

California Regulators Approve Health Net/Centene Deal With Conditions

UPDATE: March 23, 2016: California state regulators approved the Centene and Health Net merger—subject to strong conditions.

Centene announced that it received [approval from the California Department of Managed Health Care \(“DMHC”\)](#), on March 22, 2016, and [approval from the California Department of Insurance \(“CDI”\)](#), on March 23, 2016. Both state agencies placed significant—and expensive—conditions on the merger.

DMHC provided an extensive list of [undertakings](#). In addition to typical closing requirements, DMHC is requiring Centene to satisfy unique conditions. The [San Francisco Business Times](#) reported that DMHC’s conditions carry a “total price tag of at least \$340 million.” The [State of Reform](#) further explained that DMHC requires Centene to:

- keep key Health Net functions and operation in California, including the maintenance of Health Net’s headquarters;
- improve quality of care through a rating and oversight program administered by the DMHC, Department of Health Care Services, and the Office of the Patient Advocate;
- contribute \$65 million to improve enrollee health outcomes, support local consumer assistance programs, and strengthen the health delivery system;
- invest \$75 million into California’s health care infrastructure for underserved groups|and
- invest \$200 million in supporting and building a service center, in an economically distressed community in California, and employ at least 300 people therein.

California Insurance Commissioner, Dave Jones, also issued [undertakings](#), some of which overlap with DMHC's conditions and some of which add to them. Of note are the CDI conditions that Centene:

- keep Health Net domiciled in California (exceptions apply) and maintain Health Net's executive management and headquarters in California;
- increase the number of covered lives in Health Net's California products;
- maintain National Committee for Quality Assurance ("NCQA") accreditation, improve its NCQA score by 0.8 points per year, and achieve an NCQA score of at least 26.7 by 2020;
- invest \$30 million into the California Organized Investment Network ("COIN") over the next five years and use these investments to develop health care facilities or services for people with low-to-moderate income|and
- invest \$200 million in supporting and building a service center, in an economically distressed community in California, and employ at least 300 people within it.

It is clear from DMHC and CDI's conditions, as well as the questions asked at the January 2016 public CDI hearing on the Centene/Health Net merger, that California state regulators were concerned with the impact the merger could have on California's employment rates, access to health insurance, and quality of care. First, DMHC and CDI both require Health Net to remain headquartered in California and to create a service center that will employ at least 300 people. These conditions seek to retain current, and even create additional, jobs in California. Next, the state agencies will require Centene to improve Health Net's quality in various ways, including: requiring that the companies

maintain national NCQA accreditation, meet a specific quality threshold by a specific date, and allow multiple California state agencies to oversee this quality improvement process. And finally, the DMHC and CDI conditions require Centene to invest upwards of \$40 million to increase Californians' access to plan service centers and assistance programs.

According to Centene's most recent [press release](#), Centene and Health Net "expect to close the transaction in the coming days, subject to satisfaction or waiver of the closing conditions."

Background

In July 2015, Health Net, Inc. ("Health Net") [announced](#) that both Centene Corporation ("Centene") and Health Net's Boards of Directors unanimously approved Centene's acquisition of all of Health Net's shares, and in October 2015, Health Net's shareholders [approved](#) the proposed acquisition. Before it can be effectuated, this transaction requires approval by the California Department of Managed Health Care and the California Department of Insurance ("CDI").[\[1\]](#)

[Centene](#) is a publicly traded managed care organization and specialty healthcare services company, headquartered in Missouri. Centene services Medicaid, CHIP, Medicare-Medicaid "dual eligibles," Supplemental Security Income Program, and ACA Marketplace members. It also has a California subsidiary, [California Health and Wellness](#), which services Medi-Cal beneficiaries. [Health Net](#) is a publicly traded managed care organization, headquartered in California. Health Net services Medicaid, commercial, Medicare Advantage, and dual eligible members.

Legal Premise for Review

Pursuant to [California Insurance Code Section 1215.2\(d\)](#), the

Commissioner of the CDI may disprove an acquisition for one of five reasons: “(1) [a]fter the change of control the domestic insurer referred to in subdivision (a) could not satisfy the requirements for the issuance of a license to write the line or lines of insurance for which it is presently licensed|(2) [t]he purchases, exchanges, mergers, or other acquisitions of control would substantially lessen competition in insurance in this state or create a monopoly therein|(3) [t]he financial condition of an acquiring person might jeopardize the financial stability of the insurer, or prejudice the interests of its policyholders|(4) [t]he plans or proposals which the acquiring person has to liquidate the insurer, to sell its assets, or to merge it with any person, or to make any other major change in its business or corporate structure or management, are not fair and reasonable to policyholders|[or] (5) [t]he competence, experience, and integrity of those persons who would control the operation of the insurer indicate that it would not be in the interest of policyholders, or the public to permit them to do so.”

