



COMMONWEALTH OF MASSACHUSETTS
OFFICE OF CONSUMER AFFAIRS AND BUSINESS
REGULATION

Division of Insurance

Report on the Statutory Examination of
Harvard Pilgrim Health Care, Inc.

Wellesley, Massachusetts

As of December 31, 2007

NAIC COMPANY CODE: 96911

EMPLOYERS ID NUMBER: 04-2452600

Commonwealth of Massachusetts Division of Insurance
Report on the Statutory Examination of
HARVARD PILGRIM HEALTH CARE, INC.

Table of Contents

SALUTATION	1
SCOPE OF EXAMINATION	2
DESCRIPTION OF COMPANY	2
History	2
Organization	3
Plan of Rehabilitation	3
Capital and Surplus	4
MANAGEMENT	4
Articles of Organization and By-Laws	4
Members and Membership	4
BOARD OF DIRECTORS	4
Committees of the Board	6
OFFICERS	7
CONFLICT OF INTEREST PROCEDURES	8
CORPORATE RECORDS	8
Articles of Incorporation and By-Laws	8
Board of Directors Minutes	8
ACQUISITIONS, MERGERS, DISPOSALS, DISSOLUTIONS AND PURCHASES OR SALES	8
MANAGEMENT CONTINUITY AND NATIONAL EMERGENCY	8
AFFILIATED COMPANIES	9
RELATED PARTY TRANSACTIONS	9
FIDELITY BOND AND OTHER INSURANCE	9
PENSION AND INSURANCE PLANS	10
SURPLUS NOTES	10
SPECIAL DEPOSITS	12
TERRITORY AND PLAN OF OPERATION	12
Territory	12
Plan of Operation	12
PRODUCTS	12
PROVIDER CONTRACTS	14
UNPAID CLAIMS	14
REINSURANCE	14
ACCOUNTS AND RECORDS	14
SUBSEQUENT EVENTS	15
COMMITMENTS AND CONTINGENCIES	15
Lease Obligations	15
Related Party Guarantee	16
Long-Term Service Contract	16
Legal Proceedings	16
FINANCIAL STATEMENTS	17
Statutory Statement of Assets, Liabilities and Capital and Surplus as of Dec. 31, 2007	18
Statement of Revenue and Expenses for the Year Ended Dec. 31, 2007	19
Capital and Surplus for the Year Ended Dec. 31, 2007	20
Reconciliation of Capital and Surplus for the Three Year Period Ended Dec. 31, 2007	21
ACKNOWLEDGEMENT – Report of Certified Financial Examiner	22



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

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NONNIE S. BURNES
COMMISSIONER OF INSURANCE

March 20, 2009

The Honorable Alfred W. Gross, Chair
Financial Condition (E) Committee, NAIC
Commissioner
Virginia Bureau of Insurance
State Corporation Commission
1300 East Main Street
Richmond, Virginia 23219

The Honorable Joel Ario
Secretary, Northeastern Zone NAIC
Commissioner of Insurance
Pennsylvania Insurance Department
1326 Strawberry Square
Harrisburg, Pennsylvania 17120

The Honorable Nonnie S. Burnes
Commissioner of Insurance
Commonwealth of Massachusetts
Office of Consumer Affairs and Business Regulation
Division of Insurance
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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

Harvard Pilgrim Health Care, Inc.

at its Main Administrative Office located at:

93 Worcester Street
Wellesley, MA 02481-9181

The following report thereon is respectfully submitted.

SCOPE OF EXAMINATION

This statutory examination of Harvard Pilgrim Health Care, Inc., hereinafter referred to as “the Company,” “the Corporation,” “HPHC, Inc.,” or “Harvard Pilgrim,” is as of December 31, 2007, including any material transactions and 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. Such procedures were reviewed and approved by the Commonwealth of Massachusetts Division of Insurance (the “Division”).

The current examination was conducted at the direction of and under the overall management and control of the examination staff of the Division. The statutory examination was performed at the Company's main administrative office in Wellesley, Massachusetts. KPMG was engaged to perform certain agreed-upon procedures, which are in compliance with the *National Association of Insurance Commissioners (NAIC) Financial Condition Examiners' Handbook*. KPMG's Health 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 liabilities as of December 31, 2007. 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 NAIC Financial Condition (E) Committee and prescribed by the current *NAIC Financial Condition Examiners' Handbook*. The principal focus of the examination was 2007 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, Deloitte & Touche LLP (D&T). Wherever possible and wherever deemed appropriate and effective, D&T's independent work product was used to define, support, document and expedite the overall examination process.

DESCRIPTION OF COMPANY

History

Harvard Pilgrim Health Care, Inc. is the oldest nonprofit health plan in New England. The Company was founded in 1969 by the Dean of the Harvard Medical School and was the first health maintenance organization (HMO) in New England. The Company began operations as a staff-model HMO operation out of a single health center in Boston. By 1990, the Company consisted of fourteen Boston-area health centers licensed to operate in Massachusetts and eight independently contracted physician groups, designed to provide an alternative to fee-for-service health care.

Organization

HPHC, Inc. operates as a health maintenance organization providing comprehensive health insurance, access to health care and other related services in Massachusetts and Maine to group and individual members through contracts with physicians, established primary care and multi-specialty physician groups, hospitals and other health care providers. HPHC, Inc. provides comprehensive health insurance, access to health care and other related services to Medicare members through its Medicare Advantage contract with the Centers for Medicare and Medicaid Services (“CMS”). HPHC, Inc. is a tax-exempt organization under Section 501(c)(3) of the Internal Revenue Code.

Harvard Pilgrim Health Care of New England, Inc (“HPHC NE”), a not-for-profit Massachusetts corporation, and an affiliate of HPHC, Inc., operates as a health insurance plan, providing comprehensive health insurance, access to health care and other related services in New Hampshire to group members through contracts with physicians, established primary care and multi-specialty physician groups, hospitals and other health care providers. HPHC NE provides health insurance, access to health care and other related services to individual Medicare members through its Medicare Advantage contract with CMS. HPHC NE was incorporated on November 18, 1978 and commenced operations as a health insurance plan on October 1, 1980. HPHC, Inc. is the sole corporate member of HPHC NE. HPHC NE is a tax-exempt organization under Section 501(c)(4) of the Internal Revenue Code.

