



COMMONWEALTH OF MASSACHUSETTS
OFFICE OF CONSUMER AFFAIRS AND BUSINESS
REGULATION

Division of Insurance

Report on the Statutory Examination of
Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc.
Boston, Massachusetts
As of December 31, 2006

NAIC COMPANY CODE: 12219

EMPLOYERS ID NUMBER: 04-3362283

Table of Contents

SALUTATION	1
SCOPE OF EXAMINATION	2
DESCRIPTION OF COMPANY	2
History	2
Capital and Surplus	3
MANAGEMENT	3
Articles of Organization and By-Laws	3
Members and Membership	3
BOARD OF DIRECTORS	4
Committees of the Board	4
OFFICERS	5
CONFLICT OF INTEREST PROCEDURES	5
CORPORATE RECORDS	6
Articles of Incorporation and Bylaws	6
Board of Directors Minutes	6
ACQUISITIONS, MERGERS, DISPOSALS, DISSOLUTIONS AND PURCHASES OR SALES	6
MANAGEMENT CONTINUITY AND NATIONAL EMERGENCY	7
AFFILIATED COMPANIES	7
RELATED PARTY TRANSACTIONS	7
FIDELITY BOND AND OTHER INSURANCE	8
PENSION AND INSURANCE PLANS	8
SPECIAL DEPOSITS	8
TERRITORY AND PLAN OF OPERATION	9
Territory	9
Plan of Operations	9
PRODUCTS	9
PROVIDER CONTRACTS	9
RESERVES	10
INCOME TAXES	10
ACCOUNTS AND RECORDS	10
COMMITMENTS AND CONTINGENCIES	11
Lease Obligations	11
Legal Proceedings	12
FINANCIAL STATEMENTS	13
Statutory Statement of Assets, Liabilities and Capital & Surplus	14
Statement of Revenue and Expenses	15
Capital and Surplus	16
Statement of Changes in Capital and Surplus	17
ACKNOWLEDGEMENT – Report of Certified Financial Examiner	18



COMMONWEALTH OF MASSACHUSETTS
Office of Consumer Affairs and Business Regulation
DIVISION OF INSURANCE

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April 25, 2008

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The Honorable Nonnie S. Burnes
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Honorable Commissioners:

Pursuant to your instructions and in accordance with Massachusetts General Laws, Chapter 176G, Section 10, an examination has been made of the financial condition and affairs of

Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc.

At its Main Administrative Office located at:

Landmark Center
401 Park Drive
Boston, MA 02215-3326

The following report thereon is respectfully submitted.

SCOPE OF EXAMINATION

This statutory examination of Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc., hereinafter referred to as “the Company,” “the Corporation,” “HMO Blue,” or “the Plan,” is as of December 31, 2006, including any material transactions and/or events occurring subsequent to the examination date and noted during the course of this statutory examination. KPMG LLP (KPMG) has applied certain agreed upon procedures to selected records and transactions of the Company.

The current examination was conducted at the direction of, and under the overall management and control of the examination staff of the Massachusetts Division of Insurance (the Division). The statutory examination was performed at the Company's main administrative office in Boston, Massachusetts. KPMG was engaged to perform certain agreed-upon procedures, which are in compliance with the *NAIC Financial Condition Examiners' Handbook*. KPMG's actuaries were involved in the performance of those procedures to the extent that such procedures related to the Company's reserves for unpaid claims and loss adjustment expenses and provider risk sharing settlements as of December 31, 2006. KPMG's Information Technology Advisory Services (ITAS) personnel were engaged to perform an Evaluation of Controls in Information Systems Questionnaire in a form substantially similar to the one established in the *NAIC Financial Condition Examiners' Handbook*. The ITAS Specialists performed examination procedures pertaining to the examination of the IT systems as outlined in the *NAIC Financial Condition Examiners' Handbook*. All procedures were performed under the management and control and general supervision of the examination staff of the Division.

The examination was conducted in accordance with standards and procedures established by the National Association of Insurance Commissioners (NAIC) Financial Condition (E) Committee and prescribed by the current *NAIC Financial Condition Examiners' Handbook*. The principal focus of the examination was 2006 activity; however, transactions both prior and subsequent thereto were reviewed as deemed appropriate.

In addition to a review of the financial condition of the Company, the examination included a review of the Company's business policies and practices, corporate records, provider contracts, reinsurance treaties, conflict of interest disclosure statements, fidelity bonds and other insurance, employees' pension and benefits plans, disaster recovery plan, and other pertinent matters to provide reasonable assurance that the Company was in compliance with applicable laws, rules and regulations. In planning and conducting the examination, consideration was given to the concepts of materiality and risk and examination efforts were directed accordingly.

In determining the scope of the statutory examination, after review and evaluation, the examination team placed reliance on certain workpapers provided by the Company's independent auditor, Ernst & Young LLP (E&Y). Wherever possible and wherever deemed appropriate and effective, E&Y's independent work product was used to define, support, document and expedite the overall examination process.

