HIGHLINE MEDICAL SERVICES ORGANIZATION

May 4, 2009

Washington State Office of Insurance Commissioner
PO Box 40255
Olympia, Washington 98504-0255

Dear Deputy Commissioner Odiorne and Andrea Philhower:

We are writing to open a dialogue with the Washington State Office of Insurance Commissioner ("OIC") in hopes of quickly moving toward approval of the proposed transaction between Highline Medical Services Organization ("HMSO"), Physicians of Southwest Washington ("PSW") and Northwest Physicians Network ("NPN"), the three shareholders of Puget Sound Health Partners ("PSHP"). At the OIC's request, NPN and PSW submitted a Form A, describing their purchase of HMSO's ownership interest in PSHP (the "Transaction"). PSHP, PSW, NPN and HMSO have been working with the OIC since November 25, 2008 in an effort to obtain approval.

During an April 28, 2009 telephone conference, the OIC, through Jim Odiorne and Andrea Philhower, informed representatives of PSHP, NPN, PSW and HMSO that the OIC has concerns with the financial strength of PSHP that need to be addressed before the OIC could consider recommending approval of the Transaction. Mr. Odiorne and Ms. Philhower discussed the OIC's concerns and indicated that the OIC will consider recommending approval of the Transaction if:

1. The underwriting leverage concerns identified in Dennis Julnes' April 28, 2009 letter to Ms. April Golenor were resolved;
2. HMSO's ability to control PSHP as PSHP's largest contractor is addressed; and
3. Financial reporting issues identified in the OIC recent targeted financial examination are appropriately addressed (the findings have not been finalized as of the date of this letter).

We believe these issues can be quickly resolved and thus alleviate the OIC's concerns. With that in mind we address each of the issues and where appropriate propose resolutions that should satisfy any concerns that the OIC may have about the Transaction.

1. <u>Underwriting Leverage Issues</u>. Mr. Julnes' April 28, 2009 letter identified the OIC's concern with PSHP's underwriting leverage and its premium to surplus ratio. These concerns have also led the OIC to revoke PSHP's ability to maintain a reduced indemnity deposit under WAC 284-44-340(1).

a. <u>Expense to Premium Ratio</u>. While we all agree that PSHP's ratio of expenses to premiums was 102% in 2008, we were surprised to hear this presented as a concern by the OIC. PSHP financial projections submitted during the application process demonstrated an expected ratio of 107% for the first year of operations. The improvement in the ratio was generated from increased revenue due to the large number of Medicare Beneficiaries PSHP enrolled during its first year of operation which was a considerable success. The need to enroll a much larger number of Medicare Beneficiaries, caused by United Healthcare's termination of its Secure Horizons contracts with HMSO, NPN and PSW, led to significant increases in marketing and other operational expenditures for 2007 and 2008. It necessitated additional staffing in order to ensure PSHP provided service to the significantly higher number of enrollees. Fortunately, PSHP was able to leverage the marginal costs for the increased membership and reduce the overall ratio of expenses to premiums from the projected 107% to 102%.

While unfortunate that the 2009 enrollment targets were not met, PSHP can still view its enrollment and achievements to date satisfactorily when compared to other new Medicare Advantage Health Plans. PSHP ended the 2008 calendar year within eighty-nine thousand dollars of its original projections submitted to the OIC during the application process. Furthermore, actions are being taken to reduce costs as necessary in order to reach and maintain health plan profitability. This matter also appears to be a matter better addressed as part of the financial review rather than a matter that prohibits approval of the Transaction as **HMSO remaining a shareholder does not impact the expense to premium ratio.**

b. Premium to Surplus Ratio. The OIC also expressed concerns with PSHP's premium to surplus ratio. Mr. Julnes reports that PSHP's current ratio is 10 to 1. The OIC is demanding that PSHP maintain an 8 to 1 premium to surplus ratio. We have not been able to find any statutory or regulatory support for this ratio. During various conversations the OIC has stated that the ratio is based upon NAIC IRIS ratios. We found no such ratio for health plans and in fact, when we contacted the NAIC they stated that no such ratio exists for a company such as PSHP.

