



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, 2004

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.**

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

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JULIANNE M. BOWLER
COMMISSIONER OF INSURANCE

December 30, 2005

Honorable Julianne M. Bowler
Secretary, Northeastern Zone, NAIC
Commissioner of Insurance
Division of Insurance
Commonwealth of Massachusetts
One South Station
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Honorable Alfred W. Gross
Chair, Financial Condition (E) Committee, NAIC
Commissioner, Bureau of Insurance
Commonwealth of Virginia
P. O. Box 1157
Richmond, VA 23218

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 the

HARVARD PILGRIM HEALTH CARE, INC.

at its home office located at:

93 Worcester Street
Wellesley, MA 02481

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", "Harvard Pilgrim", or "HPHC, Inc." is as of December 31, 2004, 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. Such procedures were reviewed and approved by the Commonwealth of Massachusetts Division of Insurance ("the Division" or "the DOI").

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 home office in Wellesley, 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 claim adjustment expenses and provider risk sharing settlements as of December 31, 2004. KPMG's Information Risk Management (IRM) 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 IRM Specialists performed examination procedures pertaining to the examination of the EDP System 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*.

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 Division placed reliance on certain workpapers provided by the Company's external auditors, Deloitte & Touche, LLP. Wherever possible and wherever deemed appropriate and effective, their independent work product was used to define, support, document and expedite the overall examination process.

DESCRIPTION OF COMPANY

History

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

In 1990, HPHC, Inc. acquired control of the Rhode Island Group Health Association, Inc. a Rhode Island based non-profit group practice and staff model HMO serving both Rhode Island and Southeastern Massachusetts.

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Pilgrim Health Care, Inc. (PHC), a Massachusetts not-for-profit corporation became an affiliate of HPHC, Inc. in 1995 and merged into HPHC, Inc. effective January 1, 2002. PHC had unassigned funds and surplus of \$19.2 million at December 31, 2001, which has been included in HPHC's net worth at December 31, 2001 as a result of the merger.

In January 1998, HPHC acquired control of, and became the sole corporate member of Neighborhood Health Plan, (NHP), a Massachusetts non-profit corporation that provides high quality, culturally sensitive health service to a diverse, primarily urban population, including Mass Health program (Massachusetts Medicaid) enrollees and commercial enrollees.

In May 2000, HPHC, Inc. agreed to voluntarily liquidate its affiliate Harvard Pilgrim Health Care of New England, Inc. a Rhode Island Corporation (HPNE-RI), pursuant to a Plan of Liquidation and Settlement Agreement under the supervision of the Director of Rhode Island Department of Business Regulation. Once the liquidation of HPNE-RI is complete, any remaining net assets will revert to HPHC, Inc. In May 2002, HPHC and Neighborhood Health Plan deaffiliated.

In August 2004, UnitedHealth Group (NYSE: UNH) and the Company (the companies) announced that they have agreed to form a strategic business and marketing alliance to improve service and overall value for national, self-insured customers.

Organization

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

Other not-for-profit affiliates of HPHC, Inc. during the examination period included: Harvard Pilgrim Health Care of New England, Inc., Harvard Vanguard Medical Associates, Inc. (Harvard Vanguard), the Harvard Pilgrim Health Care Foundation, Inc., Harvard Pilgrim Physicians Association, Inc. and Neighborhood Health Plan (NHP). HPHC, Inc. was the sole corporate member of NHP until the entities deaffiliated on May 3, 2002. HPHC, Inc. and Harvard Vanguard were affiliated entities until they entered into a deaffiliation agreement in August 2004.

Other for-profit affiliates of HPHC, Inc. include: HPHC Insurance Company, Inc., HPHC Holding Corporation and HPHC Insurance Agency, Inc.

Plan of Rehabilitation

Harvard Pilgrim, together with Harvard Pilgrim Health Care of New England, Inc., was placed in temporary receivership for purposes of rehabilitation in January of 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 will remain subject to administrative supervision of the Commissioner of the Massachusetts Division of Insurance for so long as the requirement of the Plan that the Commissioner give prior approval to the payment of principal and interest on the Series 1998 Bonds (the "Condition imposed under the Plan") remains in effect.