DESCRIPTION OF COMPANY

History

Blue Cross and Blue Shield of Massachusetts (BCBSMA) began as the Associated Hospital Service Corporation of Massachusetts in 1937. The Corporation aimed to spread the cost of hospital treatment among a large group of employed persons and, upon its opening, was the twenty-sixth plan of its kind in the United States, differing from others in its offering of statewide coverage. In 1939, the name Blue Cross was officially adopted by the American Hospital Association as the national symbol for the Hospital Service movement and in 1941, Blue Shield was established as a result of physician interest in the prepayment concept of financing health care.

Over the years “Blue Cross” and “Blue Shield of Massachusetts” continued to grow and adapt to the needs of consumers, offering ever-increasing comprehensive coverage. The two separate organizations merged to become Blue

Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc.

Cross and Blue Shield of Massachusetts, Inc. and continued as part of a national network of affiliated plans, the Blue Cross and Blue Shield Association.

In 1992, BCBSMA launched an insured Health Maintenance Organization (HMO) line of business branded as HMO Blue. The product reflected a change that was in line with the interests of the emerging market and represented a transition from traditional health insurance to managed care.

The Blue Cross Blue Shield of Massachusetts Foundation (BCBSF) was founded in 2001. The Foundation is committed to expanding high quality care access to the underserved in Massachusetts – in line with the original charter.

In 2003, BCBSF created the Massachusetts Medicaid Policy Institute (MMPI). MMPI is an independent and nonpartisan source for information and analysis of the Massachusetts Medicaid Program (often referred to as “MassHealth”) and seeks to promote a broader understanding of the MassHealth program.

In January 2005, pursuant to a Master Reorganization Agreement (MRA), BCBSMA transferred its insured health maintenance organization line of business (with the exception of Blue Care 65, which was transferred on April 1, 2005) to Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc. (HMO Blue), a separately incorporated, and a wholly-owned subsidiary of BCBSMA. Since January 1, 2005, HMO Blue has provided hospitalization, medical and other health benefits as a licensed health maintenance organization. HMO Blue operates as a nonprofit, charitable organization and qualifies as a tax-exempt social welfare organization under Section 501 (c)(4) of the Internal Revenue Code.

Capital and Surplus

Capital and Surplus consists of capital contributed to the Company and the excess of revenues over expenses since inception. The total admitted assets, total liabilities and capital and surplus of the Company for the years ended 2005 and 2006 are shown in the following schedule.

<u>Year</u>	<u>Total Admitted Assets</u>	<u>Total Liabilities</u>	<u>Capital and Surplus</u>
2005	\$1,253,837,195	\$490,056,505	\$763,780,690
2006	\$1,397,809,545	\$558,147,869	\$839,661,676

MANAGEMENT

Articles of Organization and By-Laws

The name and purposes of the Corporation are set forth in the Articles of Organization. The Corporate By-Laws, the powers of the Corporation and of its members, directors and officers, and all matters concerning the conduct and regulation of the affairs of the Corporation are subject to the Articles of Organization.

Members and Membership

The Company's By-Laws indicate the following regarding its corporate membership:

- **Membership** – The sole member of the Corporation is Blue Cross and Blue Shield of Massachusetts, Inc., acting through its Board of Directors.
- **Meetings** – The Annual Meeting of the Member shall be held on such day and at such time and place as the Member may from time to time determine. There shall be such further meetings as may be called by the Board of Directors or the Member.

- **Action on Behalf of the Corporation** – The standing committees of the Board of Directors of the Member shall have the power to take actions for, and on behalf of, the Corporation.
- **Action without a Meeting** – Any action required or permitted to be taken may be taken without a meeting if the Member, by unanimous written consent of its Board of Directors, consents in writing and if such written consent is filed with the records of the Corporation. Such consent shall be treated for all purposes as a vote at a meeting.
- **Waiver of Notice** – Whenever any written notice is required to be given by the By-Laws, a waiver of notice is signed either before or after the action for which notice is required shall have the effect of written notice.

BOARD OF DIRECTORS

The Company's By-Laws indicate the following regarding its Board of Directors (the "Board"):

The general management of the business, property, and affairs of the Corporation shall be vested in a Board of no fewer than five (5) not more than twenty-one (21) Directors. At each Annual Meeting of the Member, the Member, acting through its Board of Directors, shall determine the number of Directors of the Corporation for the ensuing year, and the elected persons to fill any vacancies. The term of office of each Director shall be three (3) years, except that a Director may be elected for a possible term less than three (3) years so that, as nearly as possible, one-third of the Directors shall be elected each year. The Board of Directors shall meet annually immediately following the Annual Meeting of the Member. Regular meetings shall be at such place and time as the Board of Directors may from time to time determine. Special meetings may be called by the President or a majority of the Board of Directors and shall be called by the Clerk, or in the case of the death, absence, incapacity or refusal of the Clerk, by any other officer upon the written application of Directors representing at least ten (10) percent of the quorum of Directors required for a vote at all meetings of the Board of Directors. A special meeting may be held in lieu of the Annual Meeting of the Directors. Any action required or permitted to be taken may be taken without a meeting if all those entitled to vote consent in writing and if written consents are filed with the records of the Corporation. Such consents shall be treated for all purposes as a vote at a meeting.

