



Health Net, Inc.
Q1 2008 Earnings Conference Call
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Corporate Participants:

Angie McCabe, Vice President, Investor Relations
Jay Gellert, President and CEO
Joseph Capezza, Chief Financial Officer

OPERATOR: Good day, everyone, and welcome to this Health Net, Inc. first quarter 2008 conference call. Today's call is being recorded. At this time I would like to turn the call over to Angie McCabe, vice president of Investor Relations. Please go ahead, ma'am.

ANGIE McCABE: Thank you, operator. Good morning, everyone.

During this call we will make forward-looking statements that are subject to certain risks and uncertainties. Risk factors that may impact those statements and could cause actual future results to differ materially from currently expected results are described in our filings with the SEC as well as the Cautionary Statements in our press release issued in advance of this call.

In addition, today's press release makes, and the comments on this call will make, reference to certain measurements that are not calculated and presented in accordance with Generally Accepted Accounting Principles. I should note that today's press release, which is available on the company's Web site, includes a reconciliation of non-GAAP financial measures with operating results excluding legal and operations strategy-related charges. In addition, we included a supplemental schedule showing a breakout of reserves and health care costs for capitation, provider settlements, and the impact of Part D. These supplemental items provide the basis for discussion of operating metrics, excluding the charges where appropriate, and discussion of days claims payable, excluding the costs noted above.

Let me now turn the call over to our CEO, Jay Gellert. Jay ...

JAY GELLERT: Thank you, Angie. Before I begin, I'd just like to point out we have a new voice reading the disclosure statement. We're in the transition from David Olson to Angie McCabe. David will stay with us and continue to work with us as we go forward. But I do want to recognize all he's done for the company, how valuable he's been to all of us and all of you, and indicate how important a part he's been to our company. So thank you, David and thank you for joining us this morning.

Today I will review our first quarter '08 results and address our revised guidance for '08. After my remarks, Joe Capezza, our CFO, will take you through an in-depth discussion of the financials.

As you know, we announced several weeks ago that we were going to engage in a comprehensive review of our results and prospects to make certain that our 2008 earnings guidance reflected currently expected business conditions. Since the middle of March, when we made that announcement, we have engaged in examining every aspect of our business. While we were completing this review, several issues emerged.

These issues include adverse prior period development, primarily for the second half of '07, concentrated in Q4. We also saw higher utilization in both Medicare Advantage and PDP for '08 and an unusually active flu season. Finally, in February of this year, we learned of proposed rate decreases for our Medi-Cal business. The adverse prior period development was primarily the result of an unusually large number of high cost cases, and was exacerbated by a larger than normal build-up in claims inventory during the holiday season. We do not expect this anomalous condition to recur.

Most of the issues I've described impacted our Q1 results. In fact, the adverse prior period development, flu and the Medicare and PDP issues impacted our first quarter results by approximately \$95 million pretax, or \$0.53 per diluted share. As a result of both the proposed Medi-Cal rate cuts and the residual impact from MA and PDP, the remaining three quarters of the year will be impacted by approximately \$30 to \$35 million pretax, or approximately \$0.16 to \$0.19 per share.

As a result of these items, combined with the charges that we took in Q1, we are lowering our '08 EPS guidance on a GAAP basis to between \$2.47 and \$2.65 per share. Excluding the impact of the charges taken in the first quarter and the additional ops strategy-related charges we expect to take in the remaining three quarters of '08, our '08 earnings per diluted share guidance is \$3.45 to \$3.55. Although the Medi-Cal rate cuts will impact the second half of '08, we believe we can resume earnings growth in the second half of '08 compared to the second half of '07. Our revised guidance takes this 2007 development into account. As a result, our 2008 commercial health care cost guidance increases by approximately 50 basis points. Therefore, commercial premium yields in cost trends are now expected to be approximately equal at 8 percent.

Given these developments, we know there is concern about commercial pricing. We believe that our pricing discipline will produce better yields that might otherwise be expected through the balance of the year. We are confident with our pricing for '08 because more than 80 percent of the book has been priced. Therefore, we believe that the second half will bring improved margins. We expect to see an increase of more than \$6 PMPM in commercial yields between the second and third quarter. And an additional \$3 PMPM increase sequentially between Q3 and Q4, which is higher than we have experienced historically. With this encouraging pricing picture, we believe that the second half of '08 will show a significant positive spread between commercial yields and costs with concurrent improvement in the commercial MCR year-over-year, despite the increases in our cost expectations. We believe the positive spread could be 100 basis points in Q3 and Q4. If we deliver on these expectations, which we think we will, we believe it will set a very positive tone for '09 performance.

Given our pricing activity, and the generally difficult economic environment, we are reducing our commercial enrollment expectations. Instead of the 1 percent decline we targeted at our investor day, we now expect to see commercial enrollment decline of between 3 and 4 percent year-over-year.

