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Conference Call Transcript

WLP - Q2 2005 WellPoint, Inc. Earnings Conference Call

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CORPORATE PARTICIPANTS

Tami Durle
WLP - VP IR

Larry Glasscock
WLP - President and CEO

Dave Colby
WLP - CFO

CONFERENCE CALL PARTICIPANTS

Josh Raskin
Lehman Brothers - Analyst

Matthew Borsch
Goldman Sachs - Analyst

John Rex
Bear Stearns - Analyst

Charles Boorady
Smith Barney - Analyst

Patrick Hojlo
Credit Suisse - Analyst

Christine Arnold
Morgan Stanley - Analyst

Scott Fidel
JP Morgan - Analyst

Doug Simpson
Merrill Lynch - Analyst

Joe France
Bank of America - Analyst

Ellen Wilson
Sanford Bernstein - Analyst

Ed Troll
SG Cowen - Analyst

Norman Fidel
Alliance Capital - Analyst

Carl McDonald
CIBC - Analyst

Tom Carroll
Legg Mason Wood Walker, Inc. - Analyst

Peter Costa
FTN Midwest Securities - Analyst

PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by and welcome to the WellPoint, Inc. Quarterly Results Conference Call. At this time, all participants are in a listen-only mode. Later there will be an opportunity for questions and comments. Instructions will be given at that time. If

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you should require any assistance during today's call, please press star then zero and an AT&T operator will assist you. As a reminder, this conference is being recorded.

I would now like to turn the conference over to the management team. Please go ahead.

Tami Durle - ***WLP - VP IR***

Good morning and welcome to WellPoint's Second Quarter Earnings Conference Call. I'm Tami Durle, Vice President of Investor Relations, and with me are Larry Glasscock our President and Chief Executive Officer as well as Dave Colby our Chief Financial Officer. Larry will begin this morning's call with an overview of our second quarter performance, followed by Dave, who will review our financials and discuss our financial outlook for the rest of 2005.

We will be making some forward-looking statements on this call. Listeners are cautioned that these statements are subject to certain risks and uncertainties, many of which are difficult to predict and generally beyond the control of WellPoint. These risks and uncertainties can cause actual results to differ materially from our current expectations. We advise listeners to review the risk factors discussed in our press release this morning and in periodic filings we make with the SEC.

In addition, our discussion will include non-GAAP financial measures, such as comparable basis information as defined under the SEC rules. As required by the rules, a reconciliation of those measures to the most comparable GAAP measure is available on our website at www.wellpoint.com. And as a reminder, throughout our discussion today, per share numbers have been adjusted for our 2 for 1 stock split that occurred in May.

And I will now turn the call over to Larry Glasscock.

Larry Glasscock - ***WLP - President and CEO***

Good morning and thank you Tami. I appreciate it very much. We are very pleased to report an outstanding second quarter of 2005, the second full quarter of our combined Company following the merger with WellPoint Health Networks on November 30, 2004.

In the second quarter, WellPoint reported GAAP net income of $0.90 per diluted share. This is the 15th consecutive quarter, every quarter since our IPO, that we have met or exceeded our guidance. These results included a $0.10 per share charge related to an agreement resolving two national multi-district lawsuits with physicians.

In the agreement, we agreed to pay $135 million to physicians and to contribute $5 million to a not-for-profit foundation whose mission is to promote higher quality healthcare and to enhance the delivery of care to the disadvantaged and underserved. In addition, up to $58 million will be paid in legal fees as determined by the court. This $198 million expected cash payment resulted in a pre-tax charge of $103 million in the second quarter. The agreement still needs to be approved by the court and a fairness hearing is scheduled for December 2nd of this year.

We see this agreement as a very important step in further collaborating with physicians. By working together, we can find ways to continuously improve our members' health and find real solutions to the most complex health issues facing our country today, including affordability of care, access to care, and the uninsured.

Let me turn to revenues. Operating revenue totaled $11.1 billion in the quarter, a 146% increase year-over-year and an 8% increase on a comparable basis. Comparable basis information throughout our discussions today has been calculated by adding the historical information for the former Anthem, Inc. and the former WellPoint Health Networks, Inc. The comparable revenue increases I've mentioned were driven by membership growth as well as disciplined pricing.

Our enrollment has increased by 4% from year-end and now exceeds 28.8 million medical members, as we added 322,000 members in the second quarter. Our membership has increased by almost 1.6 million members or 6% on a comparable basis from June 30, 2004. Every single region contributed to this growth, with increases ranging from 3% in the Northeast region to 9% in the West.

We are working on numerous initiatives to provide our customers with more solutions to meet their healthcare needs. Just in June of this year, we acquired Lumenos, a pioneering company in consumer-directed health plans, which added 177,000 members to our enrollment. The Lumenos

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acquisition positions our Company as a leader in consumer-driven healthcare products. It will enable us to offer online tools and information to drive healthcare consumerism and will strengthen our portfolio of products.

We will continue to help consumers take an active role in their healthcare and well-being, and plan to infuse elements of consumerism throughout our product portfolio. Almost 3-quarters of our national account RFP's this year have asked about our consumer-directed health plan capabilities. We believe we have purchased the ideal platform to demonstrate value-added services that will differentiate us from our peers.

From a business mix perspective, at June 30, 2005, approximately 51% of our membership was fully insured, while 49% was self-funded. On a comparable basis at June 30, 2004, about 47% of our business was self-funded. The trend toward more self-funded business is continuing and is due to our success in attracting more national accounts and other large employers who generally self-insure their claims exposure.

We've had an excellent membership growth over the last year, and we are continuing to develop new products to keep our membership growing. We saw increases on a comparable basis for each customer type as groups continue to be attracted by our large networks, attractive discounts, and distinctive customer service for which we are known.

Our 2006 national account selling season is well underway, and the competitive landscape is similar to last year's. We are seeing continued interest on the part of employers to find ways to reduce healthcare costs. This includes network solutions, discount assessments, consumer-directed health programs, and an increasing focus on disease and case management.