At December 31, 2006, the Board was comprised of five (5) directors, which was in compliance with the Company By-Laws. Directors duly elected and serving at December 31, 2006, and business affiliations, are as follows:

<u>Director</u>	<u>Principal Occupation</u>	<u>Tenure</u>
Cleve L. Killingsworth, Jr.	President and Chief Executive Officer	2 years
William C. Van Faasen ¹	Chairman	2 years
Sandra L. Jesse	Assistant Clerk	2 years
Allen Maltz	Treasurer	2 years
Fredi Shonkoff	Clerk	2 years

Committees of the Board

The Board of Directors may delegate such of its powers as it considers advisable, except those powers which by law, the Articles of Organization, or these By-Laws may not be so delegated, to such committees as the Board of Directors or the By-Laws may from time to time establish. All committees shall serve at the pleasure of the Board of Directors.

There are no current standing committees of the Board of Directors.

¹ Mr. Van Faasen retired from the Board effective December 31, 2007. Mr. Killingsworth succeeded Mr. Van Faasen as Chairman of the Board.

OFFICERS

The Officers of the Corporation include a Chair, a President, a Clerk, a Treasurer, and such other officers as the Board of Directors may from time to time appoint. The Chair shall be a Director and each member shall be elected by the Board. The Directors, at the Annual Meeting, or special meeting in lieu thereof, shall elect all officers to hold office until the next Annual Meeting of the Board of Directors.

The officers have the powers and perform the duties customarily belonging to their respective offices, including the powers and duties listed below:

- a. The Chair shall preside at all meetings of the Board of Directors at which he or she is present and shall represent the Corporation as the Board of Directors may deem appropriate.
- b. Unless otherwise provided by the Board, the President shall be the chief executive officer of the Corporation responsible to the Board of Directors for the administration of its affairs. Except as otherwise provided by the Board of Directors or the By-Laws, the President or his or her duly authorized designee shall sign for the Corporation all deeds, agreements, and other formal instruments.
- c. The Treasurer shall be the chief financial officer of the Corporation and shall be in charge of all funds and securities of any type. With the advice and consent of the Board of Directors, the Treasurer shall have the power to invest and reinvest surplus funds. The Treasurer shall render to the Board of Directors at the Annual Meeting and whenever else it so requests an accurate account of all sums received and disbursed during the preceding fiscal year and of all sums and funds which are not expended.
- d. The Clerk shall keep records of all meetings of the Board of Directors and make a report thereon and shall issue calls and notices of meetings as provided herein.

The elected officers and their respective titles at December 31, 2006 were as follows:

<u>Officer</u>	<u>Elected Title</u>
Cleve L. Killingsworth, Jr.	President and Chief Executive Officer
William C. Van Faasen ²	Chairman
Allen P. Maltz	Treasurer
Fredi Shonkoff	Clerk
Keith Renaldi	Assistant Treasurer
Sandra L. Jesse	Assistant Clerk

CONFLICT OF INTEREST PROCEDURES

The Company has adopted a conflict of interest policy statement. The Company has an established procedure for the disclosure to the Board of any material interest or affiliation on the part of any officer or director which is in or is likely to conflict with his/her official duties.

Each Director of the Board shall annually deliver to the Board, at or about the time of the Annual Meeting, a true and complete conflicts of interest statement (a "Conflicts Statement") in the form approved by the Board; provided that each person described above shall deliver only one Conflicts Statement regardless of the number of positions listed above that he or she holds. Each Director shall promptly update his or her most recent Conflicts Statement upon the occurrence of any event that makes the information contained in such Conflicts Statement no longer true or that would be required to be reported in such Conflicts Statement at the time it is delivered to the Board.

² Mr. Van Faasen retired from the Board effective December 31, 2007. Mr. Killingsworth succeeded Mr. Van Faasen as Chairman of the Board.

The completed Conflict of Interest Disclosure Statements for Directors, Officers and Senior Managers for 2004, 2005 and 2006 were reviewed. No discrepancies were noted in the response to the General Interrogatories regarding conflicts of interest as reflected in the Company's December 31, 2006 Annual Statement.

CORPORATE RECORDS

Articles of Incorporation and Bylaws

Our review of the By-Laws and Articles of Incorporation indicated that the By-Laws were amended effective July 13, 2005.

Board of Directors Minutes

The minutes of the Board and committee meetings for the period under statutory examination were read and indicated that all meetings were held in accordance with the Company By-Laws and the laws of the Commonwealth of Massachusetts.