The OIC's position that the premium to surplus ratio cannot exceed 8 to 1, when applied to PSHP, results in PSHP being held to a significantly higher equity standard than the statutory Risk Based Capital requirements identified in RCWs 48.05.430 through 48.05.490. It has also been noted by the OIC that there was a precedent set in the KPS Health Plan situation that allows the OIC to require an 8 to1 premium to surplus ratio. However, court approval of an agreed upon settlement does not create binding precedent nor does it alter the statutory framework.

The OIC also appears not to be taking into account, in determining the premium to surplus ratio, that risk for over 95% of PSHP's membership is held by various networks which include those operated by NPN, PSW and HMSO, in return for a fixed percentage of PSHP's premium. The statutorily approved NAIC RBC takes these risk transfer contracts into account for health plans. Thus, it is inconsistent with NAIC standards to fail to give consideration through reduced capital requirements for PSHP's premium by the amount transferred to these networks under various risk based contracts. If the transferred premium is subtracted, PSHP would have a premium to surplus ratio of 3.8 to 1, which easily satisfies the OIC's requirement.

I would also like to note that not only does PSHP meet the NAIC RBC requirement, PSHP also meets the minimum net worth requirements of RCW 48.44.037.

Assuming a rule or statute required that PSHP maintain an 8 to 1 premium to surplus ratio, and ignoring the transferred risk agreements, PSHP would need an additional $1.9 million in additional surplus or need to implement a reinsurance treaty. Given the shareholder differences and HMSO's desire to sell its shares, it is highly unlikely that additional funds will be invested in PSHP before the Transaction is approved. Therefore, the only other option would require PSHP to obtain a reinsurance treaty which will cost hundreds of thousands of dollars, further hampering PSHP's ability to reduce its operational costs and expense to premium ratios. This would seem counter-intuitive and unreasonable especially given that PSHP has already contracted for other parties to take up to 95% of the risk related to the membership. A reinsurance treaty would simply be a very expensive paper transaction as the reinsurer would be charging a high premium to take risks that have already been transferred to NPN, PSW and HMSO.

Again, HMSO does not need to remain a shareholder in PSHP for these issues to be addressed.

c. Indemnity Deposit. As a consequence of the OIC's concerns with PSHP's expense to premium and premium to surplus ratios, Mr. Julnes indicated that PSHP would now be required to fund its indemnity deposit in accordance with WAC 284-44-340(2). A reduced indemnity deposit would no longer be allowed. We believe a reduced indemnity deposit remains appropriate due to the transfer of underwriting risk that has occurred with the delegated entities. Through the delegated and capitated contracts, PSHP distributes the majority of its premiums within days of receipt to the at-risk entities to allow for timely claims payments. PSHP does not retain this cash and therefore should not be required to hold the additional funds in a restricted reserve.

2. HMSO Provider Contract. The OIC also identified concerns that HMSO, as PSHP's largest contractor, could continue to control the company after the Transaction is approved. The opposite, would in fact, be true. A lack of control along with substantially different business approaches among PSW, NPN and HMSO is one of the factors that motivates HMSO to sell its shares in PSHP.

Perhaps the OIC's true concern is the impact to PSHP should PSHP lose forty percent of its membership, which could occur if HMSO terminated its provider agreement. HMSO and PSHP are currently working on ways to secure a longer term contract that should allay your concerns about the change in relationship, however the contract would need to provide HMSO with assurance that it can afford to take the underwriting risk.

It is important to note that HMSO is not obligated under the shareholder agreement to maintain a contract with PSHP. If the terms of the provider agreement do not make financial sense to HMSO, we will not continue the contract regardless of its status as a shareholder.

Again, HMSO does not need to remain a shareholder in PSHP to ensure the continuation of a provider agreement.

3. Financial Reporting Issues. I understand that the OIC's recent targeted financial examination has resulted in findings. OIC audit staff shared its preliminary report with PSHP and advised that the findings were largely procedural and that no substantial financial issues were identified. Consequently, Mr. Julnes' letter came as quite a surprise. While we have not seen the final report, we believe that PSHP has already corrected or will be able to quickly correct all issues that were communicated during the financial exam process. We trust that the OIC communicated all of its substantial concerns and that the report will simply document the findings already discussed.