HPHC Insurance Company, Inc. (“HPHC Insurance Co.”), formerly known as Harvard Pilgrim Insurance Company, Inc. is a wholly-owned, for-profit subsidiary of HPHC, Inc. HPHC Insurance Co. was incorporated on September 27, 1991 and commenced underwriting accident and health risks on January 1, 1992. HPHC Insurance Co. underwrites health risks related to out-of-network coverage for HPHC, Inc. members. HPHC Insurance Co. also underwrites health insurance for two additional group products: a Preferred Provider Organization (PPO) indemnity product and a Medicare indemnity product.

Health Plans, Inc. (“HPI”) is a wholly-owned for profit subsidiary of HPHC, Inc. HPHC, Inc. acquired HPI with approval of the HPHC, Inc. Board of Directors on January 11, 2005. HPI provides third party administrative (TPA) services for HPHC, Inc. and employer-sponsored medical, dental and short-term disability programs throughout Massachusetts, Maine and New Hampshire.

The Harvard Pilgrim Health Care Foundation, Inc. (“HPHC Foundation”) is a wholly-owned subsidiary of HPHC, Inc., which provides support and funding for teaching, research and community service programs. The HPHC Foundation is a Massachusetts not-for-profit corporation and tax exempt organization under Section 501 (c)(3) of the Internal Revenue Code.

In October 1999, HPHC, Inc. voluntarily liquidated its affiliate Harvard Pilgrim Health Care of New England, Inc. (HPNE-RI), a Rhode Island Corporation, under the supervision of the Director of Rhode Island Department of Business Regulation. The liquidation of HPNE-RI was completed in 2005.

Plan of Rehabilitation

HPHC, Inc., together with HPHC NE, was placed in temporary receivership for purposes of rehabilitation in January 2000. On May 24, 2000, a Plan of Rehabilitation (the “Plan”) was approved by The Supreme Judicial Court for Suffolk County and on June 21, 2000, the temporary receivership was dismissed. As part of the court order, Harvard Pilgrim would remain subject to administrative supervision by the Commissioner of Insurance of the Commonwealth of Massachusetts (the “Commissioner”) for so long as the payment approval conditions by the Commissioner for principal and interest on the Massachusetts Health and Educational Facilities Authority Revenue Bonds Issue 1998 Series A are in effect (the “Condition”). On June 15, 2006, having met all of the conditions of the Plan, HPHC, Inc. and HPHC NE were released from administrative supervision by the Commissioner.

Commonwealth of Massachusetts Division of Insurance
Report on the Statutory Examination of
HARVARD PILGRIM HEALTH CARE, INC.

HPHC, Inc. and Financial Security Assurance Inc. ("FSA"), the Bonds' insurer, entered into an agreement which provides that the requirement of the Plan that the Commissioner give prior approval to the payment of principal and interest on the Bonds remain in effect for the life of the Bonds after termination of the Condition imposed under the Plan. As a result of this agreement, the Bonds will continue to be treated as surplus notes after termination of the Condition imposed under the Plan. In consideration for FSA's agreement to the continuing application of the preapproval Condition, Harvard Pilgrim agreed to increase the annual principal payment it makes with respect to the obligations. Supplemental payments of additional principal would be required if certain profitability and financial conditions are met. The Company increased the principal payment due on July 1, 2007 and July 1, 2006 in accordance with the agreement. The Additional Principal Payment has been placed in escrow and will be used to call the Bonds at the earliest call date, which is July 1, 2008.

Capital and Surplus

Capital and Surplus consists of capital contributed to the Company, surplus notes 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 through 2007 are shown in the following schedule:

<u>Year</u>	<u>Total Admitted Assets</u>	<u>Total Liabilities</u>	<u>Capital and Surplus</u>
2005	\$636,190,531	\$346,270,413	\$289,920,118
2006	731,690,955	409,744,199	321,946,756
2007	754,153,763	380,681,146	373,472,617

MANAGEMENT

Articles of Organization and By-Laws

The Company's By-Laws may be altered, amended or repealed at any annual or special meeting of the Directors, notice of which shall specify the subject matter of the proposed alteration, amendment or repeal of the sections to be affected thereby, by vote of a majority of the Directors then in office.

Members and Membership

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

- The Corporation shall have no members. Any action or vote required or permitted to be taken by the members under applicable law shall be taken by action or vote of the same percentage of Directors of the Corporation.

BOARD OF DIRECTORS

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

- Powers: The affairs of the Corporation shall be managed by the Directors who shall have and may exercise all the powers of the Corporation.
- Number and Election: The Board of Directors of the Corporation shall be comprised of between seven (7) and seventeen (17) individuals. Such persons elected as Directors by the Corporation's Board of Directors shall serve for staggered terms. At each annual meeting of the Directors, the Directors shall elect the appropriate number of successors to the Directors whose terms are then expiring. At any special or regular meeting, the Directors may increase their number to not more than seventeen (17) and elect new Directors to complete the number so fixed by a vote of a majority of the Directors then in office, or they may decrease the number of Directors to not less than

seven (7), but only to eliminate vacancies existing by reason of the death, resignation, removal or disqualification of one or more Directors.