Our merger and the concerted efforts to implement best practices across our larger Company has strengthened our position in the national account market. National accounts are now defined as having 5,000 or more lives, with at least 5% of those lives outside of the headquarter state. We are finalizing a consistent product portfolio across the enterprise and are rolling out additional product enhancements for January 1, 2006.

Over the past 12 months, our national account business added over 700,000 members or 10% on a comparable basis, and has been the single largest driver of our membership growth. We continue to expect good national account growth as we already have several new national account wins for January 1, 2006.

Groups of more than 50 but fewer than 5,000 employees are included in our large group segment, and this membership increased by almost 500,000 or 4% on a comparable basis over the past 12 months. We are continuing to develop and expand new products and more cost-effective networks for this market.

In June, we began marketing our new HMO Select Limited Network product for large groups in the Denver metropolitan area. This product will offer lower prices due to a limited network of lower cost hospitals and physicians with good clinical outcomes.

Individual and small group business, or ISG as we refer to it, added over 250,000 members, growing by 5% on a comparable basis over the past 12 months. Significant progress was made during the quarter in expanding successful ISG sales and marketing practices throughout WellPoint. We implemented new regional sales management structure in Colorado and Nevada. This structure, which has been in existence in California, better meets the needs of agents and brokers who specialize in ISG business.

We also established a sales support team to telephonically assist agents with their sales. In addition, processes in underwriting were streamlined, significantly reducing application turnaround time. We continue in this market to focus on introducing affordable, innovative plans that meet the needs of different segments in the individual and small group market, including the uninsured.

We launched a new line of lower-cost plans called Basic Choice in Texas, Illinois, and other selected states that are designed to provide coverage for basic healthcare benefits. The plan should particularly appeal to groups in the service industry that often have employees who are among the working uninsured. These lower cost benefits are not intended to replace the traditional health plans the employers already have in place. Basic Choice is targeted to service-oriented physicians where employees are not eligible for the company's benefits or can't afford the company's standard benefits program. These plans have annual benefit maximums ranging up to $100,000, can supplement existing options, and gives employers the means to provide an affordable option to employees who would not otherwise have healthcare coverage.

The DirigoChoice program let me refer to. That was introduced, as you know, in January of this year in response to the state of Maine's initiative to reduce the uninsured population, and that program continues to grow. It is targeted at small groups and individual members, and over 40% of the applicants to date had no prior insurance.

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By providing more attractive and affordable options to individuals as well as small groups, we can reduce the number of uninsured Americans while continuing our goal of profitable growth. In the first half of this year we have provided new individual policies to approximately 188,000 people who had previously been uninsured. This is a very significant contribution to addressing this issue, and we are continuing our efforts to reach uninsured Americans with affordable coverage.

We are also focused on becoming easier to do business with for small employers. A redesigned small group employer portal, Employer Access, will be launched next month. The new look and feel offers improved usability with more intuitive navigation. The improved technology not only enhances the customer experience but also streamlines processes allowing for better efficiency. This launch, we believe, is just another example of the new WellPoint successfully integrating the best practices of Legacy Anthem and Legacy WellPoint.

Our state sponsored business, i.e. Medicaid and SCHIP, increased by about 85,000 members or 5% on a comparable basis over the last year, and we expect to see continued growth here. This quarter, we received 2 MediCal contracts for California's Riverside and San Bernardino Counties and have a potential to enroll an additional 90,000 members in 2006. The Texas Health and Human Services Commission also granted us a contract for the Children's Health Insurance program and the temporary assistance for needy families' population in the Dallas service area effective July 1, 2006. We expect to gain around 20,000 members from this contract.

We were disappointed to learn that we were not awarded any of the Medicaid contracts that were announced last week in Georgia. While we passed the technical screens, we lost on price. We will continue to remain disciplined in all of our customer segments to bid only at prices which will allow us to achieve margins that are both reasonable and, importantly, sustainable. We hope to be able to service Georgia in future years.

Other states are increasingly facing budget pressures with their Medicaid programs, which is creating additional managed care opportunities. Several states are considering expanding or adding managed care to their Medicaid programs including Ohio, Indiana, South Carolina, Colorado, Wisconsin, Florida, Missouri, and Kentucky. Our experience is that managed Medicaid is beneficial for recipients who receive better care and medical outcomes, for the state due to cost savings, and for WellPoint as a profitable business unit.

We are also proud to note that John Monahan, our Senior Vice President in charge of State Sponsored programs, was appointed to the Medicaid Advisory Commission by Secretary of Health and Human Services, Michael Leavitt. The commission was established to identify reforms to modernize, strengthen and stabilize Medicaid to better serve its beneficiaries in a financially sustainable way.

In addition to Medicaid, we also view the Medicare market as an attractive growth opportunity in the coming years, as Joan Herman explained on our last earnings conference call. We see the growing senior market as an opportunity, particularly as the baby-boomers age. We expect increasing demand for choice among seniors and will continue to offer a variety of plans to accommodate these choices.

Beginning this month, we are offering Smart Value, a new Medicare Advantage health plan, to Medicare beneficiaries in 80 Georgia counties. Smart Value is a private fee-for-service health product that provides not only the coverage available under traditional Medicare, but adds preventative benefits such as routine physical exams, vision services, and certain types of eye ware. Next month we will begin offering Medicare preferred PPO policies to Medicare beneficiaries in the greater Richmond and Williamsburg/Newport News areas of Virginia.

As we noted on our last call, we have filed to offer Medicare Part D nationwide. We expect to offer it on both a standalone basis and as part of our Medicare Advantage offerings. In addition, we are working with numerous employers to address their Part D needs for retirees. Medicare Part D formularies have been approved by CMS. We expect CMS approval of benefits and rates in early September. We will be able to better estimate potential 2006 membership after we know more about our competitive position.

In addition to the growth opportunities presented by our medical products, we are continuing to build deeper relationships with customers by selling our specialty products. Customers are attracted to our state-of-the-art PBM that includes excellent drug discounts, mail-order facilities, and market-leading tools to assist our clients in predicting and managing medical trends through the effective use of pharmaceuticals.

