Health Net, Inc.
Q3 2008 Earnings Conference Call
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Corporate Participants:
Angie McCabe, Vice President, Investor Relations
Jay Gellert, President and Chief Executive Officer
James Woys, Chief Operating Officer
Joseph Capezza, Chief Financial Officer

OPERATOR: Good day, everyone, and welcome to this Health Net, Inc. third 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, Pam. 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 charges related to the company's operations strategy and the company's investment holdings. 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.

We are deeply disappointed in our third quarter and year-to-date results. This is a challenging time for us. Considering our year-to-date performance, we cannot assume that the adverse trends we've seen will abate in the near future. Our guidance for the fourth quarter and next year incorporates these trends.

This in no way is meant to excuse or minimize the fact that this quarter's performance is unacceptable. Despite the challenges we face, there are several key factors to keep in mind as we move forward.

Even when you incorporate these trends and assume continued weakness in the economy, we have a clear path to earnings with our administrative cost saving efforts giving us additional opportunities to address these trends. As a result, we have the visibility that will allow us to go forward with our investor day as scheduled. It's important for us to have a full exchange with all of you about the current state of our operations and what we see for next year.

The balance sheet remains strong with no exposure to pension liabilities or other unusual issues. And, in an order to streamline and bring an intense focus to our operational challenges, all day-to-day operations of the company are now in Jim Woys' hands. He's a proven operator that many of you know and trust. Every area of the company he's worked in has done well. TRICARE is producing excellent results and has over many years under his leadership. In just a short time as a COO, he's made significant progress in reducing our administrative costs and rationalizing our infrastructure.

However, we know that is not enough. We must pay attention to the issues many stockholders have raised including structural, strategic and environmental issues. We're determined to do whatever it takes to address these issues.

In terms of addressing the future, the board of directors have directed me to focus my energies entirely on assessing our strategic challenges and pursuing whatever is necessary to deal with the issues we face.

For now, let me turn the call over to Jim Woys, our COO, who will review all the operations of the company. Then CFO Joe Capezza will discuss our financial results. Jim?

JIM WOYS: Thank you, Jay. As you've seen from this morning's management change press release, I now have an expanded role with the company. In addition to my responsibilities for the Government and Specialty Division and administrative functions, all health plans now report to me. I believe this is a positive step for the company as it centralizes all operations in a single management structure. This should help us become more responsive to the changing business, economic and political environments and should lead to a speedier achievement of our targeted G&A savings.

As Jay noted, we're all extremely disappointed with this quarter's results and the outlook for the balance of this year. We recognize that our commercial health care costs were higher than expected. As we look at the fourth quarter and next year, we're assuming that the higher cost trends continue. It is a very difficult environment, and as such, we're focused on restoring our operational momentum.

As we discussed in the press release, we experienced higher than anticipated health care costs in the third quarter. The drivers of these unexpected costs were adverse prior period developments from the first and second quarters of 2008 and higher than expected commercial, Medicare and Medicaid costs in the third quarter.

The adverse prior period development was primarily the result of higher than expected hospital costs in all three lines of business. This amounted to approximately $55 million pretax. I should note that more than 70 percent of the development was in the commercial book. The higher than expected costs in the third quarter were driven by hospital utilization and unit costs.

Due to the higher health care costs that we experienced in the third quarter and our belief that this trend will continue, we now expect the commercial health care cost trend on a per member per month basis to be approximately 10.9 percent for the full-year 2008 as compared to 8.9 percent increase for 2007. 2007's amount excludes litigation and regulatory charges. A table that reconciles GAAP to non-GAAP financials is included in the press release.

While the commercial landscape remains competitive, we do expect commercial premium yields to be approximately 8.3 percent on a per member per month basis for the full year of 2008 compared to a 9.2 percent increase in 2007. Joe will provide more detail on these numbers in his comments.

I would like now to briefly touch on the membership activity in Q3. Total commercial risk enrollment of nearly 2.1 million members at September 30, 2008 declined by 6.5 percent, or 145,000 members, from September 30, 2007. Sequentially, commercial risk enrollment declined by 2.9 percent, or 63,000 members. These declines are a result of a weakening economy and a competitive commercial environment. We expect these trends to continue in the near-term, and as a result, we now expect commercial membership declines of 8 to 9 percent for the full year of 2008 compared to our previous expectations of 6 to 7 percent decline.

Our Medicare lines of business experienced membership growth in the third quarter. In Medicare Advantage, our focus is on growing the network model HMO and PPO plans. MA enrollment grew by 54,000 members, or 23 percent, from September 30, 2007 to September 30, 2008. Sequentially, MA enrollment increased by more than 8,000 members, or 2.8 percent.

We continue to expect 20 to 25 percent membership growth in MA for the full year of 2008. Enrollment in our private fee-for-service business grew by 53 percent, or 8,000 members, over the past 12 months to 23,000 members at September 30, 2008. Sequentially, private fee-for-service membership declined by 1 percent from the second quarter.

PDP membership, which we continue to expect to grow by 40 to 45 percent this year, stood at 538,000 members at September 30, 2008, an increase of 173,000 members from September 30, 2007. Sequentially, PDP membership grew by 12,000 members, or 2.3 percent.