Arguments For and Against the Merger

In advance of the hearing, the parties, their expert witnesses, and various other interested parties submitted written testimonies and comments in support and opposition of the merger. In addition, the parties and their expert witnesses testified before the Commissioner of the Department of Insurance, Dave Jones, in a public hearing held on January 22, 2016. Members of the public were also provided an opportunity to testify at the hearing. The Source’s Managing Editor, Anne Marie Helm, and Fellow, Elizabeth Nicholson, attended the hearing.

Centene and Health Net’s Testimonies

Representatives for both Centene and Health Net testified on the

benefits of the merger. In sum, Centene argued that acquiring Health Net would create jobs in California, not decrease competition in the insurance market, result in precompetitive effects, and strengthen Health Net's ability to compete with national insurers.

The Insurance Code

Keith Williamson, Executive Vice President, Secretary, and General Counsel, Centene, submitted [written](#) and oral testimony arguing that the Commissioner should allow Centene and Health Net to merge because the transaction would not result in any of the adverse results set forth in Section 1215.2(d) of the Insurance Code (see above). Specifically, Williamson argued that there is no cause to believe that the merger would: (1) inhibit Health Net's ability to satisfy its requirements for licensure under Section 717 of the Insurance Code|(2) result in a substantial lessening of insurance competition or in a monopoly in California|(3) result in Centene jeopardizing Health Net's financial stability or prejudicing Health Net's policyholders' interests|(4) result in changes that are unfair or unreasonable to Health Net policyholders|or (5) result in operation of Health Net by incompetent people, inexperienced people, or people whose integrity would not be in the public or Health Net's policyholders' interest.

Effect on Competition

Kenneth Rone Baldwin, Executive Vice President for the Insurance Group, Centene, submitted [written testimony](#) on the merger. He argued in his testimony that the merger will have pro-competitive effects in California and will help California's economy. More specifically, he testified that (1) the merger would increase Health Net's scale, which would make it a stronger competitor against other insurance companies|(2) that

Centene's market presence does not overlap with Health Net's market, in California, so their merger would not decrease the number of competitors in the market|(3) Health Net would remain domiciled in, and operated out of, California, so the market would remain in the state|(4) the merger would allow Health Net to insource jobs it has traditionally outsourced, which would ensure jobs in California|and (5) Centene is a "growth company" and would remain committed to Health Net's capitalization, financial stability, and growth.

Steven Sell, President, Health Net Life Insurance Company, Inc., Health Net California, and Health Net, Inc., testified in his [written](#) and oral testimonies, that from the perspective of policyholders and California consumers, the merger would (1) strengthen Health Net's "existing business lines;" (2) maintain its commitment to its California-based healthcare model|and (3) would enhance competition in the California insurance market.

Centene also hired expert witnesses to study the potential effects of the merger. Dr. Lawrence Wu, President of NERA Economic Consulting, and Dr. Paul Wong, Consultant at NERA Economic Consulting, supported Centene's arguments that the merger will increase competition in California. Drs. Wu and Wong submitted [written](#) testimony, and Dr. Wu testified orally, that the merger would not only *not* have anti-competitive effects, but that it would also have pro-competitive effects on the California insurance market. The experts argue that the merger would not have anti-competitive effects because Centene and Health Net have not competed against each other, in any market, for any customers, or for any contracts, in the past and do not now. They argue that Centene and Health Net's markets are "geographically distinct but complementary" since there is no overlap in the companies' coverage of Medi-Cal, individual commercial, small group commercial, large group commercial, ASO, or Medicare.

In addition to concluding that no anti-competitive effects would occur, Dr.s Wu and Wong testified that there are strong pro-competitive reasons for Centene to acquire Health Net. They presented these pro-competitive effects as: (1) better scale and scope for Health Net, which could facilitate lower premium pricing|(2) increased ability for Centene to participate in California's Medi-Cal market, as well as the national Medicaid market, generally|(3) Centene's ability to enter both the Medicare and commercial market in California|and (4) Centene's ability to gain Health Net's expertise in the California market. In addition, the experts testified that the merger would provide Health Net with: (1) better scale, better scope, and an improved infrastructure|(2) Centene's award-winning Medicaid business|and (3) a "*willing* partner" to help Health Net compete in the insurance market, generally.