ACQUISITIONS, MERGERS, DISPOSALS, DISSOLUTIONS AND PURCHASES OR SALES

On January 1, 2005, pursuant to a Master Reorganization Agreement (MRA), BCBSMA transferred its insured health maintenance organization line of business (with the exception of Blue Care 65, which was transferred on April 1, 2005) to HMO Blue, a separately incorporated, wholly-controlled subsidiary of BCBSMA. Since January 1, 2005, HMO Blue has provided hospitalization, medical and other health benefits as a licensed Health Maintenance Organization. Effective January 1, 2005, HMO Blue received a health maintenance organization (HMO) license from the Division. HMO Blue operates as a nonprofit, charitable organization and qualifies as a tax-exempt social welfare organization under Section 501(c)(4) of the Internal Revenue Code.

The Company entered into a bilateral intercompany agreement with BCBSMA as a result of the MRA to settle any claims, fees, administrative cost expense allocation and pass-through cash and expenses paid by one company on behalf of the other company.

As a condition of granting an HMO license to HMO Blue, the Division required BCBSMA and HMO Blue to enter into an agreement with the Division granting the Division discretionary authority to require either company to issue a surplus note to the other company if either of the company's health risk-based capital (RBC) is more than seventy five percentage points higher than the other company's RBC. Under the terms of its license with Blue Cross and Blue Shield Association, BCBSMA has also entered into a unilateral agreement with HMO Blue to guarantee all current and future obligations of HMO Blue.

Under the MRA, both BCBSMA and HMO Blue have an undivided interest in what had been BCBSMA's property and equipment. The initial basis of the property and equipment were systematically allocated to each company at the date of the transaction. Ongoing depreciation expenses are charged to each company based on utilization.

Under the MRA, existing employees (Associates) of the Companies are either concurrently employed by both BCBSMA and HMO Blue or solely employed by BCBSMA. Those individuals solely employed by BCBSMA include Senior Level Management. The compensation, benefits and administrative expenses of the concurrently employed Associates are charged to BCBSMA and HMO Blue in accordance with their provision of services to each company. With respect to individuals solely employed by BCBSMA, the pro rata portion of compensation, benefits and administrative expenses attributable to services provided to HMO Blue is charged to HMO Blue on an arm's length basis, including a mark-up. A common paymaster arrangement has been established for payroll and payroll related benefits. An agency arrangement has been established for payment of claims and operating expenses and receipt of

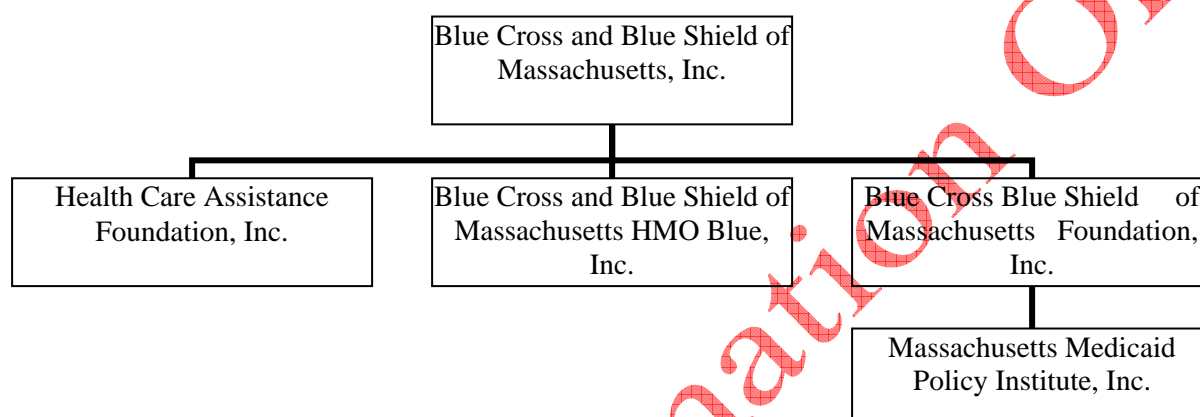
funds. The Companies' pension and postretirement benefit plans continue to be sponsored by BCBSMA. BCBSMA charges HMO Blue, as a participating employer of the benefit plans, a fee based on HMO Blue's allocated share of the benefit plans' expenses.

MANAGEMENT CONTINUITY AND NATIONAL EMERGENCY

The Company provides for the continuity of management and operations in the event of a catastrophe or national emergency in accordance with Massachusetts General Laws, Chapter 175 §§ 180M-180Q.

AFFILIATED COMPANIES

A summary of ownership and relationship of the Company and its operating subsidiaries and affiliated companies as of December 31, 2006 is illustrated below:



RELATED PARTY TRANSACTIONS

On January 1, 2005, pursuant to a Master Reorganization Agreement (MRA), BCBSMA transferred its insured health maintenance organization line of business (with the exception of Blue Care 65, which was transferred on April 1, 2005) to HMO Blue. Since January 1, 2005, HMO Blue has provided hospitalization, medical and other health benefits as a licensed HMO. The Company entered into a bilateral intercompany agreement with BCBSMA as a result of the MRA to settle any claims, fees, administrative cost expense allocation and pass-through cash and expenses paid by one company on behalf of the other company.