The court approved Plan also allowed Harvard Pilgrim to increase the carrying value of certain of its real estate to its fair market value as of the date of the Plan. The Plan further required the conversion to Surplus Notes of substantially all outstanding pre-receivership general unsecured obligations of Harvard Pilgrim except for obligations to members, providers and the Series 1998 Bonds. The Surplus Notes are subject to repayment only if the Commissioner approves such payments of principal and interest. The Surplus Notes carry an interest rate of 9.5% and are to be paid in equal installments over a ten-year period. The court approved Plan further required that payment of interest and principal on the Bonds be subject to the Condition. As a consequence of the Condition, the Bonds qualified for the same accounting treatment as the Surplus Notes under the Statutory Accounting Principles promulgated by the National

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Association of Insurance Commissioners. At December 31, 2004, approximately \$9.7 million of Surplus Notes and \$136.1 million of Bonds were reported as a component of net worth. Additionally, Harvard Pilgrim was required to establish a debt service reserve fund and deposit monthly one-sixth of the amount due on the next succeeding payment date, unless to do so would reduce its statutory net worth below \$130 million. Since the Plan's inception, all payments of interest and principal under the Surplus Notes and Series 1998 Bonds have been approved.

Harvard Pilgrim is required to request termination of the Condition imposed under the Plan and authority to prepay all amounts due under the Surplus Notes when it has attained an audited statutory net worth of at least \$130 million, irrespective of the net worth provided from the Bonds, and after satisfaction of all amounts due under the Surplus Notes. In 2004, Harvard Pilgrim 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.

See "Subsequent Events" section of the Examination Report which discusses the June 24, 2005 prepayment of the Surplus Notes.

Mergers / Acquisitions

See "Subsequent Events" section of the Examination Report which discusses the March 7, 2005 acquisition of Health Plans, Inc.

Capital and Surplus

As a nonprofit organization, Harvard Pilgrim does not have issued capital. In connection with the Plan of Rehabilitation, Harvard Pilgrim's outstanding amount of bonds, reduced by its \$29 million mortgage qualify to be treated as Surplus Notes under NAIC SAP and are included as a component of statutory capital and surplus (See "Plan of Rehabilitation" for further details). The total admitted assets, total liabilities and Capital and Surplus of the Company from 2002 to 2004 is shown in the following schedule.

<u>Year</u>	<u>Total Admitted Assets</u>	<u>Total Liabilities</u>	<u>Capital & Surplus</u>
2002	\$ 443,661,566	\$ 273,910,525	\$ 169,751,041
2003	547,714,153	337,149,881	210,564,272
2004	600,061,151	356,690,245	\$ 243,370,906

MANAGEMENT AND CORPORATE RECORDS

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 times 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, telegram or telecopy 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 such 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, and participation by such means shall constitute presence in person at a meeting.

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At December 31, 2004 the Board was comprised of 11 directors which is in compliance with the Company By-Laws. Directors duly elected and serving at December 31, 2004, with addresses and business affiliations, follow:

<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, MD 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
Jack T. Evjy, MD Bedford, NH	Independent Director	Oncologist, Commonwealth Hematology-Oncology, PC
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
Herman B. Leonard, Ph.D Concord, MA	Independent Director	Professor, John F. Kennedy School of Government
Edward F. McCauley Wellesley, MA	Independent Director	Retired Partner, Deloitte & Touche
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 Section 55 of Chapter 156B. 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, nominating and human resources committees with a board member as chair.

The current standing committees of the Board are as follows:

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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.

Executive Committee

There is currently no Executive Committee of the Board.

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.

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.

Nominating Committee

The Nominating 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.

Advisory Committees

None.

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, 2004 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
Joseph C. Capezza	Chief Financial Officer and Treasurer
Laura S. Peabody	Secretary and Clerk

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Subsequent to December 31, 2004 and pursuant to votes adopted at the annual meeting of the Company on May 11, 2005, the following officers were appointed to the positions indicated:

<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
Joseph C. Capezza	Chief Financial Officer and Treasurer
Laura S. Peabody	Secretary and Clerk

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/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 2004 board of directors records identified a few potential conflicts; however, none were of a financial significance.