- Term of Office: The terms of office of the Directors of the Corporation shall be staggered, and each Director shall hold office for a term not to exceed three (3) years and until his successor is elected and qualified, or until he sooner dies, resigns, is removed or becomes disqualified. A Director may serve more than one term, but not more than the lesser of three consecutive full or partial terms or eight consecutive years.
- Regular Meetings: Regular meetings of the Directors may be held at such places and at such times as the Directors may determine.
- Special Meetings: Special meetings of the Directors may be held at any time and at any place when called by the Chairman of the Board of Directors, the President or by two or more Directors.
- Annual Meetings: The annual meeting of the Directors shall be held on the third Thursday in January in each year (unless that day be a legal holiday at the place where the meeting is to be held, in which case the meeting shall be held at the same hour on the next succeeding day not a legal holiday) or at such other earlier or later date and time as shall be determined from time to time by the Directors or by the President.
- Notice of Meetings: Notice of the time and place of each meeting of the Directors shall be given to each Director by mail, addressed to him at his usual or last known business residence address at least seven days before the meeting, or in person or by telephone at least forty-eight hours before the meeting. Whenever notice of a meeting is required, such notice need not be given to any Director if a written waiver of notice, executed by him (or his attorney thereunto authorized) before or after the meeting, is filed with records of the meeting, or to any Director who attends the meeting without protesting prior thereto or at its commencement the lack of notice to him. Neither such notice nor waiver of notice need specify the purposes of the meeting, unless otherwise required by law, the Restated Articles of Organization or the Restated By-Laws.
- Quorum: At any meeting of the Directors, a majority of the Directors then in office shall constitute a quorum. Any meeting may be adjourned by a majority of the votes cast upon the question, whether or not a quorum is present, and the meeting may be held as adjourned without further notice.
- Action by Vote: When a quorum is present at any meeting, a majority of the Directors present and voting shall decide any question, including election of Directors and officers, unless otherwise provided by law, the Restated Articles of Organization, or the Restated By-Laws.
- Action by Writing: Any action required or permitted to be taken at any meeting of the Directors may be taken without a meeting if all the Directors consent to the action in writing and the written consents are filed with the records of the meetings of the Directors. Such consents shall be treated for all purposes as a vote at a meeting.
- Presence through Communications Equipment: Unless otherwise provided by law or the Restated Articles of Organization, members of the Board of Directors may participate in a meeting of the Board by means of a conference telephone or similar communications equipment by means of which all persons participating in the meeting can hear each other at the same time. Participation by such means shall constitute presence in person at a meeting.

Commonwealth of Massachusetts Division of Insurance
Report on the Statutory Examination of
HARVARD PILGRIM HEALTH CARE, INC.

At December 31, 2007, the Board was comprised of eleven (11) Directors, which is in compliance with the Company's By-Laws. Directors duly elected and serving at December 31, 2007, with addresses and business affiliations, were as follows:

<u>Director</u>	<u>Class of Director</u>	<u>Principal Occupation</u>
Charles D. Baker Swampscott, MA	Management Director	President and Chief Executive Officer, HPHC, Inc.
Connie Smith Barr, M.D. Needham, MA	Independent Director	Internist, Dedham Medical Associates
John H. Budd Worcester, MA	Independent Director, Chair	Of Counsel, Mirick, O'Connell, DeMallie & Lougee, LLP
Ann Clarke Jamaica Plain, MA	Independent Director	General Counsel, Massachusetts Teachers Association
Zoila Torres Feldman Newton, MA	Independent Director	Executive Director, Great Brook Valley Health Center
Katherine A. Hesse Milton, MA	Independent Director	Partner, Murphy, Hesse, Toomey & Lehane, LLP
Deborah C. Jackson Milton, MA	Independent Director	Chief Executive Officer, American Red Cross of Massachusetts Bay
Herman B. Leonard, Ph.D. Concord, MA	Independent Director	Professor, Harvard University, John F. Kennedy School of Government
Edward F. McCauley Wellesley, MA	Independent Director	Retired Partner, Deloitte & Touche LLP
Barry L. Shemin Wayland, MA	Independent Director	Consulting Actuary, John Hancock Financial Services, Inc.
Mary Ann Tocio Concord, MA	Independent Director	President, Bright Horizons Family Solutions

Committees of the Board

The Board may, by vote of a majority of the Directors then in office, elect or appoint one or more committees and delegate to any such committee or committees any or all of the powers of the directors, except those which by law, by the Restated Articles of Organization or by the Restated By-Laws they are prohibited from delegating. Unless the Directors otherwise determine, there shall be an Executive Committee which shall have all of the powers specified in Massachusetts General Laws, Chapter 156B, Section 55. Unless the Directors otherwise designate, committees shall conduct their affairs as nearly as may be in the same manner as is provided in the Restated By-Laws for the Directors. The members of any committee shall remain in office at the pleasure of the Directors. All committees of the Board, except the Executive Committee, may include members from within or without the membership of the Board of Directors. By virtue of his office, the President shall be a member of the Executive Committee.

In addition, other committees may be appointed by the Board of Directors, which shall include standing Audit, Finance, Human Resources and Nominating and Governance committees with a Board member as chairperson.

Commonwealth of Massachusetts Division of Insurance
Report on the Statutory Examination of
HARVARD PILGRIM HEALTH CARE, INC.

The current standing committees of the Board as of December 31, 2007 were as follows:

Audit Committee

The Audit Committee oversees the Company's financial reporting processes and its systems of internal controls and compliance to ensure their integrity and effectiveness.

Finance Committee

The Finance Committee oversees the financial condition of the Company to ensure the Company's financial strength and integrity.

Human Resources Committee

The Human Resources Committee ensures implementation of policies and procedures which enable the Company to attract, retain and develop the most talented staff available; to evaluate the performance of the President and Chief Executive Officer.

Nominating and Governance Committee

The Nominating and Governance Committee oversees the Board's organizational structure, composition and focus of activities to ensure the Board's effectiveness in supporting achievement of the Company's mission.

Patient Care Assessment Committee

The Patient Care Assessment Committee develops, recommends for approval by the board of directors and implements the Patient Care Assessment Plan of the corporation and its affiliates approved from time to time by the board of directors pursuant to Massachusetts General Laws, Chapter 111, Section 203 and the Qualified Patient Care Assessment Coordinator for the corporation and its affiliates pursuant to the foregoing regulations.

OFFICERS

The Company's officers consist of a Chairman of the Board, President, Treasurer, Clerk and such other officers, if any, as the Directors or the President may determine. The Clerk shall be a resident of the Commonwealth of Massachusetts unless the Corporation has appointed a resident agent to receive service of process. A person may hold more than one office at the same time.

The officers of the Corporation shall be elected by the Board at its annual meeting. Each officer shall hold office until the annual meeting of the Board next following his election and until his successor is chosen and qualified, or until he sooner dies, resigns, is removed or becomes disqualified.

