

**STATE OF WASHINGTON  
OFFICE OF THE INSURANCE  
COMMISSIONER**



**FINANCIAL EXAMINATION**

**of**

**PacifiCare of Washington, Inc.  
Mercer Island, Washington**

**NAIC CODE 48038  
DECEMBER 31, 2006**

Order No. 08-111  
PacifiCare of Washington, Inc.  
Exhibit A

**SALUTATION**

Seattle Washington  
August 11, 2008

The Honorable Mike Kreidler, Commissioner  
Washington State Office of the Insurance Commissioner (OIC)  
Insurance Building – Capitol Campus  
302 Sid Snyder Avenue SW, Suite 200  
Olympia, WA 98504

Dear Commissioner Kreidler:

In accordance with your instructions, and in compliance with the statutory requirements of RCW 48.44.145 and RCW 48.03.010, an examination was made of the corporate affairs and financial records of

**PacifiCare of Washington, Inc.**

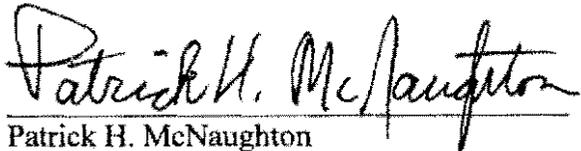
of

Mercer Island, Washington

hereinafter referred to as "PCWA" or the "Company," at the location of its home office, 7525 SE 24<sup>th</sup> Mercer Island, Washington 98101. This report is respectfully submitted showing the condition of the Company as of December 31, 2006.

**CHIEF EXAMINER'S AFFIDAVIT**

I hereby certify I have read the attached Report of the Financial Examination of PacifiCare of Washington, Inc., of Mercer Island, Washington. This report shows the financial condition and related corporate matters as of December 31, 2006.



Patrick H. McNaughton  
Chief Examiner

8-11-08

Date

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## **SCOPE OF THE EXAMINATION**

This examination covers the period January 1, 2003 through December 31, 2006 and comprises a comprehensive review of the books and records of the Company. The examination followed the statutory requirements contained in the Washington Administrative Code (WAC), the Revised Code of Washington (RCW), and the guidelines recommended by the National Association of Insurance Commissioners (NAIC) Financial Condition Examiners Handbook (FCEH). The examination included identification and disposition of material transactions and events occurring subsequent to the date of examination that were noted during the examination.

Corporate records, external reference materials, and various aspects of the Company's operating procedures and financial records were reviewed and tested during the course of this examination and are commented upon in the following sections of this report. In addition, the Company's certified public accountant's (CPA's) work papers were reviewed and utilized, where possible, to facilitate efficiency in the examination.

## **INSTRUCTIONS**

The examiners reviewed the Company's filed 2006 NAIC Annual Statement as part of the statutory examination. This review was performed to determine if the Company completed the 2006 NAIC Annual Statement in accordance with the NAIC Annual Statement Instructions and to determine if the Company's accounts and records were prepared and maintained in accordance with Title 48 RCW, Title 284 WAC, and the NAIC Statements of Statutory Accounting Principles (SSAP) as contained in the NAIC Accounting Practices and Procedures Manual (AP&P).

### **1. NAIC Annual Statement Errors and Misclassifications**

The results of the examination disclosed several instances in which the Company's filing of the 2006 NAIC Annual Statement did not conform to the NAIC Accounting Practices and Procedures Manual and the NAIC Annual Statement Instructions.

#### **a. Extraordinary Dividend**

The Company obtained approval from OIC to distribute \$24 million in extraordinary dividends in 2005. Since the Company's "Unassigned funds (surplus)" was negative at the time of the approval, the distribution should have been treated as a return of capital, not as a reduction of "Unassigned funds (surplus)" pursuant to the 2006 NAIC Annual Statement Instructions, Page 37, Line 26. (See examination reclassification No. 1., debiting, "Gross paid in and contributed surplus", and crediting, "Unassigned funds (surplus)" in the amount of \$24 million.)

#### **b. Licensing Status as a Health Care Service Contractor**

The Company is registered under RCW 48.44.15 as a Health Care Service Contractor in Washington State. In the 2006 NAIC Annual Statement, Schedule Y, and the Management's Discussion and Analysis for the same year, the Company has called itself

a Health Maintenance Organization (HMO). It was also noted in the Company's promotional material on the internet.

**c. General Interrogatories - Minimum Net Worth Requirement**

The Company has been calculating its minimum net worth based on its risk based capital level in its filed NAIC Annual Statements, General Interrogatories, Part 2, No. 11. RCW 48.44.037(1) requires that minimum net worth be calculated based on earned premiums. The Company incorrectly reported its minimum net worth during the examination period of January 1, 2003 through December 31, 2006.