BCBSMA's surplus as of December 31, 2004 was allocated between BCBSMA and HMO Blue, in accordance with the MRA, so that the post-reorganization risk-based capital (RBC) levels of the two entities were within 15 percentage points of each other. On April 1, 2005, in connection with the transfer of Blue Care 65 to HMO Blue, BCBSMA transferred surplus of \$60 million to HMO Blue so that the entities' RBC levels would remain within 15 percentage points of each other.

BCBSMA is the sole corporate member of two Foundations: the Health Care Assistance Foundation, Inc. (HCAF) and Blue Cross Blue Shield of Massachusetts Foundation (BCBSF). HMO Blue provided financial support of \$3.5 million during 2006.

The Company had a payable to BCBSMA of \$70.8 million and \$75.7 million for the years ended 2006 and 2005, respectively.

Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc.

BCBSMA and HMO Blue jointly entered into two \$100 million revolving credit agreements. Borrowings under these lines of credit bear interest on a floating interest rate basis. Each credit facility is unsecured and matured in June 2007 and August 2007. There were no amounts outstanding under either credit facility at December 31, 2006. The Company continues to renew these lines annually.

BCBSMA and HMO Blue jointly entered into a Tri-Party Agreement with Citizens Bank of Massachusetts (Citizens) and Perry South Shore Developer, LLC (the Developer) with respect to obligations of BCBSMA and HMO Blue pursuant to a Purchase and Sale Agreement with the Developer for the construction and development of a building and related improvements. The Tri-Party Agreement pledged assets of BCBSMA and HMO Blue in the amount of \$150 million to Citizens for the Developer's rights and interests under the Purchase and Sale Agreement. In September 2006, upon purchase of the building by BCBSMA and HMO Blue, the Tri-Party Agreement was terminated and the collateral was released.

FIDELITY BOND AND OTHER INSURANCE

The Corporation maintains fidelity bond coverage with an authorized Massachusetts insurer. The aggregate limit of liability exceeds the NAIC suggested minimum.

In addition to the bond insurance, the Company has further protected its interests and properties by policies of insurance covering other insurable risks. Coverage is provided by insurers licensed in the Commonwealth of Massachusetts and was in force as of December 31, 2006.

PENSION AND INSURANCE PLANS

The pension and other post-retirement benefit plans (the "Plans") are sponsored by BCBSMA and the associated costs are shared by both companies. All employees are eligible to participate in BCBSMA's Retirement Income Trust Plan (RIT), which grants benefits to retired employees at various levels based on age and years of service. BCBSMA also participates in a defined benefit plan covering medical, life and dental benefits. BCBSMA uses a December 31 measurement date for the majority of its plans. Effective January 1, 2005, HMO Blue is an active participating employer of the Plans. The pension and other post-retirement benefits costs allocated to the Company in 2006 and 2005 are \$11.1 million and \$12.9 million, respectively.

BCBSMA also sponsors a non-pension post-retirement benefit plan, including medical, dental and life benefits for retired employees. A 401(h) account was instituted by BCBSMA in December 2003. There was no contribution in 2006 and a contribution of \$9 million was made in December 2005. The companies contributions for the year ending December 31, 2007 are expected to be \$20 million for its pension plan and expected to be \$9.4 million for its post-retirement benefit plan.

BCBSMA also has a savings 401(k) plan for eligible employees. Under the employee savings plan, BCBSMA contributes an amount equal to 65% of employee contributions, up to a maximum of 6% of each employee's compensation, subject to pretax Internal Revenue Service limits. The Company's contribution for the 401(k) plan was \$2.8 million and \$2.7 million for 2006 and 2005, respectively. At December 31, 2006, the fair market value of these plan assets was \$281.6 million for BCBSMA and HMO Blue combined.

SPECIAL DEPOSITS

The special deposits of the Company at December 31, 2006 are as follows:

Description of Deposit	Where Deposited	Par or Book Value	Statement Value	Market Value
US Treasury Note 3%	State Street Bank and Trust, Boston, MA	\$1,000,000	\$1,005,167	\$997,500

TERRITORY AND PLAN OF OPERATION

Territory

The Corporation is only licensed to transact business in the Commonwealth of Massachusetts.

Plan of Operations

Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc. is headquartered in Boston, MA.

