



**Health Net, Inc.  
Q2 2008 Earnings Conference Call  
August 5, 2008  
8:00AM PDT**

**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. second 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, Carla. Good morning.

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 operation strategy 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, and thank you all for joining us this morning.

Today I'd like to review our Q2 performance and our 2008 revised guidance. We believe our Q2 results show progress on a number of fronts. We have strong core businesses and we still see our diversified business base as a real strength in the current economic and regulatory environment. Importantly, there was significant improvement in the year-over-year and sequential commercial MCRs during Q2. We also returned to a positive commercial spread between yield and costs. TRICARE performance improved sequentially, and G&A was a particularly bright spot.

At the same time, we're disappointed that we have to lower our full year 2008 guidance. On a GAAP basis, our new guidance is \$1.97 to \$2.03 per diluted share. Excluding the impact of charges, our 2008 earnings per diluted share guidance is \$2.85 to \$2.95. We believe our new guidance appropriately addresses the challenges that our company and the industry as a whole are facing.

This change in guidance is due to several factors.

When we gave our earlier guidance in April, we said that it was premised on higher commercial yields and stable claims trends. We saw higher yields in Q2, and expect them for the remainder of this year. We continue to expect commercial yields to come in at approximately 8 percent for the year. The commercial yield should increase by approximately \$5 PMPM Q3 over Q2 and by approximately \$3.50 PMPM Q4 over Q3. However, the higher yields come at the expense of membership. We now expect commercial membership declines of 6 to 7 percent for 2008 compared to 2007. The loss in membership is expected to impact earnings by approximately \$15 to \$20 million pretax.

Based on what we are currently experiencing in terms of pricing, we believe that our pricing picture will be solid in '09. RFP activity for '09 is strong, and our initial renewals seem to be going well. However, we could see continued membership pressure.

I'd like to briefly touch on membership activity in Q2. Commercial risk enrollment of 2.1 million members at the end of Q2 represents a decrease of 2.6 percent compared with the second quarter of 2007. Sequentially, commercial risk enrollment declined by 1.8 percent. These declines can be attributed to our pricing discipline and the effects of the overall economic environment. Our strategy remains to grow membership in the segments where we can compete in terms of product and network cost competitiveness and get adequate premiums to meet anticipated healthcare cost trends.

The small group and individual segment grew year-over-year but decreased sequentially. We are still focused on offering a wide array of products and on strengthening relationships with our distribution channels. However, as we mentioned on last quarter's call, we do expect to be somewhat less active in growing the individual market due to the current regulatory environment.

Our Medicare lines of business experienced very strong membership growth in the second quarter. In Medicare Advantage, our focus is on growing the network model HMO and PPO plans. During the second quarter of 2008, MA enrollment grew by 21 percent versus Q207. We continue to expect 20 to 25 percent membership growth in MA. Enrollment in our private fee-for-service business grew by 11,000 over the past 12 months to 24,000 at June 30, 2008. PDP membership, which we continue to expect to grow by 40 to 45 percent this year, stood at 526,000 members at June 30, 2008, an increase of 178,000 members from June 30, 2007.

Regarding claims costs, we are not seeing the abatement in Medicare costs that we anticipated. Therefore, we are reducing our second half expectations by \$37 million pretax as a result of higher costs related to new members added in 2008. As you know, no alteration in pricing can be made until 2009. We believe, however, our 2009 bids are adequate with regard to pricing and will allow us to recover in 2009. Private fee-for-service is not a big part of our business, so we don't expect the changes in the law passed in June to undermine our future. We remain focused on network model MA plans.

After the Q1 prior period development issues, commercial claims have stabilized. Given the high cost environment, we have made some adjustments in our guidance to mitigate potential risks in the second half. As a result we have adjusted our commercial health care costs PMPM expectations to approximately 8.4 percent for the full year of 2008. Even with this, we expect that PMPM premium yields to be greater than PMPM health care costs in the second half.

Q2 was a strong quarter for us in G&A. We are beginning to reap the benefits from our operations strategy. While we see some additional costs in the second half of '08, we remain confident in our 2009 and 2010 guidance for G&A savings.

Two final comments. First, our Federal Services division – both TRICARE and MHN – continue to perform very well. Our Federal Services division remains focused on meeting the needs of our military families. That team worked very hard and submitted our bid for the new TRICARE contract at the end of June. At this time, we have no new news regarding the procurement. We are beginning negotiations on an extension to our present contract with DoD.

Finally, we didn't purchase any shares in Q2 but we still expect to achieve our goal of repurchasing 3 to 5 percent of shares outstanding this year.

While Q2 generally performed well, we're disappointed that we are reducing our '08 guidance. We know that this is a challenging environment, but we are focused on taking the necessary steps to improve our performance, especially in our Medicare business, and set the stage for 2009.

I'd like to turn the call over to Joe Capezza for a more in-depth discussion of the financials. Joe.