**d. Premiums Received in Advance**

The Company included an entry twice for "Premiums received in advance" in the 2006 NAIC Annual Statement in the amount of \$959,157. (See examination adjustment No. 2. debiting, "Premiums received in advance" and crediting, "Uncollected premiums and agents' balances in course of collection" in the amount of \$959,157.)

**e. Additional Data Filing**

Several items in the Additional Data Statement Form (ADSF) to the NAIC Annual Statement for the year ending December 31, 2006 did not reconcile to the NAIC Annual Statement as required by WAC 284-07-050(8).

- In the ADSF, Analysis of Washington Comprehensive Line Amounts, total medical and hospital (Column 2, Line 17) for individual contacts should equal the totals in the 2006 NAIC Annual Statement, Exhibit of Premiums, Enrollment and Utilization (a), in Column 2, Line 18.
- In the ADSF, Group Enrollment and Utilization in Washington, all lines in Column 1 must be identical to respective lines in the 2006 NAIC Annual Statement, Exhibit of Premiums, Enrollment and Utilization (a).
- In the ADSF, the required indemnity deposit amount was not calculated correctly. PCWA failed to include "Aggregate health policy reserves". Additionally, the amounts recorded in the ADSF for "Incurred but unpaid claims" and "Premium received in advance" did not agree with the 2006 NAIC Annual Statement.

No adjustments are required because the Company has sufficient deposits in its indemnity bank account to cover the estimated \$780,000 shortage in its calculation of required indemnity deposit. (See section, SPECIAL DEPOSITS, of this report.)

**f. Claim Expenses and Claim Adjustment Expenses**

PCWA misclassified claim adjustment expenses in its 2006 NAIC Annual Statement in the amount of \$3,605,347. The Company recorded expenses for disease management fees and vendor fees as "Hospital/medical benefits". These are cost containment expenses as defined by SSAP No. 85, paragraph 4.a. Cost containment expenses should be classified as claims adjustment expenses. (See examination reclassification No. 3., debiting "Claim adjustment expenses" and crediting, "Hospital/medical benefits" in the amount of \$3,605,347.)

**The Company is instructed to file an accurate statement of its financial condition, transactions, and affairs in compliance with RCW 48.43.097, which requires the filing of its financial statements in accordance with the AP&P, and WAC 284-07-050(2) which requires adherence to the NAIC Annual Statement Instructions.**

**2. Premium Sample Enrollment/Application Records**

The Company could not provide supporting records for Medicare policyholders such as original applications forms and demographic forms. A sample of 29 items was selected from the Medicare premium database. Of the 29 items selected, the Company provided support documents for only 10 policyholders. The Company stated that the information was stored on magnetic reels and that it would take too long to search. The Medicare contract between the Company and the Federal Center for Medicare Services (CMS) requires the Company to keep records for the current year and the prior 10 years.

**The Company is instructed to keep and maintain sufficient detail records in accordance with RCW 48.03.030(1) and RCW 48.44.145(2).**

**3. Costs Sharing Between Affiliates are Based on Estimated Costs Not on Actual Costs**

A Management and Administrative Services Agreement (MASA) between PCWA and its parent, PacifiCare Health Plan Administrators, Inc. (PHPA), require that costs between the affiliates be based on actual costs. During the examination period of January 1, 2003 through December 31, 2006, PCWA was charged a management fee by PHPA based on 9.19% of net premiums which were not reconciled to actual costs. The amounts charged for management fees during the examination period were reported as \$198,481,345. The actual costs as calculated by the Company were \$207,336,213.

Our examination was able to verify costs incurred by PHPA on behalf of PCWA, but the accounts and records of affiliates were not received timely enough to determine that expenses flowing into PHPA from other affiliates on behalf of PCWA were fair and reasonable in compliance with RCW 48.31C.050(1)(d). (See examination adjustment No. 4, debiting, "Unassigned funds (surplus)" in the amount of \$9,209,498 for prior year adjustments, crediting, "Amounts due to parent, subsidiaries and affiliates" in the amount of \$8,854,868, and crediting, "General administrative expenses" in the amount of \$354,630 for the 2006 adjustment.)

**Pursuant to RCW 48.31C.050(1)(a-d) and SSAP No. 70, paragraph 8, the Company is instructed to reimburse affiliate transactions based on actual costs incurred by its affiliate. Pursuant to RCW 48.31C.070 and RCW 48.31C.050(1)(d), the Company is instructed to maintain accounts and records of each affiliate so that transactions clearly and accurately disclose the nature and details, including such accounting information as is necessary to support the reasonableness of the charges or fees at cost.**

#### **4. Royalty Costs are Included in Management Fees Paid to an Affiliate**

Included in the management fees paid by the Company to PHPA are royalty fees based on 1.75% of premiums. Royalty fees are not permitted pursuant to RCW 48.31C.050 and SSAP No. 70, paragraph 8, which states, "Shared expenses, including expenses under the terms of a management contract, shall be apportioned to the entities incurring the expense as if the expense had been paid solely by the incurring entity."