CORPORATE RECORDS

Articles of Incorporation and Bylaws

Our review of the By-Laws and Articles of Incorporation indicated that there were no changes over the three year examination period.

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. Activities of the committees were reported upon at various meetings of the Board.

ACQUISITIONS, MERGERS, DISPOSALS, DISSOLUTIONS AND PURCHASES OR SALES

See 'Organization' and 'Plan of Rehabilitation' on page 5.

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

Subsidiaries and Affiliated Companies

Harvard Pilgrim Health Care of New England, Inc. (New England)

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

HPHC Insurance Company, Inc. (The Insurance Company)

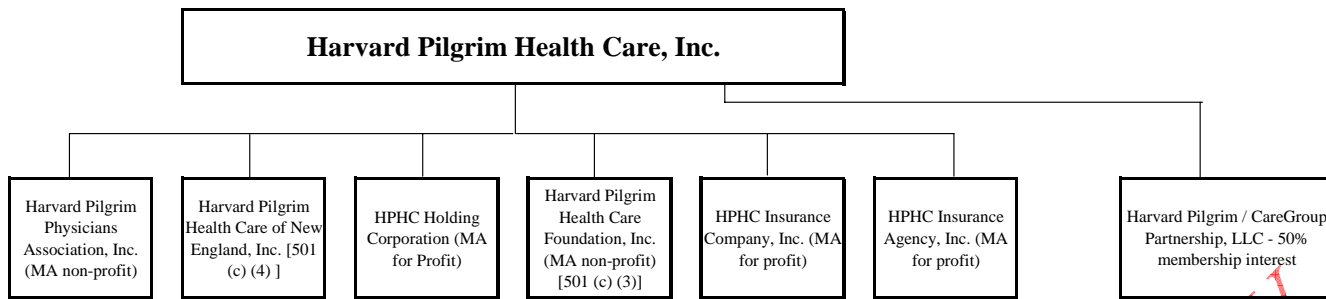
The Insurance Company, formerly known as Harvard Pilgrim Insurance Company, Inc. is a wholly-owned, for-profit subsidiary of HPHC, Inc. The Insurance Company was incorporated on September 27, 1991 and commenced underwriting accident and health risks on January 1, 1992. The Insurance Company underwrites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

HPHC, Inc. conducts transactions with a number of affiliates. Below are descriptions of the transactions:

- HPHC, Inc. provides all administrative and operational management services to New England and The Insurance Company. Administrative expenses are allocated to New England and The Insurance Company based on HPHC's departmental cost allocation methodology.
- As part of the deaffiliation agreement between HPHC, Inc. and Harvard Vanguard, HPHC, Inc. relinquished the right to appoint Trustees of Harvard Vanguard. As a result, HPHC, Inc. no longer has a role in the governance of Harvard Vanguard. The agreement also contained other provisions, mainly operational in nature, which had to be satisfied for the agreement to be finalized. One of the provisions included Harvard Vanguard providing collateral for referral expenses.
- HPHC, Inc. and Harvard Vanguard still conduct a number of transactions as follows:
 - A note receivable from Harvard Vanguard of \$2.1 million and \$3.9 million at December 31, 2004 and 2003, respectively. The note is non-interest bearing with quarterly payments and matures on March 31, 2006.
 - Other amounts receivable from Harvard Vanguard of \$5.6 million and \$9.1 million at December 31, 2004 and 2003, respectively, for operating items such as pharmacy, insurance and medical management fees.
 - Letter of credit from Harvard Vanguard, as well as three other provider groups affiliated with Harvard Vanguard (collectively, the "provider organizations") to collateralize their obligation to HPHC, Inc. for referral claim expenses incurred by these organizations but paid for by HPHC, Inc.. The amount of the letter of credit is determined based upon the collateral agreement among HPHC, Inc. and the provider organizations and is based upon both the referral expenses paid by HPHC, Inc. on behalf of the provider organizations and the referral expenses incurred by the provider organizations but not yet paid by HPHC, Inc. (i.e. incurred but not reported claims). At December 31, 2004, the total letters of credit were \$23.6 million. HPHC, Inc. did not draw funds from this letter of credit during 2004.