The elected officers and their respective titles at December 31, 2007 were as follows:

<u>Officer</u>	<u>Title</u>
John H. Budd	Chairman of the Board
Barry L. Shemin	Vice Chairman of the Board
Charles D. Baker	President and Chief Executive Officer
Bruce M. Bullen	Chief Operating Officer
Marie Montgomery ¹	Chief Financial Officer and Treasurer
Laura S. Peabody	Secretary and Clerk

¹ Joseph Capezza was CFO and Treasurer until resigning in November 2007. Ms. Montgomery served as acting CFO and Treasurer from December 2007 – June 2008. Ms. Montgomery has been replaced as CFO and Treasurer by James W. DuCharme as of June 2, 2008.

CONFLICT OF INTEREST PROCEDURES

HPHC, Inc. has adopted a conflict of interest policy statement. HPHC, Inc. has an established procedure for the disclosure to the President or Chairperson of any financial interest on the part of any officer or Director which is in or is likely to be in conflict with his or her official duties. The financial interest shall be made a matter of record through such annual or other reporting and certification procedure as the Board of Directors shall require from time to time. After disclosure of the financial interest and all material facts, and any discussion with the fiduciary, the Board shall determine whether any conflict of interest exists. The fiduciary shall leave the Board meeting while the determination of a conflict of interest is discussed and voted upon. The minutes of the Board meeting shall include the names of the fiduciaries who disclosed financial interests, the nature of the financial interests, and whether the Board determined there was a financial interest.

Review of the 2007 Board of Directors records identified no significant conflicts of interest and no financial conflicts of interest.

CORPORATE RECORDS

Articles of Incorporation and By-Laws

Our review of the By-Laws indicated that they were amended effective May 26, 2007; however, they contained no significant changes.

Board of Directors Minutes

The minutes of the Board and committee meetings for the period under statutory examination were reviewed and indicated that all meetings were held in accordance with the Company's By-Laws and the laws of the Commonwealth of Massachusetts. Activities of the committees were reported upon at various meetings of the Board.

ACQUISITIONS, MERGERS, DISPOSALS, DISSOLUTIONS AND PURCHASES OR SALES

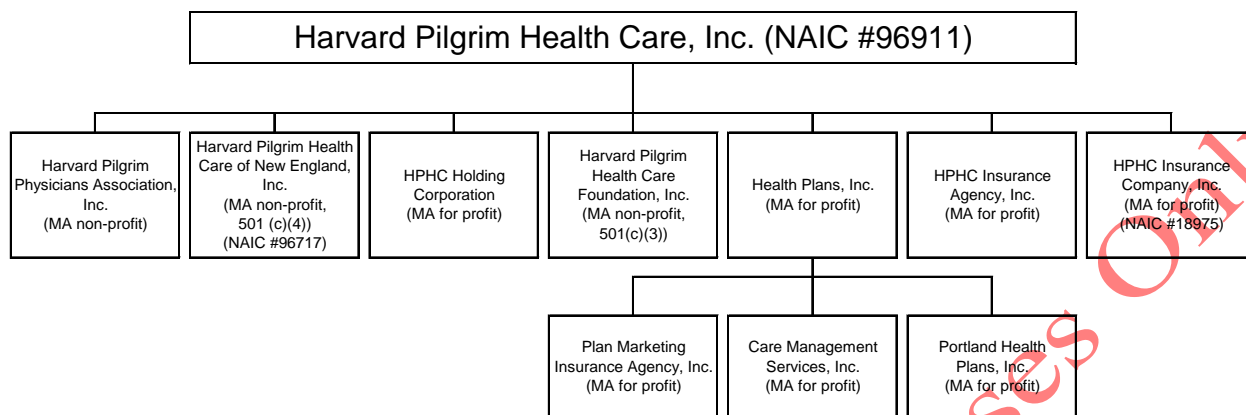
On May 1, 2006, HPHC, Inc.'s wholly-owned subsidiary Health Plans, Inc. acquired certain assets of Benefit Plan Management, Inc. ("BPM") for cash plus additional future cash consideration based upon meeting certain client retention provisions. BPM provides third party administrative services to self-funded employer groups for health, dental and short-term disability benefits. The acquisition has been accounted for under the purchase method. The excess purchase price over the fair value of assets acquired has been recorded as goodwill and other intangible assets.

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, Sections 180M-180Q.

AFFILIATED COMPANIES

A summary of ownership and relationship of the Company and its operating subsidiaries and affiliated companies as of December 31, 2007 is illustrated below:



RELATED PARTY TRANSACTIONS

HPHC, Inc. provides all administrative and operational management services to HPHC NE. Administrative expenses are charged to HPHC NE based on Harvard Pilgrim's departmental cost allocation methodology. For the years ended December 31, 2007 and 2006, total administrative expenses and claims adjustment expenses allocated to HPHC NE were \$30.7 million and \$28.7 million, respectively. As of December 31, 2007, HPHC, Inc. owed HPHC NE \$7.6 million and at December 31, 2006, HPHC NE owed HPHC, Inc. \$2.5 million.

HPHC Inc. provides all administrative and operational management services to HPHC Insurance Co. Administrative expenses are charged to HPHC Insurance Co. based on Harvard Pilgrim's departmental cost allocation methodology. For the years ended December 31, 2007 and 2006, total administrative expenses and claims adjustment expenses allocated to HPHC Insurance Co. were \$17.6 million and \$10.0 million, respectively. As of December 31, 2007, HPHC Insurance Co. owed HPHC, Inc. \$3.0 million and at December 31, 2006, HPHC, Inc. owed HPHC Insurance Co. \$1.8 million. In addition, HPHC, Inc.'s Board of Directors approved a \$10.0 million capital contribution to HPHC Insurance Co. in 2006.

HPHC, Inc. extended a line of credit to Health Plans, Inc. ("HPI") in 2005 which was paid in full in 2007. In addition, there are other operating expenses incurred by HPI which are initially paid for by HPHC, Inc. HPHC, Inc. charged HPI for interest on the line of credit as well as its share of other operating expenses. As of December 31, 2007 HPHC, Inc. owes HPI \$0.1 million for operating expenses incurred to date and as of December 31, 2006 HPI owed HPHC, Inc. \$0.6 million representing the interest charges on the line of credit and other operating expenses incurred by HPI to date. In January 2007 the HPHC, Inc. Board of Directors approved a \$1.0 million capital contribution to HPI.

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 acquiring 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, 2007.

