

Survival of the fittest:
How independent health plans
can survive in today's economy



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Foreword

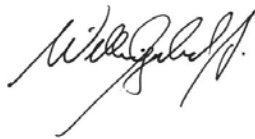
Over the last 20 years, health plans have been involved in acquisitions and mergers worth more than \$60 billion.¹ In fact, consolidation has been so relentless that today seven health plans sit among the largest 500 companies in the United States.² Among these seven, the two largest, UnitedHealth Group and WellPoint, have more than doubled their revenues since 2004 through acquisitions.³ In 2008, the five largest health plans covered over 60 percent of the insured population; some sources believe that by 2015 that percentage will be 70 to 80 percent.⁴

For the independent health plan, any strategic planning exercise should address a few key questions: “Can we stay autonomous? Are there affiliations we should pursue, particularly given the direction of health care reform? As an independent plan, how do we create a new value proposition to leverage economies of scale to remain viable? Or, is consolidation on some level the right option for our business?” Not surprisingly, many variables should be considered in reaching the “right” answers to these questions, and as discussed later in this paper, bigger may not always be better.

Given the shocking economic events of 2008/2009, some health plans are dealing with the aftermath of eroded investment portfolios and limited access to capital in addition to the looming promise of health care reform. CXOs should immediately reassess their strategy for remaining independent or for exploring varying levels of partnership. In our experience, conducting a conventional strategic planning process may not suffice.

A framework we developed called Strategic Flexibility is designed to help health plan CXOs creatively explore potential market scenarios and identify strategic options, all with the intent of remaining competitive in the future.

In this paper, we outline the major challenges independent health plans face in devising the “right” strategy, and we discuss this new way of planning that we believe can help position the independent plan for the future. This discussion about viable strategies could become a rich and rewarding dialogue. We invite you to join the conversation.



William Copeland Jr.

Principal

Deloitte Consulting LLP

National Managing Director, Life Sciences & Health Care Practice

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Executive summary

Any health plan's strategic planning process begins with a bit of "crystal ball" gazing to think about what the future might hold for the health care industry, and more importantly, what that would mean for the independent health plan. These discussions have taken on a new level of uncertainty given the Obama administration's health reform efforts, which will likely lead to dramatic changes in the future direction of health care.

With the ongoing economic crisis, more consolidation among health plans is possible if the credit crisis eases and financing is available. While large-scale consolidation decreased just a few years ago, the frequency of deals will likely increase in the near term as merger and acquisition activity shifts away from pure play growth initiatives to transactions that enable organizations to stabilize operating positions and build stronger balance sheets. Escalating competitive pressures driven from the financial crisis will likely force many organizations to seek the safety of a larger balance sheet in order to preserve their financial viability.

Because of these likelihoods, the fate of the independent health plan appears uncertain. Some will opt for consolidation; some may have consolidation forced upon them; and some may decide to stay autonomous (a choice that could require innovative alliances and affiliation arrangements with other organizations). In any case, the future is ambiguous. For this reason, a more sophisticated, flexible strategic planning framework is a necessity.

Deloitte has developed a strategic planning framework, *Strategic Flexibility*, which is designed to help health plans evaluate their choices in a way that encourages innovation and creativity — valuable qualities when the future is complex and uncertain.

For most independent health plans, the question — to stay independent or to consolidate — is not simple or straightforward and does not take into account the many options in between. The answer depends on everything from the organization's mission to its core operating capabilities, from its market position to its value proposition, from what it is today to what it would like to be tomorrow. A flexible and effective strategic planning framework is fundamental to devising the right strategy.

In this paper we will discuss whether independent health plans must forge new partnerships to develop a new value proposition or continue to go it alone. Later in this paper we present the seven key questions we believe health plan CXOs should address through strategic planning initiatives to remain viable in the future.

