"They [WellPoint] *have a very seasoned, very disciplined executive team. In terms of innovation, they are certainly up in the front ranks. They don't sit back. They were one of the first out there to provide Internet capabilities to consumers."*

Also, WellPoint has invested extensively in modifying its systems platform (a complex and costly undertaking) to have common, flexible products across different states, and also to enable minimizing the costs associated with HIPAA compliance. By having common systems, WellPoint believes that investments like HIPAA remediation will be simpler and less expensive. This is an example of how CareFirst can gain the advantages of economies of scale.

F. Products –

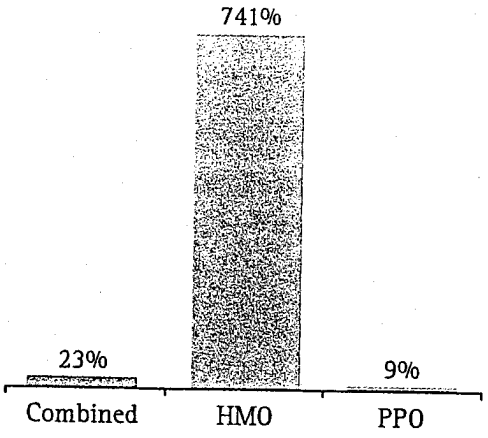
Is it likely that products would be restricted or enhanced as a result of the transaction?

Overall, availability and accessibility could improve as a result of an increase in products available.

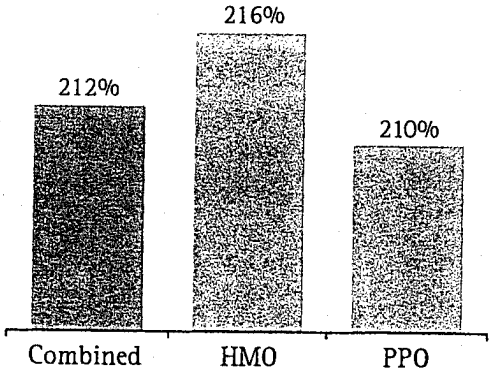
The Commercial Small Group and Individual Market Segments Appear to be Very Important to WellPoint

The histories of Blue Cross of California and Blue Cross Blue Shield of Georgia suggest that availability and accessibility could improve due to an expanded portfolio of products, especially in the individual and small group markets. WellPoint has seen its Blue Cross of California subsidiary increase its enrollment in these segments by 23% and 212% respectively since 1992[F.1].

BCC – Individual Membership Growth*
(1992-2000)



BCC – Small Group Membership Growth*
(1992-2000)



* Although PPO membership has grown slower than HMO membership, BCC had approximately seven times as many Individual PPO vs. HMO members and two times as many Small Group PPO vs. HMO members in 2000.

Source: WellPoint internal enrollment data, 2001.

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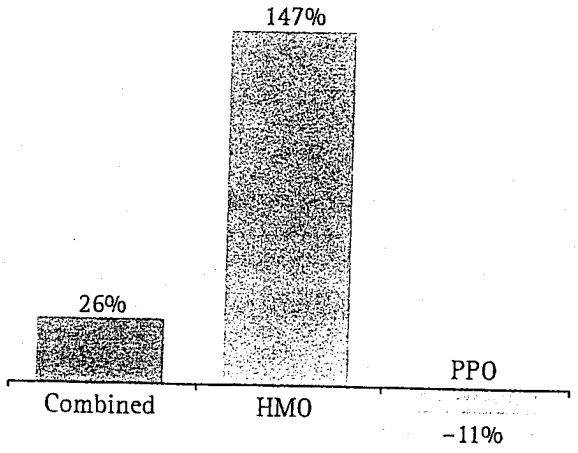
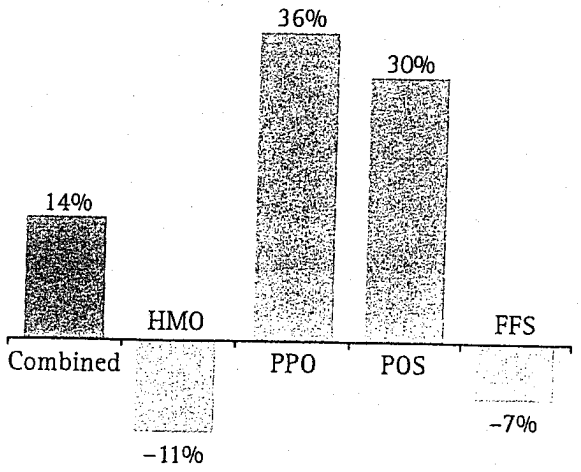
BCBS GA – Individual Membership Growth
(1999–2000)



