



May 1, 2009

Dennis Edward Julnes
Office of the Insurance Commissioner
PO Box 40255
Olympia, WA 98504-0255

Dear Mr. Julnes

I am writing in response to your letter of April 28, 2009. In your letter you cited concerns about "PSHP's significant underwriting leverage, financial reporting, financial condition and overall financial stability." You further cited that "PSHP's filed financial statements as of December 31, 2008, January 31, 2009 and February 28, 2009; and its 2008-year end and 2009 monthly financial forecasts do not allow us to confirm regulatory compliance on the issues identified above." You requested that PSHP provide a written analysis and documentation showing how PSHP believes that it is currently compliant. Following is the requested analysis and documentation.

Significant Underwriting Leverage

To investigate the statement in your letter "The NAIC's Insurance Regulatory Information System and its related reports is one of the standards the Commissioner may consider when determining whether an insurer may be operating in a financially hazardous condition. The Insurance Regulatory Information System related report identifies an acceptable premium to surplus ratio for health carriers, such as PSHP, as not more than 8:1.", I reviewed information available on the NAIC website. I found that according to the information available "Currently, the NAIC only generates IRIS ratio results for Property & Casualty, Life and Fraternal statement filers." Would you please cite the location of the NAIC Insurance Regulatory Information System that identifies acceptable premium to surplus ratios for health carriers as I was unable to locate that information?

The standard that I was able to identify from the NAIC for health entities such as PSHP is the Risk Based Capital requirement. [RCW 48.43.500, *et seq.*] The Risk Based Capital has different action levels. The Mandatory Control Level (70% of Authorized Control Level (ACL)), the Authorized Control Level, the Regulatory Action Level (150% of ACL) and the Company Action Level (200% of ACL). For PSHP, the Authorized Control Level at 12/31/08 was \$1,416,505. The PSHP Total Adjusted Capital at 12/31/08 was \$3,404,670 or 240% of ACL. PSHP did not trigger any action level in this model. As I'm sure you are aware, the Risk Based Capital model is a powerful and complex model that assigns factors to multiple elements of the carrier's financial statements. These factors vary depending on the nature of the element. The strength in this model is that it accounts for varying risks of different types of financial arrangements, including delegated risk through capitation. The model even assigns factors for excessive growth risk. Since 2008 was the first year of operations for PSHP, the model assigned a significant risk charge for excessive growth. This is a risk charge that we would anticipate to be much less significant in 2009 and going forward. Yet, even with this charge, PSHP was more than adequately capitalized.

Therefore, PSHP is compliant with the documented standards that we were able to locate. As requested above, please provide the source of the requirement for an 8 to 1 surplus ratio for health carriers.

Financial Reporting

In your letter you note that "the use of one or more hypothetical assumptions in financial forecasts is not permitted." You cite the AICPA Professional Standards AT Section 301. These professional standards are specifically for attestation services performed for a client by an independent CPA. Since the financial forecasts provided were prepared by the company, not an independent CPA, these standards do not apply. However, even if we were to apply these standards in AT section 301, I noted the following in those standards:

"Financial forecast—Prospective financial statements that present, to the best of the responsible party's knowledge and belief, an entity's expected financial position, results of operations, and cash flows. A financial forecast is based on the responsible party's assumptions reflecting the conditions it expects to exist and the course of action it expects to take. A financial forecast may be expressed in specific monetary amounts as a single point estimate of forecasted results or as a range, where the responsible party selects key assumptions to form a range within which it reasonably expects, to the best of its knowledge and belief, the item or items subject to the assumptions to actually fall. When a forecast contains a range, the range is not selected in a biased or misleading manner, for example, a range in which one end is significantly less expected than the other. Minimum presentation guidelines for prospective financial statements are set forth in Appendix A [paragraph .68]."

The forecast provided by PSHP during the fourth quarter of 2008 did use assumptions to the best of PSHP's knowledge. These assumptions were not hypothetical in nature, they were what PSHP believed to the best of its knowledge at the time and certainly were not meant to be misleading. As you noted, the forecast did include assumed enrollment levels of 5,000 and assumed timing of entering into a reinsurance agreement of March 1, 2009.

Our projection of 5000 members was based on the 2009 CMS bid which we filed in June 2008. At that time, it was reasonable to believe we would add 1,000 members in 2009 after enrolling 4,000 in 2008. The enrollment process includes choices made by consumers that are not entirely in PSHP's control. PSHP believed that 5,000 consumers would choose coverage with a PSHP plan, however, to date (through March 2009) 4,417 consumers actually have. Despite this, PSHP is profitable year to date through March 2009.