The Company denied that it paid royalty fees during this examination period and the prior examination period. In the prior examination period of January 1, 1997 thru December 31, 2002, royalty fees were classified as "Corporate charge back" fees. The Company stated that "Corporate charge back" fees were for services provided by the Corporate Office for treasury, legal, taxes and other regulatory functions not performed directly by the Company. For the current examination period, the Company classified royalty fees as "Management contract fees". However, the Company now states that royalty fees (Management contract fees) are for marketing costs and that the use of PacifiCare intellectual property is integral to the marketing of PCWA's products. The Company's parent, PHPA, pays the royalty fees to another affiliate, PacifiCare Life and Health Insurance Company, and then royalty charges are included in the inter-company billing from PHPA to PCWA.

The royalty charges were included in all inter-company monthly estimated billings and were never excluded when estimated costs were adjusted to actual costs. Royalty payments made by PCWA through inter-company transactions are as follows:

1999	\$ 7,320,233
2000	8,666,280
2001	9,483,600
2002	9,539,984
2003	10,187,748
2004	9,898,531
2005	8,659,782
2006	<u>9,158,473</u>
	\$ <u>72,914,631</u>

The adjustments required in conjunction with Examination Adjustment No. 4. above are as follows:

(For the year 2006, see examination adjustment No. 5., debiting "Receivables from parent, subsidiaries and affiliates" and crediting, "General administrative expenses" in the amount of \$9,158,473.) (For years 1999 through 2005, see examination adjustment No. 6., debiting "Receivables from parent, subsidiaries and affiliates" and crediting, "Unassigned funds (surplus)" in the amount of \$63,756,158.)

**Pursuant to RCW 48.31C.050(1)(a-c) and SSAP No. 70, paragraph 8, the Company is instructed to discontinue paying royalty fees either directly or indirectly and to seek reimbursement from PHPA for all royalty fees paid.**

## COMMENTS AND RECOMMENDATIONS

None

### COMPANY PROFILE

#### **Company History**

PCWA obtained its Certificate of Registration in Washington State on March 6, 1986 as a Health Maintenance Organization (HMO). On February 28, 1994, PCWA purchased Preferred Health Resources (PHR). PHR consisted of Network Health Plan, a Health Care Service Contractor (HCSC), and Network Management, Inc., a third party administrator. On June 30, 1994, PCWA was dissolved and all assets were transferred to Network Health Plan. On October 1, 1994, Network Health Plan changed its name to PacifiCare of Washington (PCWA). On December 20, 2005, PCWA's previous parent, PacifiCare Health System, LLC, was acquired by UnitedHealth Group, Inc., (the Parent).

#### **Capitalization**

Minimum capital requirements pursuant to RCW 48.44.037 were met with approximately \$134 million in net worth (capital and surplus) as of December 31, 2006.

#### **Territory and Plan of Operation**

The Company is registered as a HCSC in the state of Washington only. It engaged in the following lines of business: Comprehensive hospital and medical, Federal Employees Health Benefit Plans, and Title XVIII Medicare. Approximately 80% of the business comes from Medicare, which is marketed under the Secure Horizons brand name.

#### **Growth of the Company**

The following reflects the growth of the Company based on its filed NAIC Annual Statements for the years ending December 31:

<u>Year</u>	<u>Admitted Assets</u>	<u>Liabilities</u>	<u>Capital &amp; Surplus</u>	
2006	\$197,796,845	\$63,973,194	\$133,823,651	
2005	153,841,212	53,869,959	99,971,253	
2004	135,394,003	48,856,116	86,537,887	
2003	137,723,018	92,300,266	45,422,752	

