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November 15, 2017

Ms. Shelley Rouillard
Director
Department of Managed Health Care

Ms. Jennifer Kent
Director
Department of Health Care Services

Re: Blue Shield must honor its promise to return to the community Care1st's excess profits

Dear Ms. Rouillard and Ms. Kent:

We are writing to urge you to demand that Blue Shield of California honor its promise to return to the community excess profits made by its subsidiary Care1st Health Plan. In seeking regulatory approval of its acquisition of Care1st in 2015, Blue Shield promised to return any profits in excess of two percent of revenue. In 2016, its first full year under Blue Shield's control, Care1st netted profits of 5.9 percent – $98.0 million in excess of the two percent threshold.[1] Yet Blue Shield has made no move to return any of these funds.

Blue Shield promised to limit Care1st profits by returning excess earnings.

At the DMHC's 2015 public hearing on Blue Shield's proposed acquisition of Care1st, Blue Shield CEO Paul Markovich asserted that a major public benefit of Blue Shield's purchase of Care1st would be that it would "convert the company from for-profit to not-for-profit." In addition, Markovich promised that Care1st would be subject to Blue Shield's self-imposed cap on profits: "Since we made the pledge to voluntarily cap our net income at two percent in 2011 we have given back $560 million to customers and the community. When we convert Care1st to not-for-profit their results will be included in the companywide two percent pledge."[2]

The excess profits Care1st reaped in 2016 should be returned to the community.

The 5.9 percent profit Care1st made last year is not only excessive by Blue Shield's own standard; it also far outstrips the 1.1 percent and 2.1 percent margins Care1st earned in 2014 and 2015,

[1] Care1st's Consolidated Income Statement for 2016 filed with the DMHC shows a profit margin of 6.8 percent. However, some of the revenue and income reported is associated with the sale of Care1st AZ. The Consolidated Income Statement reports pre-tax revenue of $100.8 million from the sale. Blue Shield reported in its Audited Financial Statement for 2016, on page 10, an after-tax gain of $30.4 million from the sale. Subtracting both of these amounts from total revenue and income reported on the Consolidated Income Statement yields a margin of 5.9 percent, representing total income exclusive of the effects of the sale of Care1st AZ.

[2] DMHC transcript, In the Matter of Public Meeting on the Acquisition of Care1st Health Plan by Blue Shield of California, p.23.

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respectively, when it operated as a for-profit company.[3] In keeping with its promise to the DMHC and public, Blue Shield must return to the community the portion of Care1st's profits that exceeded two percent, which amounts to $98.0 million. Since federal law prohibits paying rebates to Medi-Cal and Medicare enrollees, those funds should be contributed to health care programs benefiting low-income Californians.

We anticipate that Blue Shield may argue that its promise to cap profits at two percent applies to the combined earnings generated by Care1st and the rest of Blue Shield's business, and thus it is not obligated to rebate Care1st profits unless Blue Shield's overall profits are greater than two percent. But this interpretation would mean that the profits Blue Shield can squeeze from Care1st's Medicare and Medi-Cal business are virtually unlimited. It would mean, for example, that Care1st could have generated a 17.4 percent profit last year and still not returned any excess profits.[4]

This is inconsistent with the promise Mr. Markovich made to turn Care1st nonprofit and enforce that pledge with a cap on income. The clear implication of that promise was that Blue Shield would seek *lower* profits from Care1st than its private owners had. Instead, Blue Shield nearly tripled the Medi-Cal and Medicare insurer's profits in its first year controlling the plan.

Blue Shield generated much of the excess Care1st profit by building into its rates a fee it never paid.

Under the Affordable Care Act, insurers are assessed a fee on their premiums to help fund the law's coverage expansion. The ACA exempts from the fee an insurer that is both a nonprofit and devotes 80 percent of its business to Medicaid and Medicare.[5] After converting Care1st to a nonprofit corporation, Blue Shield claimed the exemption and paid no fee in 2016 on any of Care1st's $1.88 billion in California premiums collected the previous year.[6]

However, Care1st's Medicare and Medi-Cal rates for 2016 were finalized prior to its conversion to a nonprofit in October of 2015, and thus undoubtedly included a charge for the ACA fee.[7] Approximately $50 million in charges would have been incorporated into Care1st's Medicare and Medi-Cal premiums to cover the fee.[8] These charges should have been returned, not pocketed by Blue Shield.

[3] See Care1st's Consolidated Income Statement for 2014 and 2015.
[4] Given the results of Blue Shield's other business in 2016, Care1st could have generated total earnings of $433 million, or approximately 17.4 percent of its revenues, without causing Blue Shield's consolidated margin to exceed the two percent threshold.
[5] CFR §57.2(b)(2)(iii)
[6] See Blue Shield of California, Audited Financial Statement, 2016, p.15, re the claimed exemption. Care1st 2015 premium amounts are from Care1st's 2015 Consolidated Income Statement.
[7] Even though the fee amount is based on prior year premiums, it is built into rates charged in the year it is paid.
[8] In a study commissioned by AHIP, Oliver Wyman projected that the fee would add 2.75% to premiums in 2016, which equates to $51.7 million based on Care1st's 2015 premium revenue. See https://www.ahip.org/wp-content/uploads/2015/12/Oliver-Wyman-report-HIT-December-2015.pdf

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The company's failure to return them is particularly egregious given that it denied to the DMHC during the review of its acquisition of Care1st that it had structured the transaction to achieve any tax advantage. After questions had been raised publicly about whether Blue Shield was doing exactly that and the DMHC had inquired about the company's reasons for structuring the acquisition as it had, Blue Shield asserted that its motivations had purely to do with business considerations and that "there are no tax benefits" in its approach.[9]

Blue Shield must be held to its promises.

As you know, shortly after the Care1st acquisition was finalized Blue Shield announced that it had no intention of honoring what the DMHC and we in the consumer advocacy community had been led to believe was an agreement to increase funding for the Blue Shield of California Foundation by $14 million annually. Blue Shield maintained that the agreement, incorporated as an undertaking to the approval of the acquisition, did not obligate it to increase funding by that amount, but rather not to reduce it below that level. Despite our protests, Blue Shield refused to commit to an annual increase in foundation funding, and proceeded to reduce foundation funding from $35.0 million in 2015 to $29.7 million in 2016.[10]

The DMHC cannot allow Blue Shield to renege on the promise it made to win approval of the acquisition. We urge you to direct Blue Shield to return to the community the excess Care1st profits. With Care1st showing a margin this year that is almost double the two percent standard, it is critical that you take strong action now not only to secure for the community what Blue Shield owes it, but also to prevent Blue Shield from exploiting Care1st's public insurance business to continue generating excess profits.[11]

Thank you.

Sincerely,

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Cc: Diana Dooley, Secretary, California Department of Health and Human Services

[9] California Physicians' Service, DMHC File No. 933-0043, Amendment to Notice of Material Modification Re: Acquisition of Care1st Health Plan, Exhibit E-1, June 2, 2015, p.6.
[10] See the Blue Shield of California Foundation's IRS Form 990 for 2015 and 2016 at http://www.blueshieldcafoundation.org/about/financial-information.
[11] Blue Shield's Consolidated Income Statement for the first six months of 2017 shows a Care1st margin of 3.7 percent.