Let me now turn to membership activity during the quarter. As expected, commercial risk membership of nearly 2.2 million at the end of the quarter was essentially flat compared to March 31, 2007, and declined by 45,000 members since December 31, 2007. Our commercial large group segment experienced lapses in both ASO and risk membership as we continue to prune unprofitable accounts and maintain our pricing discipline. As many of you know, our strategy is to grow membership profitably in the segments where we know we can compete in terms of product and network cost competitiveness. The small group and

individual segment grew year-over-year as we continue to focus on a wider array of products and on building relationships with our distribution channels. While this segment did experience a decrease in membership since December 31, most of the decline is attributable to lapses as we continue to maintain disciplined pricing. Going forward, we do expect to be somewhat less active in growing the individual segment.

We continue to experience strong growth in our Medicare lines of business. Our '08 guidance, which remains unchanged, is for 20 to 25 percent growth in MA, primarily in network model, HMO and PPO plans. We believe this is a more sustainable and stable business, especially with the changing political environment. During the first quarter of '08, MA enrollment grew by 53,000 members, a 24 percent increase, to 276,000 members. So, we're just about at the high end of our guidance range for MA enrollment. Enrollment in our Private Fee-for-Service business grew by more than 14,000 members over the past 12 months to 22,500 members at March 31. Sequentially, Private Fee-for-Service grew by more than 7,000 members. PDP membership, which we continue to expect to grow by 40-45 percent in '08 stood at 522,000 members on March 31, growing by 143,000 members sequentially and 181,000 members from March 31, '07.

While we are very pleased with the enrollment news, our Q1 gross margins in both MA and Part D will be lower than expected. For the balance of the year, we've incorporated approximately \$16 million of additional Medicare costs into our guidance. We will have the opportunity to rectify these issues in the pricing for our bid filing in June.

Our Federal Services division remains focused on delivering services that meets the needs of our military service members and their families. As an example, Federal Services, teaming with MHN, our behavioral health subsidiary, to introduce new programs and services, such as the Warrior Care Support Program, for those service men and women returning from military combat. Also, as many of you are aware, the RFP for the new TRICARE contract was issued during the first quarter, and our team is focused on developing and submitting a competitive proposal by the end of May. The expectation is that the new contracts will begin in April 2010. We expect that the current contracts will be extended.

Finally, a few closing remarks. While we are disappointed with our results, we are taking specific steps, including disciplined pricing, health care cost management, the implementation of our ops strategy to achieve our second half '08 expectations. We expect to resolve the PDP and MA issues in our '09 filing and expect that the cost for the flu and prior period developments will not recur in '09. We believe the worst is behind us and feel very confident going forward. Now I'd like to turn the call over to Joe Capezza, our CFO. Joe ...

JOE CAPEZZA: Thanks, Jay, and good morning everyone. As Jay mentioned, I will review our revised guidance for 2008 and then discuss first quarter results. Let me start by saying that over the past several weeks we've conducted an exhaustive analysis of all facets of our business. As a result of this analysis, we have good visibility as to our revenue outlook, health care cost trends and our ability to streamline G&A. With that in mind, we believe that we have a sound plan in place that will enable us to regain momentum in the second half of 2008 and lay the foundation for future periods.

First let me address our revised guidance. Jay provided the EPS numbers -- \$2.47 to \$2.65 on a GAAP basis and \$3.45 to \$3.55, excluding charges. This translates into an approximately \$130 million change in pretax income from prior expectations. \$94 million of this change relates to the first quarter.

Of the \$94 million, \$50 million is from adverse prior period development, primarily from the second half of 2007. Approximately \$37 million of this amount relates to the fourth quarter of last year. This adverse development was primarily the result of an unusually large number of high cost claims. Eighty percent

arose out of the commercial book. This development ran against typical seasonal utilization patterns. These unusual cases drove both institutional and physician costs higher than expected. They arose from a number of diagnostic areas including cardiovascular, neo-natal ICU, and septicemia. We have not seen evidence of these types of cases driving higher utilization in what has developed in the first quarter.

Despite our belief that this is an unusual event, we've intensified our medical management efforts. We believe this will help ensure that we will keep health care costs in line with expectations. As it is, our plan assumes that commercial health care costs develop during the year along the lines of our historical patterns.

\$20 million of the change relates to higher than expected utilization in the first quarter due to flu. Flu affected both the commercial and Medicare books.

\$24 million is due to higher than planned costs in Part D and Medicare Advantage in the first quarter that are not flu-related. In Part D we are seeing higher than expected utilization of brand drugs. So, for the next three quarters, that leaves a balance of between \$31 and \$41 million pretax.

Approximately \$15 to \$20 million of these results result from the Medi-Cal rate cuts announced earlier this year. Since the new rates will start on July 1, this will impact the third and fourth quarters.

Approximately \$16 to \$21 million is attributable to Medicare Part D and Medicare Advantage costs running higher than planned as noted above. It is now evident that our Part D bid was aggressive. We believe this impact will be more pronounced in the first half due to Part D seasonality. In both Part D and Medicare Advantage we have the opportunity to resolve these issues with our impending bids for 2009.

That summarizes the reasons for our guidance revision. Now let me talk to reported GAAP results in the first quarter.

Three charges, amounting to \$82.4 million pretax, contributed to a loss of \$0.33 per diluted share in the quarter. The components of the charges are as follows:

- \$43.2 million to cover estimated liability for litigation and regulatory action. This includes liability related to the company's rescission practices in Arizona and California. It also includes additional liabilities booked in connection with the settlement agreements of three national lawsuits. The total amount of these items was booked in health plan services expenses.
- \$35.8 million of the charge relates to severance and other expenses, including legal fees, and that was booked in the G&A line of the P&L.
- Lastly, an estimated \$3.4 million relates to the pending sale of a small, non-core subsidiary. This amount is booked in ASO and Other Income.