With regard to claims costs in our Medicare lines of business, we continue to experience higher overall utilization across the MA and Part D plans. We believe we have taken this into consideration with respect to the 2009 Medicare bids where we have made conservative assumptions. We believe our pricing, product design, and medical and pharmacy management will successfully overcome the margin deterioration we experienced in 2008. With the competitive bids released, we are now able to focus our sales and marketing efforts in areas where we have product and pricing advantage to achieve our membership goals for next year. Also, I'm very pleased with Scott Kelly's performance in the short time since he became our chief government program officer in June. Scott and his team are focused on improving the performance of our Medicare business in achieving our expected 2009 improved performance.

On the cost management front, G&A expense ratio of 9 percent – excluding the impact of the operations strategy charge – improved 130 basis points compared to the third quarter of 2007 as we continue to focus on expense management. There is a table in the earnings press release that reconciles these numbers. We also are making progress with our operations strategy, which is designed to reduce costs and reposition our business for a competitive advantage.

As part of our operations strategy, during the third quarter we entered into agreements with two premier outsourcing vendors with proven track records. First, in August we signed an agreement with IBM where they will provide us with IT infrastructure services. At the end of September, we also signed an agreement with Cognizant Technology Solutions to outsource our software applications development and management activities. By outsourcing our IT infrastructure and applications capabilities, we expect to save approximately $120 million in the next four years. We believe we are still on track to save $50 million in G&A costs in 2009 and over $100 million in 2010, as we've previously communicated.

Finally, our Federal Services Division – both TRICARE and MHN, our behavioral subsidiary – continue to perform very well. Our Federal Services Division remains focused on meeting the needs of our military families. At this time, we have no new news regarding the procurement of the new TRICARE contract. In the meantime, we continue to explore how we can apply the TRICARE model to other opportunities.

Also, delivery of services under MHN's five-year Military & Family Life Consultants Program with DOD continues to grow. This program is expected to contribute over $100 million in total revenues in 2008, compared to approximately $50 million in 2007, and will increase another 40 percent in 2009. I continue to be very proud of the work this division continues to perform every day and to benefit our military family.

While our 2008 performance has been a disappointment, we believe we're taking the necessary steps to put the company back on track in 2009. My priorities, as I assume the expanded role as the chief operating officer of Health Net are: first, to put the right people in the right chairs; to continue to aggressively pursue and exceed our G&A cost reduction targets; to ensure achievement in 2009 of our improved Medicare margins; to work closely with contracting, actuarial and underwriting to carefully review the implications of the higher health care cost trends that we have experienced this year; and focus my team on improving our margins in 2009. And finally, make sure this entire organization is focused on improving our performance in every aspect to our business to improve shareholder value.

We will provide a more in-depth review of our plans at investor day, which is scheduled for November 18th in New York City.

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

JOE CAPEZZA: Thanks, Jim, and good morning everyone.

I don't think there's any need to add to Jim and Jay's comments about our collective disappointment with these results. So what I want to do this morning is to review our financial condition and discuss our third quarter results.

We will have much more to say about the future at our investor day in two weeks. We encourage anyone who can to attend. We believe it will be an important dialog concerning where Health Net is today and what we can expect to achieve going forward.

In the past, I've started these calls by going over the P&L. Given the events in the financial markets over the past several weeks, I'm going to start with the balance sheet. I want to demonstrate to all that our balance sheet is sound and our liquidity position is strong.

We have seen cash and investments remain relatively stable over the past several quarters. Cash alone was down sequentially, however, in this quarter by $420 million. This change was primarily due to the reserve fund which was reclassified from cash to short term investments and paying down the revolver. At the end of the quarter, our investment in the reserve fund was $372 million.

As of October 31, we had monetized approximately $130 million of this investment so our cash liquidity today is much stronger than it was at the end of the quarter, and is back over $700 million. I am confident, based on the information available, that we'll be able to monetize the balance of our exposure in the reserve fund in the near future.

As some of you know, we maintain a very conservative position in our portfolio. We did take a charge for some relatively small investments in Lehman, Freddie and Fannie which amounted to approximately

$15 million pretax. This was less than 1 percent of our total portfolio of approximately $1.8 billion. We currently have $43 million of net unrealized losses in the portfolio – a relatively insignificant amount.

Our conservative portfolio is invested in several key areas – municipals, corporates and agency-backed mortgage instruments. We do not own any sub-prime paper.

The duration of our portfolio remains unchanged at approximately 3.9 years. The average credit quality of our portfolio is AA+ with more than 80 percent of the portfolio rated AA or better. Because of the Fannie and Freddie government takeovers, the mortgage-backed paper is secure.

On the debt side, we have three separate facilities. The first is approximately $400 million in senior notes. The coupon rate on these notes is 6-3/8 percent and they mature in June of 2017. Second is a low-interest amortizing financing with approximately $157 million outstanding. We will complete that full amortization in December 2012. The last is our $900 million credit facility. We currently pay 70 basis points over LIBOR on the revolver. We expect to keep this in place through June of 2012. As of September 30, 2008, we had drawn down approximately $100 million, which is down $45 million from Q2.

Our total debt-to-capital ratio is 27.6 percent, still under our 30 percent threshold.

Now let me turn to the P&L, cash flow and reserves. Total revenues climbed 3 percent compared to last year's third quarter. This was driven by health plan and government contract revenue increases while net investment income fell because of declining interest rates and the impairment charge. Our ASO fees and other income were essentially flat.

Our commercial revenue PMPM rose 7.7 percent from last year's third quarter. Sequentially, premium yields rose by approximately $8, which is more than our prior expectations of $5 to $6.