In summary, we believe the concerns identified and discussed in this letter are easily resolvable, and more importantly are not impacted by HMSO's removal as a shareholder. HMSO's involvement as a shareholder does not impact PSHP's financial position, the competence of the new PSHP executive management team, nor the ongoing relationship with HMSO as a provider group. In fact, approving the Transaction is the only way in which PSHP can create a unified management and Board with alignment in their values, goals and mission. This will simply not happen with HMSO remaining as a shareholder.

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As a final thought, if we assume for a moment, without conceding, that the OIC's position is correct that RCW 48.31C.030 is applicable in this proposed transfer of ownership, then I'd like to note that the statute **REQUIRES** approval unless it is found that "after the change of control, the domestic health carrier referred to in subsection (1) of this section would not be able to satisfy the requirements for registration of a health carrier." If you fail to approve this Transaction timely as required under this statute, then you must believe that PSHP is unable to continue operations without HMSO remaining a shareholder. I would submit that if the Transaction is not completed and HMSO is required to remain a shareholder, the issues among the shareholders will likely escalate to a level that would make it nearly impossible for PSHP to function productively. The internal disputes would negatively impact PSHP's current financial stability and would quickly lead to the need for OIC intervention through a plan of rehabilitation, subsequent receivership and liquidation. Denial will lead to a long costly process that is not in the best interest of the OIC, PSHP, its existing shareholders or, most importantly, PSHP's enrollees. The way to give PSHP the greatest opportunity for success is to unify the Board of Directors and management through recommending approval of the Transaction.

I look forward to discussing this in person next Tuesday and hope we can develop a plan together to reach a positive and amicable result for all parties.

Sincerely,

Karen L. Lee

Karen L. Lee
President, HMSO

Cc: Ron Pastuch, Dennis Julnes, Jodie Thompson

HIGHLINE MEDICAL SERVICES ORGANIZATION

February 26, 2009

RECEIVED
MAR 02 2009
INSURANCE COMMISSIONER
COMPANY SUPERVISION

Washington State Insurance Commissioner
Ron Pastuch, Holding Company Manager
P.O. Box 40259
Olympia, WA 980504-0222

Re: Puget Sound Health Partners

Dear Mr. Pastuch:

On November 25, 2008, Puget Sound Health Partners ("PSHP"), Northwest Physicians Network, LLC ("NPN") and Physicians of Southwest Washington, LLC ("PSW") submitted to your office a Form A requesting that the Office of Insurance Commissioner ("OIC") approve the sale of Highline Medical Service Organization's ("HMSO") shares in PSHP to NPN and PSW (the "Transaction"). A revised Form A was submitted on February 17, 2009. The terms of the proposed Transaction are set forth on the revised Form A and in its attachments. NPN, PSW and HMSO are the only shareholders of PSHP. Once the Transaction is complete, NPN and PSW would each hold one half of the shares of PSHP. HMSO would no longer have any ownership interest but would retain its current provider contract with PSHP.

HMSO believes that approval of the Transaction is in everyone's best interest. The basis for this conclusion is discussed below. HMSO also wants to express its full support of the Transaction and would like to know if there is anything that HMSO can do to help expedite approval of the Transaction by your office. The parties are anxious to elicit your assistance to conclude the transfer.

HMSO initially invested in PSHP to help ensure provider access to health plans willing to contract on a full risk, globally capitated basis in HMSO's service area. HMSO felt it had to make such an investment due to recent changes in the market, but never had the desire to own and direct a health plan. HMSO believes that there remains a great need for competition in the Puget Sound Insurance market and believes that PSHP is helping to fill that need. A very real benefit to Medicare beneficiaries in Washington State has been achieved since the inception of PSHP: increased competition bringing improved benefits at a lower cost.

PSHP has been operating since January 18, 2007. Over the last two years, HMSO, NPN and PSW have discovered that they have significantly different goals, management styles, decision making processes and business practices. HMSO is more conservative than are NPN and PSW, and has a much more limited view of PSHP's role in the market.