The \$0.16 in operating earnings Jay mentioned excludes the effects of these charges. There's a P&L reconciliation attached to our press release to show you how to get from the GAAP to the non-GAAP numbers for a clearer operating picture.

Of all the factors affecting our quarter, most importantly there is good news on the pricing front. We recorded a 10.3 percent increase on a PMPM commercial yields in the first quarter. That's very close to our plan, and we still expect to be on plan at 8 percent for the full year. For the full year we now expect commercial health care costs to be up approximately 8 percent, up 50 basis points from our previous

guidance of approximately 7.5 percent. The change is all due to prior period development recorded in the first quarter.

An issue several of you have asked about previously is investment income. It was up nicely in the first quarter -- \$35 million against \$31 million in last year's first quarter. Lower interest rates have actually helped more than hurt us. Less than 20 percent of our \$1.5 billion portfolio is exposed to short-term rates. In addition, there's approximately \$3 million of net unrealized gains in the rest of the portfolio. We were able to realize \$2 million of gains in the first quarter. We currently expect investment income to actually be up year-over-year and run slightly better than plan.

A different geographical mix with more taxable income coming from California than previously expected causes our effective tax rate on an operating basis to be approximately 39.5 percent. That compares with the 38.5 percent reported previous period. This impacts EPS for the year by approximately \$0.06 per diluted share. Including the charges, the effective tax rate for the full year will be approximately 40 percent. So, the better than expected investment income is offset by higher tax rates.

Interest expense did climb in the first quarter from a new financing facility that we entered into late last year. But the higher interest expense is offset by other income related to this financing. You will continue to see this phenomenon throughout 2008.

For some time, we've been telling investors that the extraordinary performance in our Government Contracts segment could not persist. The first quarter pretax margin of 4 percent is lower than recent quarters as a result of lower risk-sharing gains. We still expect the full year margin to be approximately 5 percent.

Let me take a moment to talk about reserves. The higher reserves clearly helped GAAP days claims payable. As we do every quarter, we include a table with the release that normalizes days claims payable. This quarter the normalized number is down about 1.5 days sequentially. This is consistent with what we've seen seasonally in past years.

Finally, our debt was up \$100 million as a consequence of our draw on the credit line. We are currently paying LIBOR plus 70 basis points on this debt, so it's a very attractive alternative for us.

As a result of the GAAP loss in the quarter, active share repurchases and higher debt, our debt-to-total capital ratio climbed to 27.5 percent at the end of the first quarter. We are very comfortable with this level at the moment and we believe that we can keep it under 30 percent for the balance of the year.

Let me shift briefly to cash flow. We recorded negative cash flow of \$117 million for the first quarter. We had told investors to expect Q1 to be negative due to the payments associated with litigation settlements that amounted to approximately \$160 million in the first quarter. Our full year expectation is that operating cash flow will equal approximately 60 percent of GAAP net income due to improved performance in the remaining quarters offset by the effect of the litigation-related payments. Excluding litigation payments, cash flow is expected to approximate 100 percent of net income.

On the share repurchase front, in the first quarter we bought back 3.2 million shares, spending approximately \$143 million. It is our intention to continue repurchasing shares. The range of full year earnings guidance, excluding charges, is directly tied to how many additional shares we buy. The more we buy, the more likely we are to reach the higher end of the range.

Let me make a few additional comments on guidance -- our current expectations for the second quarter is approximately \$0.77 to \$0.79 per diluted share, excluding charges related to our G&A cost reduction

efforts. We expect these efforts to contribute to a ramp-up in earnings in the third and fourth quarters to get to our revised EPS range for the full year.

Let me close by saying that we believe the balance of the year will show stronger performance. We see strong pricing in our commercial book being solidly right-side up in the second half. This will help drive year-over-year earnings growth in the third and fourth quarters. We believe we sized our Medicare issues and the 2009 bids will reflect them.

We look forward to seeing many of you in the coming weeks to discuss these issues in more detail. With that let's move on to Q&A, and let me turn in back over to Angie.

ANGIE McCABE: Thank you, Joe. Operator, we'd like to now open the call for Q&A.

OPERATOR: Thank you, Ms. McCabe. The question and answer session will be conducted electronically. If you would like to ask a question today, you may do so by pressing the star key followed by the digit one on your touchtone telephone. If you're using a speakerphone, we do want to ask that you make sure your mute button is turned off or pick up your handset before asking your question. Once again, that's star one to ask a question. And we'll go to Matthew Borsch with Goldman Sachs.

MATTHEW BORSCH: Yes, good morning. Thank you. First question I have is on your look back on 2007 commercial medical cost trend. What was it, if you could just remind us, and what is it now in light of the trend development that you saw? I guess the follow-up question is, I'm a little bit puzzled that you haven't seen -- you haven't raised your outlook at all for the '08 trend, excluding the unfavorable reserve development in light of what you saw late last year and also in light of perhaps what you've seen so far in the flu season, although I recognize it's early in the year. And that's it.