The strategic context: A difficult and dynamic environment

Fewer pieces of the pie

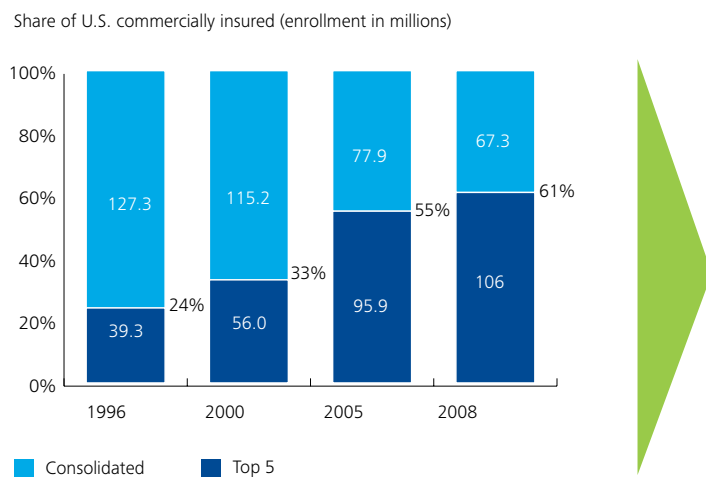
In 10 years, the health plan industry has undergone significant consolidation (Figure 1). In 1995, the 10 largest health plans accounted for 27 percent of the market.⁵ Today, membership in the five largest plans now constitutes 61 percent of the market.⁶ By 2015 several experts believe that percentage will be 70-80 percent.⁷ In most states, the top three health plans have well over 50 percent market share.⁸

We expect consolidation activity to continue and to outpace new commercial entrants into the market. While large-scale consolidation has decreased in recent years, the frequency of deals will likely continue in the near term as M&A activity shifts away from pure play growth initiatives to transactions that enable organizations to grow a larger membership base and to spread costs for capital investments. The typical national carrier has nearly four times higher average operating income and average annual capital investment than a typical independent plan, posing significant challenges for independent plans to keep pace.⁹

Additional M&A activity around specialty, ancillary, and government products is likely in the immediate future to compensate for lack of organic growth opportunities. Mergers among regional plans are also expected to continue, as these plans search for economies of scale. Not-for-profit conversions to for-profit health plans, historically a difficult sell at the state department of insurance level, may increase as state budget pressures increase, and as the economic crisis spreads.

The possibility of consolidation presents a challenge for independent health plans. For example, through consolidation, the number of licensees in the Blue Cross Blue Shield Association (BCBSA) has been cut almost in half since 1980.¹⁰ Today, BCBSA is a national federation of 39 independent BCBS health plans. However, beyond WellPoint, which comprises 15 percent market share nationally,¹¹ Blues plans do not operate with significant scale when compared to the largest national health insurers. The average enrollment in the five largest national insurers (excluding WellPoint) was 15 million members, more than 3 times larger.¹²

Figure 1. Growth of the top 5 commercial plans



Top ten health plans with total enrollment in 2008 (enrollment in millions)

Top 10 Plans	Total enrollment
UnitedHealth Group	32.7 m
WellPoint	30.6 m
Aetna	16.9 m
HCSC	12.2 m
CIGNA	9.9 m
Kaiser	8.5 m
Humana	8.5 m
Health Net	6.2 m
Highmark	5.2 m
BCBSMI	5.0 m

Source: Highlights from AIS' Database of Health Plans: U.S. Health Plans ranked by total enrollment. Atlantic Information Services, Inc. (2008)

From a capital perspective, the Blues plans enjoyed a risk based capital (RBC) ratio of 784 percent at the end of 2007. RBC is a measure typically used by the Blues that takes into account the fluctuating value of health plan assets; the financial affiliations of health plans; the risk that providers might not be able to provide contracted services; the risk that amounts due may not be recovered by reinsurance carriers; and general business risks.

