



**Commonwealth of Massachusetts
Division of Insurance**

Report on the Statutory Financial Examination

of

Aetna Health Inc. (a Massachusetts Corporation)

As of December 31, 2004

NAIC GROUP CODE 0001

NAIC COMPANY CODE 95236

EMPLOYER ID NUMBER 52-1524249

**REPORT ON THE STATUTORY EXAMINATION OF
Aetna Health Inc. (a Massachusetts corporation)
AS OF DECEMBER 31, 2004**

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COMMONWEALTH OF MASSACHUSETTS
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June 5, 2006

Honorable Alfred Gross, Chairman
Financial Condition (E) Committee, NAIC
Commissioner of Bureau of Insurance
Commonwealth of Virginia
P. O. Box 1157
Richmond, VA 23218

The Honorable Julianne M. Bowler
Commissioner of Insurance
Division of Insurance
Commonwealth of Massachusetts
1 South Station
Boston, MA 02110

Honorable Commissioners:

Pursuant to your instructions and the statutory requirements of the Commonwealth of Massachusetts, a statutory examination has been made of the books, records, and financial condition of

Aetna Health Inc. (a Massachusetts corporation)

having its home office at 400-1 Totten Pond Road, Waltham, MA 02451 and its administrative offices located at 980 Jolly Road, Blue Bell, Pennsylvania 19422.

INTRODUCTION

Aetna Health Inc. ("Aetna" or "the Company") was last examined as of December 31, 1999. The current examination covers the intervening period from January 1, 2000 through December 31, 2004, and any material transactions and/or events occurring subsequent. This financial examination was conducted in accordance with Massachusetts General laws (MGL) Chapter 176G, Section 10 and substantially complied with those standards established by the Financial Condition (E) Committee of the National Association of Insurance Commissioners (NAIC) and the *NAIC Financial Condition Examiners Handbook*, and examination standards of the Massachusetts Division of Insurance ("the Division"). It was conducted at the direction of and under the overall management and control of the examination staff of the Division. Representatives from the firm of Deloitte & Touche LLP (Deloitte) were engaged by the Division to assist in the examination by performing certain examination procedures including an actuarial review of the Company's actuarially determined items.

The examination was conducted at the Company's main administrative office at 980 Jolly Road, Blue Bell, Pennsylvania 19422.

SCOPE OF EXAMINATION

During the course of this examination, the operations, management and corporate policies, transactions, and, accounting practices and procedures and internal controls of the Company were reviewed, analyzed, and tested to the extent deemed appropriate and necessary. General operations of the Company were reviewed for compliance with applicable Massachusetts' insurance statutes. Audit work conducted by the Company's external auditors, KPMG LLP ("KPMG") was reviewed, relied upon wherever deemed appropriate and effective, and incorporated into the work papers supporting this examination. The work of the Company's internal auditors was also reviewed and relied upon to the extent deemed appropriate. The premium, loss and benefit, reinsurance, investment and operating controls employed by the Company were reviewed and found to have in place sufficient internal controls. In performing the examination, certain procedures, reviewed and approved by the Division, were applied to selected records and transactions of the Company.

INFORMATION SYSTEMS REVIEW

A review and an evaluation of the control environment of Aetna's information systems were performed. The NAIC's Information Systems (IS) Questionnaire completed by the Company was reviewed and interviews with Company staff were conducted to gather supplemental information and corroborate the Company's responses to the questionnaire. A review was also made of the documentation supporting Management and Organization Controls, Application Systems Development and Maintenance Controls, Operating and Processing Controls, Logical and Physical Security Controls, Contingency Planning Controls, Personal Computer, Local Area Network (LAN), Wide Area Network (WAN) and Internet Controls. The control environment of the Company's information systems was reviewed and found to have in place sufficient internal controls.