BCBS GA – Small Group Membership Growth
(1999–2000)



Source: BCBS GA internal enrollment data, 2001.

New WellPoint Products Offered to Small Employers and Individuals

Product	Introduced	Target Market	Product Description
High Deductible Plans	1997 – BCC and UNICARE*	Individual and Small Group	Members use the money deposited in a Medical Savings Account for routine medical expenses. Members protected with benefits if catastrophic medical or hospital coverage is needed.
HealthyCheck Centers	1997 – BCC 2000 – UNICARE (TX only)	Individual and Small Group	Members offered an affordable annual health care screening. Members have their deductible waived and pay a flat fee ($25 or $75) depending on the level of service desired. A summary of results is also provided to the member.
FlexScape	2000 – BCC and UNICARE	Small Group	A variety of plans that feature a range of high, medium and low benefits and price points: ◦ Defined Contribution: Employer decides on a set amount to be spent on employees' health coverage per month ◦ Employee Elect Plus: Employees may choose any Blue Cross Small Group Plan. Plan also gives employers the ease of administration that comes from dealing with only one health care company. ◦ Section 125: Allows pretax employee contributions to cover employees' portion of their health insurance premium
PlanScape	2001 – BCC	Individual	Members offered a wide choice of plans designed to deliver benefits at a premium to match a wide range of budgets. Prices are in a high, medium and low range along with benefit packages. This program also includes Family Elect, a feature that allows different family members to enroll in different plans, while receiving only one premium bill per family.

* Plan offered only to UNICARE individual members.
Source: WellPoint internal data.

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In order to protect and enhance its investment in CareFirst, WellPoint has an incentive to offer more, not fewer, products to the Maryland, Delaware, and Washington, D. C. markets. WellPoint's CFO, David Colby, commented on WellPoint's commitment to the small group and individual segments, stating[F.2]:

> *"We developed our FlexScape product in order to provide greater flexibility to small business owners, so they can provide a much wider variety of benefit packages to their employees. And we have over 1 million individual members, so we are committed to understanding their needs and serving them."*

Also, when commenting on growth opportunities for Blue Cross Blue Shield of Georgia, Colby stated WellPoint's commitment to the individual and small group markets in Georgia[F.3]:

> *"Obviously, one of the big opportunities in Georgia is to grow individual and small group. If we are successful at getting that up to almost 50% of the insured book, which may be tough, it'd be quite a growth."*

Finally, WellPoint CEO Leonard Schaeffer has stated, when asked about Blue Cross of California[F.4]:

> *"We've been in the ISG* [individual and small group] *business for a long time and some of you have followed us through all of that and some not. It is a very different business from large group and we have a commitment to this market segment and we have done very well in it and we think we'll continue to."*

And, regarding Blue Cross Blue Shield of Georgia, he stated[F.5]:

> *"What we would hope to do over time is to expand some of the individual and small group products to maybe address some of the issues having to do with the uninsured."*

<u>*CareFirst Has a Strong Presence in the Commercial Small Group and Individual Market Segments*</u>

The commercial small group market segment (CareFirst defines the small group segment as companies with 50 or fewer employees) and the commercial individual market segment (excluding Medicare+Choice and Medicaid) currently represent 16.4% of CareFirst's membership. Membership in each of these commercial segments has been increasing over the last few years. From 1997-2000, CareFirst's Maryland and NCA membership in the individual market segment increased 44%. Between 1999-2000 (since its merger with CareFirst) Delaware's membership in the individual market segment has increased 5.5%. In CareFirst's small group segment in NCA and Maryland, membership grew 29% between 1997-2000. In Delaware, membership increased 17.8% from 1999-2000. These statistics[F.6] suggest that the small group and individual segments of CareFirst's business are very important to the Company. Given the segments' importance to CareFirst, and WellPoint's apparent commitment to those same segments in its current markets, it is likely that continued participation in these segments would be important to CareFirst in the future.