Last week, we opened our specialty drug pharmacy in Mason, Ohio, named Precision Rx Specialty Solutions. This gives us a distinct advantage in managing our members with conditions like multiple sclerosis, hepatitis C, and cancer that utilize specialty drugs. Specialty pharmacy drugs comprise 4 to 5% of our medical spend a day. It is a rapidly growing component of our trend. We are in the process of rewriting our customer and provider contracts to enhance our specialty pharmacy efforts and are implementing a specialty pharmacy formulary.

In addition to the specialty pharmacy, we have a portfolio of member-empowering generic pharmacy initiatives. We've talked about these before. They help protect healthcare affordability and member safety. Our Prilosec OTC program is now up and running in Georgia and California and Virginia will begin next month with other WellPoint brands and geographies to follow. 2 million sample pills were distributed to 5,000 high-

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volume prescribing physicians in California for the launch. The Prilosec OTC discount program allows members, with their doctor's consent, to access a 90-day supply of Prilosec OTC for $16, considerably less than their prescription drug co-payment.

Trend for this class of drugs is continuing to decline. In addition, generic uses up to 53% due to our Generic Select and Make the Move to Generic programs. We believe there are additional opportunities to increase generic penetration.

Cholesterol-lowering drugs represent one of our highest drug expenditures at about 9% of our total drug spend. We have increased our use of generic Mevacor from 0% in 2001 to 15% today. Our success with generic Mevacor will be applied to generic Zocor in June of 2006 when it will become available as a generic. Maximizing generic Zocor use after June 30, 2006, will help make healthcare more affordable. In preparation for generic Zocor, member and provider communications are already underway.

We are also expanding other specialty programs including our dental and our vision program. A national dental PPO network is now available for Legacy Anthem markets, which increases access from 14,000 dental providers to over 60,000 dental providers nationwide.

Blue View is our new proprietary vision plan with a national network that is now available in California. Blue View offers a range of plan options that best meet the needs of employers and employees.

Our Behavioral Health business is also growing. Beginning October 1st of this year, Behavioral Health Services previously provided to our Georgia operations by an outside vendor will be provided in-house by our behavioral health company. This will add approximately 1.8 million Behavioral Health members.

Last month, we also started the pilot Workers' Compensation program on a non-risk basis in the state of Missouri. The goal of the program is to lower workers' compensation claims costs by introducing an employee assistance plan. We believe that offering employees access to confidential consultation will assist in reducing an employee's recovery time.

In addition to specialty products, we have also made great strides in important clinical initiatives in the second quarter. Nearly 30 case managers that specialize in transplant services as a part of our newly created Center of Clinical Excellence for Transplants have been added. The Center will manage all services for WellPoint members undergoing organ or bone marrow transplants, which are among the most costly and treatment intensive medical procedures.

The enterprise-wide unit also will manage a national network of transplant facilities and providers that meet or exceed high-quality, evidence-based performance criteria. By using best practice standards for contracting benefit design and medical and case management for transplants, our Company can help improve care and outcomes for members while keeping their quality healthcare affordable.

Just last week, Blue Cross of California announced the establishment of a Centers of Enterprise network for bariatric surgery, and this is a Center of Expertise. The selection criteria for the network considered both cost and quality factors. Hospitals were evaluated against industry knowns associated with higher quality of care. Hospitals with the best combination of cost and quality results were designated "Centers of Expertise."

By identifying Centers of Expertise we can provide our members, again, with easy-to-use information about where better healthcare outcomes are being achieved. We are evaluating additional Centers of Excellence programs and specialty networks for neurosurgery, orthopedic surgery, and reproductive medicine.

Our effective Radiology Management program continues to expand and gain acceptance. We've mentioned this in some of our past calls. A recent analysis in Connecticut showed a decrease in radiology utilization, while provider satisfaction with the program appears strong according to a survey of more than 200 physician offices and imaging facilities. We are continuing to expand our Radiology Management program, and it will be effective in Virginia next week.

In addition to programs to hold down medical expenses, we are also focusing on administrative expense reduction. Our SG&A ratio was 16.5% in the second quarter of 2005, equal to the prior year's quarter on a comparable basis and up sequentially due to the multi-district agreement. Excluding that agreement, our SG&A ratio would have been 70 basis points lower. We have additional opportunities to reduce our administrative costs by continuing to execute our merger integration plans and achieve our expected synergies.

As I hope you can tell from my remarks so far, a number of our accomplishments have resulted from sharing best practices across the organization. The integration is proceeding according to plan, and I'm very proud of how two high-performing organizations have come together as the new WellPoint. We are one company and one team, and I believe this is a result of good planning and very focused implementation.

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We achieved our goal of recognizing at least 35 million synergies during the second quarter, net of the cost incurred to achieve them. We continue to expect synergies to accelerate, totaling at least $150 million in 2005. We also continue to expect net savings of at least $250 million in 2006, and are well on our way to achieving this run rate.

I am very excited about what we've accomplished to date, and I would like to take a moment just to share some of the recognition we have received. In May, we were ranked number 4 on the 2005 Baron's 500, which grades how well companies have performed for investors based on rising stock prices, growing cash flows, and strategic use of information technology among other factors.

WellPoint has been named by Working Mother magazine as one of its 2005 Best Companies for Women of Color. We are honored to be recognized for our diversity initiatives, which also include diversifying our supplier base. Additionally, we support the Diversity Leadership Academy of Greater Indianapolis and are focused on addressing racial and ethnic healthcare disparity. We continue to achieve success in penetrating ethnic markets as well. In California, dozens of grassroots events, television and radio advertising in Spanish and in Chinese, as well as many other initiatives have resulted in strong sales growth in the Hispanic, Chinese, and Korean markets.

Before I turn the call over to Dave Colby, I want to mention that Dr. Sam Nussbaum, Executive Vice President and our Chief Medical Officer, was recently named one of the nation's ten most influential physician executive by Modern Physician magazine's first annual list of the top 50 physician executives in the nation. We are very pleased and proud of Sam for this recognition, and I think it speaks to the kind of difference he makes in healthcare in America.

And now, I'd like to discuss our second quarter financial performance in more detail, and to do that I'm going to turn it over to Dave Colby.