COMMENTS ON THE PREVIOUS STATUTORY EXAMINATION REPORT

Comments/Recommendations	Action/Response by Company
<u>Corporate Records</u> The Company does not hold annual or regular stockholders meetings and it is therefore recommended the Company hold stockholders meetings in accordance with the Company's by-laws.	Beginning in 1999, the Company began the process of executing an annual Written Consent of the Sole Shareholder in lieu of an Annual Meeting.
<u>Premiums Receivables</u> As a result of our premium testing it was noted that the Company is not performing account reconciliations on timely basis. The Company's accounts receivable list includes group accounts, and sub-group accounts. Sub-group accounts may represent divisions, subsidiaries, or different office locations of the insured group. It was noted in some cases that all premiums received for a particular group may be applied to one particular sub-group within that group. Subsequently, Company personnel, upon reviewing the bill and the premiums received, will reconcile the premiums for the group and its sub-	Significant changes in the area of premiums receivable reconciliations have occurred as a result of the new Oracle Premiums Receivable system implemented in September 2002.

<p>group accounts and make the proper adjustments. As a result of the Company not reconciling accounts on a timely basis the receivable balances of some of its major group accounts reflected large credit and debit balances. The examiners concluded that it is not possible to determine the reasonableness of the premiums receivable account at December 31, 1999 given our materiality factor and the knowledge that the accounts are not being reconciled on a timely basis. The Company has indicated that staff turnover and communication issues between the Company and the group policyholder perpetuated this problem. It recommended that the Company take immediate action to reconcile and to age all group premium accounts, including sub-group accounts.</p>	
<p><u>Related Party Transactions</u></p> <p>Members are offered referred coverage underwritten by the Company and non-referred coverage underwritten by an affiliate company, Corporate Health Insurance Company (CHI), a Pennsylvania domiciled insurance company. Two certificates of coverage are issued to the member. The Company processes all premiums and claims. The non-referred portion of the premium is estimated by the Company and forwarded to CHI. CHI is responsible for the actual claims related to the non-referred coverage. It has been determined that the Company's basis of calculating the amount of premium related to the non-referred coverage results in an amount not in proportion to the actual members selecting the non-referred coverage. As a consequence, the Company is remitting excessive premiums to CHI. During 1999, premiums in the amount of \$9,124,233 were paid to CHI and losses paid by CHI on this business totaled \$2,311,600. It is recommended that the Company determine the exact members selecting non-referred coverage and remit the appropriate premium to CHI.</p>	<p>As of January 1, 2001, the Company revised the basis for allocating premium to CHI to more realistically reflect the premium associated with out of network coverage.</p>

HISTORY

General

The Company was incorporated under the laws of the Commonwealth of Massachusetts on May 20, 1987 as U.S. Healthcare, Inc. authorized to operate as a health maintenance organization. On June 12, 1997 the

Company changed its name to Aetna U.S. Healthcare Inc. (a Massachusetts corporation). On July 17, 2002 the Company again changed its name to Aetna Health Inc (a Massachusetts corporation)..

GROWTH OF COMPANY

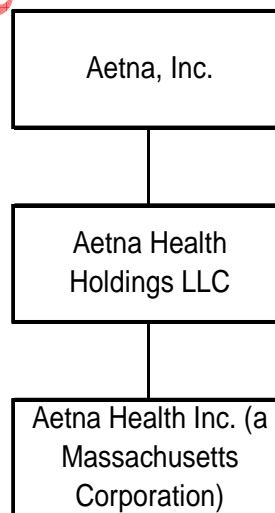
The growth of the Company since the last examination as of December 31, 2004 is illustrated in the following schedule:

Year	Premium Income	Admitted Assets	Total Liabilities	Capital and Surplus
2000	\$137,453,374	\$37,970,723	\$27,013,086	\$10,957,637
2001	176,709,492	48,196,377	39,008,361	9,188,016
2002	117,406,919	45,420,049	23,206,795	22,213,254
2003	63,560,643	24,119,593	8,553,917	15,565,676
2004	52,414,352	16,954,973	6,746,696	10,208,277

AFFILIATED COMPANIES

The Company is a wholly owned subsidiary of Aetna, Inc. On December 31, 2003 Aetna Inc. contributed all of the outstanding capital stock of the Company to Aetna Health Holdings LLC. The “ultimate controlling person” of the group is Aetna Inc., a Connecticut corporation. Aetna Inc. and its subsidiaries constitute one of the largest health benefits companies in the United States.