PENSION AND INSURANCE PLANS

Harvard Pilgrim employees participate in a defined contribution plan covering all employees. Participants can make salary deferral contributions up to 50% of their pay subject to the legally permitted maximum and, after one year of service, Harvard Pilgrim makes matching contributions equal to 100% of the first 4% of salary deferrals, subject to the legally permitted maximum. Harvard Pilgrim also makes an annual contribution of 4% of pay to each participant's account regardless of whether the employee makes salary deferral contributions or not. Harvard Pilgrim's contributions amounted to approximately \$7.1 million and \$6.7 million for the years ended December 31, 2007 and 2006, respectively.

Harvard Pilgrim's postretirement medical plan allows employees who have attained age 60 and completed ten years of service to remain in Harvard Pilgrim's group health care coverage upon retirement and until they qualify for Medicare coverage. In accordance with the provisions of the postretirement medical plan, the employee will pay 100% of the monthly premium until they reach age 65. Once they reach age 65 and enroll in both Medicare Parts A and B, Harvard Pilgrim will provide a maximum monthly contribution of \$150 to each retiree (and each spouse, if applicable), provided the employee is transitioning from an active Harvard Pilgrim employee medical plan. The plan is not currently funded. Net periodic postretirement costs, which are included as a component of general administrative expenses, for the years ended December 31, 2007 and 2006 were \$867,000 and \$648,000, respectively. Accrued postretirement benefit obligations for vested employees as of December 31, 2007 and 2006 were \$5.7 million and \$5.2 million, respectively.

SURPLUS NOTES

In connection with the Plan of Rehabilitation (the "Plan"), HPHC, Inc. issued surplus notes ("Surplus Notes") for substantially all of the pre-receivership general unsecured obligations. Payments of principal and interest on the Surplus Notes and the Bonds were made subject to the approval of the Commissioner. As such, the outstanding amount of the Bonds, which were reduced by the \$29 million mortgage, qualify to be treated as surplus notes and are included as a component of statutory Capital and Surplus. The amounts outstanding for surplus notes were as follows (000's):

	<u>2007</u>	<u>2006</u>
Massachusetts Health and Educational Facilities Authority (MHEFA) Revenue Bonds, Harvard Pilgrim Health Care Issue 1998 Series A, payable through 2028, net of \$1,759 and \$1,844 discount, respectively	\$ 139,201	\$ 148,916
Mortgage	(29,000)	(29,000)
Total surplus notes	<u>\$ 110,201</u>	<u>\$ 119,916</u>

HPHC, Inc. and Financial Security Assurance Inc. ("FSA"), the Bonds' insurer, entered into an agreement which provides that the requirements of the Plan that the Commissioner give prior approval to the payment of principal and interest on the Bonds ("the Condition") remain in effect for the life of the Bonds after termination of the Condition imposed under the Plan. As a result of this agreement, the Bonds will continue to be treated as surplus notes after termination of the Condition imposed under the Plan. In consideration for FSA's agreement to the continuing application of the preapproval Condition, HPHC, Inc. agreed to increase the annual principal payment it makes with respect to the obligations to the greater of \$9.8 million or the original principal requirement as outlined in the Loan and Trust agreement. Supplemental payments of additional principal up to a maximum of \$10 million per year and \$46 million in the aggregate would be required if certain profitability and financial conditions are met. HPHC, Inc. increased the principal payment due on July 1, 2007 and July 1, 2006, by \$3.8 million and \$4.3 million, respectively, ("Additional Principal Payment") to \$9.8 million in each year in accordance with the agreement. The Additional Principal Payment has been placed in escrow and will be used to call the Bonds at the earliest call date, which is July 1, 2008. In addition, HPHC, Inc. agreed to pay FSA an annual fee, commencing on January 1, following the release from

Commonwealth of Massachusetts Division of Insurance
Report on the Statutory Examination of
HARVARD PILGRIM HEALTH CARE, INC.

the Condition imposed under the Plan, equal to the principal amount of the Bonds outstanding on the previous December 31 multiplied by 30 basis points per year, or 15 basis points per year if the Bonds carry an investment grade rating by Moody's or Standard & Poor's on the date when such payment is due. At December 31, 2007, the Bonds carried an investment grade rating by Moody's.

In 2007 and 2006, principal payments on the Bonds were \$9.8 million and \$11.1 million, respectively. The \$9.8 million principal payment in 2007 includes the Additional Principal Payment under the FSA Agreement. The \$11.1 million principal payment in 2006 includes \$1.3 million, which was placed in escrow as a result of the bond defeasance transaction and the \$4.3 million Additional Principal Payment under the FSA Agreement. In accordance with Statement of Statutory Accounting Principles No. 91, *Sale, Transfer, and Service of Financial Assets and Extinguishments*, the debt was considered to be extinguished by an in-substance defeasance.

Interest expense related to the bonds amounted to \$7.8 million and \$8.1 million in 2007 and 2006, respectively. Interest paid related to the bonds amounted to \$7.9 million and \$8.2 million in 2007 and 2006, respectively. The payment of scheduled installments of principal and interest on the Bonds is fully insured.

At December 31, 2007 and 2006, the estimated fair market value of the Bonds was approximately \$152.4 million and \$154.4 million, respectively. The fair market value is estimated based on the quoted market prices for the same or similar issues.

The Company's special deposits include a debt service fund that was established with the bond trustee for the payment of principal and interest. The debt service fund amounted to \$3.8 million and \$3.9 million at December 31, 2007 and 2006, respectively. These funds are invested in U.S. government securities and certificates of deposit and are carried at amortized cost, which approximates estimated fair value.

The aggregate amount of maturities and sinking fund requirements of the Bonds before consideration of the aforementioned amendment, as of December 31, 2007 was as follows (000's):

Year ending December 31	Amount
2008	\$ 6,265
2009	6,580
2010	6,895
2011	7,230
2012	7,585
Thereafter	<u>106,405</u>
Total	<u>\$ 140,960</u>

Other conditions of the Bonds require Harvard Pilgrim to comply with certain covenants, the most restrictive of which is the requirement that Harvard Pilgrim maintain a GAAP debt service coverage ratio of 1:1. For the year ended December 31, 2007, all debt covenant requirements were satisfied.