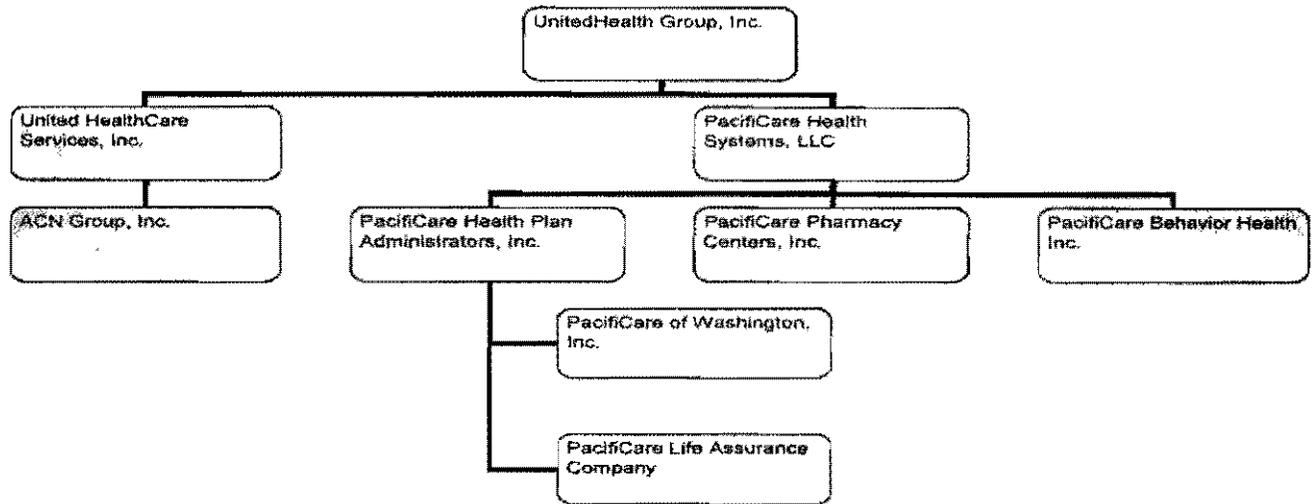
  

<u>Year</u>	<u>Premiums Earned</u>	<u>Net Underwriting Gain (Loss)</u>	<u>Net Investment Gain (Loss)</u>	<u>Net Income</u>
2006	\$514,720,411	\$57,046,720	\$7,231,183	\$42,709,390
2005	493,573,184	41,422,383	5,179,452	42,709,545
2004	565,030,258	48,723,778	4,820,310	53,544,088
2003	581,797,579	(6,654,755)	3,246,558	(3,408,197)

**AFFILIATED COMPANIES**

**Organizational Chart**

The following organizational chart as of December 31, 2006 shows the Company's Parent and direct reporting insurance subsidiaries:



**Inter-Company Agreements**

**Management and Administrative Service Agreement**

A management and administrative service agreement entered on January 1, 1999 between PHPA and PCWA. PHPA is to provide management and administrative services to PCWA in order to streamline administration and operations for PCWA and improve customer service and support through investments in technology. This agreement is effective for ten years with two ten year renewal options. (See Instruction No. 4.)

**Reinsurance Agreement**

A reinsurance agreement was entered into on January 1, 2003 for a continuous period. PacifiCare Life Assurance Company (PLAC) agreed to reinsure, and PCWA agreed to cede, a specified portion of Membership Service Agreements issued by PCWA. This reinsurance agreement was amended and updated annually on January 1, but was terminated as of January 1, 2007.

Tax Sharing/Allocation Agreement

Effective February 10, 2003, PCWA was included in the consolidated federal income tax filings of PacifiCare Health System, LLC. On December 20, 2005, PCWA was acquired by UnitedHealth Group, Inc., and included in its consolidated tax return filing.

Pharmaceutical Services Agreement

Effective January 1, 1998, PCWA agreed that PacifiCare Pharmacy Centers, Inc., would provide consultative, administrative, and claims processing services for the administration of PCWA's pharmacy benefit program.

Behavioral Health Services Agreement.

A service agreement was entered on September 15, 1997 between PCWA and PacifiCare Behavioral Health, Inc., (PBHI) for a period of three years and then renewed annually. PBHI agrees to manage the provision and delivery of chemical dependency and mental health services to PacifiCare policyholders.

Cost Reimbursement Agreement

A cost reimbursement agreement was entered on February 14, 2006 between United HealthCare Services, Inc. (UHS) and PHPA for an infinite duration. UHS agrees to provide management and administrative services to PHPA and its subsidiaries which include PCWA. In return, PHPA agrees to reimburse UHS for all costs and expenses incurred by UHS in providing such services.

**MANAGEMENT AND CONTROL**

**Ownership**

The Company is a wholly owned subsidiary of PHPA. PHPA is solely owned by PacifiCare Health Systems, LLC, formerly PacifiCare Health Systems, Inc. Effective December 20, 2005, PacifiCare Health Systems, LLC, became a wholly owned subsidiary of UnitedHealth Group, Inc.

**Board of Directors (BOD)**

Management of the Company is vested in a BOD comprised of not less than two and not more than nine members as provided for by the Company's Bylaws. A majority of the directors constitutes a quorum for the transaction of business.