An organizational chart of the Company and certain significant affiliates follows:



Agreements with Affiliates

The Company participated in the following affiliate agreements during the period under examination:

- Administrative Service Agreement

Effective November 24, 1987, Aetna Inc. agreed to provide all administrative and management services for the daily operation of the Company, including personnel services, quality assurance services, data processing services, member relations services, provider and contracting services, collection services, and maintaining general and professional liability insurance. The Company shall pay Aetna Inc. compensation for services provided a monthly fee equal to five percent of all premiums earned by the Company as determined in accordance with generally accepted accounting principles. Effective January 1, 2003, Aetna Inc. assigned its responsibility for administering its administration service agreement with the Company to Aetna Health Management, LLC (AHM). The administrative fee was revised to equal 12.5% of the Company's earned premium. Effective January 1, 2004, The Company and AHM terminated this agreement and entered into a new agreement under which the Company remits 13% of its earned commercial and Medicaid premium revenue plus 7.2% of its earned Medicare premium revenue to AHM. Service fees paid by the Company for the following years are as follows:

<u>Year</u>	<u>Service Fees Paid</u>
2004	\$ 6,829,450
2003	7,953,082
2002	14,723,549
2001	22,180,177
2000	17,260,909

- Guarantor Agreement

Effective November 24, 1987 whereby Aetna Inc. agrees in the event of the Company's insolvency to pay all expenses and claims incurred by the Company subsequent to insolvency pursuant to its obligation under its agreements with Groups and Subscribers, until the end of the contract period for which payment has been made in accordance with such agreement.

- Line of Credit Agreement

Effective November 24, 1987 whereby Aetna Inc. grants an irrevocable line of credit to the Company in the amount of \$4,000,000 to be used at such times and in such amounts as shall be required by the Company in order to finance future operating costs and to meet future cash needs. Interest shall be at a rate 10%. The Company did not use the line of credit during the years 2000 through 2004.

- Tax Sharing Agreement

The Company has a tax sharing agreement with Aetna Inc. and other affiliates. The agreement generally provides an allocation of tax liability (or receivable) among each such affiliate equal to the amount which would have been paid (or credited) to each affiliate had the affiliate filed a separate return.

- Manufacturers' Pharmacy Rebate Program

The Company entered into an agreement which enables it to receive manufacturers' pharmacy rebates from AHM. Effective January 1, 2004, the Company remits 10% of its earned pharmacy rebates to AHM as a fee. The Company earned pharmacy rebates as follows:

<u>Year</u>	<u>Earned Pharmacy Rebates</u>
2004	\$ 791,787
2003	1,096,961
2002	2,162,237
2001	3,459,014
2000	2,542,004

CAPITAL

Capital Stock

The authorized capital stock of the Company consists of 1,000,000 shares of common stock with a par value of \$.01 each. At December 31, 2004, 200 shares were issued and outstanding and such outstanding shares were owned by Aetna Health Holdings, LLC.

Gross Paid-in and Contributed Surplus

The Company's Gross Paid-in and Contributed Surplus during the period of this examination was as follows:

<u>Year</u>	<u>Amount</u>
2000	\$57,339,071
2001	72,439,071
2002	72,439,071
2003	72,439,071
2004	68,239,072

Dividends to Stockholder

Per the Annual Statements and the Board of Directors' minutes for the last five years, dividends were paid to its parent as follows:

<u>Year</u>	<u>Dividends Paid</u>
2000	\$ 0
2001	0
2002	0
2003	13,500,000
2004	\$ 9,600,000

MANAGEMENT AND CONTROL

Directors

Directors serving the Company at December 31, 2004, were as follows:

Name**Principal Affiliation**

Charles Alan Peck, M.D.
Gordon William Grundy, M.D.
Jane Snyder-Demaio

President, Aetna, Inc.
Senior Medical Director, Aetna, Inc.
General Manager-Select and Key Accounts
Northeast Region, Aetna Inc.