JOE CAPEZZA: Thank you, Jay, and good morning. This morning I would like to take you through the highlights of our income statement and balance sheet. Then I'll focus on the cash flow statement where there are several items to discuss. I'll end with some thoughts on our revised guidance. I'm going to primarily discuss results on a non-GAAP basis as we believe these more accurately reflect ongoing operating performance.

But let me first start with a brief review of our GAAP results. In the second quarter, we earned \$0.71 per diluted share. This includes the effect of a charge we took in the quarter of approximately \$13 million or \$0.03 per share for severance and other costs associated with our operations strategy effort. We expect these type of charges to continue into the third and fourth quarters, amounting to approximately \$60 to \$70 million in the aggregate. Backing out the charge, we made \$0.74 per diluted share.

Let's now review the income statement. Health plan revenues climbed 10.8 percent in the second quarter compared with the same quarter last year. Driving this increase was a 9 percent year-over-year increase in PMPM commercial revenues, a 21 percent increase in Medicare Advantage enrollment, and a 51 percent increase in Part D enrollment. Medicaid enrollment did decline year-over-year due to our exit from the Connecticut Medicaid program earlier this year. Commercial risk enrollment declined by 2.6 percent when compared to last year's second quarter.

TRICARE revenue was up 13.2 percent year-over-year. This is driven primarily by higher pricing in Option Period 5 over Option Period 4 and a substantial year-over-year growth in MHN's Department of Defense family counseling business. TRICARE's cost ratio was 94.7 percent, a very good performance from historical perspective. We said last year that the TRICARE margin would return to the 5 percent range in 2008. It has and we believe it will stay in this range for the balance of the year.

Investment income at \$20.9 million was down from both last year's second quarter and the first quarter of this year. One driver was lower interest rates. The other cause was the fair value adjustment of a swap agreement that relates to the \$175 million financing arrangement that we entered into last year. We expect investment income to be in the \$55 to \$58 million range for the second half of the year.

On the cost side, overall health plan costs were up by 11.5 percent year-over-year. On a PMPM basis, commercial costs were up by 8.6 percent. That's a 40 basis point positive commercial spread compared with the aforementioned 9 percent commercial premium yield, and is a significant achievement in a challenging market.

The commercial MCR was 84.2 percent compared to 84.5 percent a year ago, an improvement of 30 basis points in gross margin. We remain focused on sustaining these commercial margin improvements for the balance of the year and into 2009. Both Medicare and Medicaid MCRs were higher in the second quarter of 2008 than they were last year and higher than expectations. We believe these higher than expected MCRs will persist throughout 2008. As Jay noted, we incorporated this higher cost scenario into our Medicare bids for 2009.

Our performance on the G&A side was very encouraging. On a GAAP basis, it was 9.5 percent, 10 basis points better than we achieved in last year's second quarter. Backing out the charge, it was 9.1 percent. We believe we are showing real discipline in the G&A area. Depreciation and amortization rose by just over \$4 million in the second quarter of 2008 compared with last year. This relates to the buyout of the Guardian agreement that we completed last year. Interest expense was up \$3.5 million from a year ago and reflects higher debt levels in 2008 compared with 2007. In the second quarter, we drew an incremental \$45 million on a revolving credit facility to purchase equipment at the end of a lease agreement.

Lastly, on the P&L, the average weighted share count was 108.3 million. This is about 2 million shares higher than we thought it would be. The higher share count impacted Q2 earnings per share by a penny.

Now let me turn to a couple of noteworthy balance sheet items. Premiums receivable increased by \$66 million during the quarter. This is mainly due to the buildup of Medicare risk adjuster revenue in the amount of \$57 million, of which we'll receive \$47 million in July from CMS. Reserves declined sequentially in line with lower enrollment. Days claims payable, however, was higher, both on a GAAP and adjusted basis.

Let me make a brief comment about the risk profile of our investment portfolio. We've been getting questions about this recently. Our investment portfolio is comprised of all investment grade debt securities with an average credit quality of AA+ and a duration of less than four years. Approximately 34 percent of the portfolio, or \$522 million, is invested in mortgage-backed securities. A vast majority of these securities are Fannie Mae, Freddie Mac and Jennie Mae issues. As of June 30th, 2008, our mortgage-backed securities had gross unrealized losses associated with them of \$8.7 million.

Now let me talk about operating cash flow. Operating cash flow was negative by approximately \$80 million. Much of this was a result of timing issues, especially as it relates to Medicare. Our full year outlook is \$320 million, which represents approximately 105 percent of net income. This can support our stock buyback goals. The most significant factors affecting operating cash flow in the quarter include:

- Part D risk adjusters and reinsurance totaling \$87 million of which, as I mentioned before, the company received \$47 million in July;
- \$41 million for cash payments, for legal settlements and ops strategy;
- \$18 million for annual shared risk settlement with California medical groups; and
- \$28 million for various payment timing issues.

If you back out these numbers, you would get a cash flow number in excess of net income.

Now let me turn to our revised earnings guidance. The new guidance incorporates an \$87 to \$92 million reduction in our expected pretax income for the second half of this year. The revised full-year 2008 guidance is driven by the following factors.