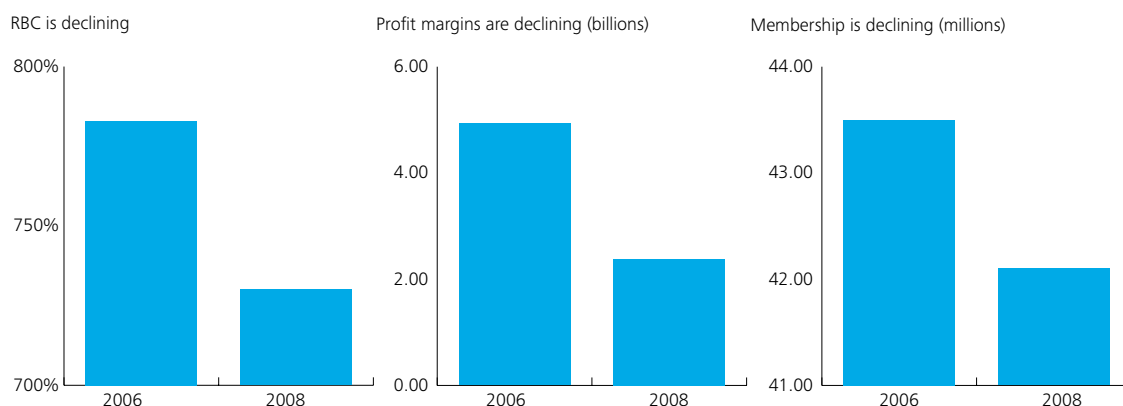
According to OneSource data, the RBC ratio for the Blues fell to 730 percent in the third quarter of 2008, and the 25 percent drop in the equity markets over the last couple of months of 2008 put the RBC ratio to little more than 700 percent at year end. Smaller, non-Blue independent, provider-owned health plans like Dean, Clarian Health Plan, and Health Alliance Plan face similar challenges when competing against the large national players.

Furthermore, the commercial market continues to shrink with rising unemployment (4.7 percent in January 2006 to 9.4 percent in June 2009). Customers are paying higher premiums now and health plans may be forced to continue to significantly raise rates over the next several years.

As independent health plans face the potential of increased consolidation in the market, they need to consider the question: "What strategy is best for our organization?" particularly in the context of economic and regulatory uncertainty and escalating competitive pressures in the market. This question will be addressed later in this paper.

In the current economic environment, even large national health plans are facing balance sheet pressures as well as declining net income and membership. (Figure 2)

Figure 2. National health plans face balance sheet pressures



Source: SEC filings and Onesource (see endnote 9)

Economic crisis and regulatory uncertainty

The health plan industry could be facing several disruptive economic and regulatory challenges that could further spur industry consolidation. Further consolidation would enable health plans to spread significant capital investments across a broader membership base and build potential scale that provides negotiating leverage and/or access to capital.

First, local economies are feeling the heat of the economic crisis. The current combined state budget deficits across the country exceed 100 billion.¹⁵ The U.S. Bureau of Labor Statistics estimates unemployment is expected to jump to 10 percent or more in the near future.¹⁶ Loss of jobs and increases in health insurance premiums are prompting insurance regulators to openly consider the need for acquisitions and affiliations of small local and regional plans.¹⁷

Second, Obama's health reform efforts involve significant reform to the health care system to address the needs of the over 46 million uninsured Americans.¹⁸ There are several potential scenarios playing out in Washington to cover the uninsured, including leveraging national health insurance carriers and their far-reaching delivery networks. If that happens, small and regional health plans will be challenged to compete for these new enrollees but may be able to leverage portability, network, and local community presence to their advantage.

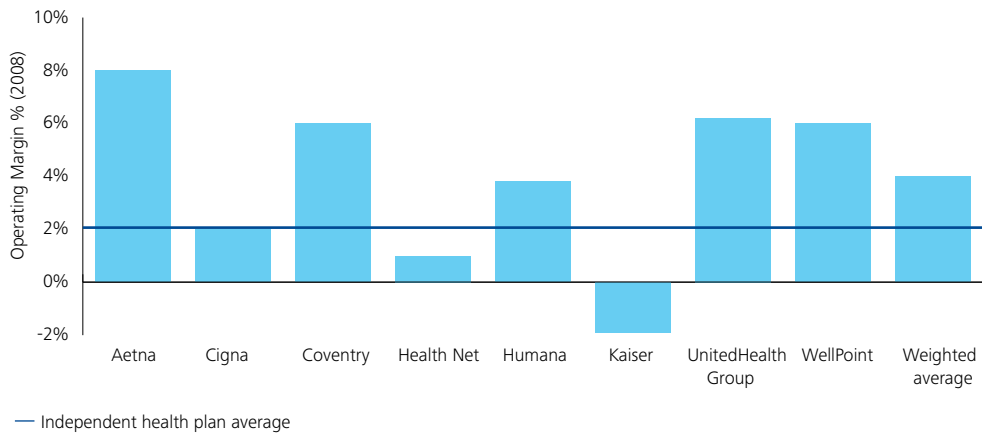
Third, it is difficult for small health plans to make the significant capital investments required to modernize technology, adopt common transparent data standards, and secure state-of-the-art data and information technology platforms.