The problem was commercial health care costs PMPM which rose 12.9 percent and was driven by prior period development from the first half and higher than expected health care costs in the third quarter. The commercial MCR came in at 86.7 percent for the quarter.

There is no escaping the fact that the health care cost environment has been very difficult. We do not expect the relentless persistency of these higher trends, most especially in hospital costs.

We have now baked in this higher trend into our expectations for the fourth quarter and into our early assumptions for next year.

Given the past volatility of our trends and reserves, I called in an outside actuarial firm to provide an independent assessment and to work closely with our internal staff in reviewing IBNR and trend data. Together they assessed where we are and produced a best estimate for reserve levels and we booked to that point estimate. We will continue to use this approach going forward.

Now let me turn to Medicare. The Medicare Advantage and PDP enrollment story is very strong, but the performance has not been satisfactory. The same cost issues that beset the commercial book also affected Medicare Advantage. The Medicare Advantage MCR rose more than 400 basis points year-over-year and came in at 90.5 percent.

We are confident that next year this measure will improve. We've assessed the competitive bids and we believe we can meet this goal.

Adjusted days claims fell by 2 days year-over-year and 3.3 days sequentially. This change in days claims payable is due to using the average of reserve levels in calculating DCP. Had we used the end of period reserves, DCP would have been flat sequentially. I call your attention to the reconciling table for DCP provided with the press release.

A few other comments on the P&L. Selling costs are higher as we continue to grow the Medicare Advantage book. Depreciation climbed sequentially by approximately $4 million as a result of higher capital expenditures due to the acquisition of assets coming off a long-term lease. Amortization was essentially flat, and interest expense dropped as our revolver draw fell and interest rates declined.

The average weighted share amount declined as well, the result of our buying back approximately 3.7 million shares in the third quarter for approximately $100 million. As noted in our earnings release, we have put the share buyback plan on hold as a consequence of the uncertain economic environment and Jay’s strategic review.

Operating cash flow was $92 million in the third quarter or about 1.6 times net income. That’s a sharp rebound from prior quarters and a testament to our ability to generate cash. We currently expect strong cash flow in the fourth quarter as well.

That ends my remarks for this morning. We will have more to say on our future plans and 2009 guidance on investor day in two weeks in New York.

We know that we must do better. It’s been a tough year so far. I am heartened by the strength in our balance sheet, our strong cash flow capacity and the new opportunities provided by the management changes we announced today.

Thanks for your time and I’ll turn it back over to Angie.

ANGIE McCABE: Pam, we’d like to get started with the Q&A.

OPERATOR: Thank you. If would you like to ask a question at this time, you may do so by pressing star-one on your telephone keypad. If you are joining us on a speakerphone, please be sure your mute function is off to allow your signal to reach our equipment. Again, that is star-one to ask a question, and our first question comes from Charles Boorady at Citi.

CHARLES BOORADY: Thanks, good morning.

My question is around health care cost trends that you’re reporting at much higher levels than what we’re seeing for the industry overall. Can you give us more supporting detail behind what the factors are? Unit price versus volume trends that you’re seeing, and also comment on whether you believe you're adversely selected against? So is some of your trend due to a riskier pool considering the losses of enrollment? As part of explaining that, if you have data on the cost trends for the customers you lost versus kept this year. Considering the big drop in enrollment, that would be helpful as well. Thanks.

JIM WOYS: Thanks, Charles. This is Jim. As we look at our increased cost trends, it's primarily around hospital and it’s primarily around unit. So when we looked at this and when we looked at what we saw back in the latter part of ’07 and the Q1 of ‘08, we thought we had an aberrant pattern there with regard to trends in hospital. Based on more recent current results, we now see there’s probably a persistent, underlying trend there. We’ve seen an increase in the non-managed admits, especially admissions through ERs, to non-contracted facilities as well as an increase in more intense cases.

We built these underlying trends into Q4 and '09, so it is around hospital. We do think that as some of the membership in the slice business we're at and regard to the economy is impacting the increase in those trends, but we've got to find a way to stem work on that issue about the hospital trends going forward. It's clearly that's where our biggest area of exposure has been, and we've adjusted our guidance for that. It's clearly hospital and primarily for events that we're not really managing, so stuff that going to the ER that's ending up in non-contracted facilities at much higher unit rates.

CHARLES BOORADY: Do you have the components of unit cost versus volumes for hospital, inpatient, outpatient and pharmacy, and do you know the loss ratios, roughly, of the customers you lost versus the ones that you are retaining?

JIM WOYS: We don't have that right in front, but we'll get back to you with that.

CHARLES BOORADY: Okay, but in terms of addressing to fix the problem, it helps to know what the real problem is. Considering how much higher your cost trends are than the competition. I'm just wondering whether there's really more of an underwriting and pricing issue than a cost issue, per se. Can you really address the high unit cost through recontracting or any other measures, or is it going to require a change in your approach to pricing and underwriting?

JOE CAPEZZA: Charles, this is Joe. I think it's going be a double-pronged approach to that. We have to take a look at our contract costs with facilities to see if we're at alignment with the competition and work to bring that back into alignment. In addition, in looking at the underwriting side, particularly in the sliced business accounts where because of either employer contribution policies or because of benefit designs we might be adversely selected against.

CHARLES BOORADY: Is it a California issue or are you seeing the same trends in the Northeast?

JOE CAPEZZA: It's pretty much across the board.