SPECIAL DEPOSITS

The special deposits of the Company, excluding the debt service fund attributable to the Surplus Notes, at December 31, 2007 were as follows:

Description of Deposit	Where Deposited	Par Value	Statement Value	Market Value
FNMA Callable, 5.0%, 1/23/2014; Money Market Funds	KeyBanc Capital Markets, Augusta, ME – State of Maine Reserve	\$ 1,704,012	\$ 1,704,012	\$ 1,708,662
U.S. Treasury Note, 4.0%, 6/15/2009	Citibank, New York, NY – Custodian For Commonwealth of Massachusetts Insurance Division	1,000,000	1,012,833	1,013,050
SEI UST Daily Income Money Market Fund *	Boston Trust & Investment, Boston, MA – State of Rhode Island Department of Labor and Training	599,543	599,543	599,543
		<u>\$ 3,303,555</u>	<u>\$ 3,316,388</u>	<u>\$ 3,321,255</u>

* The Rhode Island Department of Labor and Training released these funds in January 2008.

TERRITORY AND PLAN OF OPERATION

Territory

The Corporation is licensed to transact business in the Commonwealth of Massachusetts and the State of Maine.

Plan of Operation

Harvard Pilgrim Health Care, Inc. is headquartered in Wellesley, MA.

PRODUCTS

The Company offers the following insured products:

Health Maintenance Organization (HMO) – The HMO product is available through employers in Massachusetts, New Hampshire and Maine. HPHC, Inc. offers the HMO product in Massachusetts and Maine, while HPHC NE offers the HMO product in New Hampshire. The Harvard Pilgrim HMO features comprehensive coverage for a wide range of preventive and medical services, including routine office visits, well-baby care, immunizations, hospitalization and worldwide emergency care. In most benefit packages, prescription drug coverage is also included. HMO members choose a primary care physician who will provide or arrange care for all of their medical needs. In addition, services are typically covered in full with co-payments, which eliminates the hassle of bills or claim forms.

Point of Service (POS) - The POS plan is available through employers in Massachusetts, New Hampshire and Maine. HPHC, Inc. offers the POS product in Massachusetts and Maine, HPHC NE offers the POS product in New Hampshire, and HPHC Insurance Co. underwrites out-of-network POS coverage for members in each state. The Harvard Pilgrim POS Plan features comprehensive coverage for a wide range of preventive and medical services, including routine office visits, well-baby care, immunizations, hospitalization and worldwide emergency care. In most benefit packages, prescription drug coverage is also included. The POS Plan allows members to choose a primary care physician (PCP), but also to receive care from specialists without a PCP referral. In addition, POS members can visit doctors, hospitals and other providers that do not belong to Harvard Pilgrim's participating provider network. When provided or arranged by a PCP, services are typically covered in full with co-payments.

Services received without a PCP referral or outside Harvard Pilgrim's participating provider network are subject to deductibles and coinsurance.

Preferred Provider Organization (PPO) – The PPO plan is available through employers in Massachusetts, New Hampshire and Maine. HPHC, Inc. underwrites the PPO product in Massachusetts that has no in-network co-insurance and HPHC Insurance Co. underwrites all other PPO products in Massachusetts. HPHC Insurance Co. also underwrites the PPO product in Maine and New Hampshire. The Harvard Pilgrim PPO features comprehensive coverage for a wide range of preventive and medical services, including routine office visits, well-baby care, immunizations, hospitalization and worldwide emergency care. In most benefit packages, prescription drug coverage is also included. PPO members can choose to receive care for covered services from providers and hospitals that belong to Harvard Pilgrim's participating provider network or from out-of-network providers and hospitals. Outside of Massachusetts, Maine, New Hampshire and Rhode Island, participating providers also include the Private Healthcare Systems network of more than 360,000 providers and 3,500 hospitals across the United States. When provided or arranged by participating providers, services are typically covered in full with co-payments. Services received outside of Harvard Pilgrim's participating provider network are subject to deductibles and coinsurance.

Administrative Services Only (ASO) – The Company administers employee health benefits for certain self-insured employer groups under various ASO contracts wherein Harvard Pilgrim performs eligibility management, medical management, claims processing and disbursement activities in return for an administrative fee. The employer assumes all insurance risk under these arrangements. ASO services may be offered by either HPHC, Inc., HPHC NE or HPHC Insurance Co., depending on the type of product and service area.

Non-group – HPHC, Inc. offers non-group coverage options in Massachusetts and Maine. The Company offers a variety of plans for qualifying participants. In Massachusetts, Harvard Pilgrim non-group plans may be purchased either from HPHC, Inc. directly or through the state's Commonwealth Health Insurance Connector Authority. In New Hampshire, non-group coverage is only offered through HPHC NE as a conversion from existing HPHC NE HMO coverage.

Best Buy HMO and PPO – These options are available through employers in Massachusetts, New Hampshire and Maine. HPHC, Inc. offers the Best Buy HMO in Massachusetts and Maine and the Best Buy PPO in Massachusetts. HPHC NE offers the Best Buy HMO in New Hampshire. HPHC Insurance Co. offers the Best Buy PPO in New Hampshire. Harvard Pilgrim Best Buy plans have many of the same features as traditional HMO and PPO plans, but offer lower premiums. That is due in part to additional cost-sharing features like deductibles, coinsurance or higher co-payments for certain services.

Best Buy Health Savings Account (HSA) PPO - HPHC Insurance Co. offers a qualified high deductible HSA PPO health plan through employers in Massachusetts, Maine and New Hampshire. The Best Buy HSA PPO may help members save money on their annual premium and put money aside in an HSA to help offset medical costs.

First Seniority Freedom - First Seniority Freedom is a Medicare Advantage private fee-for-service plan offered by Harvard Pilgrim. HPHC, Inc. offers the First Seniority Freedom product in Massachusetts and Maine, while HPHC NE offers this product in New Hampshire.

Harvard Pilgrim Choice Plus & Options PPO Plans – Harvard Pilgrim Choice Plus & Options PPO Plans are offered in conjunction with United HealthCare Services, Inc. through HPHC Insurance Co. These plans are designed to meet the needs of Massachusetts employers with work sites in other states. Members are not required to choose a primary care physician and are free to visit doctors or hospitals at any time without a referral. When a member sees a provider in the national network, the member will have lower out-of-pocket costs and no bill or claim forms to submit. If the member seeks a non-participating provider, out-of-pocket costs will generally be higher and more paperwork is required.