Dave Colby - *WLP - CFO*

Thank you, Larry, and good morning. We are very pleased with our second quarter 2005 earnings per diluted share of $0.90. These results included a $0.10 per share charge related to the agreement resolving the two national multi-district lawsuits, the Shane and Thomas cases. This is $0.04 per share higher than our previous guidance due to effective cost management and higher investment income from better than expected cash flow.

Excluding the charge related to settling the national multi-district lawsuits, the second quarter diluted earnings per share of $1.00 represents an increase of 20% between the second quarter of 2004 and the second quarter of this year. Excluding the multi-district litigation settlement and the additional amortization of intangible assets in 2005, the second quarter 2005 diluted earnings per share would have increased by 26% year-over-year.

The most significant driver of second quarter year-over-year changes relates to inclusion of Legacy WellPoint Health Networks following the November 2004 merger. As in our last earnings call, my financial commentary this morning will compare current results to 3 months of Legacy Anthem and 3 months of Legacy WellPoint on a combined basis for the second quarter of last year where appropriate. I will refer to this historical data as comparable basis information, as more fully described in our press release. Reconciliations of this comparable basis information to the historical GAAP information of the legacy companies are available at our website, www.wellpoint.com.

Premium revenue for the quarter was $10.3 billion, an increase of $778 million or 8% on a comparable basis over the second quarter of last year, due primarily to organic membership growth and disciplined pricing. On a comparable basis, fully-insured membership increased by 358,000 members over the past 12 months or 2.5% led by our individual/small group businesses which increased 5%. The organic year-over-year growth in fully-insured membership is actually 75,000 members higher because we sold Unity Health Plan in Wisconsin earlier this year.

Our administrative services fees were $668 million in the quarter, an increase of $49 million or 8% on a comparable basis over the second quarter of last year, due primarily to national account membership growth. On a comparable basis, self-funded membership increased by 1.2 million members or 9%, including 177,000 members acquired in the Lumenos transaction last month. Increases in our self-funded membership were led by national accounts that added over 700,000 members or more than 10% over the second quarter of last year.

Our net investment income was higher than expected and resulted from higher invested cash balances due to our better than expected strong cash flow, rising short-term interest rates, and new investment strategies designed to increase our income yields. While higher interest rates unfavorably impact our interest expense, they are more than offset by additional income from our investment portfolio through higher yields.

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The benefit expense ratio was 81.1% in the second quarter of this year, which was equal to the second quarter of last year on a comparable basis, demonstrating our ability to price to cover medical trend in a competitive but rational market. Of the $103 million charge for the multi-district settlement, $35 million was charged to benefit expense in the quarter. Excluding this charge, the benefit expense ratio in the second quarter of this year would have been 80.8%.

During the second quarter, medical trends continue to decline as we continue to expect medical trend in 2005 to be less than 9%, about 100 basis points lower than 2004. Due to the success of our recent pharmacy programs such as improving generic use, higher mail-order use, and better contracting as we combine our PBM's, the primary drivers of medical trend are now expected to be inpatient and outpatient expenses. For 2005, we expect premium yield to equal or exceed total cost trend, where total cost trend includes the medical benefit costs and administrative expenses.

Outpatient medical cost trend is approximately 70% cost and 30% utilization related. As Larry noted, we are seeing success in our Radiology Management program. Where we have implemented this program, our radiology trend has decreased. We are continuing to roll out this highly successful program within each region. As we re-contract, we prefer to negotiate case rates or fixed-fee schedules for outpatient care. We are also implementing benefit plan changes to encourage appropriate utilization of outpatient services.

Inpatient medical cost trend is unit cost driven. Admissions are flat and days of care per thousand members are down slightly. Our preference here is to negotiate multi-year contracts on a DRG, case rate, or per diem arrangement as opposed to discounted fee-for-service. About 88% of our admissions are covered under contracts with DRG, case rate, or per diem reimbursement to the contracts.

Pharmacy cost trend, which previously had been a primary driver of overall trend increases, continues to decline as a result of our increase in generic use rates, benefit plan design changes, and drug cost savings realized from the merger. Pharmacy trend is about 75% driven by unit cost increases as drug manufacturers continue to implement rate increases.

As Larry also noted, we will actively encourage members to switch to generic versions of some high-volume branded drugs as their patents expire next year, and this will have a favorable impact on both generic utilization and pharmacy trend. Physician trend is about evenly split between cost and utilization components.

The marketplace continues to be competitive and generally rational. We remain very disciplined in our underwriting and pricing. Our gross margin, that is the premium minus benefit expense, increased on a PMPM comparable basis both year-over-year and sequentially. In the second quarter of 2005, excluding the impact of the multi-district litigation settlement agreement, we continue to see improvements in our operating margins.

The SG&A expense ratio, also excluding the impact of the multi-district litigation settlement in the second quarter of '05, was 15.8%, a 70 basis point improvement when compared to the second quarter of last year. In the quarter, $68 million of the MDL settlement charge was booked to G&A expenses. These results also included expenses of approximately $20 million for merger-related expenses. This improvement is due to excellent expense management, spreading administrative costs at the larger membership base, productivity increases, and the merger synergies.

The Health Care segment consists of our 4 health insurance geographic regions plus national accounts, as well as our Senior and State Sponsored programs business. In the second quarter of 2005, operating revenue in our Health Care segment was almost $10.7 billion, an increase of $847 million or 9% on a comparable basis over the second quarter of last year, led by our individual and small group and large group operations.

Operating gain was $786 million, with an increase of $51 million or 7% on a comparable basis over the second quarter of 2004. This is due to strong membership growth and efficiencies realized in the management of our administrative cost structure. The segment's operating gain and operating margin were negatively impacted by the multi-district litigation settlement agreement. The operating margin as reported declined by 10 basis points to 7.4% in the second quarter of '05 from 7.5% on a comparable basis in the second quarter of last year. Excluding the impact, however, of the multi-district litigation settlement, the second quarter 2005 operating margin would have been 8.3%.

The specialty segment, which includes our pharmacy, dental, vision, life, disability, behavioral health, and workmen's compensation businesses had 2005 second quarter operating revenues of $696 million, an increase of $41 million or 6% on a comparable basis over the second quarter of last year, while the operating gain was $92 million, an increase of $8 million or 9% on a comparable basis, due primarily to our mail-order pharmacy business. The operating margin in the specialty segment improved by 30 basis points to 13.2% from 12.9% on a comparable basis.