HMSO, NPN and PSW are concerned that the current differences among the shareholders could be a barrier to PSHP's success and we are hoping to resolve this as soon as possible. For example, as is the case with anyone who wants to divest their ownership interest in a company, HMSO is unwilling to invest additional capital in PSHP. At the same time, if HMSO is required to remain a shareholder, it cannot approve a substantial investment of capital by other parties as HMSO would lose many of the

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rights afforded by its current investment interest. As you know that presents us all with a significant dilemma.

NPN and PSW, and apparently the OIC, have felt that additional capital is necessary to permit appropriate growth of PSHP. HMSO agreed to the infusion of the additional million dollars into PSHP by NPN and PSW and now that they money has been put into PSHP we are hoping that has alleviated the OIC's capitalization concerns. Thus, we believe it is in everyone's best interest to allow HMSO to be removed from the equation in order to let PSHP get back to business without distraction created from the conflict resulting from our differences. Shareholder conflict can paralyze a small company, especially in cases where key decisions such as raising additional capital, entering new markets and obtaining strategic provider contracts require approval by all shareholders and/or by a super-majority of the Board. HMSO also believes that approval of the Transaction will help PSHP's new management team as the remaining shareholders will have a unified vision for PSHP and its role in the Washington State market. The new management team has impressed HMSO, especially the new Chief Executive Officer, April Golenor.

HMSO wants PSHP to be successful. HMSO agreed to structure the Transaction to limit any potential negative impact on PSHP. We understand that asking for full payment in one lump sum without any performance incentives could create hardship for NPN and PSW and weaken their ability to continue funding PSHP should it be needed. Therefore, we agreed to accept significantly less than our original investment and to accept a smaller amount up front with payments over the next year based upon retention of the membership, a vital key for PSHP's success. HMSO also remains contracted with PSHP under a global capitation arrangement that protects PSHP from the financial and operational risk of more than forty percent of its membership.

HMSO strongly believes that approval of the Transaction is consistent with RCW 48.31C.030(5) and that the Transaction should be approved. The Transaction is a simple transfer of ownership interest of a one third owner to the two remaining owners. There will be no new owner or investor. The OIC has not taken any actions against NPN or PSW.

HMSO recognizes that PSHP is currently subject to a targeted financial examination by the OIC. To date, the only findings from the review concern day to day operational issues. You also stated in your December 17, 2008 letter to Howard Thomas and Larry Loo that the OIC is concerned about financial condition of PSHP and that PSHP's financial condition needs to be at a capital level acceptable to the OIC before the OIC will request a hearing to approve the Transaction. We believe that the financial condition of PSHP has been substantially improved by the one million dollars in additional capital recently invested by NPN and PSW. All statutorily mandated ratios appear to be met.

HMSO believes that additional capital or other mechanisms to create additional surplus such as a reinsurance treaty are unnecessary. PSHP's sole product line is Medicare Advantage and its three largest contractors are HMSO, NPN and PSHP. Each of these organizations assumes the risk for all enrollees who are assigned to these organizations in return for a fixed percentage of the premium that PSHP receives from CMS. Over 96 percent of PSHP's membership is covered under risk based contracts with NPN, PSW and HMSO in return for a fixed percentage of the premium that PSHP receives from CMS. These risk based agreements are no different than a reinsurance treaty in that they fully transfer the risk and responsibility for the patient's care to NPN, PSW and HMSO and significantly strengthen PSHP's financial position. It is our understanding that the OIC auditors spent considerable time trying to understand how the risk sharing agreements were constructed and found comfort that much of the medical risk was held by the capitated entities.

We are not aware of any facts or circumstances that would prevent PSHP from continuing to operate as an HCSC in compliance with all OIC rules and regulations should PSW and NPN purchase HMSO's shares. We strongly support the Transaction and believe it is clearly in the best interest of all involved. Please feel free to call me should you have any questions about this letter or if there is anything that HMSO can do to help expedite the OIC's approval of the Transaction. If there is disagreement with the conclusion stated in this letter, then we respectfully request a meeting as soon as possible to discuss the issues preventing the transaction and potentially any alternative solutions. I can be reached at 206-878-1503.

Sincerely,

Karen L. Lee
President, HMSO

Cc: April Golenor, CEO PSHP
Pat Briggs, CEO NPN
Mariella Cummings, CEO PSW

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