JAY GELLERT: The effect of the prior period development -- that is about 50 bps for the year on the commercial side. It would make it so that we were originally about 20 to 30 bps right-side up basically turns it the other way around. We went through all those cases. One of the reasons we took so long was, in fact, to do that. We looked at Q1 and I think we feel strongly that the trends support the adjustment we made and there was no need to make a further adjustment. It's important to note that as we did our '08 plan, we didn't anticipate continued positive improvement in terms of the commercial trends. So we're comfortable with what we did. And again one of the reasons we took so long was to really assure ourselves of that.

MATTHEW BORSCH: Just so I'm clear, can you give me what the absolute figure now is in terms of your -- in other words I'm trying to understand is if you put the reserve development back where it belongs in 2007. What was '07 trend for commercial and what is now the view of '08 trend excluding that reserve development? And if you can share that.

JAY GELLERT: Let me state it but then I'll also tell you that it's obscured by the fact of the Guardian. So we have this problem where that effect changes the numbers. But I think if you try to make it apples to apples, our basic view is that the trend you look in '08 is pretty equivalent to the trend that we had in '07.

MATTHEW BORSCH: Okay, so trend is about flat.

JAY GELLERT: Yes. When you make the adjustment, so that's why we're comfortable with where we are.

MATTHEW BORSCH: And last, just last one. The individual segment. What are you guys seeing there that's causing you to back off a little bit?

JAY GELLERT: Well, I think that the pretty volatile California regulatory environment is encouraging us to be conservative in that segment until we see it play out.

MATTHEW BORSCH: Okay. Thank you.

OPERATOR: Thank you. We'll take our next question from Bill Georges with JPMorgan.

BILL GEORGES: Thanks. Good morning. Jay, I was a little bit confused by your discussion of pricing your book for the balance of the year. And if you could just provide a little more detail. If your view of cost is essentially unchanged when you normalize for the prior period development, why was your pricing sufficient to cover this new view? In other words, I would have expected you to price at a somewhat lower level in '08. But yet you've said that your pricing should be sufficient to right-size the price cost spread and then you also mentioned that you have 80 percent of the book locked in. So can you sort of explain that to me? I was confused -- I would think your pricing would be insufficient given the change in view.

JAY GELLERT: It's a good question. When we entered '08, we entered it with the assumption that some of the favorable trends we saw in '07 wouldn't continue. So we priced up both for margin and to give us some cover. If you look at, for example, our small group filings in California, you'll see that we did price up to reflect that. So what we're saying is that if you look at our cost trends, and you look at our pricing, 80 percent of which we already know, that it adequately covers them.

BILL GEORGES: Okay, and could you give a little more detail also -- exactly how developed at this point in time is your view of the first quarter? What I'm getting at there is whether or not you've seen claims mature sufficiently to know that you're kind of out of the woods with respect to the doctor and hospital utilization spike that you saw in the fourth quarter.

JAY GELLERT: I think we've studied it and really taken the time and that's why again as I said, we waited to give the guidance at this time. I think the key difference is that the backlog we had last year at the end of the year, which kind of I would say obscured some of our line of sight has now been paid down and it's back to being consistent with our usual experience.

BILL GEORGES: Okay. Can you give us a sense for just exactly what your backlog inventory looks like over say the last three quarters?

JAY GELLERT: Yeah, David and Angie can maybe walk you through that. I don't have that right in front of me, but we can get it for you, for sure.

BILL GEORGES: Okay. Thanks very much.

OPERATOR: We'll take our next question from Josh Raskin at Lehman Brothers.

JOSH RASKIN: Hi. Thanks, good morning. I will echo your comments, Jay, about Dave being helpful for us as well. Just want to talk a little bit about the guidance. I think specifically the second half. I think if I look at last year's second half, that was sort of \$2.09 reported. If I exclude the development, if I sort of take the first quarter development and put that back into the second half, I get a number close to \$1.81. And now the '08 guidance is suggesting somewhere in the range of \$2.51 to \$2.61 which is growth of over 40 percent, and I haven't even included the California impact in that. I'm just curious. Jay you had mentioned you had taken specific actions, maybe you could size some of the incremental improvements -- maybe dollar wise how much is going to come from the improvement in the spread and how much is SG&A, et cetera.

JAY GELLERT: Let me kind of highlight a few points. First of all, we have higher pricing in the second half of the year than we had in the previous period. And in fact, the higher pricing numbers we gave you pretty much balance out the prior period when you look at it. So those, I think, play each other off pretty well. We'll see improvements in G&A that make up much of the remaining difference. And so I think those are the two real effects that you'll see that can get you pretty easily from the second half of '07 to the second half of '08. Angie and David can go into the specifics with you. But those are the key points and they can walk you through them.

JOSH RASKIN: Okay, that's perfect. The second question -- just as you think about the '09 Medicare environment, you had said, I think Joe mentioned the bids for '08 were slightly competitive or slightly aggressive was the word he used. I'm just curious as you think about '09 for the Medicare book. I'm assuming your pricing to sort of fix those margins. But what are your thoughts in terms of the overall size of that book. Obviously you had tremendous growth this year. I'm just curious as you think about the Medicare side of the business.