CHARLES BOORADY: Does this compromise your ability to hang on to TRICARE?

JOE CAPEZZA: No. It shouldn't have anything to do with TRICARE. TRICARE's a separate contract with rates.

CHARLES BOORADY: Inability to manage the cost trend -- is that something that would jeopardize you there? Or is that not something they're going to look at in their process?

JIM WOYS: Their process – to go through the TRICARE contract, their process is evaluation in three areas, they're probably way along that way. Process is evaluation of our past performance which has been very good; to evaluate our technical solution with regard to their requirements of their contract; and they evaluate what our price is – our bid price. The TRICARE model is much, much different than what we have in the commercial side. We have absolutely no cost problems in our TRICARE business. We are hitting – there's a targets that we believe we would hit in conjunction with our customer. I don't believe this is at all connected to any potential of harming our TRICARE business.

CHARLES BOORADY: Alright, thanks. I'll jump back in queue. Thanks.

OPERATOR: And our next question is from Matthew Borsch with Goldman Sachs.

MATTHEW BORSCH: Hi, thank you. Good morning. So could you talk here about whether a sale of the company is on the table? Is that something that you are able to openly address in this call?

JAY GELLERT: This is Jay. We don't think it would be appropriate to speculate on that at this time.

MATTHEW BORSCH: Okay. Why is that, Jay? It would seem at this point, at least to indicate to investors that you're open to that or not, you might actually be helpful at this point.

JAY GELLERT: I think that we -- the board recognizes the need to fix these problems. But I think that idle speculation won't help solve the problem. The focus, though, will be to make sure that we look at everything, consider everything and do whatever it takes to successfully deal with these issues.

MATTHEW BORSCH: Okay. Fair enough. On the question of the outsourcing contract, are those contracts ones that you know, if there were to be a change of control for the company, would you be able to exit those contracts in a way that, presumably a successor wouldn't be burdened by them.

JIM WOYS: Every major contract we sign like that would – as anybody would, a vendor would put provisions in them to – in case of change of control.

MATTHEW BORSCH: Okay. Could you talk about what you're seeing in the Northeast, in California and even other markets where you can make a distinction in terms of where you now think the industry pricing has been, how much of a challenge you think it is? Do you see any sign that it's been getting better?

JOE CAPEZZA: We haven't seen any significant signs of improvement one way or other. In our forecast, we're not projecting for any improvement in the environment and should that happen, all the better.

MATTHEW BORSCH: Okay. Last question. Capital and free cash – may not have heard it, but free cash at the parent as of September 30th – maybe where you project that to be at year-end? And can you give us an idea of where you expect your overall RBC ratio will be now and by year-end?

JOE CAPEZZA: Currently, free cash at the parent company is approximately $140 million. I don't expect to see that change that much from the quarter – quarter to quarter. And our RBC targets have always been around the 350 percent range.

MATTHEW BORSCH: Okay, so you're at those targets and you don't think that that would change by year-end?

JOE CAPEZZA: Well, that's what we're targeting for year-end. 3 to 350 has been our target range, and we're making an assessment now as to -- once all the stat filings are completed -- as to what our RBC position is and will determine how to reallocate capital when needed.

MATTHEW BORSCH: So I'm sorry, is there -- do you think it might be materially different from the 300 to 350 range?

JOE CAPEZZA: No, no, no. It's just a question with regards to our subsidiaries. We have some subsidiaries that are overly capitalized and we'll be looking to redistribute it to have a more even balance between all our divisions.

MATTHEW BORSCH: Got it. Okay, thank you.

OPERATOR: And next we have Josh Raskin with Barclays Capital.

JOSH RASKIN: Thanks. First question – I didn't hear you talk about the guidance in the call but looking at the press release, it looks like you've got an '09 expectation of $2.25 to $2.40. If I think about the first half of the year, sort of 90 cents, and adjusted, if I do 35 cents for the third quarter, maybe 44 cents mid-point of the fourth quarter, even if I exclude that first half, and I just say, look you did 79 cents in the second half, you're looking at 79 cents in the second half. Historically you've done about 55-56 percent in the second half. That gets me a run rate of $1.41 or so. I'm just curious, how do we get from $1.40-ish run rate, to $2.25 to $2.40? And then why did you in the first place provide the guidance for '09 at this point?

JOE CAPEZZA: Okay. This is Joe. First of all, our guidance right now for Q4 is 60 to 64 cents. So it's all higher than the 45 that you're using. If you actually take out the one-timers, the PPIA related to prior years which we believe we won't have going forward especially since we're utilizing an actuary to help validate the reserve position that we're taking; if you take out the significant misses in the Medicare bids for both Medicare Advantage and PDP, take out those one-timers going forward, we expect to have earnings that are relatively about flat on adjusted basis for EPS. Then throw in additional G&A savings that we expect to attain, and it's real easy to get to those numbers.

JOSH RASKIN: Okay, it's real easy to get to those numbers. On the bids, it sounds like you feel confident you've caught the Medicare portion of that? It would seem that a lot of the issues – sort of post-June or at least the magnitude of the issue – I'm curious what gives you confidence that Medicare is fixed?