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Our specialty businesses have higher margins than our health business, and we are continuing to expand our specialty businesses through both external sales and increased penetration of our health customers. We have found that employer relationships are strengthened when both specialty products and health products are sold.

The other segment is comprised of our Medicare processing business, ARCUS Enterprises, inter-segment revenue and expense eliminations and corporate expenses not allocated to the Health Care or Specialty segment.

On a comparable basis, the operating loss decreased $4 million or 14%, due primarily to expenses for integration activities in 2004 that did not reoccur in 2005.

Now, moving to the balance sheet, our cash and current investments were $16.6 billion at June 30, 2005, an increase of $1.6 billion from December of 2004, due to strong cash flow and effective investment portfolio management.

Medical claims payable were $4.3 billion at the end of the second quarter, an increase of over $100 million from the year-end 2004. Our days in claims payable fell by 0.7 days in the quarter to 46.7 days at June 30th. The decrease was primarily attributable to the payment of risk pool settlements to HMO physicians in the quarter related to 2004 performance, that represented a 0.3 day reduction, and a number of other miscellaneous items which represented a 0.4 day reduction, which was primarily due to a reduction in the length of time between service date and claim payment date.

We've also included in our press release a reconciliation and rollforward of our medical claims payable reserves. This disclosure is comparable to the reconciliation provided in our fourth quarter 2004 press release. We calculate the percentage of prior year redundancies to total incurred claims recorded in the prior year in order to demonstrate the adequacy and consistency of prior year reserves. For the 6 months ended June 30, 2005 and 2004, this metric was 3.8% and 1.1% respectively.

Note, however, that the 2005 mathematical calculation was heavily influenced by our merger with WellPoint Health Networks. Having only 1 month of incurred claims for WellPoint Health Networks during 2004 impacted the 6/30/2005 calculation. Had the operations of WellPoint Health Networks been included for the full-year 2004, the June 30, 2005 ratio would have been approximately 1.9% and in line with our historical pattern.

This schedule also demonstrates that we are paying claims at a faster rate. The amount of claims paid in the current year resulting from claims incurred in the current year has increased from 76.7% at June 30, 2004 to 77.5% at June 30th of this year. The increase is primarily attributable to our system's auto adjudication capabilities and improved electronic connectivity with our providers' networks. This results in our ability to pay claims quicker and have more current data for actuary analysis. I believe this schedule demonstrates that we continue to establish reserves for medical costs in a consistent and conservative manner.

Our long-term debt of $4 billion at June 30, 2005 declined by 6% from year-end. Our debt to capital ratio also declined slightly to 18.4% at June 30, 2005 compared to 18.5% at year-end. Our operating cash flow was better than expected at $654 million in the second quarter of 2005, 1.2 times our net income despite 2 estimated tax payments totaling $408 million versus our tax provision of $337 million during the quarter, and indicates the strong quality of our earnings.

WellPoint's net income for the first 6 months of 2005 increased 120% year-over-year, but our operating cash flow increased 387%. During the quarter, we used $245 million of cash to repurchase approximately 3.7 million common shares. Our current share buy-back authorizations are approximately $367 million, and at our current stock price, we intend to continue our repurchase program during 2005.

Let me turn to our guidance for the remainder of 2005. For the second half of 2005, we remain comfortable with our prior guidance per diluted share of $1.00 in the third quarter and $1.03 in the fourth quarter. This would yield $3.91 per diluted share including the multi-district litigation settlement for 2005. This guidance for the second half in 2005 includes the higher synergy levels expected to be achieved in the second half and over $30 million in Medicare Part D start-up costs now being forecast.

I will now turn the call over to Larry to lead the question-and-answer session.

Larry Glasscock - ***WLP - President and CEO***

Dave, thank you very much and, operator, we'll now open the call up for questions.

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QUESTION AND ANSWER

Operator

Thank you. [CALLER INSTRUCTIONS]. Our first question today comes from the line of Josh Raskin representing Lehman Brothers. Please go ahead.

Josh Raskin - *Lehman Brothers - Analyst*

Hi. Thanks. Good morning. Just real quick-- last comment, Dave, on the preparation cost of $30 million, is that new, i.e. was not previously included in guidance?

Dave Colby - *WLP - CFO*

We're now at a point where we are getting much more formal numbers and finalizing. We always had some estimate in it, and we've always said that whatever those start-up costs are we would have to cover in our guidance.

Josh Raskin - *Lehman Brothers - Analyst*

Okay, but that's not new and completely separate than previous guidance? You're saying you've just got a better handle on what the--?

Dave Colby - *WLP - CFO*

We just now have a pretty good handle on what we'll wind up spending.

Josh Raskin - *Lehman Brothers - Analyst*

Second question on the ISG business, and maybe particularly in the California market, typically the spring, April/May were the periods where you've historically given your rate increases, I was wondering was that true this year and maybe if you could talk a little bit about was there any impact on membership there?

Dave Colby - *WLP - CFO*

We did do a number of the rate increases in particularly small group markets then. It always has some impact on our membership. But, as you can see, I think we feel pretty comfortable with the growth that we've achieved in the individual small group segment.

Josh Raskin - *Lehman Brothers - Analyst*

Yes. I was just wondering. Historically, it has been a weak quarter and I didn't really see that in the quarter, so I was wondering if you had, indeed, put the rate increases. It sounds like no change in the rate cycle and we should expect sort of similar trends to the previous years?

Dave Colby - *WLP - CFO*

Yes.

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Josh Raskin - ***Lehman Brothers - Analyst***

Okay. And then the last question, Larry, you had mentioned the consumer-directed health plan. I think you had said 75% of the national accounts have inquired, and then you said that you have already closed a couple. I know it's early, but are you actually seeing an up-tick in the selection of that or is it really at this point still just a discussion point in the RFP process?