Escalating competitive pressures

Independent health plans face increasing competitive pressure from their larger national counterparts. This competition is facilitated by larger margins, the ability to spread risk across the entire portfolio of business, and continued geographic expansion into rural and suburban regions (non-contested independent health plan core areas), applying even more pressure to independent state-locked plans.

Figure 3 (following page) shows some of the large players and their operating margins in 2008. On average, the large national health insurance carriers sustain higher operating margins compared to 2 percent for regional health plans.¹⁹ As these large carriers use their more generous margins to cushion the impact of aggressive pricing, ICD-10, health reform, and the rising retail market, smaller independent plans will likely struggle to grow when faced with the investments required to meet the same demands.

Figure 3. National health plan performance



Source: SEC filings and OneSource (see endnote 9)

National health plans have been able to leverage their scale in three important areas:

- 1. Net Income** – National plans typically generate net income percentage levels that are twice or more than that of independent plans.²⁰
- 2. Capital Sending** – The annual capital and technology budgets for national plans are typically \$400 million or more, compared to independent plans that spend in the range of \$75 million - \$150 million.²¹
- 3. Medical Loss Ratio** – Given the larger membership base and more sophisticated medical management programs, national plans can potentially create a more competitive medical loss ratio through certain clinical programs, leveraging volume discounts for services such as pharmacy and radiology benefits.



Alternative models: A range of options

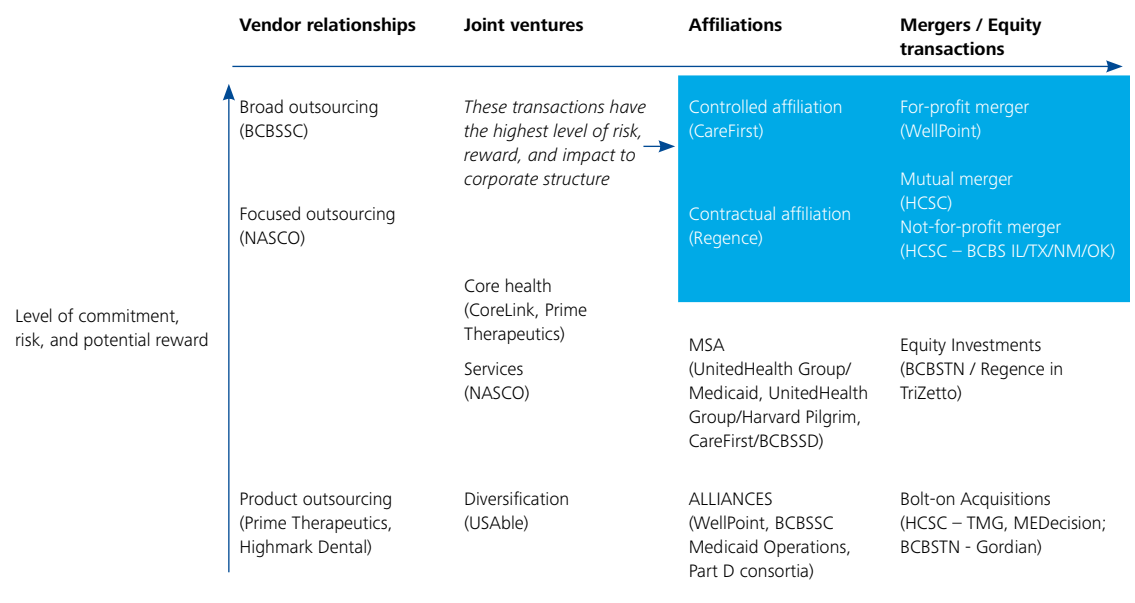
The choice – to remain independent or to consolidate – is not as black-and-white as it may appear. In fact, the health plan industry has recently seen an emergence of many new business models – from shared services, to joint ventures for a line of business, to the option to pursue a fully integrated merger with another independent or local health plan.