JOE CAPEZZA: Again we had an independent actuary help us with the bid and set the pricing. We got the pricing we wanted. In the PDP area, we exited the states that we wanted to exit because those were the states that were giving us the biggest problems and the biggest losses. We evaluated our bid on a competitive basis versus the published bid of that of our competitors. We then went back and we further adjusted projections based on what we're seeing on health care cost trends and we still believe that there is a significant upside that we're going to achieve in the Medicare program, and a lot of these questions that you're raising we'll have more detail on at investor day in two weeks.

JOSH RASKIN: Gotcha. And then just a follow-up on the cash flow. It looked like the unearned premiums and premiums receivable lines was a big source -- $113 million of cash. Was there any timing of state received or CMS payments?

JOE CAPEZZA: No. Not really.

JOSH RASKIN: Okay. Thank you.

OPERATOR: And we have Greg Nersessian with Credit Suisse.

GREG NERSESSIAN: Excuse me, good morning. My first question was just on the time line. It just seems pretty unusually late in the quarter and in the year to be identifying the escalation of some of these issues. So I just wanted to get a sense for the sort of time line for when you started to really identify that these issues were developing as negatively as they did and a sense for why it took you so long to identify them. Is it a systems problem, a mixed problem or cost reporting problem or anything else?

JOE CAPEZZA: Well, as Jim mentioned in his comments, the fourth quarter of 2007 had unusually high – historically high – trends that we believed were aberrant. Q1 and going into Q2 we had significant increase in hospitalizations which we believed were attributable to the flu and related illnesses. We started seeing an improvement in the latter part of Q2 with the May and June initially coming in at what we thought was very favorable compared to the prior four months, and we believed were returning to historical trend patterns. And this was supported by the preliminary hospital data that we were receiving.

As Jim mentioned, the hospital data was masked because of the emergency room increases and admissions that would go outside of our normal approval pattern. We started seeing these patterns change in the data we were receiving during the month of September – late August, early September. This caused us to do an in-depth review as to what was going on with the trends. We brought in the independent actuary at that time to help us evaluate the trends and track the trends going forward. That's why it occurred so late.

GREG NERSESSIAN: Okay. So it sounds like the nature of the cost trend – just the nature of where the costs were coming from – they were out of network providers that prevented you from identifying them earlier. Is that sort of the explanation as opposed to your having data in house and not -- I guess I was a little confused. It sounded at first you said it looked like things were improving then you were baking in a continuation of that improvement and then you got some late cost reporting. Is that it?

JOE CAPEZZA: Based on the hospital data that we were seeing for the initial admits, we felt that there was improvement in the trends that we were seeing in the admits. And the admits actually developed because of the admits coming in outside of the preapproval process – such as emergency room admissions and non-managed care products. Those admits actually spiked when the development came through – when the hospitals actually started sending the bills in. And there was about a two-month, three-month lag on some of those.

GREG NERSESSIAN: Okay. Moving on – the role of the independent actuary that you are now using. I'm just trying to get a sense for how your approach to reserves has changed. I was wondering if there is any metrics you can give us on maybe your IBNR per member – per commercial member, or something like that – that would give us a sense for how much reserve strengthening you've committed to with this quarter versus maybe the last quarter.

JOE CAPEZZA: Well this quarter we had approximately $55 million of reserve that we strengthened for prior periods. And what the actuary is doing is basically he's reviewed all our practices, made recommendations with regards to how we're developing our loss reserves, how we're evaluating the trends that we're seeing, to bring us to what we believe and what the actuary believes is best practices within the industry.

We've asked them to do an independent evaluation of the reserves to help us validate the best estimate pick we're using when setting the reserves, and we expect that the reserves that we're setting are going to be in line with what the actuaries are telling us. And as a result of the study, we've seen that the baseline of the trend now is up because we've asked them to validate the trends that we're using and also help us evaluate the run rate going forward.

GREG NERSESSIAN: I guess my question is – the days claims payable dropped pretty significantly on a sequential basis in the quarter which would not be supportive of the notion that you're actually have booked the full higher medical cost trend into your current reserves. Maybe if you could give us some color, that would give us some greater comfort around that.

JOE CAPEZZA: What happens is when you calculate days claims payable, and I'll try to explain it in layman's terms because the actuaries actually calculate this, what we do is we use an average based on the beginning and ending claims value. Because the PPIA that we took -- the prior period development we took – all occurred on the last day of the quarter, that reduces that average significantly. If you took the prior period development and put it back into the prior quarter, you would see the days claims payable go flat or up.

GREG NERSESSIAN: Okay. And then just the last one. What is your target MA medical loss ratio for 2009?

JOE CAPEZZA: I don't have that on me. You said 2009? I was looking at 2008. We'll get to that on investor day.

GREG NERSESSIAN: Okay. Thank you.

OPERATOR: And our next question is from Tom Carroll with Stifel Nicolaus.

TOM CARROLL: Good morning. I have two quick questions here. First one is the management change. Jay, I'm confused by your new role. What will you be doing differently in your new strategic role that perhaps you didn't or haven't been doing in your prior role?

Secondly, as we look at the Medicare book, and I realize it's not the bulk of your challenges here today, but if you could dive into that for us, maybe give us a sense of where the higher costs are coming from, especially since most of your book is network based. I'll stop there.

JAY GELLERT: Let me answer the first question. The intent of the change is to put all of the operating responsibility in the company in Jim Woys' hands. The view is – as I earlier indicated – that everything Jim has participated in in this company has hit its numbers. And one of the concerns everyone's validly raised is our inconsistent performance. So, the goal is for Jim to build – and he's already completed doing it – build a team that will report directly to him so he has a single person on the line for operating performance within the company. At the same time, I think many people have raised the issue of business mix, scale, certain of our operations and the like.