1. First, lower than expected commercial membership as a result of commercial pricing discipline, coupled with a further weakening in the economy is expected to have an impact of 15 to \$20 million. This represents a decrease of between 6 and 7 percent in all commercial enrollment for the year.
2. An anticipated increase in Medicare health care costs of approximately \$37 million due to higher utilization by new Medicare members added in 2008 and reduced Medicare revenue of approximately \$8 million as a result of lower risk adjuster revenue. However, when we filed our 2009 Medicare bids in June, we had the specific goal of producing a significant margin turnaround next year so we would expect to see an improvement in this area beginning in 2009.
3. Third, higher than anticipated commercial health care costs of approximately \$17 million. We now expect commercial health care costs to rise year-over-year between 8.3 and 8.4 percent. This is a slight increase over our original guidance of 8.0 percent at the end of the first quarter. Despite this, we do expect positive commercial spreads in both the third and fourth quarters. Full year yield over cost spread will be negative because of the adverse prior period development that was recorded in Q1.
4. Finally, higher than expected G&A costs of \$6 million and lower than expected investment income of \$4 million for the full year, we now expect investment income to be approximately \$10 million lower than our previous guidance. This mainly reflects the effects of the aforementioned swap and the interest rate environment.

To sum up, we did pretty well in the second quarter. We are maintaining pricing discipline and a positive spread between commercial yields and costs. We believe we've identified our issues and we are addressing them. We have a clear view of the balance of the year. We are confident that in addressing these issues, we can pave the way for improved performance in 2009.

Thank you for taking time this morning, and I look forward to your questions. With that I'll turn it back over to Angie.

ANGIE McCABE: Carla, we're ready to take Q&A.

OPERATOR: Thank you. The question and answer session will be conducted electronically. If would you like to ask a question, please do so by pressing the star key followed by the digit one on your touchtone telephone. If you are using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. We will proceed in the order that you signal us, and we'll take as many questions as time permits. Once again, please press star one on your touchtone telephone to ask a question. And our first question comes from Charles Boorady with Citi.

CHARLES BOORADY: Thanks. Good morning. Can you give us an update on when you expect a decision from TRICARE and what the impact would be to your TRICARE earnings if you kept the contract under the new terms versus if you lost the contract? While you do split out TRICARE earnings, I'm just curious what you might allocate in expenses to TRICARE that might not be able to be cut, if you actually lost the TRICARE contract?

JAY GELLERT: With regard to the timing, we have no new news. As we indicated earlier, if the government is going to be able to execute new contracts on April 1st, 2010, a decision has to be reached no later than May of 2009. We're presently beginning the process of negotiating extensions for the government and we have really nothing more that we can add in terms of the timing of the process. We've indicated before that we basically are assuming that the \$100 million of savings we've got in the ops strategy really will allow us to deal with the reduced size of the new TRICARE contract and cushions us in the unforeseen event that we don't regain it.

CHARLES BOORADY: Got it. And putting TRICARE aside, can you give us any key head winds or tail winds that you have going into '09 versus what you're reporting with your new '08 guidance? In other words, things that are one-time in nature that you wouldn't assume would recur -- positive or negative -- in 2009?

JAY GELLERT: I think in the -- and I never get this right. I think tail winds are positive things and head winds are negative things.

CHARLES BOORADY: That's right. And never spit into the wind.

JAY GELLERT: So let me try not spitting into the wind in responding. In terms of tail winds, I think that one of the key things that we wanted to be sure of in terms of revising our guidance was that the two main one-time events this year that would be alleviated, kind of giving us tail winds going forward. One is PPIA and the other is the diminished performance we're seeing in Medicare, both on the PDP side and the MA side. So a key goal of ours in terms of the guidance we're giving is to assure that we can alleviate those as issues and have them for all intents and purposes being tail winds going into '09. We also think we'll begin to see the benefits of the ops strategy going into '09.

Alternatively, the Medicaid adjustment that is at least in our guidance for the second half of the year, if it came to pass, would be a full year adjustment next year so that would be a head wind going into next year. So I think if you look at it, those would be the main tail and head winds that we see going into next year.

CHARLES BOORADY: Got it. One final question on hospital expenses. Anything unusual driving your hospital inpatient costs on the coding front? A couple of companies have mentioned coding creep or a change in coding that has resulted in an increase in reported intensity of service.

JAY GELLERT: Yes, we saw some evidence of it -- some of that in Q1, but not in Q2. The place where we've seen more of that is some in the outpatient arena, but we're not seeing it in the context of that much of coding in the inpatient environment.

CHARLES BOORADY: Was it because you fixed something that you found, or it just was an anomaly that ended it?

JAY GELLERT: It's primarily because most of our contracts are not particularly related to that phenomena. But secondly, some of the medical management tools we put in place seemed to have alleviated some of that risk on the inpatient side for us.

CHARLES BOORADY: All right. Thanks.

OPERATOR: And we'll take our next question from Josh Raskin with Lehman Brothers.

JOSH RASKIN: Hi. Thanks. Good morning. First question just on Medicare Advantage. The higher cost for the new members -- I guess I'm just curious. Why are you seeing higher costs this year for new members whereas it didn't appear that last year we saw that, and I think the growth in MA was about 20 percent as well last year?