JAY GELLERT: A couple of comments. First of all, regarding PDP, we've taken a pretty good look at the overall bidding versus the benchmark and I think that gives us some comfort we can rectify the PDP bid. We've also seen from both public and nonpublic companies some of the same kind of issues we've articulated. So I think we have a view that the PDP issue is going to work out. With regard to MA, I believe that in some of our more competitive markets we're doing satisfactorily, so we won't need to pick up as much margin -- the margin needs are in what I'd call less competitive markets. I think we're fairly comfortable we can kind of make that up in the bid process. I also think that with some of the new members, we really have some questions about some of the risks or two which we're looking at. I think given all that, I think the key issue is we feel good about the ability to solve the PDP problem and that the MA problem is more kind of fine tuning in some markets.

JOSH RASKIN: Okay, and then a last question -- the de-emphasis on the individual market. Can you talk about specifics there?

JAY GELLERT: Yeah, it's directly related to the present issues that exist in the California regulatory environment. The whole issue of rescission and the like. And I think until we see that settle, we want to be conservative in terms of our sales in that market.

JOSH RASKIN: Okay, so it wasn't loss ratios or competitors or anything like that.

JAY GELLERT: No, I think it's really directly the result of all the issues in the California market.

JOSH RASKIN: Okay. Thank you.

OPERATOR: We'll take our next question from Greg Nersessian with Credit Suisse.

GREG NERSESSIAN: Hi, good morning. My first question was hopefully just a little bit more color on higher physician and inpatient utilization of fourth quarter. Could you just maybe give us a little bit of sense where that came from geographically? It sounds like maybe the East more than the West. Also, were there any specific product types where you saw that? Some of your competitors have talked about high deductible plans impacting seasonality or cost. Was that a factor?

JAY GELLERT: I think we saw the effect mainly outside of California and Oregon. And I think in Arizona it was more of high deductible products, and some of those products in the Northeast it was just some specific cases like multiple births and the like, which are you know, kind of insurance risk.

GREG NERSESIAN: Okay, but you feel comfortable that your pricing in Arizona on those high deductible health plans would have captured the higher utilization even though you didn't actually see it until the beginning of the first quarter.

JAY GELLERT: Yeah, I think that our view is that the pricing was adequate, but couldn't absorb some of these unique cases. So I think we feel comfortable that it's adequate and our first quarter experience gives us that comfort.

GREG NERSESIAN: Okay. Along those lines, the lower commercial risk membership guidance -- again geographically -- where would you expect to see more of that come from?

JAY GELLERT: Well, first of all, as I said, the individual market is California and maybe a little of Arizona. The rest is probably pretty much all over the country. And we've kind of become a little more conservative in the mid market, in terms of making sure that we retain margin and discipline. Because we fundamentally believe that we hit this revenue number that it resolves our '08 issue and positions us well for '09. So it's those two issues. It's specifically individual issues in California and a little bit in Arizona which is kind of less a pricing and more just kind of a prudence issue. And then, the other one is, the conscious decision to not follow the occasional, furtive enter in the mid market.

GREG NERSESIAN: Okay, great. And just one last one -- the Medi-Cal outlook. I guess that emergency budget passed in January when you reported the fourth quarter sounded like maybe you didn't think it was going to be as big of a deal because of your capitation -- capitated provider arrangements. I guess that view has changed a little bit. What specifically has changed about your view there? And then any update on your long-term view on the Medi-Cal program? Or do you view this as a systemic fault within the program, or do you think this is just a temporary budget issue and you'll get back on your feet?

JAY GELLERT: Yeah, I would say that the biggest issue that's affected our view is that it seems like each week the California budget deficit increases by a billion dollars. So I think it was more kind of a better kind of view of kind of the realities of this situation. I do believe it's kind of a interim financial problem, not a long-term one, but I don't know how long it will last so we've incorporated it into our thinking and our guidance for the foreseeable future until something changes. But it's still a very viable business, still a business that clearly operates with a good return for us and so we want to stay in.

GREG NERSESIAN: Okay, great. Thank you.

OPERATOR: Next we'll go to Christine Arnold with Morgan Stanley.

CHRISTINE ARNOLD: Hi there. I'd just like to clarify some of your expectations here. So what you're saying is that you saw a spike in catastrophic claims related to last year and that that spike has returned to normalized levels in your view?

JAY GELLERT: Yes.

CHRISTINE ARNOLD: When did you see the spike in catastrophic claims primarily related to fourth quarter? Was that your March "don't ask don't tell" press release? Is that when you started to see it?

JAY GELLERT: It was, we saw it as we began the review process that we indicated in March. So yeah...

CHRISTINE ARNOLD: So if you didn't -- let's say the middle of fourth quarter was November, and you didn't see those claims until March, how do you -- and I know you had a claims backlog -- how do we have conviction that we've seen the end of them and that they've really died down?

JAY GELLERT: Well, the reason that we took the "don't ask don't tell" strategy was to be able to go back and look at the sources and compare it with some of the things in terms of our early indicators and fix that process up and make sure that we had successfully gone back. We even went to the point where some of the places -- the sources we've gone back and done inquiries into those facilities, checked them against our early warning indicators, our ops system and the like. So I think that that was a process we went through to give us some comfort that we had adequately set cost expectations in line with our experience.