And in the process of spending time with operations, I think the board's view is we haven't given adequate heed and attention to the issues that many of you have raised and that have been raised fairly consistently in terms of the fundamentals. So while Jim is taking singular responsibility for making sure that the numbers come in, as we project them, as we identify them, that will free me to be specifically directed to handle all of those other issues and present to the board of directors specific plans and analysis to address all of those kind of issues that have been raised consistently on these calls.

So that's the very precise direction that we've been given in terms of this management structure. It's clear, it's down the middle. It's bright-lined and it will allow us to address both the performance issues that we're talking about today, as well as kind of the fundamental structural issues that have been raised on this call in the past.

Regarding Medicare, I think Joe is going to comment on that.

JOE CAPEZZA: I'm sorry, what was the Medicare question again?

TOM CARROLL: The Medicare question really is – we've heard about some Medicare challenges this quarter, basically across the spectrum of companies. I'm wondering if maybe you would just dive a little deeper into the source of where you're seeing higher costs in your Medicare book specifically, especially because most of your Medicare book is network based as opposed to private fee.

JOE CAPEZZA: Well, we're seeing major deterioration in private fee-for-service, particularly in the hospital side. PDP is still a significant disappointment with additional deterioration anticipated in Q4. We have not seen the recovery in the PDP that we had hoped. Those are the two biggest areas.

TOM CARROLL: Okay. So your roughly 22,000 private fee-for-service members are just really the ones that are giving you most of the problem to the point that you're talking about raising your costs on Medicare?

JOE CAPEZZA: Well it's the private fee-for-service is a significant part of the problem. We're seeing the hospital utilization up for the entire Medicare population, similar to commercial.

TOM CARROLL: If I could sneak just one last one in on this. On your PDP business, how much of your book there, you mentioned 529,000, how much of that of is dual-eligible?

JOE CAPEZZA: Something in the neighborhood of 70 to 80 percent dual-eligible.

TOM CARROLL: Okay, thank you.

OPERATOR: Once again ladies and gentlemen, that is star one to ask a question. And we'll take our next question from Justin Lake with UBS.

JUSTIN LAKE: Thanks, good morning. Couple of questions. First around the capital and liquidity – I just want to kind of walk through these numbers in a little more detail and get your expectation, for instance, what are you thinking about as far as losses for the fourth quarter on the portfolio? And maybe the cash flow from the subs for 2009?

JOE CAPEZZA: Okay. Right now we haven't projected or forecasted any losses in Q4 from the portfolio. As I mentioned, we have approximately $143 million of net unrealized losses. That's in the portfolio right now. I'm sorry, $143 million of -- I'm slipping here, I'm sorry. We have $43 million of net unrealized losses here in the portfolio. I was giving you the cash number. Our cash number is 143 at the parent company.

JUSTIN LAKE: Right.

JOE CAPEZZA: And we haven't forecasted any realized capital losses for the fourth quarter. And at this point, considering where interest rates are going and our position – our conservative position in the portfolio, I don't expect to have anything significant to report in Q4 right now.

JUSTIN LAKE: What's the cash flow you expect to get from the subs?

JOE CAPEZZA: That we'll get into on investor day as well.

JUSTIN LAKE: Has that been typically, just trying to walk through it here, is the cash flow from the subs typically is kind of prior year net income. Is that a correct proxy?

JOE CAPEZZA: We talk in a percentage of prior year's net income.

JUSTIN LAKE: And what has that typically been?

JOE CAPEZZA: What has it typically been? Well, it's been anywhere between 85 and sometimes even in excess of 100 percent of net income. Depending on what the capital position of the subsidiaries are. If a subsidiary is overly capitalized, we'll look to take more out. If it's adequately capitalized, we'll look to take out what we're allowed to under statutory guidelines. It varies by subsidiary.

JUSTIN LAKE: Okay. So if we assume that it's going to be 100 percent, that might be $200-$250 million. What does it cost to run the business as far as – if you think about, for instance, interest payments you're going to make next year? I'm just trying to figure out the flexibility that you have there.

JOE CAPEZZA: We could get back to you on that. But right now we expect absolutely no problems with regards to cash flow and the amount that we need to run the business.

JUSTIN LAKE: Okay. And then just a couple quick numbers questions. I think investors at this point might be looking at health care companies like typical insurers and looking at book value and tangible book value. I look at your third quarter report and I calc out your tangible book value at a little over $8. Is it correct for me to think about this as a liquidation value? If you literally shut down the business tomorrow, you would have $8 a share in cash? Just let it run out?

JOE CAPEZZA: I couldn't tell you because we haven't contemplated shutting down the business. We haven't done that calculation.

JUSTIN LAKE: I realize that. I was just looking at the current equity values, or embedding some significant risk. I'm just thinking about worst case scenario here. Theoretically, is that correct?

JOE CAPEZZA: I'd have to look at your numbers.

JUSTIN LAKE: Okay. Last question. I know you didn't want to talk specifically on the M&A side. Can you tell us if you have hired an investment banker to work with Jay as he goes through the strategic review of assets? Have you hired a bank?

JAY GELLERT: We're going to just go forward and look at those without commenting specifically on that process.

JUSTIN LAKE: Okay, thank you very much.

OPERATOR: And next is John Rex with JPMorgan.