PRODUCTS

The Company offers the following insured products:

- **HMO Blue** — HMO Blue is licensed under Massachusetts General Laws, Chapter 176G. Members must reside in the service area, must generally choose a network primary care physician (PCP) upon enrollment and must follow plan rules in order to obtain the fullest extent of their coverage. These plans include HMO Blue, HMO Blue New England and Access Blue. Under HMO Blue New England plans, PCPs are available in Massachusetts and the New England states. Access Blue is an ‘open access’ type HMO Blue plan that does not require members to choose a PCP or to obtain PCP referrals.
- **Point-of-Service Plans** — Point-of-service (dual certificate) plans are comprised of two separate health benefit plans: an HMO plan and an indemnity plan. The “in-network” portion is an HMO Blue plan licensed under Massachusetts General Laws, Chapter 176G. The “out-of-network” portion is an indemnity plan approved under Massachusetts General Laws, Chapters 176A and 176B offered by Blue Cross and Blue Shield of Massachusetts, Inc. These plans include Blue Choice, Blue Choice New England and Access Blue Plus.
- **Nongroup Guaranteed Issue Managed Care Plans** — HMO Blue Direct and HMO Basic Blue Direct are nongroup guaranteed issue managed care plans in accordance with Massachusetts General Laws, Chapter 176M. (These plans were closed to new membership effective July 1, 2007.)
- **Medicare Advantage Plans** — Medicare Advantage Plans, such as Medicare HMO Blue and Medicare PPO Blue, are part of the Medicare Program and are also called “Part C.” These plans provide all Part A (Hospital), Part B (Medical), Part D (prescription drug) and certain additional benefits under a contract with the Centers for Medicare & Medicaid Services (CMS). Medicare HMO Blue members must reside in the Medicare HMO Blue service area, choose a network primary care physician (PCP) upon enrollment and must follow plan rules in order to obtain the fullest extent of their coverage. Medicare PPO Blue is a preferred provider organization (PPO) plan that provides comprehensive in-network and out-of-network benefits, and members must reside in the Medicare PPO Blue service area. Medicare Advantage plans are offered both on a group and nongroup basis.
- **Managed Blue for Seniors** — Managed Blue for Seniors is an HMO Blue group product that supplements the benefits available under the Medicare Program (Part A and Part B only). Members must reside in the HMO Blue service area, choose a network primary care physician and follow all plan requirements in order to receive coverage. Managed Blue for Seniors is offered only on a group basis.

PROVIDER CONTRACTS

The Company arranges for the provision of health care services to its subscribers and eligible dependents thereof through contracts with physician providers and other health care providers. Physician providers and such other

organizations or individuals are and shall be deemed to be, for all purposes, independent contractors with the Company, and shall not be characterized as officers, employees or agents of the Company.

For the HMO product, the Company, participating hospitals and physicians are generally parties to risk incentive agreements (including pay-for-performance agreements) whereby favorable and unfavorable claims experience is shared. Payments to participating physicians for medical claims are generally subject to retention by the Company. Distribution of such retention is contingent upon the results of the risk incentive arrangements.

The agreements are in compliance with Massachusetts statutes and regulation 211 CMR § 52.

RESERVES

KPMG's Health Actuaries were employed to prepare independent estimates of the Unpaid Claim Liabilities (UCL) as of December 31, 2006 and prior periods. For December 31, 2006, completion factors for the projection of ultimate claims were developed using historical payment patterns and actuarial judgment. "Low" and "High" estimates were developed by subtracting the claims paid-to-date from the actuarial range of incurred estimates. As the HMO Blue business pays fairly quickly, the range of estimates for the December 31, 2006 UCL is narrow and the actuarial estimates are similar to HMO Blue's estimates with hindsight through June 30, 2007.

HMO Blue made a separate provision for Claim Adjustment Expenses (LAE/CAE) in 2006 and the resulting expense percentage levels used are within industry norms.

The Company's premium deficiency reserve calculation was reviewed and found to be reasonable. The calculation indicated that no premium deficiency reserves were required as of December 31, 2006.

INCOME TAXES

On January 1, 2005, BCBSMA transferred the operations of its health maintenance organization ("HMO") to HMO Blue in exchange for the assumption of the liabilities of the HMO. Prior to this restructuring, BCBSMA received opinion letters from outside counsel covering three issues; (1) that BCBSMA should not recognize taxable income or gain upon the transfer of assets to HMO Blue; (2) that the transfer would not constitute a material change of BCBSMA's business and BCBSMA would continue to qualify as an existing Blue Cross Blue Shield organization under Internal Revenue Code Section 833(c)(2); and (3) HMO Blue should be a tax exempt organization.

After the split-off from BCBSMA, HMO Blue has filed tax returns as a tax-exempt entity. The Company's outside counsel issued an opinion letter stating that HMO Blue should be considered a tax-exempt entity. As noted in the opinion letter, the IRS had stopped issuing rulings regarding Section 501(m) and the definition of "commercial-type" insurance as it relates to HMO's. Because of the lack of authority regarding Section 501(m) and the lack of guidance by the Internal Revenue Service (IRS) regarding the treatment of HMO's it is difficult to conclude whether or not HMO Blue would be successful in sustaining their tax-exempt position upon examination by the IRS. No provision has been made in the statutory financial statements for any taxes.

ACCOUNTS AND RECORDS

The books and records of the Company are audited annually by the independent certified public accounting firm of Ernst & Young LLP, in accordance with 211 CMR § 23. The CPA Firm issued an unqualified opinion on the December 31, 2006 audited financial statements. The Company is also subject to review by an internal audit department.