A summary of ownership and relationship of the Company and its subsidiaries and affiliated companies as of December 31, 2004 is illustrated below:

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RELATED PARTY TRANSACTIONS

- New England has no employees and, accordingly, HPHC, Inc. provides all administrative services to New England including premium collection, claims payments, and operational management. New England has a Management and Medical Services Agreement (MMSA) with HPHC, Inc., which provides for an allocation of hospital and medical and administrative costs from HPHC, Inc. to New England. Hospital and medical expenses are charged based on the actual incurred claims experience of New England. Administrative expenses are charged to New England based on Harvard Pilgrim's departmental cost allocation methodology. For the years ended December 31, 2004 and 2003, total administrative and claims adjustment expenses charged to New England were \$18.9 million and \$15.1 million, respectively. At December 31, 2004, New England had a net payable to HPHC, Inc. of \$0.6 million and at December 31, 2003, New England had a net receivable from HPHC, Inc. of \$0.9 million, related to administrative services provided.
- The Insurance Company has no employees, and accordingly, HPHC, Inc. provides all administrative services to The Insurance Company, including premium collection, claims payments, and operational management. Administrative and claim adjustment expenses are charged to The Insurance Company based on Harvard Pilgrim's departmental cost allocation methodology. For the years ended December 31, 2004 and 2003, total administrative and claims adjustment expenses charged to The Insurance Company by Harvard Pilgrim were \$3.6 million and \$2.3 million, respectively. At December 31, 2004, The Insurance Company had a net payable to HPHC, Inc. of \$155,549 and at December 31, 2003, The Insurance Company had a net receivable from HPHC, Inc. of \$1,548,831 related to administrative services provided.

FIDELITY BOND AND OTHER INSURANCE

The Company maintains fidelity bond coverage with an authorized Massachusetts insurer, consistent with Massachusetts General Laws, Chapter 175 § 60. The aggregate limit of liability exceeds the NAIC suggested minimum.

The Company has further protected its interest and property by acquiring policies of insurance covering other insurable risks. All coverage, including its Directors and Officers Liability policy, is provided by insurers licensed in the Commonwealth of Massachusetts and was in force as of December 31, 2004.

PENSION AND INSURANCE PLANS

Employees' Retirement Plan

All eligible employees of the Company may participate in a defined contribution retirement plan which provides contributions to a fund held in trust by a corporate fiduciary. HPHC, Inc. matches 100% of the first four percent, subject to the legally permitted maximum. HPHC, Inc. also makes an annual contribution of four percent of pay to each participant's account regardless of whether the employee makes salary deferral contributions or not.

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Employees' Postretirement Medical Plan

HPHC, Inc.'s postretirement medical plan allows employees who have attained age 60 and completed ten years of continuous service to remain in HPHC, Inc.'s group health care coverage upon retirement and until they qualify for Medicare coverage. The retired employee will pay 100% of the monthly premium prior to reaching the age of 65. Once they reach age 65 and enroll in both Medicare A and B, HPHC, Inc. will provide a maximum monthly contribution of \$150 to each retiree (and spouse, if applicable) provided the employee is transitioning from an active HPHC employee medical plan. The plan is not currently funded.

SPECIAL DEPOSITS

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

Description of Deposit	Where Deposited	Par or Book Value	Statement Value	Market Value
FNMA Callable 5% 1/23/2014 JJ23	McDonald Investments, Portland, ME – State of Maine Reserve	\$ 1,500,000	\$ 1,500,000	\$ 1,500,750
U.S. Treasury Note 2 ½ % 5/31/06 MN31	State Street Corporation, Boston, MA – Custodian For Commonwealth of Massachusetts Insurance Division	500,000	497,794	497,130
U.S. Treasury Note 2 ½ % 5/31/06 MN31	State Street Corporation, Boston, MA – Custodian For Commonwealth of Massachusetts Insurance Division	500,000	499,504	498,440
SEI UST Daily Income Fund	U.S. Trust Company, Boston, MA – State of Rhode Island Department of Training and Development	535,172	535,172	535,172
		<u>\$ 3,035,172</u>	<u>\$ 3,032,470</u>	<u>\$ 3,031,492</u>

LINES OF BUSINESS/OPERATION

Harvard Pilgrim is headquartered in Wellesley, Massachusetts and operates most of its customer service and claims processing functions from its offices in Quincy, Massachusetts.