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

The agreements are in compliance with Massachusetts statutes and regulation 211 CMR 52.00.

UNPAID CLAIMS

KPMG Health Actuaries prepared independent estimates of the Unpaid Claim Liabilities (UCL) as of December 31, 2007 and prior periods. For December 31, 2007, 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 HPHC, Inc. business pays fairly quickly, the range of estimates for the December 31, 2007 UCL is narrow and the actuarial estimates are similar to HPHC, Inc.'s estimates with hindsight through September 30, 2008.

HPHC, Inc. made a separate provision for Loss Adjustment Expenses / Claim Adjustment Expenses (LAE/CAE) in 2007 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, 2007. Based upon KPMG's review, the UCL as of December 31, 2007 appears to be fairly stated.

REINSURANCE

Harvard Pilgrim carries reinsurance against excessive utilization on a per-member basis. Under its reinsurance policies, Harvard Pilgrim is reimbursed 80% of certain hospital inpatient, hospital outpatient and pharmacy claims in excess of the policy deductibles, which range from \$500,000 to \$1,000,000. Inpatient hospital, outpatient hospital and pharmacy claims are subject to additional policy sub-limits. The maximum recoverable under the reinsurance agreement is \$2,000,000 per member per lifetime. The impact of reinsurance on the financial statements is immaterial.

ACCOUNTS AND RECORDS

The books and records of the Company are audited annually by the independent certified public accounting firm of Deloitte & Touche LLP, in accordance with 211 CMR 23.00. The CPA Firm issued an unqualified opinion on the December 31, 2007 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 (Deloitte & Touche 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 Technology (IT) environment. The questionnaire was completed by the Company and reviewed by KPMG's Information Technology Advisory Services (ITAS) team, which evaluated the adequacy of the IT controls. No material deficiencies were noted.

Commonwealth of Massachusetts Division of Insurance
Report on the Statutory Examination of
HARVARD PILGRIM HEALTH CARE, INC.

The Company uses an automated general ledger system. Trial balances were traced from the general ledger and supporting documents to the 2007 Annual Statement. No material exceptions were noted.

SUBSEQUENT EVENTS

On January 2, 2008, HPHC, Inc. sold Nashua Medical Group, a wholly-owned physician practice, to an unrelated hospital group located in Southern New Hampshire. The proceeds of the sale, including the real property, were \$2.9 million and resulted in a gain of approximately \$1.1 million, which was recorded in the financial statements in 2008.

On May 14, 2008, the HPHC, Inc. Board of Directors approved a \$10 million capital contribution from HPHC, Inc. to HPHC NE.

COMMITMENTS AND CONTINGENCIES

Lease Obligations

Harvard Pilgrim has entered into several long-term non-cancelable operating leases for buildings and equipment. The terms of the leases vary through the year 2015, with options to renew through the year 2023.

The following is a schedule, by year, of future minimum rental payments required under all operating leases for buildings and equipment that have initial or remaining non-cancelable lease terms of one year or more as of December 31, 2007 (000's):

Year ending December 31	Operating Lease
2008	\$ 22,408
2009	18,106
2010	18,258
2011	16,328
2012	9,785
Balance through end of lease	\$ 22,993

Total rent expense on all leases was \$20.9 million and \$25.2 million in 2007 and 2006, respectively.

In 2007, HPHC, Inc. completed a sale-leaseback transaction of certain computer equipment and software. The assets sold had a book value of approximately \$36.4 million. There was no realized gain or loss on this transaction. The resulting lease term is for 48 months.

As lessor, HPHC, Inc. leases certain properties. The amounts due to HPHC, Inc. as of December 31, 2007 through these leases are as follows (000's):

Year ending December 31	Operating Lease
2008	\$ 2,580
2009	2,263
2010	1,910
2011	1,950
2012	1,960
Balance through end of lease	\$ 4,800

HPHC, Inc. recorded net rental income of \$2.3 million and \$2.4 million in 2007 and 2006, respectively.

Related Party Guarantee

HPHC, Inc. and its insurance affiliates, HPHC Insurance Co. and HPHC NE, participate in an intercompany Guaranty and Indemnity Agreement (“G&I Agreement”). Under the terms of the G&I Agreement, each entity guarantees the payment and performance of the others. In addition, each entity has joint and several liability for all obligations that may arise out of this G&I Agreement.

Long-Term Service Contract

HPHC, Inc. has a long-term agreement with Perot Systems Healthcare Services Corporation (“PSHS”) whereby PSHS provides information technology operations, development and claims processing services at Harvard Pilgrim facilities, under the direction of PSHS staff. Services include operational services for technology and claims operations and business project services. The agreement, which runs through 2011, calls for an annual minimum commitment of \$60.0 million, and is subject to adjustment for changes in service levels, cost management by Harvard Pilgrim and performance incentives for PSHS. In March 2008, HPHC, Inc. and PSHS extended the existing agreement through 2021 and added additional services to be performed by PSHS under similar terms.

Legal Proceedings

HPHC, Inc. is involved in legal actions in the ordinary course of business. In the opinion of management, there are no legal proceedings pending against or involving HPHC, Inc., the outcome of which is likely to have a material adverse effect upon the statutory financial statements.

FINANCIAL STATEMENTS

The Financial Statements section includes the following:

	<u>Page</u>
Statutory Statement of Assets, Liabilities and Capital & Surplus as of December 31, 2007	18
Statement of Revenue and Expenses for the Year Ended December 31, 2007	19
Capital & Surplus for the Year Ended December 31, 2007	20
Reconciliation of Capital & Surplus for the Three Year Period Ended December 31, 2007	21

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, 2007.

For Information Purposes Only

Commonwealth of Massachusetts Division of Insurance
Report on the Statutory Examination of
HARVARD PILGRIM HEALTH CARE, INC.