**Directors as of December 31, 2006:**

Robert John Sheehy  
Steven Arthur Schmidt  
Samuel Warren Ho M.D  
James Anthony Frey II

**Officers as of December 31, 2006:**

Steven Arthur Schmidt	President
Forrest Gregory Burke	Treasurer
Robert Worth Oberrender	Secretary
Donald Alan Powers	Vice President and Assistant Treasurer

Juanita Valarae Bolland Luis  
Susan Lynn Berkel

Assistant Secretary  
Chief Financial Officer

**Conflict of Interest**

The Company's policy requires that members of the BOD, officers and all employees grade 30 or above file a conflict of interest statement each year. The purpose of the statement is to detect any activities or participation on the part of an employee that could possibly be interpreted as a conflict of interest. No exceptions were noted.

**Fidelity Bond and Other Insurance**

The Company is a named insured under a crime coverage plan purchased by UnitedHealth Group, Inc. The aggregate coverage limit was \$25 million, with retention of \$500,000 per loss as of December 31, 2006. The coverage limit amounts exceed the NAIC recommended minimum coverage range of \$1.25 million to \$1.5 million.

The Company is also protected under various other insurance policies acquired by its Parent. Those policies are:

- Commercial General Liability Policy
- Professional Liability Policy
- Property and Business Interruption Policy
- Workers Compensation/Employers Liability Policy
- Professional Liability and Medical Professional Liability Policy
- Employee Benefit Plan Fiduciary Liability Insurance Policy
- Directors and Officers Liability Policy

The review of the Company's insurance policies indicates insurance coverage has been purchased and is in force covering hazards to which the Company is exposed as of the examination date. All affiliated companies are covered as named insureds under policies purchased by the Parent.

**Officers', Employees', and Agents' Welfare and Pension Plans**

PCWA has no employees during the examination period. All services are performed by its affiliates, under the Management and Administrative Services Agreement and Cost Reimbursement Agreement.

**COPORATE RECORDS**

The Articles of Incorporation, Bylaws, Certificate of Registration, and minutes of the BOD and committees were reviewed for the period under examination. All BOD meetings were conducted with a quorum present.

**ACTUARIAL REVIEW**

The OIC health actuary reviewed the Company's actuarial report, claims unpaid, and other claim

liabilities as of December 31, 2006. The claim liabilities were determined to be within a reasonable range. The review included examining the Company's reserving philosophy and methodologies to determine the reasonableness of the claim liabilities; verifying that claim liabilities include provisions for all components noted in SSAP No. 55, Paragraphs 7 and 8; reviewing historical paid claims and loss ratios; checking the consistency of the incurred-paid data from the Company's system with the figures reported in the 2006 NAIC Annual Statement; reviewing the calculation for the provision of refund for risk sharing under Medicare Part D; and estimating claims unpaid for the valuation date of December 31, 2006. One issue was noted in the review. (See Instruction No. 1.f.)

### **REINSURANCE**

PCWA has a reinsurance agreement with an affiliate, PacifiCare Life Assurance Company since January 1, 2003. Under the agreement, PacifiCare Life Assurance Company agreed to indemnify PCW for losses exceeding its retention level of \$400,000 per member per year, with a lifetime cap of \$2,000,000. In return, PCWA agreed to pay a fixed amount of premium per month to PacifiCare Life Assurance Company for the risk assumed. The fixed amount of the premium is amended annually as necessary. The reinsurance agreement was terminated on December 31, 2006.

### **SPECIAL DEPOSITS**

The OIC requires the filing of the Underwriting of Indemnity Calculation of Funded Reserve form pursuant to WAC 284-07-050(8). The Company initially calculated the required minimum special deposit at \$4.10 million. A number of errors were included in the calculation. The Company re-calculated the minimum deposit which increased the minimum deposit to \$4.88 million pursuant to WAC 284-44-330 and WAC 284-44-340. (See Instruction No. 1.e.)

The Company met the special deposit requirement with various securities with a total fair market value of 6.1 million. The securities are held in a special deposit account by the Company's custodian, Bank of New York, pursuant to RCW 48.44.030.

### **ACCOUNTING RECORDS AND INFORMATION SYSTEM**

The Company maintains its accounting records on a Generally Accepted Accounting Principles (GAAP) basis and adjusts it to Statutory Accounting Practice (SAP) basis for NAIC Annual Statement reporting. The Company was audited annually by Ernst and Young, LLP for 2003 to 2005, and Deloitte and Touche, LLP for 2006. The Company received unqualified opinions for all years under review. The Company's accounting procedures, internal controls, and transaction cycles were reviewed during the planning and testing phase of the examination and no material exceptions were noted.