Officers

Officers elected and serving the Company as of December 31, 2004 were as follows:

<u>Officer</u>	<u>Title</u>
Charles Alan Peck, M.D.	President
Emanuel Francis Germano	Principal Financial Officer
Gordon William Grundy, M.D.	Senior Medical Director
William Calvin Baskin, III	Vice President and Secretary
Russell Page Smith	Treasurer
Gregory Stephen Martino	Vice President
Kevin James Casey	Senior Investment Officer
James David Weiss	Controller
Alicia Helene Bolton	Assistant Controller

Conflict of Interest Procedures

The Company maintains a written "Conflict and Business Practice Policy." An annual questionnaire is completed by all officers, directors and key employees of the Company to disclose any material conflicts of interest or noncompliance with the Company's "Conflict and Business Practice Policy."

Corporate Records

The minutes of the Board of Directors for the period under examination were reviewed. The Board of Directors minutes indicated the approval and support of investment transactions and events.

FIDELITY BOND AND OTHER INSURANCE

The Company is a named insured, along with other subsidiaries of Aetna Inc, on a financial institution fidelity bond. The aggregate limit of liability was \$5,000,000 at December 31, 2004, an amount of coverage which is in excess of the suggested NAIC minimum coverage.

The Company is also a named insured, along with other companies in the Aetna Inc./Aetna Health Holdings LLC holding company system, on policies that provide coverage for commercial general liability, automobile liability, workers' compensation and employers' liability, all risks of physical loss or damage, umbrella for excess loss, and managed care professional liability. All policies evidencing the above coverages were with licensed carriers and were in force at December 31, 2004.

PENSION AND INSURANCE PLANS

The Company has no employees; therefore, there are no pension or insurance plans. As mentioned under the caption "Affiliated Companies" of this report, the Company's parent performs all managerial and operational functions.

TERRITORY AND PLAN OF OPERATIONS

As of December 31, 2004 the Company is licensed to transact business in the Commonwealth of Massachusetts. The Company had been licensed in the State of Rhode Island but surrendered its Certificate of Authority effective March 31, 2003.

The Company offers a variety of managed care products and services under commercial plans. Applications for the Company's insurance policies are solicited by insurance brokers and Company sales staff. Brokers and the Company's sales staff are licensed by state insurance authorities to sell the Company's policies. The Company's parent provides all policy administration.

STATUTORY DEPOSITS

The statutory deposits of the Company at December 31, 2004 are as follows:

Special Deposits

	<u>Par Value</u>	<u>Statement Value</u>	<u>Market Value</u>
Rhode Island	\$ 125,000	\$ 124,690	\$ 128,471
Massachusetts	<u>1,000,000</u>	<u>1,038,122</u>	<u>1,033,885</u>
Total	<u>\$1,125,000</u>	<u>\$1,162,812</u>	<u>\$1,162,356</u>

REINSURANCE

The following reinsurance contract was in effect as of December 31, 2004:

Reinsurer	Corporate Health Insurance Company (an affiliated company)
Ceded	100% of the loss for any member during a contract year in excess of the \$500,000 deductible amount.
Retention	\$500,000 for loss for each member during a contract year
Termination	At the end of any contract year with at least 31 days notice.

ACCOUNTS AND RECORDS

The accounting system used by the Company is common to all companies within the Aetna Inc. group. The system has "reporting elements" within the general ledger accounts that are specific for each company and for GAAP or statutory accounting. The reporting elements are used to guide transaction recording into the proper entity and to assure proper GAAP or statutory recording. Certain information was traced from support documentation through the accounting system with no material errors noted.