Larry Glasscock - ***WLP - President and CEO***

Josh, a lot of it is still discussion. What we are seeing is that there isn't interest completely in doing what would be called "full replacement". Most of the interest still is revolving around making it an option. Over time, we expect that to accelerate and we'll see some full replacements, but most of the discussions we are having with these large clients are still around offering it as an option. Yes, we're very pleased, obviously, with the Lumenos acquisition. They really focused on the large group segment. And so, we're moving along very nicely there.

Operator

Our next question is from the line of Matthew Borsch with Goldman Sachs. Please go ahead.

Matthew Borsch - ***Goldman Sachs - Analyst***

Yes, thank you. Good morning. My first question is on the reserve rollforward, and I just wanted to come back at an issue that I think we had asked about before but just to be clear. My understanding was that in past acquisitions that both Legacy Anthem and Legacy WellPoint had done that the reserves held for medical expenses at the acquired company prior to the date of acquisition were not typically taken in to earnings through the rollforward post the acquisition. And could you explain how this merger was maybe structured differently, because it is from my understanding is that the $580 million does include the claims redundancy from Legacy WellPoint.

Dave Colby - ***WLP - CFO***

The way it does work, I mean obviously at November 30th when the merger occurred, we did talk about the fact that Ernst & Young, our outside auditors, did as part of purchase accounting look at and challenge the WellPoint Health Networks' reserves. I think we mentioned that out of something like $2.8 billion of reserves, they did adjust it down about $5 million or thereabouts, $6 million is now the exact number. So there wasn't much change.

What we do have, though, is at December 31st, what we are looking at is that combined number using a common methodology and how much was in essence redundant using that methodology. So you do have development from that estimate after the purchase accounting date, which is the way it's done.

Operator

We have a question from the line of John Rex with Bear Stearns. Please go ahead.

John Rex - ***Bear Stearns - Analyst***

Hi. Good morning. I was wondering if we could look a little bit more into the State Sponsored Business. There were two components I wanted to go into. I guess one is on the loss in Georgia and kind of your assessment on that. You've had a chance to actually look at the payment rates that the winners will be receiving, so you're in a unique position because you can compare that to what you bid, something that we haven't seen. And I'd like to get a sense on kind of how those compared.

Also, when we look at the information that Georgia put out on the reasons for the unsuccessful bidders, for Blue Cross/Blue Shield, they gave us a reason that said, "Not highest bidder, but a combined technical and cost score." So I'm wondering how we should interpret that.

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And then for the last part on Medicaid, there has obviously been a few issues from Medicaid pure players speaking about unit cost issues in their markets and, particularly, on the hospital side, also speaking about flu. And since you have a fairly sizeable Medicaid book, I wonder if you could speak to what you're seeing in your own trends on that book.

Dave Colby - *WLP - CFO*

I can address the second question first, because we specifically went back to look at our Medicaid trends and they are not any different than our overall trends and seem to be in line. Again, such a high percentage of our contracts are in case rate, per diems, or DRG's that we don't have some of the issues that as I understand occurred.

In terms of the Georgia Medicaid award, we have gone back. It is our understanding as we've dug through, there were I think 10 plans that submitted bids for the Georgia contracts. There were two components, a technical proposal and a cost proposal. You had to first pass a technical screen before they would consider your cost proposal. Out of the 10 plans, 4 plans including WellPoint did pass the technical round and were reviewed for pricing.

Based on the data that we have, the state of Georgia did set an actuarially sound range for what they thought were appropriate rates. And, as we've looked at it, our proposal was somewhere between 6 and 8% higher than the high end of their actuarial range. My understanding is that 2 of the plans actually came in below their actuarial range and got brought up to the minimum and 1 was in that range. That is the data that we have. We have until July 29th to file for an appeal. But, the fact of the matter is we're above the range and I don't think we're going to appeal because we still believe we priced it correctly to, as Larry said, have a reasonable and, importantly, sustainable margin in our business.

Operator

Our next question is from the line of Charles Boorady with Smith Barney. Please go ahead.

Charles Boorady - *Smith Barney - Analyst*

Thanks. Good morning. Just to follow-on on John's question on Medicaid. Is it reasonable to start to put a mosaic together here on what's happening with a competitive landscape for Medicaid? In other words, what are the companies that won the Georgia business, and it was at least in part if not all on price versus other companies that made it past the first round of qualifying for the network and other technical standpoint?

Has the Company also suffered an earnings shortfall, which was attributed to higher unit cost increases, but it appears that the unit cost increases were pretty much in line with the industry and maybe this is a revenue problem instead of a cost problem.

So I'm just curious is it reasonable to put a mosaic together and see that Medicaid is becoming a more challenging business in some states either because of aggressive pricing or because states are raising the fee schedule for providers faster than they're raising the reimbursement to managed care plans?

Dave Colby - *WLP - CFO*

Well, I think all of our segments are competitive in nature with a number of competitors. I think the challenge in Medicaid is that the states are having funding issues and want to try to bring it back. I don't want to imply that because of this you're going to see people have difficulty making money, because I don't know what their network arrangements are, the breadth of their networks exactly, and they may be able to achieve a different cost structure that we had when we bid. All we know is that we bid what we thought was a reasonable amount and we lost. That happens and we move on.

Charles Boorady - *Smith Barney - Analyst*

How important is Medicaid to the WellPoint star or the 15% minimum EPS growth target that you set?

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Dave Colby - *WLP - CFO*

It's an important component. We think it's a good business segment. It's 6%, I think, of our membership, so it's certainly not something that is a huge driver, but for us 6% is sizeable. We are such a diversified company that it's hard to find anything that represents 6% of our business. Even that 6% is a very diversified 6% if you look at the places where we do business.

Larry Glasscock - *WLP - President and CEO*

We're in a number of different states. And, again, Charles, I think our strength is as we pointed out many times, the lack of concentration in our business. It's the way we run our business. It's very diverse, not only from a customer segment point of view but a product point of view. So our Medicare business is performing just fine and that's what we're going to continue to do.

Operator

We have a question from the line of Patrick Hojlo with Credit Suisse. Please go ahead.