CHRISTINE ARNOLD: Okay. And I understand the second quarter's going to benefit from sizable -- I mean, second half is going to benefit from sizable rate increases. Is second quarter going to benefit from sizable rate increases, given kind of the timing of when you saw this?

JAY GELLERT: Well, primarily second quarter won't benefit but it's as much because of a lack of turnover in that quarter as it is because of the line of sight. So the combination did it.

CHRISTINE ARNOLD: So here's what I'm struggling with. If second quarter is not going to benefit from a big increase in premiums, ex flu, ex charges, ex prior period negative development, first quarter looks like about a \$0.52 quarter. If you have a dime swing in PDP just because the loss reverses, that gets you to \$0.62. That's still quite a distance from 77 to 79.

JAY GELLERT: I guess David and Angie can work that through with you. But I just would call your attention to the fact that the, that as I said, the affect of the kind of one-time things was \$0.53 in Q1. So I think when you go from there, plus include some additional G&A savings, which we'll begin to run into the plan, you get to the number that we've suggested, and they can walk you through it.

CHRISTINE ARNOLD: Okay. Thanks.

OPERATOR: Next we'll go to Tom Carroll with Stifel.

TOM CARROLL: Good morning. Question for you on -- just in general -- what percent of your total claims roughly are for out-of-network providers?

JAY GELLERT: We'll have to get you that number. It would be a single digit number, but we can get you the exact number.

TOM CARROLL: So relatively low.

JAY GELLERT: Yes.

TOM CARROLL: I suppose in light of my expectations I guess a follow-up to that is how shall we think about in understanding that's a low number. How should we think about potential operational implications of the McCoy litigation? I mean I'm not asking to you comment on litigation. But I guess you know, would this drive higher medical costs for out-of-network claims which eventually just pass on to customers eventually a portion of it turns up as bad debt with providers again?

JAY GELLERT: I think that it will lead to clearer disclosure, and it will lead to decisions on the part of the employer of what level of benefits they want to buy. I think the core of the case to my view is it will demand that we be more explicit on what we mean by the term usual and customary charges. So I think your point is well-taken. That if the net result is people expect to see a higher coverage level, yet they will lead to higher premium, and so that is the issue with the case.

TOM CARROLL: Okay. Thank you.

OPERATOR: Our next question, we'll go to Justin Lake with UBS.

JUSTIN LAKE: Thanks. I guess just first on hospital pricing, had a couple of your peers mention some difficulty in hospital negotiations on the coasts, given that's where you live as well. Can you just give us an update on what you are seeing there? And has there been any increase in the tension of negotiations on hospital pricing?

JAY GELLERT: I think that we had our tension a couple of years ago. So it's kind of built into our baseline. So we're not seeing a level of heightened tension.

JUSTIN LAKE: Does that mean you just haven't negotiated any large contracts right now?

JAY GELLERT: No. We've done it. I think that -- and I don't know who the competitors are -- but there is -- what we see is that there's some evidence in some markets that some of the companies which had advantages are being challenged with those advantages. We went through that process a couple of years ago. So I think we have seen more orderly renewals.

JUSTIN LAKE: Got it. And just in regards to one of those competitors that might have had some advantages -- in California specifically -- you have a fair amount of overlap with the for-profit Blue out there -- given what they've seen as far as issues around cost trend and shadow pricing discussions in California and things of that nature. I'm just curious if you can comment. Have you seen any changes in pricing in either your West coast or East coast markets that might show -- drive some indicators of relief over the next few quarters as far as what pricing competition looks like?

JAY GELLERT: Of course I don't know the competitor to whom you refer.

JUSTIN LAKE: Sure.

JAY GELLERT: But I do believe that we've always viewed them as sound and prudent pricers. And we have every reason to believe they will continue to do that.

JUSTIN LAKE: Are you actually seeing anything in the market that tells you there's a change in their stance?

JAY GELLERT: Honestly, I think that we're comfortable they're acting intelligently, and I'll leave it at that.

JUSTIN LAKE: Fair enough. Just one more question. Given the number of charges that have been at least somewhat surprising over the last couple of quarters in regards to litigation issues and settlements, can you just update us? Is there anything else out there that you think could result in further one-time events over the next 12 to 18 months?

JAY GELLERT: You know, Justin, I think the best way to approach that is that they are fully disclosed in the Q and we're prepared to respond to questions on it. But I think that's the appropriate way to do it so there is no, so I do it consistent with kind of what's the appropriate legal steps.

JUSTIN LAKE: I guess my question is just that, if everything is disclosed in the Q and queue and I know you do a pretty good job of that. Normally, if you have these kinds of issues out there, is it that you didn't set up a reserve for them? Or is it that the reserve that you set up for the potential liability wasn't large enough? And can you comment on how those reserves look for what's still existing?

JAY GELLERT: I think that in these couple of instances, we were aware of the case but had no ability to kind of assess the magnitude or likelihood of them so these are situations where they're kind of circumstances where they don't fit within the accounting standards in terms of exactly determining how you book it.

JUSTIN LAKE: That's helpful. Thanks a lot.