The internal control structure was discussed with management through questionnaires and through a review of the work performed by the Corporation's Independent Certified Public Accountants (Ernst & Young LLP). No material

internal control weaknesses were noted in connection with the examination, nor were any such matters reported in the CPA Firm's filings with the Division.

The NAIC provides a questionnaire covering the evaluation of the controls in the Information Systems environment. The questionnaire was completed by the Company and reviewed by KPMG's Information Technology Advisory Services (ITAS) team that evaluated the adequacy of the Information Systems controls. No material deficiencies were noted.

The Company uses an automated general ledger system. Trial balances were traced from the general ledger and supporting documents to the 2006 Annual Statement. No material exceptions were noted.

COMMITMENTS AND CONTINGENCIES

As a condition of granting an HMO license to HMO Blue, the Division required BCBSMA and HMO Blue to enter into an agreement with the Division granting the Division discretionary authority to require either company to issue a surplus note to the other company if either of the company's health risk-based capital (RBC) is more than seventy-five (75) percentage points higher than the other company's RBC. Under the terms of its license with Blue Cross and Blue Shield Association, BCBSMA has entered into a unilateral agreement with HMO Blue to guarantee all current and future financial obligations of HMO Blue.

Lease Obligations

The Company and BCBSMA jointly have a long-term operating lease agreement for approximately 500,000 square feet of office space for its corporate headquarters. The term of the lease is 15 years, commencing in May 2000, with an option to extend for one period of four years and eleven months.

The Company and BCBSMA jointly have entered into several other long-term non-cancelable operating lease agreements for office space that expire at various dates through 2010.

The Company and BCBSMA's office space rental expense for 2006 and 2005 was \$23.4 million and \$26.7 million, respectively.

In addition, the Companies have an agreement with an outside vendor to provide certain information technology services for substantially all of the Companies' business operations. The Companies minimum commitments under this agreement are approximately \$51.8 million per year.

At December 31, 2006, the Companies minimum aggregate rental commitments are as follows (000's):

Year ending December 31	Operating Lease
2007	\$ 24,154
2008	19,009
2009	18,882
2010	19,654
2011	19,984
Balance through end of lease	\$ 55,119

Certain rental commitments have renewal options extending through the year 2007. Some of these renewals are subject to adjustments in future periods.

The Company has no sales-leaseback transactions at December 31, 2006.

Legal Proceedings

The Company is involved in pending and threatened litigation of the character incidental to its business or arising out of its insurance operations, and is from time to time involved as a party in various governmental and administrative proceedings. Management continues to monitor these matters, and believes the Company has accrued adequate reserves against potential liabilities.

For Information Only

FINANCIAL STATEMENTS

The Financial Statement section includes the following:

	<u>Page</u>
Statutory Statement of Assets, Liabilities and Capital & Surplus as of December 31, 2006	14
Statement of Revenue and Expenses for the Year Ended December 31, 2006	15
Capital & Surplus for the Year Ended December 31, 2006	16
Statement of Changes in Capital & Surplus For Three Years Ended December 31, 2006	17

The following financial statements are presented on the basis of accounting practices prescribed or permitted by the Commonwealth of Massachusetts Division of Insurance and by the National Association of Insurance Commissioners as of December 31, 2006.

For Information Only

**Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc.
Statutory Statement of Assets, Liabilities and Capital & Surplus
As of December 31, 2006**

	<u>Annual Statement</u>	<u>Statutory Examination Adjustment</u>	<u>Per Statutory Examination</u>
<u>ASSETS</u>			
Bonds	\$ 505,549,259	\$ -	\$ 505,549,259
Stocks:			
Preferred stocks	\$ 2,844,568	-	\$ 2,844,568
Common stocks	201,101,156	-	201,101,156
Real estate:			
Properties occupied by the company	115,178,595	-	115,178,595
Cash, cash equivalents and short-term investments	62,689,143	-	62,689,143
Other invested assets	455,398,791	-	455,398,791
Receivable for securities	10,503,312	-	10,503,312
Subtotals, cash and invested assets	<u>1,353,264,824</u>	-	<u>1,353,264,824</u>
Investment income due and accrued	4,503,992	-	4,503,992
Premiums and considerations:			
Uncollected premiums and agents' balances in the course of collection	19,993,893	-	19,993,893
Electronic data processing equipment and software	3,316,211	-	3,316,211
Health care and other amounts receivable	16,458,630	-	16,458,630
Other than invested assets	271,995	-	271,995
Total Assets	<u><u>\$1,397,809,545</u></u>	<u><u>\$ -</u></u>	<u><u>\$1,397,809,545</u></u>
<u>LIABILITIES</u>			
Claims unpaid	\$ 270,936,242	\$ -	\$ 270,936,242
Accrued medical incentive pool and bonus amounts	41,802,210	-	41,802,210
Unpaid claims adjustment expenses	4,673,672	-	4,673,672
Aggregate health policy reserves	17,971,812	-	17,971,812
Premiums received in advance	76,256,081	-	76,256,081
General expenses due or accrued	616,456	-	616,456
Amounts due to parent, subsidiaries and affiliates	70,777,271	-	70,777,271
Payable for securities	45,548,549	-	45,548,549
Other Liabilities	29,565,576	-	29,565,576
Total Liabilities	<u>\$ 558,147,869</u>	<u>\$ -</u>	<u>\$ 558,147,869</u>
<u>CAPITAL AND SURPLUS</u>			
Unassigned funds (surplus)	839,661,676	-	839,661,676
Total Capital and Surplus	<u>\$ 839,661,676</u>	<u>\$ -</u>	<u>\$ 839,661,676</u>
Total Liabilities, Capital and Surplus	<u><u>\$1,397,809,545</u></u>	<u><u>\$ -</u></u>	<u><u>\$1,397,809,545</u></u>

Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc.

**Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc.
Statement of Revenue and Expenses
For the Year Ended December 31, 2006**

	<u>Annual Statement</u>	<u>Statutory Examination Adjustment</u>	<u>Per Statutory Examination</u>
Member Months	12,370,923	-	12,370,923
Net premium income	\$4,223,732,075	\$ -	\$4,223,732,075
Change in unearned premium reserves and reserve for rate credits	(2,285,277)	-	(2,285,277)
Total revenues	4,221,446,798	-	4,221,446,798
Hospital and Medical:			
Hospital/medical benefits	2,996,746,788	-	2,996,746,788
Other professional services	131,430,643	-	131,430,643
Emergency room and out-of-area	46,408,749	-	46,408,749
Prescription drugs	570,059,644	-	570,059,644
Incentive pool, withhold adjustments and bonus amounts	39,746,655	-	39,746,655
Total hospital and medical	3,784,392,479	-	3,784,392,479
Claims adjustment expenses	218,611,393	-	218,611,393
General administrative expenses	205,530,230	-	205,530,230
Total underwriting deductions	4,208,534,102	-	4,208,534,102
Net underwriting gain	12,912,696	-	12,912,696
Net investment income earned	48,277,187	-	48,277,187
Net realized capital gains	9,082,195	-	9,082,195
Net investment gains	57,359,381	-	57,359,381
Net income after capital gains tax and before all other federal income taxes	70,272,077	-	70,272,077
Federal and foreign income taxes incurred	-	-	-
Net income	\$ 70,272,077	\$ -	\$ 70,272,077

Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc.

**Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc.
Capital & Surplus
For the Year Ended December 31, 2006**

	Annual Statement	Statutory Examination Adjustment	Per Statutory Examination
Capital and Surplus, December 31, 2005	\$ 763,780,690	\$ -	\$ 763,780,690
Net income or (loss)	70,272,077	-	70,272,077
Change in net unrealized capital gains and losses less capital gains tax	38,678,776	-	38,678,776
Change in nonadmitted assets	(32,754,218)	-	(32,754,218)
Aggregate write-ins for gains (losses) in surplus	(315,649)	-	(315,649)
Net change in capital and surplus	75,880,986	-	75,880,986
Capital and Surplus, December 31, 2006	\$ 839,661,676	\$ -	\$ 839,661,676

Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc.
Statement of Changes in Capital & Surplus
For Three Year Period Ended December 31, 2006

	<u>2004</u>	<u>2005</u>	<u>2006</u>
Capital and Surplus, prior year	\$ -	\$ -	\$ 763,780,690
Net income	0	137,054,981	70,272,077
Change in net unrealized capital gains (losses)	0	(29,879,238)	38,678,776
Change in nonadmitted assets and related items	0	(39,773,685)	(32,754,218)
Change in surplus as a result of transfer	0	696,378,632	0
Change in surplus as a result of other write-ins	0	0	(315,649)
Net change in capital and surplus for the year	0	763,780,690	75,880,986
Capital and Surplus, December 31, current year	\$ -	\$ 763,780,690	\$ 839,661,676

ACKNOWLEDGMENT

This is to certify that the undersigned is a duly qualified Certified Financial Examiner (CFE) and that, in conjunction with KPMG LLP, applied certain agreed-upon procedures to the accounting and corporate records of Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc. in order for the Division of Insurance of the Commonwealth of Massachusetts to fulfill the Commonwealth's requirements regarding periodic Statutory Examinations of Massachusetts domiciled insurers.

The undersigned's participation in this Statutory 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, those standards established by the Financial Condition (E) Committee of the NAIC and the *NAIC Financial Condition Examiners' Handbook*. This participation consisted of involvement in the planning (development, supervision and review of agreed upon procedures), administration, review of work papers and preparation of the statutory examination report.

The cooperation and assistance of the officers and employees of Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc. extended to all examiners during the course of the examination is hereby acknowledged.

John Turchi, CFE, CPCU
Supervising Examiner & Examiner in Charge (EIC)
Commonwealth of Massachusetts
Division of Insurance
Boston, MA