The management of PCWA is sufficiently knowledgeable of the information system process. System development, acquisition, and maintenance controls were evaluated to gain assurance

that appropriate internal controls are in place. Operations and application controls were reviewed to determine the type of hardware installed; operating systems and proprietary software in use; back up and recovery facilities employed; and the internal controls exercised to maintain data security. Sufficient internal controls are in place and monitored by the Company. The Company's information system department has the ability to recover from an incident or disaster and has documented these procedures in a detailed, written recovery plan.

### **SUBSEQUENT EVENTS**

An Administrative Service Agreement was entered on January 1, 2007 between ACN Group, Inc., and PCWA. ACN Group, Inc., is to provide administrative services and other general business operations to PCWA. This agreement is for a period of 12 months and automatically renews annually.

### **FINANCIAL STATEMENTS**

The following examination financial statements show the financial condition of the Company as of December 31, 2006:

Assets, Liabilities, Capital and Surplus  
Statement of Revenue and Expenses  
Four-Year Reconciliation of Surplus  
Analysis of Changes in Financial Statements Resulting from the Examination

**PACIFICARE OF WASHINGTON, INC.**  
**Assets, Liabilities, Capital and Surplus**  
**As of December 31, 2006**

	<u>BALANCE PER COMPANY</u>	<u>ref.</u>	<u>EXAMINATION ADJUSTMENTS</u>	<u>BALANCE PER EXAMINATION</u>
<b>Assets</b>				
Bonds	\$89,417,756			\$89,417,756
Cash and short-term investments	93,810,763			93,810,763
Investment income due and accrued	1,012,508			1,012,508
Premiums and considerations:				
Uncollected premiums and agents' balances	8,302,476	2	(\$959,157)	7,343,319
Amounts recoverable from reinsurers	54,982			54,982
Current federal and foreign income tax recoverable	847,080			847,080
Net deferred tax asset	2,257,577			2,257,577
Receivables from parent, subsidiaries and affiliates	150,047	5,6	\$72,914,631	73,064,678
Health care and other amounts receivable	1,943,656			1,943,656
<b>Total Assets</b>	<u><u>\$197,796,845</u></u>		<u><u>\$71,955,474</u></u>	<u><u>\$269,752,319</u></u>
 <b>Liabilities, Capital, and Surplus</b>				
Claims unpaid	\$36,192,490			\$36,192,490
Accrued medical incentive pool and bonus amounts	73,349			73,349
Unpaid claims adjustment expenses	900,994			900,994
Aggregate health policy reserves	7,418,749			7,418,749
Aggregate health claim reserves	279,995			279,995
Premiums received in advance	7,766,557	2	(\$959,157)	6,807,400
General expenses due or accrued	1,987,939			1,987,939
Amounts withheld or retained for the account of others	1,494			1,494
Amounts due to parent, subsidiaries and affiliates	4,784,949	4	8,854,868	13,639,817
Liab. for amounts held under uninsured plans	4,566,678			4,566,678
<b>Total Liabilities</b>	<u><u>63,973,194</u></u>		<u><u>7,895,711</u></u>	<u><u>71,868,905</u></u>
Gross paid in and contributed surplus	104,456,000	1	(24,000,000)	80,456,000
Aggregate write-ins for other than special surplus funds	4,534,195			4,534,195
Unassigned funds (surplus)	24,833,456	1,4,5,6	88,059,763	112,893,219
<b>Total Capital and Surplus</b>	<u><u>133,823,651</u></u>		<u><u>64,059,763</u></u>	<u><u>197,883,414</u></u>
<b>Total Liabilities, Capital and Surplus</b>	<u><u>\$197,796,845</u></u>		<u><u>\$71,955,474</u></u>	<u><u>\$269,752,319</u></u>