Harvard Pilgrim and its affiliates offer a variety of plan choices, including a health maintenance organization (HMO), a point-of-service (POS) and preferred provider organization (PPO) plan. They also feature a plan for Medicare beneficiaries, called First Seniority.

As of December 2004, Harvard Pilgrim provided care and coverage to approximately 800,000 members through its provider network. The extensive network includes 20,000 physicians and 135 hospitals. Their physicians practice in a variety of settings — including individual practices, small medical groups and large multi-specialty groups.

PRODUCTS

Harvard Pilgrim or its affiliates (together referred to as “Harvard Pilgrim in this section) provides the following managed care or indemnity products.

HMO – the HMO product is available through employers in Massachusetts, New Hampshire and Maine. 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 some benefits packages, prescription drug coverage may also be 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 copayments, which eliminates the administrative burden of bills or claim forms.

POS - the POS plan is available through employers in Massachusetts, New Hampshire and Maine. 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 some benefits packages, prescription drug coverage may also be included. Under the POS Plan, members choose a primary care physician (PCP) who provides or arranges in-network care, but they may also receive care from out-of-network providers, including specialists, without their PCP's 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.

PPO – the PPO plan is available through employers in Massachusetts, New Hampshire and Maine. 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 some benefits packages, prescription drug coverage may also be 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 those who don't. 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 generally subject to deductibles and coinsurance.

ASO – Harvard Pilgrim administers employee health benefits for certain self-insured employer groups under various administrative services only (ASO) contracts wherein it 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.

Nongroup – Harvard Pilgrim offers Non-group coverage options within Massachusetts, New Hampshire and Maine for qualifying participants. In order to qualify for Massachusetts non-group coverage, the participant must be a Massachusetts resident who is not enrolled in Medicare or Medicaid. The Company offers two plans for qualifying participants- the Standard Option and the Low Option. The difference between the two is primarily in costs and pharmacy benefits. The Standard Option includes prescription drug benefits, while the Low Option does not. The Low Option has a lower premium but higher out-of-pocket expenses. In New Hampshire, Harvard Pilgrim offers conversion nongroup coverage. In Maine, Harvard Pilgrim offers two HMO non-group plans – Standard A and Standard B.

Best Buy – this option is available through employers in Massachusetts, New Hampshire and Maine. Harvard Pilgrim Best Buy plans have many of the same features as traditional HMOs, POS plans and PPO's, but offer lower premiums, which is due in part to additional cost-sharing features like deductibles, coinsurance or higher co-payments for certain services.

Best Buy HSA PPO – Harvard Pilgrim offers a Health Savings Account (HSA) qualified high deductible PPO health plan. The Best Buy HSA PPO may help members save money on their annual premium and put money aside in a Health Savings Account to help offset medical costs.

First Seniority – First Seniority is a Medicare Advantage health plan from Harvard Pilgrim Health Care and Harvard Pilgrim Health Care of New England for people who are on or entitled to Medicare. First Seniority offers more benefits than original Medicare and costs less than some Medicare supplemental plans.

Medicare Enhance – Harvard Pilgrim offers a Medicare Plan to retirees of Massachusetts employers that complements a subscriber's Medicare coverage.

PROVIDER CONTRACTS

The Company arranges for the provision of health care services to its subscribers and eligible dependents thereof through contracts with Provider Groups and other health care providers. Provider Groups 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, participating hospitals and physicians are reimbursed under a variety of arrangements including risk incentive agreements whereby favorable and unfavorable claims experience is shared. Payments to participating physicians for medical claims are generally subject to a percentage withhold by the Company. Distribution of such withhold is contingent upon the results of the risk incentive arrangements. Certain physician groups are paid capitation and assume full risk for providing hospital and medical services for these members.

Participating hospitals and physicians are also reimbursed on a fee for service basis and can be eligible for bonuses based on meeting prescribed quality performance measures.

RESERVES

In conjunction with KPMG's examination of the statutory financial statements of the Company, KPMG was engaged by the Division to review the adequacy of the Unpaid Claim Liability (UCL) of the Company as of December 31, 2004.