OPERATOR: This is a reminder to our audience if you'd like to ask a question today, you may signal us by pressing the star key followed by the digit one. If you find your question has been answered, pressing the pound key will remove you from the queue. Next we'll go to Gregg Genova with Deutsche Bank.

SCOTT FIDEL: Hi. Actually it's Scott Fidel. First question, just back to Medi-Cal. Can you talk about what type of MLR now you're expecting once the rate cuts kick in in the back half of the year? Also do you have a percentage of the rate cuts that you're expecting to offset through med costs and admin cuts or savings with providers within the business?

JAY GELLERT: Yes, let me try and answer. The 15/20 is a net. We'll have to get you the exact number because I want to state it correctly. So we'll get that to you. We will still remain kind of in the mid- to low 80s MCR, so it's a good business.

SCOTT FIDEL: And then in terms of any estimated in terms of how much on the cut you think you can offset in terms of with providers, I mean I know you're capitated so it's a little bit difficult but –

JAY GELLERT: Let us get you the exact right number and we'll get back to you.

SCOTT FIDEL: Okay. Fair enough. Follow-up question just I know it's early here for '09. But just given that you guys have got a lot of different sort of numbers out there on earnings right now, just interested as we think about modeling '09, what would you recommend us use as sort of the baseline EPS number? Would you think the \$3.45 to \$3.55? Or more in the \$3.80ish range if we back out the '07 adverse reserve development? Which one of those you think is more of a good baseline? And then do you think you'll be able to grow earnings from that in '09?

JAY GELLERT: Let me try and instead of giving you exact baseline number, let me try and talk through the thinking and then you can work off it. I don't think we anticipate PPIA or flu recurring. I do believe we think that we can fix the PDP pricing issue. I think that we need to do more work on the MA pricing issues but I think we think there's some opportunity there. Our anticipation would be that we could grow earnings from there. We still have not renegotiated the TRICARE agreement so those are the kind of issues that we'd have to face going into '09. But we see growth opportunities and I think as we look at '09, those are - that would be the kind of framework we'd be thinking.

SCOTT FIDEL: Okay. And then just thinking about the cost components, and I know it's a bit difficult with the negative reserve development, but any view on sort of the individual cost components and where you see those on an underlying secular basis here in the first quarter?

JAY GELLERT: Yeah, I think if maybe look at it based on the 8 percent and I think where we'd go with that is physician in the mid singles, pharmacy in the mid- to high singles, and hospital in the 10 to low double-digit range.

SCOTT FIDEL: Okay. Thank you.

OPERATOR: Our next question from John Rex with Bear Stearns.

JOHN REX: Thanks. So I just want to be clear in the jumping off point here from the 1Q to the 2Q. Is it correct -- so you are suggesting essentially we add back the \$0.53 to the \$0.16? And that's kind of what you view as the cleaned-up run rate for the 1Q jumping off point?

JAY GELLERT: Yeah, I think that it is. I think we would still anticipate the \$16 million of additional Medicare that I mentioned. So that would be spread over the three quarters and then Medi-Cal in the second half of the year. But other than that, that's where I'd start.

JOHN REX: And that \$16 million would be disproportionately in the 2Q though in terms of drag? Isn't that correct, just the way that works?

JAY GELLERT: A little. But it's honestly not radically disproportionate.

JOHN REX: Okay I just want to make sure I understand the impact of the PPRD on dragging down the earnings run rate. Between the \$50 million in the press release and the \$7 million in the roll forward noted as prior period development -- unfavorable development. Why is there that discrepancy?

JOE CAPEZZA: John, this is Joe. We have a reserve for adverse deviation in our book. And what you're seeing there is the net of the \$50 million adverse development against that reserve. We had applied against it and that reserve rolls over and gets restored in 2008.

JOHN REX: But that would mean that the \$50 million wasn't fully a drag then on earnings. It would mean only we think only the \$7 million is a drag on earnings.

JOE CAPEZZA: No, that's not true. Because if we didn't have the \$50 million, we would see a \$50 million favorable development in that schedule that you're looking at.

JOHN REX: Sorry -- if you didn't have the \$50 million unfavorable.

JOE CAPEZZA: If we didn't have the \$50 million unfavorable, you'd see a \$43 million favorable number in that development schedule that you're looking at.

JOHN REX: So you're saying -- so you experience an unfavorable development of \$50 million and then you are saying you replenished it?

JOE CAPEZZA: That was applied against our reserve margin for adverse deviation. And that reserve margin was then replenished.

JOHN REX: It looks like to me the earnings report isn't bearing the \$50 million -- the full \$50 million impact.

JOE CAPEZZA: We can walk you through the math off line if you like, John.

JOHN REX: Okay, but your view is the earnings report bears the full \$50 million impact?

JOE CAPEZZA: Absolutely.

JOHN REX: Okay. So we'll walk through the discrepancy of the 50/70. Okay. Just in terms of the rising utilization again, and kind of the impact there, you've been through this. I'm not sure what else there is to say. But the higher level of high cost cases, is there a reason internally in the company -- kind of why suddenly there was a spike in these kind of cases?