JAY GELLERT: Yes, historically we assume that new members have lower costs than average members. That's been our experience. This year, we haven't had that experience. And in our guidance we're assuming that it won't occur in the second half of the year. The problem Joe raised is critical in that regard, which is if you get members who are more acute you don't get the benefit of the risk adjusters

until the next year. We've assumed no benefit from risk adjusters, but it appears that this year we ended with a more acute group of members that we attracted into our program.

JOSH RASKIN: Is that a benefit design change? I'm just curious in terms of the benefit package. I didn't notice anything dramatically different this year versus last year.

JAY GELLERT: No. It's not a benefit design change. It may be a phenomena of the fact that we operate primarily in very mature markets, and I think we have a little bit of a sense that the economy may be pushing people who were in kind of the first generation of managed care people into MA and that they may be a more acute mix.

JOSH RASKIN: Okay. And then, I guess, Jay, how does that go with the fact that you guys are taking down the revenues by \$8 million. It sounds like you're getting less risk adjusters. I'm just curious, what was the disconnect there? It didn't sound like you were expecting to get the risk adjusters on new members. So does that \$8 million relate to older members?

JAY GELLERT: It's really an alteration in terms of the older members. And it's both on the PDP and MA side. Part of it is reconciliation of '07 and part of it is in '08, but we've taken a conservative attitude about all of that.

JOSH RASKIN: And last question. What's the cost driver for the higher commercial second half assumption?

JAY GELLERT: Where it's primarily in the outpatient and physician environment and I think it's an attempt on our part to just be sure that -- to relate it to Charles' question, that we don't enter '09 with any PPIA risks, so we're being cautious in looking at possibilities for the second half of the year.

JOSH RASKIN: Similar driver that you mentioned in the first quarter is that the unusual physician and hospital utilization patterns. Is that outpatient related as well?

JAY GELLERT: Yes.

JOSH RASKIN: Okay, thanks.

OPERATOR: And now we'll move on to Matthew Borsch with Goldman Sachs.

MATTHEW BORSCH: Yes. If I could just ask on the share repurchase. So I think you said last quarter that you expected to be active in repurchasing shares. But I guess at some point you decided not to be active, and I'm wondering when you made that decision and how we should think about it now. Because obviously you guys are saying that you intend to be active again, but how do we look at that statement and juxtapose it against what you said at the end of last quarter?

JAY GELLERT: At the end of last quarter I believe we said that we intend to meet the target that we've set in our guidance and that we'd be active in that regard. And we restated that so I think it limits the time in which we have to act to meet the commitment we've made, so I think it can operate with that in mind.

MATTHEW BORSCH: Okay. I'm just reading from the transcript. It said, "It is our intention to continue repurchasing shares." I think a reasonable person's read of that was that that pattern of share repurchase, which was pretty strong in the first quarter, would have continued. Was there a checkpoint at which you decided, okay, you know what, it's best for us to wait until we let the dust settle on the second quarter?

JAY GELLERT: I think that we did take that position that we wanted to see what happened with the second quarter and that -- so that there was clarity for everyone. But again, in that statement, I believe we also said that we were committed to share repurchase targets this year, which we will meet.

MATTHEW BORSCH: Okay. Okay. And just moving on to a different topic -- how do you guys handling the repricing and the risk of adverse selection, just given the rate of attrition in your commercial risk enrollment?

JAY GELLERT: Yes, we're tracking it very closely and it in fact seem that a lot of it is coming from segments that have been less profitable, that the risk profile is staying constant, or maybe even improving a slight bit.

MATTHEW BORSCH: Okay. Okay.

JAY GELLERT: So we're following it very closely and it's relatively easy to do because what we do is we look at the rate that was required for business that's leaving and compare it with the rate that's required for new business, and we can keep a very close eye on the actuarial mix of our business.

MATTHEW BORSCH: Got it. And just to get on a different one here. As we think about your charges for this year, the charges that you've taken and intend to take in the back half. Are all of those, or what portion of them, are running through your regulated insurance subsidiaries?

JOSEPH CAPEZZA: Most of them are running through the regulated entities.

MATTHEW BORSCH: Okay. Last question here on Medi-Cal. Can you just give us an update on the impact you're projecting there? Is it unchanged, and what's your thought on how the current budget impasse is impacting the program?

JAY GELLERT: It's unchanged. There's been some speculation that the budget will end up in a potentially more favorable position, but we've not assumed any of that because we think it's such a volatile situation. The governor is reported to have -- indicated he's willing to support a sales tax increase of a penny in exchange for certain reforms in the budget process. It's very unclear as to whether that's going to prove to be a viable solution. So we've stood with the position that we've taken before, which was just to assume that what was previously said is going to continue.

MATTHEW BORSCH: Got it. Thank you.

OPERATOR: And moving on, we'll hear from Justin Lake with UBS.

