

Proposed Transaction:  
Highmark and Independence Blue Cross

Pennsylvania Insurance Department  
Public Informational Hearings

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Comments by

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Good morning. My name is David Knott and I am a Senior Vice President of Booz & Company Inc., a management consulting firm. I am also the leader of our firm's Global Health Practice, which serves private sector, government, and non-governmental clients.

We are very pleased to participate in today's hearing. I lead a team from Booz & Company that has performed in-depth analyses of the cost savings and growth opportunities that would arise from the combination of Highmark and Independence Blue Cross. Our detailed analyses have convinced us that the proposed transaction can deliver substantial benefits to their stakeholders. Today, I would like to take this opportunity to describe the methodology and the nature of the benefits that we identified in our opportunity assessment and have subsequently been validated by the two companies in integration planning.

Before I discuss these benefits, allow me to take a minute to describe our firm. Founded in 1914, Booz & Company is the world's oldest management consulting firm and a global leader in our profession. We have 3,300 employees in 57 offices that span more than 30 countries worldwide. In all of our work with clients we take a fact-based and analytically-rigorous approach to evaluating their issues and opportunities.

Our firm works extensively in the health care industry. Our health care clients are organizations that need to manage ever-faster and far-reaching change. They

need to understand how major trends like the growing role of the health care consumer, information technology shifts, changing industry structure including consolidation, globalization, and discontinuities in traditional markets and products affect their organizations. Together with my colleagues in our Global Health Practice, we have helped many of the industry's leading national health plans, Blue Cross Blue Shield companies, HMOs, pharmacy benefit managers, physician groups, hospitals, and employers. Our projects have focused on defining corporate and business unit strategies for growth and cost reduction, including the development of business cases for strategic initiatives. We have also helped health care companies define future business and IT operating visions, organization redesigns, and transformation programs to implement these changes.

In addition to our experience in the health care industry, Booz & Company has extensive expertise working with clients in mergers and restructurings. In the past five years, we have supported over 300 large scale programs of this nature globally. These engagements have spanned all major industry groups and include both opportunity assessments as well as integration planning and execution efforts. Our projects focus on capturing post-deal cost and growth opportunities through organization and process design, best practice sharing, information technology platform consolidation, and people and culture integration.

On a personal note, I have worked for over 19 years as a consultant in the health care industry and specialize in serving health plans, pharmacy benefit

management companies, and physician and hospital organizations. I have been published extensively, appeared before major industry groups such as the World Health Care Congress and the National Institute for Health Care Management, and delivered lectures on health care at Wharton, Harvard, Yale, Columbia and other universities.

Booz & Company undertakes projects with clients by assembling multi-disciplinary teams that include professionals with areas of expertise that are relevant and tailored to each situation. Joining me in our work with Highmark and Independence Blue Cross were three other officers of Booz & Company: Gerald Adolph, a senior vice president who leads our Mergers & Restructuring Practice; Mike Connolly, a vice president who specializes in health plan IT and was formerly Chief Technology Officer with Aetna; and Narayan Nallicheri, a vice president who specializes in health plan operations.

After completing an extensive set of analyses, we have concluded that as a combined company Highmark and Independence Blue Cross will be able to produce substantial benefits for subscribers, employers, providers, and other stakeholders, and will be better positioned to continue its mission to serve the people and communities of Pennsylvania in meaningful and measurable ways.

To support this conclusion, I would like to share some of the analyses that we have conducted and would, in particular, like to cover three areas: first, I will give

you a sense of the detailed analyses that we undertook and the methodology we used to evaluate the opportunities that would be created by the consolidation of the two companies. Second, I will explain the cost and growth benefits that we found during our analyses. And third, I will describe the breadth and depth of the integration planning effort and how that work has now validated our initial estimates and confirmed our belief in the value of this transaction.

Let me start by describing the intensive effort that we undertook and the methodology we used to analyze the combination. In the summer of 2006, Booz & Company was retained to evaluate whether there was a compelling business case for the consolidation of the two companies. In this engagement, we were asked to focus on several key objectives:

- First, develop cost savings and growth estimates for the consolidation
- Second, identify whether a combination could enhance both companies' ability to fulfill their missions, and, if so, how
- And lastly, identify possible specific benefits of the consolidation for major stakeholders

We studied existing information from Highmark and Independence Blue Cross to identify potential cost savings and growth opportunities that could result from bringing these two organizations together. I would like to emphasize that we built our estimates on tangible, observable differences, rather than the theoretical benefits of combining the two companies or general benchmarks from other

companies and situations. We performed a function by function, “bottoms-up” analysis to identify cost savings. We identified processes where one company is more efficient than the other and a new combined organization could take advantage of this better process. We also identified areas where there is duplication in current and future spending that could be eliminated, generating resource utilization benefits if the transaction occurs. Finally, we looked for functions where the new company could capture scale economies by sharing specific, identifiable costs and assets. Let me illustrate this approach with a few examples of the cost savings opportunities that we have identified:

- For transactional activities, like those involved in processing claims, we estimated performance differences between the two organizations and identified potential benefits from raising the “lower” performer to the level of the higher performer
- For IT activities, we reviewed line item detail in budgets to assess potential overlaps in spend with a particular focus on redundant investments in processing, compliance, and data analysis and informatics
- For administrative functions, we calculated the benefits by eliminating duplication across the two companies, typically in management positions
- For Pharmacy, purchased goods such as office supplies, and lab spending, we determined the difference in the unit prices paid by the two companies at the individual item level and calculated cost savings that the combined company would capture by eliminating part of this gap. For Pharmacy, we also evaluated the rebates that the two companies were

getting on similar 2 or 3 tier formularies for drugs and then computed cost savings from migrating to the formulary with the better rebates

After determining the “bottoms-up” savings estimates, we compared them with relevant industry and functional benchmarks to test the reasonableness of the overall cost savings.