Figure 4 depicts the strategic options via the spectrum of business models through various partnership choices, ranging from vendor relationships to full equity mergers. While there are pros and cons to each option, transaction and conversion costs are a critical consideration. Due to the uncertain future of the industry, relatively few management teams feel compelled to make an immediate decision about a partnership option now, although some activity has already occurred. Health plan executives should explore what future events might threaten that security to consider if it is worth assessing the options and making certain calculations in advance – to be prepared – since consolidation activity will likely continue.

During its strategic planning process, the independent health plan should build a business case for one or more potential options based upon where the company wants to be in the future. The business case(s) should recognize and account for market-facing factors, estimate the impacts on the current book of business, and identify impacts to distribution channels and provider networks.

The plan should also consider the implications of each potential party's operating model: not-for-profit, mutual, or for-profit. Not-for profit organizations face several regulatory hurdles to changes in control, as they typically are considered assets of the state and must undergo the Attorney General and Insurance Department approval processes when pursuing partnerships with other organizations. All operating model alternatives should address the needs of shareholder constituencies. One framework to evaluate these options and their implications is using our proprietary Strategic Flexibility model, which will be presented later in this paper.

Figure 4. The partnership spectrum²²



Note on HCSC – BCBS TX Merger: Legal dispute arose as to whether the merger constituted a not-for-profit merger. HCSC reached a settlement in 2002 with the state of IL in which HCSC set aside money for a healthcare foundation, recognizing that at least part of HCSC had been a non-profit company before becoming a mutual company in IL. Source: Consumers Union 2008

Insights for assessing strategic options

Even as all signs point to continued consolidation, and the economic climate has many health plans expecting flat or declining growth in enrollment, independent health plan leaders should understand both sides of the independence or consolidation (in one of its many forms) debate. The following presents key considerations to both sides of the discussion.

The argument for independence: Bigger isn't always better

Mission

When considering the argument for independence, it is helpful to consider the mission of the independent health plan. If the mission is to be local and community-based, then striving to be a large national plan through non-organic growth is counter to its mission. The key question to consider is where the health plan wants to be in the future, and how its mission is going to evolve from where it is today.

Brand positioning

Research indicates that independent health plans have stronger brand recognition and subsequent customer satisfaction compared to publicly traded national companies.²³ For example, the BCBS brand is the oldest and most recognized brand in the U.S. health insurance industry.²⁴ Because of this, many independent health plans have historically been able to maintain market share despite the fact that they are not the lowest cost competitor. As we move to a more retail-oriented market where individuals become more active in the purchasing decision, brand could become even more important.

The key question is whether consumers will be willing to pay more for a health insurance product from a tried and true brand.

Customer service

Larger plans may be more efficient, but they seemingly fall flat in customer service. In the 2007 National Health Insurance Plan Satisfaction Study, the independent Blues plans placed number one in 75 percent of the regions surveyed.²⁵ This may be because the Blues bridge the gap between national and local plans. They offer a national network of providers and a wide breadth of products and services, while maintaining their own independent brand and "local feel." The BCBS brand and excellent customer service are differentiating factors for these plans.

The primary consideration here is whether a superb customer service reputation and a "local brand presence" trump other factors when it comes to health insurance purchase decisions. The key question remains: In which model will the health plan be able to compete most effectively?

The argument for consolidation: Might makes right

Cost

National players typically have a 5-10 percent profit margin objective, compared to non-profits which typically have a 1-3 percent profit margin objective.²⁶ This results in very different approaches to funding and supporting key accounts and other investments. Consolidation can reduce administrative and operating costs. As the largest players expand their services nationally, they are able to leverage vendor arrangements and achieve economies of scale. In the past two years, WellPoint, Aetna and CIGNA have made major acquisitions that have expanded their delivery capabilities and/or expanded their geographic presence. Both types of expansion lead to enhanced operating scale. Furthermore, large national plans have the ability to mitigate risk through their geographic footprint. They can better weather the impacts of major investments required by individual state or regional legislation and other potential trends because they have the ability to spread costs across multiple states or regions.