JUSTIN LAKE: Thanks, good morning. A couple of questions. First just on the commercial cost increase. I got the impression from your commentary that you haven't actually seen anything in the claims trend that's telling you that's already happening. So maybe you can just tell us what you think is going to happen and what's giving you pause there.

JAY GELLERT: I think that your assumption is correct. That what we wanted to be sure is that if some of the issues that we saw last year that we successfully overcame the first half of this year were to recur in some way that we had successfully factored it into our guidance, and we thought that there was some potential possibility and that we could see the uptick in outpatient and physician that we've seen sometimes in the past, and so we just took that into consideration in giving our guidance.

JUSTIN LAKE: Okay. But you're specifically saying you have not seen those as of yet?

JAY GELLERT: That's correct.

JUSTIN LAKE: Okay. And on the Medicare Advantage side, can you just give us an idea of what the MLR in the first half is running, and what you're expecting or betting into guidance for the second half? And then can you talk to next year as far as how much improvement you think you've got built into those bids? What your target was as margin improvement there?

JAY GELLERT: Joe, do you want to do that?

JOE CAPEZZA: Okay. For Medicare, we group private fee-for-service in with the traditional Medicare Advantage product. The MCR in Q2 was running at 89.3 percent, and we expect the year to be at 89.8 percent.

JUSTIN LAKE: 89.8 percent.

JOE CAPEZZA: For the full year.

JUSTIN LAKE: Okay.

JAY GELLERT: And the bid targets that we've set are 100 to 200 bps below that.

JUSTIN LAKE: And do those bid targets -- I think you mentioned the potential for more risk adjustment revenue. That's not imbedded in that 100 to 200 basis points. Is that correct?

JAY GELLERT: That's correct.

JOE CAPEZZA: We took a conservative view for potential risk adjuster revenue.

JAY GELLERT: That's right.

JUSTIN LAKE: Okay, and just the last question on Medicare Advantage is, from a cost perspective, is there any specifics you can tell us as far as what picked up in the second quarter and why you don't think it is transitory? Why you think it sounds like you believe you've been negatively selected, and just maybe go through some of the events that kind of led you to this conclusion now rather than two or three months ago?

JAY GELLERT: Well, yes. I think the fact that it is concentrated in the new members made it so that you couldn't draw a conclusion any earlier. So we're in a situation where we just didn't have the experience of that population to even assess. The reason why we're not counting on it abating is that it's fairly broad-based in terms of type of service. So that leads us to think it's more of an adverse mix than an aberration in terms of care. For example, if we just had a pickup in hospitalization and everything else was tracking at a lower level, I think we would have maybe come to a different conclusion. But in this case, given that it's broad-based, I think our assumption is it's more of an adverse mix for which we're not getting appropriately reimbursed than it is a situation that would abate. It could. But I think our conclusion after looking at all of the data is that the sounder strategy was to change guidance as we did.

JUSTIN LAKE: Okay, and just to make sure I'm understanding the numbers here. We're talking about 50,000 members this year.

JAY GELLERT: Well, actually you're talking about 80,000 because you have the growth plus the churn.

JUSTIN LAKE: Okay. Got it.

JAY GELLERT: And again typically that population, when you make the necessary -- you assume and historically for us it's always been a better population so it's really more tracking the base. The advantage that gives us is that when we did the bid we assumed it would move to the mean so the experience of this year will not be adverse.

JUSTIN LAKE: Got it. That's helpful. Thank you.

OPERATOR: As a reminder, that is star one if you do have a question. Now we'll go to Greg Nersessian with Credit Suisse.

GREG NERSESIAN: Close enough, thank you. I was just wondering if we could quickly review the impact of the Guardian on the yields. It looks like you did about 9.5 percent in the first half of the year. The full year 8 percent. So that obviously implies 6.5 percent for the second half of the year. Is that the right number -- is that the right run rate to think about starting point for 2009?

JAY GELLERT: I think that those numbers are correct for '08. And I think that the run rate for '09 will be somewhat different because of the mix of business that's renewing, but that's the proper numbers for '08.

GREG NERSESIAN: Okay. And just in terms of the cost trend, anything you can spike out for us from a regional perspective in terms of the east versus the west? Where do you expect to see those elevated physician outpatient costs?

JAY GELLERT: I think it's probably more westward than eastward.

GREG NERSESIAN: Okay. And then just two more quick ones. It looks like you lost some ASO business in the quarter. Was that a contract loss, or was that just attrition in your existing book?

JOE CAPEZZA: That was the loss of the Connecticut Medicaid program which went ASO last year.

GREG NERSESIAN: Oh, that's right. Okay, that's fine. And then finally, California is talking about or leads to some discussion about reforms to the individual market in California. I know you've talked about perhaps de-emphasizing growth in that business going forward. Are those the types of reforms that might lead you to reconsider participating in that business altogether or maybe if you could just talk about the regulatory environment in California?