The books and records of the Company are subject to review by the Company's internal audit department and are audited annually by KPMG LLP, independent certified public accountants.

FINANCIAL STATEMENTS

The Financial Statements section includes the following:

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Statutory Statement of Assets, Liabilities, Capital and Surplus
as of December 31, 2004

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Statement of Revenue, and Expenses
for the year ended December 31, 2004

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Reconciliation of Capital and Surplus for the years ended
December 31, 2000, 2001, 2002, 2003, and 2004

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The following financial statements are presented on the basis of accounting practices prescribed or permitted by the Division of Insurance of the Commonwealth of Massachusetts and by the National Association of Insurance Commissioners as of December 31, 2004:

For Information Purposes Only

Aetna Health Inc. (a Massachusetts corporation)
Statutory Statement of Assets, Liabilities, Capital and Surplus
As of December 31, 2004

	Per <u>Annual Statement</u>	Statutory Examination <u>Adjustments</u>	Per Statutory <u>Examination</u>
Bonds	\$ 13,356,796	\$ 0	\$ 13,356,796
Investment income receivables	118,806	0	118,806
Cash, cash equivalents, s/t investments	1,633,134	0	1,633,134
Uncollected premiums in course of collection	681,651	0	681,651
Current federal and foreign income tax & interest	419,541	0	419,541
Net deferred tax asset	223,104	0	223,104
Health care receivable	178,925	0	178,925
Current franchise tax receivable	<u>343,016</u>	<u>0</u>	<u>343,016</u>
Total Assets	<u>\$ 16,954,973</u>	<u>0</u>	<u>\$ 16,954,973</u>

For Information Purposes Only

Aetna Health Inc. (a Massachusetts corporation)
Statutory Statement of Assets, Liabilities, Capital and Surplus (Continued)
As of December 31, 2004

	Per <u>Annual Statement</u>	Statutory Examination <u>Adjustments</u>	Per Statutory <u>Examination</u>
Liabilities			
Claims payable	\$ 3,988,995	\$ 0	\$ 3,988,995
Unpaid claims adj accounts	107,961	0	107,961
Aggregate health policy reserve	304,720	0	304,720
Aggregate health claim reserve	186,101	0	186,101
Unearned premiums	168,815	0	168,815
Accounts payable	545,506	0	545,506
Ceded reinsurance premiums payable	8,894	0	8,894
Amounts due affiliates	1,325,787	0	1,325,787
Federal contingency reserve	<u>109,917</u>	<u>0</u>	<u>109,917</u>
Total Liabilities	<u>6,746,696</u>	<u>0</u>	<u>6,746,696</u>
Capital and Surplus			
Common stock	2	0	2
Paid in surplus	68,239,071	0	68,239,071
Unassigned Funds	<u>(58,030,796)</u>	<u>0</u>	<u>(58,030,796)</u>
Total Capital and Surplus	10,208,277	0	10,208,277
Total Liabilities, Capital and Surplus	<u>\$ 16,954,973</u>	<u>\$ 0</u>	<u>\$ 16,954,973</u>

Aetna Health Inc. (a Massachusetts corporation)
Statement of Revenue and Expenses
For the Year Ended December 31, 2004