Patrick Hojlo - *Credit Suisse - Analyst*

Thanks guys. Could you detail for us what the cash outflows related to the merger were this quarter? And, also, if you're still comfortable saying that you think merger-related expenses will total $100 million for the year? It looks like a little deceleration and not merger expense this quarter. I wonder if we should think of that number being a little lower for the year now.

Dave Colby - *WLP - CFO*

I think in terms of when I talked about approximately $20 million of merger-related costs, that includes some expensing of some restricted stocks that had not vested at the merger, which is not really a cash expense, although it is certainly an expense, about $11 million, and then we have still some state bonuses of around $13 million. So those were the cash type of-- at least the $13 million would be the cash type.

Operator

The next question is from the line of Christine Arnold representing Morgan Stanley. Please go ahead.

Christine Arnold - *Morgan Stanley - Analyst*

Good morning. I have a couple follow-ups here. On the amortization level that we exclude from earnings in this quarter, is that higher level of amortization expected to continue? Because it looks like it was above kind of first quarter levels, but it looks like it wasn't amortization of intangibles as stated in the income statement. It looks like it was in D&A if you look at the cash flow.

Secondly, in terms of the MDL charges, can we expect more charges in future quarters after you're able to quantify this?

And, finally, on the rollforward, just a follow-up on Matt Borsch's question-- as I understand it there was no income statement benefit or detriment or change at all, because of bringing in WellPoint's reserve levels. Can you just confirm that?

Dave Colby - *WLP - CFO*

All right. Let's go to the last question. Again, in terms of the rollforward, yes we had some positive development from December 31st related to the WellPoint Health Networks that, again, positive development would have been an addition to income. However, again as we've always said, we use a very consistent methodology. So, absent significant growth or something else, we would expect the same level of development approximately next year. So what came in went back up. What were your two other questions?

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Larry Glasscock - *WLP - President and CEO*

On the MDL, we don't expect any additional charges from settling that. It's all taken care of in reserves already established and the charge then that we had in the second quarter.

Dave Colby - *WLP - CFO*

And related to the amortization of intangibles, the slight increase in the second quarter was amortization of identifiable intangibles associated with the Lumenos purchase which occurred in June.

Operator

And, ladies and gentlemen, just a reminder so we can get to as many questions as possible today, please limit yourself to one question. Thank you. Our next question is from the line of Scott Fidel representing JP Morgan. Please go ahead.

Scott Fidel - *JP Morgan - Analyst*

All right, thanks. Good morning. Larry, in your initial remarks you referenced some increasing interest from employers in disease management. Can you just update us on some of the opportunities with HCM in terms of just first penetrating your existing book and then maybe some external opportunities?

Then, just a quick follow-up is if you had any Medicare Part D expenses in the second quarter?

Larry Glasscock - *WLP - President and CEO*

Well, first of all, Scott, related to HMC, as you know, it's one of the largest disease management companies in the industry. I think at last count it was probably the fourth largest. Right now, we've been expanding the number of disease states that it covers. This came as part of the Trigon acquisition and, at that time, they handled 4 or 5 disease states, and we've expanded that now to, as I remember, 7. So we cover through HMC asthma, diabetes, congestive heart failure, coronary artery disease, end-stage renal disease. We also have a high-risk maternity segment and then COPD.

So it's pretty comprehensive, although I will tell you we are in the process of expanding the number of disease that it covers-- number of diseases that it covers. And we are focused on getting this to address the 7-or-so percent of our members that consume about 65 to 70% of our medical costs.

So I think this has a very good future. We are going to be migrating more of our internal business to it, and we've been very successful in selling it externally as well. So I think it has been a great jewel as part of our Trigon transaction and I think it has a great future.

Operator

We'll go to the line of Doug Simpson with Merrill Lynch. Please go ahead.

Doug Simpson - *Merrill Lynch - Analyst*

Hi. Good morning. Just looking at the cash flow generation of the Company, you guys have generated just about it looks like $1.4 billion year-to-date, and that's after paying it sounded like about $400 million of tax payments in the quarter, and you bought back about $330 million worth of stock. You guys certainly have the financial ability to buy more stock, and just wondering kind of what your thoughts are on that, where authorization stands, and how you're prioritizing uses of cash right now?

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Dave Colby - *WLP - CFO*

Doug, as we said on the last call, our original guidance for the year was about $400 million of share buybacks. We said at the end of the first call after our Board looked at the issue of our capital structure, where we decided that increasing the amount of buybacks was probably a better return for our shareholders than a dividend.

We decided to increase that amount and, as you can tell, we are certainly at a pace now that is well in excess of the $400 million that we had originally guided to. Our current authorization is $367 million, but our Board meets 6 times a year and I am sure once that is exhausted, they will be favorably inclined to increase that authorization back up.

Operator

You have a question from the line of Joe France with Bank of America. Please go ahead.

Joe France - *Bank of America - Analyst*

David, why not raise enrollment guidance for the year when you've already basically met your current guidance? Are you not expecting any more adds or are you expecting some attrition of some account or other?

Dave Colby - *WLP - CFO*

I think we had guided to about a 4% enrollment increase, a little bit around 1 million new members. Certainly, with the Lumenos transaction, if you count the Lumenos transaction of 177,000, we are over our million. Without Lumenos, we are still running behind it. I think that we will do better than a million new members absent the Lumenos transaction, and we'll probably do slightly better than 4%, 4-point-something percent, but it's not going to be dramatically ahead. When most of our growth is coming in national accounts and the bigger cases, those tend to come in earlier in the year.

Operator

We'll go to the line of Ellen Wilson with Sanford Bernstein. Please go ahead.

Ellen Wilson - *Sanford Bernstein - Analyst*

Yes. A question on medical cost trend-- I was wondering if you could give us the rolling 12-month trend in the quarter for each of the sub-components and highlight where that's changed from the prior quarter?

Dave Colby - *WLP - CFO*

In terms of the trend, again, we have seen-- we really haven't seen much change. Declining trend is coming and the outpatient side is continuing to come down. We're getting that down into closer to the low double-digit, 10% range, and we're bringing pharmacy from double-digits back into single-digits.