JOHN REX: Thanks. I just want to be clear on a couple of things here. So you're saying your current view assumes that trends stay level. Is that correct? Are you saying that you assume your '09 guidance is contemplated on 11 percent cost trend? Is that correct?

JOE CAPEZZA: No. We're assuming that the current level of PMPM expenses are the baseline that we're setting our trends on. And then there was a separate trend evaluation performed by state – by legal entity – to determine what's going on with cost, what's going on with utilization, and what's going on with medical management. So we're using the higher trends to establish the base and then having that as our jump off point.

JOHN REX: So what does your '09 contemplate in terms of cost trend then?

JOE CAPEZZA: Right now I think we should save that for investor day.

JOHN REX: So then just give me directionally – does it contemplate lower than 11 percent or higher than 11 percent from the baseline you are giving us for '08?

JOE CAPEZZA: It's going to be lower than 11 percent because you have to remember our current trends that we're using right now include the effect of Guardian in there.

JOHN REX: What would the 11 percent look like, ex-Guardian, then?

JAY GELLERT: It's lower.

JOHN REX: 200 basis points?

JOE CAPEZZA: It's around that.

JOHN REX: Okay. So, what does this contemplate in terms of pricing for '09? In terms of the outlook that you're providing – in line with that trend level that we're not quite sure what it is yet, it sounds like, but in line with that trend level you're expecting, or above it?

JOE CAPEZZA: Again, we'll have to give you more information on investor day. Our hopes are that we'll be able to price to at least our cost trend. However, as you know, a significant part of our book of business has already been priced at the larger counts in January renewals. So we're in the process of evaluating where those stand in relation to what the final trends are.

JOHN REX: Right, and it may be helpful to on that piece tell me what are your effective yields now on the January renewals that have occurred?

JOE CAPEZZA: I don't have that with me. I'll have to get back to you on that.

JOHN REX: Okay. Can you tell me what's going on in your bed days per thousand members trend?

JOE CAPEZZA: The bed day trends have gone up. I don't have the exact number of days with me.

JOHN REX: Can you give me an order of magnitude in terms of percentage change?

JOE CAPEZZA: At this point, I would just be giving you a bad guess. We should get back to you on that as well.

JOHN REX: Okay. I'm struggling here. What has changed in benefit design or networks that would have driven the sudden higher utilization of outer network care that you're referring to as being one of the core components? It seems very out of step. Something must have changed on your end that would drive that. Can you give us some of the things that you've thought of? I'm quite sure you don't have the precise answer at this point, but some things that you've thought of may have driven this higher utilization of network providers.

JOE CAPEZZA: It was mostly not prior authorized hospital utilization out of network. And by prior utilization – by not authorized, we're talking about emergency room visits. Here in California, there's been a trend of hospital groups to cancel contracts and accept admits on emergency basis, and once they're in it's difficult to move them. They're billing us at 100 percent of charges because there's no contracts. That's phenomena that we're struggling with right now here in California.

JOHN REX: But you are telling me that bed days per thousand members is higher. Is that correct? This is not just about unit cost. This is a utilization issue also?

JOE CAPEZZA: Yes. It's up somewhat as well. So we are looking at utilization as well as costs.

JOHN REX: Okay. When you sit back and think about this, and so you do look kind of out of step with the industry right now with the trends we're seeing more broadly from the vendor community. Have you thought about how much of this you think is a result of maybe kind of the franchise deterioration, referring to, how much of this is due to suboptimal market positions in scale? Do you think – is it now kind of accelerated to where it is more biased to that side, and that's why you're showing as somewhat of an outlier in the industry?

JAY GELLERT: John, this is Jay. I think that that the vulnerability that we see is in some of the slice business where we definitely have instances where employers are biasing themselves towards their ASO business. And, in addition, we're seeing some risk as with the economy as some younger people seem to leave accounts and so we have in group deterioration along those lines. I think one of the key points we're making today is that it's not only an execution/management issue, but there are some structural issues that you've raised. That's what we're going to be reviewing.

I think that we see the other kind of regional player (Coventry) have some of the same trends. We saw some of the same things in their announcement. So I think there is reason to consider this in some of the structural issues you've raised and that we've been directed to really look at that as well as moving the operational responsibility and that I already discussed.

JOHN REX: Okay, thank you.

OPERATOR: Our next question comes from Scott Fidel with Deutsche Bank.

SCOTT FIDEL: Thank you. First question just on the Medicaid enrollment guidance – it looks like you're guiding to be up about 4 percent this year. Are you adding a contract or something in the fourth quarter there? I didn't calculate it in the third quarter being up much.

JOE CAPEZZA: We calculate it being up excluding Connecticut which we dropped.

SCOTT FIDEL: Okay, so that's ex-Connecticut up 4 percent.

JOE CAPEZZA: Right, and risk only business.

SCOTT FIDEL: Okay. Then just relative to the commercial and Medicare MLRs – can you just give us some context around how those are tracking in the Northeast business as compared to the California, the West coast business in terms of – are they relatively similar? Is one showing a significant variation from the other? Is the Northeast business – was it profitable in the third quarter?

JOE CAPEZZA: Let me pull that data out, Scott. I have too many pieces of paper that I have to pull up on that.

SCOTT FIDEL: What about to just the more simple question of whether the Northeast business was profitable in the third quarter?

JOE CAPEZZA: Yeah, it was profitable.