JAY GELLERT: Well, I think the reason at the end of the day is kind of that we're in somewhat of an insurance business and we just got a clumping of those cases rather than a spread of the cases, and so when you look at things like septicemia, increases in septicemia, I don't think that we see a septicemia epidemic or anything. We had an unusual number of twins and triplets, so those are the kinds of things that affected it. If it was more kind of general, kind of disease trends, I think we would have a different view, but that's not what it was.

JOHN REX: Okay, and then just on the restructuring charges, am I right in thinking -- it looks like it's about \$100 million now. Do I compare that to the \$40 to \$50 million that you talked about in the November investor day?

JAY GELLERT: Yeah.

JOHN REX: Why is this so much higher? We're talking about a \$2 billion a year business -- right, that we're putting this against?

JAY GELLERT: Yeah. I think there are two reasons. One is that we're actually reducing by some more people as we complete the restructuring throughout the company. But the more significant reason is that we sped up some of the outsourcing activities which then end up accelerating some of the non-cash write-offs. When we go to outsource, we then have to write off systems. And so the fact that we originally thought those were going to happen in early '09, they were going to happen later in '08, they'll expedite the non-cash write-offs of certain assets.

JOHN REX: Of the \$100 million, how much is cash?

JAY GELLERT: About 60 percent, I believe.

JOHN REX: About 60 percent.

JAY GELLERT: Yeah, and the increase that we've just talked about is more in the non-cash items.

JOHN REX: Okay, great. Thank you.

OPERATOR: We'll go to Charles Boorady with Citigroup.

CHARLES BOORADY: Thanks, good morning. First on Medicare, what will you change in the process of putting Medicare bids together this year to prevent another shortfall next year?

JAY GELLERT: I think that fundamentally, we will be more conservative in some of our PDP assessments. We expected a continuation of a trend from brand or generic. We didn't see it and we won't count on it happening again. That's probably one issue, and then the other issue is in a couple of places we made a decision to do some regional grouping in terms of our bidding process which ended up having an effect because the membership came in in different places than we anticipated, and we're changing that strategy as we do our PDP bid for next year.

CHARLES BOORADY: That's helpful, Jay. I guess by process I was wondering, for example, could you have an independent party like a Redden & Anders or somebody else review what you're doing for reasonableness, or have a second set of eyes?

JAY GELLERT: Yeah. We will do that. We've done it. But I think the key thing is that when we went through the process before, people highlighted those kind of assumptions. And so it's the combination of having a third party review but it's as much as being realistic about the assumptions for the bid.

CHARLES BOORADY: To what extent is the high turnover in management, including people running Medicare, been a challenge for you, Jay? And what can you do to try to attract and retain talent at the company? Especially in key roles like that?

JAY GELLERT: Well, I think we'll have the same talent next year that we had last year. We'll have stability in the Medicare -- of course, I think we do end up in some situations where people get offered bigger jobs. But I think we've built the right incentive structure and we have a strong management team in Medicare.

CHARLES BOORADY: In terms of the medical costs, how much of what you saw was legitimate versus say the cause because of a lack of care management or other oversight on the part of the company? And then it seems like you're striking it up to bad luck, because you're not seeing an industry-wide rise in those trends. And I'm wondering if there's something more than just bad luck. Like is there a reason you're attracting adverse risk? Or are there other factors to consider in sort of how we buy into the story that the problem is not going to recur if the fourth quarter of this year with your current book of business.

JAY GELLERT: I think that's a fair question. And I think that in addition to reviewing the cases, we've tightened up medical management in some key areas. We found, I think it's appropriate to say, some gaps which we did fill, and those are the phenomena we're seeing, not the risk in the book of business.

CHARLES BOORADY: So the assumptions in your guidance for this year -- is it that you'll have the same level of those unusual cases as you had in the fourth quarter of '07? Or that your medical management or other changes are going to be able to bring utilization more under control?

JAY GELLERT: The assumption in the guidance is that they'll be as we've seen them spread throughout the year and that we won't have an unusual bump in them. And it's looking back over a three or four year period to what the kind of normal trend was in adjusting to that end.

CHARLES BOORADY: I wasn't totally clear on that. So the fourth quarter of '08 you will not see a recurrence of what you saw in the fourth quarter '07? It will be more like previous years?

JAY GELLERT: Yeah, it will be more like previous years in just some of these very key categories.

CHARLES BOORADY: Is there something in your benefit design that might have attracted people who were expecting multiple births or some of the other things that you've talked about, or is it really just bad luck in your view that you got these cases?

JAY GELLERT: Yeah. That's one of the things actually we looked at very closely. And I think we feel that it wasn't benefit. In fact, what gave us some comfort, Charles, was we went back and looked and it was mainly longer term accounts with longer term people. So that's why we came to that conclusion.

CHARLES BOORADY: Okay. Last question on the charge. How much of it is what you know you will owe versus an estimate to the extent that there is estimation involved? Can you give us a sense for the level of conservatism in that estimate or might these numbers have to go up again?

JAY GELLERT: I think it's a reasonable expectation based on what we know right now.

CHARLES BOORADY: Okay. Thanks.

ANGIE McCABE: Alright. With that we'd like to thank everyone for joining us today. David and I will be available to take calls. Have a nice day, everyone.

OPERATOR: That does conclude today's conference. We appreciate everyone's participation. Have a good day.

[END]