The one reason that we did say that-- I think last quarter we talked about outpatient and pharmacy as being primary drivers. Now we're saying outpatient and inpatient is because we've gotten our pharmacy trend close to what our in-patient trend is. And since inpatient is a higher percentage of our costs, that is an area that we'll now focus more on. But both pharmacy and inpatient are in the mid to upper single digits, and our physician professional services are in the mid single digits. Again, we continue to expect our trend is declining and we will be 100 basis points or so less than last year.

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Operator

Our next question is from the line of Ed Kroll representing SG Cowen. Please go ahead.

Ed Kroll - ***SG Cowen - Analyst***

Good morning. I just want to circle back to the guidance to make sure I understand. Since this is the first time you've broken out the anticipated ramp costs on the Part D, if you weren't doing that, that $30 million or so, is it safe to say you would have raised guidance for second half EPS?

Dave Colby - ***WLP - CFO***

I mean if we were not to do and spend $30 million, that's about $0.03 after tax, but we are going to.

Larry Glasscock - ***WLP - President and CEO***

And that was factored in.

Dave Colby - ***WLP - CFO***

That was factored in and now we've actually come out to a true quantification of how we're going to spend it.

Operator

Our next question is from the line of Norman Fidel with Alliance Capital. Please go ahead.

Norman Fidel - ***Alliance Capital - Analyst***

Hi, thanks. Since the last quarter, some of the components of your guidance have changed, the MLR down 60 basis points to 80.9, the SG&A or administrative cost ratio up 70 basis points to 16, and those changes seem way beyond the effect of the physician class litigation settlement which comes to tenths of a percentage point. So can you talk about the reasons behind those changes?

And also, the reduction in the revenue guidance of about $500 million, how much of that is due to divestitures and how much to possibly other reasons? Thanks.

Dave Colby - ***WLP - CFO***

Norm, that's a great question. Most of it all has to do with mix as we look at it. We are doing pretty much, I think, as expected or maybe even slightly ahead in terms of total membership. But the mix of membership is a bit different than what we would have expected early on. We're getting much more ASO business that will tend to count as membership but does have a much higher SG&A ratio per dollar, so that always increases it. A lot of the revenue increase or lack of increase or lower are things like our FEP program, which is basically a cost-reimbursed system. As our trend comes down and we do better there, that actually brings our revenue down.

We're also seeing the medical care ratio improve slightly, because as we-- where we're seeing the good growth in our insured business, it seems to be a little bit better in the individual and small group business where we run a slightly lower medical care ratio, although slightly higher SG&A because of the selling expense and the commissions associated with that product.

So, again, it's all a lot of mix and noise. You're right. The multi-district litigation settlement does have some impact, particularly in this quarter, but as you spread it over the full year has a little bit less impact. But I think overall the important thing is that we are pricing to cover trend. If you take the multi-district litigation settlement out, we continue to see our margins increasing slightly, I think increasing at a sustainable rate.

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Operator

We have a question from the line of Carl McDonald with CTIBC. Please go ahead.

Carl McDonald - ***CIBC*** - ***Analyst***

Thanks. Can you give us a sense for how you're thinking about drug trends in 2006 relative to your current trend in the high single digits? And related to that, how much spending in the statin classes, either Zocor or Pravachol?

Larry Glasscock - ***WLP*** - ***President and CEO***

We, as you know, we have not disclosed any trend information for 2006 yet. We will do that at a much more detailed level later in the year. But, obviously, one reason that we are already spending so much time with our members focusing on Zocor is we think that can make a very substantial difference in 2006, and we want to make sure that we're well-positioned when that patent expiration does happen, so more to follow on that in one of our future calls.

Carl McDonald - ***CIBC] - Analyst***

And within the current business, I mean would you--?

Operator

The next question is from the line of Tom Carroll. Please go ahead.

Tom Carroll - ***Legg Mason Wood Walker, Inc.*** - ***Analyst***

Hi. Good morning. Just a quick question-- as you plan for a national Part D offering, what per member per month revenue do you expect to recognize at this point as you're modeling it going forward?

Dave Colby - ***WLP*** - ***CFO***

Again, we try not to get into margins or specifics on products or so, but I think there are a number of analyst reports out there that have tried to quantify, and I think those we would not take exception with that type of range.

Operator

We have time for one more question today, and it will come from the line of Peter Costa with FTN Midwest Securities. Please go ahead.

Peter Costa - ***FTN Midwest Securities*** - ***Analyst***

Thanks. There have been a couple of hospital contracts, in particular in California with Blue Cross of California-- we're talking about Sharp HealthCare and then a little one up in Sacramento, Marshall Medical-- that have broken down recently. Can you talk about those and if that's some sign of something going on in California specific to you guys or anything else?

Larry Glasscock - ***WLP*** - ***President and CEO***

Well, I think the contracting environment is always very competitive, and we constantly see on occasion situations where we just can't reach agreement. But we're hopeful that we still can in every situation that presents itself. I don't want to talk specifically about Sharp or others because, obviously, we don't like to negotiate publicly on those.

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Operator

All right. Would you like the replay given out now? Do you have any closing remarks?

Larry Glasscock - *WLP - President and CEO*

Thank you very much for the questions. In closing, I just want to first of all say thanks to our 38,000 associates who really do a very good job of putting our customer first. We believe they deliver better value in the market, and they are meeting the demand for affordable health insurance products. So I am very pleased with their collective efforts.

We are very pleased with our results to date, and I hope you can tell from the call today that we remain very excited by our future. And we want to also make you aware of the fact that we're planning to hold our Annual Investor Day. We're going to do that in New York City on Tuesday, December 6th. We're going to do it at a place called Gotham Hall, and I hope you'll save the date on your calendar and hope you will be there.

Again, thank you for your interest this morning and hope you have a great day.

Operator

Ladies and gentlemen, this conference will be available for replay after 1:45 p.m. today until August 10th at midnight. You may access the AT&T Executive Playback Service at any time by dialing 1-800-475-6701 and entering the access code of 779651. International participants may dial 1-320-365-3844. Again, those numbers are 1-800-475-6701. International participants, 1-320-365-3844. Please enter the access code of 779651.

That does conclude our conference for today. Thank you for your participation and for using the AT&T Executive Teleconference Service. You may now disconnect.

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