Harvard Pilgrim Health Care, Inc.
Statutory Statement of Assets, Liabilities and Capital & Surplus
As of December 31, 2007

	<u>Annual Statement</u>	<u>Statutory Examination Adjustment</u>	<u>Per Statutory Examination</u>
<u>ASSETS</u>			
Bonds	\$ 526,719,588	\$ -	\$ 526,719,588
Stocks:			
Preferred stocks	4,559,573	-	4,559,573
Common stocks	41,751,110	-	41,751,110
Real estate:			
Properties occupied by the company	8,377,053	-	8,377,053
Cash, cash equivalents and short-term investments	86,612,488	-	86,612,488
Receivable for securities	1,934,711	-	1,934,711
Invested assets	4,495,665	-	4,495,665
Subtotals, cash and invested assets	674,450,188	-	674,450,188
Investment income due and accrued	4,352,118	-	4,352,118
Premiums and considerations:			
Uncollected premiums and agents' balances in the course of collection	12,006,920	-	12,006,920
Amounts receivable relating to uninsured plans	35,984,443	-	35,984,443
Electronic data processing equipment and software	7,919,993	-	7,919,993
Furniture and equipment, including health care delivery assets	208,594	-	208,594
Receivables from parent, subsidiaries and affiliates	3,851,721	-	3,851,721
Health care and other amounts receivable	14,899,521	-	14,899,521
Other than invested assets	480,265	-	480,265
Total Assets	\$ 754,153,763	\$ -	\$ 754,153,763
<u>LIABILITIES</u>			
Claims unpaid	\$ 214,516,966	\$ -	\$ 214,516,966
Accrued medical incentive pool and bonus amounts	32,461,620	-	32,461,620
Unpaid claims adjustment expenses	3,081,455	-	3,081,455
Premiums received in advance	26,362,045	-	26,362,045
General expenses due or accrued	55,106,437	-	55,106,437
Amounts withheld or retained for the account of others	963,961	-	963,961
Amounts due to parent, subsidiaries and affiliates	7,687,197	-	7,687,197
Payable for securities	2,715,897	-	2,715,897
Liability for amounts held under uninsured accident and health plans	31,436,492	-	31,436,492
Other Liabilities	6,349,076	-	6,349,076
Total Liabilities	\$ 380,681,146	\$ -	\$ 380,681,146
<u>CAPITAL AND SURPLUS</u>			
Surplus notes	\$ 110,201,195	\$ -	\$ 110,201,195
Unassigned funds (surplus)	263,271,422	-	263,271,422
Total Capital and Surplus	\$ 373,472,617	\$ -	\$ 373,472,617
Total Liabilities, Capital and Surplus	\$ 754,153,763	\$ -	\$ 754,153,763

Commonwealth of Massachusetts Division of Insurance
Report on the Statutory Examination of
HARVARD PILGRIM HEALTH CARE, INC.

Harvard Pilgrim Health Care, Inc.
Statement of Revenue and Expenses
For the Year Ended December 31, 2007

	<u>Annual Statement</u>	<u>Statutory Examination Adjustment</u>	<u>Per Statutory Examination</u>
Member Months	5,315,840	-	5,315,840
Net premium income	\$2,066,256,034	\$ -	\$2,066,256,034
Fee-for-service	3,309,419	-	3,309,419
Total revenues	2,069,565,453	-	2,069,565,453
Hospital and Medical:			
Hospital/medical benefits	1,419,754,883	-	1,419,754,883
Other professional services	59,457,135	-	59,457,135
Outside referrals	30,722,320	-	30,722,320
Emergency room and out-of-area	42,014,926	-	42,014,926
Prescription drugs	229,720,760	-	229,720,760
Incentive pool, withhold adjustments and bonus amounts	28,906,488	-	28,906,488
Total hospital and medical	1,810,576,512	-	1,810,576,512
Claims adjustment expenses	106,624,226	-	106,624,226
General administrative expenses	136,765,064	-	136,765,064
Total underwriting deductions	2,053,965,802	-	2,053,965,802
Net underwriting gain	15,599,651	-	15,599,651
Net investment income earned	22,631,380	-	22,631,380
Net realized capital gains	1,337,300	-	1,337,300
Net investment gains	23,968,680	-	23,968,680
Other income (expenses)	(1,493,507)	-	(1,493,507)
Net income	\$ 38,074,824	\$ -	\$ 38,074,824

Harvard Pilgrim Health Care, Inc.
Capital & Surplus
For the Year Ended December 31, 2007

	<u>Annual Statement</u>	<u>Statutory Examination Adjustment</u>	<u>Per Statutory Examination</u>
Capital and Surplus, December 31, 2006	\$ 321,946,756	\$ -	\$321,946,756
Net income or (loss)	38,074,824	-	38,074,824
Change in net unrealized capital gains and losses less capital gains tax	1,963,578	-	1,963,578
Change in nonadmitted assets	21,202,355	-	21,202,355
Change in surplus notes	(9,714,896)	-	(9,714,896)
Net change in capital and surplus	<u>51,525,861</u>	<u>-</u>	<u>51,525,861</u>
Capital and Surplus, December 31, 2007	<u><u>\$ 373,472,617</u></u>	<u><u>\$ -</u></u>	<u><u>\$373,472,617</u></u>

For Information Purposes Only

Harvard Pilgrim Health Care, Inc.
Reconciliation of Capital & Surplus
For the Three Year Period Ended December 31, 2007

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Capital and Surplus, December 31, prior year	\$ 321,946,756	\$289,920,118	\$243,370,906
Net income or (loss)	38,074,824	68,354,069	64,983,595
Change in net unrealized capital gains and losses less capital gains tax	1,963,578	621,093	1,638,765
Change in nonadmitted assets	21,202,355	(16,657,360)	(5,236,522)
Change in surplus notes	(9,714,896)	(11,034,896)	(9,676,730)
Other gains (losses) in surplus	-	(9,256,268)	(5,159,896)
Net change in capital and surplus	<u>51,525,861</u>	<u>32,026,638</u>	<u>46,549,212</u>
Capital and Surplus, December 31, current year	<u><u>\$ 373,472,617</u></u>	<u><u>\$321,946,756</u></u>	<u><u>\$289,920,118</u></u>

ACKNOWLEDGMENT

This is to certify that the undersigned is a duly qualified Certified Financial Examiner (CFE) and that, in conjunction with KPMG LLP, the undersigned applied certain agreed-upon procedures to the accounting and corporate records of Harvard Pilgrim Health Care, 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 Harvard Pilgrim Health Care, 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