JAY GELLERT: Yes, our view is that once we kind of see the regulatory environment stabilize, we can make a good assessment. I believe that if we can get clarity on the kind of rescission, underwriting, that whole process, that's critical. And there seems to be some activity in that regard. I think that would be helpful. And then to the degree there are new underwriting rules and the like, we' like to really understand what they're going to be before we go full bore in that sector. So I think your analysis is correct. At this point in time, we're slowing down until we see what the legislature does this year and also to get kind of a sense of what's going to happen next year.

GREG NERSESIAN: Okay. Thank you.

OPERATOR: And moving on, we'll hear from Scott Fidel with Deutsche Bank.

SCOTT FIDEL: First question is if we can walk through the same exercise we just did with Justin for MA for Part D in terms of what the Part D for MLR was in the first half and what you're expecting for the second half, and then what your bids are assuming for 2009.

JAY GELLERT: The Part D MLR for the first half, do we have that here? I have Q2 in front of me but let us get you that number, those numbers.

ANGIE McCABE: Yes. I can take that with you offline.

JAY GELLERT: Let us get those numbers to you. But the goal we've set is in terms of PDP is that we bid on the assumption of 4 percent margins next year, and we priced to assure that we get that.

SCOTT FIDEL: And what do you think just sort of a raw number would be an estimate for '08 margin relative to the 4 percent in '09.

JAY GELLERT: The margin in '08 I think is more in the 1 percent range; is that right? 1 percent, PDP margins, in '08.

JOE CAPEZZA: Yes.

JAY GELLERT: That's correct, 1 percent.

SCOTT FIDEL: Second question, just if you could give an update on actually how the restructuring plan so far is proceeding relative to your initial expectations, and then an update on where you stand in the systems upgrade process and if there's been any changes in the plan around that since the last call.

JAY GELLERT: We're encouraged by some of the synergies and savings we're seeing by pulling people together and integrating the work forces, and we were able to show some of that this year and we continue to be confident in the numbers for '09 and 2010. One of the outsourcing vendor contracts took a little longer than we thought, so that's pushing back the time line a bit. But in terms of the system consolidation goal of doing Arizona next year and the Northeast the year after, that's on track.

SCOTT FIDEL: And then just a follow-up question. Just thinking about from a strategic perspective and the various assets in the portfolio, are there any assets that you think might not be the best fit longer term, in terms of the overall consolidated business? Obviously a few years back you guys did do quite a bit of culling of certain assets, thinking about Florida and Pennsylvania, and just wondering in terms of thinking about the two primary commercial pieces, the West Coast and then the Northeast. Do you still view the best strategy long-term as having the synergy between the two, or would you consider potential divestiture investments there to unlock shareholder value?

JAY GELLERT: We're encouraged by the progress that the commercial business is making in the Northeast, and I think we want to get that to kind of a position where it kind of locks in. And then I think we have to look at kind of the overall strategy, but I don't think there's any kind of clear conclusion we have at this point in time.

SCOTT FIDEL: Okay. Thank you.

OPERATOR: And now we'll go to John Rex with JPMorgan.

JOHN REX: Thanks. I just want to understand how you think about your current earnings run rate. Would it be appropriate to take your \$2.90 you're guiding to now, add back the essential, I think it went to --

about \$0.50 of items that you spiked out that were native to flu, MA, non-[inaudible] items that you spiked out, and add those back to that? So do you view your current run rate as about \$3.40 a share? Is that the right way to think about how you assess your '08 right now?

JAY GELLERT: I think that we've -- the PPIA in the one time category, I think when we get to see the bids in terms of MA in the next couple or three months, we'll have the ability to really assess where we'll end up with MA. That would answer your question. At this point in time, we do expect improvement in MA from the run rate -- to improve the run rate. In terms of the flu, I think it's premature to kind of come to a conclusion where the health care trends were going to go. If I were doing run rates, I would definitely put the PPIA as a one-time item. I think there'll be improvement in Medicare from our run rate this year, but I think it would be more prudent to see the bids before we specifically say that. And in terms of flu, we should see the overall trend. So that's kind of a summary of where we are in terms of that.

JOHN REX: Thanks, I want to make sure I understand where we're at then actually. So you would see a run rate, so we pull out \$0.10 for flu, so you would still be in a run rate arena something in the \$3.20 range or something? Is what you think, are kind of jumping off from?

JAY GELLERT: I think we want to confirm that when we saw the Medicare bids but I think it's an assumption that we have to kind of -- that it's in the ballpark.

JOHN REX: Right. And it sounds like your Medicare bids, it sounds like you're targeting something like an 87 or 88 percent loss ratio in your bids, because you were talking about coming off this 89 with 100 bps or so improvement. Is that correct?

JAY GELLERT: That's correct.

JOHN REX: So that would seemingly -- when you think about the industry that's running something closer to 84-85 percent loss ratio, some in the high 70s right now, it would seem like you have a fairly competitive product. Are you anticipating as a pretty dramatic change in how your competitors approach it?