KPMG actuaries prepared independent estimates of the unpaid claim liabilities for several periods prior to July 2005 based on the data provided. For December 31, 2004, completion factors for the projection of ultimate incurred claims were developed using historical payment patterns and actuarial judgment. The "last 6" methodology was used in developing completion factors for the "Mid" estimate. The methodology considers the prior six months of claims payment patterns in calculating completion factors. This is among accepted methodologies that are widely used for calculating completion factors. "Low" and "High" estimates were developed by adjusting completion factors to reflect slightly faster and slower payment speeds. As the Company pays quickly, the range of estimates for the December 31, 2004 UCL is narrow and KPMG's estimates are similar to the Company's estimates with hindsight through July 31, 2005.

Based upon KPMG's review, the Unpaid Claims Liability at December 31, 2004 appears to be fairly stated in all material respects. The Company made a separate provision for Claim Adjustment Expenses (LAE/CAE) in 2004 in accordance with standard actuarial practice. The method used is reasonable, and results have been consistent from year to year. The resulting expense percentage levels used are within industry norms.

REINSURANCE

Harvard Pilgrim carries reinsurance against excessive utilization on a per-member basis. Under policies, Harvard Pilgrim is reimbursed 90% of certain hospital inpatient, hospital outpatient and pharmacy claims over the policy deductibles, which range from \$150,000 to \$500,000. Inpatient hospital claims are subject to Maximum Daily Allowance. Outpatient hospital and Pharmacy claims are subject to additional policy sub-limits. The maximum recoverable under the reinsurance agreement is \$2,000,000 for each member per year.

For 2004, the annual reinsurance premium paid was \$360,000 and the reinsurance recoveries were approximately equal to the premium. There were no reinsurance recoverables at year end December 31, 2004.

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 43.14. The CPA Firm issued an unqualified opinion on the December 31, 2004 audited financial statements. The Company is also subject to review by an internal audit department.

The internal controls structure was discussed with management through questionnaires and through a review of the work performed by the Company's independent certified public accountants. No material deficiencies were noted. 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 EDP systems environment. The questionnaire was completed by the Company and reviewed by KPMG's Information Risk Management (IRM) team that evaluated the adequacy of the EDP 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 2004 Annual Statement. No material exceptions were noted.

The Company has an internal audit department, including staff experienced in financial and information systems audits, who perform periodic audits of the Company's systems, controls and operational processes. KPMG reviewed the Internal Audit reports issued during the period under examination, and considered the results of the audits and, where appropriate, relied on the results during the application of the agreed-upon procedures.

SUBSEQUENT EVENTS

February 14, 2005 – The board of directors of HPHC Insurance Company, Inc. (The Insurance Company) authorized the issuance of a stock dividend to Harvard Pilgrim Health Care, Inc., the sole stockholder of The Insurance Company, of 12,000 shares of common stock at a par value of \$50 per share. This transaction had no impact on total capital and surplus.

February 18, 2005 – The Company selected the United technology platform, developed by UnitedHealth Group, to replace the Company's current core administrative system. The Company believes that the United technology platform provides one of the most flexible and powerful benefits administration and claims processing systems in the country, and its implementation will significantly reduce the Company's projected costs over the life of the agreement. Following an 18-month planning and development period, migration to the new platform is expected to begin in 2007 and will be phased in over approximately three years.

March 7, 2005 - Harvard Pilgrim acquired Health Plans, Inc. (HPI), a third-party administrator located in Massachusetts, for cash plus additional future cash consideration, provided that HPI meets certain profitability targets. The majority of the purchase price will be attributed to goodwill. HPI provides health, dental and short-term disability benefits administration to approximately 80,000 members in Massachusetts, New Hampshire and Maine.

June 24, 2005 – The Massachusetts Division of Insurance approved prepayment in full, as of June 30, 2005, of all Surplus Notes issued by Harvard Pilgrim Health Care, Inc. and Harvard Pilgrim Health Care of New England, Inc. (collectively "HPHC"), to General Unsecured Creditors pursuant to 79(a) of the HPHC Plan of Rehabilitation. As of June 30, 2005 the Surplus Notes were paid in full. – See "Plan of Rehabilitation" section of the Examination Report.