The primary question around cost competitiveness is whether the national plans will be able to truly consolidate platforms and leverage their enormous scale to their benefit.

Product and service innovation

Whether they are offering new concierge services or innovative features like Health Savings Account banking options, the national players continue to experiment with new products and service delivery features focused on the consumer. In general, independent health plans have been unable to invest at the rate of the nationals to build these capabilities. In addition, product modularity, which may require significant investments to legacy systems, and is more difficult for independent health plans to afford, is becoming increasingly important. While the consumer movement in health care has yet to fully materialize, we believe that some national players are better positioned to support the major investments that will be required to support its emergence.

The key question here is the timing and impact of consumerism on the health care industry and whether the independent plans will be able to deliver products and services that are of value in a post-health reform consumer market.

Capabilities

Not all independent health plans have the capabilities to continue to compete successfully against the large national players. Many plans still have antiquated technology platforms, leading to inadequate business capabilities. Larger health plans can spread major investments, like the significant investments required by federal and state mandates over the next several years, across a larger membership base and thereby secure a favorable cost advantage.

The key question is whether independent health plans can attain economies of scale through partnerships and other ventures since they lack the capital to invest in the capabilities required to develop a new value proposition. Absent their ability to invest on par with the nationals, the question is whether they can...through others.

CXOs: Rethink your strategy

Now is the time for independent health plan CXOs to think through the many questions that have been raised in this paper.

Are some arguments more important than others in this debate?

The “right” strategy will be different for each health plan. Not surprisingly, the rationale for independence or consolidation will not carry the same weight in each organization. Certainly, one of the primary distinctions will be the mission of the organization. For some, being autonomous (and small) might be the only way to stay competitive in the marketplace.

But given that continued consolidation activity appears inevitable and scale doesn’t necessarily confer a clear competitive advantage, how can independent plans prepare for the future health plan market? Can independent health plans forge new partnerships to develop a new value proposition by financing critical investments versus investing solo? The following are the seven key questions we believe health plan CXOs should address through strategic planning initiatives to remain viable in the future.

Insights for maintaining market position: Seven key questions

Key Question #1: What is our mission?

Do we want to keep or change our mission? Would consolidation support or alter that mission? These are fundamental questions that an independent plan should answer. Some plans might need to consolidate into a larger group (or enter into a partnership of some other kind) to preserve their mission and continue to serve their community – perhaps because they need access to capital

for strategic investments or because they want to reduce risk. Other plans might fight tooth and nail to maintain an independent local governance and local business operating model because autonomy is the only way to “be true” to themselves. In either case, it might make sense to conduct a mission and visioning refresh session to establish the goals and objectives to be pursued, measured and attained through future strategies and financial investments.

Key Question #2: How much autonomy and control do we want over our business?

An important question for health plan executives to consider is how much autonomy and control they want to retain in the future. The answer to this question will enable health plan executives to effectively explore the range of possible strategic partnering options, each of which requires varying levels of commitment and results in different levels of risk and potential reward.

Many independent health plans are reaching a point where they may need to make a decision about whether to partner to buy or build needed business capabilities. Shared goals and objectives of plans entering into an affiliation or partnering relationship might include a desire to:

- Continue to serve their local or regional community
- Maintain an independent local governance and local business operating model
- Gain access to capital for strategic investments
- Reduce the costs associated with serving large accounts
- Reduce operating and financial risk to the organization

Key Question #3: How will the industry evolve and what will be the basis of competition?

The future health plan market is fraught with uncertainty. We have highlighted some of the factors that may impact how health plans do business in the future, but there are many unknowns. Given this uncertainty, health plans should consider departing from the traditional approach to strategic planning. Transaction processing and network administration have historically been the basis of competition in the industry – but they are unlikely to be so in the future. Strong customer service and brand may be the differentiating factors in the future – both of which play to regional plans’ strengths. The question then becomes, how can independent health plans get the basic blocking and tackling, such as upgrading core administration systems and other “table stakes,” done without breaking the bank?