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As of December 2001, CareFirst had chosen to not participate in the Medicaid and Medicare Risk individual market segments. If WellPoint chooses to remain out of these market segments, there would be no impact on the availability, accessibility, or affordability of health care. If WellPoint chooses to enter these market segments in CareFirst's service area, customers in these market segments would have an additional option to obtain coverage (in addition to the offerings of existing participating health plans). WellPoint has one of the largest Medicaid populations in the United States, and therefore possesses experience in managing Medicaid populations should it decide to enter the markets in CareFirst's jurisdictions.

G. Pricing -

Is it likely that prices (health care insurance premiums) would change as a result of the transaction?

Health insurance premiums will continue to rise with medical cost inflation as they have in the past. We believe that premiums for most CareFirst customers will not change substantially beyond normal inflation as a result of this transaction. CareFirst customers in Maryland, Delaware, and possibly Washington, D.C. insured indemnity and PPO product lines would incur the additional cost of premium taxes as a result of the conversion; this revenue would benefit the states.

WellPoint has an incentive to achieve a return on its investment in CareFirst. Assuming its targets are similar to those of other publicly-traded health companies, WellPoint's return and growth target could likely be achieved through cost savings and new product sales without raising prices beyond levels they would be otherwise. Furthermore, WellPoint's ability to raise prices in Maryland, Delaware, and Washington, D.C. would be limited by competitive market pressures.

Premiums Will Continue to Rise With Medical Cost Inflation Regardless of Transaction

As discussed earlier in this Report, health care insurance premiums have risen in reaction to medical cost inflation (medical cost components include pharmaceutical, hospital, physician, nursing home and other costs, as described in the Centers for Medicare and Medicaid Services' *National Health Expenditure Projections 2000 - 2010*, March 2001). They will continue to do so regardless of CareFirst's proposed for-profit conversion and merger with WellPoint. The potential pricing impacts described in this section (section G) pertain only to the incremental change in health care insurance premiums from this ever-increasing base.

Some Members Will Incur Premium Taxes

As a result of its conversion from a non-profit to a for-profit corporation, CareFirst will incur the additional cost of premium taxes on its insured indemnity and PPO business in Maryland and Delaware. In Washington, D.C., additional taxes would be incurred if CareFirst elects to exit the open enrollment program after for-profit conversion. If CareFirst remains in the Washington, D.C. open enrollment program and converts to a for-profit corporation, the premium impact on members due to taxes is unclear.

CareFirst and WellPoint state that the new premium taxes incurred in Maryland, Delaware, and Washington, D.C. would likely be passed on in full to the affected customers. Using this assumption, approximately 510,000 CareFirst members in Maryland and Delaware would experience a premium increase of 2%[G.1], averaging approximately $4.34 per member per month as a result of the transaction[G.2]. If CareFirst elects to exit the open enrollment program in Washington, D.C., approximately 114,000 members would

experience a premium increase of 0.7%, averaging $1.82 per member per month as a result of the transaction. For members in many employer-sponsored health plans, a significant portion of these increases would be borne by the employer.

New Tax Revenue Benefits Maryland and Delaware

The additional funds collected would go directly to Maryland and Delaware. CareFirst estimates $29.0 million in new premium taxes would go to the states[G.2]. So while the affordability of health care for some customers would be adversely affected as a result of paying premium taxes, the proceeds would go directly to the states for use as they deem appropriate. The governments in Maryland and Delaware determine where and how the $29.0 million is spent, as well as the premium tax rates, so they control the eventual impact on the overall affordability of health care.