COMMITMENTS AND CONTINGENCIES

Legal Proceedings

The Company is involved in litigation incidental to its business. Management and legal counsel believe that the results of such proceedings, in the aggregate, will not have a material adverse effect on its operations or financial position.

For Information Purposes Only

FINANCIAL STATEMENTS

The Financial Statement section includes the following:

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Statutory Statement of Assets, Liabilities, and Capital & Surplus as of December 31, 2004	20
Analysis of Assets Exhibit as of December 31, 2004	21
Statement of Revenue and Expenses for the Year Ended December 31, 2004	22
Capital and Surplus As of December 31, 2004	23

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, 2004.

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, 2004**

	<u>Annual Statement</u>	<u>Statutory Examination Adjustment</u>	<u>Per Statutory Examination</u>
<u>ASSETS</u>			
Bonds	\$ 415,622,489	\$ -	\$ 415,622,489
Stocks:			
Common stocks	9,663,565	-	9,663,565
Real estate:			
Properties occupied by the company	23,611,863	-	23,611,863
Cash, cash equivalents and short-term investments	60,441,478	-	60,441,478
Other invested assets	1,070,916	-	1,070,916
Receivable for securities	139,889	-	139,889
Aggregate write-ins for invested assets - Deposits	4,663,264	-	4,663,264
Subtotals, cash and invested assets	515,213,464	-	515,213,464
Investment Income due and accrued	3,108,963	-	3,108,963
Premiums and Considerations:			
Uncollected premiums and agents' balances in course of collection	13,196,251	-	13,196,251
Amounts receivable relating to uninsured plans	25,315,538	-	25,315,538
Electronic data processing equipment and software	3,900,954	-	3,900,954
Furniture and equipment	7,711,329	-	7,711,329
Receivables from parent, subsidiaries and affiliates	1,371,642	-	1,371,642
Health care receivables	24,204,227	-	24,204,227
Aggregate write-ins for other than invested assets	6,038,783	-	6,038,783
Total Assets	\$ 600,061,151	\$ -	\$ 600,061,151
<u>LIABILITIES</u>			
Claims unpaid	\$ 154,597,037	\$ -	\$ 154,597,037
Accrued medical incentive pool and bonus amounts	62,522,071	-	62,522,071
Unpaid claims adjustment expenses	2,536,799	-	2,536,799
Premiums received in advance	52,824,883	-	52,824,883
General expenses due or accrued	45,205,067	-	45,205,067
Amounts withheld or retained for the account of others	1,539,362	-	1,539,362
Amounts due to parent, subsidiaries and affiliates	2,026	-	2,026
Payable for securities	14,218,655	-	14,218,655
Liability for amounts held under uninsured accident and health plans	14,741,235	-	14,741,235
Aggregate write-ins for other liabilities	8,503,110	-	8,503,110
Total Liabilities	\$ 356,690,245	\$ -	\$ 356,690,245
<u>CAPITAL & SURPLUS</u>			
Surplus notes	\$ 9,676,730	\$ -	\$ 9,676,730
Other Surplus Notes	136,110,884	-	136,110,884
Unassigned funds (surplus)	97,583,292	-	97,583,292
Total Capital and Surplus	\$ 243,370,906	\$ -	\$ 243,370,906
Total Liabilities, Capital and Surplus	\$ 600,061,151	\$ -	\$ 600,061,151

**Commonwealth of Massachusetts Division of Insurance
REPORT ON THE STATUTORY EXAMINATION OF
HARVARD PILGRIM HEALTH CARE, INC.**