Key Question #4: What business capability gaps exist in our organization?

In addition to understanding what level of autonomy and control are important to retain, independent health plans should have a clear understanding of what capability gaps exist relative to the market and their competition. In order to answer this question, it is important to understand what operational and technical gaps exist across the organization relative to local and national best practices and market and competitive demands. Consider the following additional questions:

- How do we compare against future market requirements?
- What do we need to do to close the operational and technical gaps we identify?
- What investments will be required to close those gaps, support innovation, and remain competitive?

Key Question #5: How do we best leverage our strong brand in the local market?

As mentioned previously, research indicates that BCBS plans have stronger brand recognition and customer satisfaction than the publicly traded national health plans.²⁷ The BCBS brand is the oldest and most recognized brand in the U.S. health insurance industry. Independent Blues plans have largely retained and grown local market position through strong brand and outstanding customer service, but the question remains, will this be enough to compete in the future marketplace?

Key Question #6: What is the local regulatory or legislative environment?

The uncertainty around the local regulatory and legislative environment can have a significant impact on the options available to independent health plans. It is important to consider impending local, state and federal regulatory requirements when conducting any strategic planning exercise.

Key issues to consider include:

- *Timing:* How will the regulatory review process impact the timeline for affiliating or merging with another plan? Will the process be lengthy and negatively impact the decision to merge or join an affiliation?
- *Strategic rationale:* Does the organization have a sufficient business case and strategic rationale to partner or merge with another organization? Is it strong enough to pass the regulatory review process?

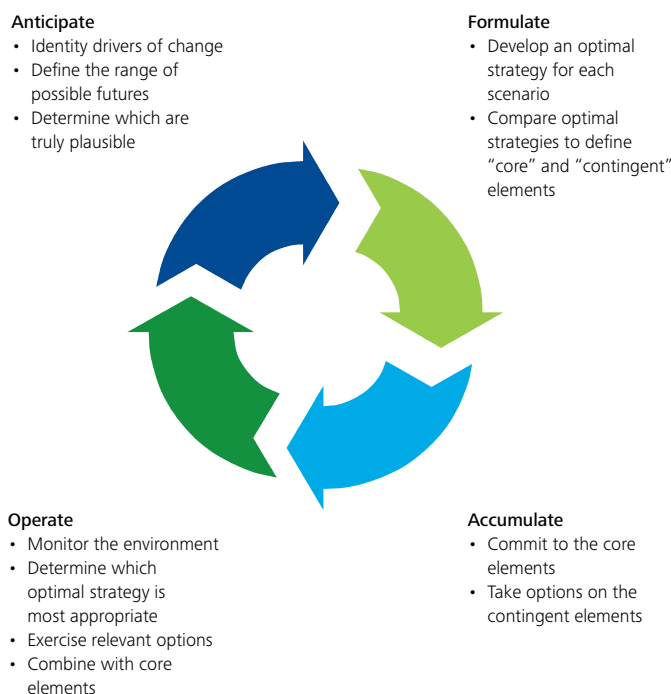
Key Question #7: What are the conversion costs?

Finally, conversion costs are a critical factor when considering any partnership or affiliation arrangement, and are a key barrier to full integration and for nonprofits seeking to convert to for-profit status. Historically, most independent health plans have experienced strong financial health, with no burning platform forcing an immediate partnership decision. The economic conditions of the last several months, however, have challenged this historical performance for independent health plans and future events could cause further disruption. For example, state health and/or insurance regulations may make the cost of a full integration so exorbitant for small local plans that a full integration is not feasible. Our recent marketplace experience suggests that every 1 million members will drive about \$1 billion in conversion costs. These potential costs make it important to understand the range of possible options.