Earnings Growth Similar to Other Publicly Traded Health Companies Appears Achievable

Whenever a for-profit health plan acquires a non-profit health plan, the concern exists that the acquiring plan would raise prices in order to increase shareholder returns. As a publicly traded for-profit, WellPoint needs to generate a return on its $1.3 billion investment in CareFirst. Based on comments from WellPoint, it appears that WellPoint's plan to achieve a return on its investment focuses on cost savings and new product sales, not raising prices. WellPoint's return on its investment would come from the earnings generated by CareFirst, and any synergies it could capture in addition to those. During a conference call with equity analysts to discuss the announced WellPoint-CareFirst Merger Agreement, WellPoint CFO David Colby stated[G.3]:

> *"We believe we will achieve revenue synergies of $30 million within 3 years. The revenue synergies will come from new products that we offer, conversion of CareFirst to our pharmacy benefit management company, and the potential for life and dental penetration in CareFirst's markets. On the cost side, the cost synergies would be reduced duplicate overhead costs, plus lower administrative costs due to economies of scale in the region."*

We queried WellPoint about its pricing intentions, asking the direct question "Does WellPoint plan to raise prices in CareFirst's jurisdictions?" to which WellPoint responded[G.4]:

> *"There will be no increase in premium rates as a result of this merger. Any increases or decreases in premium rates following the merger will be made in the same manner as those occurring prior to the merger—they will be made by local market managers after taking into account all relevant factors including increases in health care costs."*

Investors expect any publicly traded company, including publicly traded health plans, to meet certain expectations for earnings growth. WellPoint investors also have growth expectations for the company. Historically, WellPoint has achieved earnings growth through a variety of means, including revenue growth, administrative cost reduction, investment earnings, and other means. Based on its historical performance, it appears WellPoint's revenue growth has contributed about two-thirds of total growth, with the remaining growth coming from other factors.

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Health industry financial analysts project the the group of publicly-traded health companies will experience an earnings growth rate of approximately 15% annually over the next five years (First Call's Health Industry earnings growth projected for the next five years is 15.89% annually; Bloomberg's five-year earnings projection for the "MED-HMO" industry is 14.8% annually[G.5]). We assume WellPoint shareholders would hold similar expectations for WellPoint's earnings growth. If WellPoint were to achieve 15% annual earnings growth, and revenue growth were to comprise two thirds of earnings growth, annual revenue growth would have to be 10%. With private heath care inflation averaging 8.3% annually over the last five years (see Section IV, Health Care Industry Context), the large majority of the 10% revenue increase may be met merely through premium increases due to medical cost inflation. Other revenue growth could come through new customer sales, new products, or future acquisitions. The remaining earnings growth could be achieved through modest reductions in administrative costs, improvements in investment earnings and/or improvements in business mix, without resorting to additional price increases. CareFirst's financial plan for 2002-2005 describes an approach to achieve 15% annual earnings growth without price increases beyond those driven by medical cost inflation. So, it appears WellPoint could reasonably meet the expectations of shareholders without raising premiums in CareFirst's market area beyond what they would have been otherwise.

The Competitive Market Will Help Control Prices

Furthermore, CareFirst's market power will not change significantly as a result of the transaction. As a result, CareFirst's ability to raise prices significantly above competitors' prices without affecting market share would be limited. If CareFirst were to attempt such a move, it would likely cause CareFirst to lose a significant amount of business.

If WellPoint's history with its Blue Cross of California plan serves as a guide, we would expect CareFirst to strive to make its products *more*, not less, competitive in Maryland, Delaware, and Washington, D.C. after a merger with WellPoint. If it follows the same strategy as it did with Blue Cross of California, WellPoint is likely to pursue shareholder value by winning more customers (i.e., growing market share). It can only do so if customers perceive they are receiving good value (benefit minus price) from WellPoint products. Since WellPoint's initial public offering, its membership in California has nearly doubled[G.6]. This suggests people in California are purchasing more of WellPoint's products because they find them a better value than competitors' products.