Additionally, PSHP did believe to the best of its knowledge that it would enter into a reinsurance ceding arrangement by March 1, 2009. However, the process to identify good reinsurance partners with competitive rates has taken longer than anticipated. PSHP did notify your office on March 16th that we were still in the process of obtaining bids from reinsurers. Upon obtaining a bid, PSHP determined that the annualized cost of ceding premiums to achieve an 8 to 1 premium to surplus ratio would be approximately \$200,000. There was debate as to whether it was in the policy holders' and owners' best interest to reinsure premiums upon which the risk was already transferred to contracted entities through capitation. This unnecessary added cost would decrease PSHP's profitability and, likewise, reduce its ability to increase its surplus through its operations. Additionally, the organization's bylaws would require super-majority approval from the Board of Directors through the budget process to approve the expenditure. The Board of Directors was unable to achieve super-majority approval for the budget and is therefore currently unable to enter into this agreement at this time. This is just one

example of the difficulty that PSHP encounters in operating effectively with a Board of Directors that is not aligned in their values, goals and mission.

Should your office provide the supporting source requiring an 8 to 1 premium to surplus ratio for health entities, PSHP will take this matter to the Board of Directors again for budgetary approval. That said, PSHP does not believe that obtaining reinsurance on premiums for which risk has already been transferred through capitation would be a prudent business decision nor would it be healthy for our policy holders.

PSHP is providing as an attachment to this letter a revised forecast for your information. Forecasting is, by nature, a projection of the future based on the best knowledge available and is not a guarantee of future performance.

Financial Condition

You cited concerns about profitability and PSHP's combined ratio at 12/31/08 (102%). As this was PSHP's first year of insurance operations, the results of 2008 actually exceeded the financial projections submitted during the application process. Those projections demonstrated a 107% combined ratio for the first year of operations. The improvement in the ratio was generated from higher than projected enrollment and thus increased revenue for 2008. I would have thought that your office would have been as pleased as PSHP was to achieve this much success in its first year.

As noted above, we are including as an attachment to this letter a revised forecast for 2009. That forecast projects a combined ratio of 99.6% for 2009. The forecasted improvement in financial results for 2009 over 2008 is based on several factors. Among those factors is the increase in premium per member per month reimbursement from CMS. This reimbursement increase is due to the successful adjustment of our members' HCC risk scores (as noted in more detail in our monthly financial statement submissions to your office) through improved documentation and electronic submission of that documentation to CMS. This assumption was validated by CMS from prior year's HCC submissions and by the Company's actuaries during the 2010 bid process. Additionally, the company has a focus on controlling administrative costs including reducing the use of outside contractors now that the management and staff are in place and trained.

Indemnity Requirement

In your letter you state that you will now require PSHP to calculate and fund its indemnity bond according to WAC 284-44-330. We respectfully request that you reconsider this decision. The PSHP contracting model for 95% of its business immediately transfers risk and cash to capitated, delegated entities. As such, PSHP does not hold the liability for unpaid claims on 95% of its business, nor does it hold the cash to pay such claims. Allow me to elaborate. When PSHP receives premiums from both CMS and individual members, it transfers those dollars via wire transfer to the capitated and delegated contracted entities less an amount held back for administrative expenses, carve-outs and margin. Those entities assume the risk for claims and record reserves for obligations on their balance sheets. PSHP's delegation agreements provide for oversight of the delegated entity's financial condition including the adequacy of those entities' reserves for unpaid claims. However, PSHP does not hold the cash or the reserves itself. In light of that model, using an indemnity reserve calculation that is applied to gross premiums rather than health care reserves places an unreasonable requirement for restricted cash. For

instance, if PSHP were to use the gross premium calculation, it would be required to have restricted cash in the amount of 6.67 times the amount of reserves for incurred but not recorded claims. In fact, the restricted cash requirement would exceed total liabilities for the entire organization by \$1,744,757. I am attaching an exhibit showing both calculations at 12/31/08 for your review.

Overall Financial Stability

We believe that this letter will assist you in understanding how PSHP is in compliance with the issues raised and not only isn't in a financially hazardous condition, but has an incredibly bright future. I joined this organization because I believe that it provides a great service to the state, policyholders and citizens of Washington. PSHP is in this business for the long run and provides policy holders with actuarially sound benefit plans that provide predictable costs with straightforward information about what is and isn't covered and keeps funds in the state's economy. A locally owned and operated health plan that contributes to our state's economy and to the competitive environment helps insure the health of the state of Washington. I look forward to the opportunity to discuss these issues with you in our meeting on Tuesday and I look forward to working cooperatively with you for years to come.

Sincerely,



April Golenor
Chief Executive Officer
Puget Sound Health Partners, Inc.