**Harvard Pilgrim Health Care, Inc.
Analysis of Assets Exhibit
As of December 31, 2004**

	Assets	Nonadmitted Assets	Net Admitted Assets	Statutory Examination Adjustment	Per Statutory Examination
<u>ASSETS</u>					
Bonds	\$ 415,622,489	\$ -	\$ 415,622,489	\$ -	\$ 415,622,489
Stocks:					
Common stocks	9,663,565	-	9,663,565	-	9,663,565
Real estate:					
Properties occupied by the company	29,008,415	5,396,552	23,611,863	-	23,611,863
Cash, cash equivalents and short-term investments	60,441,478	-	60,441,478	-	60,441,478
Other invested assets	1,070,916	-	1,070,916	-	1,070,916
Receivable for securities	139,889	-	139,889	-	139,889
Aggregate write-ins for invested assets - Deposits	4,663,264	-	4,663,264	-	4,663,264
Subtotals, cash and invested assets	520,610,016	5,396,552	515,213,464	-	515,213,464
Investment Income due and accrued	3,108,963		3,108,963	-	3,108,963
Premiums and Considerations:					
Uncollected premiums and agents' balances in the course of collection	13,550,286	354,035	13,196,251	-	13,196,251
Amounts receivable relating to uninsured plans	25,315,538	-	25,315,538	-	25,315,538
Electronic data processing equipment and software	36,898,809	32,997,855	3,900,954	-	3,900,954
Furniture and equipment	14,024,101	6,312,772	7,711,329	-	7,711,329
Receivables from parent, subsidiaries and affiliates	1,371,642		1,371,642	-	1,371,642
Health care receivables	26,930,865	2,726,638	24,204,227	-	24,204,227
Aggregate write-ins for other than invested assets	11,167,855	5,129,072	6,038,783	-	6,038,783
Total Assets	\$ 652,978,075	\$ 52,916,924	\$ 600,061,151	\$ -	\$ 600,061,151

**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, 2004**

	Annual Statement	Statutory Examination Adjustment	Per Statutory Examination
<i>Member Months</i>	6,695,848		6,695,848
Net premium income	\$ 2,100,391,818	\$ -	\$ 2,100,391,818
Fee-for-service	1,312,860	-	1,312,860
Total Revenues	2,101,704,678	-	2,101,704,678
Hospital and Medical:			
Hospital/medical benefits	1,435,825,141	-	1,435,825,141
Other professional services	46,591,147	-	46,591,147
Outside referrals	44,303,088	-	44,303,088
Emergency room and out-of-area	34,093,976	-	34,093,976
Prescription drugs	203,307,530	-	203,307,530
Incentive pool, withhold adjustments and bonus amounts	83,412,825	-	83,412,825
Subtotal	1,847,533,707	-	1,847,533,707
Less:			
Net reinsurance recoveries	6,002,295	-	6,002,295
Total hospital and medical	1,841,531,412	-	1,841,531,412
Claims adjustment expenses	113,020,809	-	113,020,809
General administrative expenses	125,429,047	-	125,429,047
Total underwriting deductions	2,079,981,268	-	2,079,981,268
Net underwriting gain	21,723,410	-	21,723,410
Net investment income earned	13,710,884	-	13,710,884
Net realized capital gains	775,338	-	775,338
Net investment gains	14,486,222	-	14,486,222
Miscellaneous and Other Income	(2,016,149)	-	(2,016,149)
Net Income	\$ 34,193,483	\$ -	\$ 34,193,483

Commonwealth of Massachusetts Division of Insurance
REPORT ON THE STATUTORY EXAMINATION OF
HARVARD PILGRIM HEALTH CARE, INC.

Harvard Pilgrim Health Care, Inc.
Capital and Surplus
As Of December 31, 2004

	<u>Annual Statement</u>	<u>Statutory Examination Adjustment</u>	<u>Per Statutory Examination</u>
Capital and Surplus, December 31, 2003	\$ 210,564,272	\$ -	\$ 210,564,272
Net income	34,193,483	-	34,193,483
Net unrealized capital gains and losses	1,262,943	-	1,262,943
Change in nonadmitted assets	3,991,443	-	3,991,443
Change in surplus notes	(1,686,343)	-	(1,686,343)
Series 1998 Bonds Payment - Other surplus notes	(4,954,892)	-	(4,954,892)
Net change in capital and surplus	32,806,634	-	32,806,634
Capital and Surplus, December 31, 2004	<u>\$ 243,370,906</u>	<u>\$ -</u>	<u>\$ 243,370,906</u>

For Information Purposes Only

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 the 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 National Association of Insurance Commissioners (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 Smallwood, CFE
Chief Examiner & Examiner in Charge (EIC)
Commonwealth of Massachusetts
Division of Insurance
Boston, MA

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