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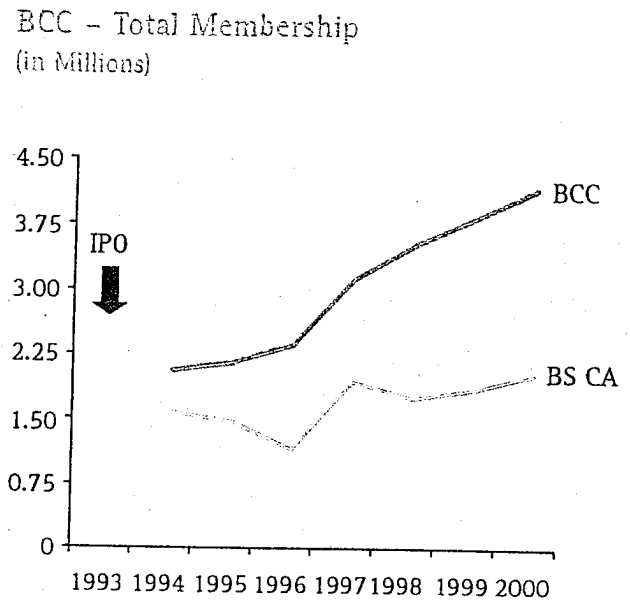

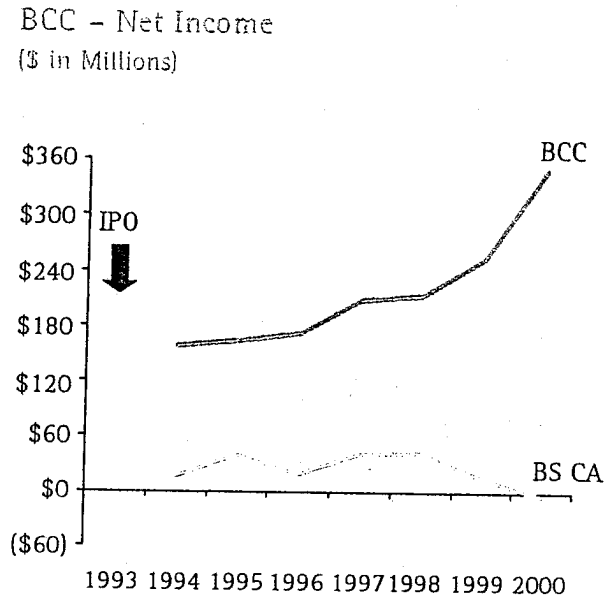

Source: InterStudy, The National HMO Financial Database, 1994-2000, data pulled from state Department of Insurance filings; Blue Cross of California membership figures include 125,000 members acquired through Omni Health Plan acquisition.

Access to Public Equity Capital Eases Reliance on Premiums as a Financing Mechanism

Access to the public equity markets through WellPoint would provide CareFirst another source of capital to finance investments, enabling it to rely less on customer revenue to finance investments. Today, CareFirst finances nearly all of its investments through its earnings. As earnings are driven, in large part, by revenues, CareFirst's ability to invest depends heavily on the premiums it collects from customers. If CareFirst has a large investment need, it must either earn more premiums or reduce its costs to fund the investment. If it is unable to do either sufficiently, it may be forced to forego the investment. If CareFirst converts to a for-profit company and merges with WellPoint, it would have access to equity capital. By virtue of being a public company, it would also have greater access to a variety of debt capital markets. This enhanced capital access would not only allow CareFirst to be less dependent on premium pricing to fund investments, it would also provide CareFirst more flexibility to invest at the time it needs to invest.

H. Governance –

Would the change in control impact availability, accessibility, and affordability?

Because of the proposed change in ownership, WellPoint would control CareFirst activity. As such, WellPoint would have the ability to affect availability, accessibility and affordability. WellPoint's long-term incentive is to favorably impact these dimensions of health care. Furthermore, the terms of the Merger Agreement call for local decision making in several significant respects.

WellPoint Will Control CareFirst Activity; Long-term Incentive Appears to Be to Respond to Customer Needs

Obviously, as a result of the transaction, WellPoint would control CareFirst. Therefore, it will have an ability to impact availability, accessibility and affordability. A number of factors provide WellPoint with the long-term incentives to favorably impact availability, accessibility, and affordability in order to

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positively respond to customer needs, including:

- Competitive Forces – As discussed in the Competition section of this document, CareFirst's market power does not appear to change significantly as a result of the transaction. Therefore WellPoint's ability to impose more restrictive policies or practices in CareFirst's jurisdictions would likely be limited, because to make such changes would risk the loss of a substantial portion of its business to competitors whose policies remain less restrictive. Increasing responsiveness to customer needs would be a more appropriate approach to those competitive pressures.
- Growth Targets – As discussed in the Pricing section, WellPoint has revenue growth goals, and the objective to meet a portion of those goals through membership growth. In order to attract new members, WellPoint would need to work with CareFirst to provide a more attractive and/or differentiated set of products and services in order to win more customers. As discussed in the Products and Operations sections, WellPoint has a history of innovative product development and proactive investment in service operations, which appear to have the long term effect of positively impacting availability, accessibility and affordability.
- Terms of the Agreement – No terms of the Merger Agreement indicate an intent on the part of WellPoint to negatively impact availability, accessibility or affordability.

Many Decisions Will be Made Locally

The terms of the Merger Agreement explicitly call for continued local governance in many important respects, including:

- A transition team well represented by local CareFirst executives – "The Parties shall form a transition team (the "Transition Team") consisting of an equal number of representatives of CareFirst and Purchaser. The Transition Team shall be responsible for facilitating a transition and integration planning process to facilitate the combination of the operations of CareFirst and Purchaser." (Section 6.2 (b))
- A CareFirst representative on WellPoint's Board of Directors, pending approval – "Effective as of Closing, Purchaser (after consultation with CareFirst) will nominate for election one non-employee member of the existing Board of Directors of CareFirst to serve on Purchaser's Board of Directors and will use Best Efforts to have the CareFirst designee appointed or elected to Purchaser's Board of Directors." (Section 6.13 (a))
- CareFirst's Chief Executive Officer will continue to be in charge of operations in CareFirst jurisdictions – "At the Effective Time, the Chief Executive Officer of CareFirst shall be named the President of Purchaser's Southeast Business Region with overall responsibility for all of the business operations of the Surviving Corporation [i.e., the merged CareFirst-WellPoint subsidiary corporation] and the CareFirst Subsidiaries in the Southeast Business Region." (Section 6.13 (b))
- CareFirst's senior executives will continue to hold significant responsibility in the merged corporation – "Other senior executives of CareFirst will be assigned significant responsibilities with respect to the business of the Surviving Corporation." (Section 6.13 (b))
- Local advisory boards will be in place to guide local relationships – "An advisory board will be formed for each of the BCBS-NCA [National Capital Area, i.e., Washington, D.C.], BCBS-MD and BCBSD...Each advisory board will provide guidance to its respective company regarding the company's relationship with subscribers (both group and non-group), physicians and hospitals, and the general public. Each director appointed to an advisory board shall serve for a term of two years from the Closing on the same terms and conditions currently applicable to such person's service on the Board of Directors of CareFirst, BCBS-NCA, BCBS-MD or BCBSD as of the date hereof." (Section 6.13 (c))

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- Local headquarters will not be moved – "The headquarters of BCBSD, BCBS-NCA and BCBS-MD shall be located in the State of Delaware, the District of Columbia and State of Maryland, respectively." (Section 2.6)

WellPoint's Stated Management Philosophy and Merger History Appear to Support Local Decision-Making
WellPoint CEO Leonard Schaeffer has repeatedly stated, "health care is locally delivered and locally consumed[H.1]." This philosophy has been put into action with WellPoint's merger with Blue Cross Blue Shield of Georgia[H.2], where:

- Former BCBS of Georgia managers occupy 12 of the top 14 officer positions in the WellPoint Georgia subsidiary.
- Warren Y. Jobe, a former member of the Blue Cross Blue Shield of Georgia Board and retired Senior Executive of the Atlanta based Southern Company, is also now a member of WellPoint's Board of Directors
- Physician, hospital, and consumer advisory boards are new innovations brought to Blue Cross Blue Shield of Georgia by WellPoint. Members of these boards are from local communities, hospitals, physician groups
- Corporate headquarters remain in Atlanta and the plan's Service Center remains in Columbus, Georgia

Local Regulations Will Remain in Effect
CareFirst will remain subject to local laws and health/insurance regulation governing for-profit health plans. Decisions made in California regarding CareFirst's business activities must comply with these laws and regulations.