**PACIFICARE OF WASHINGTON, INC**  
**Statement of Revenue and Expenses**  
**For the Year Ended December 31, 2006**

	<u>BALANCE PER COMPANY</u>	<u>rel</u>	<u>EXAMINATION ADJUSTMENTS</u>	<u>BALANCE PER EXAMINATION</u>
Member months	760,744			760,744
Net premium income	\$522,139,160			\$522,139,160
Change in unearned premium reserves	(7,418,749)			(7,418,749)
Total revenues	<u>514,720,411</u>		<u>0</u>	<u>514,720,411</u>
<b><u>Hospital and Medical:</u></b>				
Hospital/medical benefits	347,690,145	3	(3,605,347)	344,084,798
Other professional services	4,272,892			4,272,892
Emergency room and out-of-area	17,721,449			17,721,449
Prescription drugs	36,658,998			36,658,998
Incentive pool, withhold adjustments and bonus amounts	(667,909)			(667,909)
Subtotal	<u>405,675,575</u>		<u>(3,605,347)</u>	<u>402,070,228</u>
Net reinsurance recoveries	720,205			720,205
Total hospital and medical	404,955,370		(3,605,347)	401,350,023
Claims adjustment expenses	8,491,901	3	3,605,347	12,097,248
General administrative expenses	44,226,420	4.5	(9,513,103)	34,713,317
Total underwriting deductions	<u>457,673,691</u>		<u>(9,513,103)</u>	<u>448,160,588</u>
Net underwriting gain or (loss)	<u>57,046,720</u>		<u>9,513,103</u>	<u>66,559,823</u>
Net investment income earned	8,131,897			8,131,897
Net realized capital gains or (losses)	(900,714)			(900,714)
Net investment gains or (losses)	<u>7,231,183</u>		<u>0</u>	<u>7,231,183</u>
Aggregate write-ins for other income or expenses				
Net income or (loss) before FIT	64,277,903		9,513,103	73,791,006
Federal and foreign income taxes incurred	<u>21,568,513</u>			<u>21,568,513</u>
<b>Net Income (Loss)</b>	<u><u>\$42,709,390</u></u>		<u><u>\$9,513,103</u></u>	<u><u>\$52,222,493</u></u>
<b><u>CAPITAL AND SURPLUS ACCOUNT</u></b>				
Capital and surplus prior reporting period	<u>\$99,971,252</u>			<u>\$99,971,252</u>
Net Income (Loss) from above	42,709,390		\$9,513,103	52,222,493
Change in net deferred income tax	(552,064)			(552,064)
Change in nonadmitted assets	1,195,073			1,195,073
Surplus adjustments:				
Paid in		1	(24,000,000)	(24,000,000)
Dividends to stockholders	(9,500,000)			(9,500,000)
Aggregate write-ins for gains or (losses) in surplus to prior years resulting from examination adjustments		1.4.6	78,546,660	78,546,660
Net change in capital and surplus	<u>33,852,399</u>		<u>64,059,763</u>	<u>97,912,162</u>
<b>Capital and surplus end of reporting period</b>	<u><u>\$133,823,651</u></u>		<u><u>\$64,059,763</u></u>	<u><u>\$197,883,414</u></u>

**PACIFICARE OF WASHINGTON, INC.**  
**Four Year Reconciliation of Surplus**  
**For the Years Ended December**

	<u>12/31/2006</u>	<u>12/31/2005</u>	<u>12/31/2004</u>	<u>12/31/2003</u>
<b>Capital and surplus, prior reporting year</b>	<u>\$99,971,252</u>	<u>\$86,537,889</u>	<u>\$45,422,752</u>	<u>\$47,492,689</u>
Net income or (loss)	52,222,493	42,709,545	53,544,088	(3,408,197)
Change in net deferred income tax	(552,064)	(2,392,057)	3,767,653	(2,726,462)
Change in nonadmitted assets	1,195,073	115,875	21,803,396	4,064,722
Change in surplus notes		(3,000,000)	(43,000,000)	
Capital changes:				
Paid in			5,000,000	
Surplus adjustments:				
Paid in	(24,000,000)			
Dividends to stockholders	(9,500,000)	(24,000,000)		
Aggregate write-ins for gains or (losses) in surplus to prior years resulting from examination adjustments	78,546,660			
Net change in capital and surplus	<u>97,912,162</u>	<u>13,433,363</u>	<u>41,115,137</u>	<u>(2,069,937)</u>
<b>Capital and surplus, end of reporting period</b>	<u><u>\$197,883,414</u></u>	<u><u>\$99,971,252</u></u>	<u><u>\$86,537,889</u></u>	<u><u>\$45,422,752</u></u>

**PACIFICARE OF WASHINGTON, INC.**  
**Analysis of Changes in Financial Statements Resulting from the Examination**  
**For the Year Ended December 31, 2006**

