANA)
) ss.
COUNTY OF LEWIS AND CLARK)

I, MARK A. BURZYNSKI, being first duly sworn, upon my oath, state 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.

Mark A. Burzynski
Blue Cross and Blue Shield of Montana, Inc.
Senior Vice President and Chief
Financial Officer

SUBSCRIBED, SWORN TO AND ACKNOWLEDGED before me this 5th day of March 2013, by Mark A. Burzynski.

Notary Public

MOLLY A. PLUMMER
NOTARY PUBLIC for the
State of Montana
Residing at Montana City, Montana
My Commission Expires
October 21, 2016

Respectfully submitted this 5th day of March 2013.

McMAHON, WALL & HUBLEY, PLLC

BY: _____
Michael F. McMahon
212 N. Rodney Street
Helena, Montana 59601

CERTIFICATE OF SERVICE

I, Michael F. McMahon, certify that on March 5, 2013, I served a true and correct copy of the foregoing Direct Testimony of Mark A. Burzynski, by mailing it first class postage prepaid to:

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DATED this 5th day of March 2013.

Michael F. McMahon