To identify growth opportunities, we went business by business and geography by geography to identify where one company had products and/or capabilities the other could sell in their markets. We then estimated a conservative market penetration and margin for these products.

These analyses were performed independently by Booz & Company. We did not share competitive data between the firms, but we did interview over 50 senior managers of Highmark and Independence Blue Cross to validate our hypotheses and savings and growth estimates. During the course of the opportunity assessment phase, we involved 24 experts from Booz & Company in various capacities to ensure a rigorous analysis was performed.

While undertaking our analyses, we adhered to specific guiding principles that were established by the two CEOs and their Boards of Directors:

- Identify savings and opportunities that only can be realized by combining the two companies -- and not by the companies individually

- Maintain a local presence and a local market face across the state by
  - Retaining dual headquarters in Philadelphia and Pittsburgh
  - Maintaining employment presence in local markets
  - Evaluating in-sourcing opportunities afforded by a combined company's size
  - Maintaining a management and staff footprint in east, west and central Pennsylvania
- Assume no off-shoring of activities
- Assume no cost savings from negotiating deeper discounts with physicians and hospitals
- Include benefits from the consolidation of vendor spending and purchasing costs

Let me now describe the cost savings and growth opportunities that we identified for this combination:

We identified total profit margin growth opportunities, after one-time investments, of \$134 million over the six-year period after closing. In addition, we also identified Administrative and Pharmacy cost saving opportunities, after one-time investments, over the same six-year period of \$817 million. Furthermore, Highmark and Independence Blue Cross have identified other savings opportunities, such as the reduction of Workers Compensation fronting fees, of \$65 million, resulting in a total opportunity of just over \$1 billion, after one-time

investments required to realize the cost savings and growth opportunities over the six-year period after close.

In our professional judgment, the opportunities cited above and set forth in more detail in the opportunity assessment are reasonable and can be achieved by the combined company.

### **Integration Planning**

I would like to turn now to the integration planning effort that Highmark and Independence Blue Cross have undertaken subsequent to the completion of our opportunity assessment. After both Boards approved the combination agreement, and after a competitive selection process, we were engaged to guide and support the companies through integration planning. While Highmark and Independence Blue Cross continue to operate as separate companies as they await regulatory approval, it is a best practice for companies pursuing a potential combination to begin to develop an integration plan to ensure a smooth post-approval transition. Integration planning has involved the extensive participation of Highmark and Independence Blue Cross experts to scrutinize the cost savings and growth opportunities identified in the initial opportunity assessment and to define a roadmap to ensure successful implementation of the combination. A team of Booz & Company experts worked side by side with management and staff from both companies, along with other external advisors.

Supported from the highest levels of the two organizations, the companies appointed a senior leadership team to oversee and direct integration efforts, co-chaired by the chief operating officers of the two companies. The Highmark Executive Vice President of Health Services serves as the Chief Integration Officer accountable for overseeing development of the final integration plan.

A Program Management Office was created to oversee the day-to-day activities around integration processes and deliverables and is staffed by nine Highmark and Independence Blue Cross associates on a full-time basis. In addition, sixteen Integration Planning teams were created, representing every operation, administrative and support area, and co-chaired by Highmark and Independence Blue Cross executives. Those teams are supported by 75 sub-teams.

In total, there are more than 500 employees from both companies engaged in integration work and another 50 experts from Booz & Company and other advisors in human resources, legal and accounting. By undertaking this effort, the companies are creating comprehensive integration plans that are focused on ensuring a seamless transition for subscribers and other stakeholders.

While the opportunity assessment took an appropriately conservative approach to estimating cost savings and margin growth, through the integration planning process we could access more specific data and could refine our estimates. That

effort led to more specific choices that in turn allowed more precision about critical decisions with large cost and growth ramifications. One key example is the selection of an initial set of systems for the new company's core processing, subsidiary, and corporate functions such as Finance and Human Resources.

The in-depth analyses performed in the integration planning process have validated the cost savings and margin growth estimated in the opportunity assessment.

## **Conclusion**

In conclusion, my colleagues and I at Booz & Company have taken a fact-based, bottoms-up, rigorous approach to analyzing the potential benefits of a combination of Highmark and Independence Blue Cross. Based on Booz & Company's experience across health care and other industries, and after nearly 18 months of intimately focusing on analyzing a Highmark and Independence Blue Cross combination, we are convinced that the potential efficiencies are real and achievable.

Our in-depth analyses of the opportunities have convinced us that Highmark and Independence Blue Cross can deliver substantial benefits to their stakeholders. Real and significant cost savings and growth opportunities have been identified, analyzed, and then validated by external and internal experts. A combined company will be able to produce substantial benefits for subscribers, employers,

providers, and other stakeholders, and will be better positioned to continue its mission to serve the people and communities of Pennsylvania in meaningful and measurable ways.

Thank you.