JAY GELLERT: A couple of points. One, those really aren't the numbers in the capitated environment in California where we have a significant portion of our business. Secondly, I think we've been conservative in our bid to not over-promise and to not get ourselves in the position where we would end up disappointing. We think overall that the MLRs in this business are going to head up. So I think we're being reasonable in terms of our expectations. The other point for us that's really important is that it's a sustainable level. So I think it immunizes us from the risk inherit in changes in the MA business in 2010 and beyond. So I think we've said all along, we've been in competitive markets. We've been in markets that existed before MA and that while that doesn't let us get as much of a benefit from the new law; it also protects us against the change in the law which is likely to be forthcoming next year.

JOHN REX: Okay. And just last, in thinking about MA, I just want to make sure I'm clear in this. So last quarter you probably took out about \$40-\$45 million from MA; this quarter kind of a similar amount. But how was that captured in your bids in June? So we're thinking about that was the last day of April, I guess, when you took down your guidance last time, but you're essentially doubling the drag for Medicare. How would that have been incorporated in time in June, I guess? When were you seeing this? Was that just in the month of May right after you reported you started seeing this? How should we think about this and get comfort with what your bids reflect?

JAY GELLERT: There are two points. One is, again since it's concentrated in the new members, we inherently in our bid move them to a norm rate so we inherently assume adverse performance in future

years for that population. So that was reflected as part of the process. We're not getting the benefit of lesser use early, but the ramp-up was anticipated from the start. Secondly, we did factor in some conservatism in our MA bid. We didn't count on the kind of higher risk adjuster activities so, in effect, we assumed that this population in general was negative and we weren't going to benefit from it, so I think that's how it was incorporated in our bids.

JOHN REX: Okay. One more thing on cash flow, actually. Can you just step us through how you get to the full year cash flow and kind of how you think that plays out in the 3Q, 4Q?

JOE CAPEZZA: Sure, hold on a second.

JOHN REX: I'm just thinking how your expectations for 3Q cash flow just so we can get a sense of where your heads are and how you're going to get to the full year number.

JOE CAPEZZA: Could we get back to you on that one?

JOHN REX: Sure. That's fine. Thank you.

JOE CAPEZZA: Thank you.

CARL McDONALD: And now we'll open it up to Carl McDonald with Oppenheimer.

CARL McDONALD: Thanks. I just want to follow up on that last Medicare question -- just to make sure I understand. So you're saying that if you're anticipating right now that your Medicare margin is going to get better by 100 to 200 basis points, are you saying that previously you were assuming it was going to be more like 200 to 300, and now that the \$45 million higher cost is apparent, it takes it down to 100 to 200?

JAY GELLERT: No. We naturally assumed deterioration in our first year members in the preparation of our second year bid. So since that's the area that we got hit hard in, we already had built up additional costs there. And we did take a more conservative approach. So we could have gotten better performance. That's probably a fair question. But I think our goal was to kind of lock it in to make sure that we got the improvement that we articulated.

CARL McDONALD: Got it, alright. So you were assuming 100 to 200 basis points of improvement. If the \$45 million you recognized this quarter didn't show up, it would have been higher than that.

JAY GELLERT: Or we would have had more margin for error, but we're comfortable that we really built our plan to assure we got those numbers.

CARL McDONALD: Okay. And then beyond the rebid for TRICARE North region, did you bid as a prime or subcontractor in the other regions?

JAY GELLERT: I think we'd prefer not to make any comments on where and when we bid.

CARL McDONALD: Okay. Thank you.

JAY GELLERT: DoD likes us not to comment on that too.

OPERATOR: And moving on, we'll hear from Gabe Hoffman with Accipiter.

GABE HOFFMAN: Good morning, guys. Thanks for taking the question. I guess I'm just curious, earlier in the call Joe had talked about you'd done a pretty good job this quarter and you'd exuded some confidence, Jay. And I guess when I'm thinking about the company's performance, Health Net's lowered its earnings per share guidance by the largest percentage for 2008 of any company in the industry. It's losing the largest percentage of its commercial risk membership of any company in the industry, and it's the only company in the industry that reiterated its guidance in June only to then lower when it reported its second quarter earnings. So I guess I'm just trying to understand, in terms of a reality check, why is this management team not incredibly embarrassed at the state of affairs of the company at this time and characterizing its performance as, frankly, unacceptable?

JAY GELLERT: Well, I think we indicated we were disappointed in the guidance revision, and I think we were very clear at the things we've done to rectify it. And so I don't -- you're categorization of our attitude, I don't think is valid.

GABE HOFFMAN: It just didn't come across as properly chastened, frankly, and I'm disappointed.

JAY GELLERT: Okay, well I think we're chastened and I think we're focused on the remedies to fix it.

GABE HOFFMAN Okay. Well, I appreciate you taking the --

JAY GELLERT: No, it's a fair question and I understand your point.

GABE HOFFMAN: And I would hope that the management as well as the board of the company understand the degree of unacceptability relative to the performance of peer companies, and that if the right changes and remedies aren't made soon, that shareholders will have that opportunity and will be likely to do so. Thank you.

OPERATOR: And now we'll move on to Matt Perry with Wachovia Capital Markets.

MATT PERRY: Good morning. I just want to understand the attrition in the commercial business a little better. The first question is how much of that business was repriced in the second quarter?

JAY GELLERT: 10 percent.