I. Regulation –

Would CareFirst's conversion to a for-profit change regulatory oversight and thereby impact the availability, accessibility, or affordability of health care?

As a result of a conversion, regulatory powers would change in Washington, D.C. over the requirement to offer open enrollment. However the resulting Washington, D.C. foundation could assume the role of fulfilling the needs of those needing open enrollment.

As a result of a conversion, regulatory powers would change in Maryland over the management of CareFirst's reserves. However, CareFirst's financial strength and its ability to efficiently manage reserves could significantly improve as a result of a merger with WellPoint.

CareFirst's conversion to a for-profit does not appear to result in a loss or diminution of state regulatory oversight in Delaware.

Changes in Washington, D.C. Over Open Enrollment; Likely to be Covered by New Foundation
Regulations in Washington, D.C., require a non-stock, non-profit corporation (defined in 35-3501(2) of the District of Columbia Official Code, 2001 Edition) to offer an open enrollment program[I.1] (31-3514(a) of the same code states: "A corporation issued a certificate of authority under this chapter shall make available to

citizens of the District of Columbia an open enrollment program under the terms set forth in this section"). For-profit health plans are permitted to offer similar programs, but are not required to do so. As discussed in the Business Purpose and Foundations section of this Report, decisions regarding participation in these types of programs are generally made on the basis of the terms of each program and the resulting business benefit. It appears reasonable to assume that CareFirst will make decisions regarding participation on that basis. There do not appear to be any terms in the Merger Agreement that signify an intent to make decisions on any other basis. Most health plans, whether for-profit or non-profit, would not choose to offer open enrollment without compensation for doing so. We expect the resulting for-profit CareFirst entity in Washington, D.C. to behave likewise. However, similar to the Maryland foundation, we would expect the needs of those citizens utilizing an open enrollment program to be served by the Washington, D.C. foundation that would be established (please see the section in this Report on Business Purpose and Foundations).

Changes in Maryland Over Reserves

Regulators in Maryland hold the power to exercise a greater degree of control over the reserves of non-profit health plans than the reserves of for-profit health plans[L2] ((§ 14-117) (e) (2) "After the Commissioner has determined the surplus of a corporation authorized under this subtitle to be excessive, the Commissioner: (i) may order the corporation to submit a plan for distribution of the excess in a fair and equitable manner"). Such distributions improve the affordability of health coverage for individuals over a short period of time. However, this power is seldom used by regulators, and was last invoked over 15 years ago[L3]. Furthermore, it is unclear that if it is used, it actually improves affordability over the long term, since a forced distribution may hamper a health plan's ability to make investments that potentially improve long-term affordability.

CareFirst would remain subject to local laws and health/insurance regulations governing for-profit health plans. One purpose of these laws and regulations is to protect the affordability, accessibility, and availability of health care to Maryland's citizens. These laws and regulations will not change as a result of the proposed transaction.

CareFirst's Overall Reserves Meet State and BCBSA Minimums

Financial strength is required to maintain CareFirst's ability to sustain adequate levels of availability, accessibility, and affordability of health care to its members. State laws and BCBSA regulations ensure that CareFirst's capital reserves are at a level that maintains financial adequacy. The proposed transaction could improve CareFirst's financial strength and provide an opportunity to use capital more efficiently.

- Compared with other Blue Cross Blue Shield plans, CareFirst ranks near the middle in terms of its reserve level[L4].
- CareFirst's current reserve exceeds state minimum levels. Maryland, Delaware and Washington, D.C. have adopted the National Association of Insurance Commissioners (NAIC) guideline that health plans maintain reserves of at least 200% of Risk Based Capital (RBC). CareFirst's combined reserve (for all three jurisdictions) as of September 30, 2001 is 622% of RBC[L5], above the state minimums.
- CareFirst must also meet BCBSA reserve requirements in order to maintain its Blue Cross Blue Shield service mark license (its Blue Cross Blue Shield trademark). We understand that BCBSA reserve requirements are more stringent than the NAIC guideline. These requirements are proprietary and confidential, so BCBSA does not disclose them. If a Blue Cross and/or Blue Shield plan falls below a specific multiple of RBC, it is put on a monitoring program by BCBSA. If it falls further below that

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