Applying strategic flexibility to independent health plans

To help cope with this uncertainty and help enable health plans to effectively prepare for the future, we have developed a rigorous yet adaptable methodology called *Strategic Flexibility*²⁸ designed to help executives in their efforts to guide their organizations through an analysis of the evolving, complex and uncertain health care market. Developed by Michael Raynor of Deloitte Research and Deloitte Consulting LLP, Strategic Flexibility consists of a four-phase framework (Figure 4) that has been used successfully for strategic planning in other industries. The strategic flexibility framework can help health plans prepare for a range of possible futures by developing an optimal strategy for each possible scenario, so they can exercise or abandon options depending on how the future unfolds.

Figure 5. The strategic flexibility framework



Source: The Strategy Paradox, 2007

We believe using the Strategic Flexibility framework will help independent health plan executives guide their organizations through an analysis of the complex and uncertain health care market in order to identify the most viable strategic options.

Applying the Strategic Flexibility framework requires understanding the range of possible future market scenarios and identifying the dimensions of uncertainty around those scenarios. Each likely scenario should imply an optimal strategy. Each optimal strategy will contain both core and contingent elements: core elements are the strategies or capabilities that can be applied across multiple scenarios and contingent strategies are those strategies or capabilities that need to be developed only when conditions for a particular scenario are met.

Executives of independent health plans have the responsibility to mitigate strategic risk and position their health plan to exploit emerging opportunities. To do this, we believe should create strategic flexibility within their organizations by identifying strategic options or tactics that can be implemented or abandoned depending on how the future unfolds. This approach requires health plan executives to understand (1) which options to pursue; (2) how much to invest in these options; (3) how to manage the options over time; and (4) when and how to pursue or abandon these options while directing the health plan's functional/operational unit actions.

In the life sciences industry, for example, Johnson & Johnson (J&J) found a way to preserve the benefits of constraints – those limitations every organization faces around resources, structure, and strategy which can actually help to sharpen strategic focus – while using its corporate venture capital arm, Johnson & Johnson Development Corporation (JJDC), to transcend those constraints and manage the strategic uncertainty facing J&J's operating divisions. JJDC created and manages a portfolio of options and alternative strategies for J&J's operating companies to explore new products and markets for the organization.²⁹ JJDC's output enables the larger J&J organization to determine when to exercise potential options and implement specific strategic plans in advantageous market conditions. A similar approach could allow independent health plans with high-risk, high-return strategies to adjust their strategic stance as needed in order to improve overall corporate performance and lower overall corporate risk.

Conclusion

With health plan consolidation expected to continue into the foreseeable future, independent health plans should employ careful strategic planning tactics to assess their current capabilities relative to market demands, identify the range of strategic options, and employ the appropriate strategy to remain viable in the future marketplace. We believe the *Strategic Flexibility* framework can help health plans articulate a new value proposition going forward.

While this paper has focused on independent health plans in particular, given the direction of health reform, we believe there is an opportunity for larger health plans to participate in this journey and create attractive partnership opportunities appealing to independent health plans that may or may not ultimately be seeking full-blown consolidation. This consideration for larger health plans means that everyone has the opportunity to gain with an appropriately articulated value proposition.

Today, most independent health plans have dominant local market share and enjoy strong financial health. But what about tomorrow? To remain viable, whether as autonomous plans or through partnerships and affiliation arrangements with other organizations, independent plans require innovative strategies that will allow them to adapt, readily and purposefully. *Strategic Flexibility* is all about choice – the choice to succeed on one’s own terms and select a path that is an appropriate path for all of the organization’s stakeholders.



Authors

William Copeland

Principal
Deloitte Consulting LLP
Tel: +1 215 446 3440
Email : bcopeland@deloitte.com

Diane Davies

Principal
Deloitte Consulting LLP
Tel: +1 213 688 4734
Email : didavies@deloitte.com

Steven Birchard

Principal
Deloitte Consulting LLP
Tel: +1 312 486 2282
Email: sbirchard@deloitte.com

Francis Irwin

Principal
Deloitte Consulting LLP
Tel: +1 212 618 4250
Email: firwin@deloitte.com

Contributors

Anne Claussen

Senior Manager
Deloitte Consulting LLP
Tel: +1 312 486 3584
Email : aclaussen@deloitte.com

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