MATT PERRY: Okay. And how much of the 40,000-member attrition was due to the repricing versus you know, due to kind of in-group losses maybe due to the economy?

JAY GELLERT: I'd say probably half and half.

MATT PERRY: Okay. So if I think of 20,000 members lost on a total amount of repricing of like 250,000, that's something like an 8 or 10 percent attrition rate. I guess if I look forward to '09 and the first quarter when the largest amount of repricing will occur, should we be thinking about anywhere in the range of 5 to 10 percent attrition on that repricing in 1Q09?

JAY GELLERT: No. The big issue has been more the lack of new sales to compensate for natural attrition. And I think we have some new sales that we've landed for Q1 '09 already that will be different than our experience in Q2 this year.

MATT PERRY: Okay. And is that number of 20,000 kind of an accurate number reflecting the losses from repricing, or was the number actually larger but was offset but some amount of new business?

JAY GELLERT: The new business written in Q2 was diminimus, so it's a pretty fair number.

MATT PERRY: Okay, thanks. That was my only question.

OPERATOR: And now we'll open it up to Doug Simpson with Merrill Lynch.

DOUG SIMPSON: Good morning, everyone. Jay, I was just wondering, a lot of my questions have been answered, but just stepping back and given your background -- I appreciate your perspective on -- we're sitting here in the lull between the primaries and the general election, and can you just give us your latest educated guess as to how the health care debate is going to shake out over the next couple of months? And specifically if you have any color on potential for timing as it relates to any real action on any reform efforts. Is it possible we'd see something in the next six to 12 months, or is it just -- logistically, would it just take longer than that?

JAY GELLERT: I think it's a very volatile situation. It will clearly depend on who is elected president and at least the polling now makes it unclear what's going to happen there. It will depend, I think, a lot on the state of the economy and it will depend, I think, a significant amount on how Congress approaches Pay-Go and overall financing. I think there's a chance that we'll see some substantive and significant reform passed in 2009. I think that our industry as a whole believes that that's a real possibility, but I don't think anyone can give any clear assurances one way or the other because of all of those factors.

DOUG SIMPSON: And is the assumption though that if it were to pass in '09, then it probably would be -- something would be implemented down the road?

JAY GELLERT: I don't expect that we would see changes that would be implemented in 2009.

DOUG SIMPSON: Okay. Thanks.

OPERATOR: As a final reminder, that is star one if you do have a question. We'll move now to Ann Gallo with Wellington.

ANN GALLO: Hi, Jay.

JAY GELLERT: Hi, Ann.

ANN GALLO: Obviously it's a tough time for the sector, but just looking at your stock over the past decade, it really seems to have underperformed the peer group over the long term as well. And I'm just wondering, is it a strategy issue? Is it an execution issue? Do you not have the adequate scale in your markets to kind of get the performance to where it needs to be? How do you look at this?

JAY GELLERT: You know, I think that there's a strong base of business here; that we have some issues to face, and I think that we have to look at both the scale and execution issue. But I do believe that the guidance that we've given positions us well to do that and come to a conclusion effectively in 2009.

ANN GALLO: Thanks.

OPERATOR: And now we'll hear from Justin Lake with UBS.

JUSTIN LAKE: Thanks. I just have a quick follow-up. On the -- first on the PPD side, it looked like you had some positive developments in the second quarter in regards to prior year. Is that correct?

JAY GELLERT: I think we had a small amount of positive development, but it was fairly diminimus.

JUSTIN LAKE: Okay. And just, Joe, given your background on the not-for-profit side and all the questions around reserves out there, can you just give us an idea of what changes you've made from an actuarial standpoint to maybe to add some conservatism to Health Net maybe versus where you were before versus where they were before.

JOE CAPEZZA: Well, actually over the next four weeks, I'll be announcing some reorganizational changes that I'll be happy to share with you at that time, where some of these things will become more evident.

JUSTIN LAKE: Okay. And then just a quick question on the Medicare Advantage margins and stuff that's been the topic of interest. When you look at -- can you maybe just compare and contrast yourselves to the old PacifiCare book in California where it seems like United was able to really draw some significant margin improvement and what would one think would be similarly capitated circumstances in California unless I'm missing something. Is there just something inherent in your book that keeps it up in that high 80 percentage range versus a PacifiCare book? At the high 80s, what kind of margin does that indicate from an operating standpoint? And that's it for me. Thanks.

JAY GELLERT: The margins in the business that we're targeting are 4 percent. I'm not sure that we've seen over time dramatically different margins in other places. I think that PacifiCare historically had a lot more penetration in parts of Southern California that are more economically favorable than we -- but we think this is a good and reasonable target for our business.

JUSTIN LAKE: Got it. Thank you.

OPERATOR: And there are no further questions. I'll turn it back to Ms. McCabe for any closing or additional remarks.

ANGIE McCABE: We would like to thank you all for joining us today, and we'll be available for calls all day. Thank you.

OPERATOR: And that does conclude our conference for today. Thank you for your participation. Have a pleasant day. You may now disconnect.

[END]