	<u>BALANCE PER</u> <u>COMPANY</u>	<u>BALANCE PER</u> <u>EXAMINATION</u>	<u>ref.</u>	<u>INCREASE</u> <u>(DECREASE)</u> <u>IN SURPLUS</u>	<u>TOTAL</u>
<b>Capital and Surplus, December 31, 2006</b> <b>Per Annual Statement</b>					<b>\$133,823,651</b>
<b><u>ASSETS</u></b>					
Uncollected premiums and agents' balances	8,302,476	7,343,319	2	959,157	
Receivables from parent, subsidiaries and affiliates	150,047	73,064,678	5,6	(72,914,631)	
<b><u>LIABILITIES</u></b>					
Premiums received in advance	7,766,557	6,807,400	2	(959,157)	
Amounts due to parent, subsidiaries and affiliates	4,784,949	13,639,817	4	8,854,868	
<b><u>CAPTIAL AND SURPLUS</u></b>					
Gross paid in and contributed surplus	104,456,000	80,456,000	1	(24,000,000)	
Unassigned funds (surplus)	24,833,456	112,893,219	1,4,5,6	88,059,763	
<b><u>STATEMENT OF REVENUE AND EXPENSES</u></b>					
Hospital/medical benefits	347,690,145	344,084,798	3	3,605,347	
Claims adjustment expenses	8,491,901	12,097,248	3	(3,605,347)	
General administrative expenses	44,226,420	34,713,317	4,5	9,513,103	
Surplus adjustments: Paid in		(24,000,000)	1	(24,000,000)	
Aggregate write-ins for gains or (losses) in surplus to prior years resulting from examination adjustments	0	78,546,660	1,4,6	<u>78,546,660</u>	
<b>Change in surplus</b>					<u><b>64,059,763</b></u>
<b>Capital and Surplus, December 31, 2006</b> <b>Per Examination</b>					<u><b>\$197,883,414</b></u>

## NOTES TO THE FINANCIAL STATEMENTS

The Company has no special consents, permitted practices or orders from the state of Washington. There were six examination report adjustments.

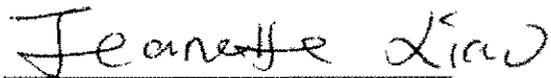
1. PCWA misclassified an extraordinary dividend in the 2005 NAIC Annual Statement in the amount of \$24,000,000. The Company reduced "Unassigned funds (surplus)" instead of "Gross paid in and contributed surplus". At the time of approval, the Company had an accumulated negative amount of "Unassigned funds (surplus)". An examination reclassification adjustment, debiting "Gross paid in and contributed surplus", and crediting "Unassigned funds (surplus)" is reflected in the preceding financial statements. (See Instruction No. 1.a.)
2. PCWA included an entry twice in recording "Premium received in advance" in the 2006 NAIC Annual Statement in the amount of \$959,157. An examination adjustment debiting, "Premium received in advance" and crediting, "Uncollected premiums and agents' balances in course of collection", is reflected in the preceding financial statements. (See Instruction No. 1.d.)
3. PCWA misclassified "Claim adjustment expenses" in the 2006 NAIC Annual Statement in the amount of \$3,605,347. An examination adjustment debiting, "Claim adjustment expenses" and crediting, "Hospital/medical benefits", is reflected in the preceding financial statements. (See Instruction No. 1.f.)
4. PCWA paid a management fee to PHPA based on 9.19% of net premiums not on actual costs. Management fees paid during the examination period were \$198,481,345. The actual cost as stated by the Company was \$207,336,213. An examination adjustment debiting, "Unassigned funds (surplus)" in the amount of \$9,209,498 for prior year adjustments, crediting, "Amounts due to parent subsidiaries and affiliates" in the amount of \$8,854,868 and crediting, "General administrative expenses" in the amount of \$354,630 for the current year adjustment, is reflected in the preceding financial statements. The tax effect is not considered in the examination adjustment. (See Instruction No. 4.)
5. PCWA paid royalty fees for year 2006 in the amount of \$9,158,473. An examination adjustment debiting, "Receivables from parent, subsidiaries and affiliates" and crediting, "General administrative expenses" is reflected in the preceding financial statements. The tax effect is not considered in the examination adjustment. (See Instruction No. 5.)
6. PCWA paid royalty fees for years 1999 through 2005 in the amount of \$63,756,158. An examination adjustment debiting "Receivables from parent, subsidiaries and affiliates" and crediting, "Unassigned funds (surplus)" is reflected in the preceding financial statements. (See Instruction No. 5.)

## ACKNOWLEDGMENT

Acknowledgment is hereby made of the cooperation extended to the examiners by the officers and staff of PacifiCare of Washington, Inc., during the course of this examination.

In addition to the undersigned, Michael V. Jordan, CPA, CFE, MHP, Assistant Chief Examiner; Carl M. Baker, CPA, CFE, CISA, Supervising Examiner; John Jacobson, AFE, CISA, AES, Automated Examination Specialist; Lichiou Lee, ASA, MAAA, Health Actuary; Shiraz Jetha, FSA, FCIA, MAAA, Health Actuary; Kathy Hicks, CPA, Financial Examiner; Ann Kauffman, CPA, Financial Examiner; Friday Enoye, Financial Examiner; Tony Quach, Financial Examiner; all from the Washington State Office of the Insurance Commissioner, participated in the examination and the preparation of this report.

Respectfully submitted,



Jeanette Jiangtao Liao, CPA, CFE  
Examiner-in-Charge  
State of Washington