	Per Annual Statement	Statutory Examination Adjustments	Per Statutory Examination
Member months	<u>169,598</u>	<u>0</u>	<u>169,598</u>
Net premium income	\$ <u>52,414,352</u>	\$ <u>0</u>	\$ <u>52,414,352</u>
Medical and Hospital:			
Hospital/medical benefits	31,464,352	0	31,464,352
Other professional services	29,570	0	29,570
Outside referrals	1,439,158	0	1,439,158
Emergency room and out-of-area	1,362,763	0	1,362,763
Prescription drugs	<u>4,413,884</u>	<u>0</u>	<u>4,413,884</u>
Total hospital and medical	38,709,727	0	38,709,727
Claim adjustment expenses	1,045,163	0	1,045,163
General administrative expenses	6,685,523	0	6,685,523
Increase in reserves for health contracts	<u>204,720</u>	<u>0</u>	<u>204,720</u>
Total underwriting deductions	<u>46,645,133</u>	<u>0</u>	<u>46,645,133</u>
Net underwriting gain	5,769,219	0	5,769,219
Net investment income	748,717	0	748,717
Net realized capital loss	<u>(218,662)</u>	<u>0</u>	<u>(218,662)</u>
Net investment gain	530,055	0	530,055
Net income before federal income taxes	6,299,274	0	6,299,274
Federal income taxes incurred	<u>2,343,549</u>	<u>0</u>	<u>2,343,549</u>
Net income	<u>\$ 3,955,725</u>	<u>\$ 0</u>	<u>\$ 3,955,725</u>

Aetna Health Inc. (a Massachusetts corporation)
Reconciliation of Capital and Surplus
For the Years Ended December 31, 2000, 2001, 2002, 2003, and 2004

	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
Capital and Surplus previous year	\$ 3,498,690	\$ 10,957,637	\$ 9,188,016	\$ 22,213,254	\$ 15,565,676
Net income	(4,349,366)	(21,943,295)	12,662,050	7,116,167	3,955,725
Change in deferred income tax		3,307,290	(2,135,185)	(998,632)	55,389
Increase in paid in surplus	8,800,000	15,100,000	0	0	0
Change in nonadmitted assets	3,008,313	121,487	2,498,373	966,605	231,487
Cummulative effect change in acct principles		1,644,897	0	0	0
Dividend to stockholders	0	0	0	(13,500,000)	(9,600,000)
Aggregate write-ins for gains in surplus	<u>0</u>	<u>0</u>	<u>0</u>	<u>(231,718)</u>	<u>0</u>
Increase or (decrease) in retained earnings:	<u>7,458,947</u>	<u>(1,769,621)</u>	<u>13,025,238</u>	<u>(6,647,578)</u>	<u>(5,357,399)</u>
December 31, Current Year	<u>\$ 10,957,637</u>	<u>\$ 9,188,016</u>	<u>\$ 22,213,254</u>	<u>\$ 15,565,676</u>	<u>\$ 10,208,277</u>

COMMENTS AND RECOMMENDATIONS

There were no comments or recommendations on the financial statements as a result of the procedures performed for the association financial examination.

ACKNOWLEDGEMENT

Report of Certified Financial Examiner

This is to certify that the undersigned is a duly qualified Certified Financial Examiner ("CFE"), and that pursuant to a proposal submitted by Deloitte & Touche LLP to the Division of Insurance of the Commonwealth of Massachusetts ("Division"), certain procedures have been applied to the accounting and corporate records of the Aetna Health Inc. (a Massachusetts corporation) for the purpose of assisting the Division in fulfilling its requirements regarding periodic Association Statutory Examinations of Massachusetts domiciled insurers.

The undersigned's participation in this Association Financial Examination as the Examiner-In-Charge encompassed responsibility for the coordination and direction of the statutory examination performed which was in accordance with, and substantially complied with, the standards established by the Financial Condition (EX4) Subcommittee of the National Association of Insurance Commissioners ("NAIC") and the NAIC Examiners Handbook. This participation consisted of involvement in the planning and administration of the examination, review of work papers prepared as documentary evidence of examination procedures performed, and preparation of the statutory examination report.

The cooperation and assistance of the officers and employees of Aetna Health Inc. extended to all examiners during the course of the examination is hereby acknowledged.

John W. Smallwood, CFE
Chief Examiner and Examiner-in-Charge
Commonwealth of Massachusetts
Division of Insurance
Boston, Massachusetts