Dr. Wu admitted in his oral testimony that there is a "small amount" of a chance that the merger could affect provider negotiations, but he dismissed the likelihood that it will occur. Dr. Wu also addressed, in his oral testimony, a CDI counsel's hypothetical that Centene could merge with Health Net and then exit the California market. Dr. Wu stated that an exit is "unlikely and unrealistic" and that it would "not be rational [for Centene] to exit a profitable situation."

Party testimonies and CVs are available [here](#).

Key Consumer Advocate Testimonies: Professor Richard Scheffler and Professor Jaime King

Various groups and individuals also submitted comments and written testimony on the proposed merger. Of note were Professor Richard Scheffler's [\[2\]](#) written testimony and Professor and Source Executive Editor Jaime King's written comment on the potential effects of the merger on insurer competition in

California.

California Consumer Premiums

Both Professors Scheffler and King argued that even if the merger allows the insurance companies to negotiate lower reimbursement rates, there is no evidence that these savings will be passed down to consumers. They cite Professor Leemore Dafny's pre-ACA studies, which found that more highly concentrated insurer markets actually resulted in higher premiums and that the 1999 Aetna and Prudential Healthcare insurance merger resulted in a 7% increase in large group premiums.

Decreased Competition

Next, Professor Scheffler argued that, with respect to hospitals, physician groups and other healthcare providers, the merger would increase the companies' Herfindahl-Hirschman Indices (a measure of market concentration|“HHIs”) in the 19 California counties where their coverage overlaps. This, Professor Scheffler argues, will decrease competition across California—and even more so in rural areas. The likely result of decreased competition and higher HHIs is higher premiums for consumers.

Professor King argued, further, that the ACA-created Medical Loss Ratio (“MLR”) would not necessarily protect consumers from increased premiums|she explained that MLR depends on competition in order to function properly, and that consolidating insurance markets will allow insurers to game the system by granting providers higher reimbursement rates, increasing premiums, and increasing their administrative costs. Professor King also pointed out that the MLR, by its nature, does not offer enrollees of self-insured plans any protection.

Potential Exit From the California Market, Post-Merger|Reduced Insurer Quality|and Stifled Innovation

Professor Scheffler also argued that the CDI should consider the possibility that once Centene acquires Health Net, Centene could exit the California market. Professor Scheffler concluded that, were this to occur, HHI ratings would exponentially increase in Southern California and would result in significant decreases in competition in the Southern California Covered California market.

In addition, Professor King urged the CDI to look at two final considerations: (1) the likelihood that the merger would reduce insurer quality and (2) the possibility that the merger would stifle innovation.

Consumer advocate testimonies and CVs are available [here](#).

The CDI's Key Concerns

The CDI asked the Centene and Health Net representatives a number of questions at the hearing. In particular, the CDI was most interested in: (1) how Health Net would be capitalized post-merger/how the merger would be paid for, (2) how Centene would ensure quality and customer satisfaction|(3) how willing Centene would be to work with the CDI to make commitments to California consumers that it would not leave the state as soon as it merges with Health Net|they were concerned with Centene's integrity given the fact that it had [breached its contract](#) with the Kentucky State Health Exchange, and (4) whether Health Net's CEO and CFO (who will be cut loose post-merger) will be given golden parachutes.

The Centene and Health Net representatives responded that: (1) Centene will bear the cost of the merger|these costs will not be passed onto consumers and that Centene will maintain Health

Net's capitalization pursuant to Health Net's capitalization history|(2) Centene will continue to try and improve quality and will strive to achieve a better NCQA score|(3) Centene stated that it is willing to talk with the CDI about how it can commit to staying in California, post-merger, and (4) Centene and Health Net admitted that Health Net's current CEO and CFO stand to make between \$7.5 and \$8.3 million, in the aggregate, in addition to their severance packages, by selling their stock. The difference in how much they could sell their stock for depends on when the merger goes through (pre- or post-March 7th) and whether the merger qualifies as a "terminating event" under their contracts.

See the Source's live tweets from the hearing [here](#).

Next Steps

One thing is for certain, there are [strong opinions](#) in both support and opposition of the merger. As CDI Commissioner Dave Jones continues to review the proposed merger, we will continue to monitor the deal and keep you updated on its status.

[\[1\]](#) According to the [written testimony](#) of Keith Williamson, Vice President, Secretary, and General Counsel, Centene, the FTC and DOJ granted Centene and Health Net early termination of the waiting period required under the Hart Scott-Rodino Antitrust Improvements Act of 1976, in August 2015.

[\[2\]](#) Distinguished Professor of Health Economics and Public Policy at the School of Public Health and the Goldman School of Public Policy at the University of California, Berkeley|Chair of the Healthcare Markets & Consumer Welfare|and the founding director of The Nicholas C. Petris Center on Health Care Markets and Consumer Welfare