SCOTT FIDEL: Okay, and then just relative to Part D. First, your expectations for how many duals you expect to lose in 2009. I know your prior guidance was to have a 1 percent margin in PDP this year. It sounds like you are backing away from that. What's your updated view around PDP margins for 2008 baseline?

JOE CAPEZZA: As far as ‘09 membership losses on PDP, we’re expecting a significant decline and we’ll get with specific with you at investor day in two weeks. Then with regards to the PDP side, we’re expecting PMPM margins to be somewhere around 8.5 to $9.

SCOTT FIDEL: Would the duals for ‘09 -- did you cite maybe down 100,000 on the duals?

JOE CAPEZZA: I hadn't said anything. But since almost 80 percent of our business is from dual-eligibles, that’s probably about right.

SCOTT FIDEL: Just one last question. On Medicare Advantage, just within the network based products, can you update us on what your SNP -- SNP membership is within that and what your plans are for SNP in ’09, and how much cost pressure you’ve seen in that book this year?

JOE CAPEZZA: I don't have that level of detail in front of me. We’ll have to follow up with you on that one, Scott.

SCOTT FIDEL: Okay.

OPERATOR: And next we have Brian Wright with Banc of America.

BRIAN WRIGHT: Thanks, good morning. Could you tell us, of the litigation settlement that you took at the end of last year, how much you have actually paid out on that?

JOE CAPEZZA: We paid out in excess of $200 million related to that settlement. We had to put it in an escrow account.

BRIAN WRIGHT: So of the 201.5 that was medical cost, you paid that out?

JOE CAPEZZA: We paid out and put into an escrow account to satisfy the claims, and the claims are in the process of being accumulated and settled.

BRIAN WRIGHT: So when it goes into escrow, does that go into your operating cash flow?

JOE CAPEZZA: Yes. Cash flow reflects the monies that we put into the settlement escrow.

BRIAN WRIGHT: Okay, thank you.

OPERATOR: And our final question comes from Justin Lake, a follow-up, with UBS.

JUSTIN LAKE: Thanks for letting me in for a follow-up. I just wanted to drill down on the commercial MCR specifically. You mentioned that it's not a geographic question, but I think you talked about the slice business here. So I think it would be pretty simple to just look at your large group business versus your small, which you break out from a membership standpoint. And if it is a slice issue, we would think that the large group business would be seeing a much larger or disproportional increase in MLR. Can you give us some color around that or specific numbers on how large group’s doing versus small group from an MLR standpoint?

JOE CAPEZZA: Everyone is doing worse than expectations. The large group business traditionally has a significantly higher loss ratio than the small to mid marketplace. We’re actually seeing a higher percentage increase with regards to absolute bps in the small group area than we are in the large.

JUSTIN LAKE: You're seeing a larger increase in the small group area? Okay, so that would argue that the issue isn't negative selection on the slice side. Is there anything else you can try to point to? Is the out of network larger on the smaller group side or …?

JAY GELLERT: Justin, one of the things is in California a lot of the small group is even in slice because of Kaiser.

JUSTIN LAKE: Is that right? What's the definition of slice or, I'm sorry, small group?

JAY GELLERT: Small group is 50 employees and below. So you have a lot of higher end of small group has some slice in it.

JUSTIN LAKE: Maybe you can tell us how many of your members are actually under a slice contract?

JOE CAPEZZA: Not right now I can't, but we'll get back to you.

JUSTIN LAKE: Okay. And then on the Medicare side? When we're seeing these kind of large increases on the MLR, just kind of curious – given the fact that you have so much capitation in Medicare, you would think that you'd be insulated on a pretty large proportion of your Medicare population…from variability in MLR? Am I not thinking about that right, or are you seeing all of the variability on your non-capitated book?

JOE CAPEZZA: The number of capitated hospitals we have in Medicare are very small in light of the total population.

JUSTIN LAKE: What about on the physician side? My understanding was you had a lot of IPAs that were taking full risk out there, or at least a significant amount of it.

JOE CAPEZZA: That hasn't been a problem.

JUSTIN LAKE: Okay. So what proportion of your book is capitative?

JOE CAPEZZA: So the physician side is about 80 percent capitated, and hospital is more along the lines of 20.

JUSTIN LAKE: Okay. So you're seeing all of the volatility outside of the physician side and the capitated hospital?

JOE CAPEZZA: Pretty much.

JUSTIN LAKE: So it would just argue that the volatility or the increase in MLR is even greater than what's stated on the face of the financial statements because the actual denominator would be much smaller as far as what you're dividing, the changes in medical costs. Does that all make sense? Do you follow me?

JOE CAPEZZA: Well, actually, capitation gets included in the calculation of MLR. We don't show an MLR calculation exclusive of cap.

JUSTIN LAKE: Right. I guess that's what I'm trying to say. MLR is several hundred basis points higher than Medicare Advantage. And yet capitation hasn't moved at all. I would think that it's up five or 600 without it. Just magnitude is staggering. I'm wondering if there's anything you could point us to there.

JOE CAPEZZA: We’re kind of getting stuck in the weeds here, Justin. Maybe we should take this one offline and walk through some numbers with you so I can see what exactly you're looking at.

JUSTIN LAKE: Okay, that's helpful. Thanks a lot.

ANGIE McCABE: Thank you for joining us, and we will see you at our investor day on November 18th.

OPERATOR: This does conclude today's conference. Thank you for attending and have a wonderful day

[END]